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Exam

New IRS LB&I Campaign Focuses on Success-Based Fees Paid by Taxpayers Not Electing to Use Safe Harbor

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Introduction

The IRS Large Business & International Division ("LB&I") recently announced a compliance campaign focusing on the allocation of success-based fees in certain types of transactions for taxpayers who did not make the safe harbor election under Revenue Proc. 2011-19.[1] So-called "facilitative" costs must be capitalized, and the Treasury Regulations provide fairly strict documentation requirements for any amount of a success-based fee to be treated as a deductible non-facilitative cost. The LB&I compliance campaign will bring increased scrutiny to the documentation required of these taxpayers, making it critical that taxpayers who engage in such transactions focus on the risks associated with not making the safe harbor election and adequately prepare for the expected documentation inquiries in an IRS audit (if no safe harbor election is made). An IRS determination that a taxpayer has failed to properly document how success-based fees are allocated between facilitative and non-facilitative services can face significantly negative financial consequences because such fees often comprise a substantial portion of the costs incurred in an acquisition or re-organization transaction. Also, preparing in advance is critical as there will be little room to maneuver for taxpayers who have not adequately prepared to meet the documentation requirement by the time any IRS examination begins.

Background

The regulations provided an exception from the requirement to capitalize facilitative costs for certain costs incurred in connection with a "covered transaction." Covered transactions include a taxable acquisition by the taxpayer of assets that constitute a trade or business, a taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer or the target) if, immediately afterward the acquirer and target are related, or certain tax-free corporate reorganizations. For covered transactions, costs that are not "inherently facilitative"

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costs do not have to be capitalized to the extent incurred before the bright-line date, generally the earliest of when a letter of intent or board or other approval is obtained for the transaction. Inherently facilitative costs include securing an appraisal or fairness opinion, structuring and preparation of documents, obtaining regulatory or shareholder approval, and conveying property between the parties.

Success-based fees typically include financial advisory fees and investment banker fees that are payable only after the successful conclusion of a covered transaction. Reg. §1.263(a)-5(f) creates a presumption that all success-based fees should be capitalized as facilitative costs, except to the extent that the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that did not facilitate the transaction. The regulations require that the documentation must be completed on or before the due date of the taxpayer's timely filed return (including extensions) for the taxable year during which the transaction closes. Thus, while it would be ideal to prepare and gather necessary documentation contemporaneous with the transaction, the regulations permit some leeway to prepare and gather the documentation prior to the filing of the return. As discussed below, documentation prepared after that will not satisfy this rule unless based on source documents that existed at the time the return was filed. Certain services provided by investment bankers and financial advisors in a covered transaction, such as due diligence services, are not inherently facilitative and would be deductible if incurred before the bright-line date and sufficiently documented by the taxpayer.

A significant challenge to documenting success-based fees is that investment bankers typically do not keep time records or produce an invoice that specifies the cost of each task. Approaching the investment bankers after the deal has closed (but before the return has been filed) to ask them to do extra work usually does not go over well. Conversations about what the taxpayer will need from the investment bankers (or other advisors) should be held in advance, ideally at the time the taxpayer enters into the agreement for a success-based fee. In addition, success-based fees inevitably include both facilitative and non-facilitative elements because the services are performed throughout the process of investigating and completing a transaction. Thus, one should always assume that some allocation will have to be made.

As one might expect, the documentation requirements led to a great deal of controversy. In response, the IRS provided a safe harbor election under Rev. Proc. 2011-29, which allows electing taxpayers to treat 70% of the success-based fees as an amount that does not facilitate the transaction. The remaining 30% must be capitalized as an amount that facilitates the transaction.[2] The safe harbor was provided in part to incentivize taxpayers to make the election rather than attempt to provide adequate documentation of the deductible amount of the success-based fee. Permitting 70% of the success-based fee to be currently deductible is a generous amount, which appeals to taxpayers with a relatively modest success-based fee relative to the effort involved in obtaining the documentation or taxpayers that prefer the certainty the safe harbor provides. Where there is a longer period of time of investigation of the transaction prior to the bright-line date and a shorter period before the transaction closes, it is often possible that the amount that would be treated as non-facilitative greatly exceeds 70%, if sufficient documentation can be obtained to sustain the deduction.

Taxpayers that choose to forgo the safe harbor election obviously are seeking to currently deduct more than 70% of the success-based fee. Seeking to deduct the extra 1%–30% puts at risk even the 70% that would have been allowed as a current deduction under the safe harbor. That is because the entire deduction (not just the extra amount) must satisfy the documentation requirements under Reg. §1.263(a)-5(f). While seemingly onerous, the regulations appear to provide some flexibility for taxpayers. The regulations do not require time records and provide that "other records" may be used to document the allocation of a success-based fee. Because the regulations do not define "other records," a wide range of documents may be used for this purpose.

In two pieces of taxpayer-favorable, but non-precedential guidance, the National Office seemed to suggest that the term "other documents" was broad to allow flexibility in exactly what documents could be relied upon to meet the documentation requirement. In LTR 2009-53-014, the National Office acknowledged as "other records" the files of attorneys, the testimony of witnesses who knew the facts, and materials such as board meeting minutes and presentations.

In TAM 2010-02-036, the IRS National Office concluded that an allocation schedule developed by an accounting firm and provided in a spreadsheet was sufficient to satisfy the documentation requirements of Reg. §1.263(a)-5(f). The allocation spreadsheet was the product of interviews and the memory of employees regarding activities performed and estimates of time spent on those activities, the National Office found. The TAM concluded

that under Reg. §1.263(a)-5(f) "records other than time records or itemized invoices can qualify as 'other records' for purposes of substantiating the non-facilitative portion of a success-based fee" and rejected the examining agent's argument that time records or itemized invoices must be provided to satisfy the documentation requirement. The TAM also concluded that "any document, whether or not labeled a 'time record' or 'itemized invoice,' can serve to establish the deductible portion of a success-based fee."

More recently, however, the National Office appears to have narrowed what a taxpayer might rely upon for purposes of the documentation requirement. In Chief Counsel Advice (CCA) 2018-30-011, the National Office found that the taxpayer's deduction of a success-based fee incurred in a covered transaction should be denied altogether because the taxpayer failed to meet the documentation requirements under Reg. §1.263(a)-5(f). On audit, the taxpayer provided a letter from an investment banker that estimated the percentage of time spent on facilitative and non-facilitative activities. The letter described the nature and scope of the investment banker's services, indicated whether such activities fell before or after an identified "bright-line" date and allocated time among the various activities. Also included on the letter was a typical caveat that the time percentages were estimates because investment bankers did not keep detailed time records. As a result, the letter stated that the taxpayer could not rely on the estimates.

The CCA noted that the letter was "merely an allocation between activities that facilitated and did not facilitate the transaction, which §1.263(a)-5(f) specifically forbids." In response to the examination team's request for additional documentation, the taxpayer provided a PowerPoint presentation that the investment banker presented to the taxpayer's board of directors. The PowerPoint presentation set forth basic information regarding the possible acquisition strategies the taxpayer explored. The CCA concluded that while the PowerPoint presentation provided some evidence that the investment banker performed non-facilitative services, it did not satisfy the documentation rules because it did not identify the amount of the fee or percentage of time that was allocable to each activity performed by the investment banker.

While the CCA is seemingly at odds with other earlier rulings that specifically allowed deductions in similar circumstances, it draws a distinction between an allocation letter provided by an investment bank and an allocation spreadsheet developed based on underlying source data, including interviews. The CCA also serves as a reminder of the importance of properly documenting any deduction taken in connection with a success-based fee and the risks involved for taxpayers who do not choose the safe harbor election.

Common Issues on Audit

LB&I compliance campaign focusing on the Allocation of Success-Based Fees Without Rev. Proc. 2011-19 identifies its goal to ensure taxpayer compliance with the current law. Because success-based fees often comprise a significant cost incurred in a covered transaction, taxpayers that opt to forgo the safe harbor election under Rev. Proc. 2011-19 face substantial financial repercussions if the IRS determines that they have failed to sufficiently document the portion of the fee that is allocable to activities that do not facilitate the transaction.

Meeting the documentation requirements demands preparation because the regulations seemingly require extensive contemporaneous supporting records to substantiate the deduction of success-based fees. For certain advisors, the regulations identify items that are not routinely maintained as part of the business relationship (*e.g.*, time records and itemized invoices). Because "other records" are not defined, IRS has accepted a wide range of substantiating documents with success-based fees. At minimum, the documentation must identify the:

- activities performed by the service provider,
- amount of the fee (or percentage of time) allocable to each activity,
- amount of the fee (or percentage of time) that is allocable to the performance of that activity before and after the relevant date, and
- the name, business address, and business telephone number of the service provider.

A recently published LB&I practice unit, "*Examining a Transaction Costs Issue*,"[3] details the issues involved and types of documentation that the examination team may find helpful in understanding the facts regarding transaction costs incurred, including:

- timeline or transaction calendar,
- engagement letters for services,
- all correspondence (including emails) during the relevant period,
- minutes of meetings,
- copies of materials from presentations,
- legal invoices that can be used to construct a timeline,
- allocation spreadsheets developed by an accounting firm and the underlying records relied on by the firm to determine the allocation, or
- interviews with service provider employees.

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Collecting and retaining these types of documents is essential. Engaging a firm to provide a study is also a wise step where significant fees are involved. In some circumstances, a taxpayer might be less than well prepared to meet the regulations' documentation requirements. Perhaps the most prudent course of action in such situations would be to make the election under Rev. Proc. 2011-19. For a cautionary tale, a taxpayer needs to look no further than CCA 2018-30-011 in which the entire amount of the taxpayer's deduction was disallowed after finding that the taxpayer failed to meet the documentation requirements.

If a taxpayer has already filed a tax return without taking the safe harbor and finds its documentation to be lacking, the taxpayer may consider whether it may still be possible to obtain adequate documentation. The documentation is required to be completed by the time the return is due. However, the LB&I practice unit notes that a taxpayer may request (and may be granted) non-automatic 9100 relief for an extension of time to meet the documentation requirements. A taxpayer may also request (and may be granted) non-automatic 9100 relief for an extension of time to make the safe harbor election. Non-automatic 9100 relief will be granted only when the taxpayer can show that it acted reasonably and in good faith and that granting relief will not prejudice the interests of the government. Assuming the taxpayer is not already under IRS examination with respect to the transaction costs, non-automatic 9100 relief may be possible, albeit costly from an administrative standpoint.

Taxpayers under IRS examination without adequate documentation may find themselves in a difficult position, especially given the expected attention the issue will receive with the onset of the campaign. However, some alternative solutions might be considered. After all, the IRS has stated that there are no limitations on the type or source of documents that can qualify as "other records." Calendar entries, emails, and other source documents may be uncovered with some additional effort. In TAM 2010-02-036, an allocation schedule provided in a spreadsheet was found sufficient to satisfy the documentation requirements of Reg. §1.263(a)-5(f). The allocation spreadsheet was the product of interviews and the memory of employees regarding activities performed and estimates of time spent on those activities. Thus, any document, whether or not labeled a "'time record" or "itemized invoice," can serve to establish the deductible portion of a success-based fee. To the extent a taxpayer has source documents that are contemporaneous with the transaction, it should be able to provide a cover memo or spreadsheet to explain the records being provided and how they achieve the desired allocation.

Conclusion/Summary

The LB&I compliance campaign will bring increased scrutiny to taxpayers deducting success-based fees without making the safe harbor election under Rev. Proc. 2011-19. Taxpayers should carefully consider whether to make that safe harbor election. Taxpayers that choose to forgo the safe harbor election must be prepared to satisfy detailed rules under Reg. §1.263(a)-5(f) concerning necessary documentation. Such preparation should not be taken lightly as the regulations seemingly require extensive contemporaneous supporting records to substantiate the deduction of success-based fees. In some circumstances, a taxpayer might be less than well prepared to meet the regulation's documentation requirements. In such cases, it is important to weigh the risk of having the entire deduction disallowed if the IRS determines the documentation requirements were not satisfied. The risk can be avoided by simply making the safe harbor election, which can be made with the filing of the return, allowing the taxpayer to assess what documentation it has as of that point in time. The risk might be mitigated by searching for creative solutions involving the use of "other records," which the IRS has indicated includes a wide range of documents.

ENDNOTES

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[1] Available at *www.irs.gov/businesses/corporations/lbi-active-campaigns#collapseCollapsible1600387880776*.

[2] Rev. Proc. 2011-29 provides a safe harbor election for allocating success-based fees paid in a business acquisition or reorganization described in Reg §1.263(a)-5(e)(3) ("covered transaction"). In lieu of maintaining the documentation required by Reg. §1.263(a)-5(f), electing taxpayers may treat 70% of the success-based fees as an amount that does not facilitate the transaction, and the remaining 30% must be capitalized as an amount that facilitates the transaction.

[3] Available at *www.irs.gov/pub/irs-utl/cda_p_225_01_01.pdf*.

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