CORPORATE, TAX & TRANSACTIONAL ALERT

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IRS Grants Extension of Time to Acquired Group to Elect to Deduct 70-Percent of Their Success-Based Advisor Fees

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In Private Letter Ruling 201722002 (published June 2, 2017), the Internal Revenue Service (IRS) granted the taxpayer, a group of corporations that were acquired pursuant to a plan and agreement of merger and became wholly owned subsidiaries of the acquiring corporation, an extension of time to elect under Revenue Procedure 2011-29, 2011-18 I.R.B. 746 to treat 70% of their advisor's success-based fee as a deductible expense, rather than a capital expenditure.

The ruling is significant because it illustrates the potential risk of not making such election, i.e., the success-based fee must be capitalized in its entirety, alerts the public as to the availability of the election and provides guidance on obtaining relief for late-filed elections.

General Rule – Amounts Paid or Incurred to Facilitate an Acquisition or Sale of a Business Must Be Capitalized

In general, Treasury Regulations § 1.263(a)-5(a) require a taxpayer to capitalize amounts paid or incurred to facilitate certain business acquisitions.

Under Treasury Regulations § 1.263(a)-5(e)(1), an amount paid by a taxpayer in the process of investigating or otherwise pursuing a "covered transaction" as defined below only facilitates that transaction if the amount relates to activities performed on or after the earlier of (i) the date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or (ii) the date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the taxpayer's board of directors (or committee of the board of directors) or, in the case of a taxpayer that is not a corporation, the date on which the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the appropriate governing officials of the taxpayer. A "covered transaction" is defined in Treasury Regulations § 1.263(a)-5(e)(3) as (i) a taxable acquisition by the taxpayer of assets that constitute a trade or business, (ii) a taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer or the target) if immediately after the acquisition the acquirer and the target are related within the meaning of §§ 267(b) or 707(b), or (iii) a reorganization described in §§ 368(a)(1)(A), (B), or (C) of the Internal Revenue Code of 1986, as amended (Code), or a reorganization described in Code § 368(a)(1)(D) in which the stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under Code §§ 354 or 356 (whether the taxpayer is the acquirer or the target in the reorganization).

Treasury Regulations Section 1.263(a)-5(f) provides that an amount paid that is contingent on the successful closing of a covered transaction (a success-based fee), is an amount paid to facilitate the transaction, except to the extent the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction.

Election under Revenue Procedure 2011-29 to Deduct 70-Percent of Success-Based Fees

To help minimize disputes, as to what portion of a success-based fee relates to activities that did not facilitate the transaction, the IRS provides taxpayers an election under Revenue Procedure 2011-29 to treat 70% of the success-based fees as amounts which do not facilitate the transaction and, therefore, do not have to be capitalized, so long as the taxpayer (i) capitalizes the remaining 30% as the portion of the success-based fee that did facilitate the transaction, and (ii) attaches a statement to its timely filed return electing to use the safe harbor treatment.

Availability of Reasonable Cause Relief for a Late-Filed Election Under Revenue Procedure 2011-29

The taxpayer in Private Letter Ruling 201722002 missed the deadline for filing the election under Revenue Procedure 2011-29 to deduct part of its advisor fees and sought an extension to do so based on reasonable cause. The Letter Ruling notes that reasonable cause relief, under Treasury Regulations Section 301.9100-3(a), is available for a late-filed election under Revenue Procedure 2011-29, to the extent the taxpayer can show that it acted reasonably and in good faith, and that granting the request will not prejudice the interests of the government.

Treasury Regulation § 301.9100-3(b)(1) provides that a taxpayer will be deemed to have acted in good faith if the taxpayer requests relief before the failure to make the election is discovered by the IRS, or if the taxpayer reasonably relied on a qualified tax professional who failed to make the election or to advise the taxpayer to make the election.

Treasury Regulation § 301.9100-3(c) provides that interests of the government will be prejudiced if granting relief would result in a lower tax liability in the aggregate for all tax years affected by the election than the taxpayer would have had if the election had been timely filed, or if the taxable year in which the election should have been made is closed at the time the relief would be granted.

The IRS found that the taxpayer acted reasonably and in good faith based on the following taxpayer representations: (a) the taxpayer provided a copy of the agreement and plan of merger to its accountant; however, its accountant never informed the taxpayer of the opportunity to the make the election under Rev. Proc. 2011-29; and (b) the accountant’s error was discovered by the taxpayer's new owners who sought relief for the late-filed election.

The IRS also concluded that granting the taxpayer’s request for relief would not prejudice the interests of the government based on the following taxpayer representations: (i) the taxpayer is not altering a return position for which an accuracy-related penalty could be imposed, because the error actually reduces its tax liability; (ii) no specific facts changed since the due date for filing the election that make the election advantageous; and (iii) the taxpayer’s tax liability for the year at issue will not be lower if relief is granted than it would have been had the election been timely filed because, although its tax liability will be lowered, it will be lowered only to the extent it would have been had the election been timely filed, and, the tax year at issue is not a closed year at the time relief would be granted.

In summary, while generally expenses incurred to facilitate a business transaction must be capitalized, by making a timely election under Rev. Proc. 2011-29, a taxpayer can deduct 70-percent of its success-based advisor’s fees and, if it misses the deadline for making that election may seek relief under the procedures outlined in Treasury Regulations § 301.9100-3 if it can show it acted reasonably, in good faith, and that granting it relief would not prejudice the interests of the government.

For assistance in determining which elections and deductions are available to you in connection with your next M&A deal or how to seek relief for any opportunities you may have missed, please contact one of the listed Roetzel attorneys from our Corporate, Tax and Transactional group.

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