

## LB&I Process Unit

### Knowledge Base – Corporate/Business Issues & Credits

Library Level	Number	Title
Shelf		Corporate Issues
Book	225	Transaction Costs
Chapter	3	Success-Based Fees
Section		

<b>Unit Name</b>	Allocation of Success-Based Fees in a Covered Transaction	
<b>Primary UIL Code</b>	263.14-00	Allocation Between Capital Expenditure and Expense

<b>Document Control Number (DCN)</b>	CDA/P/225_03-01
<b>Date of Last Update</b>	06/04/19

# Table of Contents

*(View this PowerPoint in “Presentation View” to click on the links below)*

[Process Overview](#)

[Process Applicability](#)

[Summary of Process Steps](#)

- [Step 1](#) – Did Taxpayer Pay Success-Based Fees?
- [Step 2](#) – Did Taxpayer Deduct Success-Based Fees?
- [Step 3](#) – Did Taxpayer Elect Safe-Harbor Allocation?
- [Step 4](#) – Does Documentation Meet Treas. Reg. Requirements?

# Table of Contents (cont'd)

*(View this PowerPoint in "Presentation View" to click on the links below)*

[Definitions](#)

[Other Considerations / Impact to Audit](#)

[Index of Referenced Resources](#)

[Training and Additional Resources](#)

[Glossary of Terms and Acronyms](#)

[Index of Related Practice Units](#)

# Process Overview

## Allocation of Success-Based Fees in a Covered Transaction

A taxpayer must generally capitalize amounts paid that facilitate taxable acquisitions, acquisitive reorganizations and similar transactions, including “covered transactions” defined in Treas. Reg. 1.263(a)-5(e)(3). Treas. Reg. 1.263(a)-5(a).

Amounts paid in a covered transaction often include professional fees that become payable only if the transaction is completed. A fee that is contingent on the successful closing of the transaction (a “success-based fee”) is presumed to facilitate the transaction and must be capitalized; however, a taxpayer can rebut this presumption by maintaining sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. Treas. Reg. 1.263(a)-5(f).

Rev. Proc. 2011-29 provides an elective safe harbor for allocating success-based fees paid in a covered transaction between facilitative and non-facilitative activities. This safe harbor was provided, in part, to incentivize taxpayers to make the election rather than gather and maintain documentation required to establish that a portion of a success-based fee is allocable to activities that do not facilitate a covered transaction.

A taxpayer that does not elect to allocate success-based fees paid in a covered transaction using the safe harbor allocation must maintain documentation meeting the requirements of Treas. Reg. 1.263(a)-5(f) to support an allocation of success-based fees to activities that do not facilitate the covered transaction.

This practice unit discusses a process for reviewing the allocation of success-based fees paid in a covered transaction between facilitative and non-facilitative activities when the safe harbor allocation is not elected. This practice unit should be read in conjunction with the Practice Unit, *Examining a Transaction Costs Issue*, DCN: CDA/P/225\_01-01, which discusses the rules under Treas. Reg. 1.263(a)-5 and related guidance.

# Process Applicability

## Allocation of Success-Based Fees in a Covered Transaction

For this process to apply, the taxpayer must have executed a covered transaction.

Criteria	Resources
<p>Treas. Reg. 1.263(a)-5(e)(3) defines the term “covered transaction” as including the following transactions:</p> <ul style="list-style-type: none"><li>▪ A taxable acquisition by the taxpayer of assets that constitute a trade or business;</li><li>▪ An acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer or the target in the transaction) if, immediately after the transaction, the acquirer and target are related under IRC 267(b) or 707(b);</li><li>▪ A reorganization under IRC 368(a)(1)(A), (B) or (C), or a reorganization under IRC 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction qualifying under IRC 354 or 356 (whether the taxpayer is the acquirer or the target in the reorganization)</li></ul> <p>Whether or not a transaction is a covered transaction with respect to the taxpayer depends on which party (i.e., the acquirer or the target) the taxpayer is in the transaction and how the transaction is treated for tax purposes. As discussed in more detail in the sections that follow, a transaction may be a covered transaction to one party in the transaction, but not to the other party. Also, a transaction which is recast for tax purposes may not be a covered transaction, even if the form of the transaction is a covered transaction.</p>	<ul style="list-style-type: none"><li>▪ Treas. Reg. 1.263(a)-5(e)(3)</li><li>▪ IRC 267(b)</li><li>▪ IRC 707(b)</li><li>▪ IRC 368(a)(1)(A)</li><li>▪ IRC 368(a)(1)(B)</li><li>▪ IRC 368(a)(1)(C)</li><li>▪ IRC 368(a)(1)(D)</li><li>▪ IRC 354</li><li>▪ IRC 356</li></ul>

# Process Applicability (cont'd)

Allocation of Success-Based Fees in a Covered Transaction	
Criteria	Resources
<p><u>Taxable Asset Acquisition</u></p> <p>A taxable acquisition of assets that constitute a trade or business is a covered transaction. However, a sale of assets that constitute a trade or business is NOT a covered transaction. Therefore, a taxable asset acquisition of a trade or business, such as an applicable asset acquisition defined in IRC 1060(c), is a covered transaction for the purchaser (acquirer), but is NOT a covered transaction for the seller (target).</p> <p><u>Recast Transactions</u></p> <p>A transaction may be recast (e.g., by operation of law, by the taxpayer's election, or under judicial doctrines) to a structure that differs from its form (i.e., what the parties to the transaction document in the relevant agreement). When a transaction is recast to a structure different from its form, the recast structure determines whether the transaction is a covered transaction. This concept is illustrated in the example that follows.</p>	<ul style="list-style-type: none"><li>▪ IRC 1060(c)</li></ul>

# Process Applicability (cont'd)

Allocation of Success-Based Fees in a Covered Transaction	
Criteria	Resources
<p><u>Recast Transactions (cont'd)</u></p> <p><u>Example 1: Qualified Stock Purchase with an IRC 338(h)(10) Election</u></p> <p>Facts: T is an S corporation and is wholly-owned by X. On 12/31/2015, X sells all of T's stock to P for \$250,000,000. T and X jointly elect to treat the transaction as a taxable asset acquisition under IRC 338(h)(10).</p> <p>Analysis: The legal structure of the transaction is a taxable acquisition of T's stock by P; however, under the joint IRC 338(h)(10) election made by T and X, the transaction is recast and treated as a taxable asset acquisition. In CCA 201624021, the Service concluded that the term "covered transaction" under Treas. Reg. 1.263(a)-5(e)(3)(i) only applies to the acquiring taxpayer and not the acquired taxpayer. Since T is recast as the seller, the transaction is not a covered transaction with respect to T.</p>	<ul style="list-style-type: none"><li>▪ IRC 338(h)(10)</li><li>▪ CCA 201624021</li><li>▪ Treas. Reg. 1.263(a)-5(e)(3)(i)</li></ul>

# Process Applicability (cont'd)

Allocation of Success-Based Fees in a Covered Transaction	
Criteria	Resources
<p>To determine whether the taxpayer executed a covered transaction:</p> <ul style="list-style-type: none"> <li>▪ Review the schedules and statements attached to the return for indications of a covered transaction: <ul style="list-style-type: none"> <li>– Is there a Form 8594, <i>Asset Acquisition Statement Under Section 1060</i>, or Form 8883, <i>Asset Allocation Statement Under Section 338</i>, showing that the taxpayer acquired assets constituting a trade or business in an IRC 1060 transaction or in a qualified stock purchase with an IRC 338 election?</li> <li>– Does Part III of Form 851, <i>Affiliations Schedule</i>, reflect a new subsidiary whose stock the taxpayer may have acquired during the tax year?</li> <li>– Is there a statement attached under Treas. Reg. 1.368-3(a) indicating that the taxpayer was a party to a reorganization described in IRC 368(a)(1)?</li> </ul> </li> <li>▪ Review SEC filings (e.g., 10-K, 10-Qs, S-1s, 8-Ks), news publications, research subscription services, notes to the financial statement and the company website for disclosures and discussions of transactions.</li> <li>▪ Consider whether the form of the transaction is recast for tax purposes and if the recast transaction meets the definition of a covered transaction.</li> <li>▪ Consider the taxpayer's role in the transaction and whether the transaction is a covered transaction with respect to the taxpayer.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Form 8594 - <i>Asset Acquisition Statement Under Section 1060</i></li> <li>▪ Form 8883 - <i>Asset Allocation Statement Under Section 338</i></li> <li>▪ IRC 1060</li> <li>▪ IRC 338</li> <li>▪ Form 851 - <i>Affiliations Schedule</i></li> <li>▪ Treas. Reg. 1.368-3(a)</li> <li>▪ IRC 368(a)(1)</li> <li>▪ SEC Website</li> <li>▪ Capital IQ</li> <li>▪ Bloomberg</li> <li>▪ Treas. Reg. 1.263(a)-5(e)(3)</li> </ul>

# Summary of Process Steps

## Allocation of Success-Based Fees in a Covered Transaction

### Process Steps

This process describes four steps in reviewing the allocation of success-based fees paid in a covered transaction when the safe harbor allocation of Rev. Proc. 2011-29 is not elected. The steps should be performed in sequence.

<a href="#">Step 1</a>	Did Taxpayer Pay Success-Based Fees?
<a href="#">Step 2</a>	Did Taxpayer Deduct Success-Based Fees?
<a href="#">Step 3</a>	Did Taxpayer Elect Safe-Harbor Allocation?
<a href="#">Step 4</a>	Does Documentation Meet Treas. Reg. Requirements?

# Step 1: Did Taxpayer Pay Success-Based Fees?

## Allocation of Success-Based Fees in a Covered Transaction

### Step 1

Did the taxpayer pay success-based fees in the covered transaction?

Considerations	Resources
<p>As previously stated, a success-based fee is a fee that is contingent on the successful closing of the transaction. See Treas. Reg. 1.263(a)-5(f).</p> <p>Under a success-based engagement, the fee is often a percentage of the transaction value. The transaction value is generally the consideration paid or received by the taxpayer in the transaction. When the engagement letter or contract with the service provider indicates the fee becomes due and payable upon the consummation or closing of the transaction, the engagement is success-based.</p> <p>Although a taxpayer could pay a success-based fee to any service provider, investment bankers are typically compensated under success-based fee arrangements.</p> <p>To determine whether the taxpayer paid success-based fees for the covered transaction, consider the following:</p> <ul style="list-style-type: none"><li>• Do the transaction costs study or transaction costs workpapers reflect payments of fees to investment bankers?</li><li>• Does the engagement letter or contract with any service provider include a provision that the fee becomes due and payable only when the transaction successfully closes?</li></ul>	<ul style="list-style-type: none"><li>▪ Treas. Reg. 1.263(a)-5(f)</li></ul>

# Step 1: Did Taxpayer Pay Success-Based Fees? (cont'd)

## Allocation of Success-Based Fees in a Covered Transaction

### Step 1

Considerations	Resources
<p>A success-based engagement between the taxpayer and a service provider may not be memorialized in a written agreement or may be reduced to writing after the transaction closes. Although not common, the taxpayer and service provider could have entered into an oral success-based engagement.</p> <p>If there is no written agreement or contract between the taxpayer and the service provider for the success-based fee, consider the following:</p> <ul style="list-style-type: none"> <li>▪ Does the invoice from the service provider reflect the total amount of the fee?</li> <li>▪ Is the invoice date the day the transaction closed or a subsequent date?</li> <li>▪ What additional evidence (e.g. meeting minutes and/or notes, correspondence) is available to corroborate that the fee was success-based?</li> </ul> <p> <b>DECISION POINT:</b> Did the taxpayer pay success-based fees in the covered transaction?</p> <p>If the taxpayer paid success-based fees in the covered transaction, go to Step 2.</p> <p>If the fees paid for the covered transaction are not success-based, do not continue this process. Treas. Reg. 1.263(a)-5(f) does not apply. The rules of Treas. Reg. 1.263(a)-5(e)(1) and (e)(2) will apply in determining whether the fees facilitated the covered transaction. See Practice Unit, <i>Examining a Transaction Costs Issue</i>.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.263(a)-5(f)</li> <li>▪ Treas. Reg. 1.263(a)-5(e)(1)</li> <li>▪ Treas. Reg. 1.263(a)-5(e)(2)</li> <li>▪ Practice Unit - <i>Examining a Transaction Costs Issue</i>, DCN: CDA/P/225_01-01.</li> </ul>

# Step 2: Did Taxpayer Deduct Success-Based Fees?

## Allocation of Success-Based Fees in a Covered Transaction

### Step 2

Did the taxpayer deduct any portion of the success-based fees?

Considerations	Resources
<p>Deductions are a matter of legislative grace, and the taxpayer bears the burden of proof to establish his right to the claimed deduction. <i>INDOPCO Inc. v. Commissioner</i>, 503 U.S. 79 (1992). Deductions are exceptions to the norm of capitalization and are specifically enumerated and thus, are subject to disallowance in favor of capitalization. <i>INDOPCO</i>, 503 U.S. at 84. Capital expenditures, by contrast, are not exhaustively enumerated; rather than providing a complete list of nondeductible expenditures, IRC 263 serves as a general means of distinguishing capital expenditures from current expenses. <i>Id.</i></p> <p>The capitalization rules of IRC 263 take precedence over the deduction rules of IRC 162, thereby preventing capital expenditures from being deducted currently. <i>U.S. Bancorp v. Commissioner</i>, 111 T.C. 231 (1998).</p>	<ul style="list-style-type: none"><li>▪ <i>INDOPCO, Inc. v. Commissioner</i> - 503 U.S. 79 (1992)</li><li>▪ IRC 263</li><li>▪ IRC 162</li><li>▪ <i>U.S. Bancorp v. Commissioner</i> - 111 T.C. 231 (1998)</li></ul>

# Step 2: Did Taxpayer Deduct Success-Based Fees? (cont'd)

## Allocation of Success-Based Fees in a Covered Transaction

### Step 2

Considerations	Resources
<p>Under Treas. Reg. 1.263(a)-5(f), a success-based fee is presumed to facilitate the transaction to which it relates. Under that presumption, a success-based fee is generally capitalizable.</p> <p>By meeting the documentation requirements of Treas. Reg. 1.263(a)-5(f) (which are discussed in Step 4), the taxpayer can establish the portion of the success-based fee that does not facilitate the transaction. The portion of the success-based fee that does not facilitate the transaction is not capitalizable under Treas. Reg. 1.263(a)-5; however, it could be capitalizable under another section of the IRC 263(a) regulations or another section of the Code (e.g., IRC 195), or could be deductible under IRC 162 or IRC 165.</p> <p>To determine whether the taxpayer may have deducted any portion of the success-based fees:</p> <ul style="list-style-type: none"> <li>▪ Review Schedule M-3, Part III, line 23, for current-year acquisition or reorganization investment banking fees deducted;</li> <li>▪ Review Schedule M-3, Part II, line 23e, for reported abandonment losses; and</li> <li>▪ Review the detail of Form 1120, line 26 and Schedule M-3, Part III, line 37 (2016) for other losses deducted that may include success-based fees (e.g., legal and professional fees).</li> <li>▪ Review the detail supporting Form 4562, <i>Depreciation and Amortization (Including Information on Listed Property)</i>, Part VI, Amortization, lines 42 and 43, for amortization of success based fees.</li> </ul>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.263(a)-5(f)</li> <li>▪ IRC 263(a)</li> <li>▪ IRC 195</li> <li>▪ IRC 162</li> <li>▪ IRC 165</li> <li>▪ Form 1120, Schedule M-3 - <i>Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More</i></li> <li>▪ Form 1120 - <i>U.S. Corporation Income Tax Return</i></li> <li>▪ Form 4562 - <i>Depreciation and Amortization (Including Information on Listed Property)</i></li> </ul>

# Step 2: Did Taxpayer Deduct Success-Based Fees? (cont'd)

## Allocation of Success-Based Fees in a Covered Transaction

### [Step 2](#)

Considerations	Resources
<p> <b>DECISION POINT:</b> Did the taxpayer deduct any portion of the success-based fees paid in the covered transaction?</p> <p>If the taxpayer deducted any portion of the success-based fees paid in the covered transaction, go to Step 3.</p> <p>If the taxpayer did not deduct any portion of the success-based fees paid in the covered transaction (i.e., the taxpayer capitalized 100% of the success-based fees), do not continue this process.</p>	

# Step 3: Did Taxpayer Elect Safe-Harbor Allocation?

## Allocation of Success-Based Fees in a Covered Transaction

### Step 3

Did the taxpayer elect the safe harbor allocation under Rev. Proc. 2011-29?

Considerations	Resources
<p><u>Rev. Proc. 2011-29</u></p> <p>See the Practice Unit, <i>Examining a Transaction Costs Issue</i>, for a detailed discussion of Rev. Proc. 2011-29.</p> <p>Under Rev. Proc. 2011-29, a taxpayer who pays success-based fees in connection with a covered transaction in tax years ending on or after April 8, 2011, may elect to treat 70% of the success-based fees as not facilitating the transaction, as long as the taxpayer capitalizes the remaining 30% of the success-based fees.</p> <p>A taxpayer elects to apply the safe harbor allocation by capitalizing 30% of the success-based fees paid in the covered transaction on their timely-filed original return (including extensions) for the tax year in which the success-based fee is paid or incurred and attaching a statement to that return stating it is electing the safe harbor, identifying the transaction, and indicating the success-based fee amounts that are deducted and capitalized.</p>	<ul style="list-style-type: none"> <li>▪ Practice Unit, <i>Examining a Transaction Costs Issue</i>, DCN: CDA/P/225_01-01</li> <li>▪ Rev. Proc. 2011-29</li> </ul>

# Step 3: Did Taxpayer Elect Safe-Harbor Allocation? (cont'd)

## Allocation of Success-Based Fees in a Covered Transaction

### [Step 3](#)

Considerations	Resources
<p><u>Rev. Proc. 2011-29 (cont'd)</u></p> <p>If a taxpayer properly elects to apply the safe harbor allocation under Rev. Proc. 2011-29 to success-based fees paid in a covered transaction, the taxpayer is not subject to the documentation requirements of Treas. Reg. 1.263(a)-5(f), and the Service will not challenge the taxpayer's 70/30 allocation of success-based fees between facilitative and non-facilitative activities.</p> <p>Although Rev. Proc. 2011-29 provides that the safe harbor allocation election must be made by the extended due date of the original return, a taxpayer can request (and might be granted) relief through the ruling process under Treas. Reg. 301.9100-1 and 301-9100-3 ("9100 relief") for an extension of time to make the election. See, e.g., PLR 201606003 and 201622002.</p> <p><u>LB&amp;I Directive</u></p> <p>LB&amp;I Directive - <i>Examination of Success-Based Fees in the Acquisition of Businesses</i> (7/28/11) directs LB&amp;I examiners not to challenge a taxpayer's treatment of success-based fees paid or incurred in a covered transaction in tax years ended before April 8, 2011, if the taxpayer capitalized at least 30% of the total success-based fees. If the taxpayer meets the requirements of this directive, the taxpayer's allocation of success-based fees paid in the covered transaction should not be challenged.</p>	<ul style="list-style-type: none"> <li>▪ Rev. Proc. 2011-29</li> <li>▪ Treas. Reg. 1.263(a)-5(f)</li> <li>▪ Treas. Reg. 301.9100-1</li> <li>▪ Treas. Reg. 301.9100-3</li> <li>▪ PLR 201606003</li> <li>▪ PLR 201622002</li> <li>▪ LB&amp;I Directive - <i>Examination of Success-Based Fees in the Acquisition of Businesses</i> (7/28/11)</li> </ul>

# Step 3: Did Taxpayer Elect Safe-Harbor Allocation? (cont'd)

## Allocation of Success-Based Fees in a Covered Transaction

### [Step 3](#)

Considerations	Resources
<p><u>LB&amp;I Directive (cont'd)</u></p> <p>Review the statements attached to the return to determine if the taxpayer elected to apply the safe harbor allocation under Rev. Proc. 2011-29 to success-based fees paid in the covered transaction.</p> <p>If the safe harbor allocation election statement is not attached to the return and the taxpayer capitalized 30% of the success-based fee, ask the taxpayer for documentation to support their application of the safe harbor allocation. The taxpayer may have obtained 9100 relief to make a late election. If the taxpayer has not obtained 9100 relief to make a late election, consider asking whether the taxpayer has applied for or intends to apply for such relief.</p> <p> <b>DECISION POINT:</b> Did the taxpayer elect the safe harbor allocation under Rev. Proc. 2011-29 for the success-based fees paid in the covered transaction?</p> <p>If the taxpayer did not elect the safe harbor allocation and does not meet the requirements of LB&amp;I Directive - <i>Examination of Success-Based Fees in the Acquisition of Businesses</i> (7/28/11), go to Step 4.</p> <p>If the taxpayer elected the safe harbor allocation, or the taxpayer meets the requirements of LB&amp;I Directive - <i>Examination of Success-Based Fees in the Acquisition of Businesses</i> (7/28/11) and the taxpayer capitalized 30% of the success-based fee, do not continue this process.</p>	<ul style="list-style-type: none"> <li>▪ Rev. Proc. 2011-29</li> <li>▪ LB&amp;I Directive - <i>Examination of Success-Based Fees in the Acquisition of Businesses</i> (7/28/11)</li> <li>▪ Treas. Reg. 301.9100</li> </ul>

# Step 4: Does Documentation Meet Treas. Reg. Requirements?

## Allocation of Success-Based Fees in a Covered Transaction

### Step 4

Does the documentation maintained by the taxpayer to support the allocation of success-based fees meet the requirements of Treas. Reg. 1.263(a)-5(f)?

Considerations	Resources
<p>As previously stated, the taxpayer must maintain documentation sufficient to meet the requirements of Treas. Reg. 1.263(a)-5(f) to successfully rebut the presumption that a success-based fee facilitates the transaction for which it was paid. The documentation must:</p> <ul style="list-style-type: none"><li>▪ Be completed on or before the due date of the taxpayer's timely filed original federal income tax return (including extensions) for the taxable year during which the transaction closes;</li><li>▪ Consist of more than merely an allocation (of the success-based fee) between activities that facilitate the transaction and activities that do not facilitate the transaction; and</li><li>▪ Consist of supporting records that identify:<ul style="list-style-type: none"><li>– The various activities performed by the service provider;</li><li>– The amount of the fee (or percentage of time) allocable to each of the various activities performed;</li><li>– Where the date the activity was performed is relevant to understanding whether the activity facilitated the transaction, the amount of the fee (or percentage of time) that is allocable to the performance of that activity before and after the relevant date; and</li><li>– The name, business address, and business phone number of the service provider.</li></ul></li></ul>	<ul style="list-style-type: none"><li>▪ Treas. Reg. 1.263(a)-5(f)</li></ul>

# Step 4: Does Documentation Meet Treas. Reg. Requirements? (cont'd)

## Allocation of Success-Based Fees in a Covered Transaction

### [Step 4](#)

Considerations	Resources
<p>If any requirement under Treas. Reg. 1.263(a)-5(f) is not met, 100% of the success-based fee is treated as facilitating the transaction for which it was paid and must be capitalized. Each of the requirements of Treas. Reg. 1.263(a)-5(f) is discussed in the following sections.</p> <p><u>Contemporaneous Requirement</u></p> <p>The documentation to support the allocation of the success-based fee between facilitative and non-facilitative activities must have been completed on or before the due date (including extensions) for filing the taxpayer's original return for the tax year in which the transaction closed. Stated another way, the documentation must be contemporaneous.</p> <p>This requirement does not mean that the taxpayer must possess the documentation by the extended due date of the original return, or that the analysis of the document in question needs to be performed by that date. Rather, the requirement means that the information in the document was created contemporaneously. This concept is illustrated in Example 2.</p> <p><u>Example 2</u></p> <p>P, a corporation, acquired all the stock of T, an unrelated corporation. Immediately after the transaction, P and T were related within the meaning of IRC 267(b). P paid success-based investment banking fees in connection with the transaction.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.263(a)-5(f)</li> <li>▪ IRC 267(b)</li> </ul>

# Step 4: Does Documentation Meet Treas. Reg. Requirements? (cont'd)

## Allocation of Success-Based Fees in a Covered Transaction

### [Step 4](#)

Considerations	Resources
<p><u>Contemporaneous Requirement (cont'd)</u></p> <p><u>Example 2 (cont'd)</u></p> <p>P hired an accountant to prepare an analysis of the success-based fees. The accountant reviewed and analyzed P's internal records and information obtained from the investment banker in preparing the analysis, which the accountant provided to P a few months after the extended due date for filing P's original return for the tax year in which the transaction closed.</p> <p>Even though P did not receive the success-based fee analysis by the extended due date for filing its original return, the documentation to support the allocation of the success-based fee is contemporaneous if P's internal records and records from the investment banker the accountant relied on in preparing the analysis were completed by the extended due date for filing P's return. Also, just because P did not receive the transaction costs analysis by the extended due date of its return does not mean the analysis had not been completed by that date.</p> <p>The Service has, in some cases, granted extensions of time for a taxpayer to complete the documentation required under Treas. Reg. 1.263(a)-5(f) where the taxpayer provided evidence showing that it acted reasonably and in good faith and the grant of relief would not prejudice the interests of the government. The taxpayer must request relief under Treas. Reg. 301.9100-3(a) through the letter ruling process. See, e.g., PLRs 200837005, 200907018 and 200945007.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.263(a)-5(f)</li> <li>▪ Treas. Reg. 301.9100-3(a)</li> <li>▪ PLR 200837005</li> <li>▪ PLR 200907018</li> <li>▪ PLR 200945007</li> </ul>

# Step 4: Does Documentation Meet Treas. Reg. Requirements? (cont'd)

## Allocation of Success-Based Fees in a Covered Transaction

### [Step 4](#)

Considerations	Resources
<p><u>More Than Merely an Allocation</u></p> <p>The documentation to support the allocation of success-based fees between facilitative and non-facilitative activities cannot be merely an allocation between activities that facilitated and did not facilitate the transaction.</p> <p>In CCA 201830011, as support for its allocation of a success-based fee, the taxpayer provided:</p> <ol style="list-style-type: none"> <li>1. A letter from the investment banker that estimated the percentage of time spent on facilitative and non-facilitative activities and included a caveat stating that the investment banker does not keep time records, and</li> <li>2. A PowerPoint presentation that the investment banker presented to the taxpayer's board of directors regarding basic information about the taxpayer's business and possible acquisition strategies.</li> </ol>	<ul style="list-style-type: none"> <li>▪ CCA 201830011</li> <li>▪ Treas. Reg. 1.263(a)-5(f)</li> </ul>

# Step 4: Does Documentation Meet Treas. Reg. Requirements? (cont'd)

## Allocation of Success-Based Fees in a Covered Transaction

### [Step 4](#)

Considerations	Resources
<p><u>More Than Merely an Allocation (cont'd)</u></p> <p>The Service concluded that:</p> <ol style="list-style-type: none"> <li>1. The investment banker's letter was merely an allocation between activities that facilitated and did not facilitate the transaction and thus, did not satisfy the documentation requirements of Treas. Reg. 1.263(a)-5(f);</li> <li>2. While the PowerPoint presentation provided evidence that the investment banker performed non-facilitative services, it also had no effect under the rules of Treas. Reg. 1.263(a)-5(f) 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; and</li> <li>3. Since the requirements of Treas. Reg. 1.263(a)-5(f) were not met, 100% of the success-based fee must be capitalized.</li> </ol>	<ul style="list-style-type: none"> <li>▪ CCA 201830011</li> <li>▪ Treas. Reg. 1.263(a)-5(f)</li> </ul>

# Step 4: Does Documentation Meet Treas. Reg. Requirements? (cont'd)

## Allocation of Success-Based Fees in a Covered Transaction

### [Step 4](#)

Considerations	Resources
<p><u>Supporting Records Identify Service Provider, Activities &amp; Fee Allocation</u></p> <p>The documentation must consist of supporting records that identify:</p> <ol style="list-style-type: none"> <li>1. The various activities performed by the service provider;</li> <li>2. The amount of the fee (or percentage of time) allocable to each of the various activities performed;</li> <li>3. Where the date the activity was performed is relevant to understanding whether the activity facilitated the transaction, the amount of the fee (or percentage of time) that is allocable to the performance of that activity before and after the relevant date; and</li> <li>4. The name, business address, and business telephone number of the service provider.</li> </ol> <p>The term “supporting records” is not defined in the regulations, but the regulations list “time records, itemized invoices, or other records” as examples of supporting records.</p> <p>Although Treas. Reg. 1.263(a)-5(f) provides detailed rules concerning the necessary documentation, the regulation does not require time records. Other records may be used to establish an appropriate allocation of a success-based fee. A determination as to whether other records are sufficient to establish a taxpayer’s allocation is a question to be determined upon examination. See PLR 200830009.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.263(a)-5(f)</li> <li>▪ PLR 200830009</li> </ul>

# Step 4: Does Documentation Meet Treas. Reg. Requirements? (cont'd)

## Allocation of Success-Based Fees in a Covered Transaction

### [Step 4](#)

Considerations	Resources
<p><u>Supporting Records Identify Service Provider, Activities &amp; Fee Allocation (cont'd)</u></p> <p>The term “other records” is also not defined in Treas. Reg. 1.263(a)-5(f).</p> <p>In TAM 201002036, the Service determined that allocation spreadsheets prepared by an accounting firm based on interviews of the service provider’s employees who worked on the taxpayer’s engagement qualified as “other records” under Treas. Reg. 1.263(a)-5(f). The Service stated that 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 there are no limitations on the type or source of documents that can qualify as “other records.” However, the Service made clear that the existence of “other records” does not automatically mean the portion of the success-based fee allocated to non-facilitative activities is currently deductible. Rather, the documents presented, taken as a whole, must provide the information required by Treas. Reg. 1.263(a)-5(f)(1) through (4).</p> <p>A determination must be made whether, based on the information provided, the taxpayer made an appropriate allocation of the success-based fees to non-facilitative activities. This determination is a factual determination which requires a weighing of the sufficiency of all the evidence.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.263(a)-5(f)</li> <li>▪ TAM 201002036</li> </ul>

# Step 4: Does Documentation Meet Treas. Reg. Requirements? (cont'd)

## Allocation of Success-Based Fees in a Covered Transaction

### Step 4

Considerations	Resources
<p>To determine if the documentation maintained by the taxpayer to support the allocation of success-based fees meets the requirements of Treas. Reg. 1.263(a)-5(f), consider the following questions for each success-based fee paid in the covered transaction:</p> <ol style="list-style-type: none"> <li>1. Did the taxpayer have the documentation to support its allocation of the success-based fee by the extended due date of its return for the tax year in which the transaction closed?</li> <li>2. If the taxpayer did not have the documentation to support its allocation of the success-based fee between facilitative and non-facilitative activities by the extended due date of its return:             <ol style="list-style-type: none"> <li>a. Did the documentation exist in the hands of another party by the extended due date for filing the taxpayer's return?</li> <li>b. Does the documentation rely on other records? If so, were those records completed by the extended due date for filing the taxpayer's return?</li> </ol> </li> <li>3. Does the documentation include the service provider's name, business address, and business phone number?</li> <li>4. Does the documentation identify the activities performed by the service provider?</li> <li>5. Does the documentation identify the amount of the fee or percentage of time that was allocable to each activity performed by the service provider?</li> <li>6. From an analysis of the documentation, is it possible to determine the amount of the fee that should be allocated to activities performed before and after the bright-line date for the transaction?</li> <li>7. From an analysis of the documentation, is it possible to determine the amount of the fee that should be allocated to inherently facilitative activities?</li> </ol>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.263(a)-5(f)</li> </ul>

# Definitions

## Allocation of Success-Based Fees in a Covered Transaction

### Description

- Activity - Service performed.
- Bright-Line Date - Earlier of the date on which the parties to the transaction agree in writing to the material terms of the transaction, or the date the taxpayer's board of directors (or similar governing body) approves the terms of the transaction. See Treas. Reg. 1.263(a)-5(e)(1).
- Capitalizable - Must be capitalized.
- Covered Transaction - One of the types of transactions described in Treas. Reg. 1.263(a)-5(e)(3).
- Facilitative Cost - For a covered transaction: 1) a cost incurred for investigatory and due diligence activities performed on or after the bright-line date, or 2) an inherently facilitative cost.
- Inherently Facilitative Cost - Cost incurred for certain types of activities (i.e., services performed) in the process of investigating or otherwise pursuing the transaction. An inherently facilitative cost facilitates the transaction, regardless of when the related services are performed.
- Non-Facilitative Cost - For a covered transaction, a cost incurred for investigatory and due diligence activities performed before the bright-line date that is not inherently facilitative.
- Success-Based Fee - Fee that becomes due and payable upon the successful completion of the transaction.
- Transaction Cost - Cost incurred in connection with a transaction.

# Other Considerations / Impact to Audit

Allocation of Success-Based Fees in a Covered Transaction	
Considerations	Resources
<p>In addition to the documentation requirements of Treas. Reg. 1.263(a)-5(f), a taxpayer who pays a success-based fee in a covered transaction must also comply with the general recordkeeping requirements of IRC 6001 and the regulations thereunder, which apply to any person required to file income tax returns. Under these rules, a taxpayer is generally required to keep records sufficient to establish the amount of gross income, deductions, credits or other matters required to be reported on the taxpayer's return. Such records must be retained for as long as they may become material in the administration of any internal revenue law.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.263(a)-5(f)</li> <li>▪ IRC 6001</li> </ul>
<p>Treas. Reg. 1.263(a)-5(f) does not discuss the use of estimates in allocating a success-based fee. However, courts have addressed the sufficiency of estimates in supporting allocations of amounts paid for the purpose of claiming a deduction.</p> <p>Where an allocation of time spent on legal services provided was not based on precise recordkeeping, the taxpayer "failed to prove that the allocation is anything more than a guess made to salvage some part of a deduction out of that which is simply not deductible." See <i>Stevens v. Commissioner</i>, T.C.M. 1999-259.</p>	<ul style="list-style-type: none"> <li>▪ Treas. Reg. 1.263(a)-5(f)</li> <li>▪ <i>Stevens v. Commissioner</i> - T.C.M. 1999-259</li> </ul>

# Other Considerations / Impact to Audit (cont'd)

Allocation of Success-Based Fees in a Covered Transaction	
Considerations	Resources
<p>When a taxpayer establishes that he has incurred a deductible expense but is unable to substantiate the exact amount, courts are generally permitted to estimate the deductible amount, bearing heavily against the taxpayer whose inexactitude in substantiating the amount of the expense is of their own making (“<i>Cohan</i> rule”). See <i>Cohan v. Commissioner</i>, 39 F.2d 540, 543–544 (2d Cir.1930). To apply the <i>Cohan</i> rule, however, the Court must have a reasonable basis upon which to estimate the deduction. <i>Vanicek v. Commissioner</i>, 85 T.C. 731, 742–743 (1985); <i>Williams v. United States</i>, 245 F.2d 559, 560–561 (5th Cir. 1957).</p> <p>In <i>Luman v. Commissioner</i>, 79 T.C. 846 (1982), the court considered the <i>Cohan</i> rule, but disallowed any deduction for a fee paid to establish a family trust where the taxpayer showed only that a portion of the fee conceivably could have been attributable to a deductible expense and the record did not contain sufficient evidence to allocate the fee between capitalizable and deductible amounts. The court observed that allocating any portion of the fee to a deductible expense “would be speculative, amounting to ‘unguided largess.’”</p>	<ul style="list-style-type: none"> <li>▪ <i>Cohan v. Commissioner</i> - 39 F.2d 540 (2d Cir. 1930)</li> <li>▪ <i>Vanicek v. Commissioner</i> - 85 T.C. 731 (1985)</li> <li>▪ <i>Williams v. United States</i> - 245 F.2d 559 (5th Cir. 1957)</li> <li>▪ <i>Luman v. Commissioner</i> - 79 T.C. 846 (1982)</li> </ul>

# Index of Referenced Resources

<b>Allocation of Success-Based Fees in a Covered Transaction</b>
IRC 162
IRC 165
IRC 195
IRC 263(a)
IRC 267(b)
IRC 338
IRC 338(h)(10)
IRC 354
IRC 356
IRC 368(a)(1)
IRC 707(b)
IRC 1060
IRC 6001
Treas. Reg. 1.263(a)-5(a)
Treas. Reg. 1.263(a)-5(e)
Treas. Reg. 1.263(a)-5(f)
Treas. Reg. 1.368-3(a)

# Index of Referenced Resources (cont'd)

## Allocation of Success-Based Fees in a Covered Transaction

Treas. Reg. 301.9100-3(a)

*Cohan v. Commissioner* - 39 F.2d 540 (2d Cir. 1930)

*INDOPCO v. Commissioner* - 503 U.S. 79 (1992)

*Luman v. Commissioner* - 79 T.C. 846 (1982)

*Stevens v. Commissioner* - T.C.M. 1999-259

*U.S. Bancorp v. Commissioner* - 111 T.C. 231 (1998)

*Vanicek v. Commissioner* - 85 T.C. 731 (1985)

*Williams v. United States* - 245 F.2d 559 (5th Cir. 1957)

Rev. Proc. 2011-29

PLR 200830009

PLR 200837005

PLR 200907018

PLR 200945007

PLR 201606003

PLR 201622002

# Index of Referenced Resources (cont'd)

<b>Allocation of Success-Based Fees in a Covered Transaction</b>
CCA 201624021
CCA 201830011
TAM 201002036
LB&I Directive - <i>Examination of Success-Based Fees in the Acquisition of Businesses (7/28/11)</i>
Form 851 - <i>Affiliations Schedule</i>
Form 1120 - <i>U.S. Corporation Income Tax Return</i>
Form 1120, Schedule M-3 - <i>Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More</i>
Form 4562 - <i>Depreciation and Amortization (Including Information on Listed Property)</i>
Form 8594 - <i>Asset Acquisition Statement Under Section 1060</i>
Form 8883 - <i>Asset Allocation Statement Under Section 338</i>
Bloomberg
Capital IQ
SEC Website

# Training and Additional Resources

Allocation of Success-Based Fees in a Covered Transaction	
Type of Resource	Description(s)
Saba Meeting Sessions	<ul style="list-style-type: none"><li>▪ <i>Transaction Costs Under Treas. Reg. 1.263-5(f): Success-Based Fees - 2013 Centra</i></li></ul>
Issue Toolkits	<ul style="list-style-type: none"><li>▪ Job Aid - Covered Transactions Under Treas. Reg. 1.263(a)-5(e)(3)</li><li>▪ Job Aid - Success-Based Fees Frequently Asked Questions</li></ul>

# Glossary of Terms and Acronyms

Term/Acronym	Definition
CCA	Chief Counsel Advisory
Code	Internal Revenue Code
IRC	Internal Revenue Code
PLR	Private Letter Ruling
Rev. Proc.	Revenue Procedure
SEC	Securities and Exchange Commission
TAM	Technical Advice Memorandum
Treas. Reg.	Treasury Regulation

# Index of Related Practice Units

Associated UIL(s)	Related Practice Unit	DCN
263.14-00	<i>Examining a Transaction Costs Issue</i>	CDA/P/225_01-01