

INTERNAL REVENUE SERVICE  
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

September 21, 2009

Number: **201002036**  
Release Date: 1/15/2010

Third Party Communication: None  
Date of Communication: Not Applicable

Index (UIL) No.: 263.00-00  
CASE-MIS No.: TAM-116463-09

Director  
Field Operations LMSB:HMT:

Taxpayer's Name:  
Taxpayer's Address:

Taxpayer's Identification No  
Year(s) Involved:  
Date of Conference:

LEGEND:

Taxpayer =

x =

Corporation X =

A =

Trust A =

B =

C =

Corporation Y =

Corporation Z =

y =

z =

Date 1 =

Investment Banker =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Accounting Firm =

Date 11 =

Employee A =

Employee B =

Investment Banker A =

Investment Banker B =

Date 12 =

Date 13 =

Employee C =

Date 14 =

Date 15 =

Trust B =

Firm A =

Date 16 =

Investment Banker C =

Date 17 =

#### ISSUE:

In determining what portion of the contingent fees paid to professional advisors Taxpayer may deduct in connection with its acquisition, do the allocation spreadsheets developed by Accounting Firm qualify as “other records” within the meaning of § 1.263(a)-5(f) of the Income Tax Regulations?

#### CONCLUSION:

The allocation spreadsheets developed by Accounting Firm do qualify as “other records” within the meaning of § 1.263(a)-5(f). Accordingly, LMSB must evaluate the allocation spreadsheets developed by Accounting Firm in its determination of whether Taxpayer has maintained sufficient documentation to establish what portion of the contingent fees are allocable between facilitative and non-facilitative costs.

#### FACTS:

Taxpayer, the target, was a leading designer, manufacturer, and marketer of a broad range of x, and the parent of an affiliated group that filed a consolidated federal income tax return. An affiliate of Corporation X (an Investment Banker), a private equity firm, owned A% of the outstanding common shares of Taxpayer, Trust A owned B%, and minority investors owned the remaining C%.

Corporation Y, the acquirer, is a wholly owned subsidiary of Corporation Z, a public company. Corporation Y designs, manufactures, and markets y, and Corporation Z is the world's largest manufacturer of z.

On Date 1, the board of directors ("BOD") of Taxpayer met to consider whether to sell Taxpayer. To assist Taxpayer with its potential sale, Taxpayer hired both Corporation X and Investment Banker to provide investment banking services. On Date 2, Taxpayer entered into a "Services Agreement" with Corporation X. Under the terms of the Services Agreement, Taxpayer was obligated to pay a lump-sum, contingent fee to Corporation X if Taxpayer either entered into a purchase and sale agreement (for all or substantially all of the stock of Taxpayer), or if a sale of all or substantially all of the stock of Taxpayer occurred during the timeframe specified in the Services Agreement. On Date 3, Taxpayer entered into an engagement letter with Investment Banker. Under the terms of the engagement letter, Taxpayer was obligated to pay a non-refundable retainer, and a contingent fee (determined by reference to a specific formula) in the event a sale of Taxpayer was consummated during the timeframe specified in the engagement letter.

In Date 4, a meeting was held introducing Corporation Z to representatives of Corporation X. Taxpayer's management, Corporation X and Investment Banker had all identified Corporation Z as a likely candidate for a potential transaction. Taxpayer continued negotiations and discussions with eight potential buyers up until Date 5. All potential buyers were required to complete their due diligence by Date 6.

On Date 5, Corporation Y submitted an offer to purchase Taxpayer in the form of a Stock Purchase Agreement. During a meeting on Date 5, Taxpayer's BOD approved the proposed form, terms and provisions of the Stock Purchase Agreement. A formal written indication of interest was never received from Corporation Y. Additionally, the parties did not execute a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement). Thus, Date 5, was the date on which the material terms of the transaction were approved by Taxpayer's BOD.

On Date 7, Taxpayer and Corporation Y entered into a Stock Purchase Agreement. The acquisition transaction was completed on Date 8, and Taxpayer became a wholly owned subsidiary of Corporation Y.

Corporation X's invoice for its contingent fee was dated Date 9. Investment Banker's invoice for its contingent fee was dated Date 10. Both invoices billed for costs due at closing--Date 8. Neither invoice contained any detailed breakdown of services rendered. Taxpayer has not provided or shown, because Taxpayer does not have them in their possession, any time reports or detailed invoices from Corporation X or Investment Banker.

Taxpayer engaged Accounting Firm to conduct a study of the transaction costs incurred based on services performed by Corporation X and Investment Banker from Date 11 through the date of sale, Date 8. Employee A of Accounting Firm led the study and worked primarily with Employee B of Taxpayer, Investment Banker A of Corporation X, and Investment Banker B of Investment Banker.

Employee A held preliminary discussions with Investment Bankers A and B regarding the transaction costs and services performed. Based on these discussions, Employee A drafted a preliminary general spreadsheet template (preliminary spreadsheet) of activity categories. No discussion notes or other documentation to support the preliminary spreadsheet activity categories were provided to LMSB because they no longer exist or cannot be found.

Employee A utilized the preliminary spreadsheet during a conference call with Investment Bankers A and B on Date 12, to discuss the activities performed relating to the contingent fees. After this discussion, Employee A drafted a revised description of activities performed in two "general spreadsheets," one for Corporation X and one for Investment Banker. Employee A then e-mailed the general spreadsheets (which was blank except for the description of each activity) to Investment Bankers A and B. The interview notes, and/or any other documentation relating to the general spreadsheets and the Date 12 conference call were not provided to LMSB because they no longer exist or cannot be found.

Investment Bankers A and B filled out the general spreadsheets with a percent of time spent on each activity category, including, when relevant, the percent of time spent before and after Date 5, and sent the completed general spreadsheets to Employee A via email on Date 13 (with copies to each other and Employee B). The general spreadsheet filled out by Investment Banker B represented Investment Banker B's "best guess at time allocation for the transaction."

In support of the allocation of the percentage of time in the general spreadsheets, Taxpayer provided (or made available for review) the following documentation:

Work product/work performed by Corporation X

1. Confidential document (presentation) showing summary of potential buyers.
2. Various financial statement modeling scenarios including income statement forecasting and various balance sheet assumptions prepared by Corporation X and Taxpayer personnel.
3. Confidential presentation to four investment banker candidates prepared by Taxpayer and Corporation X plus an addendum with additional detailed financial information.
4. Spreadsheet comparison of various investment banker presentations and handwritten notes of an Employee C of Taxpayer dated Date 14. The investment

banker presentations occurred over the two days and Corporation X was present during all of the presentations.

5. Notes of Employee C, establishing that a representative of Corporation X was present in this meeting, and documentation of a meeting on Date 15 with Trust B regarding Trust A representation and issues. Trust B, as Trustee for Trust A and Taxpayer engaged Firm A to provide a Fairness Opinion for Trust A. The meeting was also to discuss various compensation issues and the impact of the sales price allocation on the various stock plans.
6. Data room information including compact disks containing all of the documents provided to potential suitors. Corporation X assisted Taxpayer with the gathering and preparation of various documents. Hard copies of the documents were also provided.
7. Summary of credit facilities prepared by Corporation X.
8. Detailed history of Taxpayer prepared by Taxpayer and Corporation X.
9. Working capital analysis and adjustments prepared by Taxpayer and reviewed by Corporation X.
10. A hand written summary prepared by Investment Banker A showing dates, one to three word descriptions and day equivalents of time spent on activities, which also represents Investment Banker C's time per Investment Banker A's e-mail dated Date 17. The document is unsigned and undated.
11. Date 9 billing invoice, paid by Taxpayer on Date 8, with no detailed breakdown of services rendered.

Work product/work performed by Investment Banker

1. Investment banker presentation presented to Taxpayer and Corporation X.
2. Retainer agreement.
3. Detail of out-of-pocket expenses.
4. Booklet prepared and presented by Investment Banker, which contained the agenda and outlined the process and the proposed timeline for the process for the "kick-off" meeting on Date 16 with Taxpayer and Corporation X.
5. Letters to Trust B transmitting proposed timeline.
6. List of potential buyers.
7. Confidentiality Agreement.
8. Project working group list.
9. Notes of Employee C and documentation of Date 15 meeting with Trust B regarding Trust A representation and issues. Investment Banker presented at this meeting and prepared the presentation (along with Taxpayer) for the meeting. Firm A provided a Fairness Opinion for Trust A. This presentation was prepared and presented by Investment Banker, therefore a work product of Investment Banker.
10. Data room information including compact disks containing all of the documents provided to potential suitors. Investment Banker reviewed and organized all of

the various documents, provided and maintained hard copies, and maintained the master list of documents for the data room.

11. Date 4 "Confidential Booklet" prepared by Investment Banker and Taxpayer to send out to potential suitors introducing Taxpayer to targeted potential acquirers.
12. Billing invoice dated Date 10, paid by Taxpayer on Date 8, with no detailed breakdown of services rendered.

Based on the information in the general spreadsheets and the supporting documentation described above, Taxpayer deducted a portion of the contingent fees paid to Corporation X and Investment Banker on its return for the taxable year ending on Date 8.

#### LAW AND ANALYSIS:

Section 162(a) of the Code provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263(a)(1) of the Code provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

Section 1.263(a)-5(a) provides, in part, that a taxpayer must capitalize an amount paid to facilitate the acquisition of assets that constitute a trade or business, whether the taxpayer is the target or acquirer.

Section 1.263(a)-5(b) provides, in part, that an amount is paid to facilitate a transaction if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigation or otherwise pursuing the transaction is determined based on all of the facts and circumstances.

Section 1.263(a)-5(e)(1) provides, in part, that except for certain facilitative costs listed in § 1.263(a)-5(e)(2), an amount paid by the taxpayer in the process of investigating or otherwise pursuing a covered transaction facilitates the transaction only if it relates to activities performed on or after the earlier of the date a letter of intent or similar communication is executed or the date on which the material terms of the transaction are authorized or approved by the taxpayer's board of directors. Section 1.263(a)-5(e)(2) provides a list of costs that are inherently facilitative, which are facilitative regardless of when performed. A covered transaction is defined in § 1.263(a)-5(e)(3), and includes a taxable acquisition of assets that constitute a trade or business and certain reorganizations described in § 368.

Section 1.263(a)-5(f) provides that an amount paid that is contingent on the successful closing of a transaction 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. This documentation must 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. The documentation must consist of more than merely an allocation between activities that facilitate the transaction and activities that do not facilitate the transaction, and must consist of supporting records (for example, time records, itemized invoices, or other records) that identify—

- (1) The various activities performed by the service provider;
- (2) The amount of the fee (or percentage of time) that is allocable to each of the various activities performed;
- (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
- (4) The name, business address, and business telephone number of the service provider.

Taxpayer was acquired in a transaction to which § 1.263(a)-5 applies, and thus, Taxpayer is required to capitalize costs incurred to facilitate the transaction. To the extent Taxpayer can demonstrate that some of the activities provided by Corporation X and Investment Banker are allocable to activities that did not facilitate the transaction, Taxpayer may deduct that portion of the fees paid. Section 1.263(a)-5(f) provides specific rules concerning the documentation necessary to establish that a portion of any amount paid that is contingent on the successful closing of a covered transaction (“success-based fees”) is allocable to activities that do not facilitate the transaction. In general, this documentation must consist of more than merely an allocation between activities that facilitate the transaction and activities that do not facilitate the transaction, and must consist of supporting records that identify the activities performed, the fee allocable to those activities, the date of performance, and the service provider. The term “supporting records” is not defined, but “time records, itemized invoices, or other records” are provided as examples of supporting records. The regulations also provide that the documentation must be completed on or before the due date of a taxpayer’s timely filed tax return, including extensions.

In this case, Taxpayer utilized the allocation provided in the general spreadsheets developed by Accounting Firm to determine an allocation of the success-based fees to facilitative and non-facilitative activities, and deducted the amounts paid for non-facilitative activities on its Date 8 tax return. Neither LMSB nor Taxpayer dispute the general applicability of § 1.263(a)-5, but the parties request guidance on the operation of § 1.263(a)-5(f) to this case because Taxpayer is unable to provide time records or



itemized invoices from professional service providers to support its allocation, but did provide records in the form of general spreadsheets developed through interviews and the memory of employees regarding activities performed and estimates of time spent on those activities. Thus, the specific issue is whether the general spreadsheets developed by Accounting Firm in conjunction with employees of Corporation X and Investment Banker qualify as “other records” under the regulations.

LMSB argues that Taxpayer has not provided “other records” or sufficient documentation to prove that some of the success-based fees were attributable to non-facilitative activities, and thus, all amounts paid by Taxpayer to Corporation X and Investment Banker facilitated the acquisition, and must be capitalized. Taxpayer argues that the general spreadsheets qualify as “other records” and that sufficient documentation has been provided to support its claimed deduction.

Section 1.263(a)-5(f) must be read in conjunction with § 1.263(a)-5(e), which provides, in general, a bright line rule for determining deductible non-facilitative costs and capitalizable facilitative costs. Thus, except for “inherently facilitative” costs (defined in § 1.263(a)-5(e)(2)), an amount paid by a taxpayer in the process of investigating or otherwise pursuing a transaction facilitates the transaction only if it relates to activities performed on or after the earlier of the date of a letter of intent or a similar communication is executed or the date on which the material terms of the transaction are authorized or approved by the taxpayer’s board of directors. The rules in § 1.263(a)-5(f) were not intended to create a more stringent rule concerning the line between facilitative and non-facilitative costs. Thus, taxpayers who pay success-based fees are also entitled to deduct certain costs incurred before the bright line date, provided the taxpayer can substantiate those costs.

Under § 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. The term “other records” is not defined in the regulations, and there are no limitations on the type or source of documents that can qualify as “other records.” 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. This is true even where, as is the case here, the document was not directly produced by the service provider (i.e., investment banker) but was based on interviews of employees of the service provider. What is important is whether the documents presented, taken as a whole, provide the information required by § 1.263(a)-5(f)(1) through (4).

Under the facts of this case, Corporation X and Investment Banker clearly engaged in activities that were non-facilitative in nature, and clearly engaged in those activities before the date the material terms of the acquisition were approved by Taxpayer’s BOD. Section 1.263(a)-5(f) should not be read in a manner that would automatically preclude the deductibility of Taxpayer’s non-facilitative costs simply because the TP is unable to provide time records or itemized invoices from Corporation X or Investment Banker. Nor

does the existence of “other records” automatically ensure the deductibility of Taxpayer’s claimed allocation of non-facilitative costs. Rather, LMSB should determine, based on all of the documentation provided, whether the taxpayer made an appropriate allocation of the success-based fees to non-facilitative activities. This determination requires a weighing of the sufficiency of the evidence, not a legal determination, and therefore is a matter properly under the jurisdiction of the LMSB Operating Division.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.