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subject: Documentation Under Section 1.263(a)-5(f)

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

Whether a taxpayer can satisfy the documentation requirements under § 1.263(a)-5(f) of the Income Tax Regulations by providing a letter from an investment banker that estimates the percentage of time spent on facilitative and non-facilitative activities and includes a caveat stating the letter should not be relied on as the investment banker does not keep time records?

CONCLUSION

No, a taxpayer cannot satisfy the documentation requirements under § 1.263(a)-5(f) by providing a letter from an investment banker that estimates the percentage of time spent on facilitative and non-facilitative activities and includes a caveat stating the letter should not be relied on as the investment banker does not keep time records.

FACTS

In , Taxpayer engaged Investment Banker to explore a possible sale of Taxpayer and to identify potential buyers. The engagement letter provided that Taxpayer would pay Investment Banker a fee, determined as a percentage of the total transaction

consideration, upon successful closing of the transaction (success-based fee). Investment Banker's fee was not based on an hourly rate, but was based on a number of factors, including Investment Banker's experience.

Investment Banker identified a number of potential buyers, performed services related to vetting the potential buyers, and ultimately recommended one buyer to Taxpayer's Board of Directors. Taxpayer's Board of Directors approved the buyer. Investment Banker performed other services until successful closing of the transaction. The transaction successfully closed in and Taxpayer owed Investment Banker a fee for its services.

After the closing, Taxpayer sent Investment Banker a letter asking Investment Banker to estimate the amount of time it spent on various activities relating to the transaction. In the letter, Taxpayer advised that the day Taxpayer's Board of Directors approved the transaction is the "bright line date."

In response, Investment Banker sent Taxpayer a two-page letter stating that, as Taxpayer is aware, Investment Banker did not keep time records and Investment Banker's fee was not based on an hourly rate. Investment Banker stated that it could not provide detailed estimates based on the amount of time spent on certain aspects of the transaction because it did not keep time records. Investment Banker stated that, after talking with members of the acquisition team, it could approximate percentages of time spent on various activities. Investment Banker did not disclose the names of or contact information for the acquisition team members who were consulted.

In the letter, Investment Banker estimated that approximately 92% of its time was attributable to identifying a buyer; approximately 2% of its time was attributable to drafting a fairness opinion; approximately 4% of its time was attributable to reviewing drafts of the merger agreement; and approximately 2% of its time was attributable to performing services after the identified bright line date. Investment Banker included a caveat in the letter stating that the percentages were merely estimates and should not be relied on by Taxpayer.

On its return, Taxpayer did not elect the safe harbor for allocating success-based fees that is provided in Revenue Procedure 2011-29. Instead, based on Investment Banker's letter, Taxpayer deducted 92% of the success-based fee. On audit, Taxpayer provided the two-page letter described above as its documentation under § 1.263(a)-5(f). After Exam requested additional documentation, Taxpayer provided a PowerPoint presentation that Investment Banker presented to Taxpayer's Board of Directors. The PowerPoint presentation contained basic information regarding Taxpayer and explored possible acquisition strategies.

LAW AND ANALYSIS

Section 162(a) of the Internal Revenue Code (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) 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 an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions.

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 investigating 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 inherently facilitative amounts 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 (the "bright line date").

Section 1.263(a)-5(e)(2) provides a list of amounts that are inherently facilitative regardless of when the activities are performed, which includes, inter alia, amounts paid for securing a fairness opinion.

Section 1.263(a)-5(e)(3) provides that the term "covered transaction" means the following transactions:

(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 in the acquisition or the target of the acquisition) if, immediately after the acquisition, the acquirer and the target are related within the meaning of section 267(b) or 707(b); and

(iii) A reorganization described in section 368(a)(1)(A), (B), or (C) or a reorganization described in section 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354 or 356 (whether the taxpayer is the acquirer or the target in the reorganization).

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.

In this case, Taxpayer was acquired in a transaction to which § 1.263(a)-5 applies and, thus, Taxpayer was required to capitalize the costs incurred to facilitate the transaction. Section 1.263(a)-5(f) specifically provides that an amount paid that is contingent on the successful closing of a transaction is an amount paid to facilitate the transaction, and must be capitalized, 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.

Section 1.263(a)-5(f) provides that the documentation (1) must consist of more than merely an allocation between activities that facilitate the transaction and activities that do not facilitate the transaction, and (2) must consist of supporting records that identify the activities performed, the amount of the fee or percentage of time that is allocable to each of the activities, the date of the activity, if relevant, and the name, address, and phone number of the service provider.

Revenue Procedure 2011-29 provides a safe harbor election for allocating success-based fees paid in a business acquisition or reorganization described in § 1.263(a)-5(e)(3) ("covered transaction"). In lieu of maintaining the documentation required by § 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. This safe harbor was provided,

in part, to incentivize taxpayers to make the election rather than attempt to determine the type and extent of documentation required to establish that a portion of a success-based fee is allocable to activities that do not facilitate a covered transaction.

Here, Taxpayer did not elect Revenue Procedure 2011-29. Therefore, Taxpayer must satisfy the documentation requirements of § 1.263(a)-5(f) or the amount deductible is zero. Investment Banker's two-page letter, however, is merely an allocation between activities that facilitated and did not facilitate the transaction, which § 1.263(a)-5(f) specifically forbids. Because the two-page letter is merely an allocation, it cannot satisfy the documentation requirements. Accordingly, Taxpayer must capitalize 100% of the success-based fee.

Taxpayer attempted to provide time estimates from Investment Banker even though Taxpayer knew that Investment Banker did not keep time records. Section 1.263(a)-5(f)(2) does not require a taxpayer's supporting records to identify the percentage of time that is allocable to each activity. Section 1.263(a)-5(f)(2) requires the supporting records to identify the amount of the fee that is allocable to each activity (percentage of time is just in a parenthetical).

The estimated allocation letter from Investment Banker has no effect under the rules of § 1.263(a)-5(f). Without other documentation, Taxpayer's deduction is zero. While the PowerPoint presentation may provide some evidence that Investment Banker performed non-facilitative services, it also has no effect under the rules of § 1.263(a)-5(f) because it does not identify the amount of the fee or percentage of time that is allocable to each activity performed by Investment Banker.

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Please call if you have any further questions.