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The IRS Denies Tax Deduction for Common Sell-Side Success-Based Fees

Article By:

Timothy J. Santoli

David K. Salamon

The Internal Revenue Service (the "IRS"), in private letter ruling 202308010 ("PLR"), held that success-based fees were incurred by a private equity ("PE") sponsor (i.e., the seller) rather than by the target (i.e., a subsidiary of the PE sponsor) and therefore denied the target's request for relief for a late election under Revenue Procedure 2011-29 to deduct 70% of the success-based fees (the "Safe Harbor Election").

It is a long-standing market practice to reduce consideration paid to a PE sponsor in an M&A transaction by the amount of a target's transaction costs that include success-based fees paid to bankers that are contingent on the successful closing of the transaction. Purchase agreements in M&A transactions normally provide that success-based fees incurred by a target will be reported pursuant to the Safe Harbor Election, thereby allowing the target to deduct 70% of the success-based fees. The IRS's decision in the PLR is not consistent with the tax treatment of success-based fees in many M&A transactions and is counter to the IRS's position in many of its previously-issued private letter rulings.

Background

Generally, a taxpayer must capitalize expenditures that facilitate business acquisitions. A success-based fee is generally presumed to facilitate a transaction, and, therefore, must be capitalized unless a taxpayer maintains sufficient documentation to establish that a portion of such fee is allocable to activities that do not facilitate the transaction. In an attempt to eliminate disagreements between taxpayers and the IRS, the IRS and Treasury Department issued Revenue Procedure 2011-29 to permit the Safe Harbor Election.

The Safe Harbor Election permits 70% of a success-based fee to be treated as an amount that does not facilitate a transaction, thereby allowing the taxpayer to immediately claim a tax deduction for 70% of the success-based fee. The remaining 30% of the success-based fee is treated as a facilitative expense and must be capitalized. The Safe Harbor Election only applies to "covered transactions," which include a taxable acquisition of an ownership interest in a business entity if, immediately after the acquisition, the target and acquirer are "related" (a "Covered Transaction").

Facts of the PLR

The facts of the PLR are similar to a typical PE-sponsored M&A transaction and involve a banker that entered into an agreement with the target (and not the PE sponsor) to explore a capital transaction (including the sale of target's stock). The target agreed (and was legally obligated) to pay the banker's success-based fee. The target's management primarily led the discussions with the banker, and the banker and target corporation later consulted with the PE sponsor.

As is common in a typical M&A transaction involving success-based fees, pursuant to the sale agreement, the success-based fee was required to be paid out of the sale proceeds to the PE sponsor (and other selling shareholders). The buyer transferred a portion of the sale proceeds to the PE sponsor to satisfy certain liabilities (that included the success-based fees and other transaction costs). That same day the PE sponsor wired funds that it received from the buyer to pay the success-based fees to the bank, thereby reducing the sale proceeds payable by the buyer to the PE sponsor (and other selling shareholders). The PE sponsor treated that transaction as if it (and the other selling shareholders) received the cash (attributable to the success-based fee), and contributed such cash to the target, increasing its tax basis in the shares of target — and the target was deemed to pay the success-based fees to the banker. Accordingly, the PE sponsor (other selling shareholders) reduced the gain on the sale of the stock in target by the amount of consideration treated as a deemed contribution to the target.

The IRS denied the target's Safe Harbor Election (and corresponding tax deduction for the success-based fees), ruling that the PE sponsor (and not the target) incurred the expense of the success-based fee. The IRS rejected the target's position that it was legally obligated to pay the fee, so it should be entitled to the deduction. The IRS asserted that deductibility of such costs is not determined by who is legally obligated to pay the cost; rather, the IRS reasoned, courts look to who benefited from the cost. The IRS also noted that the target only had an incidental benefit for such cost.

Accordingly, the IRS concluded that the success-based fee should be treated as a capitalized cost of the PE sponsor selling property rather than the target's cost because the success-based fee was directly and proximately connected to, and arose from, the PE sponsor's activity of investing and selling portfolio companies, while the success-based fee only indirectly related to the target's business activity. The IRS noted that the PE sponsor operated as a fund that sought to profit from the purchase and sale of portfolio company businesses and that the amount of the compensation paid to the bank was directly linked and dependent on the occurrence of a sale and the amount of sale proceeds generated.

Observations

The PLR is inconsistent with multiple private letter rulings previously issued by the IRS, which concluded that success-based fees may be taken into account by a target pursuant to a Safe Harbor Election. In addition, it is a long-standing M&A market practice for targets of a PE sponsor to take into account success-based fees pursuant to a Safe Harbor Election. It is not clear from the PLR whether the IRS is reconsidering its historical position on this matter or whether the decision is limited to the specific facts of the PLR.

Notwithstanding the inconsistency and lack of clarity resulting from the PLR, the PLR indicates that the IRS is scrutinizing which party to an M&A transaction should properly take into account success-based fees for U.S. federal income tax purposes. As such, it is important for a target and seller to carefully evaluate the specific facts of a transaction in order to determine which party should take into account success-based fees.

Importantly, the issue here arose because the taxpayer missed the deadline for the Safe Harbor Election and sought relief from the IRS for an extension of time to make the Safe Harbor Election. As such, taxpayers should ensure to file timely Safe Harbor Elections to mitigate the risk of being denied the ability to rely on the Safe Harbor Election. In addition, until there is further clarity, taxpayers should carefully review banker agreements and document the benefits of the transaction to the target to the extent a target intends to take a deduction with respect to success-based fees pursuant to a Safe Harbor Election.

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