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M&A Success Fees: Bright Lines, Safe Harbors, and Code Sec. 338(h)(10)

By Donald P. Board • Wood LLP

If there is one thing readers of *The M&A Tax Report* are likely to agree on, it's the importance of fees that lawyers, accountants and other professionals are paid to advise on mergers and acquisitions. Of course, if there are investment bankers in the picture, the professionals' fees are likely to look rather pallid by comparison. Even so, the presentation of a professional's final invoice has been known to add a bit of drama to an otherwise humdrum closing.

As the market for professional services has grown more competitive, "alternative fee arrangements" have become increasingly popular, at least with the companies that pay the bills. Flat fees, capped fees, blended rates and other arrangements can reduce client uncertainty. On a good day, they may even promote the more efficient delivery of professional services.

But as long as clients expect professionals to discover and protect them from the subtle and sometimes highly technical risks that may be lurking in a transaction, there may be a limit on how much can be done to cut their bills. So, it seems likely that substantial professional fees will continue to be piled on top of a mountain of other deal expenses.

Fees Neither Simple Nor Absolute

Those other expenses can include the costs of appraisals, proxy solicitations, SEC filings, printing, and investment banking services. A major portion of any investment banking fees will probably be due only if the deal closes. But if the piper must be paid, his "success fee" may run to five percent (or more) of total deal value.

Tax professionals may not be able to do much about their *own* fees, much less total M&A transaction costs. But they should at least get a handle on how deal expenses are likely to affect a client's after-tax bottom line.

This can be more than just a matter of feeling the client's pain. As we will see, the Treasury Department has found it necessary to issue detailed regulations governing the tax treatment of M&A transaction costs. The resulting network of rules is complex, but a bit of planning can sometimes improve the client's results.

Suppose, for example, that the target of a stock acquisition is an S corporation. How much—at a minimum—should the target "charge"

the buyer to join in an election to treat the transaction as an asset acquisition under Code Sec. 338(h)(10)?

This can be a tricky question for a tax professional to answer even *without* transaction costs. But there is no rest for the weary. As discussed below, the calculation will be incomplete unless it considers how the election will affect the target's ability to deduct its expenses.

INDOPCO—Too Much of a Good Thing?

One must draw lines between business expenses, which can be deducted in the current tax year, and outlays that must be capitalized. This is one of the classic problems facing the federal income tax. The Supreme Court has addressed it many times, perhaps most notably in *INDOPCO, Inc*. [SCt, 92-1 USTC ¶50,113, 503 US 79, 112 SCt 1039]. The case concerned—of all things—the tax treatment of M&A transaction costs.

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The taxpayer in *INDOPCO* was a corporation that deducted the investment banking fees it had incurred as the target of a friendly stock acquisition. Relying on *Lincoln Savings & Loan Ass'n* [SCt, 71-1 USTC ¶9476, 403 US 345, 91 SCt 1893], the target contended that it did not need to capitalize its expenses. After all, the fees, which were paid to facilitate a *shareholder-level* transaction, had not created or enhanced any "separate and distinct asset" of the target.

The Supreme Court brushed this aside. True, the payments had not created or enhanced any specific corporate asset. Nevertheless, the target *had* advised its shareholders to vote in favor of the acquisition, claiming that it was in the long-term best interest of the corporation.

Taking the target at its word, the Court concluded that the fees had provided the corporation with an intangible—but clearly significant—benefit. What's more, this benefit would extend beyond the current taxable year. Under *INDOPCO*, that is enough to trigger capitalization.

The "significant future benefit" standard is theoretically correct. However, it turned out to be an administrative nightmare for taxpayers and even for the IRS. Within a few years, the Large and Midsize Business Division found itself devoting as much as *40 percent* of its audit and litigation resources to disputes about capitalization under *INDOPCO*. Mae West notwithstanding, sometimes too much of a good thing can be anything but wonderful.

Anti-*INDOPCO* Regulations

A wave of *INDOPCO*-inspired cases started to surge through the courts. It soon became clear that a welter of fact-specific judicial decisions exploring the meaning of "significant future benefits" was not going to make life easier for taxpayers or the IRS.

The Treasury responded by proposing elaborate regulations intended to define "the exclusive scope of the significant future benefit test." This would be done by establishing "specific categories of intangible assets for which capitalization is required." Theoretical correctness was jettisoned in favor of detailed rules that would provide the "certainty and clarity necessary for compliance with, and sound administration of, the law." [REG125638-01, 67 FR 77,701, 77,702 (Dec. 19, 2002).]

The final regulations, which became effective in 2004 ("2004 Regulations"), deal generally with payments to acquire or create intangibles [*see* Reg. §1.263(a)-4]. But they also include a set of rules directed specifically at payments that facilitate certain financings, restructurings and acquisitions [*see* Reg. §1.263(a)-5]. We will focus on the latter.

Capital Transactions

Reg. §1.263(a)-5(a) lays down the baseline rule: Taxpayers must capitalize the costs they incur to facilitate any of the following transactions ("Capital Transactions"):

- The taxpayer's acquisition or disposition of assets constituting a trade or business;
- The taxpayer's acquisition of an ownership interest in any kind of business entity, so long as the taxpayer and the target entity are related after the acquisition;
- A third party's acquisition of an ownership interest in the taxpayer;
- The restructuring, recapitalization, or reorganization of the capital structure of any business entity;
- Any transfer described in Code Sec. 351 or 721;
- Formation of a disregarded entity;
- An acquisition of capital; and
- A stock or debt issuance.

The first three items—asset and stock acquisitions—are the most important for M&A purposes. Of course, it is common to encounter the other Capital Transactions as elements in the big-picture acquisition plan. The costs of facilitating those associated transactions must be capitalized, too.

Which Costs "Facilitate"?

Reg. §1.263(a)-5(b)(1) states that an amount "facilitates" a Capital Transaction only if it is paid "in the process of investigating or otherwise pursuing" the transaction. This is generally determined based on all the facts and circumstances. The fact that the payment would not have been made but for the transaction is "relevant, but not determinative."

The 2004 Regulations also adopt a number of *per se* rules. Reg. §1.263(a)-5(b)(1) declares that any amount paid to determine the "value or price" of a transaction is paid in the process of investigating or otherwise pursuing that transaction. Similarly, Reg. §1.263(a)-5(e)(2) provides a list of deal costs that are "inherently facilitative." These are amounts paid for:

- Securing an appraisal, formal written evaluation, or fairness opinion related to the transaction;
- Structuring the transaction, including negotiating the structure and obtaining relevant tax advice;
- Preparing or reviewing documents that effectuate the transaction;
- Obtaining regulatory approvals;
- Obtaining shareholder consent to the transaction (e.g., proxy solicitation costs); or
- Conveying property between the parties (e.g., transfer taxes and title registration costs).

At the same time, the 2004 Regulations declare that some costs are *not* facilitative, even if they look like they should be. Under these "simplifying conventions," the taxpayer's payroll and overhead expenses *never* facilitate a transaction. That includes the $20 million bonus paid to reward the CEO for all of his or her great work on the Acme merger. [*See* Reg. §1.263(a)-5(d).]

Timing Rule for "Covered Transactions"

The 2004 Regulations include special provisions applicable to most (but not all) of the Capital Transactions that are the focus of M&A practice. Reg. §1.263(a)-5(e)(3) defines "Covered Transaction" to mean:

- A taxable acquisition of assets constituting a trade or business (where the taxpayer is the acquirer);
- A taxable acquisition of an ownership interest in a business entity (whether the taxpayer is the acquirer or the target in the acquisition) if, immediately after the acquisition, the acquirer and the target are related; or
- A reorganization described in Code Sec. 368(a)(1)(A), (B), or (C) or a reorganization described in Code Sec. 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred assets are distributed in a transaction that qualifies under Code Sec. 354 or 356 (whether the taxpayer is the acquirer or the target in the reorganization).

If a Capital Transaction qualifies as a Covered Transaction, the taxpayer gets the benefit of a timing rule that cuts back on the general rule that facilitative costs must be capitalized. Under Reg. §1.263(a)-5(e), the costs of investigating or

otherwise pursuing a Covered Transaction are *not* treated as facilitating the transaction if (1) the costs relate to activities performed *before* what is commonly known as the "bright-line date," and (2) the costs are not "inherently facilitative" as described in Reg. §1.263(a)-5(e)(2).

The bright-line date is the earlier of (1) the date on which the acquirer and the target sign a letter of intent, an exclusivity agreement, or a similar written communication; and (2) the date on which the material terms of the transaction are authorized or approved by the taxpayer's board of directors [§1.263-5(e)(1)]. There are analogous rules for non-corporate entities.

Of course, real life may not be so simple. Suppose that a target corporation and a would-be acquirer enter into a merger agreement on March 31. The boards of directors of the two companies approve the transaction that same day.

However, the merger agreement includes a "go shop" provision. The target has entered into a binding contract, but it retains the right, until April 30, to continue looking for *another* acquirer willing to make a *better* deal. If it finds one and the original acquirer won't match the competing offer, the target can abandon the initial merger in favor of a deal with the competing acquirer.

In this case, however, the target sticks with its original suitor and closes the deal in the fall. What is the bright-line date? The two corporations signed the papers on March 31. But the "go shop" provision means they were not really in an *exclusive* relationship until after April 30.

In CCA 201234026, the IRS concluded that March 31 remains the bright-line date. The CCA explained that the "go shop" clause was just one provision of the merger agreement, and that it did not negate the document's execution. Nor did it trump the approval of the deal terms by the two boards of directors.

This rationale is circular because the issue is whether the inclusion of the "no shop" *should* negate the execution of the agreement or trump the approval by the two boards. Nevertheless, the result seems eminently justified. If we want to keep the bright line bright, the IRS must ignore some complicating factors.

Of course, the Treasury's pursuit of bright lines can have substantive consequences. By focusing so tightly on *when* agreements are signed or approved, Reg. §1.263(a)-5(e)(1) ends up exempting a large swath of "investigative" costs from capitalization. By the time a letter of intent is signed, most of the investigative horse is going to be out of the barn.

It is also notable that the 2004 Regulations leave it up to the parties to decide when to close the door. It is they, after all, who decide when to sign an LOI or take some other triggering step. Business exigencies will normally predominate, but the parties could be motivated to manipulate the timing if the tax incentives are high enough.

The liberal timing rule of Reg. §1.263(a)-5(e)(1) does not, however, affect the capitalization of *inherently* facilitative expenses. In a Covered Transaction, the costs of getting an appraisal, structuring the transaction, preparing deal documents, obtaining regulatory approvals, soliciting shareholder consents and conveying property must be capitalized no matter when they are incurred.

Does this carve-out for inherently facilitative costs make a difference? It certainly matters for the costs of *structuring* a Covered Transaction. Most structuring costs (other than opinions) seem like they would be incurred *before* an LOI is signed or the material terms of the transaction are approved.

But many of the other inherently facilitative costs, *e.g.*, the costs of obtaining regulatory approvals or fairness opinions, are likely to be incurred *after* the bright-line date. Such expenses would have to be capitalized under Reg. §1.263(a)-5(e) in any event.

Success-Based Fees

Service providers who are in the business of bringing together buyers and sellers, *e.g.*, investment bankers, are frequently compensated with fees that are payable only if the deal happens. Under Reg. §1.263(a)-5(f), any fee that is contingent on the successful closing of a Capital Transaction (a "success-based fee") is presumed to facilitate that transaction. The taxpayer can rebut this presumption, but that requires rigorous documentation demonstrating that the fee should be allocated to activities that did not facilitate the transaction.

The regulatory presumption may reflect the notion that a service provider who is paid only

if a transaction closes has probably been hired to *make* the transaction happen. Payments for such services are almost self-evidently payments to facilitate the transaction. If the taxpayer does not want to capitalize such fees under Reg. §1.263(a)-5(a), it seems fair to demand clear evidence that the fees were paid for *non*-facilitative services.

If a success-based fee is simply a percentage of the deal value, there is no reason for the service provider to submit an invoice detailing the activities it undertook on the taxpayer's behalf. However, the 2004 Regulations warn that it is *not* sufficient to simply allocate the fee between activities that facilitate the transaction and those that do not.

Instead, Reg. §1.263(a)-5(f) demands that the taxpayer obtain time records, itemized invoices or "other records" that identify:

- The various activities performed by the service provider;
- The amount of the fee (or percentage of time) that is allocable to each of the activities performed; and
- The amount of the fee (or percentage of time) attributable to the periods before and after any date that is relevant to determining the tax treatment of the fee (*e.g.*, the bright-line date).

Even lawyers, who are accustomed to documenting their professional lives in six-minute increments, may find this burdensome. Is it realistic to expect high-flying investment bankers to maintain these sorts of records? On the other hand, one might ask what investment bankers do that is *not* intended to facilitate a transaction.

We need to recall, however, that "facilitate" has a technical meaning in Covered Transactions. Under Reg. §1.263(a)-5(e), any activity relating to the period before the bright-line date is treated as non-facilitative. (This assumes, of course, that the activity is not inherently facilitative.)

Hence, the most important information about an investment banker's activities may simply be the *dates* on which the services were performed. In keeping with this, the IRS National Office has advised that even after-the-fact spreadsheets prepared by the taxpayer's accountants can count as adequate documentation of an investment banker's activities. [*See* TAM 201002036 (Sept. 21, 2009).]

70/30 Safe Harbor

On the whole, however, the documentation requirements for success-based fees proved to be a pain in the neck for both taxpayers and the IRS. Recognizing that too many audit resources were now being devoted to documentation issues, the IRS decided that the game just wasn't worth the candle.

The result was Rev. Proc. 2011-29, which provides a safe-harbor rule for the allocation of success-based fees in Covered Transactions. Instead of painstakingly maintaining the documentation required by Reg. §1.263(a)-5(e), a taxpayer may elect to treat 70 percent of its success-based fees as an amount that does *not* facilitate the transaction. The corollary is that the remaining 30 percent is facilitative and must be capitalized.

This 70/30 split sounds like a good deal by anybody's measure. To top it off, the safe harbor means that taxpayers can stop stressing about how their service providers are documenting their activities. As the transaction marches (or stumbles) toward closing, taxpayers and service providers both have better things to do.

The taxpayer must make a separate election for each transaction. The election, which is irrevocable, requires a statement identifying the transaction and allocating the success-based fees. Finally, the statement must be attached to the taxpayer's original return. A taxpayer cannot elect when filing for a refund.

More Good News

Rev. Proc. 2011-29 was effective for tax years ending on or after April 8, 2011. The new rules were expected to reduce the audit burden, but they would take a couple of years to have any effect. What about the IRS's existing caseload?

The IRS's Large Business & International Division took matters into its own hands. Citing the need "to balance current resources and workload priorities," LB&I instructed its examiners that they should not challenge a taxpayer's treatment of success-based fees incurred even in tax years ending *before* April 8, 2011, so long as the taxpayer's original return had capitalized at least 30 percent of the fees. [*See* LB&I Directive 040511-012 (July 28, 2011).] If any taxpayers wondered about LB&I's authority to make Rev. Proc. 2011-29 retroactive, they kept their doubts to themselves.

LB&I followed this up with taxpayer-friendly directives on the treatment of investment-banking "milestone payments." Rev. Proc. 2011-29 covers only fees that are contingent on the *closing* of the transaction. Milestone payments, in contrast, are contingent on achieving some deal-related target short of closing, *e.g.*, signing an LOI.

If a milestone payment does not have to be refunded if the deal fails to close, it falls outside Rev. Proc. 2011-29. [*See* CCA 201234027 (Aug. 24, 2012).] But LB&I was in no mood to fight with taxpayers about non-refundable payments, either. Consequently, it told its examiners not to challenge "eligible" milestone payments if the taxpayer had capitalized at least 30 percent. [*See* LB&I Directive 04-0114-001 (Jan. 27, 2014).]

For a milestone payment to be "eligible," it must be creditable against the investment banker's ultimate success-based fee. Perhaps this requirement is intended to create a colorable connection to Rev. Proc. 2011-29. But *non*-creditable milestone payments would seem to impose the same administrative burdens on the IRS. Is there a case for making them eligible for the 70/30 election, too?

Interaction with Code Sec. 338(h)(10)

In CCA 201624021 (June 10, 2016), the IRS considered how Rev. Proc. 2011-29 applied to the acquisition of an S corporation (Target). The shareholders of Target sold all their shares to another corporation (Acquirer) for cash. The shareholders and Acquirer then made a joint election under Code Sec. 338(h)(10) to treat the transaction as a sale of Target's assets to Acquirer followed by a liquidating distribution to Target's shareholders.

Target had paid an investment bank success-based fees to create financial models and prepare buyer lists. Target paid other service providers non-success-based fees for general marketing to buyers and the review of acquisition documents. Let's assume that the investment bank's success-based fee was a modest $1 million.

Target's Return Position

When it filed its Form 1120-S, Target included a statement electing the 70/30 safe-harbor allocation. Accordingly, it treated $700,000 of the $1 million it had paid the investment bank as a non-facilitative expense. Target deducted the $700,000 and capitalized the remaining $300,000 as a facilitative cost.

The $700,000 deduction would have reduced the amount of ordinary income passing through to Target's shareholders. That would have translated into a $277,200 federal tax benefit, assuming a 39.6-percent individual rate.

The $300,000 that had to be capitalized also produced an immediate benefit. Under Reg. §1.263(a)-5(g)(2)(ii)(A), the target in a taxable asset acquisition treats the capitalized amount as a *reduction in the amount realized* from the disposition of its assets. Assuming, for simplicity, that the sale of Target's assets produced nothing but long-term capital gain, reducing the amount realized by $300,000 would have saved Target's shareholders about $71,400 (assuming a 23.8-percent tax rate).

The total tax benefit from the $1 million success-based fee would have been $348,600. Whether that's good or bad depends on what we compare it to. If the entire $1 million had been capitalized as a facilitative cost, the tax benefit would have been only $238,000. That's almost 32 percent *less* than in the 70/30 split.

What if Target had been able to document that the full $1 million related to activities undertaken *before* the bright-line date? In that case, Target could have *skipped* the election, deducted the entire $1 million, and saved its shareholders $396,000. That would have beaten an elective 70/30 split by $47,000.

Read the Fine Print

Reg. §1.263(a)-5(f) requires enhanced documentation for any success-based fee incurred in a Capital Transaction. Under Rev. Proc. 2011-29, the 70/30 election is available when a success-based fee is incurred in a Covered Transaction. Unfortunately for Target and its shareholders, however, a deemed asset sale under Code Sec. 338(h)(10) is *not* a Covered Transaction.

In fact, taxable asset sales *in general* are not Covered Transactions. This may come as a bit of a surprise because the definition of "Covered Transaction" in Reg. §1.263(a)-5(e)(3) appears to round up all the usual M&A suspects. Taxable asset acquisitions, taxable stock acquisitions, and acquisitive reorganizations are all on the list. The problem is that the idiosyncratic definitions do not always reach *both sides* of the transaction.

A taxable stock sale is a Covered Transaction "whether the taxpayer is the acquirer in the acquisition or the target of the acquisition." The same goes for reorganizations. [*See* Reg. §1.263(a)-5(e)(3)(ii) & (iii).]

Asset acquisitions are another story. Reg. §1.263(a)-5(e)(3)(i) states that "Covered Transaction" includes a "taxable acquisition *by the taxpayer* of assets constituting a trade of business." [Emphasis added.] Perhaps Target—a *seller* of assets—thought this was a typo. But the CCA concludes that the regulatory language means precisely what it says.

Therefore, an acquirer's taxable *purchase* of assets constituting a trade or business is a Covered Transaction—but the target's *sale* of those same assets to the acquirer is *not*. The CCA does not cite any reason for the asymmetrical treatment of the two sides of the sale. It simply concludes that the Treasury intended this result.

Code Sec. 338(h)(10) does not create this trap, but it makes it easier for taxpayers to fall into it. The real-world transaction in the CCA was a *stock* sale. The only reason Target found itself on the wrong side of the "Covered Transaction" definition was the election to treat the stock sale as an asset sale pursuant to Code Sec. 338(h)(10).

Bumping the Sale Price

Acquirers always like to get a stepped-up basis in the assets they purchase. When the target is a successful S corporation, the acquirer will typically want to do this by purchasing stock and making a Code Sec. 338(h)(10) election.

The S corporation's shareholders, on the other hand, will generally prefer *not* to make the election. If they have held their shares for more than a year, a straight-up stock sale will produce nothing but tax-advantaged long-term capital gain.

If the shareholders join in an election under Code Sec. 338(h)(10), on the other hand, the deemed sale can leave them with a substantial slug of ordinary income. Depreciation recapture is often the biggest culprit. This can increase the tax rate to 39.6 percent.

The usual solution is for the acquirer to bump up the purchase price. The additional consideration should leave the selling shareholders at least as well off, on an after-tax basis, as they would have been if they had not joined in the disadvantageous election.

The necessary calculation can be complicated. But anyone representing an S corporation or its shareholders should make sure that it also takes account of the fact that the Code Sec. 338(h)(10) election will prevent the S corporation from treating the sale as a Covered Transaction. That will mean no 70/30 election for any success-based fees under Rev. Proc. 2011-29.

The amount required to compensate the shareholders for giving up the safe harbor will depend on two main factors. First, how well can the S corporation document what its success-based service providers have been doing on its behalf? If the documentation is spotty or unconvincing, Reg. §1.263(a)-5(f) could bar the S corporation from allocating *any* fees to non-facilitative activities.

The second factor is timing. Because a target's actual or deemed asset sale is not a Covered Transaction, the S corporation cannot rely on the bright-line rule of Reg. §1.263(a)-5(e)(1). The fact that an expense was incurred before the bright-line date will not protect it from being classified as a facilitative cost.

But what if the S corporation has incurred substantial up-front costs to investigate and structure the transaction? Here, it will want to be sure that the bump to the purchase price compensates shareholders for the loss of their ordinary deductions.

Success-Based Professional Fees?

Now that professionals are experimenting with alternative fee arrangements, we should also ask how *their* success-based fees will be treated. It should not be too hard to get professionals to generate detailed invoices that satisfy the enhanced documentation requirements of Reg. §1.263(a)-5(f).

Of course, even perfect documentation will not help if the professional's activities are inherently facilitative. For example, a lawyer working on a deal may be fully occupied with structuring the transaction, preparing and reviewing documents, and obtaining regulatory approvals. These will all have to be capitalized pursuant to Reg. §1.263(a)-5(e)(2).

But suppose that 40 percent of the lawyer's fee for structuring, *etc.*, is payable only if the

transaction closes—a success-based fee. Can the client include the contingent portion of the lawyer's fee in an election under Rev. Proc. 2011-29?

Nothing in Rev. Proc. 2011-29 says that it does *not* apply to inherently facilitative costs, so the door is apparently open. This seems anomalous because the documentation requirements of Reg. §1.263(a)-5(f) will rarely pose a problem when the service provider is a lawyer. If records are readily available, letting the S corporation deduct 70 percent of these inherently facilitative costs may be pushing the rule a bit far.

It would not have been out of the question for the IRS to limit Rev. Proc. 2011-29 to success-based fees paid to investment bankers. After all, the rule governing milestone payments does exactly that. To qualify as an "eligible milestone payment," the milestone must be a payment "for investment banking services that is creditable against a success-based fee"). [*See* LB&I Directive 04-0114-001, *supra.*]

Concluding Observation

INDOPCO is a bit like the Battle of Blenheim in Southey's poem. Even today, everyone knows that "'twas a famous victory" for the IRS. But it was only a decade before the Treasury had to propose dozens of pages of regulations to pull the IRS out of the administrative quagmire created by the Supreme Court's principled approach to the capitalization of M&A transaction expenses.

Despite—or rather *because* of—their almost baroque elaboration, the 2004 Regulations and Rev. Proc. 2011-29 have been getting the job done. And they have been doing it with a minimum of fuss. After more than a dozen years, there are *still* no reported cases involving the transaction-cost regulations.

Of course, there are unexpected twists from time to time. But now they are handled at the regulatory level, and they seem to be limited to specialized topics such as milestone payments and Code Sec. 338(h)(10) elections. This is clear evidence, if any is needed, that Reg. §1.263(a)-5 should be accounted a capital success.

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