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Tax Advisory

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Safe Harbor for Success-Based Investment Banking Fees

On April 8, 2011, the Internal Revenue Service issued an advance copy of Rev. Proc. 2011-29, which provides a safe harbor election for allocating success-based fees paid in conjunction with business acquisitions or reorganizations. The safe harbor election allows taxpayers to treat 70 percent of success-based fees (such as investment banking fees that are contingent upon the successful closing of a transaction) as currently deductible and 30 percent as capitalizable. Taxpayers are allowed to rely on the safe harbor percentage in lieu of maintaining the documentation otherwise required by the Treasury Regulations to claim a deduction for a portion of a success-based fee.

Current Treasury Regulations require taxpayers to capitalize amounts paid to facilitate a "covered transaction," including certain taxable acquisitions or tax-free reorganizations. An amount "facilitates" a transaction if the amount is paid in the process of investigating or otherwise pursuing a transaction. Success-based fees are presumed to facilitate a transaction. Pursuant to the Treasury Regulations, a taxpayer can rebut that presumption only by maintaining sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction.

The Revenue Procedure's safe harbor 70% election represents a welcome liberalization as compared with the current approach. In Rev. Proc. 2011-29, the IRS acknowledges that the treatment of success-based fees is a source of controversy between taxpayers and the IRS. Numerous disagreements have arisen regarding the type of documentation required to establish that a portion of a success-based fee is for non-facilitative activities. Specifically, the investment banking community maintains that they do not keep timesheets, yet the IRS has taken the position that such timesheets are the only form of acceptable documentation. The IRS expects that much of this controversy will be eliminated with taxpayers electing to use the safe harbor.

Pursuant to the safe harbor in Rev. Proc. 2011-29, the IRS will not challenge a taxpayer's allocation of a success-based fee in a covered transaction if the taxpayer:

- treats 70 percent of the success-based fee as an amount that does not facilitate the transaction;

- capitalizes the remaining 30 percent as an amount that facilitates the transaction; and
- attaches a statement to its federal income tax return for the taxable year in which the success-based fee is paid or incurred stating that the taxpayer is electing the safe harbor, identifying the transaction and identifying the amounts of the success-based fee that are deducted and capitalized.

Additionally, the election applies only to the transaction for which the election is made and is irrevocable once made. Further, an election made for any transaction does not constitute a change in method of accounting for success-based fees generally.

The safe harbor is effective for success-based fees paid or incurred in taxable years ending on or after April 8, 2011.