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Extension granted for safe harbor election:

IRS continues to look at the location of transaction costs to determine accountability

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In PLR 202335013, the IRS granted the taxpayer extension for safe harbor election for a success-based fee paid on the completion of a reverse merger transaction. The extension was granted because the IRS believed that the taxpayer acted in good faith reasonably and the services were availed and benefited the taxpayer. The requirements of IRS Regulations 301.9100-1 and 301.9100-3 were met, and accordingly, the IRS granted a 60-day extension from the date of the ruling to elect the safe harbor for the Success Fee.

Applicable Law

Revenue Procedure 2011-29 was introduced to end the dispute over the allocation of success-based fees and corresponding documentation requirements. It provided taxpayers with the safe-harbor election for allocating 70% of the success-based fees incurred or paid in a transaction (as defined under IRS Regulations 1.263(a)-5(e)(3)) to activities that do not facilitate the transaction and is deductible and, the balance 30% of the success-based fees must be capitalized as a sum that facilitates the transaction.

Request

The taxpayer submitted a request under the IRS Regulations 301.9100-1 and 301.9100-3 for a time extension to make a safe harbor election under the Revenue Procedure 2011-29.

Facts

The taxpayer was a privately held corporation that used an accrual method of accounting on a calendar year basis. The taxpayer and the buyer entered into a merger agreement whereby the taxpayer was acquired in a reverse merger by a domestic corporation, a wholly owned subsidiary of the buyer. Post the merger, the taxpayer became a wholly owned subsidiary of the buyer. The transaction was treated as a taxable acquisition for US income tax purposes. No seller had a controlling interest in the taxpayer before the transaction. The domestic corporation did not engage in any business activities or issue any debt to effectuate the transaction. The taxpayer's funds were not used to acquire the taxpayer’s stock. The taxpayer did not incur debt related to the merger and did not assume the domestic corporation or the buyer’s debt.

Prior to the transaction, a financial advisor was hired by the taxpayer to perform several services in relation to the possible transaction on behalf of the taxpayer. A contingent fee equal to the percentage of the aggregate value of the transaction as mandated by the agreement was agreed upon between the taxpayer and the financial advisor (Success Fees). Upon the successful closure of the transaction, the success fees were paid and viewed by the taxpayer as a capital contribution by the sellers as it was paid from the sale proceeds received by the sellers.

The tax return preparer of the taxpayer was unaware of the safe harbor election for success-based fees. Accordingly, while preparing the taxpayer's pre-close return, it did not elect a safe harbor election under Revenue Procedure 2011-29 for success-based fees.

Ruling

The taxpayer's request was granted, and the IRS gave a 60-day extension from the date of the ruling to elect the safe harbor under Revenue Procedure 2011-29 for the Success Fee.

Reason for ruling

The IRS Regulations 1.263(a)-1(e)(1) requires commissions and other transaction costs paid to aid the sale of property to be capitalized and used to reduce the amount realized in the tax year in which the sale occurs. They are not currently deductible under IRC Section 162 or IRC Section 212. For a taxpayer to deduct the cost under IRC Section 162, the expense must meet the "direct and proximate benefit" test, i.e., it must be directly connected with a taxpayer's business activity. As cited in Deputy v. du Pont, the Court focuses on the nature of the expense to the respective business of the parties while determining the party that must take a deduction.

IRS Regulation 1.263(a)-5 applies to costs paid or incurred by a target corporation. Citing INDOPCO, Inc. v. Commissioner, the Court has not typically claimed that the expenses paid by the non-majority-controlled public target company must be treated as the costs of the selling shareholders and not as the costs of the target corporation.

Conclusion

The key highlights of the ruling are:

- The IRS's continued scrutiny of the allocation of the transaction costs, especially on the sell-side. The better test to determine the allocation of transaction costs is a facts and circumstances analysis, including (i) whether the taxpayer had a legal obligation to incur the expense, (ii) whether the taxpayer bore the economic burden of the expense, and (iii) whether the taxpayer benefitted from the expense.
- The ruling implies a specific consideration in the IRS's evaluation of whether the costs should be allocated to the selling shareholder, or the target corporation based on the "direct and proximate benefit" test.
- The 'direct and proximate benefit' test allows a deduction to the party who submits verifiable evidence that the expense was incurred in connection with the party's trade or business.

The allocation of transaction expenses must be evaluated based on the benefit, chargeability, and payment. Hence, if a taxpayer has a legal obligation to bear the expense, has an economic outflow, and benefits from the payment, then the allocation of the deductibility of the transaction costs is that of the taxpayer.

This ruling is significant in determining the allocation of transaction costs. But there are other essential aspects as well in the case of transaction costs incurred, such as bifurcation between facilitative and non-facilitative, and what can be considered as deductible or capitalization in case of non-success-based costs. Taxpayers must conduct a detailed transaction costs study/analysis to ensure that a correct treatment for transaction costs is considered on tax returns.

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