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RE: SELLER'S SUCCESS-BASED TRANSACTION COSTS AND IRS CCA 201624021

Dear Ms. Kroening and Gentlemen:

An internal IRS communication (CCA 201624021) by the National Office to LB&I reaches two conclusions that seem to provide both unfavorably and potentially favorable news for sellers of assets that incur success-based transaction costs. The unfavorable conclusion is that a seller of assets is not eligible to use the Rev. Proc. 2011-29 safe harbor that allows 70% of the success-based costs to be deductible. The Rev. Proc. 2011-29 safe harbor allows an ordinary deduction for

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a large portion of certain success-based transaction fees without the need for any documentation regarding the timeline of when any portion of the services associated with such costs were provided and without regard to whether any portion of such amounts were incurred before or after a nonbinding letter of intent (one of the bright-line dates). The potentially favorable conclusion is that the communication seems to allow for sellers to deduct a portion of success-based fees if appropriate documentation can be demonstrated showing when the related work was provided, even if the taxable asset sale is not a "covered transaction" with respect to the seller.

The following discusses that the unfavorable conclusion reached should be further questioned and that the favorable conclusion is interesting and seemingly confusing. The CCA was released on June 10, 2016 and presents a communication dated July 8, 2015.

It is understood that a CCA is merely an internal communication, but its conclusions are definitely considered by the field and taxpayers in the application of the regulations. The first conclusion reached in the CCA is not surprising and consistent with prior conversations with the National Office, but if this issue should resurface hopefully the additional points raised in this letter are considered in the future administration of both Rev. Proc. 2011-29 and the regulations.

This issue is particularly relevant when the selling entity is a pass-through entity (e.g., an S corporation, partnership, or LLC) having ownership interests owned by individuals. In these situations, claiming an ordinary deduction allows sellers to benefit at the highest tax rate against operating income. If the cost must be capitalized, it will then usually benefit the seller at the lower capital gain rate as an offset against the goodwill being transferred on an asset sale.

The success-based fees referenced in this letter are primarily broker and investment banking fees.

A. Unfavorable Conclusion and Counter Points.

Reg. 1.263(a)-5(e) and Rev. Proc 2011-29 provide favorable guidance that allow a portion of success-based fees to be claimed as an ordinary deduction but only if the fees relate to a "covered transaction," as defined in Reg. 1.263(a)-5(e)(3). The critical discussion is whether a seller of assets fits within the "covered transaction" definition.

Reg. 1.263(a)-5(e)(3)(i) lists as one of three "covered transactions, "A taxable acquisition by the taxpayer of assets that constitutes a trade or business." The position reached in CCA 2016240121 from a plain reading of this regulation is that the reference to "acquisition by the taxpayer" limits the availability of "covered transaction" only to the purchaser who acquires the assets.

While there is no question that a first read would reach the conclusion stated in the CCA, there is much more to this issue that should raise further consideration to whether this is the correct conclusion. The following are a list of points that would support the conclusion that the seller (like the buyer) in an asset sale should also be treating as participating in a "covered transaction."

1. Covered Transaction Definitions.

a. The reference to "taxable acquisition" in Reg 1.263(a)-5(e)(3)(i) would normally include the seller because it is the seller to whom there is a determination of whether the transaction is taxable or tax free.

b. As a second form of "covered transactions," Reg. 1.263(a)-5(e)(3)(ii) refers to "a taxable acquisition of an ownership interest in a business entity….." This can be read broadly to possibly include the seller side of a stock sale, but it can also be read narrowly. This regulation goes on to state that it is applicable to the target corporation. In this context, the target corporation might arguably limited to the entity whose stock is being acquired, rather than the seller of the target's stock, but a broader reading is also possible.

c. As a third form of "covered transactions," Reg. 1.263(a)-5(e)(3)(iii) definitely includes the seller/transferor of assets in a tax free acquisition by specifically referencing the target corporation. In the context of an Section 368(a)(1)(A) merger, a Section 368(a(1)(C) asset transfer, and a Section 368(a)(1)(D) acquisitive reorganization, the target corporation would be the transferor of assets. The reference to the seller in this context provides credence that the seller should also be included in the other two covered transactions listed. There does not seem to be a logical basis to have "covered transactions" include both sides in some transactions and only one side in a taxable asset sale.

2. Acquisition of S corporation and Section 338(h)(10) Election. The CCA quickly dismisses that the stock purchase of an S corporation in a Section 338(h)(10) context could allow Reg. 1.263(a)-5(e)(3)(ii) to apply as "a taxable acquisition of an ownership interest in a business entity," with respect to the target S corporation. The explanation given is, "Target cannot demonstrate stock ownership post-acquisition." No detail is provided on why the requisite post-acquisition stock ownership cannot be demonstrated. In most situations, the fact that the acquirer

and the target corporations are related within the meaning of Section 267(b) or Section 707(b) can easily be shown.

3. Success Fees Related to Covered Transactions. Reg. 1.263(a)-5(e)(1) references the special rules applicable to acquisition transactions costs paid by the taxpayer in the process of investigating or otherwise pursuing a covered transaction described in (e)(3). All taxable asset transactions can be said to be "described in" (e)(3)(i), and the focus on the acquirer and the seller should be irrelevant.

Another way of making this point is that the "covered transaction" refers to a transaction whereby the purchaser obtains an increase in the tax basis of the assets acquired. This is definitely the case in a taxable asset acquisition. Meeting this requirement should be sufficient to reach the conclusion that there is a "covered transaction," which allows the success-based fees incurred by "the taxpayer" (referencing either the acquirer or the seller) are within Reg. 1.263(a)-5(e)(1) and within Rev. Proc. 2011-29. For the purpose of applying Reg. 1.263-5(e)(1), "the taxpayer" who pays the success-based fee should include the acquirer, the seller, and the target.

4. No Discussion from Proposed Regulations supports the CCA 201624021 Conclusion. The proposed regulations were much broader than the final regulations in the description of the transactions to which the Reg. 1.263(a)-5(e) rules applied. The final regulations were drafted to carve out Section 355 spin-offs and totally tax-free Section 351 transactions, but do not discuss carving out the seller in a taxable acquisition transaction.

The final regulations expanded the rules to apply to the acquisition of both intangible and tangible assets. The preamble to the final regulations state that a single set of rules apply to amounts to facilitate an acquisition, regardless of whether the transaction is structured as a stock or asset acquisition. "To avoid the application of one set of rules to intangible assets acquired in the acquisition of a trade or business and a different set of rules to the tangible assets acquired in the acquisition, the final regulations under section 1.263(a)-5 provide a single set of rules for amounts paid to facilitate an acquisition of a trade or business, regardless of whether the transaction is structured as an acquisition of the entity or as an acquisition of assets (including tangible assets) constituting a trade or business."

The position taken in CCA 201624021 negates the stated single set of rules approach by applying a different result for the buyer and the seller in a taxable asset transfer, along with a different result depending on whether there is a taxable asset sale, a taxable stock sale, or a tax-free acquisition.

5. Tax Treatment of Costs relating to Asset Sales. The regulations infer that not all of the seller's success-based costs on a taxable asset sale should be a capitalized cost that reduces the amount realized on the sale. Instead, the regulations acknowledge that a portion of a seller's success-based fees does not need to be capitalized.

Reg. 1.263(a)-5(g)(2)(ii) discusses the treatment of a seller's transaction costs in a taxable asset acquisition and states, "an amount required to be capitalized under this section by the target is treated as a reduction of the target's amount realized on the disposition of its assets." The reference to "an amount required to be capitalized under this section" infers that the 1.263-5 is not intended to automatically capitalize the full amount of success-based fees paid by the selling corporation in a taxable asset sale.

If the seller on an asset transaction would be required to capitalize the full amount of success-based fees in all events, then it would have seemed that the - 5(g)(2)(ii) regulation would have to read that all such amounts incurred by the seller would be a reduction in the amount realized. The wording of Reg. 1.263(a)-5(g)(2)(ii) implies that not all costs are capitalized.

On this point, the final regulations are consistent with the proposed regulations, and the proposed regulations would have actually reached an even more generous result. There is no discussion that the final regulations were to be applied to reach a more narrow result with respect to sellers. The proposed regulations read,

> Reg. 1.263-4(e)(4)(ii)(B) Taxable asset sales. An amount paid to facilitate the sale of assets in a transaction not described in section 368 is not required to be capitalized under this section *unless* the sale is required by law, regulatory mandate, or court order and the sale itself facilitates another transaction referred to in paragraph (e)(1)(i) of this section. For example, where a target corporation, in preparation for a merger with an acquirer, sells assets that are not desired by the acquirer, amounts paid to facilitate the sale are not required to be capitalized as amounts paid to facilitate the merger. Conversely, where a taxpayer, in order to secure regulatory approval for its proposed acquisition of a target corporation, complies with a government mandate to divest itself of a particular trade or business and sells the assets of that trade or business in a taxable sale, amounts paid to facilitate the sale are amounts paid to facilitate the acquisition of the target and must be capitalized under this section.

6. Comparison of Transactions Listed in -5(a) and -5(e). The 1.263-5 regulations provide a general rule of capitalization in -5(a) and an exception in -5(e) for limited

transactions. The general rule of -5(a)(1) covers all asset acquisitions, both on the acquirer and the target side. The same general rule also covers stock acquisitions in -5(a)(2). It is interesting to note that the -5(a)(2) provision applies to, "An acquisition by the taxpayer of an ownership interest in a business entity." Reg -5(a)(2) suffers from the same criticism with respect to the use of the words, "by the taxpayer." Practitioners would not expect that the use of the words "acquisition by the taxpayer" in the general -5(a)(2) rule would cause the IRS to reach a conclusion that such general provision is inapplicable to sellers in a stock transaction.

In the same manner that the use of "by the taxpayer" in -5(a)(2) should not be limited to the acquirer, nor should -5(e)(3)(i) be limited to the acquirer.

7. Rev. Proc. 2011-29. As stated in Rev. Proc. 2011-29 Section 3, the 70% safe harbor is available to a taxpayer for success-based fees for services performed in the process of investigating or otherwise pursuing a "transaction described in 1.263(a)-5(e)(3)." Like the statement in Reg. 1.263-5(e)(1), the Rev. Proc. states that it is applicable to "a transaction described in 1.263(a)-5(e)(3)." The Rev. Proc. does not contain any stated limitation that it is limited to the acquirer with respect to a "covered transaction."

Section 3 clearly reads that the Rev. Proc. applies to any taxpayer that incurs a success-based fee in pursuing a transaction "described in Reg. 1.263(a)-5(e)(3)." There is no question that a taxable asset sale is the type of transaction "described in" Reg. 1.263(a)-5(e)(3). Accordingly, as a transaction described in the regulation, the Rev. Proc. should apply to both the acquirer and the seller.

8. Favorable Language in LB&I Directives. LB&I should consider that its two Directives addressing whether "milestone payments" qualify within the Rev. Proc. are also useful to this discussion. While both LB&I pieces of guidance are applicable only to "covered transactions" within Reg. 1.263-5(e)(3), the Directives make the broad statement that they apply to investment banking fees incurred by either an acquiring or a target corporation.

The regulations could have been written in a manner that is clearer on this issue. If this question resurfaces in the future, this letter is intended to highlight points that surface from the full set of the regulations and from the wording of the related guidance that has since been issued. We hope that this is useful to allow application the favorable administrative Rev. Proc. 2011-29 safe harbor to sellers in a taxable asset transaction.

B. Potentially Favorable Conclusion and Administration of the Tax Laws.

The CCA also contains the following statement, "Taxpayer must capitalize the success-based fees that it claimed as a current expense on its 2012 return, unless it establishes through documentation that a portion of the costs are allocable to activities that do not facilitate the transaction. Treas. Reg. § 1.263(a)-5(f)." (Underlining Added)

The IRS statement seems to open the door to (1) allow for a portion of a success-based fee to be deductible even though the fee does not relate to a "covered transaction" described in Reg. 1.263-5(e)(3) and (2) continue the same level of controversy between selling taxpayers and the IRS regarding 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 the transaction.

Questions and comments are raised by the additional CCA statement.

First, an opportunity seems to be raised by the CCA to allow a deduction based on substantiating documentation showing that a portion of the success-based fees is allocable to activities that do not facilitate a transaction. Prior to such statement, it would have appeared that success-based fees related to transaction that are not considered "covered transactions" would be deemed paid to facilitate a transaction within the meaning of Reg. 1.263(a)-5(a) and (b) and required to be capitalized. It would have also appeared that the documentation exception of Reg. 1.263(a)-5(f) is relevant only to the application of the Reg. 1.263(a)-5(e) bright line dates which is limited to "covered transactions." Under this general approach, if a transaction is not a "covered transaction," then there would be no opportunity to develop documentation to allow any portion of the success-based fee to be deductible.

The IRS statement in CCA 201624021 regarding the breadth of the Reg. 1.263(a)-5(f) documentation exception seem to allow for one of two approaches:

a. Provide deductions to sellers if the documentation can illustrate the portion of the services rendered and the portion of the success-based fee relating to the period prior to the Reg. 1.263(a)-5(e)(1) bright line date.

b. To possibly use the approach that was available prior to the 2003 issuance of Reg.1.263(a)-5.

Second, if the documentation procedure is a method to allow for sellers to claim a deduction for success-based fees (and the Rev. Proc. 2011-29 safe harbor is unavailable), a question to ask is whether this is a good administration of the tax rules. The IRS acknowledges the controversy that surrounds the documentation requirement with respect to obtaining the requisite information from investment bankers and what is acceptable to the IRS. If the IRS accepts that sellers can claim a deduction for success-based fees, then why shouldn't the Rev. Proc. safe-harbor be equally available to sellers. In the same manner that the safe harbor is an administrative solution for buyers, it should be an administrative solution for sellers.

Third, an additional question is raised by the above-quoted statement from the CCA. For all transactions that are not "covered transactions," would the 1.263(a)-5(f) documentation rules be available to claim a deduction in such instances. This would include spin offs and Section 351 and Section 721 transactions.

We hope these comments are useful to any future discussion of the issue addressed by CCA 201624021. If the IRS National Office feels bound to the position stated in the CCA and LB&I is open to accepting a different approach in resolving field issues, one resolution is for LB&I to reach a different conclusion, as it has done with its Directives regarding "milestone" payments.

Thank you for any further consideration of this issue.

Sincerely,

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