

Client Alert.

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IRS Provides 70% Safe Harbor For Deducting Success-Fees in Connection With Capital Restructurings and Acquisitions or Reorganizations

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On April 8, 2011, the Internal Revenue Service (“IRS”) published Revenue Procedure 2011-29 (the “Revenue Procedure”) adopting a safe-harbor election whereby taxpayers may elect to deduct 70% of “success-fees” incurred in connection with certain capital restructurings and acquisitions or reorganizations.

BACKGROUND

Treasury regulations currently provide that certain costs incurred by a taxpayer in connection with certain capital restructurings and acquisitions or reorganizations must be capitalized rather than currently deducted for federal income tax purposes. Specifically, the capitalization rule applies to the following transactions: (1) an acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer in the acquisition or the target of the acquisition), (2) an acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related for certain federal income tax purposes, (3) an acquisition of an ownership interest in the taxpayer (other than an acquisition by the taxpayer of an ownership interest in the taxpayer, whether by redemption or otherwise), (4) a restructuring, recapitalization, or reorganization of the capital structure of a business entity, (5) certain transfers to a corporation controlled by the transferor and certain transfers to a partnership (whether the taxpayer is the transferor or transferee), (6) a formation or organization of a disregarded entity, (7) an acquisition of capital, (8) a stock issuance, (9) a borrowing (including certain exchanges or modifications of debt), and (10) writing an option.

The costs that must be capitalized are amounts paid that facilitate the relevant transaction. An amount is treated as facilitating a transaction if it is paid in the process of investigating or otherwise pursuing the transaction and typically includes an amount paid to determine the value or price of a transaction. In addition, an amount that is contingent on the successful closing of a transaction (a “success-fee”) is presumed to facilitate the transaction. However, a taxpayer may rebut this presumption by maintaining sufficient documentation to establish that a portion of such a success-fee is allocable to activities that do not facilitate the transaction. This documentation must meet certain requirements set forth in Treasury regulations.

SAFE HARBOR

According to the IRS, disagreements between taxpayers and the IRS commonly arise regarding the type and extent of the documentation required to establish that a portion of a success-fee is allocable to activities that do not facilitate the transaction and therefore are currently deductible for federal income tax purposes. To eliminate these disagreements, the

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Revenue Procedure creates a safe harbor election pursuant to which a taxpayer may elect to treat 70% of the amount of the success-fee as an amount that does not facilitate the transaction (and therefore is currently deductible) and to treat the remaining 30% as an amount that does facilitate the transaction (and therefore is capitalized). The Revenue Procedure is effective for success-fees paid or incurred in taxable years ending on or after April 8, 2011.

A taxpayer elects the safe harbor by attaching a statement to its original federal income tax return for the taxable year in which the success-fee is paid or incurred, stating that the taxpayer is electing the safe harbor, identifying the transaction and stating the success-fee amounts that are deducted and the amounts that are capitalized. The election applies only to the transaction for which it is made, is irrevocable and applies with respect to all success-fees paid in the transaction.

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