Bloomberg BNA

Tax Management
Real Estate Journal™

Opportunities and Traps In the Tax Treatment of Transaction Costs and Intangible Asset Costs

By Andy A. Torosyan and Rob Razani[*]

I. INTRODUCTION

Companies buying or selling businesses incur billions of dollars in transaction costs[1] every year. Unlike typical business expenses, there are rules that prevent taxpayers from currently deducting transaction costs and, in some cases, ever deducting these costs.[2]

To clarify this area, in 2003 Treasury and the Internal Revenue Service issued final regulations under §263.[3] Reg. §1.263(a)-4 and Reg. §1.263(a)-5[4] provide comprehensive rules about the treatment of costs related to intangible assets, including transaction costs incurred in mergers and acquisitions and certain real estate transactions. The IRS has also issued guidance for success-based fees (or contingent transaction costs)[5] and for milestone payments.[6] However, it appears the safe harbor provisions for success-based fees exclude sellers' costs in asset sales.

The phrase ''transaction costs'' includes direct and indirect costs. Specifically, costs incurred in facilitating the acquisition or disposition of a trade or business, a change in capital structure, formation of legal entities, borrowings, and other similar transactions. Costs incurred in other transactions, such as construction of real estate and the purchase of machinery also are subject to capitalization. The focus of this article is transactions described in Reg. §1.263(a)-4 and Reg. §1.263(a)-5 with a focus on opportunities and pitfalls.

II. SCOPE OF REG. §1.263(a)-4 — COSTS INCURRED TO ACQUIRE OR CREATE INTANGIBLE ASSETS

In the case of costs related to intangible assets, the IRS clarified that only five types of costs are required to be capitalized under Reg. §1.263(a)-4.

---

[*] Andy A. Torosyan is a tax partner at Holthouse, Carlin & Van Trigt LLP, based in Los Angeles, California (contact: andyt@hcvt.com). Rob Razani is in the Large Business & International business unit of the Internal Revenue Service. (The comments in this article express the author's personal views. To learn about the IRS position on tax matters, visit www.irs.gov). With special thanks to Robert Wiegand, tax associate at Holthouse, Carlin & Van Trigt LLP.

[1] The term ''transaction costs'' refers to expenses incurred when buying and selling securities. These costs commonly include, but are not limited to investment banker fees, accounting fees, lender fees, attorney fees, loan fees, appraiser costs, and SEC fees.

[2] See TAM 200532048 and TAM 200503026 regarding the IRS's treatment of stock issuance costs. The IRS considers stock issuance costs to be the equivalent of selling stock at a discount, which is consistent with GAAP but permanently denies a deduction for the corporation. TAM 200532048. ''[Stock issuance costs] do not create an expense that could give rise to a deduction.'' *Id. But see* §165 (''There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.''); *Charles Ilfeld Co. v. Hernandez*, 292 U.S. 62 (1934) (permitting only one deduction for a single economic loss); *Woods Inv. Co. v. Commissioner*, 85 T.C. 274 (1985) (allowing a duplicate deduction for a single economic loss in certain instances when statutory interpretation provides); *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001) (holding that the duplicated loss component of Reg. §1.1502-20 of the Income Tax Regulations, which disallows certain losses on sales of stock of a member of a consolidated group, is an invalid exercise of regulatory authority for its inequitable treatment of consolidated groups). See discussion under heading ''Stock Issuance Costs,'' below.

[3] Unless otherwise indicated, all ''§'' references herein are to the Internal Revenue Code of 1986, as amended (the ''Code'').

[4] All ''Reg. §'' references herein are to the Treasury Regulations published as Title 26 of the Code of Federal Regulations (26 C.F.R.).

[5] Rev. Proc. 2011-29, 2011-18 I.R.B. 746.

[6] CCA 201234027.

Amounts Paid to Acquire Intangible Assets

First, taxpayers must capitalize amounts paid to another party to acquire any intangible in a purchase.[7] This includes the acquisition of an ownership interest in an entity, a debt or financial instrument, an annuity or insurance contract, a lease, or a mortgage servicing right.[8]

Amounts Paid to Create Intangible Assets

Second, taxpayers must capitalize amounts paid to create certain intangible assets,[9] including costs paid to another party to create, originate, enter into, renew, or renegotiate[10] a financial interest with that party.[11] A financial interest includes an ownership interest in an entity, a debt instrument, and a financial instrument such as a letter of credit or a financial derivative.[12]

Taxpayers also must capitalize prepaid expenses;[13] amounts paid to an organization to obtain, renew, renegotiate, or upgrade a membership in that organization;[14] and amounts paid to a governmental agency to obtain, renew, renegotiate, or upgrade its rights under a trademark, copyright, license, permit, or similar right granted by that agency.[15]

Taxpayers also are required to capitalize amounts paid to another party to create, originate, enter into, renew, or renegotiate certain contract rights with that party.[16] For example, Lessee seeks to enter into a commercial lease in an exclusive location with Lessor. Lessee pays $50,000 to Lessor in exchange for Lessor's agreement to lease the property to Lessee. A 10-year lease is entered into by the parties, providing for monthly rental payments. Lessee's $50,000 payment to Lessor represents an amount paid to another party to enter into an agreement providing Lessee the right to use tangible property. Because the payment is not de minimis, Lessee must capitalize the $50,000 payment.[17] Similarly, if Lessee makes a $50,000 payment to Lessor when the lease has three years remaining on its term, seeking to modify the lease and extend its term by five additional years, the payment must be capitalized. The payment represents an amount paid to another party to renegotiate an agreement providing Lessee the right to use property.[18] However, the parties to a lease agreement should examine the terms of a lease closely. In the example above, if the original 10-year lease provided Lessee with the right to terminate the lease at any time by paying Lessor a $75,000 early termination fee, then Lessee's exercise of that right and payment of the fee need not be capitalized. Lessee's payment in these circumstances is not a payment to another party to renegotiate an agreement.[19] In general, termination payments are deductible if the payments are not tied to approval rights of the lessor/landlord.[20] Additionally, if Lessor paid outside counsel $7,000 to draft and negotiate the agreement, Lessor's payment to its outside counsel is an amount paid to facilitate the creation of that agreement and would have to be capitalized.[21]

Capitalization is not required for amounts paid by a lessor to a lessee as a construction allowance, to the extent the lessee spends the money on property owned by the lessor.[22] There is also a $5,000 de minimis exception.[23]

Taxpayers are also required to capitalize amounts paid to another party to terminate (i) a lease between the taxpayer (lessor) and the lessee; (ii) an agreement that grants that party the exclusive right to acquire or use the taxpayer's property or services or to conduct the taxpayer's business; or (iii) an agreement that prohibits the taxpayer from competing with that party or from acquiring property or services from a competitor of that party.[24]

A taxpayer also must capitalize amounts paid for real property if the taxpayer transfers ownership of the real property to another person and it is reasonable to expect the taxpayer to receive significant economic benefits from the real property after the transfer.[25] Further, a taxpayer must capitalize amounts paid to produce or improve real property owned by another party if it is reasonable to expect the taxpayer to re-

---

[7] Reg. §1.263(a)-4(c).

[8] *See* Reg. §1.263(a)-4(c) for a detailed list and examples.

[9] The regulations allow taxpayers a deduction for certain intangibles that meet the 12-month rule contained in Reg. §1.263(a)-4(f), such as prepaid expenses.

[10] A renegotiation includes a modification of the terms of a contract and in certain cases a termination of a contract. Reg. §1.263(a)-4(d)(2)(iii).

[11] Excluded from this capitalization requirement are payments made with the mere hope of developing or maintaining a business relationship with that party. Reg. §1.263-4(d)(2)(ii).

[12] *See* Reg. §1.263(a)-4(d) for a detail list and examples.

[13] Reg. §1.263(a)-4(d)(3).

[14] Reg. §1.263(a)-4(d)(4).

[15] Reg. §1.263(a)-4(d)(5).

[16] Reg. §1.263(a)-4(d)(6).

[17] Reg. §1.263(a)-4(d)(6)(vii), *Ex. 1*.

[18] *Id. Ex. 2.*

[19] *Id. Ex. 4.*

[20] *See id. Exs. 3*, *4*, and *5*.

[21] *See* Reg. §1.263(a)-4(e)(5), *Ex. 3*.

[22] Reg. §1.263(a)-4(d)(6)(vi).

[23] Reg. §1.263(a)-4(d)(6)(v).

[24] Reg. §1.263(a)-4(d)(7). This section does not apply to break-up fees of a transaction described in Reg. §1.263(a)-5(a). *See* Reg. §1.263(a)-5(c)(8).

[25] Reg. §1.263(a)-4(d)(8). Sales for fair value are excluded.

ISSN 8755-0628

ceive significant economic benefits from the real property.[26] For example, Corporation operates a quarry on one side of a city's river and a stone crusher on the other. Corporation must transfer stone from its quarry to its crusher using the city's existing bridges. The city's existing bridges are insufficient to accommodate Corporation's trucks, thereby reducing Corporation's productivity. Corporation contributes $1,000,000 to the city to defray in part the cost of constructing a publicly owned bridge capable of accommodating Corporation's trucks. The payment to the city to improve the bridge is reasonably expected to produce significant economic benefits for Corporation. Therefore, Corporation must capitalize the $1,000,000 payment.[27] If Corporation also transfers real property to the city in connection with its contribution, Corporation would capitalize both the adjusted basis of the real property contributed and the $1,000,000 payment.[28]

Taxpayers are not required to capitalize amounts paid to satisfy one-time charges imposed by a state or local government against new development to finance specific off-site capital improvements for general public use that are necessitated by the new or expanded development, and taxpayers are not required to capitalize amounts paid for real property or improvements to real property constructed by the taxpayer where the real property or improvements benefit new development or expansion of existing development, are immediately transferred to a state or local government for dedication to the general public use, and are maintained by the state or local government.[29] For example, if Corporation is engaged in the development and sale of residential real estate and is required by the city to construct ingress and egress roads to and from its project and immediately transfer the roads to the city for dedication to general public use, Corporation is not required to capitalize these amounts.[30] Taxpayers are required to capitalize amounts paid to another party to defend or protect title to intangible property if that other party challenges the taxpayer's title to the intangible property.[31]

Amounts Paid to Create Separate and Distinct Intangible Assets

Taxpayers must capitalize amounts paid to create or enhance a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable state, federal, or foreign law and the possession and control of which is intrinsically capable of being sold, transferred, or pledged separate and apart from a trade or business.[32]

Amounts Paid to Create a Future Benefit

Taxpayers must capitalize amounts listed in any published guidance identifying the future benefit of such intangible.[33] To date, no guidance has been issued.

Amounts Paid to Facilitate the Acquisition or Creation of an Intangible

Taxpayers must also capitalize amounts paid to facilitate the acquisition or creation of the intangible assets described in Reg. §1.263(a)-4.[34] This includes investigatory costs incurred in determining whether to pursue a transaction. However, the regulations permit a deduction for investigatory costs that are incurred before the earlier of the date the taxpayer begins preparing its bid for the agreement or the date the taxpayer begins discussing or negotiating the agreement with another party to the agreement.[35] The regulations also permit a deduction for employee compensation, overhead, and de minimis costs.[36]

In PLR 201447004, the IRS ruled privately that a manufacturer did not have to capitalize payments made to another manufacturer under a development agreement where the agreement provided no obligation to produce goods or final selling price. The agreement simply granted the purchasing manufacturer exclusivity if the parts were produced. The IRS reasoned that, although the payments made under the agreement were part of a strategy intended to result in sales, the payments were not part of a plan to create or acquire an interest in an identifiable intangible asset. Therefore, they were not required to be capitalized.[37]

---

[26] *Id.* There is an exception for taxpayers selling services for fair market value to produce or improve the real property.

[27] *See* Reg. §1.263(a)-4(d)(8)(v), *Ex. 1*.

[28] *See id. Ex. 2*.

[29] Reg. §1.263(a)-4(d)(8)(iv). Capitalization may be required under §263A.

[30] *See* Reg. §1.263(a)-4(d)(8)(v), *Ex. 3*.

[31] Reg. §1.263(a)-4(d)(9).

[32] Reg. §1.263(a)-4(b)(3). See the exceptions under Reg. §1.263(a)-4(b)(3).

[33] Reg. §1.263(a)-4(b)(2).

[34] Reg. §1.263(a)-4(e).

[35] Reg. §1.263(a)-4(e)(1)(iii).

[36] Reg. §1.263(a)-4(e)(4).

[37] PLR 201447004.

ISSN 8755-0628

III. BACKGROUND ON TAX TREATMENT OF TRANSACTION COSTS INCURRED IN MERGERS AND ACQUISITIONS

Under generally accepted accounting principles (GAAP), transaction costs are treated as an expense in the year incurred.[38] Given that the default rule for income tax purposes is to capitalize transaction costs, it is critical to identify and correctly report transaction costs for income tax purposes.

Section 263(a) provides for the capitalization of the following expenditures:

> (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate . . . [and]
>
> (2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Court decisions aid in understanding the statutory wording. In *Woodward v. Commissioner*,[39] the United States Supreme Court held that the majority shareholders must capitalize the fees paid to their advisers. The Court noted that ''courts have held that legal, brokerage, accounting, and similar costs incurred in the acquisition or disposition of [property having a useful life substantially beyond the taxable year] . . . are capital expenditures.''[40] The Court went on to say, ''such ancillary expenses incurred in acquiring or disposing of an asset are as much part of the cost of that asset as is the price paid for it.''[41]

In *Commissioner v. Lincoln Sav. & Loan Ass'n*,[42] the Supreme Court held that ''the presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year.'' The effect of this decision was to permit taxpayers to continue to assert the argument that expenditures not creating a separate and distinct asset were currently deductible costs.

The next important decision in this trilogy of cases was *INDOPCO Inc. v. Commissioner*.[43] In *INDOPCO*, the Supreme Court held that the buyer must capitalize costs of facilitating its purchase of another corporation. Moreover, it did not matter that those expenditures did not create a separate and distinct asset.

Litigation continued, and taxpayers received a favorable ruling in 2000 from the Eighth Circuit Court of Appeals.[44] The court held, and the IRS conceded, that the taxpayer's costs of investigating the expansion of the taxpayer's business were deductible under §162.

In 2003, Reg. §1.263(a)-4 and §1.263(a)-5 were issued to provide bright-line tests for the treatment of certain costs related to intangible assets, including transaction costs incurred in mergers and acquisitions and certain real estate transactions. Some commentators called these regulations the anti-*INDOPCO* regulations because they permit taxpayers to deduct certain costs notwithstanding the broad reach of the *INDOPCO* decision.

IV. SCOPE OF REG. §1.263(a)-5 — COSTS INCURRED TO FACILITATE CERTAIN TRANSACTIONS

If Reg. §1.263(a)-5 does not compel capitalization, taxpayers still must determine whether other provisions of the Code apply. For example, a taxpayer might incur costs in starting a new business. Such costs would be subject to the capitalization and amortization rules of §195.[45] However, if a taxpayer was already in that line of business, the costs may qualify as an expansion cost deductible under §162.[46]

To be claimed as a deduction on a tax return, transaction costs must (i) navigate the rules in Reg. §1.263(a)-5, and (ii) qualify for the exceptions under other capitalization provisions in the Code. The default rule of Reg. §1.263(a)-5 is that a taxpayer must capitalize costs incurred to ''facilitate'' certain transactions. Under Reg. §1.263(a)-5(a), these facilitative costs include the following.

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

[38] ASC 805-10-25-23.

[39] 397 U.S. 572, 576 (1970).

[40] *Id.*

[41] *Id. See also Ellis Banking Corp. v. Commissioner*, 41 T.C.M. 1107 (1981), *aff'd in part*, 688 F.2d 1376 (11th Cir. 1982).

[42] 403 U.S. 354 (1971).

[43] 503 U.S. 79 (1992).

[44] *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874, 888 (8th Cir. 2000), *aff'g in part, rev'g in part Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999). *See also PNC Bancorp, Inc. v. Commissioner*, 212 F.3d 822 (3d Cir. 2000).

[45] Note that if a transaction is covered by both Reg. §1.263(a)-5 and Reg. §1.263(a)-4, then the rules of Reg. §1.263(a)-5 govern. Reg. §1.263(a)-5(b)(2). In general, Reg. §1.263(a)-4 relates to costs related to the creation of intangible assets in transactions that are not M&A-related — for example, a patent registration fee.

[46] *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973).

ISSN 8755-0628

the acquisition, the taxpayer and the business entity are related within the meaning of §267(b) or §707(b). (See Reg. §1.263(a)-4 for rules requiring capitalization of amounts paid by the taxpayer to acquire an ownership interest in a business entity, or to facilitate the acquisition of an ownership interest in a business entity, where the taxpayer and the business entity are not related within the meaning of §267(b) or §707(b) immediately after the acquisition.)

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). See n. 67, below.

4. A restructuring, recapitalization, or reorganization of the capital structure of a business entity (including reorganizations described in §368 and distributions of stock by the taxpayer as described in §355). This also includes amounts paid to determine value or price of the transaction[47] and amounts paid by a taxpayer-debtor to institute or administer a proceeding under Chapter 11 of the Bankruptcy Code.[48]

5. A transfer described in §351 or §721 (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.[49]

9. A borrowing. For purposes of this section, a borrowing means any issuance of debt, including debt issued in an acquisition of capital or recapitalization. A borrowing also includes debt issued in a debt-for-debt exchange under Reg. §1.1001-3; and

10. Writing an option.

The word ''facilitate'' is defined in Reg. §1.263(a)-5(b) as the ''process of investigating or otherwise pursuing the transaction.'' In practical terms, ''facilitative'' costs include the costs for due diligence, investigating various facts or assertions with respect to the transaction, determining the value or price, negotiating the terms of the transaction, and reaching an agreement.

In other words, most direct and indirect transaction costs are potentially subject to capitalization under these regulations.

Covered Transactions

The regulations provide an exception to the general rule of capitalization for ''covered transactions.'' Reg. §1.263(a)-5(e)(1) provides that the costs of facilitating covered transactions are only required to be capitalized if they relate to activities performed after a ''bright-line date.''[50] Covered transactions include: (1) a taxable asset acquisition by the taxpayer;[51] (2) a taxable acquisition by the taxpayer of interest in a business entity (whether the taxpayer is the acquirer or target) if after the acquisition the taxpayer and the business entity are ''related;''[52] and (3) a tax-free acquisitive reorganization as defined in §368.[53] Notably missing in this definition is a taxable sale of assets by the taxpayer.

Therefore, taxpayers who meet the covered transaction definition must look to the ''bright-line'' date to achieve their goal of deductibility. The ''bright-line'' date is the earlier of (1) the date when the parties to the transaction execute a letter of intent, exclusivity agreement, or similar written document (''term sheet''),[54] or (2) the date on which taxpayer's board of directors authorizes and approves the material terms of the transaction.[55] The acquirer and target must reach agreement on material terms or execute a term sheet. If otherwise, the bright-line date remains open. However, once the parties agree on a term sheet, the costs become subject to capitalization under these regulations.

Once a term sheet is agreed to, taxpayers must evaluate two other rules. First, the regulations require capitalization for ''inherently facilitative costs'' no matter when incurred. Second, Reg. §1.263(a)-5 specifically excludes certain costs from capitalization.

[47] Reg. §1.263(a)-5(b)(1).

[48] Reg. §1.263(a)-5(c)(4).

[49] The regulations reserve guidance on the treatment of capitalized stock issuance costs. Reg. §1.263(a)-5(g)(3). However, while the regulations seem to indicate capitalization is required, the IRS issued guidance that a netting approach is proper. See n. 2, above. Query: Which is more proper? It seems the regulations mandate capitalization.

[50] The term ''bright-line date'' is found only in the preamble to the regulations. See Proposed Regulations (REG-125638-01) issued December 19, 2002, Explanation of Provisions, Section V.B. and T.D. 9107, Explanation of Provisions, Section III.E.

[51] Reg. §1.263(a)-5(e)(3)(i).

[52] Reg. §1.263(a)-5(e)(3)(ii). A business entity includes a partnership. The term ''related'' in this context is defined by §267(b) or §707(b). *Id.*

[53] Reg. §1.263(a)-5(e)(3)(iii). The regulation refers to type ''A,'' ''B,'' ''C,'' or acquisitive type ''D'' reorganizations where the target's assets are absorbed by the taxpayer under either §354 or §356. *Id.*

[54] Reg. §1.263(a)-5(e)(1)(i). The regulations exclude confidentiality agreements. *Id.*

[55] Reg. §1.263(a)-5(e)(1)(ii).

ISSN 8755-0628

Under Reg. §1.263(a)-5(e)(2), inherently facilitative costs that are required to be capitalized are:

1. Getting an appraisal, formal written evaluation, or fairness opinion;
2. Negotiating the structure and getting tax advice;
3. Preparing and reviewing the documents for the deal;
4. Getting regulatory approval, including regulatory filings;
5. Obtaining shareholder approval;
6. Conveying property between the parties (for example, transfer taxes and title registration costs); and
7. Costs to figure out value or price of the deal.[56]

A list of costs which are not capitalizable under Reg. §1.263(a)-5 regardless of when incurred include the following:

1. Costs of asset sales, not in connection with the sale of a trade or business;[57]
2. Mandatory stock distributions;[58]
3. Liquidation costs;[59]
4. Stock issuance costs of open-end regulated investment companies;[60]
5. Integration costs;[61]
6. Registrar and transfer agent fees for the maintenance of capital stock records;[62]
7. Termination payments are deductible only if the termination does not facilitate a second transaction which is mutually exclusive;[63]
8. Overhead;[64]
9. Certain amounts treated as employee compensation;[65]
10. De minimis and internal costs;[66]
11. Redemption costs;[67] and
12. Fees associated with early retirement of debt.[68]

---

[56] Reg. §1.263(a)-5(b).

[57] Reg. §1.263(a)-5(c)(2). This is true regardless of the taxpayer's motivations. *See* T.D. 9107, 2004-1 C.B. 447. For example, a target corporation can sell assets not desired by the acquiring corporation to a third party immediately before a merger without having to capitalize the costs associated with the sale of the unwanted assets. In general a sale of a group of assets that includes goodwill is considered a sale of a business and would be subject to capitalization under Reg. §1.263(a)-5. Reg. §1.197-2(e)(1).

[58] Reg. §1.263(a)-5(c)(3).

[59] Reg. §1.263(a)-5(c)(4). This regulation requires capitalization of costs incurred in connection with a Chapter 11 Bankruptcy proceeding and does not extend to costs incurred in a Chapter 7 Bankruptcy proceeding, which generally involves the liquidation of the debtor. Costs associated with a liquidating bankruptcy appear to be deductible. *See, e.g.,* Rev. Rul. 77-204, 1977-1 C.B. 40 (1977).

[60] Reg. §1.263(a)-5(c)(5).

[61] Reg. §1.263(a)-5(c)(6). This is true regardless of when the integration activities occur. *Id.*

[62] Reg. §1.263(a)-5(c)(7).

[63] TAM 200749013 (''If a taxpayer investigates and pursues multiple separate transactions, costs properly allocable to any abandoned transactions are deductible even if some transactions are completed. Further, if a taxpayer engages in a series of transactions and abandons one of those transactions, a loss is allowed even if the taxpayer later proceeds with a similar transaction. [The] authorities allow a deduction upon the abandonment of a proposed transaction even if subsequent or alternative transactions are pursued. By contrast, if the proposals are mutually exclusive alternatives, meaning that only one can be completed, then no abandonment loss is proper unless the entire transaction is abandoned. The costs of pursuing any alternatives not consummated must be capitalized as part of the cost of the completed alternative.'') (citations omitted). *See also* Reg. §1.263(a)-5(l), *Exs. 12*, *13*, and *14*.

[64] Reg. §1.263(a)-5(d)(1). Overhead costs include fixed costs, such as rent, utilities, and depreciation. I.R.M. 32.1.4, *Published Guidance and Other Guidance to Taxpayers* (Oct. 11, 2011).

[65] Reg. §1.263(a)-5(d)(2). ''The term employee compensation means compensation (including salary, bonuses and commissions) paid to an employee of the taxpayer. For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.'' Reg. §1.263(a)-5(d)(2)(i).

[66] Reg. §1.263(a)-5(d)(3). De minimis costs refer to amounts (other than employee compensation and overhead) that are attributable to investigating or otherwise pursuing a transaction and in the aggregate do not exceed $5,000. Reg. §1.263(a)-5(d)(3)(i).

[67] Reg. §1.263(a)-5(a)(3) removed redemptions expenses from the scope of the Reg. §1.263(a)-5 regulations. They must be capitalized under either §162(k) or Reg. §1.263(a)-4. Which one remains uncertain. Regardless, it is worth noting that corporations must file Form 1099 when redeeming stock. IRS Publication 17: Your Federal Income Tax (Nov. 26, 2013).

[68] Costs associated with borrowings are capitalized and amortized over the term of the debt. See n. 82, below. Generally if the original debt instrument is terminated through either defeasance (the substitution of collateral which in effect terminates the original agreement) or early repayment of the debt, then the costs associated with the initial borrowing are immediately deductible (as are any prepayment penalties or defeasance premiums). *Schoellkopf Products Inc. v. Commissioner*, 65 T.C. 640 (1975); Rev. Rul. 57-198, 1957-1 C.B. 94 (1957); Blake D. Rubin, Andrea Macintosh Whiteway and Jon G. Finkelstein, *Tax Planning for Conduit Loan Defeasance Transactions, Including Like-Kind Exchanges*, J. Passthrough Entities 11 (2006). However, the rules get more complicated when a taxpayer pays off the original debt instrument with the proceeds received from a new debt. If the new loan originates from a different lender, then the fees associated with the original loan should be currently deductible. However,

ISSN 8755-0628

As noted earlier, taxpayers still have to figure out whether other provisions of the Code apply to prevent a current deduction.

Treatment of Capitalized Costs

Acquirer Costs

Reg. §1.263(a)-5(g) provides guidance with regard to the treatment of capitalized costs. Buyers in taxable stock or asset purchases must add the capitalized transaction costs to the basis of the stock or assets.[69]

Seller Costs

Targets in taxable asset dispositions, including real estate, use capitalized transaction costs as a reduction in the amount realized;[70] however, the regulation writers reserved the section for taxable stock dispositions.[71] It appears target shareholders have alternative ways to account for transaction costs. Target shareholders can choose to reduce the amount realized[72] or increase the basis.[73] There are authorities on both sides, and the regulations are silent; therefore, it seems reasonable to conclude that target shareholders have a choice.

Costs in Tax-Free Acquisitive Transactions

The regulation writers also reserved the section for tax-free acquisitive transactions.[74]

Reporting Transaction Costs on Tax Returns

As a result of these rules, the buyer and the seller will have different amounts to report on the purchase price allocation forms. On the one hand the buyer will increase purchase price while the seller will decrease sale price. Therefore, the total amounts will not match on forms like Form 8894 and Form 8883.

In an asset sale that involves future payments that qualify for installment sale treatment, it is unclear whether the transaction costs reduce the amount realized or increase the basis of assets. The regulations under §453[75] require an increase to the basis, while Reg. §1.263(a)-5 requires a reduction of the amount realized; presumably Reg. §1.263(a)-5 controls.

Stock Issuance Costs

The subsection that deals with stock issuance transactions is reserved.[76] As mentioned previously, the IRS ruled that the proper accounting for these costs is to net them with the proceeds received. (See note 2, above). However, by netting the corporation pays stock issuance costs but does not record such costs on its balance sheet. For example, if the corporation pays $1,000,000 to print stock certificates in an issuance and the corporation raises $100,000,000, the entry, without netting, would be as follows:

Entry 1	Debit	Credit
Cash	$100,000,000	
Common stock and additional paid in capital		$100,000,000
Entry 2	Debit	Credit
Stock issuance costs	$100,000,000	
Cash		$100,000,000

The stock issuance costs would not be currently deductible based on Reg. §1.263(a)-5 and *INDOPCO*. However, these costs would be an asset on the tax balance sheet. The regulations contemplate this and have reserved guidance on whether and when a taxpayer can recover such costs.[77]

The IRS netting approach described in TAM 200532048 would result in the following entries:

Entry 1	Debit	Credit
Cash	$99,000,000	
Common stock and additional paid in capital		$99,000,000

The company would still issue Forms 1099 to the service providers for the $1,000,000 paid to create certificates. The service provider would recognize income for services rendered. However, no deduction would be available to the company because the balance sheet shows only the net amount.[78]

---

when the new loan originates from the same lender, the taxpayer will be required to capitalize the costs associated with the original loan over the term of the new instrument unless the loan is considered separate and independent of the original. *Schoellkopf Products Inc. v. Commissioner*. There is a series of cases following *Schoellkopf* that specifically address whether or not a new loan is separate from and independent of the original. *See Sleiman v. Commissioner*, 74 T.C.M. 1270 (1997), *aff'd*, 187 F.3d 1352 (11th Cir. 1999); *Wilkerson v. Commissioner*, 655 F.2d 980 (9th Cir. 1981); *Williams v. Commissioner*, 42 T.C.M. 1616 (1981); *Lay v. Commissioner*, 69 T.C. 421 (1977); FSA 200207011.

[69] Reg. §1.263(a)-5(g)(2)(i).

[70] Reg. §1.263(a)-5(g)(2)(ii)(A).

[71] Reg. §1.263(a)-5(g)(2)(ii)(B).

[72] *See* TAM 200503026.

[73] See discussion under heading "Accounting for Seller's Transaction Costs in Stock Sales," below.

[74] Reg. §1.263(a)-5(g)(1).

[75] Reg. §15a.453-1(b)(2)(v).

[76] Reg. §1.263(a)-5(g)(3).

[77] *Id.*

[78] Similar to stock issuance costs, syndication costs for partnerships include brokerage fees, registration fees, legal fees of the underwriter or placement agent and the issuer (the general partner or the partnership) for securities advice and for advice pertaining

ISSN 8755-0628

Accounting for Seller's Transaction Costs in Stock Sales

The IRS treatment of stock issuance costs is one of the pitfalls confronting tax advisors. Often sellers pay the transaction costs with funds from the buyer. In these instances, the costs paid are a reduction in the proceeds received by the seller. For example, if a buyer furnishes $100,000,000 for the stock of the target and $1,000,000 goes toward the transaction costs, the seller would receive only $99,000,000. However, the sellers would report $100,000,000 as the amount realized because that amount includes costs paid on behalf of the sellers.

However, these transaction costs do not belong to the sellers. Although the sellers indirectly paid these costs because they reported $100,000,000 as the amount realized, the sellers actually received only $99,000,000. The transaction costs are properly identified as those of the target because the target is the beneficiary of these costs. Moreover, the target, not the sellers, hired the advisers. The target is properly the beneficiary of the transaction costs because the buyer will continue the target's business operations.[79] Therefore, the sellers add these costs to their stock basis because the amount of the transaction costs represents a capital contribution.[80] The sellers have an amount realized of $100,000,000 and increase their stock basis by $1,000,000.

The target would capitalize or deduct the $1,000,000 of transaction costs by comparing the dates it incurred the costs to the bright-line date. The target can benefit from a diligent adviser when it accounts for the transaction costs.

This result is identical to having the buyer pay $100,000,000 to the sellers and then having the sellers take $1,000,000 and contribute it to the capital of the target to pay the transaction costs immediately before the shares are transferred to buyer. The steps are simplified by having the buyer pay $99,000,000 to the sellers and pay $1,000,000 of transaction costs on behalf of the target.[81]

Borrowing Costs

Reg. §1.263(a)-4(e)(1)(iv) and Reg. §1.263(a)-5(g)(4) provide that Reg. §1.446-5 governs capitalized costs paid to facilitate any borrowing. Under Reg. §1.446-5 these costs are recovered over the term of the debt and are treated as a reduction in net proceeds that creates original issue discount.[82]

Costs Associated with Writing an Option

Costs that facilitate writing an option are not currently deductible.[83] Instead, these costs are a reduction to the premium the writer receives.[84]

Method Changes

If a taxpayer has incorrectly accounted for transaction costs, it must seek permission to change to the correct method of accounting by filing Form 3115.[85] In the taxpayer's first taxable year, it is automatically granted the consent of the Commissioner to change its method of accounting if it follows the administrative procedures set forth under Reg. §1.446-1(e)(30)(ii).[86] In subsequent years, it appears the Commissioner has discretion whether to grant approval.

to the adequacy of tax disclosures in the prospectus or placement memorandum for securities law purposes, accounting fees for preparation of representations to be included in the offering materials, and printing costs of the prospectus, placement memorandum, and other selling and promotional material. Under Reg. §1.709-2(b), syndication costs are capitalized. These costs would be capitalized as an intangible asset on the balance sheet. *See* Rev. Rul. 89-11, 1989-1 C.B. 179 (1989); *see also* Rev. Rul. 85-32, 1985-1 C.B. 186 (1985); Rev. Rul. 88-4, 1988-1 C.B. 264 (1988). On liquidation, Reg. §1.709-2(b)(3)(i) precludes a deduction as well — but only for the partnership; partners are not referenced. However, Rev. Rul. 87-111 makes it clear that although a partner may not claim a deduction, these costs remain in a partner's outside basis. Therefore, a partner receiving only cash on liquidation would have a capital loss under §731(a)(2), or by analogy, a partner receiving other property would take as her basis in that property, her outside basis under §732. This would preserve her outside basis as an offset to the proceeds upon a later disposition of that property. Rev. Rul. 87-111's conclusion permits one to draw the inference that the intangible asset has no value in liquidation or that the asset leaves the balance sheet before liquidation. The costs do have value because the partnership raised capital. Therefore, like stock issuance costs, the costs will be a charge against the partners' capital accounts, but unlike stock issuance costs, the debit will not occur until liquidation. The treatment under §704(b) is like stock issuance costs. Under Reg. §1.704-1(b)(2)(iv)(*i*), syndication costs are not capitalized; instead they reduce the partners' §704(b) capital accounts immediately. Therefore, the treatment of syndication costs for tax purposes differs from the treatment under §704(b). The latter uses a netting approach like stock issuance costs. These approaches are inconsistent with one another.

[79] *See, e.g., Wells Fargo & Co. v. Commissioner*, 224 F.3d 874 (8th Cir. 2000), *aff'g in part, rev'g in part Norwest Corp. v. Commissioner*, 112 T.C. 89 (1999); PLR 9326001.

[80] *Craft v. Commissioner*, 90 T.C.M. 149 (2005). Such payments constitute either capital contributions or loans to the corporation. *Deputy v. Du Pont*, 308 U.S. 488, 494 (1940).

[81] Presumably this approach would cause the seller's transaction costs to be capitalized into basis under §453 instead of reducing the amount realized under Reg. §1.263(a)-5(g)(2)(ii)(A). This impacts the seller's reporting of an installment sale.

[82] The regulations treat debt issuance costs as a reduction in the issue price of a debt instrument. *See* Reg. §1.446-5(b)(1). The taxpayer will amortize the debt issuance costs over the term of the debt using the constant yield method. *Id.*

[83] Reg. §1.263(a)-5(g)(5).

[84] *Id.*

[85] Reg. §1.263(a)-5(n).

[86] *Id.*

ISSN 8755-0628

Coordination with Other Provisions of the Internal Revenue Code

Nothing in this Reg. §1.263(a)-5 changes the treatment of an amount expressly provided for under another provision of the Internal Revenue Code (other than §162(a) or §212) or regulations thereunder.[87]

Treatment of Indirect Payments

For the purposes of Reg. §1.263(a)-5, references to amounts paid to or by a party include amounts paid on behalf of that party.[88]

V. SUCCESS-BASED FEES OR CONTINGENT TRANSACTION COSTS

Reg. §1.263(a)-5(f) defines all expenditures for which payments are contingent on the successful close of the transaction as ''success-based fees'' and provides them special treatment. Under the regulations, success-based fees are presumed to facilitate a deal. The regulations provide an exception to the extent the taxpayer maintains sufficient documentation to show that costs can be allocated to activities that do not facilitate a transaction.[89] This documentation must be completed by the filing deadline (including extensions) for the year in which the transaction closes.[90] The regulation also provides guidance on the type of documentation necessary to support a deduction for success-based fees. The regulation requires documents (such as itemized invoices and time records) that identify the service provider, the various activities performed, and the amount or percentage of the fee allocated to each activity.[91] For covered transactions, the regulation also demands the substantiation of amounts allocated to activities before and after the bright-line date.[92]

Practical Problems in Application of the Success-Based Fee Rules

The stricter requirement for substantiation and record keeping for success-based fees are understandable. After all, an arrangement that makes a payment for services contingent on the successful completion of the transaction creates a presumption that those services facilitate that transaction. However, things do not always work out as neatly as described in the regulations. Sometimes taxpayers pay success-based fees to a service provider who performs a variety of services. Although success-based fees most often go to investment bankers, the invoices often describe both facilitative and non-facilitative services. For the documentation to be acceptable under Reg. §1.263(a)-5(f), an invoice must provide sufficient detail, such as time charged to each activity, to enable the taxpayer to allocate the fee correctly. However, investment-banking firms usually do not require daily time sheets for each project.

The taxpayer might allocate the fee using estimates and making educated guesses; however, that is insufficient under the regulation.[93] Alternatively, the taxpayer could ask for additional detail from the service provider. Under the regulation, the documentation to support the taxpayer's allocation must be gathered by the deadline provided in the regulation — that is, by the extended due date for the tax return for the year in which the taxpayer completes the deal. However, the IRS has granted extensions of time for completing the required documentation.[94]

Suppose the taxpayer used the invoices to allocate its costs, and the IRS challenges the allocation during an examination. If the invoice is insufficient to support the taxpayer's allocation, the entire success-based fee will have to be capitalized because the deadline for gathering support is the extended due date of the tax return.

The taxpayer could request a ruling about the adequacy of its documentation to support the allocations proposed for its tax return. The taxpayer would provide the documentation and the allocation it proposes for its tax return, and request the IRS to rule that its proposed allocations are correct. Even though a positive ruling would provide assurance to the taxpayer, many are reluctant to go this route for a couple of reasons. First, the taxpayer must pay for a ruling, but the primary concern would be that the IRS would issue an adverse ruling. The IRS has not encouraged taxpayers to request rulings, and the IRS has not issued any ruling on this issue to date.

Another issue arises for success-based fees for covered transactions. As discussed earlier, the documentation for this type of cost must support the taxpayer's allocation to activities before the bright-line date. However, taxpayers agree to an amount for success-based fees before the service provider provides any services. When the deal closes, the taxpayer gets a bill

[87] Reg. §1.263(a)-5(j).

[88] Reg. §1.263(a)-5(k).

[89] Reg. §1.263(a)-5(f).

[90] *Id.*

[91] Reg. §1.263(a)-5(f)(1), §1.263(a)-5(f)(2).

[92] Reg. §1.263(a)-5(f)(3).

[93] Reg. §1.263(a)-5(f).

[94] *See, e.g.,* PLR 200837005, in which the IRS extended the due date where the taxpayer miscalculated the due date of the return. *See also* PLR 200907018 and PLR 200945007 (time was extended even when the taxpayers failed to extend the time for filing the return).

ISSN 8755-0628

for the agreed-upon amount. What is the taxpayer to do in that case?

Reg. §1.263(a)-5(f) requires that ''supporting records'' be provided to claim a deduction for nonfacilitative success-based costs. However, the regulation does not define ''supporting records'' and provides little guidance to taxpayers. As examples of supporting records, the regulation lists invoices, time records, and other records.[95] However, the regulation does not define ''other records.'' What ''other records'' can the taxpayer provide as adequate substantiation for the non-facilitative portion of the success-based fees? Can the taxpayer put together this documentation itself or hire someone to do it?

In TAM 201002036, the taxpayer hired an accounting firm to conduct a study of the transaction costs incurred for services performed by an investment banker. The accounting firm developed allocation spreadsheets by interviewing employees of the investment banker regarding the activities performed and the time spent on the activities. The IRS examination team argued that the taxpayer had not provided sufficient documentation to prove that any of the success-based fees were for non-facilitative activities; therefore, the entire fee must be capitalized.[96] The taxpayer argued the spreadsheets qualified as ''other records'' sufficient to support its claimed deduction.[97]

The IRS National Office agreed the spreadsheets qualified as ''other records.'' According to the TAM, ''other records'' is not defined in the regulations, and there are no limitations on the type or source of materials that can qualify as ''other records.''[98] Thus, almost any material can establish the deductible portion of a success-based fee, even if not from the service provider. If the materials presented, taken as a whole, provide the information required by Reg. §1.263(a)-5(f), the documentation is sufficient.

The taxpayer should keep other substantive documentation in support of (or in lieu of) direct evidence, to assist in supporting its cost allocation. This documentation would be ''other records'' in support of the allocations made. It includes:

1. Copy of the engagement letter and amendments;
2. Copy of the signed letter of attestation (the service provider's estimated allocation of the success-based fee);
3. Copies of e-mails and other communications between the service provider and the taxpayer;
4. Copies of minutes of meetings: 1) between the service provider, the taxpayer, and other party, and 2) of the taxpayer's board of directors.[99]

Rev. Proc. 2011-29

As discussed above, the proper allocation of success-based fees (or contingent transaction costs) is a factually intensive determination. There has been much controversy between taxpayers and the IRS about the proper allocation of transaction costs. To reduce some of this controversy, the IRS issued Rev. Proc. 2011-29.[100]

Rev. Proc. 2011-29 applies to success-based fees for covered transactions incurred in taxable years that end after April 8, 2011. If the taxpayer agrees to capitalize 30% of success-based fees, the taxpayer may deduct the remaining 70% on its tax return. The IRS will not challenge the deduction if the taxpayer meets all the requirements of Rev. Proc. 2011-29 as a taxpayer-friendly compromise that also eases the auditing burden for revenue agents. In particular, Rev. Proc. 2011-29 is taxpayer-favorable because it is elective; the taxpayer has the choice of relying on or disregarding Rev. Proc. 2011-29, as it wishes. However, taxpayers should keep the following in mind:

1. As mentioned, the safe harbor provided in Rev. Proc. 2011-29 is elective. It is available only if properly elected by the taxpayer.[101] The election is for the entire transaction. Therefore, once made, it applies to all success-based fees for that deal. Moreover, the election is irrevocable.
2. The Rev. Proc. applies only to success-based fees.
3. The safe harbor (70% deduction) applies only to fees for a ''covered transaction'' as defined in Reg. §1.263(a)-5(e). The safe harbor does not apply to fees incurred by sellers in taxable asset sales. Moreover, the safe harbor does not apply to transactions under §338(g), §338(h), and §338(e) and the sale of 100% of LLC units.
4. Rev. Proc. 2011-29 is effective only for success-based fees incurred in taxable years ending on or after April 8, 2011. Note that it is the taxable year that matters. For example, transaction costs incurred in January 2011 by a calendar-year taxpayer are eligible, because the tax year ends after April 8, 2011.

[95] Reg. §1.263(a)-5(f). *See also* PLR 200830009 (stating, ''[o]ther records may be used to establish an appropriate allocation. A determination as to whether records establish such an allocation is a question to be determined upon examination.'').

[96] TAM 201002036.

[97] *Id.*

[98] *Id.*

[99] PLR 200953014.

[100] 2011-18 I.R.B. 746.

[101] *But see* PLR 201418010, wherein the IRS granted an extension to a taxpayer that had inadvertently failed to make an election or claim the deduction on its original return.

ISSN 8755-0628

LB&I Industry Director's Memo 04-0511-012

The IRS also issued a directive to the Large Business & International (LB&I) Division to liberalize the position in Rev. Proc. 2011-29.[102] It directs LB&I examiners to not challenge a taxpayer's treatment of some success-based fees. The fees must be paid or incurred in tax years ended before April 8, 2011, and the taxpayer must capitalize at least 30% of the success-based fees on its original return. The directive applies only to transaction costs paid or incurred in covered transactions[103] and only to costs incurred by either an acquiring or a target corporation. Further, the directive applies only to deductions on original, timely filed returns not to refund claims (whether formal or informal).

LB&I Industry Director's Memo 04-413-002

The LB&I Division issued another Industry Director's Memo about success-based fees that also may be useful. The LB&I issued a memo in response to an IRS National Office Ruling. According to the ruling, nonrefundable ''milestone payments'' made to an investment banker for a business acquisition or reorganization described in Reg. §1.263(a)-5(e)(3) do not qualify for the safe harbor in Rev. Proc. 2011-29;[104] LB&I Industry Director's Memo 04-413-002 provides another safe harbor.[105] The safe harbor applies to only an ''eligible milestone payment'' to an investment banker. A milestone is an event during a covered transaction. A milestone payment is a nonrefundable amount paid upon completion of a milestone. Moreover, an ''eligible milestone payment'' is a milestone payment to an investment banker that is creditable against a success-based fee.[106] The safe harbor rule of this directive states that LB&I examiners will not challenge the treatment of eligible milestone payments on the originally filed return if certain conditions described in the directive are satisfied. While those conditions include deduction of no more than 70% (capitalization of at least 30%) of the eligible costs, there are additional requirements. Moreover, the requirements differ for costs incurred in taxable years ending on or after April 8, 2011 than those incurred in taxable years ending before that date. The discussion of these rules and conditions is beyond the scope of this article. The reader should refer to the Industry Director's Memorandum and seek advice if she has questions about eligible milestone payments.

LB&I Industry Director's Memo 04-0114-001

LB&I Industry Director's Memo 04-0114-001 broadened the term ''milestone'' to ''an event, including the passage of time, occurring in the course of a covered transaction (whether the transaction is ultimately completed or not).'' The 2014 directive also implied by omission that milestone payments included amounts that would have been paid or incurred even if the milestone were not achieved.[107]

Remaining Issues Surrounding the Deductibility of Success-Based Transactions

It is easy to see how a taxpayer could stumble while trying to take advantage of this ''taxpayer-friendly'' Rev. Proc. For example:

1. The transaction may not be a covered transaction listed in Reg. §1.263(a)-5(e).
2. The transaction costs may not be success-based or contingent.[108]

---

[102] *See* LB&I-04-0511-012 (July 28, 2011).

[103] *See* Reg. §1.263(a)-5(e)(3).

[104] CCA 201234027.

[105] LB&I-04-413-002 (Apr. 29, 2013).

[106] CCA 201234027.

[107] *See* LB&I-4-0114-001 (Jan. 27, 2014). The 2013 directive states that milestone payments do not include these amounts. The 2014 directive omits this clarification.

[108] It is worth noting that just because a transaction cost is contingent, that does not necessarily mean it will be governed by Reg. §1.263(a)-5(f). For example, sometimes employee bonuses are payable only upon the successful closing of a transaction. Therefore, while these payments technically meet the definition of success-based fees set out in Reg. §1.263(a)-5(f), Reg. §1.263(a)-5(d)(1), which governs employee compensation, specifically states that these fees do not facilitate a transaction. Because two different subsections of the regulation could apply in this situation, the AICPA has requested clarification from the IRS. Jeffrey A. Porter, *Recommendation for Modification of Rev. Proc. 2011-29 Concerning the Safe Harbor Election for Success-Based Fees*, AICPA (June 12, 2014), http://www.aicpa.org/advocacy/tax/downloadabledocuments/aicpa%20comment%20letter%20-%20success-based%20fee%20dated%2006%2012%202014%20final.pdf. The canon of statutory construction states that specific provisions targeting a particular issue apply instead of more general provisions covering the issue. *D. Ginsberg & Sons, Inc. v. Popkin*, 285 U.S. 204, 208 (1932) (''General language of a statutory provision, although broad enough to include it, will not be held to apply to a matter specifically dealt with in another part of the same enactment. Specific terms prevail over the general in the same or another statute which otherwise might be controlling.'') (internal citations omitted). Statutory construction would then lead one to believe that Reg. §1.263(a)-5(d)(1) governs in this instance as it is the more specific provision. The AICPA is in agreement with the authors of this article on this issue, but use different reasoning in support of its conclusion. *Id.*

ISSN 8755-0628

As mentioned above, the safe harbor rule of Rev. Proc. 2011-29 does not apply to success-based fees deals treated as an asset sale for tax purposes. While capitalized amounts would reduce the amount realized on the sale of assets, the reduction would reduce capital gain. Therefore, a seller of assets and any other transaction that is not a covered transaction must keep contemporaneous documentation sufficient to support the deductible portion of success-based fees.

In contrast, buyers that incur success-based transaction costs in a taxable asset acquisition may deduct 70% as an ordinary expense in the year of purchase.

One has to wonder why the seller of assets is at a disadvantage — especially because sellers bear most of the success-based fees. Sellers in actual asset sales and deemed asset sales cannot take advantage of this favorable treatment. Instead, these taxpayers must depend on detailed documentation and recordkeeping to get an ordinary deduction for some portion of their transaction costs. However, the regulations provide that capitalized transaction costs incurred by sellers in taxable asset sales would simply reduce the amount realized in the sale. So, individual taxpayers who incur such cost in taxable asset sales directly or through flow-through entities will benefit at capital gain rates instead of ordinary income rates.

VI. CONCLUSION

Notwithstanding all the current guidance, transaction costs continue to be a difficult area for advisers to plan through with their clients. Proceed with caution and exercise care and diligence when advising your clients.

ISSN 8755-0628

ISSN 8755-0628