



June 12, 2014

Mr. Andrew Keyso, Jr.
Associate Chief Counsel
(Income Tax & Accounting)
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Recommendation for Modification of Rev. Proc. 2011-29 Concerning the Safe Harbor Election for Success-Based Fees

Dear Mr. Keyso:

The American Institute of Certified Public Accountants (AICPA) appreciates this opportunity to submit comments with respect to the application of Rev. Proc. 2011-29, in which the Internal Revenue Service (IRS) provided a safe harbor method for taxpayers to allocate success-based fees. These comments were developed by the Success-Based Fee Task Force of the AICPA's Tax Methods and Periods Technical Resource Panel, and approved by the Tax Executive Committee.

The AICPA is the world's largest member association representing the accounting profession, with more than 394,000 members in 128 countries and a 125-year heritage of serving the public interest. Our members advise clients on Federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

Executive Summary

This letter addresses a number of interpretive issues that we have identified in the application of Rev. Proc. 2011-29 and provides suggestions as to how the revenue procedure could be modified to address these issues to prevent further controversy in this area.

Background

Treasury Reg. § 1.263(a)-5 provides definitive rules with respect to the proper treatment of amounts paid or incurred on or after December 31, 2003, in the process of investigating or otherwise pursuing certain specified transactions.

Under Treas. Reg. § 1.263(a)-5(b), a taxpayer must capitalize amounts paid to facilitate a transaction described in Treas. Reg. § 1.263(a)-5(a). Such facilitative amounts include

certain amounts expended in the process of investigating or otherwise pursuing a transaction.

Treasury Reg. § 1.263(a)-5(e) provides that in the case of a covered transaction (described below), a taxpayer is not required to capitalize costs incurred before the earlier of (i) the date on which a letter of intent, exclusivity agreement, or similar written communication is executed by representatives of the acquirer and the target, or (ii) the date on which the material terms of the transaction are authorized or approved by the taxpayer's board of directors, (the "bright-line date") to the extent such costs are not inherently facilitative costs.

A covered transaction, as defined in Treas. Reg. § 1.263(a)-5(e)(3), includes the following transactions: a taxable acquisition by the taxpayer of assets that constitute a trade or business; a taxable acquisition of an ownership interest in a business entity if, immediately after the acquisition, the acquirer and the target are related within the meaning of section 267(b) or 707(b); or a reorganization described in section 368(a)(1)(A), (B), or (C) or a reorganization described in section 368(a)(1)(D) in which stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354 or 356.

Notwithstanding the rules above, Treas. Reg. § 1.263(a)-5(f) provides that an amount paid that is contingent on the successful closing of a transaction described in Treas. Reg. § 1.263(a)-5(a) is an amount paid to facilitate the transaction except to the extent the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction.

Subsequent to the issuance of the final regulations in 2003, there was significant controversy between IRS examining agents and taxpayers as to what constituted "sufficient documentation" to support an allocation of a success-based fee between facilitative and non-facilitative activities. On January 10, 2007, the AICPA submitted comments requesting that the IRS and Department of the Treasury (Treasury) publish guidance clarifying the documentation requirements under Treas. Reg. § 1.263(a)-5(f) and alternatively consider providing a safe harbor for success-based fees as a means of resolving and avoiding further controversy in this area.¹

On April 8, 2011, the IRS and Treasury published Rev. Proc. 2011-29, which creates a safe-harbor election for taxpayers seeking to allocate success-based fees between facilitative and non-facilitative amounts for "covered transactions" described in Treas. Reg. § 1.263(a)-5(e)(3). This safe harbor states that, in lieu of providing the required documentation specified in Treas. Reg. § 1.263(a)-5(f), taxpayers may use a simplified, percentage-based allocation for determining which portion of success-based transaction costs must be capitalized because they facilitate the transaction and which portion may be treated as not facilitating the transaction. Subsequent to the issuance of Rev. Proc. 2011-29, the IRS

¹See

http://www.aicpa.org/Advocacy/Tax/TaxMethodsPeriods/DownloadableDocuments/final_success-based_comments_1_10_07.doc.

Large Business and International (LB&I) Division on July 28, 2011, issued a directive (LB&I 04-0511-012) directing examiners not to challenge a taxpayer's treatment of success-based fees paid or incurred in tax years ended before April 8, 2011, if the taxpayer capitalized at least 30% of the total success-based fees incurred with respect to the transaction. Consistent with Rev. Proc. 2011-29, the directive only applies to transaction costs paid or incurred in connection with a covered transaction (as defined in Treas. Reg. § 1.263(a)-5(e)(3)).

Issues

The AICPA commends the IRS and Treasury for providing guidance that will likely reduce the current level of controversy between IRS examining agents and taxpayers. While the safe harbor rules are welcome guidance for taxpayers, there are a few areas of ambiguity that, without further clarification, could create new areas of debate. These issues are described in more detail below.

Allocation between Covered and Non-covered Transactions

In the context of certain acquisitive transactions, a taxpayer may engage a service provider, such as an investment banker, to provide a variety of services, some of which may relate to a covered transaction and some of which may relate to a transaction that is not a covered transaction. For example, a taxpayer that is exploring a taxable acquisition of assets that constitute a trade or business may engage an investment banker to assist with various aspects of the transaction, including assisting with due diligence and providing a fairness opinion. However, the taxpayer may also need assistance to secure financing for the transaction. In such a situation, the investment banker may be involved in helping the taxpayer with various aspects of the borrowing in addition to the services provided in connection with the taxable acquisition of assets. An investment banker in this example is typically compensated for all of its services based on the successful completion of the transaction. However, because Treas. Reg. § 1.263(a)-5(c)(1) specifically provides that amounts paid for services that facilitate a borrowing do not facilitate a covered transaction, it is not clear how or if Rev. Proc. 2011-29 might apply.

Section 3 of Rev. Proc. 2011-29 limits the application of the safe harbor allocation method to success-based fees incurred in connection with a covered transaction. The scope of this rule creates ambiguity in situations similar to the example provided above. Specifically, it is unclear how the safe harbor allocation method should be applied to a success-based fee that is attributable to multiple transactions, some of which may not be covered transactions.

As noted above, Rev. Proc. 2011-29 only applies to success-based fees incurred in connection with a covered transaction. Therefore, in applying the safe harbor allocation method described in Rev. Proc. 2011-29, a taxpayer must determine an appropriate manner to bifurcate the success-based fee between the portion attributable to the covered transaction and the portion that is attributable to any transaction that is not covered, which would include a borrowing. For taxpayers that are interested in electing the safe harbor method

described in Rev. Proc. 2011-29, the AICPA is concerned that imposing the documentation requirements of Treas. Reg. § 1.263(a)-5(f) (or similar requirements) to support such an allocation would frustrate the purpose for providing a simplified method of allocating success-based fees and invite a new controversy between taxpayers and IRS examining agents.

Therefore, the AICPA recommends that Rev. Proc. 2011-29 be clarified to provide taxpayers electing the safe harbor allocation method to choose one of options: (1) the electing taxpayer may treat 70% of the total fee as non-facilitative, and the remaining 30% as facilitative, but must assume that it facilitates the covered transaction only; or (2) the electing taxpayer may first allocate the entire fee between the covered and non-covered transaction, complying with the documentation requirements, and then apply the 70/30 method solely to allocate that portion between facilitative and non-facilitative costs with respect to the covered transaction.

Milestone Payments Applied to Payment of Success-Based Fee

Another area of ambiguity arises in situations where a service provider may receive a milestone payment (e.g., a payment due upon the occurrence of a particular event that relates to all services to be rendered during the transaction) that will be applied to a success-based fee (if earned), but is nonrefundable if the transaction does not successfully close. For example, during the course of investigating a potential covered transaction, a taxpayer may request its investment banker to provide a fairness opinion. In some cases, the engagement letter with the investment banker provides that a milestone payment will be paid at the time the fairness opinion is rendered. In these situations, the engagement letter further provides that in the event a covered transaction is consummated, the investment banker will be entitled to a success-based fee and that the prior milestone payment(s) will be applied as a credit against the success-based fee to determine the amount of the final payment owed to the investment banker. A similar situation occurs when engagement letters for attorneys provide that, in the event a covered transaction is consummated, the attorneys will be entitled to a success-based fee against which prior payments received in connection with legal services rendered during the transaction will be credited.

These situations are becoming more common and introduce another ambiguity for taxpayers that would like to utilize the safe harbor allocation method described in Rev. Proc. 2011-29. Specifically, there is some question as to whether the safe harbor allocation method should be applied to the full amount of the success-based fee (a portion of which was paid upon attaining a certain milestone) or whether the safe harbor allocation method should be applied only to the final payment (i.e., the success-based fee less the milestone payment(s)).

The IRS recently addressed the treatment of milestone payments in Chief Counsel Advice 201234027, dated July 16, 2012 (the “CCA”). Under the facts in the CCA, an investment banker received two milestone payments totaling \$2 million for services related to a covered transaction, as defined in Treas. Reg. § 1.263(a)-5(e)(3). Further, if the transaction successfully closed, the milestone payments would be credited to a \$10 million success-

based fee owed to the investment banker, resulting in an additional payment of \$8 million upon closing. If the transaction did not successfully close, then the milestone payments were nonrefundable. The CCA concludes that the safe harbor election in Rev. Proc. 2011-29 would apply to the additional \$8 million payable at closing, but not to the \$2 million milestone payments, because the milestone payments did not meet the definition of a success-based fee as defined in Treas. Reg. § 1.263(a)-5(f). The CCA further concludes that, with respect to the milestone payments, the taxpayer must establish, based on all the facts and circumstances, whether the investment banker's activities were facilitative or not.

The crediting of milestone payments to the amounts owed upon the successful closing of the transaction demonstrates that the milestone payments relate to all the services performed under the engagement. The fact that milestone payments are paid before the closing date of a transaction and are nonrefundable in nature does not alter the intent of the parties that the payments relate to all services performed under the contract. Instead, these conditions merely acknowledge the need to provide some interim compensation to support the amount of services provided prior to closing and the lengthy period of time over which these services are provided. The conclusion in the CCA allows for a different allocation percentage for milestone payments than for the remainder of payments due upon closing. This creates the illogical result that different allocation percentages can be applied to the same services performed at the same time.

The IRS LB&I Division recently published a directive, LB&I-04-0114-001 (the "Directive") providing that if the requirements set forth therein are satisfied, examiners will not challenge a taxpayer's application of the safe harbor to "eligible milestone payments" incurred during the course of a covered transaction. This directive updates and modifies an earlier similar directive (LB&I-04-0413-002), and expands the scope of eligible milestone payments. The directive defines an eligible milestone payment to mean a milestone payment paid for investment banking services that is creditable against a success-based fee. The directive does not define what services are included in the scope of the term "investment banking services." The AICPA believes that this directive will help to prevent needless controversy between taxpayers and the IRS regarding the type and extent of documentation required to establish that a portion of a milestone payment for investment banking services is allocable to activities that do not facilitate a covered transaction based on the conclusion in the CCA. The directive will not, however, prevent such controversy for milestone payments for services other than investment banking and is not an official pronouncement that is binding on the Service in the event of a controversy.

While the AICPA appreciates the action that LB&I has taken to minimize the potential controversy that could result based on the holding in the CCA, the AICPA nonetheless recommends that the IRS and Treasury clarify Rev. Proc. 2011-29 to provide that, in situations where a milestone payment is earned and ultimately applied as a credit against a success-based fee, a taxpayer may apply the safe harbor allocation method to the entire fee (including the milestone payment), regardless of the services related to the milestone payment and regardless of when the milestone payment was paid during the course of the transaction. The AICPA believes that allowing taxpayers to apply the safe harbor allocation

method to the total success-based fee whether payable to an investment banker or any other service provider when fee is payable upon the successful closing of the transaction is consistent with the purpose of Rev. Proc. 2011-29, would serve to reduce the controversy between the IRS and taxpayers, and would increase the administrability of Rev. Proc. 2011-29.

Contingent Employee Compensation

It is common for employee bonuses or other compensation to be triggered as a result of the closing of a transaction. In such a situation, an issue arises as to whether such compensation is subject to the success-based fee safe harbor. A success-based fee is defined in Treas. Reg. § 1.263(a)-5(f) as an amount that is contingent on the successful closing of a transaction described in Treas. Reg. § 1.263(a)-5(a). This is a broad definition that, on its face, could include employee compensation contingent on the closing of a transaction. However, Treas. Reg. § 1.263(a)-5(d)(1) contains a simplifying convention whereby employee compensation is treated as an amount that does not facilitate a transaction described in Treas. Reg. § 1.263(a)-5(a). For this purpose, Treas. Reg. § 1.263(a)-5(d)(2) provides that the term employee compensation includes compensation (including salary, bonuses, and commissions) paid to an employee of a taxpayer.

If the definition of success-based fee is read broadly to include employee compensation contingent upon the closing of the transaction, the simplifying convention for employee compensation would be in conflict with the general rule that success-based fees are presumed to facilitate a transaction unless the taxpayer maintains documentation establishing otherwise. This conflict is heightened by the application of the safe harbor method in Rev. Proc. 2011-29 because such a broad definition would require that 30% of the contingent employee compensation be capitalized. To avoid this conflict, the definition of a success-based fee should be interpreted not to include contingent employee compensation. Such compensation would be treated as an amount that does not facilitate the transaction under the regulations. Such an interpretation would be consistent with the conclusions reached in a number of Technical Advice Memoranda (TAM), including TAM 9527005, TAM 9721002, and TAM 9540003, where the IRS concluded that the origin of such compensation is the employment relationship and not the transaction triggering the compensation. The AICPA is concerned that the definition of a success-based fee could be construed broadly, and as such, believes this clarification is necessary to prevent any potential controversy between examining agents and taxpayers as to the proper treatment of contingent employee compensation.

Documentation and Clear Reflection of Income

The AICPA is concerned that examining agents may assert that the safe harbor allocation method, even if properly elected, does not result in a clear reflection of income in a situation where documentation relating to a success-based fee could be interpreted in a manner that supports capitalizing more than 30% of the fee. The AICPA believes that clarification is needed to establish that the safe harbor method in Rev. Proc. 2011-29 is appropriate

regardless of whether documentation related to the success-based fee could be interpreted as requiring more than 30% of the success-based fee to be capitalized. Therefore, the AICPA believes that Rev. Proc. 2011-29 should be clarified to provide that the safe harbor method would still be proper in such a situation. In addition, the AICPA recommends that Rev. Proc. 2011-29 further clarify that the safe harbor method would still apply in such a situation even if the examining agent did not believe that the method clearly reflected income under a taxpayer's facts and circumstances (i.e., the proper election of the safe harbor method will be deemed to clearly reflect the taxpayer's income).

Illustrative Examples

The AICPA believes that the areas of ambiguity described above could be clarified with the addition of examples to illustrate how the safe harbor allocation method described in Rev. Proc. 2011-29 should be applied in various situations. Included below are three examples that the AICPA believes would address the concerns described above.

Example 1. Allocation of success-based fee to covered and non-covered transactions. Company A engaged Investment Banker to provide investment banking services for a potential taxable acquisition of assets that constitute a trade or business, which is a covered transaction described in Treas. Reg. § 1.263(a)-5(e)(3)(i). Investment Banker also assisted Company A with a borrowing described in Treas. Reg. § 1.263(a)-5(a)(9) in connection with the transaction. Company A paid a single success-based fee of \$30 million to Investment Banker for all services provided in connection with the transaction. Company A is able to document that \$5 million of the \$30 million relates to the borrowing. Company A elects to apply the safe harbor allocation method described in section 4 of Rev. Proc. 2011-29. Therefore, Company A may \$5 million as attributable to the borrowing and apply the safe harbor to the remaining \$25 million. Thus, under this option, it would treat 30% of the \$25 million portion, or \$7.5 million, as an amount that facilitated the transaction and 70%, or \$17.5, as an amount that did not facilitate the transaction. Alternatively, Company A may instead opt to apply the safe harbor to the entire \$30 million fee. As a result of this option, 30% of the total fee, or \$9 million, is deemed to facilitate the covered transaction, and the remaining \$21 million is deemed not to facilitate a capital transaction.

Example 2. Milestone payment applied to payment of success-based fee. Company A engaged Investment Banker to provide investment banking services for a potential taxable acquisition of an ownership interest in a business entity where, after the acquisition, the acquirer and the target would be related within the meaning of section 267(b) or 707(b), which is a covered transaction described in Treas. Reg. § 1.263(a)-5(e)(3)(ii). The engagement letter between Company A and Investment Banker stipulated that Company A must pay a nonrefundable milestone payment of \$3 million upon the issuance of Investment Banker's fairness opinion to Company A, and such milestone payment will be applied to the total success-based fee payable to Investment Banker upon the successful closing of the transaction. Upon the successful closing of the transaction, Company A owed Investment Banker a success-based fee of \$40 million. Because Company A previously paid the \$3 million milestone payment to Investment Banker, Company A paid Investment Banker \$37

million at the time the transaction closed. Company A elects to apply the safe harbor allocation method described in section 4 of Rev. Proc. 2011-29. Therefore, Company A will treat 30% of the \$40 million fee paid to Investment Banker (inclusive of the milestone payment), or \$12 million, as an amount that facilitated the transaction and will treat the remaining 70%, or \$28 million, as an amount that did not facilitate the transaction.

Example 3. Contingent employee compensation, documentation and clear reflection of income. Company B was the target acquired in a transaction described in Treas. Reg. § 1.263(a)-5(e). Company B paid a fee of \$1,000,000 to Investment Banker that was contingent upon the successful closing of the transaction. Company B also paid bonuses to employees in the amount of \$200,000 that were required to be paid upon the closing of the transaction. These were the only fees paid by Company B that were contingent upon the successful closing of the transaction. Documentation exists that supports that more than 30% of the activities performed by Investment Banker facilitated the transaction. Company B elected to apply the safe harbor allocation method described in section 4 of Rev. Proc. 2011-29. Therefore, Company B treated \$300,000 of the fee paid to Investment Banker as an amount that facilitated the transaction and treated the remaining \$700,000 as an amount that did not facilitate the transaction. In addition, Company B did not treat any portion of the bonuses paid to the employees as amounts facilitating the transaction.

Because of the simplifying rule for employee compensation in Treas. Reg. § 1.263(a)-5(d)(1), Company B was not required to treat the bonuses paid to the employees as an amount that facilitated the transaction. Further, because the safe harbor allocation method under Rev. Proc. 2011-29 is applied in lieu of maintaining the documentation required by Treas. Reg. § 1.263(a)-5(f), the safe harbor allocation method may be applied by Company B regardless of any interpretation or existence of documentation relating to the activities underlying the success-based fee. Further, the safe harbor allocation method is deemed to clearly reflect income. Therefore, Company B may apply the safe harbor allocation method described in section 4 of Rev. Proc. 2011-29 to the success-based fee paid to Investment Banker. The safe harbor allocation method described in section 4 of Rev. Proc. 2011-29 does not apply to the bonuses paid to the employees.

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We appreciate your consideration of our recommendations and believe they require minor, but important, changes that are necessary to fully carry out the objective of Rev. Proc. 2011-29. We welcome a further discussion of these issues and our recommendations, and members of the task force are available to meet with government officials in this regard. If you have any questions, please contact David Auclair, Chair, AICPA Success-Based Fee Task Force and Immediate Past-Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (202) 521-1515, or david.auclair@us.gt.com; Carol Conjura, Chair, AICPA Tax Methods and Periods Technical Resource Panel, at (202) 533-3040, or cconjura@kpmg.com; or Jason Cha, AICPA Technical Manager, at (202) 434-9268, or jcha@aicpa.org.

Mr. Andrew Keyso, Jr.
June 12, 2014
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Respectfully submitted,

A handwritten signature in black ink, appearing to read "Jeffrey A. Porter". The signature is fluid and cursive, with the first name "Jeffrey" being the most prominent.

Jeffrey A. Porter, CPA
Chair, Tax Executive Committee

cc: Scott Dinwiddie, Special Counsel to the Associate Chief Counsel (Income Tax & Accounting), Internal Revenue Service
Alexa Claybon, Attorney-Advisor, Office of Tax Legislative Counsel, Department of the Treasury
Scott Mackay, Taxation Specialist, Office of Tax Legislative Counsel, Department of the Treasury