Internal Revenue Service

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Department of the Treasury
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Person To Contact:

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Date:
February 24, 2016

TY:

LEGEND:

Taxpayer =
Acquisition Assistant =
Country1 =
Country2 =
Corp1 =
Corp2 =
CPA1 =
CPA2 =
CPA3 =
Date1 =
Date2 =
Date3 =
Date4 =
Date5 =
Date6 =
Year1=
Year2 =
Year3
Taxable Year =
$a =
$b =
$c =

Dear :

This is in response to your letter dated Date1. Taxpayer requests an extension of time be granted for the purpose of allowing Taxpayer to select the safe harbor treatment under Rev. Proc. 2011-29, 2011-18 I.R.B. 746, by amending Taxpayer's original Taxable Year return, and including the mandatory statement regarding the election to use the safe harbor method of allocating success-based fees. This request is made in accordance with §§ 301.9100-1 and 301.9100-3 of the Procedure and Administration Regulations.

Taxpayer represents the following facts:

Taxpayer is a C-corporation and parent of a Country1 consolidated return group. Taxpayer is engaged in the exploration, exploitation, acquisition, development and production of crude oil, natural gas and natural gas liquids in numerous states.

The Transactions:

On Date2, Taxpayer acquired Corp1, a publicly traded exploration and production company in a stock-for-stock exchange. This transaction was intended to qualify as a reorganization under § 368(a)(1)(c) of the Internal Revenue Code.

On Date3, Taxpayer acquired Corp2 (including its wholly-owned Country1 subsidiary), a publicly traded Country2 oil and gas company, in a stock-for-stock exchange.

To assist Taxpayer in the two acquisition transactions, Taxpayer engaged Acquisition Assistant to act as financial advisor to Taxpayer. The fee for the Assistant's services for both Corp1 and Corp2's acquisition was equal to1.20% and 1.00%, respectively, of the fair value of consideration paid for each acquisition (but, in no event less, than $a) plus reimbursement of our-of-pocket expenses. These fees were payable to Acquisition Assistant on consummation of each acquisition. Therefore when Taxpayer closed on Corp1 on Date2, and Corp2 on Date3, Taxpayer paid the Acquisition Assistant $b and $c, respectively.

Circumstances of Late Election:

Taxpayer did not have an internal tax department or a tax director. Accordingly, Taxpayer engaged CPA1 to assist in the preparation and filing of its federal income tax return for the Taxable Year.

CPA1 reported the acquisition fees consistent with Taxpayer's method of accounting adopted for financial statement purposes, and treated these fees as a deductible expense. CPA1 did not consider the requirements or documentation as set forth under § 1.263(a)-5(f) of the Income Tax Regulations to establish that a portion of either fee paid to the Acquisition Assistant was allocable to activities that did not facilitate either transaction, nor did CPA1 mention a safe harbor election under Rev. Proc. 2011-29.

Relying on CPA1's expertise, Taxpayer deducted the entire amount it paid to its Acquisition Assistant for the taxable year ended Date4.

Taxpayer then engaged CPA2 to provide an independent examination of Taxpayer's financial statements from Year1 through the second quarter of Year2. During that period CPA2 provided an unqualified opinion including assertions that no material weaknesses existed for failing to disclose uncertain tax positions (including, for example, uncertainty associated with treating the acquisition fees as a deductible expense without satisfying the documentation requirements under the § 1.263(a)-5(f) of the regulations. Both CPA1 and CPA2 believed the deduction treatment to have been correct. Taxpayer relied on their expertise unaware of both CPAs' incompetence and oversight.

At the end of Year2, Taxpayer hired a new firm, CPA3, as an independent auditor. During part of its initial audit, CPA3 found and immediately informed Taxpayer of the improper tax treatment of the acquisition fees paid to the Acquisition Assistant. Taxpayer had deducted all the fees as instructed by CPA1 and reassured by CPA2. CPA3 explained to Taxpayer that the acquisition fees should have only been partially deducted under the substantiation requirements of §1.263(a)-5(f) of the regulations or in lieu of this requirement, Taxpayer's former CPAs should have advised Taxpayer to use the safe-harbor election available under Rev. Proc. 2011-29. The oversight was not yet uncovered by the Internal Revenue Service. Therefore, CPA3 advised Taxpayer to file a letter ruling requesting additional time to amend Taxpayer's original federal income tax return for Taxable Year.

Although advised by CPA3 to file for a letter ruling in late Year2, extenuating circumstances precluded Taxpayer from requesting relief to elect the safe harbor as proper treatment until Year3. The late filing was due to Taxpayer's internal changes such as creating a tax department and hiring a new Tax Director, and external changes of tax advisors. This created competing priorities and limited resources to rectify a number of material weaknesses including the tax treatments of the fees.

Finally, we note that when this letter ruling was filed with the Service on Date1, the Taxable Year at issue was open. However, during the processing of the request, the Taxpayer's Taxable Year closed on Date6.

LAW:

Section 263(a)(1) and § 1.263(a)-2(a) provide that no deduction shall be allowed for any amount paid out for property having a useful life substantially beyond the taxable year. In the case of an acquisition or reorganization of a business entity, costs that are incurred in the process of acquisition and that produce significant long-term benefits must be capitalized. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 89-90 (1992); Woodward v. Commissioner, 397 U.S. 572, 575-576 (1970).

Under § 1.263(a)-5 of the regulations, a taxpayer must capitalize an amount paid to facilitate a business acquisition or reorganization transaction described in § 1.263(a)-5(a). An amount is paid to facilitate a transaction described in § 1.263(a)-5(a) if the amount is paid in the process of investigating or otherwise pursuing the transaction.

Section 1.263(a)-5(f) provides that an amount that is contingent on the successful closing of a transaction described in § 1.263(a)-5(a) ("success-based fee") is presumed to facilitate the transaction, and thus must be capitalized. A taxpayer may rebut the presumption by maintaining sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction, and thus may be deductible.

A taxpayer's method for determining the portion of a success-based fee that facilitates a transaction and the portion that does not facilitate the transaction is a method of accounting under § 446.

Because the treatment of success-based fees was a continuing subject of controversy between taxpayers and the Service, the Service published Rev. Proc. 2011-29. Rev. Proc. 2011-29 provides a safe harbor method of accounting for allocating success-based fees paid in business acquisitions or reorganizations described in regulations § 1.263(a)-5(e)(3). In lieu of maintaining the documentation required by § 1.263(a)-5(f), this safe harbor permits electing taxpayers to treat 70 percent of the success-based fee as an amount that does not facilitate the transaction that is, amounts that can be deducted. The remaining portion of the fee must be capitalized as an amount that facilitates the transaction.

Section 4.01 of Rev. Proc. 2011-29 allows the taxpayer to make a safe harbor election with respect to success-based fees. Section 4.01 provides that the Service will not challenge the taxpayer's allocation of success-based fees between activities that facilitate a transaction described in § 1.263(a)-5(e)(3) (cost that must be capitalized) and activities that do not facilitate the transaction (cost that may be deductible) if the taxpayer does three things. First, the taxpayer must treat 70 percent of the amount of the success-based fee as an amount that does not facilitate the transaction and thus may be deductible. Second, the taxpayer must capitalize the remaining amount of the success-based fee as an amount which does facilitate the transaction. Finally, the taxpayer must attach a statement to its original federal income tax return for the taxable year the success-based fee is paid or incurred, stating that the taxpayer is electing the safe harbor, identifying the transaction, and stating the success-based fee amounts that are deducted (treated as not facilitating the transaction) and capitalized (treated as facilitating the transaction).

Section 301.9100-1(c) provides that the Commissioner has discretion to grant a reasonable extension of time under the rules set forth in §§ 301.9100-2 and 301.9100-3 to make certain regulatory elections. Section 301.9100-1(b) defines a "regulatory election" as an election whose due date is prescribed by a regulation published in the Federal Register, or a revenue ruling, revenue procedure, notice or announcement published in the Internal Revenue Bulletin.

Sections 301.9100-1 through 301.9100-3 provide the standards the Commissioner will use to determine whether to grant an extension of time to make an election. Section 301.9100-2 provides automatic extensions of time for making certain elections. Section 301.9100-3 provides extensions of time for making elections that do not meet the requirements of § 301.9100-2.

Section 301.9100-3(a) provides that requests for relief under § 301.9100-3 will be granted when the taxpayer provides evidence to establish to the satisfaction of the Commissioner that the taxpayer acted reasonably and in good faith, and that granting relief will not prejudice the interests of the government.

In the instant case, Taxpayer did not have an internal tax department or expertise to determine the proper treatment of the Acquisition Assistant's fee following the reorganization and stock acquisition transactions in Taxable Year. Thus, Taxpayer hired tax experts to properly advise him and correctly file the Taxable Year return. CPA1 advised Taxpayer to deduct the entire cost of the acquisition fee. Taxpayer relied on CPA1's expertise and followed his instructions. Then Taxpayer hired CPA2 to double check his reliance on CPA1. CPA2 found no error in CPA1's advice to Taxpayer. The improper tax treatment was discovered by CPA3 in Year2. CPA3 informed Taxpayer of the improper treatment of the acquisition fees and, in turn, the safe harbor under Rev. Proc. 2011-29. Taxpayer made a good faith effort to file his taxes correctly by hiring several CPAs. CPA1 and CPA2, however, failed to properly advise Taxpayer. Only CPA3 was familiar with the law including whether to elect the safe harbor treatment under Rev. Proc. 2011-29, and informed Taxpayer to file a ruling request for relief. Taxpayer acted in good faith and reasonably relied on the tax professionals, but his reliance on the first two CPAs was detrimental.

Section 301.9100-3(c)(1) provides that the interests of the government are prejudiced if granting relief would result in the taxpayer having a lower tax liability in the aggregate for all taxable years affected by the election than the taxpayer would have had if the election had been timely made. The interests of the government are ordinarily prejudiced if the taxable year in which the regulatory election should have been made, or any taxable years that would have been affected by the election had it been timely made are closed by the period of limitations on assessment.

In Taxpayer's case, granting relief will not result in Taxpayer having a lower tax liability in the aggregate for all taxable years affected by the safe harbor election than it would have had if this election had been timely made. Taxpayer filed its federal tax return on Date5 for tax year ended Taxable Year. Moreover, Taxpayer reported a net operating loss that exceeded the amount of the deduction for the transaction fees, and for each tax year succeeding tax year ended in Taxable Year, Taxpayer reported a net operating loss. Thus, the interests of the government will not be prejudiced by granting the request for relief.

CONCLUSION:

Based upon our analysis of the facts as represented, Taxpayers acted reasonably and in good faith, and granting relief will not prejudice the interests of the government, and therefore the requirements of §§ 301.9100-1 and 301.9100-3 have been met.

Furthermore, granting relief will not result in Taxpayer having a lower tax liability in the aggregate for all taxable years affected by the election than Taxpayer would have had if the election had been timely made, nor is Taxpayer seeking to alter a return position or using hindsight. Taxpayer is not seeking to alter a return position or using hindsight as the relief requested benefits the Service and not Taxpayer as it requires an unfavorable adjustment to Taxpayer's net operating loss (NOL). Therefore, the interests of the government will not be prejudiced by granting the request for relief.

Moreover, now that Taxable Year is a closed year, we believe the interests of the government are not prejudiced as the request results in an adjustment to Taxpayer's NOL carry forward and such adjustment would be in an open year.

Finally, granting relief will not prejudice the interests of the government associated with the special rules for accounting method regulatory elections, in this case the safe harbor election for success-based fees. The election provided by Rev. Proc. 2011-29 for allocating the success-based fees is granted on an automatic basis (if all proper procedures including the attaching the mandatory statement are followed), does not require a § 481(a) adjustment, is not an issue under consideration, and does not provide a more favorable method of accounting if the election is made by a certain date or taxable year.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. In particular, no opinion is expressed as to whether Taxpayer properly included the correct costs as its success-based fees subject to the retroactive election, or whether Taxpayer's transactions were within the scope of Rev. Proc. 2011-29.
This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, a taxpayer filing its return electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

THOMAS D. MOFFITT
Chief, Branch 2
Associate Chief Counsel
(Income Tax & Accounting)

cc: