Private Equity/Venture Capital

Cohnnection

June 2012

Favorable Tax Treatment for the Deductibility of Success-Based Investment Banking Fees

Taxpayers who paid a success-based fee to an investment banker or private equity firm that was contingent on the closing of a transaction may be able to deduct a substantial portion of such a fee on their 2011 tax return. Previous Internal Revenue Service ("IRS") regulations generally required that these fees, or a very large portion thereof, be capitalized. However, a new Revenue Procedure provides for a very taxpayer-friendly treatment of success-based fees and is welcome relief to acquisitive taxpayers.

Our View of the News

The safe harbor election will be beneficial to many taxpayers who were not able to benefit in the past. Taxpayers should begin to review transactions to determine if the safe harbor election applies to their situation.

In Revenue Procedure 2011-29, the IRS announced a safe harbor election that will generally allow an electing taxpayer to deduct 70 percent of its success-based fees paid in merger and acquisition transactions (commonly investment banking fees).

This safe harbor will have the effect of making it possible for taxpayers in M&A deals to deduct a much larger proportion of fees that are contingent on the closing of a deal. It is a significant departure from the previous rules, which generally presume such fees to be non-deductible.

The election will be beneficial to taxpayers that do not have proper documentation supporting an allocation of more than 70 percent of a contingent fee to activities that do not facilitate the transaction and are, therefore, deductible. The safe harbor election will also provide relief to taxpayers who do not wish to, or simply cannot, obtain and maintain such documentation, or that simply want to avoid a dispute with the IRS.

The previous rules require taxpayers to maintain supporting documentation to support the assertion that a portion of a deal fee that is "allocable to activities that do not facilitate the transaction" is indeed deductible. This requirement forced taxpayers to perform a detailed analysis of their deal costs in an effort to establish the deductible portion. Understandably so, the subjectivity of such an analysis led to numerous disputes between taxpayers and the IRS during examinations.

In Revenue Procedure 2011-29, the IRS states that it is "aware that the treatment of success-based fees continues to be the subject of controversy…numerous disagreements have arisen regarding the type and extent of documentation required to establish that a portion of a success-based fee is deductible… We expect that much of this controversy can be eliminated by providing taxpayers a simplified method."

This new safe harbor election applies to success-based fees for services performed in the process of investigating or pursuing certain enumerated types of M&A transactions, such as a merger or another acquisitive corporate reorganization, a purchase of a majority ownership interest in a target company, or an asset purchase of a business.

The election is effective for fees paid or incurred in taxable years ending on or after April 8, 2011. If the election is made with respect to a transaction, it applies to all similar fees paid with respect to that specific transaction, but does not extend to other transactions.

A taxpayer making the safe harbor election must:

- treat 70 percent of the success-based fee as an amount that does not facilitate the transaction and is therefore deductible;
- capitalize the remaining 30 percent as an amount that does facilitate the transaction and is therefore not deductible; and
- attach a statement to its original Federal income tax return for the taxable year in which the fee is paid or incurred stating that the taxpayer is making the safe harbor election, identifying the specific transaction for which the election is made, and listing the success-based fee amounts that are deducted and capitalized.

It is also important to note that the new safe-harbor election for success-based fees is irrevocable once made. ■

For more information on J.H. Cohn's Private Equity/Venture Capital Practice, go to http://www.jhcohn.com/services-and-solutions

Joel Boff, CPA, is a J.H. Cohn partner. He can be reached at jboff@jhcohn.com or 646-254-7490.

Solutions Capital in the Middle Market: *Video Series*

In parts two and three of the video series, Solutions Capital In the Middle Market, Privcap CEO, David Snow, leads discussions with Anthony Zecca, J.H. Cohn partner; Richard Leonard, managing director Angelo, Gordon & Co.; and Béla Szigethy, co-CEO of Riverside Company—veterans of the private equity middle-market, who describe the effort that leads to true portfolio company value creation.

Candid Advice for Sellers

The importance of chemistry between the private equity firm and company management is a key take-away from this segment. Other topics discussed include: how to evaluate important differences between potential private equity bidders, differences in available capital between firms, how to see beyond a firm's "spiel" to "get the real story," fees that some GPs charge their portfolio companies, nailing down an operating plan before the deal closes, how life changes post-deal, important differences between the goals of different sellers, and the delicacies of changing management teams.

Tales of Value Added (And Plans Botched)

In the final segment, David Snow opens by reiterating the importance of value. He says, "As everybody knows, or at least anybody who follows private equity should know, it's all about adding value now. It's not just financial engineering; it's about bringing solutions to middle market companies."

Key Takeaways

- Financial Capital isn't everything
- Operating partners are becoming an important part of the private equity value proposition
- "Chemistry" between GP and management is key
- Replacing underperforming management is a powerful, but gut-wrenching solution

The panel also covers the importance of helping portfolio companies with pricing and how botching industry trends and management and technology transitions can ruin an investment, and how companies need to prepare to be acquired by private equity firms.

Access all the segments *here*. Once you click the link, you will need to complete a short registration form to get free access to the video program and additional supporting content. ■

CALIFORNIA

Los Angeles
11755 Wilshire Boulevard
17th Floor
Los Angeles, CA 90025
310-477-3722

San Diego
9255 Towne Centre Drive
Suite 250
San Diego, CA 92121-3060
858-535-2000

Warner Center
21700 Oxnard Street
7th Floor
Woodland Hills, CA 91367
818-205-2600

CAYMAN ISLANDS

P.O. Box 1748 GT
27 Hospital Road
George Town, Grand Cayman
877-704-3500 x7839

CONNECTICUT

Farmington
76 Batterson Park Road
Farmington, CT 06032
860-678-6000

Glastonbury
180 Glastonbury Blvd.
Glastonbury, CT 06033
860-633-3000

New London
125 Eugene O'Neill Drive
Suite 120
New London, CT 06320
860-442-4373

Stamford
1177 Summer Street
Stamford, CT 06905
203-399-1900

MASSACHUSETTS

Springfield
One Monarch Place
Suite 2020
Springfield, MA 01144
413-233-2300

NEW JERSEY

Roseland
4 Becker Farm Road
Roseland, NJ 07068
973-228-3500

Eatontown
27 Christopher Way
Eatontown, NJ 07724
732-578-0700

Metro Park
333 Thornall Street
Edison, NJ 08837
732-549-0700

Princeton
103 Carnegie Center
Suite 311
Princeton, NJ 08540
609-896-1221

NEW YORK

Manhattan
1212 Avenue of the Americas
New York, NY 10036
212-297-0400

Long Island
100 Jericho Quadrangle
Suite 223
Jericho, NY 11753
516-482-4200

White Plains
1311 Mamaroneck Avenue
White Plains, NY 10605
914-684-2700

J.H. COHN LLP
ACCOUNTANTS & CONSULTANTS

877-704-3500
www.jhcohn.com

Circular 230: In compliance with U.S. Treasury Regulations, the information included herein (or in any attachment) is not intended or written to be used, and it cannot be used by any taxpayer for the purpose of i) avoiding penalties the IRS and others may impose on the taxpayer or ii) promoting, marketing or recommending to another party any tax related matters.

This has been prepared for information purposes and general guidance only and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is made as to the accuracy or completeness of the information contained in this publication, and J.H. Cohn LLP, its members, employees and agents accept no liability, and disclaim all responsibility, for the consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.