Deductibility of Legal Fees and Transaction Costs for Tax Purposes

In any real estate, acquisitive or restructuring transaction, legal fees and other consultant fees can become a substantial cost during the deal. IRS regulations outline several limitations on deductibility, so it is important to understand these limits and potential exceptions to capitalization to maximize the "after-tax" dollars spent on legal fees and other transaction costs.

Facilitative Costs

Generally, amounts paid "*to produce or facilitate the acquisition of real (tangible, immovable property such as a house) and personal property (movable or intangible property such as stocks)*" have to be capitalized into the cost basis of the property. Additionally, amounts paid to "*facilitate the acquisition of a trade or business, a change in the capital structure of a business entity and similar transactions*"[1] may also need to be capitalized.

These are known as facilitative costs and include amounts paid to attorneys in the process of investigating or pursuing the purchase of property. Whether costs are facilitative is based on facts and circumstances. It does not matter that a cost would or would not have been incurred but depends upon the purchase of the property in determining the requirement for capitalization. Accordingly, taxpayers will need to better understand what is included in their attorney's invoice to determine what fees must be capitalized into the cost of property.

Investigatory Phase Costs

Pre-decisional costs may be deductible by taxpayers. This means investigatory and pursuit costs paid or incurred in the process of trying to determine whether to proceed with a transaction are deductible, unless they are inherently facilitative costs (in which case they are capitalized). The regulations provide a list of inherently facilitative costs incurred in the investigatory phase that must be capitalized into the basis of the property. Among other costs included:

- Securing an appraisal or determining the value or price of property
- Negotiating the terms or structure of the acquisition and obtaining tax advice on the acquisition
- Preparing and reviewing the documents that effectuate the acquisition of the property (for example, preparing the bid, offer, sales contract or purchase agreement)
- Examining and evaluating the title of property
- Obtaining regulatory approval of the acquisition or securing permits related to the acquisition, including application fees
- Conveying property between the parties, including sales and transfer taxes, and title registration costs

[1] Regulation 1.263(a)-5

- Finder’s fees or broker’s commissions, including contingency fees
- Services provided by a qualified intermediary or other facilitator of §1031 like-kind exchange

When real and personal property are purchased in a single transaction, such as the acquisition of a building with machinery, deductible investigatory and capitalized facilitative costs should be segregated using a reasonable allocation method. However, all investigatory costs related to the acquisition of personal property must be capitalized into the basis of the personal property.

Facilitative costs, including attorney fees, must be capitalized even if the property is not acquired. Inherently facilitative costs and other capitalized costs related to property that is not eventually acquired can be recovered through depreciation or deducted as an abandonment loss when the decision not to buy is made.

Retail Example

The IRS regulations provide a helpful example of these rules. For example, a taxpayer named Alice owns several retail stores in Georgia. Alice decides to investigate opening a new store in Macon. In October of 2019, Alice hires and incurs costs for a development consulting firm to study Macon demographics and perform market surveys, evaluate zoning and environmental requirements and make preliminary reports and recommendations for areas that Alice should consider for purposes of locating a new store. In December of 2019, Alice continues to consider whether to purchase real property in Macon and which property to acquire.

Through this decision process, Alice hires, and incurs fees for an appraiser to perform appraisals on two different sites in Macon to determine a fair offering price for each site. In March of 2020 Alice decides to acquire one of these two sites for the location of her new store. Alice is not required to capitalize amounts paid to the development consultant in 2020 because the amounts relate to activities performed in the process of determining whether to acquire real estate property and the amounts are not inherently facilitative costs.

However, Alice must capitalize amounts paid to the appraiser in 2019, because in this case the appraisal costs are inherently facilitative costs, as they were used in facilitating the purchase of her new retail store. In 2020, Alice must also include the appraisal costs allocable to property acquired in the basis of the property acquired. In addition, Alice may recover the appraisal costs allocable to the property that was not acquired either through depreciation or as a loss.[2]

Title Capitalization Considerations

IRS regulations also require taxpayers to capitalize the costs of defending or protecting a title to property they already own. For example, Jeff owns real property located in Martin County. Martin County files an eminent domain complaint condemning a portion of Jeff's property to use as a roadway. Jeff then hires an attorney to contest the

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[2] See IRS regulation 1.263(a)-2(f)(4) example 8

condemnation. The amounts that Jeff pays to the attorney must be capitalized because they were incurred to defend Jeff's title to the property.[3]

Deductibility of Legal Fees Incurred as Employee Compensation

One way to maximize deductibility for legal fees or other transaction expenses would be to hire in-house legal counsel instead of an external law firm. Employee compensation is not considered a facilitative cost and does not have to be capitalized, unless the cost is related to inventory (i.e. property produced or purchased for resale). This means work done by in-house counsel is deductible, even if these costs would have to be capitalized if this same work was done by an external law firm. A taxpayer can elect to capitalize the cost of in- house counsel into the basis of the purchased property. This election is made separately for each property purchased.

Deductibility of Success-Based Fees

Another area that taxpayers may be able to maximize transaction cost deductibility is under the safe harbor available for success-based fees. IRS regulations indicate that a payment that is contingent on the successful closing of any type of acquisitive transaction is capitalized except to the extent that the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. This documentation must be completed on or before the due date of the taxpayer's timely filed original federal income tax return, including extensions, for the tax year during which the transaction closes. The documentation must consist of more than merely an allocation between activities that facilitate the transaction and activities that do not facilitate the transaction and must have supporting records.

However, in lieu of the substantial documentation requirements above, the taxpayer may make a safe harbor election under Rev. Proc 2011-29 which will allow the taxpayer to treat 70% of the costs as non-facilitative and deductible and 30% of the fees as facilitative and capitalizable. Depending on the magnitude of the success-based fees incurred, the safe harbor election may minimize documentation requirements for the taxpayer.

Key Takeaways

Taxpayers should be prepared to request detail from their attorneys and other consultants in order to appropriately categorize legal and transaction fees and maximize deductibility. Taxpayers should also consider utilizing safe harbor elections where available. Some larger organizations may seek to maximize the use of in-house counsel or other employees to maximize the deductibility of legal and transaction fees. If invoicing fees to your clients, you should be familiar with these rules and the potential impact to your client.

For more information about the deductibility of legal fees, please contact Trey Webb or Amy Hess by calling 770.396.2200.

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[3] See IRS regulation 1.263(a)-2(e)(2) example 1