IRS directive on milestone payments leaves some issues unresolved

May 28, 2013

In brief

The IRS Large Business and International Division (LB&I) recently issued a memorandum directing LB&I staff to not challenge the treatment of certain 'eligible milestone payments' paid in the course of a covered transaction in which the taxpayer also incurs a success-based fee and certain other requirements are met (the directive). (For prior coverage of the directive, see WNTS Insight, "IRS issues favorable guidance on certain transaction costs," May 7, 2013.) However, the directive may not provide the simplification and certainty that taxpayers desire.

In detail

What are milestone payments?

Taxpayers often engage investment banks and law firms to provide various services in the investigation of a potential transaction. The service provider may require payments upon the occurrence of certain events -- e.g., upon signing of an engagement letter, the issuance of a fairness opinion, signing a merger agreement, or obtaining shareholder approval -- or simply the passage of time. These payments, which are referred to as milestone payments, generally are creditable against the total amount due upon the successful consummation of the transaction, but are not refundable in the event the transaction ultimately is unsuccessful.

Milestone

The directive defines 'milestone' as an event occurring in the course of a covered transaction (regardless whether the transaction is ultimately completed) that is:

- the execution of an agreement described in Reg. sec. 1.263(a)-5(e)(1)(i) -- i.e., a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement),
- an event described in Reg. sec. 1.263(a)-5(e)(1)(ii) -- e.g., when the material terms of the transaction (as tentatively agreed to by representatives of the acquirer and the target) are authorized or approved by the taxpayer's board of directors, or
- some other specified event (other than the successful closing of the transaction) that does not occur ***prior*** to any event described in Reg. sec. 1.263(a)-5(e)(1)(i) or (ii).

In other words, under this definition, a milestone cannot occur before the earlier of a letter of intent, exclusivity agreement, or approval of the transaction by the board of directors.

Milestone payment

The directive defines 'milestone payment' as a non-refundable amount that is contingent on the achievement of a milestone. Amounts that would be paid regardless of the achievement of

the milestone are not includible in a milestone payment.

Eligible milestone payment

The directive defines 'eligible milestone payment' as a milestone payment paid for investment banking services that is creditable against a success-based fee.

Examples: Application of the directive

Because the directive provides a very specific definition of 'milestone,' it is possible that a taxpayer may incur fees related to a milestone that is not covered by the directive. The examples below highlight common situations in which milestone payments arise and address the appropriate federal income tax treatment of these amounts in light of the recently issued directive and CCA 201234027, which concluded that milestone payments are not eligible for the safe harbor under Rev. Proc. 2011-29. (For prior coverage of CCA 201234027, see WNTS Insight, "IRS rules that certain milestone payments are not success-based fees," September 21, 2012.)

Situation 1

Pursuant to the terms of an engagement letter, a taxpayer agrees to pay an investment bank $10 million upon the successful closing of a transaction in which the taxpayer acquires 100 percent of the outstanding stock of a target company. The engagement letter also provides that the taxpayer will pay the investment bank $1 million when the merger agreement is signed and an additional $1 million upon shareholder approval of the proposed transaction. Both payments are non-refundable and are creditable against the total $10 million fee due upon the successful closing of the transaction. A letter of intent regarding the proposed transaction was signed prior to the signing of the merger agreement and shareholder approval.

Observation: In this case, the payments are (1) paid for investment banking services; (2) contingent upon the achievement of a milestone as defined in the directive; (3) non-refundable; and (4) creditable against a success-based fee. As a result, the payments constitute 'eligible milestone payments,' having met the specific criteria outlined in the directive.

Situation 2

Same facts as Situation 1, except that the payments are made to a law firm.

Observation: Although the payments meet the criteria of milestone payments under the directive, the payments do not appear to qualify as 'eligible milestone payments' because the amounts are not paid for investment banking services. As a result, the taxpayer must perform a separate analysis to determine whether the amounts paid are facilitative or non-facilitative.

Situation 3

Similar facts as Situation 1, except the engagement letter provides that taxpayer will pay the investment bank $5 million when the merger agreement is signed and an additional $5 million upon shareholder approval. The agreement does not contemplate a success-based fee.

Observation: The payments do not meet the directive criteria because they are not creditable against a success-based fee. As a result, the taxpayer must perform a separate analysis to determine whether the amounts paid are facilitative or non-facilitative.

Situation 4

Pursuant to the terms of an engagement letter, a taxpayer agrees to pay an investment bank $10 million upon the successful closing of a transaction in which the taxpayer acquires all the assets of a target company. The engagement letter provides that the taxpayer will pay $5 million to the investment bank for a fairness opinion on the terms of the transaction. The payment is non-refundable and is creditable against a success-based fee of $10 million payable upon the successful closing of the transaction. No letter of intent or exclusivity agreement was executed. The fairness opinion is issued before the material terms of the transaction are authorized by the taxpayer's board of directors.

Observation: In this case, the payment is (1) paid for investment banking services; (2) contingent upon the achievement of a specific event; (3) non-refundable; and (4) creditable against a success-based fee. However, because the fairness opinion was issued before the material terms of the transaction are authorized by the taxpayer's board of directors, the issuance of the fairness opinion is not a 'milestone' as defined under the directive. As a result, the payment is not an 'eligible milestone payment' for purposes of the directive. Accordingly, the taxpayer must perform a separate analysis to determine whether the amount paid is facilitative or non-facilitative.

Situation 5

Pursuant to the terms of an engagement letter dated April 1, 2013, a taxpayer agrees to pay an investment bank $10 million upon the successful closing of a transaction in which the taxpayer acquires all the assets of a target company. The engagement letter provides that the taxpayer will pay $500,000 to the investment banker upon signing the engagement letter, $2 million to the investment bank for a fairness opinion

on the terms of the transaction, and $1 million when the deal is publicly announced. All payments are non-refundable and are creditable against the success-based fee of $10 million. The investment banking firm issues its fairness opinion on November 30, 2013, the taxpayer's board of directors authorizes the transaction on December 1, 2013, and a public announcement is made on December 15, 2013. No letter of intent or exclusivity agreement was executed.

Observation: In this case, all payments are (1) paid for investment banking services; (2) contingent on the achievement of a specific event; (3) non-refundable; and (4) creditable against a success-based fee. Because the signing of the engagement letter and the issuance of the fairness opinion occur prior to the authorization granted by the board of directors, these payments are not 'eligible milestone payments' as defined under the directive. Therefore, the taxpayer must perform a separate analysis to determine whether the amounts paid are facilitative or non-facilitative.

However, the $1 million payment paid for investment banking services that is due at the time of the public announcement is an 'eligible milestone payment' as defined in the directive because it occurs after the taxpayer's board of directors authorizes the transaction. Accordingly, the IRS will not challenge the taxpayer's treatment of the $1 million payment if the taxpayer treats 70 percent of the payment as non-facilitative and 30 percent as facilitative, and otherwise complies with the directive – that is, the taxpayer documents that it intends to elect the safe harbor in Rev. Proc.2011-29 with regard to the respective success-based fees payable upon the successful closing of the transaction.

The takeaway

Engagement letters entered into between taxpayers and service providers often include up-front payments and additional payments payable prior to the successful closing of a transaction that are based on specified points in time. In light of the specific definition of 'milestone' in the recently issued directive, taxpayers seeking to determine whether these amounts are subject to the safe harbor election under Rev. Proc. 2011-29 should analyze carefully payments made to service providers to determine whether such payments constitute 'eligible milestone payments, so that the taxpayer will not be challenged if it elects to treat 70 percent of the eligible milestone payment as non-facilitative and 30 percent as facilitative.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Federal Tax Services

Jeff Brooks
(267) 330-6201
jeffrey.t.brooks@us.pwc.com

Jennifer Kennedy
(202) 414-1543
jennifer.kennedy@us.pwc.com

George Manousos
(202) 414-4317
george.manousos@us.pwc.com

Scott Thompson
(202) 346-5131
scott.d.thompson@us.pwc.com