IRS issues favorable guidance on certain transaction costs

May 7, 2013

In brief

The IRS Large Business and International Division (LB&I) recently issued a memorandum for all LB&I staff regarding the treatment of eligible milestone payments paid or incurred in the course of certain transactions in which the taxpayer also incurs a 'success-based fee' (the directive). The directive states that the treatment of such milestone payments should not be challenged if certain requirements are satisfied. The directive is welcome relief for taxpayers and should greatly simplify the treatment of milestone payments.

In detail

Background

Rev. Proc. 2011-29

Rev. Proc. 2011-29 provides a safe harbor election for allocating success-based fees paid in connection with a 'covered transaction' (as described in Reg. sec. 1.263(a)-5(e)(3)). A success-based fee – generally, the fee charged by an investment banker for its services — is a payment that is contingent on the successful closing of a covered transaction. That term is defined to include only:

- 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 that qualifies under Section 354 or Section 356.

Under the safe harbor, a taxpayer may elect, for a tax year ending on or after April 8, 2011, to treat 70% of all success-based fees paid or incurred in that tax year as non-facilitative, with the remaining 30% being treated as facilitative. Generally, fees that are deemed to be facilitative must be capitalized, while those that are deemed to be non-facilitative can be treated as either currently deductible or amortizable, as applicable. (For prior coverage of Rev. Proc. 2011-29, see WNTS Insight, "IRS seeks to minimize documentation controversy with safe-harbor election for success-based fees," April 14, 2011.)

Following the issuance of Rev. Proc. 2011-29, LB&I in July 2011 issued a directive (the 2011 directive) instructing LB&I examiners not to challenge the treatment of success-based fees paid or incurred in a tax year ending prior to April 8, 2011, if the taxpayer's original return position capitalized at least 30% of the total success-based paid or incurred in connection with a covered transaction.

Milestone payments

Rev. Proc. 2011-29 left unresolved the treatment of certain 'milestone payments,' which the new directive defines as a non-refundable payment that is contingent upon the achievement of a milestone event in connection with a proposed transaction. Examples of milestone payments include payments that are due upon the issuance of a fairness opinion, signing of a merger agreement, or obtaining shareholder approval.

Milestone payments typically are not refundable in the event the proposed transaction is not successful, and are creditable against the total amount due upon the successful completion of the transaction (i.e., creditable against a success-based fee). Accordingly, although milestone payments are payments that are contingent on the occurrence of a certain event, such payments technically are not within the precise definition of a success-based fee as defined under the Section 263(a) regulations, i.e., a payment that is contingent on the successful closing of a covered transaction.

CCA 201234027

Rev. Proc. 2011-29 did not specifically address whether nonrefundable milestone payments should be viewed as a success-based fee for purposes of applying the safe harbor. However, in Chief Counsel Advice 201234027, the IRS took the position that non-refundable milestone payments generally are not eligible for the safe harbor. (For prior coverage of CCA 201234027, see WNTS Insight, "IRS rules that certain milestone payments are not success-based fees," September 21, 2012.)

Scope of the directive

The new directive applies only to "eligible" milestone payments, defined as milestone payments that are incurred by either an acquiring corporation or a target corporation and that are paid for investment banking services that are credible against a success-based fee. Further, the directive applies only to amounts deducted on originally filed returns, and not for claims, whether formal or informal.

The directive instructs LB&I examiners not to challenge a taxpayer's treatment of eligible milestone payments if certain requirements are satisfied. Specifically, for tax years ending on or after April 8, 2011 (the issuance date of Rev. Proc. 2011-39), a taxpayer that qualifies for and timely elects to apply the safe harbor for a covered transaction will not be challenged on eligible milestone payments so long as it has not deducted more than 70% of such payments on an originally filed tax return and is not contesting its liability for such payments.

Similarly, for any milestone payment paid or incurred in a tax year before a taxpayer can elect the safe harbor -- e.g., the covered transaction closed in a tax year ending on or after April 8, 2011, but the milestone payment was paid or incurred prior to such date -- LB&I examiners are instructed not to challenge a taxpayer's treatment of any eligible milestone payment if the taxpayer has not deducted more than 70% of the milestone payment on an originally filed federal income tax return and is not contesting its liability for such payments. In addition, such taxpayers must have documented, in the year the eligible milestone payment was made, an intention to elect the safe harbor with respect to the applicable success-based fee and ultimately elected the safe harbor for the tax year the covered transaction successfully closed.

Finally, the directive provides guidance on the treatment of eligible milestone payments paid or incurred in tax years prior to the effective date of the safe harbor. Specifically, LB&I examiners are instructed not to challenge the treatment of milestone payments paid or incurred in tax years ending before April 8, 2011, if the taxpayer met the above requirements of the 2011 directive, has not deducted more than 70% of such milestone payments on its originally filed federal income tax return, and is not contesting its liability for such payments.

The takeaway

To elect the safe harbor, the transaction must be a covered transaction as defined in Reg. sec. 1.263(a)-5(e)(3), and a formal election statement must be attached to the taxpayer's originally filed federal income tax return for the tax year in which the success-based fees are paid or incurred. The statement must identify the transaction and the amounts that are being capitalized and deducted.

Let's talk

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

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