Office of Chief Counsel
Internal Revenue Service
Memorandum

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from: Nancy Lee
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subject: Allocation of Success-based Fees

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

SUMMARY

This memorandum responds to your request for assistance in determining whether nonrefundable milestone payments made to a service provider for activities performed with respect to a covered transaction qualify for the safe harbor provided in Rev. Proc. 2011-29, 2011-18 I.R.B. 746. For the reasons discussed below, we conclude that nonrefundable milestone payments that are creditable to a success-based fee are not, themselves, success-based fees. Therefore, these milestone payments do not qualify for the safe harbor provided in Rev. Proc. 2011-29. Please contact Jason Kristall at (202) 622-5020 if you would like further assistance or have any questions about this memorandum or our conclusion.

FACTS

A corporation ("Taxpayer") retains an investment banker to provide services as part of a transaction described in Treas. Reg. § 1.263(a)-5(e)(3) ("covered transaction"). The relationship between Taxpayer and the investment banker is memorialized in an engagement letter. Pursuant to that engagement letter, the investment banker will receive $10,000,000 upon the successful closing of the transaction. The engagement

letter further requires Taxpayer to pay $1,000,000 upon the signing of a merger agreement and another $1,000,000 upon shareholder approval of the transaction. These amounts, once paid, are creditable toward the $10,000,000 that will be owed upon the closing of the transaction. Accordingly, when the transaction closes, Taxpayer will pay $8,000,000 to the investment banker. If the transaction does not close successfully, the two $1,000,000 milestone payments are nonrefundable.

LAW

Treas. Reg. § 1.263(a)-1T(c)(3) provides that no deduction is allowed for an amount paid to acquire or create an intangible, which under Treas. Reg. § 1.263(a)-4(c)(1)(i) and (d)(2)(i)(A) includes an ownership interest in a corporation or other entity. See also Treas. Reg. § 1.263(a)-4(a).

Under Treas. Reg. § 1.263(a)-5, a taxpayer must capitalize an amount paid to facilitate the business acquisition or reorganization transactions described in Treas. Reg. § 1.263(a)-5(a). An amount is paid to facilitate a transaction described in Treas. Reg. § 1.263(a)-5(a) if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. Treas. Reg. § 1.263(a)-5(b).

Treas. Reg. § 1.263(a)-5(e)(1) provides that an amount (other than an inherently facilitative amount) paid in the process of investigating or otherwise pursuing a covered transaction facilitates the transaction only if the amount relates to activities performed on or after the earlier of (1) the date on which a letter of intent, exclusivity agreement, or similar written communication (other than a confidentiality agreement) is executed by representatives of the acquirer and the target; or (2) the date on which 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 committee of the board of directors) ("bright-line date"). Any amounts paid for activities described in Treas. Reg. § 1.263(a)-5(e)(2)(i) through (vi) are inherently facilitative and facilitate the transaction regardless of whether the amount is paid for activities performed on or after the bright-line date.

Treas. Reg. § 1.263(a)-5(f) provides that an amount that is contingent on the successful closing of a transaction described in Treas. Reg. § 1.263(a)-5(a) (i.e., a success-based fee) is presumed to facilitate the transaction. 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.

Rev. Proc. 2011-29 provides a safe harbor election for taxpayers that pay or incur success-based fees for services performed in the process of investigating or otherwise pursuing a covered transaction. Under Rev. Proc. 2011-29, a taxpayer may allocate a success-based fee between activities that facilitate the transaction and activities that

do not facilitate the transaction by treating 70 percent of the amount of the success-based fee as an amount that does not facilitate the transaction and by capitalizing the remaining 30 percent as an amount that does facilitate the transaction.

ANALYSIS

A success-based fee is an amount paid or incurred that is contingent on the successful closing of a transaction described in Treas. Reg. § 1.263(a)-5(a). See Treas. Reg. § 1.263(a)-5(f). Nonrefundable milestone payments are not contingent on the successful closing of the transaction. Rather, they are guaranteed payments incurred upon the occurrence of a specified milestone or upon some other date or event. Such payments are not success-based fees.

Under Rev. Proc. 2011-29, taxpayers may allocate success-based fees by treating 70 percent of the amount of the success-based fee as an amount that does not facilitate the transaction and by capitalizing the remaining 30 percent as an amount that does facilitate the transaction. This same allocation cannot be used for nonrefundable milestone payments. Under the facts described herein, Taxpayer may make a safe-harbor election under Rev. Proc. 2011-29 to allocate the $8,000,000 payable as a success-based fee. However, with respect to the two $1,000,000 milestone payments, Taxpayer must establish, based on all the facts and circumstances, whether the investment banker's activities were facilitative or not. See Treas. Reg. § 1.263(a)-5(e)(1) and (2).

CONCLUSION

Nonrefundable milestone payments that are creditable to a success-based fee are not, themselves, success-based fees. Therefore, they do not qualify for the safe harbor provided by Rev. Proc. 2011-29.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.