Deducting Milestone Fees? The 70-Percent Solution

By Robert W. Wood • Wood LLP • San Francisco

Taxpayers are generally required to capitalize amounts paid to facilitate corporate acquisitions. In fact, this rule applies to any collection of assets that constitutes a trade or business. The "you-better-capitalize-it" rule applies whether the taxpayer is the target or acquirer. [*See* Reg. §1.263(a)-5(a).]

With this background, you might assume that fees paid on the consummation of the deal always facilitate it and therefore must always be capitalized. Yet Reg. §1.263(a)-5(f) provides a window that can, at times, be bigger than a door. When an amount is paid that is contingent on the successful closing of a transaction, it is deductible 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 closing itself.

In other words, you can deduct it if you can prove it. Documentation is key. The documentation of the nonfacilitative character of the contingent fee is usually based on time records, itemized invoices and other records. The biggest variable is what facilitates the deal and what does not.

Still, in the majority of cases, it may [not] be clear what goes into the unattractive category of "to be capitalized." And much like other hot button words in the tax field—words like "nexus"—"facilitate" is given broad definition. In this context, it typically refers to amounts that are paid in the process of investigating or otherwise pursing the transaction. [*See* Reg. §1.263(a)-5(b).]

Amounts paid to determine the value or pricing of the target are certainly included within this category, so they too should be capitalized. Of course, not all costs incurred by

an acquirer or target are necessarily facilitative. In fact, Reg. §1.263(a)-5 provides rules allowing for the deduction of certain costs despite their facilitative character.

Conversely, some costs are "inherently facilitative," which means they are always in the "to be capitalized" column. Such "inherently facilitative" costs can never be deducted, regardless of when they are incurred. These costs include:

- securing an appraisal, a formal written evaluation or a fairness opinion related to the transaction;
- structuring the transaction, including negotiating the structure and obtaining tax advice on the structure (for example, on the application of the reorganization provisions);
- preparing and reviewing the documents that effectuate the transaction (for example, a merger agreement or purchase agreement and all that goes with it);
- obtaining regulatory approval of the transaction, including preparing and reviewing regulatory filings;
- obtaining shareholder approval of the transaction (for example, proxy costs, solicitation costs and costs to promote the transaction to shareholders); and
- conveying property between the parties to the transaction (for example, transfer taxes and title registration costs). [*See* Reg. §1.263(a)-5(e)(2).]

But putting these inherently facilitative costs to the side, an amount generally facilitates a deal only after a signed letter of intent or the communication of deal terms of a similar nature is issued. The idea is that a capitalization line is drawn once the material terms of the transaction are approved by the taxpayer's board of directors. [*See* Reg. §1.263(a)-5(e).]

If all of this seems a bit much, then you may especially like the IRS's latest safe harbor. The IRS Large Business & International ("LB & I") division has instructed examiners *not* to challenge taxpayers' treatment of eligible milestone payments made or incurred in the course of a covered transaction under Reg. §1.263(a)-5(e)(3). This is for taxpayers who incur a success-based fee.

Plus, the IRS has expanded the definition of what constitutes a milestone. [*See* LB & I-04-0114-001, "Updated Guidance on the Examination of Milestone Payments in the Acquisition of Businesses" (Jan. 27, 2014).] Under Reg. §1.263(a)-5, amounts paid to facilitate a business acquisition or reorganization must be capitalized. The covered costs include those paid in the process of investigating the transaction.

Not surprisingly, a success-based fee is an amount paid that is contingent on the successful closing of a transaction. It is also no surprise that such fees are *presumed* to facilitate the transaction. However, this presumption can be rebutted if you have sufficient documentation to establish that a portion of the fee is allocable to activities that *do not* facilitate the deal. [Reg. §1.263(a)-5(f).]

This is yet another place where documentation is the real key. But a safe harbor could obviate at least some of it. The safe harbor has come in several pieces. First, the IRS provided a safe harbor election in Rev. Proc. 2011-29, IRB 2011-18, 746.

The safe harbor is available if you pay or incur a success-based fee for services performed in a covered transaction. An example would be services performed in the process of investigating or pursuing a business acquisition. If you take advantage of the safe harbor, your allocation of a success-based fee between activities that facilitate the deal and those that don't will be respected as long as you:

- treat 70 percent of the success-based fee as an amount that does not facilitate the transaction; and
- capitalize the remaining 30 percent.

Old Milestones

LB & I-04-0413-002 said that an eligible milestone payment was a milestone payment for investment banking services that is creditable against a success-based fee. A milestone payment is simply a nonrefundable amount that is contingent on the achievement of a milestone. What is a milestone?

A milestone is an event occurring during the course of the covered transaction, regardless of whether the transaction is ultimately completed, if the event is:

- the execution of an agreement such as a letter of intent, exclusivity agreement or similar written communication other than a confidentiality agreement;
- the authorization or approval of a transaction agreed to by representatives of the acquirer

and the target, by the taxpayer's board of directors or by a board committee; or

- some other specified event (other than the successful closing of the transaction), provided that the event does not occur prior to the first occurrence of an event described above.

New Milestones

The IRS's latest directive, LB & I-04-0114-001, replaces the old milestone definition with a much broader triggering event. Now, it includes an event, even something like the passage of time that occurs in the course of a covered transaction. Moreover, this definition is relevant regardless of whether the transaction is ultimately consummated.

Documentation for allocating fees is optional. Rev. Proc. 2011-29 establishes the safe harbor for allocating success-based fees paid or incurred in covered transactions. It says that in lieu of maintaining the necessary documentation to support a deduction for a portion of a success-based fee, you can elect to treat 70 percent as deductible. The remaining 30 percent of the fee must be capitalized.

The election applies to all success-based fees paid or incurred by a taxpayer in a covered transaction for which the election is made. Once made, the election is irrevocable.

Keep Those Records

Even if you rely on the safe harbor, it is hard to argue with the logic that records never hurt. Perhaps good records might even influence whether you make the safe harbor election in the first place. The 70/30 deal may or may not be attractive. And good documentation might help.

In TAM 201002036 (Sept. 21, 2009), a company sought to deduct a portion of the success-based contingent fees it paid to investment bankers pursuant to a merger. The taxpayer hoped to substantiate the deduction based on spreadsheets containing certain general records of the work performed by the investment bankers before the merger was approved by the taxpayer's board.

Unfortunately, though, the taxpayer had no time records or itemized invoices to substantiate the allocation between the facilitative and nonfacilitative work the investment bankers did. Some expenses aided the deal; others did not. The spreadsheets had been prepared by the taxpayer's accountants.

The taxpayer argued they qualified as "other records" that adequately substantiated the two classes of work done by the investment bankers. Predictably, though, the IRS was not a pushover. The IRS's Large & Mid-Sized Business ("LMSB") Division argued that the spreadsheets were not "other records" sufficient to prove that some of the success-based fees were attributable to nonfacilitative activities.

Fortunately, the taxpayer's view prevailed. The TAM concludes that time records, itemized invoices or other documents can suffice. The type of document and what you call it is not as important as the attention to detail required in it.

Of course, contingent fees, by their nature, cannot be assessed until after the deal has closed. Substantiating deductions can be tedious. However, taxpayers should retain detailed records of every expense incurred in the transaction. Despite the general rules and the predisposition of the IRS to see items capitalized, not everything goes into that category.