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Breakup Fees, Capitalization and Code Sec. 1234A

By Donald P. Board • Wood LLP

Despite jitters about Brexit and the U.S. elections, the final numbers indicate that 2016 was an outstanding year for M&A. Admittedly, deal volume fell short of the record set in 2015. But worldwide M&A activity in 2016 still exceeded $3.8 *trillion*.

Transactions involving U.S. companies accounted for $1.66 trillion of this mind-boggling sum. And like the stock market in general, 2017 is off to a fast start. U.S. deal volume was already up 36 percent in January. Animal spirits have evidently revived, making it fair to ask, is domestic M&A getting a Trump bump?

As usual, cash was king. In 2016, fully 63 percent of U.S. public deals were for cash only. Pure stock transactions represented just 16 percent. Buyers paid for the remaining 21 percent with a combination of cash and shares.

But, curiously, 2016 was an even better year for deals that did *not* close. Globally, withdrawn transactions totaled *$840 billion*. Putting aside 2007–2008, when the global financial system teetered on the brink, 2016 set a new record.

Roster of the Fallen

A good number of the best-known deals that went south did so because of problems with one or more governments. Not surprisingly, antitrust issues derailed some of largest announced transactions.

Halliburton Co. and Baker Hughes Inc. scrapped their $34.6 billion merger after European regulators objected and the U.S. Department of Justice filed suit to stop the deal. A successful challenge by the FTC shot down Staples' proposed $6.3 billion acquisition of Office Depot. United Technologies Corp. didn't end up in court, but it cited antitrust concerns when it declined a gigantic $103 billion buyout offer from Honeywell International.

Antitrust is already making its mark in 2017. In January, a judged blocked Aetna from acquiring Humana Inc. for $37 billion. In February, another judge ruled against Anthem's proposed $54 billion acquisition of Cigna Corp.

Tax issues had to play catch up. Still, they brought down what would have been the third largest acquisition in history. Early in the year, Pfizer was moving toward closing a $160 billion inversion with Ireland's Allergan plc.

On April 4, 2016, however, the Treasury issued temporary regulations that would have branded Allergan a "serial inverter" for purposes of Code Sec. 7874. This regulatory change would have skewed a critical calculation, leaving Pfizer's shareholders with (deemed) ownership of more than 60 percent of the post-inversion entity.

Under Section 7974, that would have eliminating many of inversion's expected tax benefits. Within 48 hours, the deal imploded. [*See* Donald P. Board, *Cardtronics, Terex, Johnson Controls and Pfizer Face Anti-Inversion Regulations*, THE M&A TAX REPORT (July 2016).]

The government played no role in the collapse of Energy Transfer Equity's $33 billion acquisition of fellow pipeline giant The Williams Company. Instead, the deal fell through after ETE's tax counsel determined that it could not opine that a contribution of assets "should" qualify for tax-free treatment under Code Sec. 721.

ETE claimed that, without that opinion in hand, it was free to terminate what had become losing deal. The Delaware Court of Chancery agreed, and ETE ran, not walked, to the nearest exit. [*See* Donald P. Board, *Hook Stock Torpedoes "Should" Opinion, Buyer Scuttles Mega-Merger*, THE M&A TAX REPORT (September 2016).]

Termination Fees

Perhaps a bit like getting engaged, signing an acquisition agreement can come with a hefty price tag. Right off the top, there are the costs of hiring investment bankers, lawyers and experts of all sorts to assist with investigating, structuring, vetting and documenting the proposed transaction. Seeking regulatory approvals and dealing with the SEC can get expensive, too.

Even more significant costs are not paid in dollars. A big acquisition requires a major investment of time, energy and attention by both parties, including, notably, their senior management. Reputations, egos and huge executive paydays are frequently on the line.

There are also opportunity costs. For targets, signing up to be acquired by Company A means *not* signing up with Company B. Buyers can purchase multiple targets, so they have more elbow room. But there are limits, especially if the targets are large and their shareholders want cash. Buyers don't want to be left standing at the altar, either.

Termination fees (a.k.a. "breakup fees" or, more abruptly, "break fees") create a well-defined incentive for one or both parties to close the deal. These fees can also allocate the risk of regulatory and other mishaps that can block a transaction despite the best intentions of the parties. As a form of liquidated damages, breakup fees can also reduce uncertainty about the *amount* of a party's exposure if something (or someone) kills the deal.

In 2016, the average termination fee payable by U.S. target companies was set at about 3.5 percent of total equity value. In the scheme of things, that may not sound too bad. When would-be acquirers agreed to "reverse" termination fees, they averaged about 5.2 percent.

Again, those are averages—your actual breakup fee may vary. Pfizer, for example,

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paid Allergan just $150 million, less than one-tenth of one percent of their titanic deal price. Reportedly, the payment was only intended to cover Allergan's out-of-pocket expenses. If $150 million still sounds like a lot, bear in mind that Allergan would have owed its investment bankers $142 million if the deal had actually closed.

Cigna is currently suing Anthem to have their transaction declared legally dead—and to collect a $1.85 billion reverse termination fee. That's a relatively modest 2.7 percent of their $37 billion deal-gone-wrong. But Cigna is also demanding *$13 billion* in damages.

Breakup fees are usually exclusive remedies, but Cigna retained a right to sue Anthem for "willful" breach of its obligations. Anthem has responded in kind. It is suing Cigna for "sabotaging" the deal, allegedly because its executives were disappointed that they would not be getting the positions they wanted in the combined companies.

Halliburton's reverse break fee helped to pump up the average. The $3.5 billion it paid to Baker Hughes represented more than *10 percent* of the deal price. The acquisition agreement specifically designated this mammoth charge an "antitrust termination fee," so Halliburton went in with its eyes open.

When the market is hot, eager buyers will gamble on deals that others—including the target—think are pushing the limit. Baker Hughes was apparently skeptical, but it played its cards just right. The deal folded, but it still raked in the chips.

Deduct or Capitalize?

As the late Senator Dirksen supposedly observed, "A billion here, a billion there, pretty soon you're talking real money." So, naturally, the tax treatment of termination fees has become a matter of considerable interest. It remains so both to the IRS and to the companies that pay or receive these often prodigious fees.

Let's start with a fundamental question. Can the payor deduct a breakup fee as a business-related loss or expense? Or, is the payor required to capitalize the fee under Code Sec. 263?

Taxpayers must generally capitalize the cost of acquiring tangible or intangible property whose useful life extends beyond the close of the tax year. These capitalized costs become part of the taxpayer's basis for computing (1) depreciation or amortization expense (if permitted), and (2) gain or loss if the property is sold or otherwise disposed of.

Plainly, the price paid to purchase target stock is a capital expenditure. But it is also necessary, under the *INDOPCO* principle, to capitalize expenses related to the acquisition if they provide "significant benefits" that may be realized in future years. [*INDOPCO, Inc.*, SCt, 92-1 USTC ¶50,113, 503 US 79, 112 SCt 1039.]

Termination fees are paid when an acquisition does *not* happen. This means capitalization is usually irrelevant. If the would-be acquirer drops a billion or two when a court blocks a proposed merger, it will usually have no problem deducting the cost of the breakup.

But situations sometimes arise in which a fee paid to terminate one deal can be characterized as a cost incurred to carry out a *second* transaction. That can trigger Reg. §1.263(a)-5(a), which requires capitalization of costs that "facilitate" the acquisition of more than a 50-percent interest in a business entity.

Reg. §1.263(a)-5(c)(8) fleshes this out. The amount paid to terminate the first acquisition facilitates the second only if the two transactions are "mutually exclusive." Suppose that a target pays a breakup fee to get out of merging with one buyer in order to merge with a second at a higher price.

The target cannot merge with *both* companies, so the mutual-exclusivity requirement is satisfied. Mutual exclusivity by itself, however, is insufficient to trigger capitalization. There must also be a purposive link.

We smuggled that into the example by saying the target paid the breakup fee "in order to" merge with the second buyer. But, suppose that the target sincerely *wants* to close but is unable to satisfy a material condition in the merger agreement. After paying a large breakup fee, the target goes back on the market and promptly merges into some *other* buyer.

The two mergers are still mutually exclusive. But the target did not pay the termination fee in the first transaction *in order* to engage in the second. The breakup fee did not *facilitate* the subsequent merger. Thus, the target should not have to capitalize its payment under Reg. §1.263(a)-5(c)(8).

The Dark Knight

Depending on the facts, this kind of analysis can get nuanced. Suppose that Target Co. is concerned about a potential hostile takeover. Target approaches White Knight Corporation, which agrees to purchase Target.

Not coincidentally, White Knight believes that the best way to build value is to contribute additional capital to Target and to let its existing management implement the company's long-term business plan. Before the acquisition can close, Dark Knight, Inc., makes an unsolicited offer to acquire all of Target's stock for $200 million more than White Knight is willing to pay. Dark Knight makes it clear that it does not think much of Target's existing business, which it plans to shut down.

All that Dark Knight *really* wants is access to the valuable mineral deposits under Target's factory. Target's directors are distressed by this news, but their lawyers tell them they have a fiduciary duty to accept Dark Knight's more lucrative offer. Target sends its regrets to White Knight along with a $65 million termination fee.

This little fable hardly has a surprise ending. As soon as Dark Knight completes the acquisition, it replaces Target's management and fires the bulk of its employees. Dark Knight then tears down Target's factory and starts digging a huge pit.

Can Target deduct the $65 million it paid to White Knight? One would think not, since it was paid to clear the way for the second of two mutually exclusive transactions. But before answering, it is worth reviewing the decision of the Tax Court in *Santa Fe Pacific Gold Co.* [132 TC 240, Dec. 57,793 (2009)].

Santa Fe Gold involved a fee paid before Reg. §1.263(a)-5 became effective. But it may still provide at least a glimmer of hope. The facts were roughly analogous to the Dark Knight scenario described above. The Tax Court recognized that the $65 million payment facilitated Dark Knight's acquisition of Target. It also understood that the Dark Knight acquisition had served the financial interests of Target's *shareholders*, who got a higher price for their stock.

Nevertheless, the Tax Court concluded that the acquisition had not provided *Target* itself with any "significant benefit" extending beyond the current tax year. It pointed out that Dark Knight had completely abandoned all of Target's existing business plans. Indeed, it had terminated Target's operations and left the company as little more than a hole in the ground.

If the acquisition did *not* provide Target with any significant benefits, neither did its payment to "facilitate" the transaction. Paying the breakup fee failed to meet *INDOPCO*'s basic criterion for capitalization. As a result, the Tax Court allowed Target to deduct the $65 million.

Today, the IRS would no doubt argue that this line of reasoning is foreclosed by the language of Reg. §1.263(a)-5(c)(8). The Regulations even include an example concluding that a target must capitalize a termination fee paid to a white knight following an unsuccessful takeover defense. [*See* Reg. §1.263(a)-5(l), Example 13.]

The Regulations certainly make themselves clear. But, do they actually come to grips with the Tax Court's argument under *INDOPCO*? If a target can persuade a court that it truly did not derive any "significant benefit" from the subsequent acquisition, it might still have a shot at deducting the break fee under *Santa Fe*. [*See generally* Robert W. Wood, *Deductible Termination Fees?* THE M&A TAX REPORT (August 2009).]

Capital or Ordinary?

As 2016 made clear, enormous deals that crash and burn can trigger enormous termination fees. Because the fees do not facilitate a second transaction, they do not face capitalization under Reg. §1.263(a)-5(c)(8). But there is still room for controversy about how these payments should be taxed.

A corporation can generally deduct its losses under Code Sec. 165(a). But, as Code Sec. 165(f) reminds us, losses from sales or exchanges of capital assets are allowed only as permitted by Code Sec. 1211. A corporation's capital losses are allowed only to the extent of its capital gains.

If a corporation has excess capital losses in a particular year, it can carry them back for three years and forward for five more [Code Sec. 1212(a)(1)]. If the corporation's capital gains during this period are insufficient to cover the excess losses, the unabsorbed portion will expire without producing any tax benefit.

Paying a $1 billion termination fee is never fun. But if the payor cannot gin up $1 billion in capital gains before the loss expires, it will be even more painful. Payors therefore have an incentive to characterize their payments as *ordinary* losses.

Payees, on the other hand, will prefer capital treatment. Corporations pay the same rate of tax on ordinary income and capital gains. Even so, capital gains are better because they are the key to deducting capital losses.

What about the IRS? In revenue terms, its incentives are the opposite. If the taxpayer is the payor of a breakup fee, the IRS will prefer to characterize it as a capital loss. When facing the payee, the IRS will prefer to treat it as ordinary income.

U.S. Freight

The most important case on the tax treatment of termination fees is (or at least *was*) *U.S. Freight Co.* [CtCls, 70-1 USTC ¶9244, 422 F2d 887, 190 CtCls 725]. The taxpayer in *U.S. Freight* had contracted to purchase the target's shares from an individual stockholder. The purchase agreement provided that the taxpayer's $500,000 down payment would be forfeited as liquidated damages if the deal failed to close by a certain date.

Predictably, the taxpayer backed out and forfeited its down payment. It reported a $500,000 ordinary loss under Code Sec. 165(a). The IRS asserted that the loss was actually capital and therefore allowable only to the extent of the taxpayer's capital gains.

To get there, the IRS had to argue that the taxpayer's failure to perform under the purchase contract somehow constituted a sale or exchange of a capital asset. That probably seemed like a stretch, so the IRS appealed to logic and policy. The IRS drew an analogy to the treatment of options under Code Sec. 1234 ("Options to Buy or Sell").

Suppose that the taxpayer had paid $500,000 for an *option* to purchase the shares, and had then allowed its option to lapse. Under Code Sec. 1234, the taxpayer's loss when the option expired would have been treated as if it were a loss from the sale or exchange of the capital asset (target stock) to which the option related. So far, so good.

The IRS then argued that an option to purchase stock is, if anything, a *less* substantial interest in the underlying shares than a right to obtain them under an existing purchase contract. Yet, Code Sec. 1234 treats a loss from the expiration of an option as a loss from the sale or exchange of a capital asset. Hence, it "makes no sense" to deny such treatment to a loss resulting from breach of a full-fledged purchase contract.

The Court of Claims conceded that such a result might indeed be illogical. But it reminded the IRS that "'what makes sense' does not necessarily dictate the definitive answer in the tax area." On the contrary, "apparent conceptual niceties often must give way to the hard realities of statutory requirements." [*U.S. Freight*, 422 F2d at 892.]

The Claims Court was referring to the statutory requirement that there be a sale or exchange. The expiration of an option is not a sale or exchange in the conventional sense. That is why Congress, when it decided that the expiration of certain options should generate *capital* losses, had to provide in Code Sec. 1234 that expiration losses would be "considered" and would be "deemed" losses from a sale or exchange.

Policy or logic might dictate that forfeiture of a down payment under an *actual* purchase contract should be treated the same way as a loss from the expiration of an analogous option. But the hard reality in 1970 was that the Code did not provide taxpayers (or the IRS) with the means to recharacterize the termination of rights under a purchase contract as a sale or exchange.

Revolution from Above: Code Sec. 1234A

As originally enacted in 1981, Code Sec. 1234A was a technical provision. It was designed to prevent taxpayers from claiming ordinary losses following "the cancellation, lapse, expiration, or other termination" of a tax straddle involving "actively traded" personal property. Practitioners not involved in the esoteric world of financial derivatives would be tempted to ignore Code Sec. 1234A.

And mostly, they seemed to do just that. In 1997, however, Congress did something unusual: it deleted almost all the restrictions on the scope of Code Sec. 1234A. An obscure provision enacted to fight abusive straddles suddenly became a rule of general application.

As amended, Code Sec. 1234A deals broadly with gain or loss attributable to the cancellation, lapse, expiration or other termination of "a right or obligation … with respect to property." If the property is (or on acquisition would be) a capital asset in the hands of the taxpayer, the gain or loss attributable to the termination of the related "right or obligation" is treated as gain or loss from the sale of a capital asset.

The legislative history of the 1997 amendments leaves no doubt that amended Code Sec. 1234A was intended to apply to *all* kinds of property, including real estate and "non-actively traded" personal property. As an example of the latter, it cited *U.S. Freight* and "the forfeiture of a down payment under a contract to purchase stock." [*See* S. Rep. No. 33, 105th Cong., 1st Sess. 132, 134–135 (1997).]

The IRS Responds—or Doesn't

Despite the strong hint, it took taxpayers and the IRS a surprisingly long time to consider how expanded Code Sec. 1234A applies to termination fees. This is illustrated by Technical Advice Memorandum 200438038 (Sept. 17, 2004), which practitioners have frequently cited.

The taxpayer in the TAM had entered a contract with a target corporation to acquire all of its stock. The target reneged and paid the taxpayer a breakup fee. The taxpayer reported the fee as a return of basis, contending that it was compensation for the damages the target's breach had inflicted on its assets, including its goodwill.

The IRS National Office disagreed. Following an extended analysis, it advised that the termination fee had been paid as compensation for *lost profits*. The fee was therefore reportable as ordinary income.

At no point did the National Office refer to Code Sec. 1234A. This seems odd, at least in retrospect. The taxpayer had a contractual right to acquire the target's stock, which would have been a capital asset in its hands. The target paid the breakup fee to terminate the taxpayer's right. That sounds like a *prima facie* case for capital gain under Code Sec. 1234A.

The IRS got a second bite at the analytical apple in 2008. Another would-be buyer requested a private letter ruling concerning the fee it received when the target backed out of a planned stock acquisition. The IRS concluded that the breakup fee was ordinary income, once again relying on its "lost profits" analysis. [*See* LTR 200823012 (June 6, 2008).]

This time, however, the IRS at least mentioned Code Sec. 1234A. But, all it said was that the provision did not apply. This cryptic conclusion has also puzzled observers.

At a conference in October 2016, however, IRS officials shed some informal light on the matter. The officials explained that the IRS had taken a very narrow view of Code Sec. 1234A based on the legislative history. The IRS thought that the 1997 amendments were focused on overruling *U.S. Freight*.

This was important, the IRS believed, because of the special facts in that case. The buyer in *U.S. Freight* had contracted directly with one of the target's shareholders. The buyers in the 2004 and 2008 guidance, on the other hand, had contracted with the *target*.

According to the IRS officials, the "thinking at the time" was that this was put the payment outside the scope of Code Sec. 1234A. This is not very persuasive as regards the tax treatment of the buyer. Regardless of the steps involved, it still had a right to acquire target's shares.

Those shares would have been capital assets in the buyer's hands, so the termination would have fit comfortably within Code Sec. 1234A. However, the IRS would have been on firmer ground if the ruling had involved the tax treatment of the *target* in a cash-for-stock deal.

The target's payment would have terminated its obligations "with respect to" property within the meaning of Code Sec. 1234A, but that property would have been the target's own shares. But if the target had acquired its own shares, they would have become *treasury stock*, which is disregarded for tax purposes. It would have been hard for the IRS to argue that these disregarded shares would have been capital assets in the target's hands.

In a stock-for-stock deal, in contrast, the target is also paying to terminate its obligations with respect to the acquisition of the *buyer's* shares. The buyer's stock would be a capital asset in the target's hands, so Code Sec. 1234A can apply. This analysis doesn't work when the buyer has agreed to pay *cash* because cash is not a capital asset.

Compare this with the situation in *U.S. Freight*. There, the would-be buyer contracted directly with the target's shareholders. The target shares were certainly capital assets in *their* hands. As a result, there would have been no problem applying Code Sec. 1234A to the shareholders' receipt of a termination fee. The same analysis would have applied if the shareholders had *paid* a break fee to terminate their obligation to sell their stock.

The IRS Changes Course

In the years since 2008, taxpayers have given the IRS a crash course in Code Sec. 1234A. That included four trips to the U.S. Circuit Courts of Appeal. [*See Pilgrim's Pride Corp.*, CA-5, 2015-1 USTC ¶50,211, 779 F3d 311; *J.W. Alderson*, CA-9, 110 AFTR2d 2012-5125 (2012); *H. Samueli*, CA-9, 2011-2 USTC ¶50,697, 661 F3d 399; *J.A. Freda*, CA-7, 656 F3d 570 (2011).]

Although these cases did not involve termination fees, they would have awakened the IRS to the possibilities for applying Code Sec. 1234A in innovative ways. When we combine this with the fact that some huge breakup fees were starting to come up on audit, it is not surprising that the IRS reconsidered how Code Sec. 1234A might apply.

Advice from the Field

On September 9, 2016, the IRS released Field Attorney Advice 20163701F. The FAA deals with yet another reverse termination fee. Many observers suspect that the fee in question is the $1.64 billion that AbbVie Inc. paid Shire plc when it backed out of their planned inversion in 2014.

The FAA describes an inversion that collapsed after the Treasury issued a notice adversely affecting the tax benefits of the proposed acquisition. The acquirer pulled the plug and had to pay the foreign target a breakup fee.

An inversion is a three-party transaction in which the acquirer and the target *both* become subsidiaries of a new foreign parent. The acquirer's shareholders, however, get a majority of the new parent's stock.

Given the structure of the transaction, the acquirer in the FAA had *two* sets of contractual rights and obligations. One involved its shareholders' acquisition of the new parent's shares. The other concerned the new parent's acquisition of the acquirer's shares.

The parent's shares would have been capital assets in the hands of the acquirer. Consequently, Code Sec. 1234A applied to the acquirer's payment to terminate its obligations with respect to those shares. The FAA therefore concluded that the acquirer had to report a *capital loss*.

Advice from the National Office

On October 14, 2016, the IRS issued Chief Counsel Advice 201642035. The CCA addressed how Code Sec. 1234A would apply if the acquirer had *received* a termination fee in another unsuccessful stock acquisition. The agreement permitted the target to terminate in order to accept a better offer from a third party.

If it did so, however, the target would have to pay the jilted acquirer a $1 million break fee. The CCA first considered the consequences if the acquirer received the $1 million after incurring $200,000 in capitalized costs. The acquirer had a right with respect to the target's stock, which would have been a capital asset in its hands.

The acquirer therefore had an $800,000 capital gain under Code Sec. 1234A. What if the Acquirer had incurred capitalized costs of $1.1 million? The CCA concluded that Code Sec. 1234A still applied. Now the acquirer would have recognized a $100,000 capital *loss*.

The CCA closed by noting that its conclusion was contrary to that of LTR 200823012. The 2008 ruling, it observed, had "held without explanation" that the acquirer's receipt of a termination fee resulted in ordinary income. Private letter rulings are not precedential, but taxpayers should consider the 2008 field guidance overruled.

Unfinished Business

The IRS's 2016 rulings clarify how an *acquirer* will be taxed if it pays or receives a termination fee in a stock deal. Code Sec. 1234A will apply, and the acquirer will report a capital gain or loss. It seems reasonable to expect that the *target* in a stock acquisition will also get capital treatment if it pays or receives a breakup fee.

As noted above, however, Code Sec. 1234A's "capital asset" requirement can complicate the analysis in a cash-for-stock transaction.

Sometimes, it must be said, there may be work-arounds. For example, the target will typically have agreed, pending the closing, that it will not undertake transactions outside the ordinary course of business.

That means the target cannot suddenly sell all its assets to a third party. This run-of-the-mill covenant imposes an obligation on the target with respect to its own property. That is likely to include some capital assets.

If the target pays a breakup fee, can the IRS argue that a portion of the target's loss is "attributable" to the termination its obligations with respect to its own capital assets? Of course, the target did not pay *in order to* avoid the pre-closing covenant. But it might still take a court to settle whether the target's loss was "attributable" to the termination for purposes of Code Sec. 1234A.

With billions on the line, one may question whether the tax treatment of breakup fees should depend on what are arguably accidental features of the underlying transactions. But the IRS can only interpret Code Sec. 1234A. It cannot amend the statute on its own.

Last year, Senator Wyden, the ranking Democratic member of the Senate Finance Committee, proposed the Modernization of Derivatives Tax Act of 2016. MODA would have *repealed* Code Sec. 1234A as part of a radical simplification of derivatives taxation. It does not appear, however, that anyone considered what the consequences might be for the treatment of M&A termination fees.

If Code Sec. 1234A ends up on the chopping block, Congress should take the opportunity to enact a provision that specifically deals with breakup fees. Repeal and replace?

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