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Deals, Kill Fees, and Taxes

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In this article, Wood and Board examine merger and acquisition termination fees and their tax treatment under section 1234A.

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Signing an acquisition agreement always comes with a price tag. Investment bankers, lawyers, accountants, and others cost money. Seeking regulatory approvals and dealing with the SEC do, too. Acquisitions require time, energy, and attention by both sides, including senior management.

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.

Kill fees, termination fees, breakup fees (or whatever you call them) create another incentive for one or both parties to close a 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.

In 2017 the average termination fee payable by U.S. target companies in public deals was set at about 4 percent of total deal value.[1] When would-be acquirers agree to pay "reverse" termination fees, they are often set a bit higher. When Broadcom Inc. was pursuing Qualcomm in early 2018, it tried to sweeten the deal by offering an $8 billion reverse breakup fee — about 6.6 percent of total deal value.

On the other hand, when Pfizer backed out of its proposed $155 billion acquisition of Allergan in 2016, it paid Allergan just $150 *million*. That was a microscopic one-tenth of 1 percent of their titanic deal price. Reportedly, the payment was intended only to cover Allergan's out-of-pocket expenses.

Anthem's proposed acquisition of Cigna fell victim to antitrust concerns in 2017. Cigna has sued Anthem, seeking to collect a $1.85 billion reverse termination fee. That's a respectable 5 percent of their $37 billion deal-gone-wrong.

However, Cigna is also seeking $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, suing Cigna for allegedly "sabotaging" the deal.

Halliburton's attempted 2016 acquisition of Baker Hughes was also derailed by antitrust

[1] *See* FactSet Mergerstat, "Direct Termination Fee Average and Median Percentage of Total Invested Capital and Deal Size 2017," 76 (May 2018).

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issues. The $3.5 billion reverse breakup fee that Halliburton paid represented more than *10 percent* of the deal price, which may be a record. The acquisition agreement specifically provided for this mammoth charge as an "antitrust termination fee," so Halliburton went in with its eyes open.

When the market is hot, eager buyers may gamble on deals that others — including the target — may think are pushing the limit. Baker Hughes was reportedly skeptical that the antitrust regulators would approve the transaction. But for a free $3.5 billion, it was willing to let Halliburton give it a shot.

Just Deduct It

Can the payer deduct breakup fees as a business loss or expense? Or must they be capitalized under section 263? Taxpayers must generally capitalize the cost of acquiring 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. It is also necessary, under *INDOPCO*,[2] to capitalize expenses associated with an acquisition if they provide "significant benefits" that may be realized in future years.

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

However, 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. section 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. section 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.

The example above posits that the target paid the breakup fee in order to merge with the second buyer. Suppose, however, that the target sincerely wanted to close with its initial suitor but was unable to satisfy a material condition in the merger agreement. After paying a large breakup fee, the shamefaced 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. section 1.263(a)-5(c)(8).

Gold From *Santa Fe*

Suppose Target Co. is concerned about a potential hostile takeover. Target approaches White Knight Corp., which agrees to purchase Target. White Knight believes that the best way to build value is to contribute additional capital to Target and 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 if given the chance.

Unlike White Knight, all Dark Knight really wants is access to the valuable mineral deposits that happen to lie beneath 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.

[2] *INDOPCO Inc. v. Commissioner*, 503 U.S. 79 (1992).

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This little fable ends predictably: As soon as Dark Knight completes the acquisition, it replaces Target's management and terminates the bulk of its employees. Dark Knight then tears down Target's factory and starts digging a huge pit to get at those minerals.

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 it is worth reviewing the decision of the Tax Court in *Santa Fe*.[3]

Santa Fe involved a fee paid before reg. section 1.263(a)-5 became effective, but it may still offer Target a glimmer of hope. The facts were roughly parallel to the Dark Knight scenario. If we pursue the analogy, the Tax Court in *Santa Fe* recognized that the $65 million termination payment had facilitated Dark Knight's acquisition of Target. It also understood that the acquisition had served the financial interests of Target's *shareholders*, who obtained 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 tax year. It pointed out that Dark Knight had completely abandoned all of Target's existing business plans. Indeed, Dark Knight 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 Target's payment to "facilitate" the transaction. Paying the breakup fee therefore failed to meet *INDOPCO*'s basic criterion for capitalization. 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. section 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.[4]

The regulations certainly make themselves clear. But do they 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 may still be able to deduct the breakup fee under *Santa Fe*.[5]

Capital or Ordinary?

Deals that simply crash and burn can also trigger termination fees. Because the fees do not facilitate a second transaction, they do not face capitalization under reg. section 1.263(a)-5(c)(8). But there is still room for controversy about how the payments should be taxed.

A corporation can generally deduct its losses under section 165(a). But, as section 165(f) reminds us, losses from sales or exchanges of capital assets are allowed only as permitted by sections 1211 and 1212. Under section 1211(a), a corporation's capital losses are allowed only to the extent of its capital gains.

If a corporation has *excess* capital losses in a specific year, it can carry them back for three years and forward for five more under section 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 not fun. But if the payer cannot gin up $1 billion in capital gains before the loss expires, it will be even more painful. Payers 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, but 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 payer 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.

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[3] *Santa Fe Pacific Gold Co. v. Commissioner*, 132 T.C. 240 (2009).

[4] *See* reg. section 1.263(a)-5(l), Example 13.

[5] *See generally* Roger Jones and Andrew Roberson, "To What Extent Can Treasury Abandon or Overrule INDOPCO?" *Tax Notes*, May 3, 2010, p. 547; Robert W. Wood, "Deductible Termination Fees?" *The M&A Tax Report* (Aug. 2009).

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Carry the Freight

In *U.S. Freight*,[6] the taxpayer 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 specific date.

Predictably, the taxpayer backed out and forfeited its down payment. It reported a $500,000 ordinary loss under section 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 argued 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, drawing an analogy to the treatment of options under section 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 section 1234, the taxpayer's loss when the option expired would have been treated as 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 section 1234 treats a loss from the expiration of an option as a loss from the sale or exchange of a capital asset. The IRS contended that it "makes no sense" to deny such treatment to a loss resulting from the breach of a full-fledged purchase contract.

The Court of Federal Claims conceded that such a result might indeed be illogical. But it reminded the Service 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."[7]

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 some options should generate capital losses, had to provide in section 1234 that expiration losses would be "considered" and "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 forfeiture of a deposit as a sale or exchange.

Section 1234A?

As enacted in 1981, section 1234A 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. In 1997, however, Congress removed almost all the restrictions on the scope of section 1234A. A formerly obscure provision enacted to fight abusive straddles became a rule of general application.

As amended, section 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 indicates that amended section 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."[8]

It took taxpayers and the IRS a surprisingly long time to consider how expanded section 1234A applies to termination fees. This is

[6] *U.S. Freight Co. v. United States*, 422 F.2d 887 (Ct. Cl. 1970).

[7] *U.S. Freight*, 422 F.2d at 892.

[8] *See* S. Rep. No. 33, 105th Cong., 1st Sess. 132, 134-135 (1997).

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illustrated by TAM 200438038, which practitioners have frequently cited. The taxpayer in the technical memorandum had entered a contract with a target corporation to acquire all 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 Service refer to section 1234A. In 2008 another would-be buyer requested a private letter ruling concerning the fee it received when the target backed out of a planned acquisition. The IRS concluded that the breakup fee was ordinary income, once again relying on its "lost profits" analysis.[9] This time, the IRS mentioned section 1234A, but only to say that the inconvenient provision did not apply.

1234A Lives

Since 2008, section 1234A has been making a name for itself, with five notable visits to various circuit courts of appeal.[10] Although these cases did not involve termination fees, they have certainly awakened the IRS to the possibilities for applying section 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 section 1234A should apply.

On September 9, 2016, the IRS released FAA 20163701F. It dealt with yet another reverse termination fee. Many observers suspect that the fee in question was the $1.64 billion that AbbVie Inc. paid Shire PLC when it backed out of their planned inversion in 2014.

The advice describes an inversion that collapsed after 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, end up with a majority of the new parent's stock. Under the acquisition agreement, the acquirer was required: (1) to transfer its own shares to the new parent; and (2) to recommend to its shareholders that they exchange their acquirer shares for shares of the new parent.

FAA 20163701F treated the acquisition agreement as subjecting the acquirer to "obligation[s] . . . with respect to property" — that is, the corporate shares that would have been issued in the inversion. The shares were or would have been capital assets in the acquirer's hands, so section 1234A applied to the acquirer's payment to *terminate* its obligations regarding the shares. The acquirer was therefore required report the breakup fee as a capital loss.

Chief Counsel Advice

On October 14, 2016, the IRS issued ILM 201642035. The advice addressed how section 1234A would apply if an acquirer *received* a termination fee in another unsuccessful stock acquisition. The agreement at issue 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 breakup fee. The advice 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 section 1234A. What if the acquirer had incurred capitalized costs of $1.1 million? The advice concluded that the acquirer would have recognized a $100,000 capital loss.

The advice 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

[9] *See* LTR 200823012.

[10] *See CRI-Leslie LLC v. Commissioner*, 882 F.3d 1026 (11th Cir. 2018); *Pilgrim's Pride Corp. v. Commissioner*, 779 F.3d 311 (5th Cir. 2015); *Alderson v. United States*, 686 F.3d 791 (9th Cir. 2012); *Samueli v. Commissioner*, 661 F.3d 399 (9th Cir. 2011); *Freda v. Commissioner*, 656 F.3d 570 (7th Cir. 2011).

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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. Section 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.

Section 1234A's "capital asset" requirement can complicate the analysis in a cash-for-stock transaction. The target will typically agree, pending the closing, not to 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 regarding 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 of its obligations regarding 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 of its obligation for purposes of section 1234A.

With billions on the line, one may question whether the tax treatment of breakup fees should depend on arguably accidental features of the underlying transactions. But the IRS can only interpret section 1234A; it cannot amend the statute on its own. ■

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