I.R.S. ADDS NEW THEORY WHY MERGER TERMINATION FEES ARE CAPITAL RATHER THAN DEDUCTIBLE COSTS

Authors
Kenneth Lobo
Nina Krauthamer

Tags
Capital
Deductions
Mergers & Acquisitions

The I.R.S. and taxpayers have long argued whether fees paid by one party to another in a failed merger are capital costs or deductible costs. For some taxpayers, the consequences may be severe, as sufficiently large capitalized costs paid in failed mergers may never be fully offset by future income. In two recent internal memoranda, the I.R.S. added another theory in support of its capitalization position.

DEDUCTIBLE COSTS V. CAPITAL COSTS

Under the Internal Revenue Code (the "Code"), all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" are allowed as deductions.[1] To qualify for a deduction, an item must

- be paid or incurred during the taxable year,
- be for carrying on any trade or business,
- be an expense,
- be a necessary expense, or
- be an ordinary expense.[2]

A taxpayer is required to capitalize amounts paid to facilitate a transaction that provides the taxpayer with significant long-term benefits.[3] Unlike deductions, corporate capital losses from capital assets are allowed only to the extent of capital gains from capital assets. Stock is generally considered a capital asset.[4] There is a carryover permitted in the event of excess capital losses.[5] Accordingly, it is possible that a corporation may find itself in the undesirable position of never offsetting the entire capital loss unless it triggers a sufficiently large capital gain.

In a merger, whether a cost should be capitalized or deductible depends on the facts of each transaction. Often, an acquiring corporation ("Acquirer") and a target corporation ("Target") enter into an agreement where one party must pay the other a "termination fee" should one party disavow the merger. The balance of this article will be narrowly focused on these termination fees, and not on any other merger-related costs.

---

1 Code §162(a).

2 *Comm'r v. Lincoln Sav. & Loan Association*, 403 U.S. 345, 352, 91 S. Ct. 1893.

3 Treas. Reg. §1.263(a)-5.

4 *Appalachian Electric Power Co. v. U.S.* (1958 Ct. Cl), 1 AFTR 2d 628.

5 Code §§1211 and 1212.

REGULATIONS AND PAST RULINGS

Past revenue rulings have held that where an Acquirer and a Target have incurred costs in attempting a merger, those costs should be deductible as a loss.[6] However, the regulations indicate that under certain circumstances, merger termination fees must be capitalized. For example, if termination fees are paid to facilitate a second transaction, those fees must be capitalized but only if the second alternative transaction is mutually exclusive to the first transaction.[7] In other words, if Acquirer could purchase both Target 1 and Target 2, but decides only to purchase one of the corporations, those costs are likely deductible.[8] The costs would be capitalized if Acquirer could not purchase both Target 1 and Target 2, since those transactions would then be "mutually exclusive."[9]

"The I.R.S. did not reference the Treasury Regulations when making its determination. Instead, it based its analysis on Code §1234A and the legislative history."

CODE §1234A

Code §1234A requires a capital gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right with respect to property that is (or on acquisition would be) a capital asset in the hands of a taxpayer to be treated as a gain or loss from the sale of a capital asset. Code §1234A was added so that a contract to deliver a capital asset would be treated for tax purposes as equivalent to the capital asset itself.[10] Code §1234A was enacted in 1981 as part of a comprehensive tax package designed to prevent tax avoidance "straddle" transactions. The provision was originally included to prevent derivatve traders from obtaining both a capital gain and an ordinary loss on the same transaction.

RECENT I.R.S. DECISIONS

The facts of the recent I.R.S. memorandum, Legal Advice Issued by Field Attorneys: Break Fee, are as follows:[11]

- Acquirer and Target entered into a merger agreement whereby Acquirer was obliged to pay a termination fee to Target should it withdraw from the merger.
- Upon receiving a notice from the U.S. Treasury Department that would adversely affect the potential tax benefits from the merger, Acquirer withdrew its offer.
- According to the I.R.S., since stock is a capital asset, "rights" relating to that capital asset must also be capital in nature. Thus, the I.R.S. held that the termination fee was a capital cost and therefore non-deductible.

Readers should note that the I.R.S. did not reference the Treasury Regulations

---

6 Rev. Rul. 73-580, 67-125, 79-2.

7 Treas. Reg. §1.263(a)-5(c)(8).

8 Treas. Reg. §1.263(a)-5(l), Example 14.

9 Treas. Reg. §1.263(a)-5(l), Example 13.

10 S. Rep. No. 97-144, at 170-171; see also H.R. Rep. No. 97-201, at 213.

11 "Legal Advice Issued by Field Attorneys: Break Fee," May 3, 2016, Office of Chief Counsel, Internal Revenue Service, FAA 20163701F.

when making its determination. Instead, it based its analysis on Code §1234A and the legislative history of the statute determining whether an asset was considered a capital asset. It determined that any rights or obligations arising from a transaction involving a capital asset should be capitalized.

In a second recent legal memorandum, the I.R.S. was asked to address whether a taxpayer who investigates a stock acquisition and receives a termination fee is entitled to a deduction for those costs.[12] The I.R.S. held that because the contract provided the potential Acquirer with a "bundle of rights" relating to the acquisition of a capital asset (*i.e.*, Target's stock), under Code §1234A, those rights would likewise be considered capital assets. Accordingly, both the merger termination and investigation fees were considered capital costs. The I.R.S. supported its decision by noting that the legislature indicated an intent to provide certainty concerning the modification of property rights when drafting the Code sections relating to lapsed rights and capital assets. It was noted that this ruling was contrary to an earlier private letter ruling, P.L.R. 200823012, which held without explanation that the receipt of a termination fee under similar facts was ordinary.

CONCLUSION

Whether a merger-related cost is deductible depends on the facts and circumstances of each merger. However, the I.R.S. seems to be exploring a theory that would characterize the vast majority of (if not all) merger termination costs as capital rather than deductible costs. In some cases, if the termination costs are sufficiently large, a correspondingly large capital loss may practically never be offset by future income.

---

[12] Andrew M. Irving to David Q. Cao, February 9, 2016, Office of Chief Counsel, Internal Revenue Service, Receipt of Merger Termination Fee, 201642035.

Disclaimer: *This newsletter has been prepared for informational purposes only and is not intended to constitute advertising or solicitation and should not be relied upon, used, or taken as legal advice. Reading these materials does not create an attorney-client relationship.*