Termination and Break-Up Fees

Has IRS changed its position as to their deductibility?

By Dean M. Hottle, CPA, ABV, Partner

Most business sale/purchase agreements contain a termination agreement. These agreements generally provide that if the agreement is terminated because a better offer came along or because of the inability to obtain funding, then the terminating party is required to pay a fee to discontinue the agreement. This payment is usually significant in size. There are income tax consequences to both the payer and the payee.

Deductible or Not

In National Starch and Chemical Corp., CA-3, 918 F2d 426, the court held that consulting fees, legal fees, and other expenses incurred by a company's board of directors in the process of deliberating and accepting another company's friendly takeover bid were capital expenditures and could not be currently deducted. The change in ownership, which brought a manufacturer and distributor together, resulted in synergy that would provide significant long-term benefits.

However, in Federated Department Stores, Inc., DC Ohio, 171 BR 603, the court held that break-up fees paid to "white knights" in connection with a failed corporate merger were currently deductible business expenses. The decision to engage in a "white knight" defense was ordinary and necessary in the context of a hostile-takeover battle. Capitalization of the expenses was improper because no benefit accrued beyond the year in which the expenditures were made and no separate and distinct assets were created. Rather, the expenditures were attempts to defend the business against attack, not to restructure it.

The Origin-of-the-Claim Doctrine

In TAM 200438038, the IRS stated that both the courts and the IRS typically look to the origin-of-the-claim doctrine with respect to determining the proper treatment for a recovery received in a judgment or settlement, and that a termination fee is similar to a settlement, having the underlying purpose of avoiding litigation. The rationale being that the termination of an acquisition agreement is, generally, a bargained-for position similar to a negotiated settlement. The IRS asserted that "in analyzing the case under the origin-of-the-claim doctrine, the focus should be on the origin and character of the claim with respect to which the payment is made, the bargained-for termination fee, rather than its potential consequences to the taxpayer's business operations." The IRS also noted that the agreement did not explain the purpose of the payment, and the taxpayer was not alleging that the termination fee was a claim for loss of profits.

The IRS further explained that if the agreement is silent as to the allocation of the recovery to either lost profits or damage to capital, it has substantial support for the position that whenever the status of the payment is unclear or no allocation is made, the recovery will be treated as lost profits. Accordingly, the IRS concluded that the receipt of the termination fee by the taxpayer resulted in ordinary income to the taxpayer. In addition, the payer is entitled to an ordinary business expense deduction.

IRC Sec. 1234A and Termination Fees

Recently, the IRS took a different view with respect to the characterization of termination fees. In CCA 201642035, the IRS addressed a situation where the taxpayer ("Acquirer") received a break-up fee. Acquirer entered into an agreement to acquire the stock of Target. The agreement provided that Target could terminate the agreement upon (i) entering into another agreement based on a superior offer, (ii) a rejection of Acquirer's offer by Target's shareholders, or (iii) a failure to obtain approval of Target's shareholders by a certain date. If the agreement was terminated due to one of the aforementioned reasons, Target was required to pay a termination fee of $1 million to Acquirer. In Situation 1, Acquirer also incurred transaction costs in the amount of $200,000. In Situation 2, the transactions costs were $1.1 million, i.e., exceeding the amount of the termination fee.

In its analysis, the IRS started with citing Code Sec. 1234A, stating Code Sec. 1234A provides that gain or loss attributable to the cancellation, lapse, expiration or other termination of a right or obligation with respect to property — which is (or, on acquisition, would be) a capital asset in the hands of the taxpayer — is treated as gain or loss from the sale of a capital asset. The IRS continued by stating that the Target stock, if acquired, would be a capital asset in the hands of Acquirer. The IRS explained that the agreement between Target and Acquirer, referred to as the "Contract," gave Acquirer a bundle of rights with respect to Target that related to Acquirer's proposed acquisition of Target stock, stating:

> "Although the Contract is between Acquirer and Target rather than between Acquirer and Target's shareholders, a contract between the acquiring corporation and the target corporation is a customary part of the process by which the stock of a publicly held corporation is acquired. As discussed above, the Contract imposes obligations on both parties with respect to Target's stock. The Contract also provides Acquirer with rights with respect to Target's stock."

The IRS then uses the same language as in the previous authorities, indicating that the payment of the termination fees is in the nature of liquidated damages rather than as a compensation for services. The IRS then concludes that consistent with the purpose of Code Sec. 1234A, any gain or loss realized by Acquirer on the termination of the Contract, which provides rights and obligations with respect a capital asset, would be capital in nature.

Consider Separate Termination Agreement

The CCA creates significant uncertainty around what many practitioners thought was well settled. Although the character may not be all that important to a corporate acquirer if it is receiving the break-up fee, it is certainly important if it is paying the break-up fee. The TAM and LTR 200823012 provided support for the deduction of a break-up fee as an ordinary item by the party paying the break-up fee. A capital loss would not be the preferred result for most taxpayers.

The CCA calls into question the legal analysis in the prior cases and rulings as well. Is the origin-of-the claim really the termination of the contract for the purchase of a capital asset or an agreement to compensate one party for loss of profits? In most circumstances, it would seem like it is really a payment for the time and expense incurred in going through the deal process. Going forward it would seem that the parties might want to explicitly provide for the purpose of the termination fee. In fact, it might be beneficial to enter into a termination agreement that is separate from the stock purchase agreement. That is, an agreement that solely provides for compensation for loss of profits should the purchase terminate, so that the agreement is no longer part of a contract to acquire property rights.

Contact us

For more information, please contact to Dean M. Hottle, CPA, ABV, Partner at dhottle@pkfod.com or 914.421.5635 or any member of the PKF O'Connor Davies team.

About PKF O'Connor Davies