

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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from: Andrew M. Irving
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subject: Receipt of merger termination fee

This memorandum responds to your October 5, 2015, request for advice.

ISSUES

1. Under the circumstances discussed below, how is gain or loss determined by a taxpayer who incurs expenses investigating an acquisition of stock, and also receives a fee for the termination of an agreement between the taxpayer and a target corporation pursuant to which the parties agree to undertake a series of steps designed to lead to the taxpayer's acquisition of the target corporation's stock?
2. Whether, under the circumstances discussed below, section 1234A applies to the gain or loss realized?

CONCLUSIONS

1. Under the circumstances discussed below, gain or loss is determined by reducing any fee received for the termination of the agreement by any costs incurred in the process of investigating and pursuing the transaction that were properly capitalized under section 1.263(a)-5(e) of the Income Tax Regulations.

2. Under the circumstances discussed below, section 1234A applies to the gain or loss realized by the taxpayer.

FACTS

Situation 1

A domestic corporation (“Acquirer”) enters into an agreement (“Contract”) with another corporation (“Target”) pursuant to which the parties agree to undertake a series of steps that are designed to lead to Acquirer’s acquisition of Target’s stock. At the time that the Contract is entered into, Target’s stock is publicly traded on an established exchange.

The Contract is a bilateral agreement that requires both Acquirer and Target to pursue a plan of merger by making best efforts to effectuate Acquirer’s proposed stock acquisition through a merger of a newly formed, wholly owned subsidiary of Acquirer with and into Target, including by recommending the deal to their respective shareholders and obtaining required governmental approvals.

Regarding Target’s obligations under the Contract, the Contract requires Target to recommend to its shareholders that they approve the plan of merger, subject to the receipt of a superior offer. The Contract provides that Target may terminate the contract 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. The Contract provides that in the event the Contract is terminated due to one of the foregoing, Target must pay a termination fee of \$1,000,000 to Acquirer.

Target receives a superior offer from an unrelated company and enters into another agreement with the company making the superior offer. As a result, Target terminates the Contract and pays Acquirer the \$1,000,000 termination fee. At the time the Contract is terminated, Acquirer has incurred \$200,000 of costs in the process of investigating and pursuing the transaction that Acquirer properly capitalized as costs of facilitating the proposed transaction under section 1.263(a)-5(e) of the Income Tax Regulations.

Situation 2

The facts are the same as in Situation 1, except that Acquirer incurs costs in the amount of \$1,100,000 that Acquirer properly capitalized as costs of facilitating the proposed transaction under section 1.263(a)-5(e) of the Income Tax Regulations.

APPLICABLE LAW AND ANALYSIS

Section 1222 provides that capital gain or loss is gain or loss from the sale or exchange of a capital asset.

Section 1221 defines a capital asset as property held by the taxpayer, with certain exceptions.

Section 1234A(1) of the Code 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 legislative history to section 1234A provides that the Committee believed that the law as it existed was deficient because it “taxes similar economic transactions differently,” and “its lack of certainty makes the tax laws unnecessarily difficult to administer.” S. Rept. No. 105-33, at 134, 1997-4 C.B. (Vol. 2) at 1214. The legislative history to section 1234A further provides that—

...[a] major effect of the Committee bill would be to remove the effective ability of a taxpayer to elect the character of gains and losses from certain transactions. Another significant effect of the Committee bill would be to reduce the uncertainty concerning the tax treatment of modifications of property rights.

S. Rept. No. 105-33, at 135, 1997-4 C.B. (Vol. 2) at 1215. The explanation of the provision provides further that—

...[t]he bill extends to all types of property the rule which treats gain or loss from 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 [as capital gain or loss].... Thus, the committee bill will apply to (1) interests in real property and (2) non-actively traded personal property.... An example of the second type of property interest that is affected by the committee bill is the forfeiture of a down payment under a contract to purchase stock. See *U.S. Freight Co. v. U.S.* 422 F.2d 887 (Ct. Cl. 1970), holding that forfeiture was an ordinary loss.

S. Rept. No. 105-33, at 135, 1997-4 C.B. (Vol. 2) at 1215.

Section 1.263(a)-5(e) of the regulations provides that amounts paid in the process of investigating or otherwise pursuing certain acquisitive transactions are capitalized as costs of facilitating the transaction.

Section 165(a) provides that there shall be allowed as a deduction any uncompensated loss sustained during the taxable year. Section 165(f) provides that capital losses are subject to the limitations in sections 1211 and 1212.

Section 1211 provides that in the case of a corporation, losses from sales or exchanges of capital assets are limited to gains from such sales or exchanges. Section 1212 provides for the carryover of excess capital losses.

In both *Situation 1 and Situation 2*, under section 1221 Target's stock would be a capital asset in Acquirer's hands upon acquisition. The Contract provides Acquirer with a bundle of rights vis-à-vis Target that relates to Acquirer's proposed acquisition of Target stock. 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 termination fee payable to Acquirer under the Contract is in the nature of liquidated damages rather than as compensation for services. Consistent with the purpose of section 1234A, any gain or loss realized by Acquirer on the termination of the Contract, which provides rights and obligations with respect to Target's stock, a capital asset, would be capital in nature.

Based on these particular facts we conclude:

In *Situation 1*, Acquirer's amount realized from the receipt of the termination fee (\$1,000,000) is reduced by Acquirer's capitalized facilitative costs (\$200,000). Because this gain was attributable to the termination of Acquirer's right with respect to Target's stock -- property that would have been a capital asset in Acquirer's hands -- the gain is treated as a gain from the sale of a capital asset under section 1234A. Accordingly, Acquirer has a capital gain of \$800,000 (the termination fee income of \$1,000,000 less Acquirer's capitalized facilitative costs of \$200,000).

In *Situation 2*, Acquirer's amount realized from the receipt of the termination fee (\$1,000,000) is reduced by Acquirer's capitalized facilitative costs (\$1,100,000), resulting in a loss of \$100,000. Because this loss was attributable to the termination of Acquirer's right with respect to Target's stock -- property that would have been a capital asset in Acquirer's hands -- the loss is treated as a loss from the sale of a capital asset under section 1234A. Accordingly, Acquirer has a capital loss of \$100,000 (the termination fee income of \$1,000,000 less Acquirer's capitalized facilitative costs of \$1,100,000) that Acquirer may deduct under section 165, subject to the limitations on capital losses in sections 1211 and 1212.

This advice applies only in the situations and under the facts and circumstances described herein.¹ The label "termination fee" is not determinative, and the

¹ We note that the conclusion in this memorandum is contrary to the conclusion reached on similar facts in PLR 200823012, which held without explanation that the receipt of a termination fee like that in *Situation 1* resulted in ordinary income.

specific provisions of the contract in question in a given case must be examined to determine the correct tax treatment.

Pursuant to section 6110(k)(3) of the Code, this document may not be used or cited as precedent. Please call (202) 317-7003 if you have further questions.