INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

December 29, 2004

Third Party Communication: None
Date of Communication: Not Applicable

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District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Taxpayer	=
Y	=
Z	=
Year 1	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=

j =
k =
l =
m =
n =

ISSUE(S):

Whether the Termination Fee paid by Taxpayer is deductible under § 162 of the Internal Revenue Code or is capitalized under § 263.

CONCLUSION(S):

The Termination Fee is a capital expenditure that must be capitalized under § 263.

FACTS:

Taxpayer is in the trade or business of providing broadband internet and other media services (e.g., video, telephone, and high-speed data services) over a cable network. As part of its competitive broadband strategy to expand the geographical reach of its networks, Taxpayer sought to acquire additional communications systems through business combinations with other companies. In the early part of Year 1, Taxpayer's board of directors began to consider a business combination with Y, and, following presentations by financial and legal advisers, determined that a merger would be beneficial to Taxpayer and that it would be fair and in the best interests of Taxpayer's shareholders.

On Date 1, Taxpayer and Y executed a merger agreement (Y Merger Agreement), whereby Y would acquire Taxpayer stock. The Y Merger Agreement provided a number of situations in which Taxpayer and/or Y were permitted to terminate the agreement generally by reason of mutual agreement, the nonoccurrence of conditions precedent, or breach by the other party, and in some cases a fee of a dollars was required (Termination Fee). The Y Merger Agreement also provided that Taxpayer could terminate the agreement if:

> (A) The Board of Directors of [Taxpayer] authorizes [Taxpayer], subject to complying with the terms of this Agreement, to enter into a binding written agreement concerning a transaction that constitutes a Superior Proposal and [Taxpayer] notifies [Y] in writing that it intends to enter into such an agreement, attaching the most current version of such agreement to such notice …; (B) [Y] does not make, within five days … of receipt of [Taxpayer's] written notification of its intention to enter into a binding agreement for a Superior Proposal an offer that the Board of Directors of [Taxpayer] determines, in good faith after consultation with its financial advisors, is at least as favorable to the stockholders of [Taxpayer] as the Superior Proposal; (C) [Taxpayer] prior to such termination

> pursuant to this clause … pays to [Y] in immediately available funds the [Termination Fee]; (D) such termination takes place [within 45 days] and (E) [Taxpayer] shall have complied with [the agreement's provision prohibiting Taxpayer from soliciting other acquisition proposals].

Within a few days after Date 1, a significant Taxpayer shareholder expressed concern to Taxpayer's board of directors that the Y Merger Agreement was not in the best interests of the shareholders, and he received permission to develop a Superior Proposal. Pursuant to the shareholder's efforts, on Date 2 Z made a proposal to Taxpayer to acquire Taxpayer's stock (Z Proposal). Taxpayer determined that the Z Proposal could be a Superior Proposal, and Taxpayer notified Y, as required by the Y Merger Agreement, that it intended to negotiate with Z.

On Date 3, Taxpayer's board of directors met to consider the Z Proposal. Following the presentation by Taxpayer's management and financial and legal advisors, Taxpayer's board of directors concluded that the terms of the Z Proposal constituted a "Superior Proposal" over the Y Merger Agreement. In accordance with this determination, Taxpayer's board of directors unanimously voted to authorize the termination of the Y Merger Agreement and authorized and approved the officers of Taxpayer to enter into a merger agreement with Z (Z Merger Agreement).

At the Date 3 meeting, Taxpayer's board of directors resolved:

> WHEREAS, [Z] has informed [Taxpayer] that, upon approval of [the Z Merger Agreement] by the Board of Directors and delivery of the notice of termination of [the Y Merger Agreement], Z is prepared to execute [the Z Merger Agreement] and deliver a letter to [Taxpayer] committing to pay to [Taxpayer] the amount of the [$a] fee payable to [Y] upon termination of [the Y Merger Agreement].

Taxpayer issued a letter notifying Y of its intent (1) to terminate the Y Merger Agreement because of the Superior Proposal from Z, (2) to enter into the Z Merger Agreement, and (3) to pay the Termination Fee. The letter also recognized Y's right, under the Y Merger Agreement, to counter with a proposal at least as favorable as the Superior Proposal within a certain period of time.

Subsequently, representatives of Y and Z met to negotiate a possible transaction under which Y agreed not to interfere with Z's effort to acquire Taxpayer. As a result of these negotiations, Y and Z agreed to a cash and stock deal whereby both companies would divide the assets of Taxpayer. Y subsequently notified Taxpayer that it did not intend to make a counter offer and that it would accept the termination of the Y Merger Agreement upon receipt of the Termination Fee.

On Date 4, Taxpayer terminated the Y Merger Agreement and paid the Termination Fee. Taxpayer and Z entered into the Z Merger Agreement, which included the following relevant provision:

> At a meeting duly called and held, [Taxpayer's] Board of Directors has unanimously: (i) determined that this Agreement and the transactions contemplated hereby are advisable and fair to and in the best interests of [Taxpayer's] stockholders; (ii) approved and adopted this Agreement and the transactions contemplated hereby; and (iii) resolved … to recommend approval and adoption of this Agreement by its stockholders.

The Z Merger Agreement also provided, as a condition of the merger, that Taxpayer's representation and warranty that the Y Merger Agreement "has been duly terminated by [Taxpayer] pursuant to [the termination provision in the Y Merger Agreement]" shall be true.

The Taxpayer Proxy Statement, dated Date 5, in which Taxpayer's board of directors recommended that the shareholders approve and adopt the Z Merger Agreement, described Taxpayer's reasons for the merger with Z:

Taxpayer's shareholders subsequently approved the merger with Z.

On Taxpayer's Year 1 federal income tax return, a deduction was claimed in Other Deductions of a dollars. This deduction was listed as "[Y] Termination Fee." IRS Form 8275, Disclosure Statement, was attached to Taxpayer's consolidated federal tax return for Year 1, indicating that the deduction was claimed under § 162, as a buyout fee paid to Y as compensation for Taxpayer's breach of merger contract in the amount of a dollars.

The agent disallowed the deduction, finding that the Termination Fee was a nondeductible capital expenditure related to Taxpayer's merger with Z.

LAW AND ANALYSIS:

General Background

Section 162(a) generally allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Sections 161 and 261, however, provide in part that the allowance of a deduction under § 162 is subject to the exception provided by § 263. Section 263(a)(1) disallows deductions for "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Section 263 reflects the basic principle that a capital expenditure may not be deducted from current income. *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974).

In *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), the Supreme Court rejected the taxpayer's argument that the creation or enhancement of an asset is a prerequisite to capitalization, but instead looked at the nature of the benefits realized by the taxpayer. The Court recognized that "the presence of an ensuing benefit that may have some future aspect is not controlling" in determining whether an expense represents a capital expenditure (citing *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 354 (1971)), and that "the mere presence of an incidental future benefit … may not warrant capitalization," but the Court emphasized that "a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization." 503 U.S. at 87.

The Court also indicated that "the 'decisive distinctions' between current expenses and capital expenditures 'are those of degree and not of kind,' and that because each case turns on its special facts the cases sometimes appear difficult to harmonize." 503 U.S. at 86 (citations omitted).[1]

Corporate Merger Expenses

Generally, the expenses incurred for the purpose of changing the corporate structure for the benefit of future operations are capital expenditures. *INDOPCO, Inc. v. Commissioner*, 503 U.S. at 89; *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 715 (8th Cir.), *cert. denied*. 379 U.S. 832 (1964).

In *INDOPCO*, the Supreme Court considered whether costs incurred by the taxpayer in a reverse subsidiary cash merger (in which the taxpayer became a wholly-owned subsidiary of the acquiring corporation) were nondeductible capital expenditures. The Court found that the merger produced "significant benefits to [the taxpayer] that extended beyond the tax year in question" and therefore the expenditures were not deductible under § 162(a). 503 U.S. at 88. In particular, the Court pointed out representations in the record that (1) the taxpayer would benefit greatly from the acquiring corporation's enormous resources, (2) some synergy may exist with the acquiring corporation because of the nature of its operations and its strong consumer products orientation, (3) because it was now a wholly owned subsidiary the taxpayer was no longer subject to substantial shareholder relations expenses, and (4) the taxpayer was allowed, in the interests of administrative convenience and simplicity, to reduce the number of authorized shares.

In *A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997), the taxpayer, faced with a hostile takeover, incurred expenses adopting antitakeover measures, but the taxpayer eventually accepted the tender offer. The court focused on the taxpayer's concerns about the proposed takeover (the suitor had no capital, marketing, or research and development; the suitor intended to abandon the taxpayer's long-term strategic business plans) to find that the taxpayer was "defending against an unwanted acquisition in an effort to maintain and protect an established business," 119 F.3d at 490. The court determined the costs were incurred to frustrate, not facilitate, the merger with the hostile suitor and to preserve the status quo, not to produce future benefits.

In *United States v. Federated Dep't Stores, Inc.*, 171 B.R. 603 (S.D. Ohio 1994), the taxpayers entered into merger agreements with "white knights" to stave off tender offers from a hostile suitor, but despite the taxpayers' efforts the suitor acquired the taxpayers (and the taxpayers paid break-up fees to the white knights). The court found that, unlike the merger in *INDOPCO*, the taxpayers' mergers did not create synergy (especially because the suitor had no experience in the taxpayers' field), but rather the fees were paid as a result of unsuccessful attempts to defend the business from the hostile suitor.

[1] The Internal Revenue Service and the Department of the Treasury have issued capitalization rules at § 1.263(a)-5(c)(8) of the Income Tax Regulations that specifically apply to merger termination payments. However, the regulations are effective only with respect to amounts paid or incurred on or after December 31, 2003, and do not apply in this case.

The court also found that the completed merger agreements were separate transactions from the terminated merger agreements and that the break-up fees, payable upon failure of the mergers with the white knights, had no relevant effect on the subsequent merger.

In *Wells Fargo & Co. v. Commissioner*, 224 F.3d 874, 886 (8th Cir. 2000), the court, phrasing the issue as turning on the "origin of the claim doctrine," [2] considered the tax treatment of employees who, as part of their duties as directors of the employer, performed services indirectly and incidentally related to a corporate acquisition. The court stated that, in applying the origin of the claim doctrine, "the ultimate question is whether the expense is directly related to the transaction [that] provides the long term benefit."

In *Metrocorp, Inc. v. Commissioner*, 116 T.C. 211 (2001), the court, in a reviewed opinion, determined that the entrance and exit fees paid to the F.D.I.C. by the taxpayer upon its acquisition of a failed savings and loan association in a conversion transaction did not provide significant future benefits. In arriving at this conclusion, the court focused narrowly on the nature of benefits arising from the payments standing alone; the court explicitly declined to determine whether the fees should be capitalized in connection with the taxpayer's acquisition of another financial institution. 116 T.C. at 217.

Cancellation of Unfavorable Contracts

Cases involving the deductibility of payments to cancel contracts have looked at the nature of the benefit received by the termination. Generally, the cancellation of a contract does not, in and of itself, require capitalization of the cancellation payment; although the payor enjoys the general benefit of disposing of an unfavorable and burdensome contract and is able to enter into a more favorable contract, these general benefits do not require capitalization. See *Capitol Indemnity Ins. Co. v. Commissioner*, 237 F.2d 901 (7th Cir. 1956); *Cassatt v. Commissioner*, 137 F.2d 745 (3d Cir. 1943). There are also situations in which a cancellation payment is made in order to acquire a new benefit, but the cancellation is not connected closely enough to the benefit to require capitalization. In *The 12701 Shaker Boulevard Co. v. Commissioner*, 36 T.C. 255 (1961), the court allowed the taxpayer to deduct a prepayment penalty incurred in paying off existing debt in order to acquire a loan from a new lender. Similarly, in Rev. Rul. 73-146, 1973-1 C.B. 61, a corporation's payments to cancel pre-existing stock options as a condition of a merger agreement were not required to be capitalized.

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[2] The "origin of the claim doctrine," as originally developed, requires a factfinder to determine the tax attributes of legal expenses by looking at the matter being litigated rather than at the indirect consequences of the expenses. See *United States v. Gilmore*, 372 U.S. 39 (1963); see also *Woodward v. Commissioner*, 397 U.S. 572 (1970) (although stock appraisal, standing alone, may be a deductible expense, the appraisal litigation expenses at issue originated in the acquisition of a capital asset and therefore must be capitalized). Reflecting the general rule that the nature and character of a payment depends on the transaction from which it originated, the doctrine has been invoked in situations not involving litigation expenses (as in *Wells Fargo*).

However, where the cancellation payment is more closely linked to the acquisition of a long-term benefit, courts have treated the payment as a capital expenditure. For example, in *U.S. Bancorp v. Commissioner*, 111 T.C. 231 (1998), a lessee was required to capitalize a lease cancellation payment made in order to enter into a more favorable lease with the same lessor. See also *Basin Electric Power Cooperative v. Commissioner*, T.C. Memo. 2004-109. Similarly, lessors have been required to capitalize lease and license cancellation payments made to reacquire possession of the property. See *Rodeway Inns v. Commissioner*, 63 T.C. 414 (1974); *Peerless Weighing & Vending Machine Corp. v. Commissioner*, 52 T.C. 850 (1969).

In *Darlington-Hartsville Coca-Cola Bottling Co. v. United States*, 273 F. Supp. 229 (D. S.C. 1967), *aff'd*, 393 F.2d 494 (4th Cir. 1968), the taxpayer bottling companies, in order to acquire soft-drink syrup directly from the soft-drink company and avoid the middleman's mark-up, paid the soft-drink company's expenses of acquiring and liquidating the middleman. The taxpayers deducted the expenses as paid solely to eliminate burdensome and onerous contracts. However, the court viewed the payment as made pursuant to an overall plan to improve taxpayer's profits through the acquisition of a more favorable contract to acquire the syrup, the benefits of which could reasonably be expected to continue for an indefinite period.

Discussion

There is no issue in this case regarding whether the Termination Fee is related to Taxpayer's trade or business; and if it is not a capital expenditure then it is currently deductible under § 162[3] as a payment akin to liquidated damages. In determining whether the Termination Fee is a capital expenditure, the inquiry must focus on the nature of the benefits realized by Taxpayer upon entering into the Z Merger Agreement and whether the Y Merger Agreement was terminated (and the Termination Fee paid) to achieve that benefit.

Clearly the Z Merger Agreement provided long-term benefits to Taxpayer. Taxpayer had initially entered into the Y Merger Agreement because of the anticipated benefits to its business, and the Z Proposal was more advantageous. As in *INDOPCO*, the Z Merger Agreement was entered into, at least in part, because of anticipated synergies

[3] Taxpayer and the agent submitted the request for technical advice based on § 162, but at the adverse conference and in a supplemental memorandum Taxpayer raised the issue of whether the Termination Fee should be considered a capital expenditure more properly attributable to the Y Merger Agreement and thus deductible under § 165 and § 1.165-2(a) as a loss related to the abandonment of that transaction. This issue arose in *Federated Department Stores, Inc.* (discussed above), where the court determined, in the alternative, that the termination fee was irrelevant to the subsequent merger and that the facts were distinctive from the facts found in *Darlington-Hartsville Coca-Cola Bottling Co.*, *Peerless Weighing & Vending Machine Corp.*, and *Rodeway Inns of America* (discussed above). In looking at these cases as well as cases cited by Taxpayer (*Tobacco Prods. Export Corp. v. Commissioner*, 18 T.C. 1100 (1952), and *Portland Furniture Mfg. Co. v. Commissioner*, 30 B.T.A. 878 (1934)), it appears that the analysis under § 165 parallels the analysis under § 162. If , based on all the facts and circumstances, the payment is *directly related* to the acquisition of a *significant future benefit*, then there is no bona fide, deductible loss, and the payments are capital expenditures.

between the two companies. The Taxpayer Proxy Statement emphasized the benefits Taxpayer expected to achieve from the merger:

The Z Proposal was at no point considered to be a hostile tender offer threatening Taxpayer's business, as was the case in *A.E. Staley Mfg. Co.* and *Federated Dep't Stores, Inc*.; the Termination Fee was not paid pursuant to an arrangement to fend off suitors in order to maintain the status quo. Rather, Taxpayer sought out opportunities to combine with other businesses, and it welcomed the Z Merger Agreement.

Taxpayer suggests that the relevant inquiry is whether the Termination Fee itself produced a benefit related to the Z Merger Agreement, and Taxpayer concludes that payment of the Termination Fee paid to Y was a detriment rather than a benefit because, absent such payment, the combined corporations would have $a of additional resources. We do not believe the inquiry should be so narrowly focused -- clearly *any* payment has a negative effect on the payor's cash flow, but a board of directors bound by fiduciary duty would not make such a payment unless some benefit was expected. Further, we are not constrained, as the court was in *Metrocorp, Inc.*, to focus narrowly on the nature of the benefits resulting solely from the payment of the Termination Fee – it is clear from the record that Taxpayer terminated the Y Merger Agreement, and paid the Termination Fee, with a goal of achieving the significant benefits expected from the merger.

The Termination Fee will be treated as a capital expenditure made to achieve the benefit inherent in the Z Merger Agreement if it is *directly related* to the agreement (see *Wells Fargo & Co.*). In this case, Taxpayer and Z contemplated that Taxpayer would cancel the Y Merger Agreement in order to enter into the Z Merger Agreement – it was a condition of the merger. Further, the termination provision in the Y Merger Agreement specified that Taxpayer could terminate the agreement, and would be required to pay the Termination Fee, *in order to enter into a binding written agreement concerning a Superior Proposal*. Otherwise, Taxpayer's board of directors was required (in the absence of mutual consent, breach, or other specified conditions) to recommend that shareholders approve of the Y Merger Agreement.[4] Accordingly, the Y Merger Agreement was terminated, and the Termination Fee was paid, specifically to enter into the Z Merger Agreement. These facts are significantly different from those found in *The*

[4] Taxpayer suggests that, because the board of directors has a fiduciary duty to shareholders to pursue Superior Proposals, the provisions in the Y Merger Agreement limiting its ability to investigate these proposals are unenforceable and invalid – and thus the payment of the Termination Fee is not the source of Taxpayer's right to investigate these proposals. However, we do not believe the fiduciary rules dictate the tax result. Certainly Taxpayer's board of directors had the ability and the duty to seek Superior Proposals; but if the board chose to do so, and Taxpayer entered into a Superior Proposal, the Y Merger Agreement required payment of the Termination Fee.

12701 Shaker Boulevard Co., discussed above, where expenses incurred to cancel an existing contract were not found to be closely related to the new contract; the facts are also different from those in *Federated Dep't Stores, Inc.*, where the court found that the terminated merger was a separate transaction from the subsequent merger. The payment of the Termination Fee bears a direct relationship to the Z Merger Agreement.

Taxpayer's suggestion that the Y Merger Agreement was an "unfavorable contract," for which extrication expenses are deductible, regardless of the subsequent Z Merger Agreement, is not persuasive. The Y Merger Agreement was entered into because Taxpayer's board of directors determined that it would be in the best interest of Taxpayer and its shareholders. There is nothing in the record suggesting that Taxpayer would have suffered any economic detriment had it completed the merger with Y or that Taxpayer would have extricated itself from the agreement if there had been no Superior Proposal. Rather, unlike *Capitol Indemnity Ins. Co.* and *Cassatt*, but more like *Darlington-Hartsville Coca-Cola Bottling Co.*, *U.S. Bancorp v. Commissioner*, *Rodeway Inns*, and *Peerless Weighing & Vending Machine Corp.*, Taxpayer terminated the Y Merger Agreement, and paid the Termination Fee, specifically to acquire a benefit (the synergies promised by the Z Merger Agreement) that, otherwise, would not be available.

Because Taxpayer's payment of the Termination Fee is directly related to the Z Merger Agreement, and because the Z Merger Agreement confers significant future benefits to Taxpayer, the Termination Fee is a capital expenditure. The Termination Fee, therefore, is not a deductible expense, but rather it must be capitalized under § 263.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.