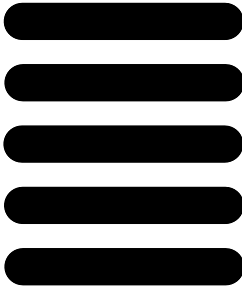

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Breaking up Is Hard to Do or, The St. Valentine's Day Massacre

By Mark A. Muntean · Robert W. Wood, P.C. · San Francisco

General Motors' roughly $2 billion ($1.55 billion) payment on Valentine's Day ended the U.S. auto giant's five-year relationship with Fiat SpA. The divorce reportedly will cost the U.S. automaker's shareholders a whopping $840 million by way of an after-tax charge to income. The settlement avoided a contentious custody battle during which Fiat could have forced GM to marry the Italian and assume a blistering $10 billion in debt.

GM's engagement with Fiat began in 2000, when GM paid $2.4 billion for a 20-percent stake in Fiat Auto (later reduced to 10 percent). [*See generally* Adrian Michaels and Bernard Simon, *GM Pays Fiat _ 1.55bn to end legal dispute,* FINANCIAL TIMES, Feb. 14, 2005, at 1.] The two companies planned to cooperate on the development and production of engines and autos. GM sought to annul its agreement with Fiat by voiding the Italian company's option to put its auto unit to GM. Fiat arguably had the right to force GM to the altar at a value GM and Fiat had agreed would be determined by third-party bankers.

Divorce, Italian Style

Generally, businesses paying a break-up fee hope that any such payment will be deductible as an ordinary and necessary business expense. However, frequently the IRS does not see it that way. Following the Supreme Court's seminal opinion in *INDOPCO, Inc.* [SCt, 92-1 USTC ¶50,113, 503 US 79, 112 SCt 1039] and its recent *INDOPCO* regulations, saying what expenditures qualify as a deductible expense any more is a conundrum worthy of divine inspiration.

Certainly, a good argument in favor of GM might be that the assertion that the payment to Fiat was a payment to end a burdensome contract, treating its 10-percent interest in Fiat as a worthless stock loss. [*See Stuart Co.*, 9 TCM 585, Dec. 17,762(M), *aff'd*, CA-9, 52-1 USTC ¶9236, 195 F2d 176 (cancellation of a burdensome contract); LTR 9842006

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(June 22, 1998) (cancellation of an uneconomic agreement); FSA 199918022 (Jan. 25, 1999) (to the extent a payment of a fee is to cancel a burdensome contract, a current deduction is allowed).] Yet, as appealing as this argument may be, this is hardly a no-brainer.

Indeed, the Tax Court has occasionally followed the IRS down the *INDOPCO* rabbit hole, concluding that taxpayers must capitalize expenditures when the taxpayer incurs expenses (1) to create or enhance a separate and distinct asset; (2) to produce a significant future benefit; or (3) "in connection with" the acquisition of a capital asset. [*D.J. Lychuk*, 116 TC 374, Dec. 54,353 (2001).] On the other hand, in *Metrocorp Inc.* [116 TC 211, Dec. 54,308 (2001)], the court allowed a bank to deduct exit fees paid to be released from a fund, and entrance fees paid to its own fund, in order to switch funds. The court reasoned that the fees were cost-saving expenditures incurred in minimizing recurring operating costs. Clearly GM's separation from Fiat was a cost-saving strategy.

INDOPCO Logic

The IRS frequently focuses on the second and third prongs of the *INDOPCO* rubik's cube to assert capitalization. The Supreme Court in *INDOPCO* stated that the mere presence of an incidental future benefit may not warrant capitalization. After all, many expenses that undeniably are currently deductible have prospective effect beyond the tax year of the expenditure.

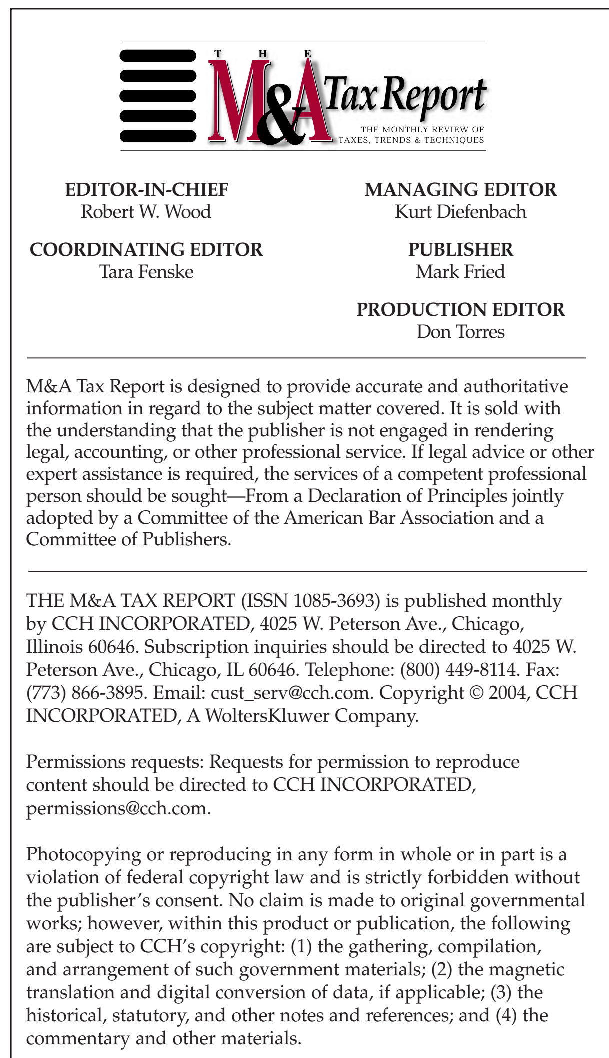
Yet, a taxpayer's realization of benefits beyond the year in which they incur the expenditure is important in determining whether capitalization or a current deduction is the appropriate tax treatment. Thus, where the expenditures produce significant benefits to the taxpayer extending beyond the tax year in question, they must capitalize the expenditures.

In GM's case, being relieved of the future obligation to acquire Fiat and to assume as much as $10 billion in debt might be considered a significant future benefit. In fact, depending on how myopic one is, that future benefit could be huge. The question is how that benefit stacks up against existing authorities about the nature of future benefits.

Don't Go Away Mad

GM can take some solace in the authorities relating to payments to cancel employment contracts. For example, a corporation was held to be entitled to deduct a payment made to a former CEO to settle current litigation and to obtain a release from the CEO's employment contract. Despite benefits that probably went on past that tax year, these expenditures were held to be ordinary and necessary business expenses under Code Sec. 162(a). [*Chief Industries, Inc. and Subsidiaries*, 87 TCM 1002, Dec. 55,554(M), TC Memo. 2004-45.]

In *Chief*, the Tax Court held that the payment to the CEO was not a capital expenditure. After all, the litigation and settlement originated with the CEO's removal from his position. The firing of the CEO was directly related to (and was necessary to defend against) attacks on taxpayers' business practices. Thus, they were ordinary costs of maintaining such defense. [*See also* Rev. Rul. 94-77, 1994-2 CB 19.]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Despite the clarity of *Chief*, the authorities are hardly consistent. For example, a taxpayer who made severance payments to avoid legal disputes with laid-off employees and to facilitate a corporate restructuring was not so lucky. He was required to capitalize the payments since the payment was viewed as not part of the corporation's historic compensation package. [*Great Lakes Pipe Line Co.*, DC Mo., 73-1 USTC ¶9158, 352 FSupp 1159.]

This suggests that if the IRS believes GM's payment to Fiat was to restructure its relationship with Fiat profitably (relying on their ongoing relationship to share engines and other auto parts), it may require capitalization. However, if GM argues that the payment was to avoid costly litigation that would ultimately terminate its relationship with Fiat, that argument may help GM to sustain current deductibility.

Just Go Away

GM might find additional comfort in cases relating to lease cancellation payments. In a series of these, the IRS has allowed such payments as current deductions in the year incurred where such lease cancellation fees were in the nature of damages paid to secure relief from an unprofitable contract. [*T.J. Enterprises, Inc.*, 101 TC 581, Dec. 49,473 (1993); *Cassatt*, 47 BTA 400, Dec. 12,594 (1942), *aff'd*, CA-3, 43-2 USTC ¶9579, 137 F2d 745.] Also, a lump-sum amount paid as damages by a lessee to the lessor for the cancellation of a lease was held deductible as a business expense. [Rev. Rul. 69-511, 1969-2 CB 23.] Likewise, where offices were closed and consolidated after a merger, the lease cancellation costs were held to be deductible. The rationale for this favorable rule was the fact that the offices were closed to eliminate duplication, not to facilitate the merger. [FSA 1999-896 (Nov. 23,1992).]

These authorities involved a cancellation fee that provided the taxpayer relief from a future obligation, yet the IRS allowed a current deduction. Of course, these lease cancellation authorities represent only one side of the coin. Cases requiring the capitalization of a lease cancellation fee generally involve a cancellation payment to facilitate a new contract or a move to a new location.

In *U.S. Bancorp & Consolidated Subsidiaries* [111 TC 231, Dec. 52,871 (1998)], the Tax Court required the taxpayer to capitalize a lease termination payment where the contract required the taxpayer to pay a second, higher termination fee if they did not sign a new lease. The court held that the termination fee was part of the costs of acquiring the new lease. The court rejected the taxpayer's argument that the termination was independent of the new contract. [LTR 9607016 (Nov. 20, 1995).]

It's Not Personal, It's Business

As if all this isn't enough, effective for transactions after December 31, 2003, under new regulations, taxpayers must capitalize amounts paid or incurred to facilitate the acquisition of a trade or business, a change in the capital structure of a business entity and certain other transactions. [Reg § 1.263(a)-5. *See also* Wood and Daher, *Capitalizing Legal Fees Related to Acquisitions: Will* INDOPCO *Ever Die?* 13 M&A TAX REPORT 3 (October 2004), at 7.]

Moreover, under the regulations, a taxpayer must capitalize an amount paid to facilitate each of the following transactions, without regard to whether the transaction comprises a single step or a series of steps carried out as part of a single plan, and without regard to whether gain or the taxpayer recognizes loss in the transaction:

- An acquisition of assets that constitute a trade or business
- An acquisition by the taxpayer of an ownership interest in a business entity if, immediately after the acquisition, the taxpayer and the business entity are related within the meaning of Code Sec. 267(b) or 707(b)
- An acquisition of an ownership interest in the taxpayer
- A restructuring, recapitalization or reorganization of the capital structure of a business entity, including Code Sec. 368 transactions
- Code Sec. 351 or Code Sec. 721 transactions
- A formation or organization of a disregarded entity
- An acquisition of capital
- A stock issuance
- A borrowing
- Writing an option

[Reg §1.263(a)-5(a)(1)–(10).]

GM's termination payment to Fiat does not fit neatly within any of the 10 transactions listed above. Additionally, Example 14 of Reg. §1.263-4, addressing break-up fees in connection with transactions not mutually exclusive, indicates

the regulations might be favorable to GM. Example 14 states as follows:

> N corporation and U corporation enter into an agreement under which U would acquire all the stock or all the assets of N in exchange for U stock. Under the terms of the agreement, if either party terminates the agreement, the terminating party must pay the other party $10,000,000. U decides to terminate the agreement and pays N $10,000,000. Shortly thereafter, U acquires all the stock of V corporation, a competitor of N. U had the financial resources to have acquired both N and V. U's $10,000,000 payment does not facilitate U's acquisition of V. Accordingly, U is not required to capitalize the $10,000,000 payment under this section.

Reg. §1.263(a)-4(d)(7) contains the rules for contract termination payments. This regulation requires capitalization of termination payments for any of the following:

1. Contracts for the lease of the taxpayer's real or personal tangible property
2. Contracts that provide the exclusive right to acquire or use the taxpayer's property or services
3. Contracts that prevent taxpayer from competing with or acquiring property or services from a competitor of the other party to the contract

Similar to the pre-2004 cases cited above, the regulations require a taxpayer to capitalize transaction costs, including cancellation and termination fees that facilitate subsequent transactions. For example, an amount paid to terminate a contract will be capitalized if a replacement contract required the cancellation.

Dream River

Of course, perhaps I'm just spit-balling about all of this. Not having any information in connection with the GM/Fiat transaction other than what was reported by the press, it would be presumptuous to opine on any tax positions to be claimed by either GM or Fiat. However, now that I have said that, I can be presumptuous and give my thoughts about it anyway.

It would seem to me that the GM/Fiat transaction is outside the reach of Reg. §§1.263(a)-4 and -5. Certainly, calling off the GM-Fiat wedding should significantly impact competition in the auto industry. Moreover, there does not appear to be a transaction on the horizon for GM that this divorce would facilitate. The press has not reported that GM has a mistress waiting in the wings for the Fiat affair to fall apart. Therefore, Example 14 may just address this situation.

Origin of the Claim Test

Finally, no tax analysis seems complete in this area without an examination of the origin of the claim test. That old saw comes out like toasts at a wedding. To determine the origin of the claim, courts and the IRS simply ask, "In lieu of what is the termination or cancellation fee paid?" [*See Raytheon Production Corp.*, CA-1, 44-2 USTC ¶9424, 144 F2d 110; LTR 200108029 (Nov. 24, 2000).] A taxpayer should characterize such fees for tax purposes in the same manner as the item for which they intend it to substitute. [*Id.; J.R. Knowland,* 29 BTA 618, Dec. 8332 (1933).]

In *L. Kisska* [42 TCM 1651, Dec. 38,418(M), TC Memo. 1981-655], the taxpayer sought to deduct a fee to a lender releasing the taxpayer from liability on a deed and promissory note. The court disagreed with the taxpayer and required the fee to be capitalized. The court based its decision on its interpretation of the origin of the claim. The origin of the claim here was the purchase and disposition of a building. Therefore, the court held the taxpayer should capitalize the fee to the property's basis, rather than deduct it.

The origin of the claim test may actually cut against GM as to its Fiat cancellation fee. If the IRS applies the court's reasoning in *Kisska,* the origin of GM's payment to Fiat may be the 2000 acquisition agreement when GM first acquire a 20-percent stake in Fiat. If that course of reasoning is followed, the break-up fee might be considered a capital expenditure.

Benediction

Since this is a 2005 transaction, GM has quite a while to review its tax position before a final tax return is due. Given the uncertainty surrounding break-up fees and cancellation fees, they might need some time for that review. However, no matter how the taxes shake out, I'm somehow guessing that GM will be happy to say "Grazie mille!"