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Deductible Termination Fees?

By Robert W. Wood • Wood & Porter • San Francisco

Call it a merger-termination fee, an exit charge, a breakup fee or perhaps even the macho-sounding "kill fee." When you pay it, is it deductible? Bankers and business people are likely to shout a resounding "yes." Readers of the M&A TAX REPORT know the answer is a more muffled "it depends."

It has been more than 15 years since the Supreme Court decided *INDOPCO, Inc.*, SCt, 92-1 USTC ¶50,113, 503 US 79 (1992). For a while, diehards called it *National Search*, the company's old moniker, but even diehards today use the now not-so-new nomenclature. The Court in *INDOPCO* famously held that in general, expenses incurred to change a corporate structure for the benefit of future operations must be capitalized.

This is no small matter, ranking as one of the IRS' bigger victories in recent decades and triggering a wave of significant concerns about capitalization issues. The High Court held that these costs produced significant benefits to the taxpayer (new resources, synergies, *etc.*), and that these benefits extended beyond the tax year in question. Ever since then, *INDOPCO*-mania has been palpable.

The solution to the IRS's penchant for capitalization often involves a little surgery. As we often have noted in these pages, taxpayers in the real world tend to respond with a divide-and-conquer mentality. One response to *INDOPCO* has been to recognize the duality in many expenditures.

After all, when one pays for something, one is often paying for *several* things, not merely for one item. The mantra of bifurcation has prevailed in legal fees, investment banking fees and in many other contexts. Nevertheless, it cannot be denied that *INDOPCO* is still a major impediment to many tax deductions.

Smile Train

The Tax Court in *Santa Fe Pacific Gold Co. and Subsidiaries*, 132 TC No. 12 (2009), gave taxpayers and their advisors some happy

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news. The court dealt a significant victory for taxpayers and a significant defeat for the IRS. The question in the case was whether a merger-termination fee paid to clear the way for a merger with another suitor could be currently deducted.

Santa Fe Pacific Gold Company was spun off from its parent into a stand-alone entity. Several years later, Santa Fe was faced with a hostile takeover attempt by Newmont Mining Corporation, a competitor. Santa Fe tried to avoid the threat of being swallowed up, particularly (it would seem) since it had gained its independent wings so recently.

Accordingly, Santa Fe entered into a merger agreement with Homestake Mining Company, a company that it perceived as a proverbial white knight. The merger agreement called for the payment of a termination fee should the agreement be terminated. Thereafter, Newmont increased its offer for Santa Fe.

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When the Santa Fe Board was confronted with this higher offer (which exceeded Homestake's offer), the Board felt it had a fiduciary duty to terminate the Homestake offer and to accept the higher offer from Newmont. Pursuant the contracts in question, Santa Fe paid $65 million as a termination fee to Homestake. Santa Fe deducted the payment. The IRS disallowed it, asserting that the expense had to be capitalized.

Who's on First?

To begin, the Tax Court in *Santa Fe* looks to the surrounding transaction and the circumstances under which the Santa Fe and Homestake agreement was executed. This termination fee, said the Tax Court, did not lead to significant benefits to Santa Fe extending past the year in question. Moreover, there was no question that the Santa Fe-Homestake agreement was defensive in nature.

Plainly, Santa Fe's agreement with Homestake was designed to prevent a takeover by Newmont. The termination fee was a part of that defensive agreement. That meant that any benefit as a result of incurring the termination fee died along with the Santa Fe-Homestake agreement.

Put differently, the fee was meant to protect the Santa Fe-Homestake agreement and to deter competing bids. From Homestake's perspective, the fee was designed to reimburse Homestake for its time and effort in the event the deal was terminated. In fact, that turned out to be exactly what happened.

Defense vs. Offense?

Given the Tax Court's focus, it is interesting to contemplate how defensive maneuvers should be undertaken. The Tax Court acknowledged that Santa Fe had other structural defenses in place. Yet the Tax Court recognized that Santa Fe's major defensive strategy was to engage in a capital transaction with a third-party (Homestake) to prevent Newmont's acquisition. The best defense, as they say, is a good offense.

Depending on how you look at it, that effort failed. Alternatively, at least it prompted Newmont to throw more money at Santa Fe. The IRS argued that this entire course of conduct was seamless, and that the termination fee actually did allow the Newmont deal to proceed (which in a way, it did). Despite that argument, the Tax Court found that Santa Fe's act of paying a termination fee to Homestake simply did not produce any long-term benefit to Santa Fe.

When the deal closed, Santa Fe became a Newmont subsidiary. The Tax Court found that this fact was not significant to Santa Fe. That meant a business expense deduction under Internal Revenue Code Section ("Code Sec.") 162 was proper.

Alternative Arguments

The IRS also argued that the potential Newmont and Homestake deals were mutually exclusive alternatives. Each deal, said the IRS, represented a broad restructuring goal. Nevertheless, the IRS said these two possible combinations were not part of an overall plan by Santa Fe to change its capital structure.

In fact, Santa Fe viewed the Homestake and Newmont transactions as separate and distinct. The Tax Court specifically found that the Santa Fe-Homestake agreement was a closed and completed transaction. It was abandoned by Santa Fe when it entered into the Santa Fe-Newmont agreement. The termination fee was paid as a result of that abandonment.

Therefore, concluded the Tax Court, it could also represent a cost of the abandoned Homestake merger. That meant Santa Fe would be entitled to a deduction under Code Sec. 165 as a loss, quite apart from the availability of the Code Sec. 162 deduction.

Pushing Paper

It is very clear that documents play an important role in a case such as this. The Tax Court had an easy time in ruling that Santa Fe's Board of Directors and management did not want to be taken over by a large competitor, particularly such a brief period of time after completing the spinoff from its former parent. The documents also made clear that Santa Fe viewed Newmont as a hostile bidder. The documents even showed that Santa Fe unabashedly entered into a white knight agreement with Homestake specifically to prevent Newmont from acquiring it.

When Santa Fe was later forced to abandon its agreement with Homestake (because Santa Fe's Board was under a fiduciary duty to accept the deal with the highest bidder), Newmont's offer simply had to be accepted. This forced Santa Fe to breach the Homestake agreement and pay the termination fee. At that moment, it abandoned the Homestake merger.

Axiomatically, Code Sec. 162(a) allows a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business. Code Sec. 165(a) allows a deduction for a loss not compensated for by insurance. The Tax Court held that either one could apply to Santa Fe's $65 million termination fee paid to Homestake.

Shell Game?

Cancellation payments are tricky. On the one hand, your instinct will likely always be to deduct them if you can. But unquestionably, sometimes a cancellation payment is closely linked to the acquisition of a long-term benefit. There, the payment will have to be capitalized.

Readers should note that regulations under Code Sec. 263 currently provide that an amount paid to terminate an agreement to enter into certain acquisitions and other transactions will be treated as paid to facilitate a second transaction if the two transactions are mutually exclusive. [*See* Reg. §1.263(a)-5(c)(8).] In the case of Santa Fe, this particular provision in the regulations did not apply, since the transaction predated December 30, 2003. If this same circumstance were to occur today, these regulations would require a termination fee (paid under the circumstances in which Santa Fe paid one to Homestake) to be capitalized.

Indeed, where a termination fee is paid to a white knight in an unsuccessful effort to defend against a hostile takeover by another corporation, the transactions will be viewed as mutually exclusive. Only one deal can take place. That means the termination payments would have to be capitalized as amounts paid to facilitate the takeover. [*See* Reg. §1.263(a)-5(1), Example 13.]

Nevertheless, more than a few practitioners will be scratching their heads over *Santa Fe*, no matter how favorable a decision it may be. When you consider this area, consider these authorities and try to discern a clear rule:

- *A.E. Staley Manufacturing Co.,* 105 TC 166, Dec. 50,882 (1995), *rev'd*, CA-7, 97-2 USTC ¶50,521, 119 F3d 482 (1997) (hostile takeover, no white knight; defensive expenses were held deductible, but "facilitative" expenses had to be capitalized)

- *Victory Markets, Inc.*, 99 TC 648, 48,800 (1992) (friendly takeover; no white knight; expenses were all deemed to facilitate a new deal so had to be capitalized)
- *INDOPCO, Inc.*, *supra* (friendly takeover; no white knight; expenses to facilitate transaction lead to long-term benefit and had to be capitalized)
- *In re Federal Dept. Stores, Inc.*, 135 Bankr. 950 (Bankr. S.D. Ohio 1992), *aff'd*, 171 Bankr. 603 (S.D. Ohio 1994) (hostile takeover; white knight; no long-term benefit; expenses deductible)

If nothing else, we know that hostility is good from a tax perspective. How much more we know is debatable.