PERSPECTIVE

Los Angeles | Daily Journal

MONDAY, AUGUST 8, 2022

Twitter, Elon Musk, $1 Billion Fee and Taxes

By Robert W. Wood

Elon Musk is in the news a lot for all sorts of things. That was certainly true when he said he would buy Twitter. It started with Musk buying some Twitter stock and trying to get on the board. Some people at Twitter didn't like that, and considering the size of Musk's wallet, he somehow ended up saying that he would buy the whole company instead. Money talks, and Musk looked to his own resources and funds from his backers to assemble an army of capital to close the enormous $44 billion deal.

For a time, it seemed like the whole country was talking about whether Musk in charge of Twitter would be a terrible or a good thing. There was the offer by Musk to buy the social media giant, the employee and public outrage, the pushback and more. Eventually, there was a deal struck for the meg-billionaire to pay $44 billion for the platform. Then, Musk started complaining about bots and a lack of proof for how many good accounts he was buying. Some observers claimed that Musk was trying to renegotiate.

Then, Musk called off the purchase publicly and in a Securities and Exchange Commission filing. Twitter didn't like that, so in a move that was as quick as a tweet, Twitter sued Musk to make the mercurial billionaire make good on his deal, or pay the $1 billion kill fee. How could taxes play out in Musk's on-again, off-again bid to buy Twitter?

Musk talks and tweets a lot about taxes, including about how much tax he should pay on selling Tesla stock. He's also complained about high California taxes and why he moved himself and Tesla to Texas. But is there a tax deduction anywhere in the $44 billion deal or its aftermath? Win, lose or settle, the tax implications are many and complicated. Perhaps a bit like getting engaged, signing an acquisition agreement can come with a hefty price tag.

Right off the top, there are the costs of hiring investment bankers, lawyers and experts of all sorts to assist with investigating, structuring, vetting and documenting the proposed transaction. Seeking regulatory approvals and dealing with the SEC can get expensive, too. Other costs are not paid in dollars. A big acquisition requires a major investment of time, energy and attention by both parties, including, notably, their senior management. Reputations, egos and huge executive paydays are frequently on the line.

There are also opportunity costs. For buyers and sellers, committing to a deal means excluding other opportunities. And neither side wants to be left standing at the altar. Whatever you call them – termination fees, breakup fees or kill fees – create a well-defined incentive for one or both parties to close a deal. These fees can also allocate the risks of regulatory and other mishaps that can block a transaction despite the best intentions of the parties. As a form of liquidated damages, breakup fees can also reduce uncertainty about the amount of a party's exposure if something (or someone) kills the deal.

If Musk has to pay, can he deduct the deal breakup fee as a business loss or expense? There was a kill fee in the deal, kind of a $1 billion nonrefundable deposit if Musk called it off. In fact, Musk and Twitter agreed that if either party chose to withdraw from the deal, that party would have to pay a fine of $1 billion. In a letter to Twitter, Musk's lawyer claimed that the company was in material breach of multiple provisions of its agreement with Musk. Musk does not believe that Twitter provided adequate information about how many fake and spam accounts populate the platform, and Musk says Twitter's failures should let him off the hook without a payment.

To understand that tax issue, it's important to start with a purchase. When you buy something, you have a basis in your purchase, but no tax deduction. In fact, in corporate deals of this sort, even the legal fees have to be capitalized and added to the purchase price. That is so even though in business, most legal fees are fair game to claim as business expenses. Even though most legal expenses are deductible by a business, some have to be capitalized, like legal expenses for negotiating to buy a new building. The same is true for corporate acquisitions.

But what happens when Musk backed out? Musk hopes not to pay the fee, but if he has to, the tax law says he can write it off as an expense. He can also write off all the legal fees he is incurring in Twitter's big lawsuit too. Not only that, but all those legal fees and other deal expenses that he could not deduct while his Twitter deal was *active* are now suddenly deductible. IRS rules clearly require those costs to be capitalized while the deal is negotiated, documented and closed.

But if the deal is scuttled, there is no asset to capitalize the expenses to, and you can write them off. Termination fees are paid when a deal does not happen, which usually means that capitalization is no longer relevant. Even if a would-be acquirer drops large amounts when a court blocks a proposed merger, it will usually have no problem deducting the cost of the breakup. However, in some cases, a fee paid to terminate one deal can be characterized by the IRS as a cost of carrying out a second transaction.

The possibility of a second deal facilitated by the termination of a proposed transaction can trigger tax rules that require capitalization of costs that facilitate the acquisition of more than a 50% interest in a business entity. That seems unlikely in the case of Twitter, but it can sometimes be a block to what might seem to be a slam dunk tax deduction. Taxpayers must generally capitalize the cost of acquiring intangible property whose useful life extends beyond the close of the tax year.

Termination fees, on the other hand, are paid when an acquisition does not happen.

We'll know more about how this may play out sooner than Musk may want. Twitter prevailed it its request for a quick trial, which is set to take place in a Delaware court over five days in October. Stay tuned.

Robert W. Wood *is a tax lawyer with www.WoodLLP.com, and the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This is not legal advice.*