Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **202224010**
Release Date: 6/17/2022

CC:FIP:ICFriedman
POSTF-119443-19

UILC: 1234A.01-00, 1001.00-00, 165.00-00, 263.08-03

date: February 24, 2022

to: Associate Area Counsel ( )
(Large Business & International)
Attn:

from: Ian C. Friedman
Attorney, Branch 1
(Financial Institutions & Products)

---

subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=
Target	=
	=
	=
Asset Buyer	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
$X	=
$Y	=

ISSUE

Whether the termination fees Taxpayer paid to
described below are treated as capital losses of Taxpayer under section

1234A of the Internal Revenue Code (the “Code”), or whether Taxpayer properly claimed the fees as business expense deductions under section 162. In particular, this memorandum considers:

(a) Whether there was a section 165 loss (rather than a section 162 expense) upon termination of each transaction;

(b) Whether the Treasury Regulations accompanying section 263(a) provide that the termination fees are deductible under section 162 if the fees are not expressly capitalized by those regulations;

(c) Whether case law pertaining to terminations and the origin of the claim doctrine requires that the Service accept Taxpayer’s treatment of the termination fees as section 162 expenses; and

(d) If the terminations of the transactions resulted in section 165 losses to which section 1234A can apply, how section 1234A applies to those losses.

CONCLUSIONS

We conclude as follows:

(a) Taxpayer’s terminations of the transactions resulted in dispositions under section 1001 that gave rise to losses under section 165 rather than business expenses under section 162;

(b) The regulations accompanying section 263(a) do not require that the termination fees be treated as section 162 expenses;

(c) The case law pertaining to terminations and the origin of the claim doctrine does not require that the Service accept Taxpayer’s treatment of the termination fees as section 162 expenses; and

(d) Section 1234A applies to characterize the section 165 losses that result from the terminations of the transactions as capital losses to the extent those losses were attributable to the termination of rights or obligations with respect to capital assets. As discussed below, Taxpayer’s loss resulting from the termination of is characterized as capital to the extent that loss was attributable to property that would have been capital assets in Taxpayer’s hands, if Taxpayer had acquired that property pursuant to . Taxpayer’s loss resulting from the termination of the is characterized as capital to the extent the property that Taxpayer would have sold pursuant to the constituted capital assets of Taxpayer.

FACTS

dated as of Date 1 (" Agreement"), which provided for Taxpayer's acquisition of Target. If the Merger Agreement had been carried out pursuant to its terms,

The provided that Taxpayer or Target could terminate if,
,
, was not consummated by a specified date. If such a termination was triggered and certain other circumstances existed, Taxpayer was required to pay Target a termination fee of $X.

On Date 2,

(" "). On Date 3,

. Shortly thereafter, due to the impracticability, if not impossibility, of proceeding with , Taxpayer and Target agreed to terminate the Agreement and Taxpayer paid the termination fee of $X (the " Termination Fee"). Because Taxpayer was the acquirer in the proposed transaction, the Termination Fee paid by Taxpayer is commonly known as a "reverse" termination fee.[1]

While the was ongoing, in an effort to address issues raised in that litigation, Taxpayer entered into an Agreement with Buyer,

"). The Agreement permitted the parties to terminate if the Agreement was terminated by its terms. If the Agreement was terminated because the Agreement was terminated, the Agreement provided that Buyer became entitled to receive a termination fee

[1] Where a agreement sets forth break-up fees to be paid by a party seeking to terminate the agreement, the fee to be paid by the target is known as the "termination fee," and the fee to be paid by the acquirer is known as the "reverse termination fee." See Afra Afsharipour, "Transforming the Allocation of Deal Risk Through Reverse Termination Fees," 63 Vand. L. Rev. 1161, 1163-64 (2010).

.

When Taxpayer and Target terminated the Agreement, Taxpayer and Buyer executed a termination agreement in which Taxpayer agreed to pay the termination fee required by the Agreement, which was $Y (" Termination Fee").

Taxpayer reported the Termination Fee and the Termination Fee (collectively, the "Termination Fees") as ordinary business expense deductions under section 162 on its Form 1120, U.S. Corporation Income Tax Return, as filed. On audit, the Service is considering disallowing the ordinary business expense deductions and recharacterizing all or part of the Termination Fees as capital losses pursuant to sections 165 and 1234A.

Taxpayer's position is that section 1234A does not apply to the Termination Fees and Taxpayer is permitted business expense deductions for the Termination Fees under section 162.

LAW AND ANALYSIS

Whether the Termination Fees Taxpayer paid to terminate the and the related are treated as capital losses of Taxpayer under section 1234A, or whether Taxpayer properly claimed them as business expense deductions under section 162.

Section 1234A in relevant part provides:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—
>
> (1) a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
>
> (2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,

shall be treated as gain or loss from the sale of a capital asset.

Application of section 1234A begins with the plain language of the statute. See CRI-Leslie, LLC v. Commissioner, 882 F.3d 1026, 1033 (11th Cir. 2018), aff'g 147 T.C. 217 (2016). The plain language of section 1234A sets forth the following requirements in determining whether a transaction is subject to section 1234A(1):

(1) There is gain or loss attributable to an extinguishing event – (i.e., cancellation, lapse, expiration, or other termination);

(2) That event extinguishes a contractual right or obligation;

(3) The contractual right or obligation concerns underlying property that is a capital asset in the taxpayer's hands (or that would be a capital asset if the property were acquired by the taxpayer); and

(4) There is a "with respect to" nexus or connection between the right or obligation and the underlying capital asset.

With respect to the first two requirements, the Agreement and the Agreement created contractual rights and obligations for the Taxpayer and the other parties to those agreements. The rights and obligations in those agreements were extinguished by events within the scope of section 1234A: the terminations of the agreements. Moreover, the payments of the Termination Fees and the tax consequences of those payments were attributable to those extinguishing events.

In sections a., b., and c. below, we explain that the termination of each agreement and the payment of the Termination Fee required by that agreement resulted in "gain or loss" and, accordingly, that the remaining element of the first two requirements for the application of section 1234A(1) was satisfied. In section d. below, we address how the remaining two requirements apply to the terminated rights and obligations in each transaction.

a. Whether there was a section 165 loss (rather than a section 162 expense) upon termination of each transaction.

Section 1234A implicitly requires that there be a "gain or loss" in order for the gain or loss attributable to a cancellation, lapse, expiration, or other termination to be treated as "gain or loss from the sale of a capital asset." Section 1234A creates a deemed "sale of a capital asset," but contains no special definition of "gain or loss." Taxpayer argues that its payment of the Termination Fees resulted in section 162 expenses and that section 1234A applies to losses but not section 162 expenses.

As discussed in detail below, case law, a revenue ruling, and the regulations accompanying section 263(a) demonstrate that the facilitative costs of mergers and other similar major corporate transactions, including acquisitions or dispositions of assets constituting a trade or business, are required to be capitalized.[2] If the acquisition

[2] See Treas. Reg. § 1.263(a)-5(e); see also 67 Fed. Reg. 77701, 77706 (Dec. 19, 2002) (preamble to proposed regulations under section 263(a), providing that the rules in Rev. Rul. 99-23, 1999-1 C.B. 998, are being replaced with the rules set forth in the proposed regulations for ease of administration); T.D. 9107, 69 Fed. Reg. 436, 442-43 (Jan. 5, 2004) (preamble to final regulations under section 263(a), discussing modifications to the rules set forth in the proposed regulations).

is terminated or abandoned, these facilitative costs are recovered as section 165 losses.[3]

Moreover, the legislative history of section 1234A reflects Congress's assumption that the making of a payment to terminate contracts with respect to capital assets results in the requisite gain or loss to apply the statute. The legislative history of the 1997 amendment of section 1234A also demonstrates Congress's intent that section 1234A as amended would apply to the making of a fixed payment to terminate a contract to acquire stock (or other capital assets).

For all these reasons, we conclude that terminations of the Agreement and the Agreement were dispositions of property for purposes of section 1001 that gave rise to gain or loss, and that Taxpayer's payments of the Termination Fees are taken into account in determining the amount of Taxpayer's losses from the dispositions of the agreements.[4] For the same reasons, we conclude that the first two requirements for the application of section 1234A(1) were satisfied when the Agreement and the Agreement were terminated.

In Portland Furniture Mfg. Co. v. Commissioner, 30 B.T.A. 878, 881 (1934), the court allowed a deduction for an ordinary loss in the amount of the taxpayer's share of the expenses of investigating the feasibility of an abandoned merger. Rev. Rul. 73-580, 1973-2 C.B. 86, holds that the portion of the compensation paid by a corporation to its employees attributable to services performed in connection with corporate mergers and acquisitions must be capitalized; however, such amounts paid with respect to abandoned plans for mergers or acquisitions are deductible as losses in the year of abandonment. Treas. Reg. § 1.263(a)-5(d)(1), which post-dates Rev. Rul. 73-580, now provides that employee compensation (as defined in Treas. Reg. § 1.263(a)-5(d)(2)) is treated as an amount that does not facilitate a capital transaction set forth in Treas. Reg. § 1.263(a)-5(a). The preamble to the proposed regulations explains that the departure from the conclusion in Rev. Rul. 73-580 was made to provide a simplifying assumption to resolve much controversy between taxpayers and the Service, and to eliminate the burden on taxpayers of allocating certain transaction costs among various

[3] Deductions for abandonment losses are not specified in section 165. Treas. Reg. § 1.165-2(a), however, allows a deduction under section 165(a) for a loss incurred in a business (or in a transaction entered into for profit) and arising from the sudden termination of the usefulness in such business (or transaction) of any nondepreciable property, in a case where such business (or transaction) is discontinued or where such property is permanently discarded from use therein. Accordingly, merger and acquisition costs, otherwise capitalizable, are deductible losses under section 165 when the transaction is abandoned.

[4] We understand that Taxpayer capitalized facilitative transaction costs of the and the . The loss resulting from the termination of the and the loss resulting from the termination of the are each determined by taking into account both the Termination Fee paid to terminate the transaction and the Taxpayer's properly capitalized facilitative transaction costs of that transaction.

intangible assets.[5] This simplifying convention is intended to be a rule of administrative convenience, and not a substantive rule of law. The final regulations retained this simplifying convention, with several modifications that are not relevant to this discussion.[6] Accordingly, the general principle illustrated by Rev. Rul. 73-580, i.e., that facilitative expenses that would have to be capitalized to the transaction are deductible as losses if the transaction is abandoned, still holds.

Treas. Reg. § 1.263(a)-5(a) requires capitalization of costs that facilitate capital transactions. Treas. Reg. § 1.263(a)-5(a)(4) requires capitalization of costs in transactions involving a restructuring, recapitalization, or a reorganization of the capital structure of a business entity (including a reorganization described in section 368). Treas. Reg. § 1.263(a)-5(a)(2) requires capitalization of costs in transactions involving the acquisition by a 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 sections 267(b) or 707(b). Treas. Reg. § 1.263(a)-5(a)(1) requires capitalization in cases involving an acquisition of assets that constitute a trade or business (whether the taxpayer is the acquirer or the target of the acquisition).

Treas. Reg. § 1.263(a)-5(e)(3)(iii) identifies a reorganization described in section 368(a)(1)(A), (B), or (C), and certain reorganizations described in section 368(a)(1)(D), as a "covered transaction". This designation requires that "inherently facilitative amounts" (as defined in Treas. Reg. § 1.263(a)-5(e)(2)) paid in the process of investigating or otherwise pursuing the reorganization be capitalized, regardless of whether the amount is paid for activities performed prior to the date determined under Treas. Reg. § 1.263(a)-5(e)(1), i.e., the date described in the regulations after which amounts paid in the process of investigating or otherwise pursuing a covered acquisition (or reorganization) are deemed to facilitate the transaction. See Treas. Reg. § 1.263(a)-5(e)(2).

Treas. Reg. § 1.263(a)-5 contemplates that the costs required to be capitalized by that section will be recovered as section 165 losses when the transactions are terminated or abandoned. Treas. Reg. § 1.263(a)-5(l), Example 3 provides that costs associated with evaluating "an acquisition by Z of a competitor, and an acquisition of Z by a competitor" must be capitalized and are recoverable by Z as losses under section 165 when Z abandons the acquisition transactions. Treas. Reg. § 1.263(a)-5(l), Example 4 requires that appraisal costs incurred in investigating the acquisition of certain targets be capitalized and are recovered as section 165 losses in the year the planned mergers are abandoned.

The case law dealing with the taxation of merger termination fees further supports the conclusion that Taxpayer's payments of the Termination Fees gave rise to section 165

---

[5] See 67 Fed. Reg. 77701, 77707 (Dec. 19, 2002) (explaining decision to treat employee compensation as not a facilitative cost and that this decision was part of a simplifying convention intended to be a rule of administrative convenience, and not a substantive rule of law).

[6] See T.D. 9107, 69 Fed. Reg. 436, 439-440 (Jan. 5, 2004) (discussing retention of simplifying conventions for employee compensation generally).

losses. In Santa Fe Pac. Gold Co. v. Commissioner, 132 T.C. 240 (2009), and United States v. Federated Dept. Stores, Inc., 171 B.R. 603 (S.D. Ohio 1994), the taxpayer was the target of an unwanted (but ultimately successful) acquisition attempt. To try to prevent the acquisition, the taxpayer entered into a "white knight" merger agreement with a preferred partner. When the unwanted acquisition succeeded, the taxpayer in each case terminated the white knight agreement and paid a termination fee to the white knight.[7]

The issue in Santa Fe and Federated was whether the termination fee was deductible when the fee was paid and the white knight transaction was abandoned, or whether (as contended by the government) the taxpayer had to capitalize the fee to the hostile merger that actually occurred and account for that cost (for tax purposes) in connection with that subsequent transaction. The courts in both cases concluded that the merger termination fees were deductible currently under two Code sections, including section 165, when the white knight mergers were abandoned.[8] See Santa Fe, 132 T.C. at 276-79 (explaining that section 165 allows a current deduction for "costs associated with an abandoned capital transaction," stating that the merger termination fee was a "cost" of the abandoned merger, and concluding that the taxpayer was entitled to deduct the fee under section 165); Federated, 171 B.R. at 610-13 (stating that "[s]ection 165 allows a current deduction for costs associated with an abandoned capital transaction," that each corporation was presented with "two mutually exclusive capital transactions: a merger with the white knight or a merger with [the unwanted suitor]," and concluding that the break-up fees were costs incurred in abandoned transactions and therefore were currently deductible under section 165); see also A.E. Staley Mfg. Co. v. Commissioner, 119 F.3d 482, 490-92 (7th Cir. 1997) (concluding that most of taxpayer's failed efforts to prevent an unwanted (but ultimately successful) takeover attempt concerned "alternative capital transactions" whose costs were deductible as section 165 losses), rev'g 105 T.C. 166 (1995).[9] Moreover, the issue in this case is not only whether there is "loss" versus "expense" generally, but also the applicability of section 1234A to the termination. The courts in Santa Fe and Federated did not have to consider whether there was a "loss" (and not an "expense") for purposes of section 1234A because the transactions in those cases occurred before the 1997 amendment to section 1234A.[10] Accordingly, case law pertaining to terminated agreements supports the

[7] The opinion in Federated considered merger termination fees paid by two corporations, each of whom was the subject of an unwanted takeover attempt and entered into a white knight merger agreement in an unsuccessful attempt to prevent that takeover.

[8] The courts in Santa Fe and Federated concluded that the white knight merger termination fees could also be deducted as section 162 expenses. As explained below in part c. of this memorandum, the rationale of those courts in concluding that the taxpayers could deduct the termination fees under section 162 is not applicable in this case.

[9] The Court of Appeals in A.E. Staley concluded that the costs of the alternative capital transactions could also be deducted as section 162 expenses. The Tax Court had concluded that the costs were capital expenditures and no deduction was allowable under either section 162 or section 165.

[10] The 1997 amendment is discussed in the text below at pp. 10-12.

treatment of merger terminations as dispositions of capital transactions that result in losses under section 165 to the payor of the termination fee.

Finally, the legislative history of section 1234A reflects Congress's assumption that the making of a payment to terminate contracts with respect to capital assets results in the requisite gain or loss to apply the statute. Section 1234A was enacted by section 507(a) of the Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172, 333 ("1981 Act"). To address how Congress understood the phrase "gain or loss" when enacting section 1234A, we turn first to the legislative history from 1981, which explains:

> The definition of capital gains and losses in section 1222 requires that for gain or loss to be capital gain or loss, there must be a "sale or exchange" of a capital asset. Court decisions have interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss. This interpretation has been applied even to dispositions which are economically equivalent to a sale or exchange of a capital asset. [Text omitted].
>
> The committee believes that the change in the sale or exchange rule is necessary to prevent tax-avoidance transactions designed to create fully-deductable [sic] ordinary losses on certain dispositions of capital assets, which if sold at a gain, would produce capital gain. . . . The committee considers this ordinary loss treatment inappropriate if the transaction, such as settlement of a contract to deliver a capital asset, is economically equivalent to a sale or exchange of the contract.

H. Rep. No. 97-201, at 212 (1981) (emphasis added; footnote omitted) [hereinafter "1981 House Report"]. The 1981 House Report further provides, as an example of a type of transaction that prompted enactment of section 1234A, the following straddle transaction composed of forward contracts referencing foreign currency or securities:

> Some of the more common of these tax-oriented ordinary loss and capital gain transactions involve cancellations of forward contracts for currency or securities. For example, a taxpayer may simultaneously enter into a contract to buy German marks for future delivery and a contract to sell German marks for future delivery with very little risk. If the price of German marks thereafter declines, the taxpayer will assign his contract to sell marks to a bank or other institution for a gain equivalent to the excess of the contract price over the lower market price and cancel his obligation to buy marks by payment of an amount in settlement of his obligation to the other party to the contract. The taxpayer will treat the sale proceeds as capital gain and will treat the amount paid to terminate his obligation to buy as an ordinary loss.

1981 House Report at 213 (emphasis added). This example reflects Congress's understanding that making a payment to terminate a burdensome contract may give rise to a loss for tax purposes, which taxpayers were then treating as an ordinary loss in reliance upon case law and the limited "sale or exchange" language of section 1222. Congress enacted section 1234A to deem certain non-sale or exchange dispositions to be sales or exchanges to ensure that gain or loss from such dispositions had the same character as a gain or loss from selling the contract. Congress did not have to provide that a "gain or loss" arose from such dispositions in order to achieve uniform character because such dispositions already resulted in gain or loss prior to enactment of section 1234A.

In 1997, Congress amended section 1234A to apply it to a broader variety of transactions. As originally enacted in 1981, section 1234A applied to the termination of "a right or obligation with respect to personal property (as defined in section 1092(d)(1)) which is (or on acquisition would be) a capital asset in the hands of the taxpayer. . . ."[11] Section 1092(d)(1) at that time defined personal property to include only "personal property (other than stock) of a type which is actively traded . . . ."[12] The 1997 amendment broadened the scope of section 1234A by replacing the reference to "personal property (as defined in section 1092(d)(1))" with the word "property," thereby causing section 1234A to apply to the termination of a right or obligation with respect to any property that is (or on acquisition would be) a capital asset in the taxpayer's hands.[13]

The legislative history of the 1997 amendment, consistent with the legislative history from 1981, also confirms Congress' belief that, before the enactment of section 1234A, the termination of burdensome contracts with respect to capital assets resulted in losses, which some taxpayers were treating as ordinary losses. The 1997 legislative history further confirms that section 1234A was intended to provide that terminations of such contracts at an economic loss would result in losses that were capital losses, despite the absence of a sale or exchange. A Senate Report describing the 1997 amendment explains:

> There has been a considerable amount of litigation dealing with whether modifications of legal relationships between taxpayers is to be treated as a "sale or exchange." . . . Several court decisions interpreted the "sale or exchange" requirement to mean that a disposition, that occurs as a result of a lapse, cancellation, or abandonment, is not a sale or exchange of a capital asset, but produces ordinary income or loss.
> . . . .

---

[11] See sec. 507(a) of the Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172, 333.

[12] In 1984, section 1092(d) was amended to include certain stock involved in straddle-type transactions in that section's definition of personal property. See sec. 101(b) of P.L. 98-369, Deficit Reduction Act of 1984, 98 Stat. 494, 618-19.

[13] See sec. 1003(a) of P.L. 105-34, Taxpayer Relief Act of 1997, 111 Stat. 788, 909-10.

> More recently, in Stoller v. Commissioner, 994 F.2d 855 (1993), the Court of Appeals for the District of Columbia held, in a transaction that preceded the effective date of section 1234A, that losses incurred on the cancellation of forward contracts to buy and sell short-term Government securities that formed a straddle were ordinary because the cancellation of the contracts was not a "sale or exchange."
> . . . .
>
> Courts have given different answers as to whether transactions which terminate contractual interests are treated as a "sale or exchange." This lack of uniformity has caused uncertainty to both taxpayers and [the Service] in the administration of the tax laws.

S. Rep. No. 105-33, at 132-35 (emphasis added) [hereinafter "1997 Senate Report"].[14] The legislative history from 1997 reaffirms Congress's concerns, expressed in 1981, that taxpayers could elect character through the form of disposition of an asset. The legislative history from 1997 further explains that Congress amended section 1234A to create more uniformity and certainty generally as to the character of transactions that terminate contractual interests.

The 1997 Senate Report, in describing how the amendment to section 1234A would affect specific transactions, explains as follows:

> 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. [footnote 81, citing U.S. Freight Co. v. United States, 422 F.2d 887 (Ct. Cl. 1970)]. The committee bill does not affect whether a right is "property" or whether property is a "capital asset."

1997 Senate Report at 135-36.

The case cited in the above-quoted language from the 1997 Senate Report (U.S. Freight) is of particular relevance in the present case because it also involved a fixed termination payment. In U.S. Freight, a taxpayer entered into a forward contract to acquire stock and paid part of the purchase price upfront. The contract provided that, if the taxpayer did not complete the sale, the seller would retain the fixed upfront payment as liquidated damages. The taxpayer became concerned that the contract price was unfavorable and terminated the burdensome contract, at which time the seller retained the upfront payment. The Court of Claims recognized that a contract with respect to a capital asset such as stock likely was itself a capital asset whose sale or exchange

[14] The parties in Stoller, a case cited in the legislative history, assumed that cancellation fees that the taxpayer paid upon termination of forward contracts resulted in "loss" from disposition of the contracts, and, thus, the only issue was whether the losses were ordinary or capital.

would produce capital gain or loss.[15] The court nevertheless concluded that the upfront payment gave rise to an ordinary loss rather than a capital loss because the termination of the contract was not a sale or exchange. Accordingly, the 1997 Senate Report is clear: Congress understood that the fact pattern in U.S. Freight was a disposition that generated gain or loss that would be covered by section 1234A, thereby overriding the result in that case and characterizing the gain or loss as capital because the disposition would be a deemed sale or exchange. More generally, the legislative history of section 1234A reflects Congress's understanding that terminations of contracts with respect to capital assets (such as the stock in U.S. Freight) were dispositions of the contracts, which would generate gain or loss for purposes of applying section 1234A.

For all of the above reasons, we conclude that Taxpayer's terminations of the were dispositions of property within the meaning of section 1001. Upon termination, the Taxpayer was able to recover the Termination Fee, the Termination Fee, and the facilitative costs required to be capitalized by Treas. Reg. § 1.263(a)-5(a) as losses under section 165.

b. Whether the Treasury Regulations accompanying section 263(a) provide that the Termination Fees are deductible under section 162 if the fees are not expressly capitalized by those regulations.

Taxpayer asserts Treas. Reg. § 1.263(a)-5(c)(8) provides that a fee paid to terminate a can be deducted when paid unless the fee was paid to engage in a second, mutually exclusive capital transaction. Taxpayer infers that, if the Termination Fees are not expressly capitalized under the regulations accompanying section 263(a), then they must necessarily be deductible (as section 162 expenses) when paid. We disagree.

Section 263(a)(1) provides that no deduction shall be allowed for amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Treas. Reg. § 1.263(a)-4 provides rules for applying section 263(a) "to amounts paid to acquire or create intangibles." See Treas. Reg. § 1.263(a)-4(a). Treas. Reg. § 1.263(a)-5 provides rules for applying section 263(a) to amounts paid "to facilitate" an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions. For this purpose, an amount is paid to facilitate one of the specified transactions "if the amount is paid in the process of investigating or otherwise pursuing the transaction." See Treas. Reg. § 1.263(a)-5(b)(1).

---

[15] See U.S. Freight, 442 F.2d, at 892 n.3 ("We consider the substance of our assumption for purposes of argument, that a contract right to purchase what would be a capital asset in the purchaser's hands is itself a capital asset, to be not only reasonable, but also the subject of authoritative support.") (citing Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962)). Although the court in U.S. Freight concluded that the forfeiture of the deposit for the purchase of stock was fully deductible as a loss under section 165(a), the court further explained that it "need not decide" whether the forfeited amount was deductible in the alternative under section 162, raising the possibility that the item could have been both a loss and an expense. U.S. Freight, 422 F.2d, at 896 n.8.

Treas. Reg. § 1.263(a)-5(c)(8)[16] considers when a fee paid to terminate an agreement to enter into a transaction is a cost of facilitating another, subsequent transaction, and thus must be capitalized to the subsequent transaction. Under Treas. Reg. § 1.263(a)-5(c)(8), the fee to terminate the first transaction is a cost paid to facilitate the subsequent transaction, only if the transactions are mutually exclusive. Examples 13 and 14 of Treas. Reg. § 1.263(a)-5(l) illustrate this rule.

Treas. Reg. § 1.263(a)-5(c)(8) and Examples 13 and 14 of Treas. Reg. § 1.263(a)-5(l) do not address whether a termination fee paid is deductible under section 165 or section 162 when the requirements of Treas. Reg. § 1.263(a)-5(c)(8) are not applicable, which is the case here.

Section 263 and its regulations provide guidance as to when a taxpayer must capitalize an expense otherwise deductible (or subject to specific treatment) under another section of the Code such as sections 161 through 261. When section 263 and its accompanying regulations require capitalization, the taxpayer can only deduct (or otherwise account for) the expense when the terms of a Code section are satisfied (as is the case when a merger is terminated or abandoned allowing deduction of the capitalized expense as a section 165 loss). The preamble to the advance notice of proposed rulemaking that preceded the issuance of Treas. Regs. §§ 1.263(a)-4 and -5 states:

> A fundamental purpose of section 263(a) is to prevent the distortion of taxable income through current deduction of expenditures relating to the production of income in future taxable years. See Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974). Thus, the Supreme Court has held that expenditures that create or enhance separate and distinct assets or produce certain other future benefits of a significant nature must be capitalized under section 263(a). See INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992); Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971).
> . . . .
> Recently, much of the uncertainty and controversy in the capitalization area has related to expenditures that create or enhance intangible assets or benefits. To clarify the application of section 263(a), the forthcoming notice of proposed rulemaking will describe the specific categories of expenditures incurred in acquiring, creating, or enhancing intangible assets or benefits that taxpayers are required to capitalize. . . .
> . . . .
> The proposed standards and rules described in this document will not alter the manner in which provisions of the law other than section 263(a) (e.g.,

[16] Treas. Reg. §1.263(a)-4(d)(7)(ii) provides that Treas. Reg. §1.263(a)-4(d)(7)(i) does not apply to termination fees paid in connection with a transaction described in Treas. Reg. §1.263(a)-5(a), as is the case here. See also Example 4 of Treas. Reg. § 1.263(a)-4(d)(iii).

> sections 195, 263(g), 263(h), or 263A) apply to determine the correct tax treatment of an item. Moreover, these standards and rules will not address the treatment of costs other than those to acquire, create, or enhance intangible assets or benefits . . . . [17]

The preambles to the proposed and final regulations similarly limit the scope of the issues addressed to amounts related to the creation or acquisition of intangible assets or to the facilitation of specified transactions.[18] In addition, with regard to termination costs, the preamble to the final regulations states:

> The final regulations clarify when costs of terminating a transaction described in § 1.263(a)–5 (including break-up fees) are treated as facilitating another transaction described in § 1.263(a)–5. . . . [A]n amount paid to terminate (or facilitate the termination of) an agreement to enter into a transaction described in the regulations is treated as facilitating another transaction described in the regulations only if the transactions are mutually exclusive and the agreement is terminated to enable the taxpayer to engage in the second transaction.[19]

Section 263 and its regulations require capitalization and thus deny current deductibility for an otherwise deductible expenditure. Once capitalized the expenditure is only recovered if the terms of a Code section are independently satisfied. In this case, section 165's terms were satisfied when the were terminated/abandoned, allowing Taxpayer losses equal to the Termination Fees and the facilitative costs required to be capitalized by Treas. Reg. § 1.263(a)-5(a).

For all these reasons, section 263 and its regulations do not control whether the Termination Fees are expenses under section 162 or losses under section 165, or (in the case of section 165 losses) otherwise limit the application of section 1234A to those losses.

c. Whether case law pertaining to merger terminations and the origin of the claim doctrine requires that the Service accept Taxpayer's treatment of the Termination Fees as section 162 expenses.

[17] 67 Fed. Reg. 3461, 3462 (Jan. 24, 2002) (emphasis added).

[18] See the preamble to the proposed regulations under section 263(a), 67 Fed. Reg. 77701, 77701 (Dec. 19, 2002) ("[t]his document contains proposed regulations that explain how section 263(a) of the Code applies to amounts paid to acquire, create, or enhance intangible assets"); T.D. 9107, 69 Fed. Reg. 436, 436 (Jan. 5, 2004) ("the final regulations provide that an amount paid to acquire or create an intangible not otherwise required to be capitalized by the regulations is not required to be capitalized on the ground that it produces significant future benefits for the taxpayer, unless the IRS publishes guidance requiring capitalization of the expenditure").

[19] 69 Fed. Reg. at 441-42.

Taxpayer next argues that the case law discussed above pertaining to merger termination fees, and the origin of the claim doctrine, require that the Service accept Taxpayer's treatment of the Termination Fees as section 162 expenses.

Taxpayer's reliance upon the cases discussed above, Santa Fe and Federated, is misplaced. The threshold question in Taxpayer's case is whether the Termination Fees resulted in current "losses" under section 165(a)[20] to which section 1234A could apply, rather than business expenses under section 162. The merger cases cited by Taxpayer were primarily concerned with whether merger termination fees (i) were currently deductible under either section 162 or section 165 (or both) when the transaction with respect to which the fees were incurred was terminated, or (ii) instead were required to be capitalized and deferred under section 263(a) with respect to some subsequent transaction. They thus answered a question of timing rather than one of "expense" vs. "loss."[21] Nevertheless, as noted above, each of the cases supports our conclusion that a fee paid to terminate a proposed generates a loss under section 165(a) when the transaction is abandoned altogether.

As Taxpayer correctly notes, the courts in Santa Fe and Federated reached alternative conclusions under both section 162 and section 165: The courts concluded that the merger termination fees were deductible under section 162 because the fees fit within the rubric of expenses paid to defend an existing business against attack, and the courts alternatively concluded that the fees were deductible under section 165 as losses from abandoned capital transactions.[22] Taxpayer suggests that the alternative holdings in Santa Fe and Federated under sections 162 and 165 mean that its payments of the Termination Fees must properly be viewed as deductible expenses under section 162. The section 162 rationale in Santa Fe and Federated, however, is not applicable to the present case because the Termination Fees were not ordinary and necessary business

[20] Section 165(a) provides that "[t]here shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise" (emphasis added). Treas. Reg. §1.165-1(b) provides that "a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and . . . actually sustained during the taxable year."

[21] In Santa Fe and Federated, the government argued that the cost of defending against an eventually successful hostile acquisition was required to be capitalized into the eventual acquisition under section 263(a), rather than currently deducted under either sections 162 or 165. The courts rejected the government's arguments, reasoning instead that the "white knight" or "alternative" transactions were not part of the eventual merger.

[22] The court in Federated found "that the bankruptcy court did not err in determining that the break-up fees were currently deductible under section 162 as ordinary and necessary business expenses," and further held in the alternative that "the break-up fees represent costs incurred in abandoned transactions" and that "therefore they are currently deductible under section 165." Federated, 171 B.R. at 610. The court in Santa Fe likewise held that the merger termination fee was deductible under section 162, and alternatively concluded that the taxpayer was entitled to a deduction for the merger termination fees under section 165 because "the termination fee was paid as a result of that [merger] abandonment and was therefore a cost of the abandoned merger . . . ." Santa Fe, 132 T.C. at 276, 278.

expenses of defending against unwanted attacks on Taxpayer's trade or business.[23] Most importantly, as noted previously, the issue in this case is not only whether there is "loss" versus "expense," but the impact of section 1234A on the termination – an issue which was not in Santa Fe and Federated because the transactions in those cases occurred before the 1997 amendment to section 1234A.[24] As explained above, the legislative history of section 1234A demonstrates Congress's understanding that making a payment to terminate a contract with respect to capital property would result in a "loss" to which section 1234A could apply.

Lastly, Taxpayer argues that the Termination Fees are deductible as section 162 expenses because they were negotiated to compensate Target and Buyer for their transaction costs. This appears to be a reference to the origin of the claim doctrine, under which courts analyze "the origin and character of the claim with respect to which an expense was incurred" to determine its tax consequences. See United States v. Gilmore, 372 U.S. 39, 49 (1963). Taxpayer provides little evidence that the Termination Fees (other than a small portion of the Termination Fee) were solely intended to compensate Target and Buyer for their current expenses, although any such evidence would not affect our analysis under section 1234A. That a portion of a Termination Fee may have compensated the payee for its own expenses does not alter the fact that Taxpayer paid the Termination Fees to dispose of its rights and obligations arising from capital transactions.[25]

---

[23] As noted above, the Court of Appeals in A.E. Staley similarly concluded that the costs of the taxpayer's abandoned alternate (and defensive) capital transactions were deductible under section 162 and section 165. Like the section 162 conclusions in Santa Fe and Federated, the section 162 conclusion in A.E. Staley was based on the rationale that the expenses were paid to defend an existing business against attack.

The current regulations accompanying section 263(a) were not in effect when the transactions in Santa Fe and Federated occurred. Under the current regulations, the termination fees paid would be capitalized to the mergers that occurred. See Treas. Reg. § 1.263(a)-5(c)(8) and Treas. Reg. § 1.263(a)-5(l), Example 13.

[24] As noted above, before the 1997 amendment, section 1234A could apply only to the termination of rights or obligations with respect to personal property as defined in section 1092(d)(1). At the time of the transactions in Santa Fe and Federated (as well as at the time of the transactions in A.E. Staley), the definition of personal property in section 1092(d) was limited to personal property of a type that was actively traded and generally excluded stock. Accordingly, it is unlikely that the terminations in those cases could have involved rights or obligations with respect to property within section 1234A's scope at that time. In any event, the courts in Santa Fe and Federated did not consider whether section 1234A applied to the merger termination fees in those cases, nor did the courts in A.E. Staley consider whether section 1234A applied to the costs of the alternative capital transactions in that case.

[25] As noted above, because Taxpayer was the acquirer, the Termination Fee was a "reverse" termination fee. The development of fixed reverse termination fees has raised the issue of valuing merger agreements (from the acquirer's perspective) as comparable to discrete financial instruments. See Vijay Sekhon, "Valuation of Reverse Termination Options in Mergers and Acquisitions," 7 Berkeley Bus. L.J. 72, 75 (2010) (explaining that similarity of transactions with reverse termination fee provisions to European call options makes it possible to use a modified version of the Black-Scholes option pricing formula to estimate the transaction's value to a merger acquirer). This lends further support to the conclusion that the Termination Fee is a cost of disposing of a type of contract to which section 1234A was intended to apply, rather than a section 162 expense.

The case law is clear: A taxpayer who makes a payment to terminate a or similar transaction is disposing of a capital transaction and generally has a loss. We have seen no evidence in this case that would warrant our departure from this general rule.

d. How section 1234A applies to the section 165 losses that result from the termination of the transactions.

As noted above, based on the plain language of section 1234A, there are four requirements in determining whether a transaction is subject to section 1234A(1):

(1) There is gain or loss attributable to an extinguishing event – (i.e., cancellation, lapse, expiration, or other termination);

(2) That event extinguishes a contractual right or obligation;

(3) The contractual right or obligation concerns underlying property that is a capital asset in the taxpayer's hands (or that would be a capital asset if the property were acquired by the taxpayer);[26] and

(4) There is a "with respect to" nexus or connection between the right or obligation and the underlying capital asset.

With respect to the first two requirements, the Agreement and the Agreement created contractual rights and obligations. The termination of those agreements resulted in the payment of the Termination Fees. Moreover, as we have just explained, the termination of those rights and obligations resulted in section 165 losses equal in value to the Termination Fees and the costs to facilitate the transactions required to be capitalized under Treas. Reg. § 1.263(a)-5(a). Accordingly, we now consider the third and fourth requirements, i.e., whether the rights and obligations embodied in the Agreement and the Agreement were with respect to property that either was a capital asset in Taxpayer's hands, or would have been a capital asset in Taxpayer's hands, if Taxpayer had acquired it.

The . If the had been consummated in accordance with its terms,

). Though the Agreement does not explicitly state the type of reorganization contemplated by the parties, it describes a transaction that was intended to qualify as a reorganization under section 368(a).

The would have resulted in the acquisition of Target stock by Taxpayer. That transaction, viewed in isolation, would have given Taxpayer rights and obligations

[26] We note that, as used in section 1234A, the term "capital asset" does not include property described in section 1221(a)(2) (certain property used in the taxpayer's trade or business), even if the sale or exchange of that property would give rise to capital gain or capital loss under section 1231. See CRI-Leslie LLC, 882 F.3d at 1030.

with respect to Target stock—a capital asset in Taxpayer's hands, if Taxpayer had acquired it. However, immediately after the First Merger, Target would have merged with and into Merger Sub, LLC, a DE. Under step transaction principles, because the Second Merger was a step in an integrated plan that included the First Merger, the First Merger and Second Merger would have been treated as a single statutory merger of Target into Taxpayer which would have, if consummated, qualified as a reorganization under section 368(a)(1)(A) (an "A Reorganization"). See Rev. Rul. 2001-46, 2001-2 C.B. 321; Treas. Reg. § 1.368-2(b)(1)(iii), Example 2. Because an A Reorganization results in an asset acquisition by the acquiror, the Agreement provided Taxpayer with rights and obligations with respect to Target's assets.

The . The Agreement was labeled agreement and provided for the sale by Taxpayer to Buyer of . We have not seen any evidence that the should be characterized for tax purposes in a manner different from its form. Accordingly, we believe the involved rights and obligations to the that Taxpayer would have sold pursuant to the Agreement.

Application of Section 1234A. Applying the third and fourth requirements of section 1234A to the facts of this case as analyzed immediately above, Taxpayer's section 165 loss resulting from the termination of the is treated as capital under section 1234A to the extent that loss is attributable to the property of Target that would have been capital assets in Taxpayer's hands if Taxpayer had acquired it. Similarly, Taxpayer's loss resulting from the termination of the is treated as capital under section 1234A to the extent that loss is attributable to capital assets of Taxpayer that Taxpayer would have sold to Buyer if the had been consummated. The amount of loss attributable to capital property may be determined by dividing the value of Target's property that would have been capital assets in Taxpayer's hands by the total value of Target's property that Taxpayer would have acquired and then multiplying the loss by that fraction. Similarly, the amount of loss attributable to capital property may be determined by dividing the value of Taxpayer's capital assets that it would have sold pursuant to the by the value of all property that Taxpayer would have sold pursuant to that transaction and then multiplying the loss by that fraction.[27] Cf. Watson v. Commissioner, 345 U.S. 544 (1953); Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945) (for purposes of determining the character of gain or loss upon the sale of a business or other group of assets for a lump sum, the sale must be comminuted into its parts and the lump sum must be allocated among the individual assets based on their relative fair market values).

[27] As explained at n.26 above, capital assets for these purposes do not include property described in section 1221(a)(2), even if the sale or exchange of that property would give rise to capital gain under section 1231.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call (202) 317-4451 if you have any further questions.

By: ____________________________

Robert A. Martin
Senior Technician Reviewer, Branch 6
(Financial Institutions & Products)

cc: Robin Greenhouse
Division Counsel
(Large Business & International)