Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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March 10, 2008

LEGEND

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Taxpayer =
B =
C =
$r =
$s =

Dear :

This is in reply to a letter dated September 11, 2007, submitted by your authorized representatives, requesting a ruling concerning the federal income tax consequences of termination fees received by Taxpayer. Specifically, you request a ruling that the termination fees received in connection with an abandoned merger transaction will be treated as ordinary income under § 61 of the Internal Revenue Code, rather than as capital gain.

FACTS

On Date 1, Taxpayer and B entered into an agreement (Agreement 1) under which the parties agreed to use their best efforts to take a series of steps that were designed to lead to Taxpayer's acquisition of the stock of B for consideration consisting of cash plus a specified number of shares of Taxpayer common stock. The proposed acquisition was subject to a number of substantial conditions, including the approval by the shareholders of Taxpayer and B, both of which were publicly-traded corporations. The shareholders of B were not parties to Agreement 1. Under the terms of Agreement 1, B agreed not to solicit other offers regarding an acquisition of B, but had the right to

terminate Agreement 1 if it received an unsolicited, superior third party bid. Termination of Agreement 1 by either party under certain circumstances, such as failure to obtain approval by a party's board of directors or shareholders or a change in recommendation by a party's board, would give rise to an obligation to pay termination fees to the other party. Agreement 1 provided certain terms and conditions regarding the payment of the termination fees but did not indicate whether the termination fees related to any particular item or specify the purpose for the termination fees. Also, Agreement 1 provided that, except in the case of a breach of Agreement 1, all fees and expenses incurred in connection with Agreement 1 and the transactions contemplated thereby were to be paid by the party incurring such expenses whether or not the acquisition was consummated.

On Date 2, C, an unrelated company, commenced an unsolicited tender offer to purchase for cash all outstanding common shares of B. Because B's board of directors believed C's offer could amount to a superior proposal as defined in Agreement 1, B began discussions and negotiations with C.

By its terms, Agreement 1 could not be formally terminated until a shareholder vote was taken and the planned acquisition by Taxpayer was rejected. Under Agreement 1, B would be required to pay Taxpayer $r as a termination fee if B's shareholders met and formally rejected the acquisition and an additional $s termination fee if B consummated a change-of-control transaction on or prior to Date 6. It became clear to Taxpayer and B, however, that the acquisition would not be approved by B's shareholders, based on the proxies received from B's shareholders. To avoid the need for a shareholder meeting to conduct a formal vote, on Date 3, two days before the scheduled meeting of B's shareholders for such a vote, Taxpayer and B entered into an agreement (Agreement 2) terminating Agreement 1.

Agreement 2 included termination provisions that mirrored those of Agreement 1, except that an actual vote of B's shareholders was not a condition to payment to Taxpayer of the $r termination fee. Like Agreement 1, Agreement 2 was silent as to the purpose of the termination fees.

On the same date that Agreement 2 was entered into, B paid Taxpayer $r as a termination fee. On Date 4, B's board recommended that its shareholders accept the bid from C, and on Date 5, C acquired control of B. B thereby became obligated to pay Taxpayer the additional $s termination fee described above, which it subsequently paid to Taxpayer.

LAW AND ANALYSIS

Part 1

Section 61 of the Code and § 1.61-1(a) of the Income Tax Regulations provide that gross income includes all income from whatever source derived unless excluded by law. The Supreme Court of the United States has long recognized that the definition of gross income sweeps broadly and reflects Congress' intent to exert the full measure of its taxing power and to bring within the definition of income "any accession to wealth." *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955). Accordingly, any receipt of funds by a taxpayer is presumed to be gross income unless the taxpayer can demonstrate that the accession fits into one of the narrowly construed exclusions provided by law. *See Glenshaw Glass Co.* at 431; *United States v.* Burke, 504 U.S. 229, 248 (1992).

Under the origin-of-the-claim doctrine, the taxability of the proceeds of a settlement or a judgment depends on the nature of the claim and the actual basis of recovery. *United States v. Gilmore*, 372 U.S. 39 (1963). If the amount received represents damages for lost profits, it is taxable as ordinary income. However, if the recovery is received as the replacement of capital destroyed or injured rather than for lost profits, the money received is a return of capital and taxable only to the extent it exceeds the basis of the destroyed capital. *Freeman v. Commissioner*, 33 T.C. 323, 327 (1959). The burden is on the taxpayer to demonstrate that the amounts received are for capital replacement. *Raytheon Production Corporation v. Commissioner*, 1 T.C. 952 (1943), *aff'd*, 144 F.2d 110 (1st Cir. 1944), *cert. denied*, 323 U.S. 779 (1944).

The courts and the Internal Revenue Service have typically applied the origin-of-the-claim doctrine in situations involving a recovery received pursuant to a judgment or a settlement. Contractual termination fee provisions and settlements are similar in that the underlying purpose of each is the avoidance of litigation through arms-length negotiations. The termination fee provision that is part of Agreement 1 and Agreement 2 represents a bargained-for position[1] similar to that of a negotiated settlement between two adversarial parties. In the present case, since no litigation was initiated on which a negotiated settlement was based, our focus must be on the bargained-for termination fee in determining the character of the payment received by Taxpayer.

Taxpayer has chosen not to present any legal authority to support the position that the original claim, the bargained-for termination fee, was intended to compensate Taxpayer for capital destroyed or injured. However, the Service has considered such arguments and has determined that there is prevailing support for Taxpayer's position that the receipt of the termination fee is for the recovery of lost profits.

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[1] Termination fee provisions have become "the most intensely negotiated provisions in these acquisitions," and are becoming an expected part of negotiating a merger. See Thomas A. Swett, *Merger Terminations after Bell Atlantic: Applying a Liquidated Damages Analysis to Termination Fee Provisions*, 70 U. Colo. L. Rev. 341, 355, (1999) quoting Lou R. Kling et al*., Summary of Acquisition Agreements*, 51 U. Miami L. Rev. 779, 782-92 (1997).

The termination fee provision in Agreement 1 and Agreement 2, beyond providing the trigger for the payment of the termination fees, is silent as to the allocation of the recovery to either lost profits or damage to capital and does not lend any guidance in resolving the issue. However, commentators have provided significant insight as to the purpose of termination fee provisions.

> To guard against this risk of non-consummation, and to protect their interests in the event this risk is realized, potential acquirors insert various deal-protective provisions into merger agreements. These measures can, for example, reimburse would-be acquirors for their expenses and lost profits should another bidder emerge and prevail in a bidding contest. These provisions have the additional and intentional effect of making the target less financially or otherwise attractive to subsequent bidders, thereby deterring such bidders from entering the competition for the target. Thus, deal-protective measures can encourage bids by offering bidders some measure of comfort that their deals will go through, and perhaps the promise that they will be compensated if they do not. Judd F. Sneirson, *Merger Agreements, Termination Fees, and the Contract-Corporate Tension,* 2002 Colum. Bus. L. Rev. 573, 578.

The bargained-for termination fee provision in Agreement 1 and Agreement 2 provides Taxpayer an effective manner in which to address the consequences of a failed acquisition. The termination fee provision is similar to a liquidated damages[2] provision in that it provides for “a sum stipulated and agreed on by the parties, at the time of entering into a contract, as being payable as compensation for injuries in the event of a breach.”[3] The termination fee provision protects each parties’ contractual interests and the termination fee is paid in lieu of damages for failure to consummate the contract. Commentators have discussed termination fees under the principles of contract law in merger agreements.

> One purpose of contract law is to protect the expectations that arise when parties agree to exchange things in the future. When there is a breach, contract law thus aims to put the injured party in the position she would have occupied had the breaching party satisfied his obligations. This ‘expectation interest’ gives the injured party the benefit of her bargain. In a merger agreement, where a party repudiates or breaches, the expectation interest would entail putting the disappointed bidder in the position it would have occupied had the target not repudiated or breached. If the merger agreement is not specifically enforced, this would translate to substantial relief in the form of money damages to

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[2] Liquidated damages are taxable as ordinary income. *Harold S. Smith v. Commissioner*, 418 F.2d 573 (9th Cir. 1969) *aff’g*, 50 T.C. 273 (1968); *Binns v. U.S.*, 385 F. 2d 159 (6th Cir. 1967) *aff’g*, 254 F. Supp 889 (M.D. Tenn. 1966).

[3] 67A AM. JUR. 2D Sales § 894 (1985).

> approximate the benefits the disappointed acquirer would have enjoyed had the merger agreement been consummated. Sneirson at 599.
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> The principal purpose of contract law is to protect the justified expectations that arise from promises underlying bargains. Contract law also "further[s] the general good by encouraging parties to enter into … productive transactions." The parties' contractual expectations are protected by awarding "benefit of the bargain" or "expectation" damages as the usual remedy for breach. Such damages place the injured party in the same financial position as if the contract had been fully performed. This measure of damages also may include lost profits expected from the exchange. Paul L. Regan, *Great Expectations? A Contract Law Analysis for Preclusive Corporate Lock-Ups,* 21 Cardozo L. Rev. 1, 33 (1999).

In *Glendale Federal Bank, FSB, v. United States*, 239 F.3d 1374, 1380 (Fed.Cir. 2001), the court discussed the basic principles of contract law and expectancy damages.

> One way the law makes the non-breaching party whole is to give him the benefits he expected to receive had the breach not occurred. *See Restatement (Second) of Contracts* § 344(a) (1981). The benefits that were expected from the contract, "expectancy damages," are often equated with lost profits, although they can include other damage elements as well. *See Restatement (Second) of Contracts* § 347.

Accordingly, based on the underlying purpose of the termination fee provisions as discussed above, principles of contract law, and the above-mentioned authorities, it is reasonable to conclude that Taxpayer's bargained-for termination fees provided for benefit of the bargain or expectancy damages. As such damages are equated with lost profits, Taxpayer's receipt of the termination fees is for the recovery of lost profits. There is ample authority to support the position that recovery for loss of anticipated profits is ordinary income. *Martin Bros. Box Co. v. Commissioner*, No. 110,397 (T.C.M. 1943), *aff'd*, 142 F.2d 457 (6th Cir. 1944); *Estate of Carter v. Commissioner*, 35 T.C. 326 (1960), *aff'd*, 298 F.2d 192 (8th Cir. 1962).

Additionally, as the termination fee provision in Agreement 1 and Agreement 2 is silent as to the allocation of the recovery to either lost profits or damage to capital, the Service has substantial support for the position that whenever the status of the payment is unclear or no allocation is made, the recovery will be treated as lost profits. *Evans v. Commissioner*, T.C.M. 1980-142; *Armstrong Knitting Mills v. Commissioner*, 19 B.T.A. 318 (1930); *Walley, Inc. v. Commissioner*, No. 13,499 (T.C.M. 1948).

In *Walley, Inc. v. Commissioner*, *supra*, the taxpayer in an action for breach of contract requested damages for lost profits and injury to goodwill. The settlement document provided for a general release covering all causes of action and did not allocate the

payment. The court stated that the taxpayer had failed to provide any evidence of what portion of the recovery was received for injury to goodwill and held that the entire amount was for the recovery of lost profits. *See Vanderlaan v. Commissioner*, T.C.M. 1962-130 (taxpayer received an amount pursuant to a settlement that was held to be ordinary income because nothing in the settlement agreement or in other evidence presented convinced the court that the payment should be treated otherwise).

Part 2

Section 1234A of the Code provides that gain or loss attributable to the cancellation, lapse, expiration or other termination of a right or obligation with respect to property which is a capital asset in the hands of the taxpayer will be treated as gain or loss from the sale of a capital asset.

The Service has concluded that § 1234A does not apply to the termination fees received by Taxpayer.

CONCLUSION

The termination fees paid by B to Taxpayer will be treated as ordinary income to Taxpayer.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Michael J. Montemurro
Branch Chief, Branch 4
(Income Tax & Accounting)