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Federal Tax Advisory: Break-Up Fee Income and Business Location Inducements

Break-Up Fee Income

LTR 200823008

Break-up fees are said to be the most heavily negotiated part of many corporate acquisition agreements. The IRS has ruled twice in recent months that jilted corporate acquirers must treat their receipt of such fees as ordinary income rather than capital gain. LTR 200823008; LTR 200823012; see also TAM 200438038.

Stakes

The stakes for C corporations are fairly limited. There is no rate differential for capital gains; however, corporations can deduct capital losses only against capital gains. IRC § 1211(a). The two letter rulings involved public companies, so we know they were C corporations. It is possible that the TAM involved an S corporation, whose shareholders could have benefited from capital gain income.

Analysis

The IRS articulated the basic rule that the character of a settlement payment is derived from the "origin of the claim," citing *Gilmore*, 372 US 39 (1963) (which was a deduction, not an income, case). Then the IRS quoted a business journal stating that such termination fees were normally paid for expenses and lost profits and ultimately concluded that the taxpayer had lost the benefit of the bargain, which was lost profits.

This seems to have been somewhat of a leap. The ruling could have as easily said that the contract right was a capital asset that the taxpayer lost and was paid for. The business news is fairly full of various analyses showing that less than half of all studied business acquisitions produce profitable synergies.

Planning Idea

The ruling indicated that the absence of any statement in the agreement between the parties that would identify the purpose of the termination fee affected the conclusion. That is, it appears that the parties might have phrased the agreement in such a

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way as to aid the acquirer in reporting such income as a capital gain, if that were beneficial. The taxpayer in the ruling actually had two chances to make such a statement, because the parties restated the agreement concerning the fee at the time of the termination, and still failed to identify its purpose.

Although this is a fairly remote point, acquirers with capital losses they can't use might think about how their acquisition agreement might steer a large potential termination fee into the capital gain category.

Business Location Inducements

LMSB Coordinated Issue Paper 04-0408-023

This LMSB Coordinated Issue Paper (CIP) deals with a tax-reduction plan that evidently has some traction in the business community: A business gets an inducement from a state or local government in the form of a future tax reduction; the business reports the inducement currently as gross income that is excluded under IRC §118 as a contribution to its capital, but the business claims a deduction for the tax it did not have to pay, and reduces its basis in assets as the "price" of the exclusion under IRC §362(c). If this works, the business gets a current deduction for a tax it did not pay and the only downside is a possible income increase later. The CIP advises agents that this won't work.

Reasoning

The surprising aspect of the paper is how little law the IRS could cite to support its position that the payments are not income at all. Moreover, the reasoning depended on the critical, assumed fact that "the taxes ... are never due and payable." Therefore, the position stated in the paper can apply only to unaccrued future taxes.

The no-gross-income position reflects an about face executed by the IRS in *Snyder v. CIR*, 894 F. 2d 1337 (6th Cir. 1990) (unpublished opinion). In the Tax Court, the IRS had won a ruling that the right to similar future tax reduction was current income. 1988-320 TC Memo (1988).

Tax Rebates Generally

This subject matter is delicate ground for the IRS because it borders closely on subjects like frequent flyer discounts (see Ann. 2002-18) and the taxation of tax rebates, the payment of which has been a popular tool recently. One has to read down to near the bottom of the "Other Questions" section 8 of the FAQs on the Treasury Website concerning the 2008 Economic Stimulus Payments to find the information that they are not taxable.

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