INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

June 02, 2004

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Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Year Involved:
Date of Conference: January 21, 2004

LEGEND:

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Taxpayer =

B =

C =

Year 1 =

$x =

ISSUE:

Is a termination fee received by Taxpayer as the result of a failed merger and acquisition ordinary income or a return of capital and includible in income only to the extent that it exceeds the basis in Taxpayer's property?

CONCLUSION:

The termination fee received by Taxpayer is ordinary income.

FACTS:

On Date 1, Taxpayer entered into an Agreement and Plan of Merger with B (Agreement 1) to acquire the stock of B for stock, cash, and the assumption of debt. Under the terms of Agreement 1, B was prohibited from soliciting other offers during the period prior to closing but was permitted to consider and accept unsolicited superior offers. If B agreed to accept a superior offer, B was required to communicate that offer to Taxpayer to afford the latter an opportunity to meet or beat the superior offer within 5 days. If the superior offer was finally accepted, B agreed to pay Taxpayer a termination fee of $x.

In general, the termination fee provision in Agreement 1 provides certain terms and conditions regarding the payment of the termination fee; however, it is silent as to its underlying purpose. Also, the provision provides that all costs and expenses incurred will be paid by the party incurring such cost or expense whether or not the merger is consummated.

On Date 2, C submitted an unsolicited offer to purchase B for stock, cash, and the assumption of debt. The offer constituted a binding irrevocable offer to enter into a Merger Agreement (Agreement 2) subject to C's right to withdraw the offer if not accepted and executed by B within 10 days. C also agreed, for the purpose of inducing B to deliver to Taxpayer a notice that it had accepted a superior offer, to pay B the sum of $x upon the termination of Agreement 1 and B's execution and delivery of Agreement 2.

On Date 2, B's Board of Directors met and concluded that C's offer constituted a superior offer, and that it was in B's best interests to terminate Agreement 1 and accept Agreement 2. Later that day, B notified Taxpayer that it had received a superior offer from C and that it was terminating Agreement 1. The notice of termination triggered Taxpayer's right to submit a superior counteroffer within 5 days.

During the 5-day period Taxpayer and C conducted negotiations in an attempt to reach an acceptable alternative to a round of competitive bidding. On Date 3, as a result of these negotiations, Taxpayer and C entered into a separate Letter Agreement (Agreement 3) whereby Taxpayer agreed to withdraw from Agreement 1 once it had been paid the $x termination fee. Moreover, Taxpayer and C agreed to trade franchises in selected parts of the country. The exchange of franchises was to take place even if Agreement 2 was not consummated. Agreement 3 contained a second provision calling for a second exchange of franchises to be implemented if Agreement 2 was consummated.

On Date 4, B agreed to be acquired by C, C paid Taxpayer the termination fee of $x, and Taxpayer and C agreed to exchange franchises.

Taxpayer, on its Year 1 income tax return, reported the entire $x termination fee as capital gain. Shortly thereafter, Taxpayer filed a claim for refund taking the position that the termination fee represented compensation for damages to its corporate infrastructure. As such, the termination fee was asserted to be a return of capital entirely excluded from income as Taxpayer's basis in its property exceeded the amount received.

The examination team is of the view that the termination fee paid to Taxpayer under Agreement 1 constitutes a recovery for lost profits and is ordinary income.

LAW AND ANALYSIS:

Section 61 of the Internal Revenue 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 not taxable. *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. 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 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 takes the position that the termination fee represents damages for injury to goodwill that is properly treated as a return of capital, and is includible in income only to the extent it exceeds its basis in the property. Taxpayer bases its position on the principals of *Durkee v. Commissioner*, 162 F.2d 184 (6th Cir. 1947); *Raytheon*; and *Farmers and Merchant's Bank of Catlettsburg, Kentucky v. Commissioner*, 59 F.2d 912 (6th Cir. 1932). Taxpayer states that *Durkee*, *Raytheon*, *and Farmers and Merchant's Bank* stand for the proposition that damages received for injury to a taxpayer's overall business, including damages to prospects for future growth of the business, are properly treated as a return of capital. Over the years, Taxpayer had made a substantial investment, in the form of higher premiums over market value in various acquisitions than were typical in the industry, in developing an infrastructure with the intention and expectation of becoming a dominant force in the industry. Taxpayer asserts that the failed acquisition of B deprived it of a unique opportunity resulting in a diminution of the value of its infrastructure.

Taxpayer's reliance on *Durkee*, *Raytheon*, and *Farmers and Merchant's Bank* is misplaced for several reasons. First, these cases are factually distinguishable. They dealt with a conspiracy, an anti-trust violation, and other tortious acts that resulted in actual damage to goodwill or virtual destruction of a taxpayer's business. The present situation does not deal with tortious acts but concerns a contract that provides for a bargained-for termination fee. The termination fee was a payment in lieu of damages for failure to consummate a contract of sale. Such payments have been viewed as liquidated damages and treated 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).

Secondly, in analyzing this case under the origin-of-the-claim doctrine, the focus should be on the origin and character of the claim with respect to which a payment is made, the bargained-for termination fee, rather than its potential consequences on the business operations of Taxpayer.

Taxpayer relies on *Durkee*, *Raytheon*, and *Farmers and Merchant's Bank* for the proposition that damages received for injury to a taxpayer's overall business, including damages to prospects for future growth of the business, are properly treated as a return

[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).

of capital. In these cases, the litigation on which the settlements were based alleged only damages to goodwill and did not seek lost profits. “No claim is made for lost profits.” *See Durkee*, 162 F.2d at 186. “Upon examination of Raytheon’s declaration in its anti-trust suit we find nothing to indicate that the suit was for the recovery of lost profits.” *See Raytheon*, 144 F.2d at 113. “Petitioner not only did not insist upon the restoration of anticipated profits as a matter of fact, but based its claim for damages upon an alleged tortious injury to the good will of its business.” *See Farmers and Merchant’s Bank*, 59 F.2d at 913. In each case, the court concluded that the original claim in litigation was intended to compensate the taxpayers for damages to goodwill. In the present situation, Taxpayer has provided no evidence to support the conclusion that the original claim, the bargained-for termination fee, was intended to compensate Taxpayer for damages to goodwill. To the contrary, there is indirect support for the position that Taxpayer’s receipt of the termination fee is for the recovery of lost profits.

The termination fee provision in Agreement 1, beyond providing the trigger for the payment of the $x termination fee, 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 provides Taxpayer an effective manner in which to address the consequences of a failed merger. The termination fee provision is similar to a liquidated damages 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.”[2] The termination fee provision protects each parties’ contractual interests and was 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.

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

> 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 approximate the benefits the disappointed acquirer would have enjoyed had the merger agreement been consummated. Sneirson at 599.

> 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.

Based on the underlying purpose of the termination fee provision as discussed above, principles of contract law, and the above-mentioned authorities, it is reasonable to conclude that Taxpayer's bargained-for termination fee provided for benefit of the bargain or expectancy damages. As such damages are equated with lost profits, Taxpayer's receipt of the termination fee 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 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. *Stocks v. Commissioner*, 98 T.C. 1 (1992); *Evans v. Commissioner*, T.C.M. 1980-142; *Armstrong Knitting Mills v. Commissioner*, 19 B.T.A. 318 (1930).

In *Walley, Inc. v. Commissioner*, No. 13,499 (T.C.M. 1948), 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, which 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 unclearly designated as “funds received for development.” The payment was held to be ordinary income.)

Taxpayer has not sustained the burden of proof in demonstrating that its accession of wealth fits in the narrowly construed exclusion that the termination fee is an amount received for damage to capital. The termination fee received by Taxpayer is ordinary income.

CAVEAT:

A copy of this technical advice memorandum is to be given to the Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.