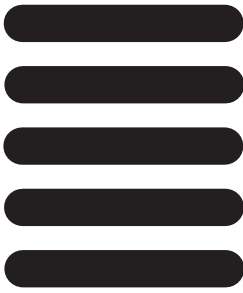




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Deductible Termination Fees?

By Robert W. Wood • Wood & Porter • San Francisco

Call it a merger-termination fee, an exit charge, a breakup fee or perhaps even the macho-sounding "kill fee." When you pay it, is it deductible? Bankers and business people are likely to shout a resounding "yes." Readers of the M&A TAX REPORT know the answer is a more muffled "it depends."

It has been more than 15 years since the Supreme Court decided *INDOPCO, Inc.*, SCt, 92-1 USTC ¶150,113, 503 US 79 (1992). For a while, diehards called it *National Search*, the company's old moniker, but even diehards today use the now not-so-new nomenclature. The Court in *INDOPCO* famously held that in general, expenses incurred to change a corporate structure for the benefit of future operations must be capitalized.

This is no small matter, ranking as one of the IRS' bigger victories in recent decades and triggering a wave of significant concerns about capitalization issues. The High Court held that these costs produced significant benefits to the taxpayer (new resources, synergies, etc.), and that these benefits extended beyond the tax year in question. Ever since then, *INDOPCO*-mania has been palpable.

The solution to the IRS's penchant for capitalization often involves a little surgery. As we often have noted in these pages, taxpayers in the real world tend to respond with a divide-and-conquer mentality. One response to *INDOPCO* has been to recognize the duality in many expenditures.

After all, when one pays for something, one is often paying for several things, not merely for one item. The mantra of bifurcation has prevailed in legal fees, investment banking fees and in many other contexts. Nevertheless, it cannot be denied that *INDOPCO* is still a major impediment to many tax deductions.

Smile Train

The Tax Court in *Santa Fe Pacific Gold Co. and Subsidiaries*, 132 TC No. 12 (2009), gave taxpayers and their advisors some happy

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news. The court dealt a significant victory for taxpayers and a significant defeat for the IRS. The question in the case was whether a merger-termination fee paid to clear the way for a merger with another suitor could be currently deducted.

Santa Fe Pacific Gold Company was spun off from its parent into a stand-alone entity. Several years later, Santa Fe was faced with a hostile takeover attempt by Newmont Mining Corporation, a competitor. Santa Fe tried to avoid the threat of being swallowed up, particularly (it would seem) since it had gained its independent wings so recently.

Accordingly, Santa Fe entered into a merger agreement with Homestake Mining Company, a company that it perceived as a proverbial white knight. The merger agreement called for the payment of a termination fee should the agreement be terminated. Thereafter, Newmont increased its offer for Santa Fe.

When the Santa Fe Board was confronted with this higher offer (which exceeded Homestake's offer), the Board felt it had a fiduciary duty to terminate the Homestake offer and to accept the higher offer from Newmont. Pursuant the contracts in question, Santa Fe paid \$65 million as a termination fee to Homestake. Santa Fe deducted the payment. The IRS disallowed it, asserting that the expense had to be capitalized.

Who's on First?

To begin, the Tax Court in *Santa Fe* looks to the surrounding transaction and the circumstances under which the Santa Fe and Homestake agreement was executed. This termination fee, said the Tax Court, did not lead to significant benefits to Santa Fe extending past the year in question. Moreover, there was no question that the Santa Fe-Homestake agreement was defensive in nature.


Plainly, Santa Fe's agreement with Homestake was designed to prevent a takeover by Newmont. The termination fee was a part of that defensive agreement. That meant that any benefit as a result of incurring the termination fee died along with the Santa Fe-Homestake agreement.

Put differently, the fee was meant to protect the Santa Fe-Homestake agreement and to deter competing bids. From Homestake's perspective, the fee was designed to reimburse Homestake for its time and effort in the event the deal was terminated. In fact, that turned out to be exactly what happened.

Defense vs. Offense?

Given the Tax Court's focus, it is interesting to contemplate how defensive maneuvers should be undertaken. The Tax Court acknowledged that Santa Fe had other structural defenses in place. Yet the Tax Court recognized that Santa Fe's major defensive strategy was to engage in a capital transaction with a third-party (Homestake) to prevent Newmont's acquisition. The best defense, as they say, is a good offense.

Depending on how you look at it, that effort failed. Alternatively, at least it prompted Newmont to throw more money at Santa Fe. The IRS argued that this entire course of conduct was seamless, and that the termination fee actually did allow the Newmont deal to proceed (which in a way, it did). Despite that



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argument, the Tax Court found that Santa Fe's act of paying a termination fee to Homestake simply did not produce any long-term benefit to Santa Fe.

When the deal closed, Santa Fe became a Newmont subsidiary. The Tax Court found that this fact was not significant to Santa Fe. That meant a business expense deduction under Internal Revenue Code Section ("Code Sec.") 162 was proper.

Alternative Arguments

The IRS also argued that the potential Newmont and Homestake deals were mutually exclusive alternatives. Each deal, said the IRS, represented a broad restructuring goal. Nevertheless, the IRS said these two possible combinations were not part of an overall plan by Santa Fe to change its capital structure.

In fact, Santa Fe viewed the Homestake and Newmont transactions as separate and distinct. The Tax Court specifically found that the Santa Fe-Homestake agreement was a closed and completed transaction. It was abandoned by Santa Fe when it entered into the Santa Fe-Newmont agreement. The termination fee was paid as a result of that abandonment.

Therefore, concluded the Tax Court, it could also represent a cost of the abandoned Homestake merger. That meant Santa Fe would be entitled to a deduction under Code Sec. 165 as a loss, quite apart from the availability of the Code Sec. 162 deduction.

Pushing Paper

It is very clear that documents play an important role in a case such as this. The Tax Court had an easy time in ruling that Santa Fe's Board of Directors and management did not want to be taken over by a large competitor, particularly such a brief period of time after completing the spinoff from its former parent. The documents also made clear that Santa Fe viewed Newmont as a hostile bidder. The documents even showed that Santa Fe unabashedly entered into a white knight agreement with Homestake specifically to prevent Newmont from acquiring it.

When Santa Fe was later forced to abandon its agreement with Homestake (because Santa Fe's Board was under a fiduciary duty to accept the deal with the highest bidder), Newmont's offer simply had to be accepted. This forced

Santa Fe to breach the Homestake agreement and pay the termination fee. At that moment, it abandoned the Homestake merger.

Axiomatically, Code Sec. 162(a) allows a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business. Code Sec. 165(a) allows a deduction for a loss not compensated for by insurance. The Tax Court held that either one could apply to Santa Fe's \$65 million termination fee paid to Homestake.

Shell Game?

Cancellation payments are tricky. On the one hand, your instinct will likely always be to deduct them if you can. But unquestionably, sometimes a cancellation payment is closely linked to the acquisition of a long-term benefit. There, the payment will have to be capitalized.

Readers should note that regulations under Code Sec. 263 currently provide that an amount paid to terminate an agreement to enter into certain acquisitions and other transactions will be treated as paid to facilitate a second transaction if the two transactions are mutually exclusive. [See Reg. §1.263(a)-5(c)(8).] In the case of Santa Fe, this particular provision in the regulations did not apply, since the transaction predated December 30, 2003. If this same circumstance were to occur today, these regulations would require a termination fee (paid under the circumstances in which Santa Fe paid one to Homestake) to be capitalized.

Indeed, where a termination fee is paid to a white knight in an unsuccessful effort to defend against a hostile takeover by another corporation, the transactions will be viewed as mutually exclusive. Only one deal can take place. That means the termination payments would have to be capitalized as amounts paid to facilitate the takeover. [See Reg. §1.263(a)-5(1), Example 13.]

Nevertheless, more than a few practitioners will be scratching their heads over *Santa Fe*, no matter how favorable a decision it may be. When you consider this area, consider these authorities and try to discern a clear rule:

- *A.E. Staley Manufacturing Co.*, 105 TC 166, Dec. 50,882 (1995), *rev'd*, CA-7, 97-2 USTC ¶50,521, 119 F3d 482 (1997) (hostile takeover, no white knight; defensive expenses were held deductible, but "facilitative" expenses had to be capitalized)

- *Victory Markets, Inc.*, 99 TC 648, 48,800 (1992) (friendly takeover; no white knight; expenses were all deemed to facilitate a new deal so had to be capitalized)
- *INDOPCO, Inc.*, *supra* (friendly takeover; no white knight; expenses to facilitate transaction lead to long-term benefit and had to be capitalized)
- *In re Federal Dept. Stores, Inc.*, 135 Bankr. 950 (Bankr. S.D. Ohio 1992), *aff'd*, 171 Bankr. 603 (S.D. Ohio 1994) (hostile takeover; white knight; no long-term benefit; expenses deductible)

If nothing else, we know that hostility is good from a tax perspective. How much more we know is debatable.

Back-to-Back Loans, S Corporations and Basis

By Robert W. Wood • Wood & Porter • San Francisco

Few tax aficionados do not know that S corporations are fundamentally unlike partnerships in their treatment of basis. The rules are not all that complicated, but they need to be observed. Perhaps of greatest moment is the nonintuitive rule that you can't claim losses from an S corporation unless you have sufficient basis.

Yet basis here comes in two forms, stock basis and debt basis. Both count. It is therefore quite common for tax lawyers and accountants, and for clients themselves, to wake up near the end of a tax year and realize that there's a big loss coming down the pike for the year, but one or more shareholders of the S corporation just won't have sufficient basis to claim it. What to do?

Traditionally, the answer has been to loan money to the S corporation. After all, a shareholder loan to the corporation will increase the shareholder's basis in his S corporation stock. There can be difficulties with this, as where the shareholder loans the money to the corporation on December 25, and the corporation repays the money on January 5. Should the loan be respected?

Most people will probably argue that it should, assuming that you can make the case that the loan was really debt for tax purposes when it was made. Yet there may well be disagreement, particularly where the loan is outstanding a short time. It is even worse where the corporation and shareholder do this every year.

Then there is the back-to-back loan issue. Most practitioners, seasoned and unseasoned alike, know that you generally don't want an S corporation to itself incur debt. Instead, you want the shareholder(s) to incur it and then to loan the proceeds to the corporation. Why?

Because if the corporation is the obligor to the outside lender, that loan doesn't create debt basis to the shareholders. Conversely, if the shareholders borrow the money, and in turn loan it to the S corporation, they are credited with debt basis. Along with their basis in their S corporation stock, their basis in their debt loaned to the S corporation will be available as a repository against which they can deduct losses from the S corporation.

AICPA Plan

One can't deny that this is formalistic. Of course, formalism and tax law seem to go together like bread and butter. Nevertheless, many an old-time practitioner out there (like me) may well wonder if there's a way to clean up this area.

That's what the AICPA has recently proposed in comments to the Treasury on Guidance Under Section 1367 Regarding S Corporations and Back-to-Back Loans. What have they proposed? Well, the nuggets of their proposal are here.

A shareholder note would be treated as debt qualified to permit the S corporation shareholder to increase his basis in indebtedness from the corporation (and assuming the taxpayer meets the at-risk and passive activity loss limitations) to deduct losses under Code Sec. 1366(d) only if it has all of the following characteristics:

1. The note is a written unconditional promise by the corporation to pay the shareholder, on demand or on a specified date, a sum certain in money.
2. The interest rate specified in the instrument meets, at a minimum, the applicable federal rate for the type of loan and for the period the loan is made.
3. Interest payment dates are specified in the instrument.

4. The instrument is legally enforceable under state law.
5. The S corporation is not an obligor or co-obligor on the note issued by the shareholder to the primary lender in a back-to-back situation. A guarantee or pledge of corporate assets is not to be considered as making the company an obligor.
6. Interest and principal payments are made pursuant to the agreement, *i.e.*, the company pays the shareholder, and the shareholder pays the primary lender (if mistakes are made and direct payment is made, the books and records are adjusted and appropriate information reporting forms are filed).
7. Loans are reported appropriately on tax returns and year-end financial statements, if any, of the company and shareholder.

These criteria are more extensive than those of the straight debt safe harbor of Code Sec. 1361(c)(5)(B), which are intended solely to ensure that debt does not create a second class of S corporation stock. Given that the sole purpose of this new debt safe harbor is to ensure that a shareholder receives an increase in his debt basis, the AICPA admits it doesn't cover all situations. Factual situations outside the safe harbor would be judged on all the facts and circumstances.

Here are a few examples from the AICPA of what they have in mind:

Example 1—Back-to-Back Loans Involving Unrelated Third Party Lenders. Bank lends \$100,000 to Individual A at commercially reasonable rates and terms (the "X Bank Loan"). Individual A immediately lends the funds to Corporation L, an S corporation, in the form of debt for use as working capital. The terms of the loan from A to L are also commercially reasonable. The payments

of the X Bank Loan to A are made by A according to the terms. If the shareholder debt otherwise meets all requirements of the safe harbor, Individual A would have an increase in adjusted basis in debt of \$100,000 under section 1366(d)(1).

Example 2—Substituted or Subrogated Debt. A, an S corporation, is owned by shareholders B and C. A has borrowed \$500,000 from Bank. Subsequently, shareholders B and C substitute personal notes with the bank for A's corporate note with the bank such that the corporation now owes B and C \$500,000, and B and C owe the bank. The bank fully extinguishes the indebtedness of the corporation to the bank. If the shareholder debt otherwise meets all requirements of the safe harbor, the new shareholder loans should give rise to combined B and C debt basis of \$500,000.

Conclusion

It is too soon to say what will become of the AICPA's comments. They seem to make sense, and they recognize that these issues have been litigated over and over again. Still, one part of the issue has more to do with taxpayer sloppiness than with anything else.

Indeed, it remains surprising just how ignorant some people are of these rules. More than a few tax practitioners have been forced to play Monday morning quarterback, looking at debt that is badly designed and implemented, where the goal is to insure that S corporation shareholders have sufficient basis to use losses. Often, practitioners are thrust into this role when it is arguably too late to do much about it.

Whatever happens to the AICPA's plea for clarity here, we need more focus on the basics *before* these problems arise.

Golden Parachute Guidance

By Robert W. Wood • Wood & Porter • San Francisco

Golden parachute payments, one must admit, have a storied past. Golden parachute payments first came to prominence back in 1984 with the enactment of Code Sec. 280G, and the corollary excise tax enacted by Code Sec. 4999. Proposed Regulations were first released in 1989, and then re-proposed in 2002. They were finalized in 2003.

The golden parachute label, along with the reciprocal golden handcuffs, features prominently in many business deals. Notably, these rules apply to private as well as public companies.

Chief Counsel Advice 200923031 (Feb. 2, 2009) gives new guidance on the implications of these rules in the context of a reorganization.

Just the Basics

A parachute payment isn't entirely proscribed, but isn't favored either. It incurs two extra tax burdens if it is of a certain size, being deemed "excess." A parachute payment is a payment in the nature of compensation to (or for the benefit of) a disqualified individual that is contingent on a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the corporation's assets. If the payment has a present value of at least three times the disqualified individual's base amount (generally the person's average annual compensation for the five years before the change), the payment becomes an *excess* payment.

That makes the payment nondeductible to the extent it exceeds that base amount. [See Code Sec. 280G(b)(1).] The bad consequences come with a double whammy: not only is the payment nondeductible to the payer, but it also incurs an excise tax. The excise tax is assessed on the recipient of the excess parachute payment. The excise tax is 20 percent of the excess parachute payment, and it too is expressly made nondeductible.

"Disqualified individuals" are defined in a way one would expect. Generally, they include any employee, independent contractor or other person specified in regulations who performs personal services for a corporation, and who is an officer, shareholder or highly compensated individual. [See Code Sec. 280G(c) and Reg. §1.280G-1, Q&A-15 through Q&A-20.] "Highly compensated" is defined to mean anyone who is a member of the highest paid one percent of employees or, if less, the highest paid 250 employees. [See Code Sec. 280G(c).]

Most of the niceties of golden parachute practice involve not merely cash payments but other types of consideration. In fact, cash is relatively straightforward. Other consideration is often confusing. The law is clear that payments may come in a variety of forms, and the restricted property rules of Code Sec. 83 are very much in the mix. For example, the vesting of options is treated as a payment in the nature of compensation. [See Reg. §1.280G-1, Q&A-13.]

Over the years, a considerable amount of attention has also been paid to triggering events. In general, a payment will be treated as contingent on an ownership or control change if it *in fact* would

not have been made had no change occurred. This is so even if the payment is expressly conditioned upon another nonacquisition event. [See Reg. §1.280G-1, Q&A-22(a).]

New Guidance

You may think you have mastered these rules, and that you can spot a parachute payment when you see one. Nevertheless, CCA 200923031 suggests that there are subtleties here or, more pejoratively, traps for the unwary. Essentially, this Chief Counsel Advice examines consideration in an acquisition. More particularly, it examines the extent to which the cancellation of nonlapse restrictions under Code Sec. 83, and/or the acceleration of vesting of unvested stock rights, constitute parachute payments.

In the ruling, a company maintained a stock rights plan for designated executives. The stock rights were options to purchase Class A Common at book value, and the right to purchase Class B Common at par value. Notably, the issuing corporation has rights and obligations under the plan to repurchase at book value the Class A Common (this is referred to as a "book value restriction") and to repurchase the Class B Common at par value.

A transaction is planned in which the corporation will be acquired by an unrelated third-party buyer. We are told that in this transaction, the book value restriction provided in the plan will be cancelled. As a result, the corporation's shareholders will be entitled to receive fair market value for their Class A Common on the closing of the transaction. Moreover, certain unvested stock rights will become fully vested, and the stock rights and certain Class A Common will be cashed out.

The IRS concludes that the removal of the book value restriction with respect to the Class A Common is a non-compensatory cancellation of a nonlapse restriction under Code Sec. 83. Of course, that is good. It means that this cancellation will not require an amount to be included in the income of the executives.

Furthermore, the IRS concludes that no portion of the consideration of the transaction payable with respect to the vested Class A Common is a parachute payment. The amount of the parachute payment attributable to the

acceleration of the vesting of the unvested stock rights, however, is determined by applying the regulations to the value of the stock rights at the time of vesting (taking into account the transaction consideration, not limited by the book value restriction).

What seems key about this ruling comes in the company's representations to the IRS. The company represented that the cancellation of the book value restriction will affect all Class A Common and stock rights to acquire Class A Common. Moreover, the company represented that the cancellation is occurring pursuant a negotiated arm's-length transaction.

The company was even able to represent to the IRS that the executives who participate will not take a salary adjustment in connection with the cancellation. Finally, the company represented that it would not treat the cancellation of the book value restriction as a compensatory event.

Saving Grace

Savings clauses are pretty common in various types of agreements. A golden parachute

payment savings clause would typically operate as a stop-gap, to say that no matter what all of the other provisions in a compensation agreement may state, no "excess parachute payment" will be made. Some savings clauses may require an executive to repay any amount of compensation that ends up being viewed as an excess parachute payment.

Note, however, that such "unring-the-bell" provisions are less common with golden parachute payments than they are with regular old compensation that is later adjudged to be unreasonable. (An example of the latter type of savings clause is featured in *Menards, Inc.*, No. 08-2125 (7th Cir. 2009) [see Robert W. Wood, *Funny Money: Deducting Reasonable Compensation*, M&A TAX REP., Apr. 2009, at 5], where the Seventh Circuit rejected the IRS's arguments based on the savings clause). Far better than savings clauses, particularly of the repayment variety, is to avoid the problem from the start. CCA 200923031 suggests ways to do that in the case of some acquisitions.

Tax Credits and the Cohan Rule

By Robert W. Wood • Wood & Porter • San Francisco

There is almost nothing more widely understood about our tax system than the notion that one must have receipts. Receipts for the tax man are even fodder for comedians. From Lucille Ball to Jerry Seinfeld to SATURDAY NIGHT LIVE, we laugh nervously at proving up tax deductions. Even so, to my knowledge no one has joked about the *Cohan* Rule made famous by Broadway impresario George M. Cohan.

In an early era of Broadway, George M. Cohan brought us *Yankee Doodle Dandy* and many other hits. Today, George M. Cohan may be mostly known to tax advisors as the namesake of a very important tax rule, despite the fact that few taxpayers even have heard of it. The genesis of the *Cohan* Rule is *G.M. Cohan*, CA-2, 2 USTC ¶438, 39 F.2d 540 (1930).

Cohan had many of his show business travel and entertainment expenses disallowed by the IRS because he had no receipts. Yet Cohan actually succeeded in arguing that he was frantically busy, and had little time to document his expenses. He thus successfully challenged

stringent IRS recordkeeping requirements, proving by "other credible evidence" that he in fact had incurred the expenses and that in fact they were business related. Cohan proved up by his testimony (including his recollections and approximations of the amounts incurred) cab rides, tips and restaurant expenses for Cohan and his considerable entourage.

To be sure, the *Cohan* Rule doesn't always impress the IRS, and it doesn't always work. It is most classically applied in the case of travel and entertainment expenses. But theoretically, it could apply to virtually any item. If the IRS is convinced by oral or written statements or other supporting evidence, and a reasonable approximation can be made, you may nevertheless be entitled to the expense notwithstanding a failure to have it documented.

Who Knew?

The research credit provided by Code Sec. 41 has been controversial, particularly in recent years. In broad strokes, it allows a

generous credit for the costs of research that would typically need to be capitalized. It has spawned a cottage industry of accountants and lawyers who, generally on a contingent fee basis, help clients to claim the credit, usually on amended tax returns. It was therefore somewhat surprising to see the *Cohan* Rule dusted off and used by a taxpayer—and successfully used—in this context.

The Fifth Circuit applied the *Cohan* Rule to the research credit, and many taxpayers are sitting up to take notice. [See *United States v. Arthur McFerrin et ux*, Tax Analyst Document No. 2009-13123, 2009 TNT 101-15 (5th Cir. 2009).] In some ways, this decision is quite logical. After all, many of the disputes about the research credit involve substantiation.

In this case, McFerrin had owned three S corporations. He hired Alliantgroup LP to determine if he qualified for an increasing research tax credit. Based on what Alliantgroup provided, McFerrin amended his 1999 return in 2003, claiming a credit of \$472,092 plus interest. The government issued the refund but then later sued to recover it, claiming that the credits were unsubstantiated.

The U.S. District Court determined that the projects didn't qualify for the credit and that there were no records of hours worked on the various projects. The Fifth Circuit, however, was convinced by evidence that was not traditional receipts, invoices and payroll records. For example, one key piece of evidence involved a review of the minutes of meetings. In addition, the Fifth Circuit found that the District Court was unwilling to consider rough estimates given by employees years after the fact to substantiate the claimed credit.

The Fifth Circuit remanded the case, noting that the Tax Court should look to testimony and other evidence in determining a fair estimate. The Fifth Circuit admonished that this evidentiary examination should include the institutional knowledge of employees,

Privilege

The Fifth Circuit opinion in *McFerrin* is being widely cited for its discussion of Code Sec. 7525, Privilege and Tax Shelters. However, *McFerrin's* dusting off of the *Cohan* Rule is arguably more important. It may well turn the research credit back into something much more viable for many more taxpayers.

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