

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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date: May 03, 2016

to:

Revenue Agent  
(Large Business & International)

from:

(Large Business & International)

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subject:

This memorandum responds to your request for assistance. This advice has been reviewed by Financial Institutions and Products in National Office. This advice may not be used or cited as precedent.

**DISCLOSURE STATEMENT**

**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.**

**ISSUE**

Whether (Taxpayer) payment of a break fee arising from the termination of an agreement of merger gives rise to a capital loss under section 1234A.

**CONCLUSION**

Yes. Under the circumstances discussed below, section 1234A applies to Taxpayer's loss arising from the payment of a break fee attributable to the termination of an agreement of merger, and the loss is a capital loss.

**FACTS<sup>1</sup>**

On \_\_\_\_\_, Taxpayer announced in a press release the recommended combination of Taxpayer and \_\_\_\_\_ (Target), a \_\_\_\_\_ company organized under the laws of \_\_\_\_\_

Also on \_\_\_\_\_, Taxpayer and Target entered into a \_\_\_\_\_ Agreement that intended to give effect to the terms and conditions set forth in the press release recommending the merger.

To facilitate the merger, Taxpayer formed a new company, \_\_\_\_\_, which is incorporated in \_\_\_\_\_. Under the terms of the \_\_\_\_\_ Agreement, Target shareholders would be entitled to receive \_\_\_\_\_. Taxpayer stockholders would receive \_\_\_\_\_. Both Taxpayer and Target would become \_\_\_\_\_ subsidiaries of \_\_\_\_\_, with \_\_\_\_\_ stock being listed on the \_\_\_\_\_ Exchange.

The merger was conditioned upon Taxpayer's board recommending the merger to its shareholders. Before the transaction could be consummated, the U.S. Treasury Department issued a notice that adversely affected the expected tax benefits of the proposed merger. In \_\_\_\_\_, Taxpayer withdrew its recommendation for the merger.

Under the \_\_\_\_\_ Agreement, Taxpayer was required to pay a break fee to Target if Taxpayer withdrew its recommendation for the merger. On \_\_\_\_\_, Taxpayer and Target entered into a \_\_\_\_\_ Agreement to terminate the \_\_\_\_\_ Agreement. The \_\_\_\_\_ Agreement provided that Taxpayer would pay Target the break fee because Taxpayer did withdraw its recommendation for merger. Taxpayer paid a break fee of \$ \_\_\_\_\_ to Target on \_\_\_\_\_

This break fee also operated as the Target's sole and exclusive remedy for the terminated merger.

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<sup>1</sup> Our understanding of the facts of this case is limited to the information that you have provided to us unless otherwise stated. We have not undertaken any independent investigation of the facts of this case. If the facts known to us are incorrect or incomplete in any material respect, you should not rely on this advice, but instead should contact our office immediately.

During the \_\_\_\_\_, Taxpayer provided a copy of the wire transfer and description of line item for this amount to be reflected in its \_\_\_\_\_ U.S return.

### LAW AND ANALYSIS

#### *Law*

Section 1222 provides that capital gain or loss is gain or loss from the sale or exchange of a capital asset.

Section 1221(a) defines a capital asset as any property that is held by the taxpayer, regardless of whether it is connected to the taxpayer's trade or business, unless it is one of the exceptions listed under section 1221(a).

Section 1234A states that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation (other than a securities futures contract) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset.

The law under section 1234A as it existed (prior to its amendment in 1997) was deficient because "it taxes similar economic transactions differently," and "its lack of certainty makes the tax laws unnecessarily difficult to administer." S. Rept. No. 105-33, at 134, 1997-4 C.B. (Vol. 2) at 1214. The legislative history further provides that a "major effect of the Committee bill would be to remove the effective ability of a taxpayer to elect the character of gains and losses from certain transactions. Another significant effect of the Committee bill would be to reduce the uncertainty concerning the tax treatment of modifications of property rights." S. Rept. No. 105-33, at 135, 1997-4 C.B. (Vol. 2) at 1215.

The explanation of section 1234A further provides –

The bill extends to all types of property the rule which treats gain or loss from the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer [as capital gain or loss].. . . Thus, the committee bill will apply to (1)

interests in real property and (2) non-actively traded personal property. . . . 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. See *U.S. Freight Co. v. United States*, 422 F.2d 887 (Ct. Cl. 1970), holding that forfeiture was an ordinary loss.

S. Rept. No. 105-33, at 135, 1997-4 C.B. (Vol. 2) at 1215.

Section 165(a) provides that there shall be allowed as a deduction any uncompensated loss sustained during the taxable year. Section 165(f) provides that capital losses are subject to the limitations in sections 1211 and 1212. Section 1211 provides that in the case of a corporation, losses from sales or exchanges of capital assets are limited to gains from such sales or exchanges. Section 1212 provides for the carryover of excess capital losses.

#### *Analysis*

Section 1234A treats as gain or loss from the sale of a capital asset a “[g]ain or loss attributable to the cancellation, lapse, expiration, or other termination” of a right or obligation “with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer.” A capital asset is any property that is held by the taxpayer, with eight exceptions listed in section 1221(a). Stock is generally considered a capital asset. *Appalachian Elec. Power Co. v. United States*, 158 F. Supp. 138, 140 (Ct. Cl. 1958).

stock would be a capital asset in Taxpayer’s hands upon acquisition. Taxpayer and Target had entered into a Agreement in which Taxpayer and Target each would acquire stock. Furthermore, the Agreement required Taxpayer and Target to obtain clearances in order to implement the merger. The Agreement outlined a list of obligations that Taxpayer and Target would undertake, which consisted primarily of the respective parties providing

The contract thus provided Taxpayer with rights and obligations with respect to Target’s and stock.

Under the Agreement, if Taxpayer makes an adverse recommendation change and the merger fails to go through, Taxpayer was required to pay a break fee to Target. Per the Agreement and Agreement, the break fee provision was for “

” The break fee operated as Target’s sole and exclusive remedy against Taxpayer and was in the nature of liquidated damages rather than as compensation for services.

The break fee relates to a contractual right and obligation concerning a capital asset (the right and obligation to acquire \_\_\_\_\_ stock). Consistent with the purpose of section 1234A, any gain or loss realized by Taxpayer on the termination of the contract, which provides Taxpayer with rights and obligations with respect to \_\_\_\_\_

\_\_\_\_\_ stock, a capital asset, would be capital in nature. Therefore, section 1234A applies and Taxpayer's loss on paying the break fee is a capital loss.

This advice applies only in the situations and under the facts and circumstances described herein. Pursuant to section 6110(k)(3) of the Code, this document may not be used or cited as precedent. Please call \_\_\_\_\_ if you have any further questions.

Associate Area Counsel  
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By: \_\_\_\_\_

Attorney, ( \_\_\_\_\_ )  
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