



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

June 20, 2000

Number: **200049004**

Release Date: 12/8/2000

CC:DOM:FS:IT&A

-
UILC: 1033.02-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: DISTRICT COUNSEL,

FROM: ASSISTANT CHIEF COUNSEL (FIELD SERVICE) CC:DOM:FS

SUBJECT: I.R.C. § 1033 -- NONRECOGNITION: "BREAK-UP" FEES

This Field Service Advice responds to your request dated March 20, 2000. It is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND:

Taxpayer	=			
Target	=			
Corp. A	=			
		Corp. B	=	.
Year 1	=			
Year 2	=			
Year 3	=			
Date 1	=			
Date 2	=			
\$	=			
\$X	=			
\$\$X	=			
\$\$\$X	=			

ISSUE:

Whether certain “break-up” or “termination” fees that Taxpayer received in connection with the termination of a planned merger with Target and paid pursuant to a prior agreement are eligible for nonrecognition treatment under I.R.C. § 1033.

CONCLUSION:

There was no involuntary conversion within the meaning of section 1033; thus, the fees are ineligible for section 1033 nonrecognition treatment.

FACTS:

During early Year 1, a certain Corp. A made an unsolicited merger proposal to Target. Target’s board rejected the proposal, but during the remainder of Year 1 and throughout the first three quarters of Year 2, Target’s board and management continued to consider the possibility of merging.

Taxpayer is an accrual basis taxpayer and parent of a consolidated group of corporations. It was looking for a merger partner during the times involved here. In Year 2, Target and Taxpayer met to discuss the feasibility of such a merger. Subsequent to that meeting, Target met with Corp. A, at Corp. A’s request, for the

same purpose. Later in Year 2, Corp. A announced that it had delivered an unsolicited merger proposal to Target. That same day, other companies, including Taxpayer, contacted Target to express interest in a possible merger. After a number of meetings and discussions, the Target board concluded that the most promising options were a merger with either Corp. A or Taxpayer.

After further discussions among the companies, the Target board met to consider both the Corp. A and Taxpayer merger proposals. At that meeting the board approved and authorized the execution and delivery of an agreement for the merger of Target with Taxpayer. That consisted of: (1) an agreement and plan of merger; (2) reciprocal stock option agreements; and (3) reciprocal termination fee agreements.

The stock option agreement granted Taxpayer an option to acquire a portion of Target's common stock upon the occurrence of certain events. A triggering event was defined in the agreement as any of a number of enumerated events preliminary to a potential merger or acquisition of Target by a third-party, subject to certain conditions subsequent. These events included Target's entering into an agreement for its acquisition by a party other than Taxpayer; the acquisition of beneficial ownership of a stated percentage of Target's common stock by a third-party; the filing with the SEC by a third-party of a registration statement relating to a potential acquisition of Target; or the breach by Target of any covenant in the merger agreement in anticipation of engaging in a merger with a third-party. The option agreement also limited Taxpayer's "total profit" thereon to \$X, essentially equaling the net amount realized by Taxpayer from the sale of option shares, Target's repurchase of the option, or Taxpayer's sale of the option.

The termination fee agreement provided that Target would pay Taxpayer a termination fee of \$ if the merger were terminated and one of the following five events occurred prior to the termination: (1) failure of the Target board to recommend the merger agreement to its shareholders, or withdrawal of the board's recommendation; (2) approval or recommendation to the stockholders of an acquisition proposal with a third-party; (3) failure of Target's shareholders to approve the merger agreement after a public announcement of a proposal by a third-party; (4) acquisition by a third-party of 50 percent or more of Target's common stock; or (5) any breach after an acquisition proposal by a third-party of any covenant which would allow Taxpayer to terminate the merger agreement.

Corporation A, nevertheless, continued to pursue a merger with Target even after announcement of the merger agreement between Target and Taxpayer. By Year 3, after certain corporate and regulatory developments, the Target board authorized management to engage in discussions with Corp. A respecting a merger.

Eventually, the boards of Target and Corporation A authorized an agreement for the merger of Target with Corp. A.

Target, Corp. A, and Taxpayer entered into a settlement agreement which terminated the related litigation between the parties, terminated the fee agreement and the option agreement, and provided for Taxpayer to receive a payment upon the agreement's execution and an additional payment upon the closing of the Target and Corp. A merger. The merger agreement between Corp. A and Target was publicly announced on Date 1. Target paid Taxpayer in accordance with the settlement agreement.

Taxpayer attached a statement to its Year 3 federal tax return purportedly electing under section 1033(a)(2) not to recognize gain of \$\$X on the \$\$\$X received pursuant to the settlement agreement. The statement described the property converted as a written executory contract to merge the two companies through the acquisition of stock.

On Date 2, Taxpayer acquired Corp. B in a cash transaction. Taxpayer treated the acquisition as an acquisition of replacement property for the terminated merger agreement and recognized the balance received in the settlement that was not otherwise "reinvested" into income.

LAW AND ANALYSIS:

Under sections 61(a)(3) and 1001(c), generally, gain realized on the disposition of property must be recognized. Since 1921, however, Congress has provided relief of some sort to taxpayers whose property has been taken from them (disposed of) against their will when they realize a gain. See Internal Revenue Act of 1921, Ch. 136, § 214(a), 42 Stat. 227. Prior to the 1921 Act, the Treasury Department had already promulgated regulations achieving the same substantive relief. Treas. Regs. § 45, Arts. 49, 50 (1919 ed.). The apparent impetus for both the regulations and the subsequent legislation was the destruction or requisitioning of property necessitated by World War I. See American Natural Gas Co. v. United States, 279 F.2d 220 (Ct. Cl.), cert. denied, 364 U.S. 900 (1960). It was viewed as unfair to make an owner, for example, who had his boat "submarine" by the enemy or requisitioned by the Government, pay the tax on any gain and possibly, therefore, be unable financially to replace that boat in his business.¹ The deduction for qualified replacement costs initially provided for by the statute was eventually

¹ See "Notes on the Revenue Act of 1918 (Part I), Submitted by the Secretary of the Treasury, Printed for Use of the Committee on Ways and Means (1919), at 15."

supplanted by nonrecognition treatment. Revenue Act of 1924, § 203(b)(5), 43 Stat. 253.

Section 1033(a) requires that the taxpayer's property be "compulsorily or involuntarily converted" into other property or money; yet, simply put, the provision does not cover all situations where taxpayers are deprived of property rights without their permission. It is limited, rather, to the property's involuntary destruction, theft, seizure, requisition or condemnation, or disposition under the threat of requisition or condemnation.² The reason for such limitations are obvious. If it were not so constrained, the section would be applicable to many "compulsory" sales or exchanges dictated by adverse business considerations.

The congressional intent did not contemplate relief for dispositions required by business necessity or expediency, such as what occurred here; rather, it intended relief for taxpayers faced with the actual or threatened loss of their property to the government and or a loss by casualty. Moreover, regardless of some government interest or direct involvement therein,³ forced sales or exchanges made pursuant to state statute (Hitke v. Commissioner, 296 F.2d 639 (7th Cir. 1971); Dear Publication and Radio, Inc. v. Commissioner, 274 F.2d 656 (3d Cir. 1960); Rev. Rul. 69-550, 1969-2 C.B. 161; Rev. Rul. 55-717, 1955-2 C.B. 248), a Securities and Exchange Commission order (American Natural Gas Co. v. United States, 279 F.2d 220 (Ct. Cl.), cert. denied, 364 U.S. 900 (1960); Rev. Rul. 57-517, 1957-2 C.B. 524), an antitrust order (Behr-Manning Corp. v. United States, 196 F. Supp. 129 (D. Mass. 1961); Rev. Rul. 58-11, 1958-1 C.B. 273), a court order of partition (Roth v. Commissioner, T.C. Memo. 1977-17), a loan foreclosure (Cooperative Publishing Co. v. Commissioner, 115 F.2d 1017 (9th Cir. 1940); Recio

² Section 1033(a)(2)(A) provides that if, during a specified period, the taxpayer purchases other property similar or related in service or use to the property so converted, at the election of the taxpayer the gain shall be recognized only to the extent that the amount realized exceeds the cost of such other property. See also Treas. Reg. § 1.1033(a)-2(c). The quid pro quo for this nonrecognition, of course, is a lower basis in the qualified replacement property. Section 1033(b). In actuality, therefore, it is just deferral of recognition.

³ A factor entirely absent in the circumstances of this case on any level. At any rate, even outright condemnation of property by the government is not always an involuntary conversion under section 1033 if the public health and welfare is involved. For example, where real property may be unfit for human habitation, the condemnation thereof is not under section 1033. Rev. Rul. 57-314, 1957-2 C.B. 523. Compare Rev. Rul. 82-147, 1982-2 C.B. 190 (sale of a resort hotel where Congress had declared the surrounding region a wilderness area constituted an involuntary conversion).

v. Commissioner, T.C. Memo. 1991-215), a tax delinquency sale (Rev. Rul. 77-370, 1977-2 C.B. 306), and bankruptcy (Rev. Rul. 79-269, 1972-2 C.B. 297) or receivership proceedings (Shields v. United States, 74-2 U.S.T.C. ¶ 9537 (W.D. Tex. 1974)) are just some of the numerous examples of property dispositions that are not involuntary conversions within the purview of section 1033—notwithstanding the taxpayer’s manifest unwillingness to part with the property involved.⁴

The Tax Court, for its part, has expressly and consistently acknowledged the congressionally intended limitations of section 1033. See, e.g., Wheeler v. Commissioner, 58 T.C. 459 (1972) (where a taxpayer tore down a building in contemplation of another party’s agreement to secure financing—ultimately unsuccessful—for a new building on the site, monetary judgment proceeds received held not to qualify as proceeds of an involuntary conversion since legislative history encompasses nonrecognition treatment only for governmental taking and casualty losses).

Taxpayer’s memorandum argues for an application of section 1033 that is far beyond any previous authoritative interpretation. At the outset of its discussion of the relevant legal authorities (at pp.16-17), it quotes from General Counsel Memorandum 39182 (March 6, 1984). It relies upon that GCM, apparently, for the proposition that the Service should construe the statute liberally because:

“[n]either the statutory language nor the accompanying regulations compel a result that restricts the applicability of §1033 to taxpayers whose property rights have been substantially diminished by involuntary conversion[;] furthermore, so restrictive an interpretation is not supported by the purpose of §1033.”

Id. Taxpayer’s reliance upon this language in the GCM is misplaced.

⁴ Although not controlling authority, there are two private letter rulings that stand out on facts quite similar to those presented here. In PLR 9118005, limited partners who unsuccessfully challenged the sale of certain assets of the partnership by the general partners were held not to be victims of a section 1033 involuntary conversion because there was no governmental taking. Similarly, in PLR 8722083, a “freeze out” merger where a minority shareholder’s disapproval of the deal was inconsequential and, thus, its proxy was not sought, was not an involuntary conversion of that shareholder’s stock. See also Carver v. Commissioner, T.C. Memo.1985-454 (a redemption of stock settling a management dispute with a corporation’s directors is ineligible for section 1033 nonrecognition treatment).

Irrespective of the obvious point that the GCM is not a controlling statement of Service position or practice, much more importantly, the quoted language does not stand for Taxpayer's proposition. The quoted passage is merely attempting to elucidate the degree to which the property in issue must be encumbered before section 1033 applies. In other words, the GCM is utterly irrelevant for purposes of expanding what kind of involuntary conversions qualify; clearly, nothing in the GCM questions the aforementioned authorities. The focus of the quoted passage is upon the "substantially diminished" aspect of the property, not the nature or origin of the conversion itself. In this regard, the GCM was expressly interpreting the scope of Rev. Rul. 72-433, 1972-2 C.B. 470, and it noted how the holding of that revenue ruling, and others, need not be limited to situations where the taxpayer has suffered a "substantial loss" or loss of "practically all" of their rights in a particular property.

Target's abdication of the contemplated merger and the payment of the termination fees here was not an involuntary conversion within the meaning of the Code; indeed, the arrangement was not only voluntary, it was a particular eventuality, the possibility of which was not only foreseen but specifically bargained for by Taxpayer with Target. The Taxpayer's memorandum itself (see p. 6) points out the economic and practical reasons such "termination" clauses are routinely contained in merger agreements in the first place. Its recitation of the lawsuits filed and/or considered against Target and Corporation A does nothing to change the routine nature of the contingency arrangement involved. These kinds of deals frequently fall through upon the emergence of a "better deal" for the Target. As such, therefore, the fees are really only in the nature of liquidated damages.

As a "mere" business maneuver or disincentive to forego the merger agreement, the subsequent invocation of the termination fees clause upon Target's reconsideration and rejection of the planned merger with Taxpayer does not merit further consideration as being an eligible disposition under section 1033. Consequently, we see no need to address individually the remaining required elements of the statute.⁵

⁵ For example, we think it unlikely that the planned merger "rights" even constituted property within the meaning of section 1033. See generally Beck v. Commissioner, T.C. Memo. 1987-359 (ownership of cattle not recognized for federal income tax purposes despite executory contract for sale). In addition, from its memorandum, it appears that the Taxpayer would necessarily rely on "destruction" of the contract as the supporting element; however, destruction in the section 1033 context, as legislative history shows, means a casualty or war hazard loss. See, e.g., H.R. Rep. No. 486, 67th Cong., 1st Sess. (1921), reprinted in 1939-1 (Part 2) C.B. 206; S. Rep. No. 275, 67th Cong., 1st Sess. (1921), reprinted in 1939-1 (Part 2) C.B. 181.

There is little, if any, relevant authority supporting the asserted notions of Taxpayer. The legal memorandum that Taxpayer's counsel has submitted—while long on characterizations of the purported nefarious actions of Corporation A and the alleged crass connivance therein of the Target's board of directors--fails to address convincingly the Taxpayer's most formidable obstacle, i.e., that the provisions of section 1033 were not intended to reach mere business arrangements, whether involuntary or otherwise.

By: _____
RICHARD L. CARLISLE
Chief, Income Tax & Accounting Branch
Field Service Division