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"Break Fee" Classified as Ordinary Deduction: *AbbVie, Inc. v. Commissioner*

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Two companies may agree to facilitate a merger or other combination in which shareholders of one or both companies exchange their stock for stock in a combined enterprise and/or other consideration. The companies' agreement may also provide for a fee, commonly known as a "break fee," to be paid by one company to the other if the combination is not completed or specified conditions relating to the combination are not met.

If such a fee is paid, the payor will generally want to reflect the payment on its tax return as a business expense deductible under section 162 of the Internal Revenue Code or as a loss deductible under Code section 165. In a recent case of first impression, the IRS asserted that under Code section 1234A, relating to termination of rights or obligations with respect to property that is – or would be, if acquired by the payor -- a capital asset in the hands of the taxpayer, a break fee payment must be treated as a capital loss that can be used solely to offset the payor's capital gains, if any. The Tax Court, however, concluded that, on the specific facts before it, section 1234A did not apply.

Facts in *AbbVie*

The boards of directors of AbbVie, Inc., a domestic corporation with publicly traded stock, and of Shire plc, a non-U.S. public limited company, agreed in July 2014 that AbbVie and Shire would be combined through a holding company structure. Shareholders of AbbVie would surrender their shares in exchange for stock of the holding company, and shareholders of Shire would exchange their shares for stock of the holding company and cash. The combination was subject to various conditions, including regulatory and shareholder approval.

To facilitate the combination, AbbVie and Shire agreed to cooperate with each other to obtain the necessary approvals and otherwise implement the proposed combination. In particular, AbbVie agreed to take the lead in obtaining regulatory approval and to recommend shareholder approval of a related merger agreement.

Prior to the anticipated shareholder vote, however, the IRS issued a notice describing regulations to be issued concerning "inversion" transactions that could have the effect of removing assets from US tax jurisdiction. The notice caused AbbVie's board to withdraw its recommendation that the shareholders of AbbVie approve the merger agreement. As it was now clear that the combination would not be approved by AbbVie's shareholders, the companies terminated their agreement to cooperate, and AbbVie agreed to pay Shire the fee that would have been required to be paid under the cooperation agreement upon a "Break Fee Payment Event." AbbVie made the resulting payment of approximately $1.6 billion in October 2014.

AbbVie's 2014 corporate income tax return claimed the fee paid to terminate the cooperation agreement as an ordinary deduction. In a notice of deficiency for that year, however, the IRS asserted that the fee was not deductible as a business expense under section 162 or as an ordinary loss under section 165, but rather was required to be treated as a loss from the sale of a capital asset under section 1234A. Such a loss would be allowable to AbbVie only to the extent of AbbVie's capital gains, if any.

AbbVie filed a petition for review of the notice of deficiency by the Tax Court. Through cross-motions for summary judgment, the parties asked the court to resolve whether section 1234A was applicable, and whether the fee paid was properly reported as an ordinary deduction.

Discussion

The opinion observes that, "[i]n the normal course, section 165(a) allows a deduction for costs relating to abandoned capital transactions" (citations omitted); and that ordinary and necessary business expenses are deductible under Section 162(a). Under cases cited in the opinion, it seemed reasonably clear that an ordinary deduction would be allowable to AbbVie under one of those sections for the year in which it paid the fee, absent application of section 1234A.

The government argued that section 1234A was applicable. Under that provision, "[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 . . . shall be treated as gain or loss from the sale of a capital asset."

Legislative history discussed in the court's opinion explains that section 1234A was intended to counter arrangements under which taxpayers sought to obtain electivity in the character of gain or loss from closing out contractual arrangements such as foreign currency contracts. For example, taxpayers would perform under a contract relating to property that had appreciated in a manner resulting in capital gain, but a contract that declined in value would be "terminated" through a cancellation payment resulting in an ordinary loss. Although the scope of section 1234A has been expanded since its original enactment, nothing in the legislative history summarized in the opinion suggested to the court that the tax treatment of break fees was intended to be altered by that expansion.

AbbVie argued that section 1234A by its terms applied only where a taxpayer owned a right or obligation "with respect to property." The fee in issue, however, was paid to terminate a cooperation agreement that did not provide ***AbbVie*** with any right or obligation to acquire stock or other property, but rather only the right and obligation to provide services to facilitate an intended exchange of property ***by others*** – namely, the shareholders of AbbVie and Shire.

The court acknowledged that AbbVie had obligations under the cooperation agreement to implement the proposed combination if it was approved, and that those obligations were terminated through the termination of the cooperation agreement. It also agreed with the government that the circumstance that obligations were contingent rather than absolute should not preclude the application of section 1234A.

Nevertheless, the court ultimately agreed with AbbVie that the phrase "with respect to property" in section 1234A limits the scope of the provision to situations in which the taxpayer has "a right or obligation to exchange (i.e., to buy, sell, or otherwise transfer or receive) an interest in property"; and that the cooperation agreement was not, at its core, an agreement to buy, sell, or otherwise transfer property.

AbbVie and the government disagreed as to whether section 1234A would apply in a situation where a taxpayer made the payment to terminate an obligation of another, related person, such as a subsidiary, to buy or sell property. (Apparently, no AbbVie shareholder owned a large enough stake to be considered "related" to AbbVie for this purpose.) The court concluded that it need not decide whether a taxpayer must have the right itself to acquire property in order for section 1234A to apply, because the cooperation agreement did not provide AbbVie with the right to compel a purchase or sale to AbbVie or to any other entity owned by it.

The opinion also indicates in a footnote that, given the court's conclusion that the cooperation agreement was not an agreement "with respect to property" for purposes of section 1234A, it did not need to address other arguments apparently made by the parties before it potentially bearing on the applicability of section 1234A, such as whether the fee was either an ordinary and necessary business expense under section 162(a) or a loss under section 165(a). One of the requirements for section 1234A to apply is that there be "gain or loss," and it is possible that AbbVie may have argued that the fee paid was a mere (albeit substantial) business expense under section 162(a) that did not give rise to a gain or loss potentially subject to section 1234A.

Observations

The Tax Court in *AbbVie* reached the conclusion on the facts before it that was desired by the taxpayer, but its reasoning was fact-specific. The Tax Court might reach a different conclusion with respect to other break fees. For example, if a corporation enters into an agreement itself to acquire the stock or other equity interests of another company, but subsequently makes a payment to terminate the acquisition agreement, we expect that the IRS will assert that *AbbVie* is not controlling in the direct acquisition context, and that section 1234A should still apply to preclude an ordinary deduction. The Tax Court (or another court) might well agree with that view.

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