"The Santa Fe Pacific Gold decision should prompt companies to revisit the tax treatment of payments related to certain failed merger transactions and consider the potential impact on Treasury Regulations finalized after the year at issue in the case."

Tax Court Permits Deduction of Termination Fee Under IRC Sections 162 and 165

In *Santa Fe Pacific Gold*, the United States Tax Court allowed a deduction for a $65 million termination fee pursuant to Section 162 of the Internal Revenue Code of 1986, as amended (the IRC), because the payment did not lead to significant long-term benefits for the taxpayer. Perhaps more importantly, the court also allowed the deduction pursuant to IRC Section 165 as a cost of an abandoned transaction. The *Santa Fe Pacific Gold* decision should prompt companies to revisit the tax treatment of payments related to certain failed merger transactions and consider the potential impact on Treasury Regulations finalized after the year at issue in the case. The decision provides much needed judicial guidance on the proper tax treatment of costs associated with failed or abandoned merger transactions, and, accordingly, may have a significant impact on the manner in which such costs are reported for federal tax purposes.

Santa Fe Wins $65 Million Deduction for Termination Fee

Santa Fe Pacific Gold Co. (Santa Fe) was approached by the larger Newmont USA Limited (Newmont) about a business combination. Santa Fe initially rejected Newmont’s offers because it believed that Newmont was interested only in Santa Fe’s land holdings and that Newmont would shut down Santa Fe’s independent operations. Seeking a white knight, Santa Fe pursued a business combination with Homestake Mining Co. (Homestake), which was of comparable size to Santa Fe. Santa Fe and Homestake entered into a merger agreement which, among other things, obligated Santa Fe to pay a $65 million termination fee to Homestake if Santa Fe received a superior offer from a third party and thereafter terminated the merger agreement with Homestake. After learning of Santa Fe’s merger agreement with Homestake, Newmont initiated a hostile takeover of Santa Fe. Santa Fe’s board determined that its fiduciary duties under Delaware law required it to obtain the highest value for its shareholders, and Newmont’s offer was determined to be superior to Homestake’s. Santa Fe terminated its agreement with Homestake, paying the $65 million termination fee to Homestake. After consummating the acquisition, Newmont aggressively cut duplicative costs, including by eliminating Santa Fe staff and closing Santa Fe offices. Santa Fe deducted the termination fee on its federal income tax return, and this position was challenged by the IRS.
The Tax Court separately addressed the deductibility of the termination fee as a business expense under IRC Section 162 and as an abandonment loss under IRC Section 165. While there was no real dispute that the termination fee satisfied the general requirements for deductibility under IRC Section 162, the court turned to the tests under IRC Section 263 to determine whether the termination fee must nonetheless be capitalized. The relevant test applied by the court in Santa Fe Pacific Gold was whether payment of the termination fee generated significant long-term benefits for Santa Fe under INDOPCO. Focusing on the hostile nature of Newmont’s acquisition, the court found that the only “synergies” in the Santa Fe-Newmont merger benefited Newmont exclusively.

Newmont obtained Santa Fe’s land and cut duplicative costs, while Santa Fe, in many respects, no longer functioned as an independent company. The court’s forward-looking focus on what actually occurred, rather than on what the parties expected, is significant in the context of merger transactions, where there often can be a significant disparity between benefits that are anticipated and described to shareholders and those that are actually realized.

In addition, the court focused on the purpose of the termination fee and the effect of state law fiduciary duties. As several courts and commentators have noted, a termination fee clause can deter competing bids and compensate the non-terminating party for its costs and lost opportunity. The court in Santa Fe Pacific Gold held that the termination fee paid to Homestake compensated it for its expenses as well as its opportunity costs, and that Santa Fe’s board believed its fiduciary duties to shareholders required it to accept Newmont’s offer. Under the court’s ruling, it remains an open question whether capitalization would be required if the consummated merger were less hostile or the benefits to the taxpayer from the merger were to materialize to a greater extent than occurred in Santa Fe Pacific Gold.

The court alternatively held that the termination fee paid to Homestake was deductible as a cost associated with an abandoned capital transaction under IRC Section 165. The court focused on whether the proposed merger with Homestake was actually abandoned, and dismissed the IRS’s argument that the Homestake and Newmont transactions were part of a single overall business plan. Instead, the court agreed with Santa Fe that the two mergers were separate and distinct and not parts of a unified plan of corporate restructuring, and attached no significance to the mutually exclusive nature of the two transactions.

The court’s ruling that the termination fee was a deductible abandonment loss under IRC Section 165 may be more important than its holding on the capitalization issue. Although the court did not indicate whether an abandonment loss under IRC Section 165 is permitted for a cost otherwise determined to be capital under IRC Section 263, its approach suggests that this may be possible. In some merger transactions, the target corporation is not pursuing a corporate restructuring when it is approached by a potential acquiror. Once contact is made, however, the target board’s fiduciary obligations may be triggered; the target’s board and its advisors may conclude that the board is obligated to consider—and possibly accept—a competing offer, regardless of whether the potential acquiror is friendly or hostile or any synergies are expected from the combination. Under these circumstances, the Santa Fe Pacific Gold decision suggests that a deduction may be allowed under IRC Section 165 regardless of whether the cost constitutes a capital expenditure under IRC Section 263.
Potential Impact on Treasury Regulations

Effective for amounts paid or incurred on or after December 31, 2003, the Regulations provide that an amount paid to terminate (or facilitate the termination of) an agreement to enter into certain transactions, including stock and asset acquisitions, must be capitalized if it “facilitates” a second transaction. An amount “facilitates” a second transaction, according to the Regulations, only if the transactions are “mutually exclusive.” Although these Regulations were not effective for the year at issue in Santa Fe Pacific Gold, the court’s analysis and holding is in direct conflict with them, because it specifically allows a deduction for a payment that “facilitated” a second transaction under the standard enunciated in the Regulations.

Next Steps

Given the Tax Court’s approach and decision in Santa Fe Pacific Gold, taxpayers that paid termination or other similar fees in open taxable years may wish to reassess the manner in which those costs were reported for federal income tax purposes, and, if appropriate, consider filing amended returns taking the position that such costs are currently deductible. Taxpayers may also want to consider the decision and its potential impact on the Regulations with respect to future tax reporting positions.

Endnotes

1 Santa Fe Pacific Gold Co. v. Commissioner, 132 T.C. No. 12 (April 27, 2009).
3 The fact that the consummated merger leads to significant benefits to the taxpayer extending beyond the year at issue does not necessarily mean that capitalization is required under IRC Section 263 because courts also look at whether the costs at issue originate with and are directly related to the capital transaction. See, e.g., Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000); Lychuk v. Commissioner, 116 T.C. 374 (2001). The court in Santa Fe Pacific Gold acknowledged that the origin of the claim test can be helpful in determining whether a termination fee is more closely tied to the terminated transaction or the consummated transaction, but found it unnecessary to address the issue because Santa Fe did not reap the types of benefits present in INDOPCO.
4 Treas. Reg. § 1.263(a)-5(a).
5 Treas. Reg. § 1.263(a)-5(c)(8). A target can only merge with one company, whereas a potential acquirer might have the resources to acquire multiple companies. Examples 13 and 14 of Treasury Regulation Section 1.263(a)-5(l) allow an acquirer with sufficient financial resources to deduct a termination fee after breaching one agreement to enter into another whereas a target with the same financial resources cannot deduct a termination fee under the same circumstances.
If you have any questions about this 

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