PLI: **FINANCIAL INSTRUMENTS IN M&A AND OTHER CORPORATE TRANSACTIONS**

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Polling Questions

Question: Is the tax treatment of a transaction fixed once money has changed hands?

A. Yes
B. No

Agenda

1. Market flex
2. SPAC- tax treatment of SPAC units
3. Morphing of Section 163(j)- select issues
4. Merger termination fees

Market Flex

Market Flex

- **What is "market flex"?**
  - A market flex is a provision that allows arrangers in debt financing to change certain key terms of the debt until the debt is successfully syndicated.
  - The most common flex provision involves "pricing flex," dealing with interest rate or a one-time fee: If necessary for successful syndication, the arrangers are permitted:
    - to increase the interest rate (or margin)
    - to offer a fee
  - Compare with firm commitment or a "bought deal" in which the banks providing commitment for the financing bear the risk of unsuccessful syndication (see Slide #14).

Market Flex

Post-closing market flex and “deemed exchange”

- A market flex is generally available starting from the date of the commitment until the closing of the primary syndication.
- When a market flex is utilized after the issuance of the debt instrument, a question arises as to whether the change triggered as a result of the market flex provision causes a deemed exchange of the debt instrument under Section 1001.
- If such change is treated as a modification and if such modification is “significant” within the meaning of Treas. Reg. Section 1.1001-3, it could be treated as causing a deemed exchange of the original debt for a deemed new det.
- The Issuer could recognize cancellation of debt income (CODI) if the issue price of the deemed new debt is lower than the adjusted issue price of the existing debt.
- The issue price of the deemed new debt is generally its fair market value as of its deemed issue date, assuming it is treated as publicly traded for US federal income tax purposes.
- As a result, if market flex is triggered, there is a concern that the borrower may recognize potential CODI.

Market Flex

- **Arguments against treating a change pursuant to market flex as a modification of the terms for US federal income tax purposes**
  - the underwriter rule
  - unilateral option
  - purchase price adjustment

Market Flex

Arguments against treating a change pursuant to market flex as a modification of the terms for tax purposes (continued)

The Underwriter rule

- If there is a significant modification, any potential resulting CODI to the issuer is the difference between the "issue price" of the deemed new debt and the "adjusted issue price" of the unmodified debt.
- For this purpose, the adjusted issue price is determined under Teas. Reg. Section 1. 1275-1(b) and the issue price of the deemed new debt is determined under Sections 1273 and 1274 – i.e., applying the OID principles.
- For purposes of determining the issue price and the issue date, sales to bond houses, brokers, or similar persons or organizations acting in the capacity of underwriters, placement agents or wholesalers are ignored (the "Underwriter Rule"). Treas. Reg. Section 1.1273-2(e)
- The Underwriter Rule is part of the OID principles.
- It should be reasonable to apply the Underwriter Rule to treat the arrangers as "underwriters" and deem any change pursuant to market flex as part of the process leading to the determination of the "issue price," rather than a modification that needs to be analyzed under Treas. Reg. Section 1.1001-3.
- Compare with a "bought deal" discussed on Slide #14.

Market Flex

- **Arguments against treating a change pursuant to market flex as a modification of the terms for tax purposes (continued)**
  - **Unilateral Option**
    - An alteration of a legal right or obligation occurring by operation of the terms of a debt instrument is not a modification.
    - An alteration occurring as a result of the exercise of a unilateral option provided to an issuer or a holder is not a modification, if certain conditions are met.
    - An option is not a unilateral option if, at the time the option is exercised or as a result of the exercise, the other party right to alter or terminate the debt.
    - Normally, during the period market flex is exercisable by the arrangers, the borrower also has a call right.
    - What if a borrower voluntarily giving up the call right during the period of market flex?
    - Could the borrower wait to give up the call right until it is certain that the arranger will exercise the market flex?

Market Flex

Arguments against treating a change pursuant to market flex as a modification of the terms for tax purposes (continued)

Purchase Price Adjustment

- A post-closing purchase price adjustment is frequently utilized in the context of an acquisition when a buyer and a seller cannot agree on pricing.
- Such adjustment is generally treated as "relating back" to the original transaction, rather than a separate transaction. *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952)
- Conceptually, post-closing market flex is similar to a purchase price adjustment – e.g., the borrower and the arranger agree to enter into a financing transaction at what they believe are market terms that would be acceptable to investors but agree to adjust the terms if the investors at the time of syndication demand a higher return than previously expected when the arranger funded a loan.
- If respected as a purchase price adjustment, the change resulting from market flex should not give rise to a separate taxable event but rather treated as part of the original financing transaction.

Market Flex

Alternative Ways to Mitigate the Deemed Exchange Risks

- **Even though there are strong arguments supporting that market flex should not give rise to a modification for tax purposes, the answer may not be certain. Can any deemed exchange issue be avoided entirely?**
  - General cooperation clause
  - Exercise no later than 12 days after the closing
  - One time exercise
  - AHYDO savings clause
  - Reverse flex
  - Issuer's option to trigger partial or full exercise immediately prior to the closing

Market Flex

Alternative Ways to Mitigate the Deemed Exchange Risks (continued)

- **General cooperation clause**
  - Many market flex precedents simply include a general cooperation clause among parties that the flex provision must be exercised in a manner to reduce or eliminate adverse tax consequences to the issuer.
  - Unclear how this provision is meant to apply.
- **Exercise no later than within 12 days after closing**
  - A strong argument can be made that the arranger in such case is treated an underwriter, based on the 12 day concept in the definition of “same issue”.
- **One time exercise**
  - Certain market flex provisions require that the market flex be exercised all at once, thereby avoiding the risk of having multiple deemed exchanges.
- **AHYDO savings clause**
  - If market flex is exercised, parties agree to insert an AHYDO savings clause as needed.

Market Flex

Alternative Ways to Mitigate the Deemed Exchange Risks (continued)

- **Reverse flex**
  - If market flex needs to remain outstanding post-closing, the parties could choose to close the financing with terms reflecting the maximum flex allowed under the market flex provisions (including maximum OID), and add a “reverse flex” provision.
  - Under the reverse flex provision, the arranger is required to make issuer-friendly changes if it is able to successfully syndicate the loan with terms that are more favorable to the issuer (i.e., a lower margin or less OID).
  - If syndication is difficult (meaning that, generally, the trading value might be below par), there is no additional flex to be utilized, meaning the terms will likely remain the same, thus avoiding significant CODI issues.
  - If syndication is better than expected, the margin or OID would be adjusted down, while the trading value of the loan would generally be par or above, thus avoiding significant CODI issues.
  - Cf. OID v. coupon
- **Issuer’s option to trigger partial or full exercise immediately prior to the closing**
  - Some market flex provisions entered into far prior to the closing include an option for the issuer to partially or fully flex the terms at the time of the closing.
  - Such issuer option then can be combined with the reverse flex discussed above.

Market Flex

- **Comparison with a "bought deal" (firm commitment underwriting)**
  - An underwriter commits to buy bonds at a certain price and purchases them at such price regardless of the resale price.
  - If the commitment is made far before the closing or the market is unstable, the underwriter may end up selling the bonds below the price at which it buys (taking into account the underwriting fee), suffering net loss.
  - Potential tax issues
    - The Issuer – treatment of the proceeds in excess of the issue price
      - Is it potentially income to the issuer? It shouldn't be.
    - Fungibility
    - AHYDO

SPAC- tax treatment of SPAC units

Tax Treatment of SPAC Units

- **Question: Is a SPAC unit an "investment unit," consisting of components?**
- **SPAC units**
  - Typically, each SPAC unit has an offering price of $10.00 and consists of one Class A ordinary share and a fraction (e.g., 1/2, 1/3 or 1/4) of one redeemable warrant.
  - No separate trading for several weeks (generally, 35 days to 52 days). Cf. the underwriter's greenshoe normally lasts 45 days in the US.
  - SPAC warrants are intended to compensate the investors for the waiting period before the business combination.
  - The size of a SPAC warrant in a unit varies depending on the SPAC sponsor.

Tax Treatment of SPAC Units

- **Comparison of SPAC units**
  - The stock exchange on which the SPAC units are listed and its governing rules dictate the structure of a SPAC unit.
  - The jurisdiction of incorporation of the SPAC is less relevant.
- **SPAC units listed on a US stock exchange:**
  - Each unit “consists of one class A ordinary share… and [one-third] of one redeemable Warrant”.
  - Separation of SPAC units into SPAC shares and SPAC warrants is permitted after 45 days plus 7 days (52 days) at the option of the holders.
  - 3 different trading symbols: each separate symbol for the SPAC unit, for the SPAC share and for the SPAC warrant

Tax Treatment of SPAC Units

- **SPACs listed on a Dutch exchange**
  - Description of a SPAC unit is not consistent among the offerings.
  - The trading symbol of a SPAC unit continues to the SPAC share.
  - Sample Dutch Listing #1
    - Each unit "*consists of one class A ordinary share* ***that additionally entitles its holder to receive [one-third] of a redeemable public warrant***". "*As from the earlier of the 35th calendar day after the First Listing and Trading Date…, the whole Public Warrants* ***will be distributed*** *and the Class A Ordinary Shares and the whole Public Warrants* ***will automatically trade separately****."*

Tax Treatment of SPAC Units

- **SPACs listed on a Dutch exchange (continued)**
  - Sample Dutch Listing #2
    - Each Unit "*comprises* ***one class A ordinary share …that entitles its holder to acquire an additional one-third (1/3) of a Class A Ordinary Share on the same terms as the Warrants****... . This entitlement will cease upon the delivery to each holder of a Unit of one-third (1/3) of a warrant in respect of each Unit held by them*." "*From the 35th calendar day after the First Listing and Trading…,* ***the Units will be automatically redeemed for Ordinary Shares and Warrants****."*
  - Sample Dutch Listing #3
    - Each Unit consists of "***one class A ordinary share … and a right to receive*** *one-half 1/2 of a redeemable warrant on the 35th day after the First Listing and Trading Date*."

Tax Treatment of SPAC Units

- **SPACs listed on a UK stock exchange:**
  - **The offering is of ordinary shares.**
    - *"The Company is offering … Ordinary Shares at a price per Ordinary Share of £10.00 …. **Each Ordinary Share gives the holder the automatic right to receive 1/3 of a redeemable Warrant**."*
  - **The warrants are issued at closing to a third party institution, which is obligated to transfer the warrants to the holders of ordinary shares as of a designated date.**
    - *"The Warrants will be held by … which has irrevocably agreed with the Company to automatically transfer the Warrants at … to Ordinary Shareholders….*

Tax Treatment of SPAC Units

- **Are SPAC warrants issued part of an investment unit or should they be treated as distribution on SPAC shares?**
  - If treated as investment unit
    - Receipt of the SPAC warrant is a non-event for tax purposes.
    - Tax basis is allocated between the ordinary share and the warrant based on their relative fair market value as of the issue date.
  - If treated as distribution on shares
    - Receipt of warrant may be taxable dividends under Section 305
      - Potentially a disproportionate distribution under Treas. Reg. section 1.305-3?
      - Impact of partial redemption upon business combination and/or sponsor share redemption to cover negative interest or other expenses must be considered.
    - If non-taxable distribution, the warrant may have zero tax basis unless its fair market value is at least 15% of the fair market value of the corresponding shares or the holder makes an election.
    - Form 8937?

Tax Treatment of SPAC Units

- **Are SPAC warrants part of an investment unit or distribution on SPAC shares? (continued)**
  - The SPAC share and the SPAC warrant should be treated as separate properties.
    - Legally separable after several weeks
    - No economic compulsion to hold them together
    - Actual separation not uncommon
    - Identifiably different economic rights
  - Is the right to receive warrants (in particular, in the case of Dutch/ UK listed SPACs) separate from the shares from the closing, even though it is not separately transferable?
  - The delivery of the warrants is built-in from Day 1. Declaration by board is not needed
  - Should the delivery of warrants be treated as deferred delivery/ issuance of a separate property?

Morphing of Section 163(j) – Select Issues

Morphing of Section 163(j) – Select Issues

- TCJA
  - General Rules: The TCJA imposed a 30% of ATI general cap on net business interest deductibility.
  - Any excess business interest expense disallowed under Section 163(j) is carried forward to the following tax year as a disallowed business interest expense carryforward (DBIC). ATI closely approximates EBITDA for tax years beginning before January 1, 2022, **and EBIT for tax years beginning on or after January 1, 2022**.
  - Special Rules for Partnerships:
    - In general, the Section 163(j) limitation applies at the partnership level.
    - To the extent a partnership has business interest expense (the EBIE) in excess of its Section 163(j) limitation, the EBIE is allocated to the partners,
    - The EBIE reduces (but not below zero) their outside basis in their partnership interests.
    - EBIE deduction in subsequent years is limited by future allocations of certain taxable income and business interest income from the same partnership.
- CARES Act:
  - The 30% general cap is increased to a 50% general cap for any taxable year beginning in 2019 or 2020. A taxpayer can elect out.
  - Special Rules for Partnerships

Morphing of Section 163(j) – Select Issues

- Definition of “interest”
  - The final regulations narrow the scope of the definition and exclude the following:
    - Certain substitute interest payments that are made or received in the ordinary course of a taxpayer’s business
    - Commitment fees, and other similar fees
    - Debt issuance costs
    - Guaranteed payments for the use of capital, subject to expanded anti-abuse rules
    - Income, deduction, gain or loss from hedging transactions, subject to expanded anti-abuse rules

Morphing of Section 163(j) – Select Issues

- Expanded anti-abuse rule
  - Any expense or loss "economically equivalent to interest" is interest, if "a principal purpose" is to reduce interest expense.
  - An expense or loss is "economically equivalent to interest" if the item is
    - deductible by the taxpayer
    - incurred by the taxpayer in a transaction(s) in which the taxpayer secures the use of funds for a period
    - substantially incurred in consideration of the time-value of money, and
    - not otherwise described in the regulations.
  - A principal purpose? Depends on facts and circumstances.
  - E.g., preferred equity in a partnership?

Merger Termination Fees

Overview of Merger Termination Fees

Deal-protection device acquirers and target companies use to ensure that a proposed acquisition or merger transaction closes as planned.

- Generally a cash payment (typically 3% to 4% of transaction value) the target company makes to the buyer if it terminates the acquisition or merger agreement for any reason specified in the agreement.

BASIC TERMINATION FEE

- Acquirers generally request termination fees for the following reasons:
  - Deal certainty: The target company typically retains a fiduciary out that allows it to terminate the agreement to accept a superior offer or otherwise to comply with its fiduciary duties and the termination fee is the price for exercising the fiduciary out.
  - Evidence of commitment: A termination fee can be used to demonstrate a target company's commitment to the transaction.
  - Compensation for opportunity costs: Acquirer loses contemplated synergies and market share.
  - Reimbursement of acquirer's expenses.

Overview of Merger Termination Fees (cont.)

REVERSE TERMINATION FEE	❑ A reverse termination fee is a payment by acquirer to the target company if the acquirer is unable to close the transaction (*e.g.*, due to a lack of financing).

If a proposed acquisition or merger transaction is terminated, typically the acquirer and target company will enter into a separate agreement terminating the transaction and paying the relevant termination fee.

Why the Tax Treatment of Termination Fees Matters

	PAYOR	RECIPIENT
Character	Capital losses are subject to limitations, ordinary are not.	Capital gains can be used to offset capital losses, ordinary income can't.
Withholding	Ordinary income is more likely to be FDAP. Sourcing depends on characterization of the fee.	
Treaty Characterization	Ordinary income may be harder to characterize for treaty purposes, with more risk that treaty does not eliminate US tax.	
ECI, Commercial Activities Income under section 892, Unrelated Business Taxable Income	N/A	Ordinary income may be more likely to be treated as ECI, commercial activities income, or UBTI.

Section 1234A

1234A Gains or losses from certain terminations

- Gain 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 to 1234A

The property referenced in 1234A(1) was initially limited to actively traded personal property, which Congress expanded in 1997 to include all types of property.

- This change increased the number of instances where modifications of legal relationships gives rise to sale or exchange treatment.

Legislative History to 1234A (cont.)

Legislative History (Senate Report to the 1997 amendment to 1234A):

- The Committee believes that present law is deficient since it [ ] taxes similar economic transactions differently . . . and [ ] its lack of certainty makes the tax laws unnecessarily difficult to administer.
- 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.
- 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. U.S., 422 F.2d 887 (Ct. Cl. 1970), holding that forfeiture was an ordinary loss.* [Emphasis added]

Core Questions with Respect to Termination Fees

How do merger termination fees implicate the policy underlying Section 1234A?

Is there “property which is (or on acquisition would be) a capital asset in the hands of the taxpayer? Does the answer to this question depend on whether the termination fee is a regular or reverse termination fee?

Should character of payment as ordinary or capital match as to payor and recipient?

Does it matter if the fee is subject to a separate contract after termination or the amount is renegotiated?

IRS Guidance—TAM 200438038

Acquirer entered into an agreement with target (Agreement 1) to acquire all of target's stock.

- Agreement 1 provided that if target received a superior offer, it had to give notice of such offer to acquirer and an opportunity for acquirer to meet or beat the offer, and if the target accepted the superior offer, target would have to pay acquirer a termination fee.
- Agreement 1 did not state the underlying purpose of the termination fee.

A third party made a superior offer to target and target notified acquirer.

- Acquirer and the third party then negotiated directly and came to a separate agreement (Agreement 2) whereby acquirer agreed to withdraw Agreement 1 once it had been paid the termination fee specified in Agreement 1.
- Pursuant to Agreement 2, the third party paid acquirer the termination fee directly and agreed to exchange other assets.

IRS Guidance—TAM 200438038 (cont.)

IRS concluded that the termination fee was for liquidated or expectancy damages that was for the recovery of lost profits treated as ordinary income to the acquirer.

- ❑ Section 1234A's application to the termination fee was not addressed.

IRS Guidance—PLR 200823012

Acquirer had entered into an agreement with target (Agreement 1) to acquire all of target's stock.

- Agreement 1 provided that target would have to pay acquirer a termination fee if target's shareholders rejected taxpayer's offer.

A third party subsequently made target a superior offer.

- When it became clear that the target shareholders would reject the acquirer's offer, and before the formal vote on the offer, acquirer and target entered into a separate agreement (Agreement 2) terminating Agreement 1.
- The termination provisions in Agreement 2 mirrored those in Agreement 1, except an actual vote of target's shareholders was not a condition to payment to acquirer of the termination fee provided in Agreement 1.
- Agreements 1 and 2 were silent as to the purpose of the termination fee.

IRS Guidance—PLR 200823012 (cont.)

IRS concluded that the termination fee was similar to liquidated damages and was for the recovery of lost profits treated as ordinary income to the acquirer.

- The IRS concluded that section 1234A should not apply to the termination fee without stating its reasoning for such conclusion

IRS Guidance—20163701F

Acquirer and target signed an agreement (Agreement 1) for what seems to be an inversion transaction.

- Pursuant to Agreement 1, acquirer and target would become subsidiaries of a newly formed company (Newco) with the shareholders of acquirer and target receiving stock of Newco.
- Agreement 1 was conditioned upon acquirer's board recommending the transaction to its shareholders, and acquirer would be required to pay a reverse termination fee to target if acquirer's board withdrew its recommendation for the transaction.

Prior to the consummation of the transaction, the Treasury Department issued a notice that adversely affected the expected tax benefits of the proposed transaction.

- Acquirer's board withdrew its recommendation for the proposed transaction and acquirer and target entered into a separate agreement terminating Agreement 1, with acquirer paying the reverse termination fee.

IRS Guidance—20163701F (cont.)

IRS concluded that:

- The reverse termination fee was in the nature of liquidated damages.
- Newco stock would be a capital asset in acquirer's hands upon acquisition.
- Agreement 1 provided acquirer with rights and obligations with respect to target's and Newco's stock.
- The termination fee related to a contractual right and obligation concerning a capital asset, so section 1234A applies and acquirer's loss on paying the termination fee is a capital loss.

IRS Guidance—CCA 201642035

Acquirer enters into a contract (Contract) with target pursuant to which the parties agree to undertake a series of steps that are designed to lead to acquirer's acquisition of target's stock.

- The Contract requires target to recommend to its shareholders that they approve the transaction, subject to receipt of a superior offer.
- Target may terminate the Contract, and must pay a $1m termination fee, upon (i) entering into another agreement based on a superior offer, (ii) a rejection of acquirer's offer by target's shareholders or (iii) a failure to obtain approval by target's shareholders by a certain date.

Target receives a superior offer from an unrelated company and terminated the Contract, paying acquirer the $1m termination fee.

IRS Guidance—CCA 201642035 (cont.)

IRS concluded that the termination fee payable to acquirer under the Contract is in the nature of liquidated damages and any gain or loss realized by acquirer on the termination of the Contract, which provides rights and obligations with respect to target's stock, a capital asset, would be capital in nature.

The IRS ruled that the calculation of gain or loss on receipt of a termination fee should include any capitalized facilitative costs. That is, the capitalized costs are netted against any termination fee received.

The IRS also ruled that if such costs exceed the amount of the termination fee, the loss deducted under section 165 is subject to the limitations applicable to capital losses.

Footnote acknowledged that position is contrary to PLR 200823012.