Federal Court of Appeal Confirms Tax Treatment of Break Fees

by Steve Suarez

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Canada’s Federal Court of Appeal (FCA) on November 21 issued its decision in Morguard Corp. v. The Queen (2012 FCA 306), a case that dealt with the tax treatment of break fees (amounts paid by one party to another on the termination of merger and acquisition agreements, also known as termination fees). The issue has been a matter of some uncertainty in Canada, but the FCA ruling offers only limited guidance because of the relatively unusual nature of its facts.

In Morguard, the FCA confirmed a decision issued earlier this year by the Tax Court of Canada, which held that a break fee received by the company was fully taxable as normal income. This is because Morguard had “adopted a business strategy of acquiring controlling interests in real estate companies,” and had carried out numerous transactions in that context, the tax court said. (For the Federal Court of Appeals decision in Morguard, see Doc 2012-24169 or 2012 WTD 228-24; for the Tax Court of Canada decision in Morguard Corp. v. The Queen (2012 TCC 55), see Doc 2012-24172 or 2012 WTD 229-20.)

In one such transaction, Morguard entered into an agreement with a target corporation (Acanthus), in which Morguard already owned a significant number of shares, to acquire all the remaining shares with the support of Acanthus’s board of directors. The merger agreement provided for break fees totaling C $7.7 million to be paid to Morguard in case Acanthus’s board withdrew its support for Morguard’s bid, which in fact did occur when a higher competing bid emerged that Morguard declined to match.

As of February 24, the date of the Tax Court hearing, Morguard had received no other break fees in relation to any of its other investments.

Morguard reported the break fees (net of expenses) as a capital gain on its tax return.1 The Tax Court determined that Morguard “was essentially in the business of doing acquisitions and take-overs” and that the break fees were simply income from that business, rather than a tax-free windfall or a capital gain.

In a short judgment, the FCA found that the Tax Court’s findings of fact — including that the receipt of the break fees was “a normal and expected incident of [Morguard’s] business activities” — were reasonable, and that the court had correctly applied the law that requires the character of a payment to be determined with reference to its purpose and its connection with the regular business operations of the recipient. Under that precedent, an amount received as part of the taxpayer’s “ordinary business operations” that is “inextricably linked” to those operations can properly be characterized as business income, even if received as a result of negotiations pertaining to an item on capital account. As such, it was open to the Tax Court to conclude, as it did, that Morguard had received the break fees as business income, and the FCA declined to overturn that ruling.

While this case is definitely interesting, in practice the reasoning will likely be confined to its particular facts. In most cases, M&A transactions are clearly outside the scope of the parties’ ordinary business operations, unlike in Morguard (as found by the Tax Court).

In such cases, break fees paid as consideration for the termination of the recipient’s rights under an agreement governing a transaction on capital account would certainly appear to be properly characterized as a capital gain. Therefore, the findings in Morguard are likely to be of little precedential value, apart from confirming that in characterizing the receipt, the correct legal test is to look at factors such as the purpose of the payment and its connection with the recipient’s regular business operations. (For a prior discussion of the tax treatment of break fees, see Doc 2012-7960 or 2012 WTD 96-12.)

◆ Steve Suarez, Borden Ladner Gervais, Toronto

1Only 50 percent of capital gains are included in income for tax purposes in Canada; at the time of the transaction in question, however, the inclusion rate for capital gains was two-thirds.