Capitalizing M&A Legal Fees

by Robert W. Wood • San Francisco

To delete or not to delete, that is the question. Whether to deduct or capitalize legal fees has always been an issue of virtually Shakespearean magnitude. The incentives for taxpayers (and the government) are pretty clear. As high as attorneys' fees can be, they can be made significantly less painful if an ordinary deduction is available. In the wake of such landmark cases as *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 112 S. Ct. 1039 (1992), the circumstances in which legal fees have to be capitalized has been expanded.

Here at *The M&A Tax Report*, it is no surprise that our focus is legal fees paid or incurred in the context of an acquisition. In this specific context, the stakes can be huge. It is worth broadening our topic, not only to cover legal fees, but also to cover investment banking fees, accounting fees, consulting fees, and all of those other ancillary fees that are paid or incurred in this context.

Indeed, perhaps we should note that legal fees in an acquisition are typically a "minnow" (or maybe a "trout") compared to the "whale" of investment banking fees (but we don't sound jealous, do we?). Given how big all of these fees combined can be, it should not be surprising that a lot of attention gets paid to this topic. And, recent authority is always worth watching.

Winter of Our Discontent

A recent Tax Court case, *Jeffrey Winter, et ux. v. Commissioner*, T.C. Memo 2002-173, Tax Analysts Doc. No. 2002-17047, 2002 TNT 141-10, deals with a couple who waged litigation over the price of an asset after the sale was completed. The Tax Court held that the couple must capitalize legal and consulting fees paid in connection with litigation over the price of an asset after the sale.

On February 20, 1991, Jeffrey and Karen Winter executed a contract offering to purchase the Truckee Hotel for $1.2 million from the Meglin Hotel Partnership (MHP). Gerhard Meglin was the general partner of MHP, which accepted the offer. Meglin provided the couple with income and expense statements for the hotel from 1989 to 1991. The couple found inconsistencies in the information in a brochure that was provided during escrow. The couple completed the purchase on April 4, 1991.

The Winters paid down a portion of the purchase price and executed a promissory note for the balance. After the purchase, more irregularities were found, and the couple filed a complaint for damages against MHP and Meglin. After arbitration failed, the couple commissioned an appraisal of the hotel, which valued the property (as of the time of the sale) at $800,000.

The parties settled in 1994, with Meglin agreeing to pay the couple $271,474 by releasing them from that amount under the promissory note. The couple paid legal and consulting fees for the lawsuit, which they deducted on their 1994 Schedule C. In 2000, the IRS issued a deficiency notice disallowing the legal fees, asserting that because they were incurred in connection with the establishment of the hotel's purchase price, they should be capitalized. The Winters argued that the fees were postacquisition expenditures not related to the purchase, that the origin of the claim wasn't the purchase, and that acquisition costs must be capitalized only when a new asset is acquired.

Just Timing?

The Tax Court noted that just because legal costs are incurred after the purchase of a capital asset doesn't necessarily mean they weren't incurred in connection with the acquisition. The court dismissed the couple's reliance on *Freeland v. Commissioner*, T.C. Memo, 1986-10, concluding that those fees arose from a foreclosure action. In reality, the fees in this case arose from misrepresentations by Meglin that caused the couple to pay an inflated price for the hotel.

The Tax Court rejected the argument that the acquisition costs would have to be capitalized only if they created or added value to a capital asset. The court found that the test for capitalization doesn't hinge on the amount of value added to the property but looks to the nature of the expense. Thus, the Court held that the couple acquired a capital asset and, on discovering that they were overcharged, filed suit for damages for causing them to pay more than the hotel was worth.

Further Reading

Loyal readers of *The M&A Tax Report* will recognize these "no separate asset" arguments, and may want to revisit some of our coverage of *INDOPCO* issues in the past. Here is a spate of them, all of which we think deserve a revisit:

- Muntean, "Legal Fees Defending Hostile Acquisition Held Capital!" Vol. 8, No. 12, *M&A Tax Report*, July 2000, p. 1.
- Muntean, "Third Circuit Puts Brakes On Service's Wild *INDOPCO* Driving," Vol. 8, No. 12, *M&A Tax Report*, July 2000, p. 6.
- Muntean, "PNC Bancorp v. Commissioner," Vol. 9, No. 3, *M&A Tax Report*, October 2000, p. 1.
- Wood, "Whoa! Eighth Circuit Reigns In *INDOPCO* for Wells Fargo," Vol. 9, No. 4, *M&A Tax Report*, November 2000, p. 1.