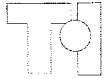


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Fifth Circuit in *U.S. v. Houston Pipeline Co.* Rules No Deduction on Stock Redemption Payment to Fend Off Takeover

by Robert W. Wood • San Francisco

In yet another refinement to the doctrine stemming from *Five Star Manufacturing Co. v. Commissioner*, 355 F.2d 724 (5th Cir., 1966), the Fifth Circuit Court of Appeals has found that a corporation that was the target of a hostile takeover attempt could not deduct a

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redemption payment. In *U.S. v. Houston Pipeline Co.*, No. 93-2737 (5th Cir., November 7, 1994), the court considered a takeover attempt of Houston Natural Gas Corp. by a subsidiary of Coastal Corporation. Coastal made a tender offer to purchase 45% of Houston Gas' outstanding common stock.

Concluding that the tender offer was not in the best interests of the shareholders, Houston Gas' board devised a plan to make Houston Gas unattractive as a target. Houston Gas offered to purchase all of the outstanding common stock of Coastal for \$875.6 million, thus turning the tables on the offerer. Plus, Houston Gas made a self-tender offer to buy up to 19 million shares of its own stock for \$1.3 billion. Houston Gas also obtained a bank commitment of \$1.8 billion to finance the plan.

Had both proposed transactions been completed, Houston Gas would have devastated itself financially. Debt would have increased from \$437 million to \$3.61 billion; stockholders' equity would have fallen from more than \$1.4 billion to less than \$85 million. The anti-takeover moves, in short, would make Houston Gas a pig in a poke.

Three weeks after the original offer, Coastal proposed to withdraw its offer on the condition that Houston Gas purchase Coastal's 5.05% in Houston Gas. In February 1984, this redemption was accomplished, with Houston Gas paying Coastal \$124.53 million.

To Deduct or Not to Deduct?

When Houston Gas filed its 1984 tax return, it did not initially deduct the \$124 million it paid to redeem its stock from Coastal Gas. However, during the course of an IRS examination, Houston Gas claimed the deduction as a business expense under Section 162(a). Eventually, a successor to Houston Gas sued for a refund of the taxes paid (\$47.9 million). The District Court granted summary judgment to the IRS, concluding that the stock redemption was not necessary to Houston Gas' survival, thus distinguishing the case from *Five Star Manufacturing Co. v. Commissioner*, 355 F.2d 724 (5th Cir., 1966). The Fifth Circuit affirmed this result, rejecting Houston Gas' contention that there

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were procedural defects in the summary judgment grant.

Furthermore, the Fifth Circuit considered the merits and agreed with the District Court that *Five Star Manufacturing* was inapplicable because the redemption was not necessary to Houston Gas' survival. The court held that the *Five Star* case did not apply to profitable, solvent corporations. That this appears to be a fairly high standard is evident from the Fifth Circuit's comment that Houston Gas' survival as a going concern was not threatened in any way. Houston Gas had the option, said the court, of simply letting itself be taken over!

***Five Star* Fired?**

The line drawing done by the Fifth Circuit in *U.S. v. Houston Pipeline Co.* should cause us to wonder whether any of that happy result in *Five Star* remains. A deduction was traditionally (since 1986) available under the *Five Star* doctrine where the stock buyback was necessary to the survival of the corporation and the redemption expenditure was needed to save the company from the brink of ruin. Just how one defines the dire circumstances that could produce this home run result could be debated, of course. Perhaps the facts in *Five Star* were truly extraordinary and are unlikely to be repeated. In *Five Star*, the corporation's sole asset was a license agreement. The holder of the licensed patent threatened to cancel the license—which would have forced a liquidation of *Five Star*—if *Five Star* did not redeem the stock owned by a disruptive shareholder.

The courts have not looked favorably on this notion. In part, this may be because virtually no other company has faced the kind of annihilation that would have befallen *Five Star Manufacturing*.

No Continuing Effect

In large part, of course, the interpretation may be moot now (prospectively) anyway. After all, Section 162(k) of the Code disallows any deduction for amounts paid or incurred by a corporation in connection with a redemption of its stock. This provision was added by the Tax Reform Act of 1986. ■