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Allocating Fees: To Deduct or Capitalize?

by Robert W. Wood • San Francisco

It is not too often that I get a chance to comment on something that sounds like a cross between the tax treatment of settlements and judgments (one of my pet areas), and the seemingly pre-eminent *INDOPCO* deduct vs. capitalize feud. (Regarding the latter, see Chambers and Schiffhouer, "*INDOPCO* Takes Flight: The Capitalization of Aircraft Maintenance Costs," Part I, *M&A Tax Report*, Vol. 5,

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No. 5, (December 1996), p. 1, and Part II, *M&A Tax Report*, Vol. 5, No. 6, (January 1997), p. 1.) However, a recent technical advice memorandum seems to bridge that gap, talking about the bases upon which one deducts or capitalizes certain costs.

Technical Advice Memorandum 9641001 deals with a corporation that incurred certain expenses for a consent solicitation and debt tender offer. The corporation was a member of a controlled group that was restructured for both future expansion and business development. Part of the complex restructuring involved the corporation going to its bondholders for consent, bondholder approval being required by the bond indenture agreement. In order to induce the bondholders' to consent, the corporation offered consent payments, and made a debt tender offer in which it agreed to purchase outstanding bonds at a premium. The corporation paid consent fees to bondholders, premiums to purchase tendered bonds, and fees to its investment banker.

The corporation deducted all of these costs and fees. The IRS field office disallowed the deductions, ruling

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them to be capital, and the National Office was asked for its view.

Origin of the Claim

Here's where the TAM starts to sound like virtually the entire (and these days, popular) field of settlements and judgments taxation. The TAM relies on the hoary case of *U.S. v. Gilmore*, 372 U.S. 39 (1963). That case is one of the seminal ones stating that the origin and character of the claim for which an expenditure is incurred ultimately determines the nature of the payment for tax purposes. In *Gilmore*, the taxpayer sought to deduct legal fees arising out of his divorce. Because Gilmore was fighting his divorce to retain his ownership of the car dealerships that constituted his business, Gilmore deducted the legal fees.

The Supreme Court, however, ruled that the origin of the claim in which the legal fees were paid or incurred was personal: the divorce action. The fact that there might be business reasons why it was necessary to fight particularly hard on certain issues did not convert the legal fees into deductible payments. *U.S. v. Gilmore*, a testament to the flexibility of the "origin of the claims" doctrine, is one of those cases that one can analyze from a number of different angles. That flexibility (and consequent taxpayer confusion) is one of the themes that is picked up in Technical Advice Memorandum 9641001.

Consent Payments Examined

In the TAM, the Service applied the reasoning of *Gilmore* to the consent payments made to the bondholders. The corporation made the consent payments, according to the IRS, in order to enable it to engage in a capital transaction, namely the restructuring. In fact, the merger agreement was expressly conditioned on the corporation obtaining a sufficient number of consents to amend the bond indenture agreements. Likewise, the debt tender offer was reciprocally conditioned on the consummation of the merger transaction. The corporation presented the consent solicitation and debt tender offer together.

Interestingly, the TAM also notes that the transaction was effectuated by the corporation's acquisition of its Class B common stock. That part of the transaction, of course, was a redemption. The bond indenture agreements prohibited the corporation from making any payment in connection with the redemption of its capital stock. The redemption of the Class B common stock—which was an integral part of the overall transaction—could not have been effected without first obtaining the requisite number of consents to amend the bond indenture agreements.

Stock Redemption and Related Costs

The TAM also goes on to consider the expenses incurred in the redemption of the Class B common stock. Here, too, the National Office confirms that the expenses incurred in the redemption of the Class B common must be capitalized under Section 263. This, said the IRS, is the general treatment accorded to the purchase of stock, including the purchase of the issuing corporation's own stock. (Interestingly, a footnote to the TAM indicates that the application of Section 162(k) to this transaction is not considered.)

The same treatment is generally given to any incidental expenses connected with such a purchase. For this proposition, the ruling cites *Proskauer v. Commissioner*, 46 T.C.M. 679 (1983), and *Frederic Weisman Co. v. Commissioner*, 97 T.C. 563 (1991). The consent solicitation payments, even though they related to the bondholders, were inextricably tied to the stock redemption.

Actually, the TAM gives two different reasons why the consent solicitation payments must be capitalized. The TAM recognizes the IRS field agent's alternative ground for disallowing the deduction of the consent solicitation payments, based on the case of *Denver & Salt Lake Railway Co. v. Commissioner*, 24 T.C. 709 (1955), *appeal dismissed*, 234 F.2d 663 (10th Cir. 1956). Payments that are inextricably tied to a transaction can be considered part of the same transaction's expenses. It is not clear exactly how this "alternative ground" differs from the primary one. And, the TAM does not make any of this crystal clear. However, the TAM does note that the case in question is similar to the facts in the *Denver & Salt Lake Railway* case, where costs were incurred by a taxpayer to obtain the consent of its bondholders to allow the railway to go through with a merger.

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Bond Redemption Premiums

As indicated above, it was necessary to the corporation to obtain a sufficient number of consents to amend the bond indenture agreements, and the corporation did not rely on the consent payment alone to induce the bondholders to consent. Rather, the corporation offered to repurchase the bonds at a premium, over and above the incentive payments.

The field agent argued that the expenses of the debt tender had their origin in the transaction in which the Class B common stock was redeemed, and consequently would have to be capitalized under Section 263. Here the National Office of the IRS drew the line. According to the TAM, it was the restrictive covenant in the bond indenture agreement that made it necessary for the corporation to obtain the consent of the bondholders to go forward with the transaction.

However, there were no such restrictions making it necessary for the corporation to call in and retire the pre-existing bond issue. Unlike the consent solicitation, the early retirement of the bonds was not an integral part of the overall transaction. Whether done at maturity, or at some earlier date, the corporation had a pre-existing obligation to retire the bonds and pay off the bondholders. The TAM finds that the repurchase payments did not have their origin in the transaction in which the Class B common stock was redeemed. For these payments, capitalization was therefore not required.

Finding that these bond repurchase premiums originated from the pre-existing debt obligations, the TAM concludes that these premium payments amount to interest within the meaning of Section 163. Interest is compensation for the use or forbearance of money. The TAM cites a number of cases (mostly quite old) for the notion that penalty payments on indebtedness constitute additional interest to the payor.

Then, the TAM finds no distinction between the premium paid to retire a bond issue prior to its maturity date, and a penalty paid by an obligor for the early termination of its obligation. In each case, the nature of the payment is the same. See *Union Pacific Railroad Co., Inc. v. United States*, 524 F.2d 1343 (Ct. Cl. 1975), *cert. denied*, 429 U.S. 827 (1976). Thus, the TAM concludes that a premium paid for the early retirement of a bond issue represents additional interest for the use of the bondholder's money (citing Revenue Ruling 70-368, 1970-2 C.B. 40).

Grant and Tender Fees

The grant and tender fees the corporation paid to its investment banker applied to two different items. They applied both to the restructuring transaction, and to the debt tender offer. The fees that could be allocated to the consent solicitation, were thus nondeductible capital expenditures. The fees allocated to the debt tender offer, on the other hand, were ordinary and necessary business expenses deductible under Section 162.

Interestingly, the TAM states that the taxpayer did not allocate the grant and tender fees between the consent solicitation and the debt tender offer. Consequently, the TAM states that a "reasonable allocation" will have to be made in order to properly classify the fees. The incentives will be rather clear. The portion of the fees allocated to the consent solicitation is required to be capitalized, while the portion of the fees allocated to the debt tender offer will be an ordinary and necessary business expense.

This kind of allocation notion obviously conjures up images of *INDOPCO*, a case that finally finds its way into the TAM two paragraphs after this discussion of allocation. (Of course, one assumes that an allocation before the fact is far less likely to be scrutinized than an allocation done pursuant to the insistence of a field agent of the IRS!) Actually, the TAM cites *INDOPCO* only when discussing bonuses, our next topic below.

The Origin of Bonuses

The last issue addressed by the TAM concerns a bonus. A special bonus was paid by the corporation to its management. The field office of the IRS had argued that the bonus had to be regarded as a capital expenditure because it originated out of the restructuring. (See how the "origin of the claims" doctrine can have far-reaching effects?)

The only mention of *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), comes where the

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TAM mentions a special bonus, which the field agent stated originated out of the restructuring. The TAM cites *INDOPCO* for the notion that expenditures incurred incident to a transaction that altered the capital structure of the corporation for the benefit of future operations generally constitute nondeductible capital expenditures. Interestingly, the field agent supported his arguments with the clear linkage of the bonus plan to the restructuring. The special bonus was to take effect only upon the successful consummation of the restructuring. Furthermore, the special bonus plan was non-amendable, and was explicitly linked to this transaction—which the agent assumed would be for the "overall betterment" of the corporation rather than its daily business.

Happily, the National Office disagreed, concluding that the bonus had its origin in the pre-existing employment relationship, even though the bonus was coincidental to the restructuring. It is perhaps a testament to the "origin of the claims" doctrine that it is precisely on this basis that the National Office disagrees with the field agent. Admitting that the special bonus plan was "coincidental" to the restructuring, the TAM finds the origin of the claim for the bonus to be in a pre-existing employment relationship between the company and its management team.

Furthermore, the National Office states that the surrounding circumstances indicate that the employment relationship was the basis for the payments. After all, the primary purpose of the bonus was to compensate management for past efforts in building the equity of the corporation. Plus, the special bonus was intended to induce the management group to continue their association with the company *after* the restructuring. Finding the special bonus to originate from both past and future services of the management team, the TAM concludes that deductibility is clear.

All's Reasonable In Love and War?

Navigating all these hurdles, the TAM turns to the question of "reasonableness" for the compensation, quickly concluding that the payments are reasonable. A prime determinative factor on the reasonableness question was the fact that the agreement between the company and its managers was negotiated and freely entered into by the parties. See Reg. §1.162-7(b)(2). One wonders how much to make of this rather short-shrift treatment of reasonableness. Although there is nothing in the facts of the TAM to indicate that the payments were not reasonable, this standard that seems to rely solely on a freely negotiated bargain entered into by the parties might seem to allow a great deal of latitude in the future.

Conclusion

All in all, Technical Advice Memorandum 9641001 is a useful and interesting read. More than anything else, it seems to underscore what was perhaps one of the major lessons to be derived from *INDOPCO* and its progeny: allocate fees at the time they are paid. Although the TAM indicates that a reasonable allocation of fees will have to be made, we all know that after the fact, allocations can be difficult. Besides, the IRS is more likely to look askance at an allocation made later rather than earlier on. That said, it is curious that *INDOPCO* gets only extremely brief reference: one sentence! ■

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