Corporate Deals, Tax Deductions, and the Wisdom of Solomon

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Even in this day of supposedly innovative law firms and creative alternatives to the billable hour, legal fees can add up. Besides, in a reversal that bucks the trend in favor of discount deals, some top legal talent may be able to justify charging more, not less. Charging a premium may be possible with some kinds of specialized transactions that everyone wants to emulate. For example, consider 2014's race for corporate inversions. As U.S. companies rushed to find foreign merger partners and to get inversion deals closed before either Congress or the White House took action that would restrict the tax benefits of these transactions, law firms could charge a premium for getting the deals done in a hurry.

Whoever provides the legal advice for business acquisitions and dispositions, the price of due diligence, documentation, and structuring work can add up. The most classic way to ameliorate the cost of legal fees is a tax deduction, and the sooner, the better. Yet there are decided limits to being able to deduct legal fees.

It does not take a tax expert to know the basics. Business people and corporate lawyers alike know that legal fees are deductible. However, they also know that there are many situations in the context of a transaction where all or a part of the deal costs (including legal fees) cannot be deducted. They must be capitalized as a part of the transaction.

Capitalizing legal fees means they are added to the cost of the asset in question and then written off ratably over the life of the asset or held as part of the basis in the asset until sale. Capitalizing legal fees does not mean the tax benefit of a deduction is lost forever. But it does mean that the tax deduction may be a long time in coming, spread over what can seem like an infinite number of years.

What's Capital?

A recent Tenth Circuit case, *Ash Grove Cement Company v. United States*,[2] shows that the issue of whether legal fees can be deducted can be surprisingly complex. This was a tax refund case, one that did not go well for the taxpayer. Nevertheless, it may help others negotiate the nuances of deducting legal fees as well as legal settlements.

Ash Grove Cement Company manufactured and sold cement. Vinton Corporation owned about two-thirds of its stock. Vinton also owned the Lyman-Richey Corporation, a ready-mix cement company. Vinton was wholly owned by the Sunderland family.

And while Vinton owned two-thirds of Ash Grove directly, the remainder of the Ash Grove stock was spread among members of the Sunderland family (approximately 6%); another about 2% was owned by the Ash Grove Employee Stock Ownership Plan (approximately 2%); and about 150 unrelated shareholders owned the remaining stock.

Under the terms of a reorganization plan, Ash Grove acquired Vinton and Lyman-Richey, and the Sunderland family received Ash Grove stock in return. In order to execute the plan and negotiate the proposed transaction, Ash Grove's board created a special committee of the board. Its two members were not members of the Sunderland family or employees of Ash Grove.

On November 2, 2000, the committee approved the reorganization, with an exchange rate of 876 shares in Ash Grove for each share in Vinton. The transaction was completed on December 31, 2000, and Ash Grove thereafter owned Lyman-Richey. Moreover, the Sunderland family members who previously owned stock in Vinton became direct owners of Ash Grove stock.

Lawsuit and Settlement

On January 18, 2002, Daniel Raider, a minority shareholder in Ash Grove, filed a class action complaint against Ash Grove and each member of its board. Mr. Raider (no comments about the serendipity of his name) alleged that the reorganization constituted self-dealing by the Sunderlands and that the special committee of the board was not meaningfully independent of the family.

He claimed that the transaction had unfairly diluted the minority shareholders' interests in Ash Grove. He sought rescission, imposition of a constructive trust on all of the "profits and benefits" the individual defendants had "wrongfully obtained." He also sought compensation from the individual defendants to himself and the class "for all losses they have sustained as a result of the [t]ransaction."

In August 2005, the suit was settled, with Ash Grove paying $15 million into a trust for the class. During the 2005 tax year, Ash Grove also paid $43,345 for legal fees incurred in defense of its board members and related to the suit. Ash Grove had previously adopted corporate bylaws that included indemnification rights for directors of the company.

The bylaws stated that "the Corporation shall indemnify and advance expenses to each person who is or was a director or officer of the Corporation . . . to the full extent permitted by the laws of the State of Delaware." These bylaws would turn out to be important to the company in the arguments it would later make in its tax dispute.

Ash Grove filed a consolidated return, deducting the settlement payment and the $43,345 in legal fees as business expenses. The IRS disallowed the deductions, calling them capital expenditures. This suit was all about the structure of the company and its architecture, and that made the legal fees not regular business expenses. Ash Grove paid the deficiency and sued for a refund. The district court granted summary judgment for the government and the plaintiffs appealed to the Tenth Circuit Court of Appeals.

Issues on Appeal

Although the section of the tax code allowing a deduction for all ordinary and necessary business expenses is as big as all outdoors, the principles of capitalization contained in *INDOPCO, Inc. v. Commissioner*[3] loom large in the court's opinion. Sure, legal settlements and legal fees get deducted all the time by businesses. But deductions for professional expenses relating to changes in corporate structure are different.

Indeed, expenses of litigation arising out of the acquisition of a capital asset are capital expenses.[4] In general, that is so whether or not the taxpayer's purpose in incurring them is the defense or perfection of title to property.

Origin of the Claim

Whether litigation expenses are ordinary or capital is governed by the origin of the claim test.[5] It seeks to find the transaction or activity from which the taxable event proximately resulted, or the event that led to the tax dispute.[6] Courts have repeatedly concluded that litigation costs arising out of corporate reorganizations are capital expenditures.[7]

Maybe so, argued Ash Grove, but not here. Here, the class action litigation did not involve the purchase of a capital asset. It did not even involve the setting of the price of a capital asset.

Besides, Ash Grove was not the real party in interest in the class action, the company contended. However, the Tenth Circuit was not convinced. The court noted that the complaint expressly concerned the terms of the reorganization, particularly the purchase price for Vinton and Lyman-Richey.

The complaint sought, among other remedies, rescission of the transaction. And to the court, that meant that the legal fees and settlement operated to defend and maintain the reorganization itself. The court relied upon the Supreme Court's conclusion in *United States v. Hilton Hotels Corp*.[8] There, the Court ruled that a variation in state law changing the relationship between parties in a suit regarding capital expenses did not impact the tax deductibility of the expenses.

In *Hilton Hotels Corp.,* New York law provided that title to the dissenters' stock passed as soon as they formally registered their dissent. That put them in the relationship of creditors of the company for the fair value of the stock. But under Iowa law, the passage of title was delayed until *after* the price was settled in the appraisal proceeding.

Did that matter? The Supreme Court said that it did not. And the Tenth Circuit found this issue to be quite similar. Here, the class action complaint filed by Mr. Raider sought payment and rescission to ensure that minority shareholders retained the fair value of their stock in the reorganization.

The Tenth Circuit ruled that the fact that Delaware law allows a suit against the board of directors to seek those remedies did not matter. That did not change the fact that the suit, and Ash Grove's related payments, proximately resulted from the transaction itself.

The plaintiffs also argued about the impact of the director indemnity provisions. They pointed the Tenth Circuit to the decision in *Larchfield Corp. v. United States*.[9] In that old case and others like it, amounts paid for counsel for individual defendants pursuant to an indemnification bylaw were deductible even though the same payments would not have been deductible if incurred by the corporation itself.

The Tenth Circuit was still not convinced, explaining away this authority. First, it noted that *Larchfield* was decided before cases clarified the origin of the claim doctrine. Moreover, the court said that even in *Larchfield*, the court made clear that expenses of a suit against directors were not *always* deductible.

The Tenth Circuit thus ended up opting to simply apply the origin of the claim test, not what it called the *Larchfield* test. The court ruled that expenses of a suit against directors are not always deductible, and this was one such case.

Suit in Name Only

Ash Grove also contended that it was named in the class action only to invoke the Delaware Court of Chancery's jurisdiction for rescission. In fact, the company argued to the Tenth Circuit that the class action had failed to assert a claim on which the Delaware courts could have granted relief. What's more, they argued, there was actually no cause of action alleged against Ash Grove.

The company said that meant that the indemnification claims were paramount, and they were all deductible. The Tenth Circuit dismissed this argument too. The court noted that even if it assumed that the outcome of the origin of the claim test would be different if Ash Grove had not been a party to the case and did not have real motivations to seek a settlement for its own benefit, that was not enough. The court held that the plaintiffs failed to carry their burden in demonstrating their right to a deduction.

The court even went on to state that it was not clear whether the question of Ash Grove's indispensability in the Delaware litigation was even relevant to the analysis. The payments made by Ash Grove were clearly made in connection with the class action lawsuit and the reorganization. The court said that it did not need to interpret state law regarding proper joinder of parties to determine the nature of the connection.

The payment settling the class action and the reorganization transaction were clearly related, and quite closely at that. The court therefore concluded that the district court had been correct. The government was entitled to summary judgment. The legal fees and the settlement payment made by Ash Grove were simply nondeductible capital expenses.

Whose Expense?

Was *Ash Grove Cement* a simple case? In some ways, yes, it was. When it comes to transaction costs, *INDOPCO* stands as a barrier to deductibility. But it is worth to remember that it may be possible to allocate fees among several categories.

Some of the fees may be deductible. In general, the more specific vendors or service providers are about exactly what they did and to what end, the better. For that matter, sometimes, even allocating costs and benefits between *entities* can make a difference.

For example, in Letter Ruling (2008) 30009,[10] a surviving company was acquired in a merger, and sought to allocate merger transaction costs between itself and the target which merged into it. Most of the actual contracts and costs came at the parent level. The parent paid fees for financial advice, legal services, due diligence, etc. The question the IRS addressed was which entity could claim credit for these fees.

The ruling begins with a recitation of the deduction versus capitalization rules. The regulations under section 263 carve out covered transactions, making it clear that transaction fees to pursue covered transactions must be capitalized. However, the question was how those fees should be allocated.

The IRS ruled that Survivor could allocate the transaction costs to Target or the acquisition company (which merged into Survivor) based on the entity to which the services were rendered and/or the entity on whose behalf they were provided. That can allow some flexibility. Indeed, the ruling notes that these were lump-sum costs from the various vendors. Plus, said the IRS, detailed billing records were not available.

Even so, the IRS found the records sufficient to support an appropriate allocation between the entities. You may be used to the old law that one taxpayer cannot deduct costs paid on behalf of another. Yet here, we are only talking about an allocation of transaction costs, with appropriate sharing based on which entity received the services. The silver lining of Letter Ruling (2008) 30009 is simply that transaction costs can be allocated among entities.

This in itself provides some flexibility, even though it is obvious that a current deduction is the real bonanza. On that point, there were some costs that the IRS said could be deducted (for example, some investigatory expenses). Similarly, there were some financing costs related to a securitization financing plan that the IRS ruled were eligible for an abandonment loss under section 165. One financing plan was abandoned. Its abandonment (along with the sunk costs to pursue it) therefore allowed that abandonment loss deduction.

In the current climate, one may be lulled into thinking that everything must be capitalized. But it is often worth parsing legal and accounting fees, banking costs, etc. The results of such efforts can be surprising.

Categorizing Expenses

This advice never seems to go out of style. Often, what is nondeductible can be deductible after all with some forethought, some hairsplitting, and some good documentation. It might even save the company some legal fees. Lawyers tend to be more discerning when they have to be very specific.

In *West Covina Motors, Inc. v. Commissioner*,[11] a variety of legal expenses were in question. The Tax Court had to decide whether the taxpayer could deduct the legal expenses it incurred in the bankruptcy of its landlord. The Tax Court also had to consider whether the taxpayer could deduct legal expenses related to the purchase of another car dealership.

Next, the Tax Court had to evaluate miscellaneous legal expenses that were questioned by the IRS. Most clients do not like "for services rendered" statements. Clients generally expect their legal bills to be detailed, describing the legal work and the categories of legal expenses, particularly if the client is concerned about the tax impact of such payments.

In *West Covina Motors*, the first category of legal expenses the Tax Court considered related to the landlord of the car dealership. The landlord had filed for bankruptcy, not so much to maintain its position as lessee of the dealership, but to expand it. In fact, when the smoke cleared after the bankruptcy reorganization, West Covina Motors was able to expand its business onto two additional parcels of land that the erstwhile bankrupt landlord had acquired as a result of the reorganization.

The taxpayer's legal fees for all of the bankruptcy work thus lead to a significant expansion of the taxpayer's business premises. The Tax Court had a relatively easy time viewing these legal expenses as capitalizable and not currently deductible. Traditionally, legal expenses incurred to defend claims that would injure or destroy a business are classified as ordinary and necessary expenses. The Tax Court actually said that if West Covina Motors had been paying legal expenses in the bankruptcy as a way of insuring that West Covina Motors would continue to be able to occupy its business premises, those expenses would be ordinary and necessary, and therefore deductible.

The problem, said the Tax Court, was that West Covina Motors incurred its bankruptcy legal fees not merely to survive, but actually to expand its business onto several additional parcels. Although West Covina Motors attempted to paint a picture of the bankruptcy-related legal fees as necessary merely for West Covina Motors to survive, the Tax Court found otherwise.

Acquisition Legal Fees

Legal fees paid to acquire another company have traditionally been required to be capitalized.[12] You must capitalize them along with the purchase price for the assets or company in question.[13] The second tranche of legal fees considered in West Covina Motors related to the taxpayer's purchase of the assets of another car dealership.

The taxpayer acquired another dealer's inventory, parts, accessories, and fixed and intangible assets. The purchase price was more than $6 million. The purchase agreement required West Covina Motors to assume the seller's legal expenses.

In that connection, West Covina Motors paid $100,000 in fees to the seller's counsel as well as approximately $20,000 in fees to its own counsel. The Tax Court had an easy time concluding that these were capital-related legal fees, and that they, too, had to be capitalized. Despite the stacked deck against it, *West Covina Motors* had an ingenious argument.

Inventory?

The taxpayer argued that the bulk of the purchase price for the other dealer's assets was allocable to its inventory. The car dealer's inventory usually turned over every 90 to 150 days. The taxpayer argued from this that it was inappropriate to capitalize the bulk of these legal fees. They could be directly traced to inventory, so had to be ordinary. The Tax Court found the argument creative, but found no factual support for it.

The Tax Court concluded that less than 40% of the purchase price was allocable to inventory. The Tax Court discounted the testimony as self-serving and uncorroborated. The Tax Court pointed out that even the dealership's records showed that the inventory did not turn every 90 to 150 days.

Accordingly, the Tax Court ruled that *all* of the acquisition legal expenses had to be capitalized. Record keeping also did the taxpayer in on the approximately $54,000 in miscellaneous legal fees that were next questioned by the Tax Court. These may well have been perfectly legitimate legal expenses incurred in carrying on the West Covina Motors dealership business.

Unfortunately, the taxpayer presented no evidence about these legal expenses, so the Tax Court ruled them to be nondeductible. The taxpayer's last slap in the face from the Tax Court came in the discussion of penalties. The IRS assessed substantial understatement penalties too.

Talk about an unhappy result. The taxpayer argued that the return positions were reasonable, that it had substantially disclosed them, and that in any case it had reasonable cause for its failures. The Tax Court disagreed on every point.

Lasting Lessons

It is hardly a new lesson that legal fees related to acquiring or preserving capital assets must be capitalized. We know this, and yet we need reminders. Not infrequently, taxpayers lose out because of a lack of proof. They cannot produce detailed legal bills showing what work was done.

They cannot produce evidence of the requisite nexus between the legal expenses and the ongoing operation of their active trade or business. They cannot produce copies of checks. Most of these deficiencies are quite curable. Moreover, in many cases difficult situations can be ameliorated with the Wisdom of Solomon: split the baby.

Divide and Conquer

Taxpayers often bifurcate legal bills between personal and tax (divorce), or between personal and investment (say, a legal dispute between neighboring homeowners). Taxpayers can divide bills between ordinary business expenses and capital expenditures, in litigation concerning ongoing business operations as well as title to assets. In the corporate arena, the division will often be a way to get half a loaf or more, rather than no loaf at all.

Bifurcation was one of the earliest and most persistent lessons of *INDOPCO*. The Supreme Court in *INDOPCO* said the legal and investment banking fees of an acquisition had to be capitalized. Since then, parsing legal and other expenses has become the norm: divide and conquer.

The same techniques can be used between investment expenses and additions to basis. Bifurcation has often been the ticket to a deduction, perhaps not as large as one would like, but decidedly better than nothing. In making allocations, be reasonable. Yet records and documents are key.

In fact, documentary evidence—checks, bills, pleadings, correspondence, declarations, and the like—may keep you from needing to resort to testimony. That is good because the evidentiary standards for testimony may be tougher than the level of informality with which many legal fee tax disputes can be resolved. Keep a good file, and when it comes to bifurcating fees, be reasonable.

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1 This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

2 No. 13-3058, 2014 U.S. App. LEXIS 7505 (10th Cir. Apr. 22, 2014).

3 503 U.S. 79 (1992).

4 *See INDOPCO, Inc. v. Comm'r,* 503 U.S. 79 (1992).

5 *See United States v. Gilmore*, 372 U.S. 39 (1963); *see also Woodward v. Comm'r*, 397 U.S. 572 (1970).

6 The Tax Court has described the origin of the claim rule as follows:

> Quite plainly, the "origin of the claim" rule does not contemplate a mechanical search for the first in the chain of events which led to the litigation but, rather, requires an examination of all the facts. The inquiry is directed to the ascertainment of the "kind of transaction" out of which the litigation arose. . . . Consideration must be given to the issues involved, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertaining to the controversy.

Boagni v. Comm'r, 59 T.C. 708, 713 (1973), *acq*., 1973-2 C.B. 1.

7 *Woodward*, 397 U.S. 572.

8 397 U.S. 580, 583 (1970).

9 373 F.2d 159 (2d Cir. 1966).

10 I.R.S. Priv. Ltr. Rul. 08-30-009 (July 25, 2008) *available at* www.irs.gov/pub/irs-wd/0830009/pdf (last visited Dec. 12, 2014).

11 T.C. Mem. 2008-237.

12 *See United States v. Hilton Hotels Corp*., 397 U.S. 580 (1970); *Ellis Banking Corp. v. Comm'r*, 688 F.2d 1376 (11th Cir. 1982); *Am. Stores Co. v. Comm'r*, 114 T.C. 458 (2000).

13 *See INDOPCO v. Comm'r*, 503 U.S. 79 (1992).