Deducting a Repurchase Premium on Stock

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As painful as it may be for a corporation to pay a premium on a repurchase of its own stock, it is even more painful if there is no deduction for the premium element. If there is no immediate deduction for the premium, then perhaps there will at least be an amortization allowance. If there is neither, then the purchaser will indeed be unhappy. Such was the case, however, in the recent case of *Lane Bryant Inc. et al. v. U.S.*, No 92-5022 (Fed. Cir. Sept. 21, 1994).

In that case, two shareholders of Lane Bryant began accumulating Lane Bryant stock in late 1979 or early 1980. By 1981, the two shareholders (Hatleigh Corp. and Mico Enterprises Ltd.) had about 20% of Lane Bryant's stock. In order to rid itself of these potentially disruptive shareholders, and the related fear of a takeover attempt, Lane Bryant negotiated settlements with each shareholder in 1981. The company agreed to purchase Hatleigh's 206,300 shares of stock for $23 per share, and to purchase Mico's 700,900 shares of stock for $22.50 per share. At the time, the Lane Bryant stock was trading at $17.625 per share, so each purchase reflected a substantial premium. The agreements covering these purchases each contained a waiver of dividend rights, and provided for the cessation of all litigation. However, no part of the consideration paid for the stock was referenced in the agreement as being allocable to these waivers and releases.

The agreement specifically carved out any liability or action under the short-swing profits rules of the securities laws. And, after buying back the stock, Lane Bryant sued to recover short-swing profits from one of the sellers under section 16(b) of the Securities and Exchange Act of 1934. During this litigation, the parties stipulated that Lane Bryant had paid one party $23 per share, and had paid the other party $22.50 per share. Based on this finding with respect to the stock sale prices, the District Court in the Section 16(b) action awarded judgment in favor of Lane Bryant.

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DEDUCTING A REPURCHASE

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But Now They're Business Expenses. . .

Despite this evidence of the treatment of the stock purchase premiums, Lane Bryant deducted $5.3 million on its 1981 tax return on the theory that the repurchase premiums paid to the two shareholders were for two "nonstock" items (the dividend relinquishment and the release of litigation). Consequently, said Lane Bryant, the items were deductible as ordinary and necessary business expenses. When the IRS disagreed, Lane Bryant eventually paid a $2.1 million deficiency and sued for a refund. By this point, the company was arguing that the payments either represented ordinary and necessary business expenses under section 162, or should be viewed as an amortizable asset under section 167(a).

Agreement in Black and White

Unfortunately for Lane Bryant, the Court of Federal Claims granted the government's motion for summary judgement, finding the taxpayer to be bound by the characterization given the payments in the two purchase agreements. These agreements allocated none of the admittedly high consideration to anything other than the repurchase of the stock. In effect, the taxpayer had made its bed and had to lie in it. See *Commissioner v. Danielson*, 378 F.2d 771 (3d Cir. 1967), *cert. denied*, 389 U.S. 858 (1967).

Now, Lane Bryant has received more of the same on appeal in the Federal Circuit. In response to the taxpayer's arguments, the appeals court even noted that the result would have been different had there been an express allocation of consideration to the other elements covered in the two purchase agreements. Lane Bryant even argued that these purchase agreements were, in effect, simply gross agreements which made no allocation between the different elements of consideration. Much like a general settlement agreement and release in litigation, the taxpayer argued, this kind of agreement did not mean that all of the consideration had to be allocated to the stock.

Appeals Court Upholds Agreement

Unfortunately for Lane Bryant, however, the appeals court found that these agreements rather plainly referred to a specific dollar figure being paid for the stock—and the stock alone. A simple reading of the agreements reflected the fact that all of the cash consideration was allocated to the stock, with nothing to the dividend waiver and/or the termination of litigation.

The lesson from cases such as *Lane Bryant* may be painful, but it is also painfully obvious. The Federal Circuit noted in the case that the taxpayer had offered no explanation why the purchase agreements were not drafted to specifically reflect what the taxpayer later asserted was such an obvious economic reality.

Just as a taxpayer can generally not assert that a settlement agreement drafted one way really means something else, the same is true with purchase agreements. The real icing on the cake—and what made *Lane Bryant* an easy case for the government to win—is where in some independent act (here, the Section 16(b) securities litigation), the taxpayer makes it clear that it really did regard the payment as one thing, and only later (for tax purposes?) began to regard it as something else.

Easy Window Dressing

Whatever the motivations, this kind of thing is particularly painful where a taxpayer finds that the desired tax treatment could have been obtained with only a modicum of redrafting. That, it would seem, is one of the great lessons of the litigation settlements area, where the courts (and even the IRS) often give considerable weight to the content of the settlement agreement even where the parties do not have adverse tax interests.

(Note: For extensive treatment of the tax treatment of settlement agreements, see *Wood, Taxation of Damage Awards & Settlement Payments* (Tax Institute 1991, with 1994 Suppment). This 500 page treatise is available for only $119 plus tax and shipping.■