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## Investment Banker Fees Held Deductible in *Pope & Talbot*

by Robert W. Wood • San Francisco

Many of us have spent so much time talking about the hostile vs. friendly and deduct vs. capitalize dichotomy that it sounds a little like Abbott & Costello's classic "Who's On First?" routine. Stripped of its various machinations, the *INDOPCO* case stands for the now rote notion that expenses incurred in connection with a friendly takeover producing long-term benefits will have to be capitalized. The decision in *A.E. Staley Manufacturing Co., et al. v. Commissioner*, 105 T.C. No. 1 (1995), goes a good deal farther than *INDOPCO*.

Basically, *A.E. Staley* says that even a takeover that was initially hostile may turn friendly at the end, but this will not change the *INDOPCO* no deduction taint of the ostensibly hostile takeover. According to the Tax Court, the fees in *A.E. Staley* could not be deducted but had to be capitalized because these costs were incurred in connection with a change in the ownership of the target that had "extended future consequences" for the target. This seemed to be a refinement (or sidestepping) of the notion that long-term benefits had to be contemplated in the acquisition.

There was no shortage of commentary about the *A.E. Staley* case. Indeed, in this newsletter, we pointed out at the time that it was quite disturbing that the facts of *A.E. Staley* clearly involved an eleventh hour friendship. In *A.E. Staley* there was overt hostility until literally days before the parties were able to come to agreement. We questioned whether it was not appropriate to have expenses bifurcated, with the admittedly substantial expenses leading up to the hostile-to-friendly metamorphosis being deductible, and only those thereafter being capitalized.

There were two dissenting opinions filed in *A.E. Staley*, one by Judge Maryanne Cohen and the other by Judge David Laro. While Judge Cohen found the *A.E. Staley* facts indistinguishable from *INDOPCO*, it was Judge Laro's dissent that was fascinating, arguing that this truly ***was*** a hostile takeover.

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But, Judge Cohen's dissent did at least expressly advocate bifurcation of the expenses, given that the initial period during which the Staley board resisted a takeover and sought out alternatives was the expensive and time-consuming one. (For further discussion of *Staley* and planning techniques, see Wood, "*INDOPCO* Rears Its Ugly Head, Preventing Deductions, Says Full Tax Court," Vol. 4, No. 4 *M&A Tax Report* (Nov. 1995), p. 1.)

### Papal Authority?

Now let's look at the latest *INDOPCO* flap embodied in *Pope & Talbot, Inc., et al. v. Commissioner*, T.C. Memo 1997-116 (1997). The *Pope & Talbot* case first appeared in a published Tax Court decision back to 1995 (see 104 T.C. 574 (1995)). There, the taxpayer was a publicly held corporation in the timber, land development and resort business in Washington state. In October of 1995, the board directors and shareholders adopted a plan of distribution calling for the transfer of assets of certain businesses to Pope Resources, a newly formed limited partnership. The partnership had two Delaware corporations as managing general partner and standby general partner, respectively.

These two corporate partners were initially owned equally by two of the principal shareholders. Under the plan, one corporation was to receive partnership units when Pope & Talbot transferred the Washington properties to the partnership. This corporate general partner was then to make a pro rata distribution of partnership units to the Pope & Talbot shareholders.

In late 1985, pursuant to the plan, Pope & Talbot transferred its Washington timberlands to the partnership subject to a substantial and newly-acquired loan. Also transferred were the land development and resort businesses, and $1.5 million in cash. Pursuant to the plan, the general partner issued partnership units to each holder of record of Pope & Talbot stock, with each shareholder receiving one partnership unit for every five shares of common stock held.

The big issue was how to value the property that was distributed. The distribution was clearly taxable, since the common shareholders of Pope & Talbot wound up receiving partnership interests in a partnership holding some of the assets that were previously held by the company. The question was just how much the partnership units were worth. The taxpayer argued that the fair market value of the property should be determined by reference to the value of the partnership units received by each shareholder. In contrast, the IRS argued that Section 311(d) required the fair market value of the property that was distributed to be determined as if the property had been sold in its entirety. (For prior coverage of this case, see Wood, "Taxable Spinoffs May Now Carry Greater Tax Liabilities," Vol. 3, No. 11 *M&A Tax Report* (June 1995), p. 6.)

After weighing the statutory language of Section 311(d)—which was relied on by both the taxpayer and the government—and looking at the legislative history, the Tax Court concluded that the corporation could not avoid tax on any inherent gain by distributing property to its shareholders. After a lengthy diatribe about the meaning of the legislative history, the court held that the taxpayer's gain on the distribution of the properties had to be determined as if the taxpayer had sold its interest in the properties at their fair market value on the date of the distribution.

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### *Pope & Talbot II*

The Tax Court has now rendered its second (albeit Memorandum) decision in *Pope & Talbot, Inc., et al. v. Commissioner*, T.C. Memo 1997-116 (1997). The new *Pope & Talbot* case considers, among other issues, our old friend *INDOPCO*. Actually, a huge portion of the second *Pope & Talbot* opinion is devoted to an even lengthier diatribe on valuation. Since the valuation methodology and details are not pertinent to our discussion here, let's move on to the real grist of *Pope & Talbot II*. There were actually several *INDOPCO*-type issues raised in the case.

First, the new iteration of *Pope & Talbot* deals with the fees paid to an investment banker hired to render advice concerning potential hostile takeovers. No such takeover was ever consummated—or even threatened. In fact, the costs in question related to the usual items, legal, accounting, investment banking, and other fees relating to the formation of the partnership, the transfer of the Washington properties, and the distribution of the partnership units.

The taxpayer agreed that these expenses were capital in nature, and were therefore not deductible under Section 162. However, the taxpayer argued that these were sales expenses and could therefore be used to offset the gain realized by the corporation on the taxable distribution. One of the issues was simply how one regarded this Section 311(d) distribution as a sale. Section 311(d), of course, provides that if a corporation distributes appreciated property to a shareholder, then the gain must be recognized as if the distributed property had been sold at the time of the distribution.

In other words, the transaction is treated as a deemed sale, even though no actual sale takes place. One question was simply how one regarded transactions costs that would properly be offset against the sales price in an *actual* sale, in a situation that was only a *deemed* sale. Sensibly, the court found the sales were capital expenditures, and equally sensibly, found no reason why transaction costs should be treated differently in a deemed sale than they are in an actual sale. Consequently, the Tax Court held that Pope & Talbot could offset its expenses incurred in connection with the distribution against its Section 311(d) gain.

### Other Fees

There was also another *INDOPCO*-type issue in the case. The court faced another set of fees, being investment banking fees for advice regarding potential hostile takeovers. This was the more interesting issue, since it dealt with the old "hostile is good" deductibility issue.

The court quickly disposed of this issue, ruling that Section 162 allows a deduction for all ordinary and necessary expenses. Echoing the big issue in most *INDOPCO*-type cases, the court said that it needed to look at the nature of the services provided by the advisor, rather than the designation of these services or their treatment by the taxpayer.

The nature of the services performed by the investment banking firm (Bear Stearns) engaged by Pope & Talbot was business planning and advice, and did not result in any change in corporate structure or long-term benefit. The court therefore distinguished this case from *INDOPCO* and from *A.E. Staley Manufacturing Co.*, both of which involved acquisitions of the corporate taxpayer's stock with consequent long-term benefits. Here, no acquisition or takeover was ever threatened or attempted. Thus, the court held the fees to be deductible.

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### Conclusion

Maybe all this last holding means is that if none of the banker's advice ever comes to fruition, at least its deductible! ■