

## LBO Loan Fees KO'd in *Kroy*

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**A**re fees and expenses associated with a loan used to make an acquisition deductible? Considering that there were innumerable LBO transactions in years that are either under examination or still open under the statute of limitations, the question has enormous implications. Or, as *M&A Tax Report* Advisory Board Member Bob Willens was quoted in the *Wall Street Journal*, "it has broad significance given the fact that most LBOs left the companies liable for buy-out or redemption."

Hopefully, the issue is debatable. That is exactly what happened in two recent decisions, the first in bankruptcy court, and the second in an Arizona district court. (See *U.S. v. Kroy (Europe) Ltd.*, DC Ariz., 10/29/92, *rev'g Bkrpcty. Ct. Ariz.*, 2/14/92.)

### An Ounce of *Kroy*

The Government filed a proof of claim against the bankruptcy estate for taxes owed as a result of the Service's disallowance of deductions claimed by the debtor for loan fees and expenses. The fees and expenses were incurred in connection with loans obtained by *Kroy* to finance an employee stock ownership buyout plan, under which all of *Kroy's* common shares outstanding prior to the merger were bought back for cash. Of the total \$78.5 million needed to finance the buyout, \$60.6 million was obtained through bank loans. As is typical with such loans, loan covenants required the borrowed money to be used specifically for the stock purchase.

The fees for which tax deductions were disputed included the following:

- A credit arrangement and facility fee of \$1 million, paid to one of the lending banks.
- A commitment fee, a closing fee, and an agent bank fee totaling \$677,000, and paid to another bank.
- Legal and accounting fees totaling \$599,170, paid to both banks.
- Investment banking fees of \$1.825 million.

In all, *Kroy* paid and amortized more than \$4 million in fees and expenses relating to the loans; the Service disallowed the amortization.

### Early Victory

The bankruptcy court found that the amortized loan fees and expenses were deductible, and sustained *Kroy's* objection to the Government's claims. In reaching its conclusion, the court determined that the loan fees were ordinary and necessary, but should be amortized ratably over the term of the loan, pursuant to Section 167.

In response to the Government's contention that Section 162(k) precludes any deduction for the fees, the court noted that while that provision precludes a taxpayer from deducting amounts paid or incurred by a corporation in connection with the redemption of its stock, *Kroy's* transaction was not the type of takeover Congress tried to single out in Section 162(k). In fact, the court concluded that, in Section 162(k), Congress merely intended to clarify

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that redemption costs are not deductible, but did not change the law allowing the deduction of loan acquisition fees.

Dealing with authorities such as *Woodward*, 90 S.Ct. 1301 (1970), which invite analysis of the underlying transaction, the bankruptcy court found that Kroy's underlying transaction was a loan. The purpose of the loan (the redemption) was irrelevant. The bankruptcy court also found it significant that Section 162(k) was intended to clarify prior law when it was enacted in 1986, and not to disallow deductions allowable under prior law.

**District Court Disagrees**

The Arizona district court agreed with the Government that it did not have to consider whether the loan fees qualified as ordinary and necessary business expenses, on the theory that regardless of whether they so qualified, Section 162(k) knocked these expenses out of contention. Thus, the district court considered Section 162(k)'s disallowance rule first, and did not need to reach any other question. Berating the bankruptcy court for its analysis of Section 162(k)'s legislative history, the district court concluded that the plain language of Section 162(k)(1) applies to all expenses incurred in connection with any redemption.

The court also found no basis for the bankruptcy court's conclusion that Congress really meant to single out only hostile takeovers in Section 162(k), leaving the friendly variety to more favorable treatment. Furthermore, the district court concluded that while congressional reports showed that Section 162(k) was meant to clarify prior law, it was not enacted solely for that purpose.

To allow it to examine the ultimate use of the funds generated as a result of the loan fees, the district court concluded that the cases relied on by Kroy only established that a court should not look to what loan proceeds are used for in determining whether loan expenses are ordinary or capital. Since it was uncontroverted that the loan fees and expenses were paid by Kroy to secure loan money that was used to redeem stock—and indeed, the loan agreements required that the funds be used for this purpose—it did not take much of a leap for the court to conclude that Section 162(k) applied to deny any deduction.

**Fee for Services or Interest?**

While the district court took a firm view of the scope of Section 162(k), there is at least one respect in which—had the facts been different—it might not have entirely knocked out Kroy's deductions. Noting that Section 162(k) excepts from its scope any deductions allowed under Section 163 (relating to interest), the court questioned whether any of the payments were interest as opposed to payments for services. Unfortunately for Kroy, the bankruptcy court had already determined that the loan fees were payments for services actually rendered to it, and the district court concluded this was supported by the evidence. Most of the other fees were paid to entities that did not loan any money (investment bankers, attorneys, etc.), so these clearly could not be considered interest.

**Mere Coincidence?**

We know everyone is tired of hearing about *National Starch/INDOPCO*, 112 S.Ct. 1039 (1992), and actually, the now-infamous case is not even mentioned in either of the *Kroy* decisions. Ultimately, *Kroy* is simply unhelpful authority under Section 162(k). But now that *National Starch/INDOPCO* has been mentioned, do you see any trend here? ■