Loan Fees In LBOs: Back To The Drawing Board

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Until relatively recently, there was a little discussion of Section 162(k). Enacted in 1986, Section 162(k) generally disallows a deduction for amounts paid or incurred by a corporation in connection with a redemption of its stock. There are exceptions to this general rule, with Section 162(k)(2) listing the following exceptions from this deduction prohibition: (1) interest deductible under Section 163; (2) dividends paid under Section 561; and (3) redemption expenses incurred by mutual funds which are regularly required to redeem shares.

This question has now produced several cases in conflict with each other. In *In re Kroy (Europe) Ltd., et al.*, 27 F. 2d 367 (9th Cir. 1994), the Ninth Circuit Court of Appeals held that Section 162(k) does not disallow the amortization of investment banking fees incurred by a corporation in borrowing money to refinance a redemption of its own shares. Now, only a few months after the Ninth Circuit decided *Kroy*, the Tax Court has handed down *Fort Howard Corp. v. Commissioner*, 103 T. C. No. 18 (August 24, 1994). In *Fort Howard*, the Tax Court declined to follow the result in *Kroy*, and held on not dissimilar facts that fees incurred to obtain borrowed funds used to redeem stock are nondeductible.

Although the facts in the two cases differ somewhat, in both cases large fees were paid to investment bankers for arranging financing for an LBO orchestrated by existing management. In both *Kroy* and *Fort Howard* the investment banker essentially brokered the loan (the investment banker was not loaning the money itself), and both loans were conditioned on the use of the funds to repurchase the borrower's stock.

Rationale in *Kroy*

Kroy involved a company that decided to go private through a leveraged buyout. To accomplish this, Kroy paid approximately $4,000,000 in fees to several banks and credit organizations, obtaining $60.6 million to finance the acquisition. Kroy amortized and deducted the $4,000,000 in fees as business expenses, and the matter wound up in court.

Because Kroy filed a Chapter 11 petition in 1990 and the IRS filed a proof of claim, the Bankruptcy Court determined the deductibility question, ruling in favor of Kroy. The District Court then reversed on the theory that the fees were not deductible because of the prohibition of Section 162(k). The District Court noted that these fees were clearly incurred with respect to a redemption of Kroy's stock.

The Ninth Circuit, however, agreed with the Bankruptcy Court that the expenses were deductible. The Ninth Circuit relied on the fact that there really were two separate transactions: a borrowing transaction and a stock redemption transaction. One of the prime reasons the Ninth Circuit found for the taxpayer was that it noted Section 162(k) had been enacted to codify and clarify existing law. According to the Ninth Circuit, only one case, *Five Star Manufacturing Company v. Commissioner*, 355 F. 2d 724 (5th Cir. 1966), had held that funds paid to redeem stock in response to a hostile takeover were deductible under Section 162(a). The Ninth Circuit felt the IRS was trying to extend Section 162(k) to situations involving the borrowing of funds where the loan proceeds are used to redeem stock.

Fort Howard Says No to Deductions

The Tax Court's decision in *Fort Howard Corp. v. Commissioner*, 103 TC. No. 18 (1994), directly contradicts the Ninth Circuit decision in *In re Kroy*. Noting that the expenses cannot be deducted if they are considered incurred "in connection with" the buyback, the *Fort Howard* court concluded that they were so incurred. The Tax Court found that the phrase "in connection with" should be interpreted broadly and means "associated with or related to." The court found that the fees were incurred in connection with the buyback because there was a logical relationship between the buyback, the need to obtain financing, and the costs (i.e., the fees) incurred to obtain the financing.

The court acknowledged the fact that interest expense on debt incurred in connection with a buyback is deductible. Interest is a cost of financing, and the court noted that there would have been no need to provide an exception for it if related financing costs, such as the fees in question in this case, were not considered to be "in connection with" the buyback.

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Fort Howard Facts

Fort Howard's management determined that a leveraged Buyout (LB0) would be the best way to increase stockholder value in the corporation. In June 1988, the corporation's board voted to accept an LBO of Fort Howard for $53 per share by its senior management, its largest individual shareholder, and outside investors consisting of Morgan Stanley Group Inc., Bankers Trust Co., and institutional investors. Morgan Stanley played a substantial role in getting the commitment from the five lead banks and in selling the LBO as a credit risk to the remaining banks in the syndicate. It also acted as financial adviser and dealer manager for all stages of the LBO.

Under a merger plan, Morgan Stanley organized FH Holdings Corp. and its wholly owned subsidiary, FH Acquisition Corp. Investors would initially become shareholders of FH Holdings. FH Acquisition would receive debt capital for the purpose of making a tender offer for all of Fort Howard's outstanding shares. In October, FH Holdings was merged into FH Acquisition, which in turn, merged into Fort Howard, with Fort Howard as the survivor.

Fort Howard paid many expenses to complete the LBO, including legal fees and fees for the services of Morgan Stanley and the various banks, and the costs of obtaining the various loans and issuing debt and equity. On its 1988 return, Fort Howard treated $169.1 million in debt-financing and loan-financing costs as capital expenses and deducted $43.4 million, representing the costs and debt amortized or retired in 1988.

Fort Howard paid Morgan Stanley a $40 million transaction fee that, according to the invoice from Morgan Stanley, was for financial advisory services rendered in organizing the financing for the purchase of all Fort Howard's outstanding common stock. On its 1988 return, Fort Howard treated $36 million of the $40 million paid to Morgan Stanley as a cost of obtaining financing for the LBO. Fort Howard allocated this $36 million on a debt issued in the transaction, and deducted the portion of this amount allocated to debt amortized or retired in 1988.

Disputed Costs

The IRS disallowed deductions claimed by Fort Howard with respect to the LBO on the grounds that they are disallowed by Section 162(k). The IRS also determined that some of the expenses incurred by Fort Howard in 1988 constituted a fee for services, as opposed to interest deductible under Section 163.

The Tax Court in a reviewed decision, held that Fort Howard's costs of obtaining debt financing were incurred in connection with the redemption of its stock under Section 162(k)(2) and are not deductible. The court then concluded that the expenses were incurred "in connection with" the redemption, finding "a clear logical relation between [Fort Howard's] redemption, and corresponding need for financing, and the costs incurred to obtain that financing."

The court rejected numerous arguments advanced by the taxpayer. It concluded that the prohibition on deductions extended to the financing costs associated not only with the bridge loans, but also with the permanent financing. This was so because Morgan Stanley testified that the permanent debt was part of the plan of redemption. Indeed, only eight days separated the buyback and the issuance of the permanent debt. Finally, Morgan Stanley's fee for arranging the financing was found to be part of the cost of raising the debt capital and not, as Fort Howard argued, deductible interest expense.

Interest is compensation for the use of money and, of necessity, there is a relationship between such amounts and the principal sum borrowed and the time period for which the payment is designated. In this case, Morgan Stanley received its fees without regard to the dollar amount of bridge notes purchase by it or the period during which the notes

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of INDOPCO, so also may they become adept at bifurcating loan fees and interest in this area.

In any case, it seems doubtful that any of us has heard the last word on either taxpayer or IRS interpretations of Section 162(k). ■