Redemption Borrowing Expenses Slated to be Deductible

by Robert W. Wood • San Francisco

With all the flap over the current tax bills, it is easy to miss several of the notable provisions that could have a dramatic effect on the corporate world, particularly on acquisition and financing techniques. We first reported on the case of *Kroy (Europe) Ltd.* back in 1993. (See Wood, "LBO Loan Fees KO'd in *Kroy*," Vol. 1, No. 9, *M&A Tax Report* (April 1993), p. 4.) In *Kroy*, the Bankruptcy Court in Arizona had to consider whether it was proper for Kroy to amortize more than $4 million in fees and expenses relating to a loan. The purpose of the loan was financing of Kroy's employee stock ownership buyout plan.

All of Kroy's common shares outstanding prior to the merger were reacquired for cash. In short, Kroy did a redemption. The Bankruptcy Court allowed the deductions. The District Court reviewing the Bankruptcy Court decision disagreed, and ruled for the government, holding that Section 162(k) knocked out the deductions. According to the District Court, it did not have to consider whether the loan fees in question were ordinary and necessary business expenses. Regardless, Section 162(k) precluded them. That provision, of course, prevents deductions for amounts paid or incurred by a corporation "in connection with" the redemption of its stock.

Section 162(k) has not exactly been a controversial provision, but it has generated at least these few significant cases. Section 162 was enacted in 1986, ostensibly to clarify prior law. There is a fair amount of discussion both in the Bankruptcy Court opinion and subsequent District Court decision in *Kroy*, about the intent of Section 162(k). For example, the Bankruptcy Court in *Kroy* (in a judgment that was ultimately approved by the Ninth Circuit), concluded that all Congress intended in Section 162(k) was to clarify that redemption costs were not deductible. Congress had no intent, said the Bankruptcy Court (as endorsed by the Ninth Circuit) to change the law allowing the deduction of loan acquisition fees.

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Indeed, dealing with authorities such as *Woodward*, 90 S.Ct. 1301 (1970), inviting analysis of the underlying transaction, the Bankruptcy Court in *Kroy* found that the underlying transaction was a loan. The purpose of the loan (the redemption) or the use of the loan proceeds was irrelevant.

The District Court in *Kroy* found no basis for the Bankruptcy Court's conclusion that Congress meant to single out only hostile takeovers in Section 162(k). The District Court found that as it was uncontroverted that the loan fees and expenses were paid by Kroy to secure loan money that was used to redeem stock—indeed, the loan agreements required that the funds be used for this purpose—Section 162(k) prevented any deduction.

Interestingly, the District Court in *Kroy* ruled that it did not have to consider whether the loan fees qualified as ordinary and necessary business expenses. According to that court, regardless of whether they so qualified, Section 162(k) eliminated these expenses from the deductible category. Likewise 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 District 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 the purpose of endorsing that law.

It is perhaps ironic (or amusing?) that the friendly vs. hostile dichotomy arises yet again (see "*INDOPCO* Rears Its Ugly Head, Preventing Deductions, Says Full Tax Court," in this issue). In any event, there was yet another chapter—if not two chapters—in the *Kroy* and Section 162(k) saga.

Ninth Circuit vs. Tax Court

The Ninth Circuit—sometimes still called the "taxpayer circuit" by true aficionados—came to the rescue, ruling that Section 162(k) did not disallow recovery through amortization of the investment banking fees incurred by a corporation to borrow money to finance a redemption of its own shares. See *In Re Kroy (Europe), Ltd., et al*, 27 F.3d 367 (9th Cir. 1994). Unfortunately, shortly after the Ninth Circuit came to the rescue, the Tax Court issued a reviewed decision disagreeing with the Ninth Circuit's view.

The Tax Court issued its diatribe on the subject in *Fort Howard Corp. v. Commissioner*, 103 T.C. No. 18 (1994). There, the Tax Court considered a similar set of circumstances involving large fees paid to investment bankers for arranging financing for a management-led LBO. Just as in the *Kroy* case, the loan in *Fort Howard* was conditioned on the use of the funds to repurchase the company's stock. The Tax Court found Section 162(k) squarely applicable, and concluded that it would not follow the Ninth Circuit's decision in *Kroy*.

Legislative Response

Under the House Ways & Means Committee version of the pending tax bill, Section 162(k) would be corrected to permit the deduction of expenses associated with borrowing to finance a redemption of the issuing corporation's equity. (See Section 13402 of the pending Revenue Reconciliation Act of 1995.) This proposal is cast as a technical correction, although it arguably goes a good deal further. As a technical correction, of course, the proposed effective date is quite favorable to taxpayers (see "Retroactive Effect" below).

The build-up to this proposal was rather predictable, with taxpayers pointing out that Section 162(k) is a disallowance provision. It exists not to require capitalization rather than deduction, but to disallow *entirely*. By virtue of its rather onerous rule, companies are subjected to entirely different treatment for entering into a transaction to purchase their own shares as opposed to someone else's.

If the amendment passes, fees incurred in connection with a redemption would not be immediately deductible, but would rather be amortized over the term of the indebtedness. There could still be disputes, of course. For example, some have noted that taxpayers are likely to have disputes with the IRS (assuming the passage of this provision) concerning whether the expenses that the

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redeeming corporation seeks to deduct are properly allocable to the loan. Nonetheless, the provision is certainly a favorable one from a taxpayer perspective.

Retroactive Effect

A good number of taxpayers will be affected by the very favorable effective date to be given to this provision. If enacted in its current form, the provision would be effective retroactive to 1986. Loan fees that taxpayers amortized during these years would therefore be retroactively blessed. Of course, as with any provision enacted currently which reaches back in time nine years (!), there are some interesting statute of limitations questions presented. Many companies were doubtless more persuaded by (and pleased with) the Ninth Circuit's opinion in *Kroy* than they were with the Tax Court's opinion in *Fort Howard*. These taxpayers would be vindicated by the bill's passage and its validation of the rule in *Kroy*. ■

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