Redemption Forbearance Payments: Now Deductible?

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It is a well-worn axiom that corporations cannot deduct payments made to redeem stock. Indeed, Internal Revenue Code Section ("Code Sec.") 162(k)(1) flatly prohibits a tax deduction "for any amount paid or incurred by a corporation in connection with the reacquisition of its stock." The "in connection with" link suggests that the deduction prohibition is a broad one.

It covers not only the consideration paid for redemption, but also all fees and expenses.

Code Sec. 162(k) even trumps other Code sections. It expressly provides that even an otherwise allowable deduction cannot be taken for a payment paid or incurred in connection with the reacquisition of corporate stock or the stock of any related person. That sounds definitive. In 1996, Congress even expanded this provision to apply not only to redemptions, but also to any stock reacquisition expenses.

Forbearance Payments?

What tax treatment should apply to payments to shareholders not to *redeem* stock, but rather to compensate them for *not* redeeming it? That question was before the Tax Court in *Media Space Inc.*, 135 TC No. 21, Dec. 58,359 (2010). The Tax Court first considered whether these forbearance payments resembled interest sufficiently so as to be deductible as interest under Code Sec. 163. Second, the court considered whether the payments were deductible under Code Sec. 162 as ordinary and necessary business expenses.

Other People's Money

The taxpayer was a corporation in the field of media advertising sales. Sensibly, it raised capital by issuing shares of its stock. With series A and series B preferred stock outstanding, the corporate charter provided for dividends at a rate of eight percent per year on each. Both series A and B had certain redemption rights.

Commencing on September 30, 2003, holders of series A and series B preferred could demand redemption out of legally available funds for up to 100 percent of the originally issued and outstanding shares. Holders had to give notice to other preferred shareholders, and the company was required to redeem the shares only if a majority of the holders of the specific series elected redemption.

In addition to the "legally available funds" buzzword, the corporate charter specifically addressed the possibility that there might not be funds available for redemption. In such a case, the company had to pay interest at the rate of four percent per annum, increasing by 0.5 percent for each six months, subject to a maximum rate of nine percent per annum. The company was also required to continue paying the eight-percent dividend on shares it could not redeem.

Cash Becomes King

With mounting concerns over the lack of funds for redemption, the company and its investors negotiated a forbearance agreement. Under it, investors agreed to forbear from exercising their redemption rights until September 30, 2004. In exchange for this promise, the company agreed to pay a "forbearance amount" on September 30, 2004. The payment bore an eerie resemblance to the calculation of interest under the original redemption right.

In other words, the forbearance amount was equal to interest at four percent plus an additional one half of one percent for each six-month period thereafter, but not to exceed nine percent per annum. As the Tax Court noted, the "forbearance amount" payments were thus equal to the amounts the company would have been required to pay the investors as interest under its corporate charter had the investors elected to have their shares redeemed but found the company unable to redeem them. The course of communications between the company and its investors made it clear that everyone intended these payments as interest.

Plainly, the payments compensated the investors for the use of the redemption funds. As to documentation, although the key document in question was the corporate charter, the forbearance agreement was a separate contract. With funds remaining tight and September 30, 2004, approaching, the parties agreed to an eight-month extension of the forbearance agreement to May 31, 2005.

As with the original, the extension tracked the interest provisions in the governing documents. A second extension was granted to May 31, 2006, and four additional extensions thereafter carried the forbearance agreement through May 31 2010. In each case, the interest provisions of the governing documents were replicated.

A Rose by Any Other Name?

For its 2004 and 2005 tax years, the company deducted over $2 million in forbearance payments, treating the payments as interest for 2004 and as a business expense for 2005. The IRS disagreed and issued a notice of deficiency, landing the company in Tax Court. The IRS argued that the payments could not be interest because they were not made on indebtedness.

Indeed, there was no indebtedness to the IRS because the investors did not exercise the redemption right to create it. The taxpayer, on the other hand, argued that indebtedness may be conditional, and that in any case, it was irrelevant whether the investors had actually elected the redemption. There was no question but that the company *had* to make the payments under a binding agreement, and they looked and sounded like interest.

The court engaged in an elaborate and detailed analysis of what constitutes interest, hinging on the existence of an unconditional and legally enforceable obligation for the payment of principal. [*See S.G. Howlett,* 56 TC 951, Dec. 30,917 (1971).] While the parties clearly *intended* this payment to be interest, the court found that there was no written election for the company to redeem the stock. That meant there could be no unconditional obligation.

The company, on the other hand, pointed out cases in which conditional obligations were treated as extant. In these cases, payments of interest could be deducted notwithstanding the lack of an unconditional obligation. Nevertheless, the court could not get past the fact that there was no redemption election here. There was no principal debt; therefore, there could be no interest.

The court even tried to examine substance over form, but simply found that this was not legal indebtedness. That meant the company could not deduct the forbearance payments as interest under Code Sec. 163.

It's Just Business

The taxpayer had deducted the payments in one year as interest. Yet it switched gears and treated the forbearance payments in the other as a business expense. Not surprisingly, the Tax Court had a far easier time with the business expense argument, concluding, though, that the payments were only deductible in part.

The ordinary and necessary business expense language of Code Sec. 162 is interpreted broadly. An expense is "ordinary" even though it might occur only once in the taxpayer's lifetime. The taxpayer in *Media Space* produced an expert report showing that forbearance agreements were common. Similarly, an expense is "necessary" if it is appropriate and helpful to the business.

The court had little difficulty concluding that these forbearance payments were ordinary and necessary. However, the court still had to confront whether Code Sec. 162(k) prevented a deduction because of the payment's symbiotic connection to the stock redemption.

The forbearance payments may have been connected to the redemption, said the court, but it was certainly distinct. In view of all the facts, the Tax Court found that the forbearance agreement between the company and its investors was not in form or in substance a reacquisition of stock. That meant Code Sec. 162(k) did not prevent deducting the payments.

Recapitalization?

Faced with a blizzard of IRS arguments, the Tax Court went on to consider whether this transaction could be considered a recapitalization under Code Sec. 368(a)(1)(E). The IRS had argued that a reshuffling of the company's capital structure had occurred. The company exchanged forbearance payments and new preferred stock with deferred redemption rights for the old preferred stock, which had nondeferred redemption rights. Reverting to references to both form and substance, however, the Tax Court simply said that a deduction was not prohibited under Code Sec. 162.

The IRS's next theory was that the forbearance payments were *in substance* nondeductible distributions to investors with respect to their stock. The Tax Court, however, took issue with this characterization. The court disagreed with the IRS that the forbearance payments were in substance distributions with respect to the investor's stock. After all, said the court, the company received valuable deferral rights in return for the forbearance payments.

There was nothing to suggest that the amounts the company paid to its investors for forbearance were in excess of the fair market value of those rights. In other words, when investors received forbearance payments they were being paid for forbearing. They were not receiving a return on their investment.

Capitalization

Finally, the Tax Court confronted whether any of these amounts had to be capitalized. The IRS first contended that capitalization was required because the forbearance payments created a stock interest. Yet the Tax Court said this simply was not an exchange of stock, in form or in substance. No financial interest was created.

Next in the IRS' bag of tricks was the argument that if no financial interest was created, one was modified. Before the forbearance agreement was entered into, the investors *could have* exercised their redemption right. Thereafter, they were not able to. This was a modification, argued the IRS.

After considerable discussion, the Tax Court had to agree with the IRS: The reality was that *this* forbearance agreement modified the *charter* provision, impacting the date upon which the investors would gain the redemption right. The court therefore found that capitalization of the forbearance payments was required. Because of this conclusion, the court had to go on to consider the argument that these forbearance payments related to rights that did not extend beyond 12 months—the 12-month rule.

This required an analysis into the reasonable expectations that the rights would be renewed, something that occurred repeatedly with the forbearance payments. After multiple pages of discussion about capitalization, the 12-month rule and even the financial condition of the company, the court concluded that the company could take advantage of the 12-month rule for its 2003 and 2004 forbearance agreements, but not thereafter. While earlier forbearance payments could be deducted, the forbearance payments accruing during 2005 had to be capitalized.

Conclusion

In the land of closely held companies, there is far more deduction mania than you might expect. Notwithstanding the myopic focus on capitalization that *INDOPCO* brought to many practitioners, in the unwashed world of small business, many clients *assume* that if it moves, it must be deductible. Clearly, there can be preferences between treating something as interest and as a business expense.

But *Media Space* is a not-so-gentle reminder that sometimes payments that seem awfully plain and simple—interest, for example—may require a multifaceted analysis. The case also shows that sometimes, like a rat terrier with a toy, the IRS will pick and pick at multiple threads until it finally unravels a taxpayer's plans.

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