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Tax Law - In Re Kroy (Europe) Limited: Whether A Corporation May Amortize And Deduct Loan Fees Incurred In Financing A Stock Redemption

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TAX LAW

IN RE KROY (EUROPE) LIMITED: WHETHER A CORPORATION MAY AMORTIZE AND DEDUCT LOAN FEES INCURRED IN FINANCING A STOCK REDEMPTION

I. INTRODUCTION

In *In re Kroy (Europe) Limited*,[1] the Ninth Circuit held that a corporation could amortize and deduct fees which it incurred in borrowing funds used to redeem stock under § 162(a) of the Internal Revenue Code.[2] Section 162(a) allows a corporation to deduct ordinary and necessary business expenses.[3] *Kroy* required the court to decide whether § 162(k) of the Internal Revenue Code,[4] an exception to § 162(a), applied to

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1. In re Kroy (Europe) Limited, 27 F.3d 367 (9th Cir. 1994) (per McLaughlin, J.; the other panel members were Leavy, J., and Reinhardt, J.).

2. *See Kroy*, 27 F.3d at 370. The pertinent portions of I.R.C. § 162(a) provide: "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . ." I.R.C. § 162(a) (1988 & Supp. V 1993).

3. *See* I.R.C. § 162(a).

4. The pertinent portions of I.R.C. § 162(k) provide:

> (1) IN GENERAL. - Except as provided in paragraph (2), no deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred by a corporation in connection with the redemption of its stock.
> (2) EXCEPTIONS. - Paragraph (1) shall not apply to -
> (A) CERTAIN SPECIFIC DEDUCTIONS. - Any -
> (i) deduction allowable under section 163 (relating to interest), or
> (ii) deduction for dividends paid (within the meaning of section 561).

I.R.C. § 162(k) (1988) (emphasis in original).

these fees and would preclude their deduction.[5] Section 162(k) disallows deduction of any expenses incurred "in connection with" a stock redemption.[6] The Ninth Circuit determined that § 162(k) did not apply to the fees because the fees were incurred in a separate borrowing transaction which was not "in connection with" the stock redemption.[7]

In its decision, the Ninth Circuit reversed the district court decision and affirmed an earlier bankruptcy court holding.[8]

II. FACTS AND PROCEDURAL HISTORY

Kroy is a corporation that manufactures computer-based lettering systems.[9] In 1986, Kroy's management decided to take Kroy private in a leveraged buyout transaction (hereinafter "LBO").[10] Kroy lacked sufficient funds to repurchase its stock.[11] Therefore, Kroy borrowed $60.6 million from First Bank of Minneapolis and Quest Equities Corp. to finance the LBO.[12] To obtain the loans, Kroy paid loan fees totaling $4,091,170.[13] For tax purposes, Kroy amortized and deducted

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5. *See Kroy*, 27 F.3d at 368.

6. *See* I.R.C. § 162(k).

7. *See Kroy*, 27 F.3d at 370.

8. *See id.* at 368.

9. In re Kroy (Europe) Limited, 27 F.3d 367, 368 (9th Cir. 1994). Kroy is principally engaged in the manufacture and marketing of computer-based lettering systems as well as the sale of signs and sign systems. In re Kroy (Europe) Limited, 1992 Bankr. LEXIS 1249, at *2 (Bankr. D. Ariz. Feb. 14, 1992).

10. *See* In re Kroy (Europe) Limited, 27 F.3d 367, 368 (9th Cir. 1994). In December 1986, Kroy became a private company in a leveraged buyout transaction in which Kroy merged with Kappa Acquisition Corporation to form a new merged Kroy. *Kroy*, 1992 Bankr. LEXIS 1249, at *2. Kappa was formed for the purpose of taking Kroy private. *Id.* The stockholders of the new Kroy were pre-LBO Kroy management, several investors and the Kappa Acquisition Corporation Employee Stock Ownership Plan. *Id.* All pre-LBO common shares of Kroy which were outstanding prior to the merger were bought back for cash. In re Kroy (Europe) Limited, No. CIV. 92-491, 1992 U.S. Dist. LEXIS 17169, at *2 (D. Ariz. Oct. 29, 1992).

11. *Kroy*, 27 F.3d at 368.

12. *Id.*

13. *Id.* The loan fees consisted of: i) an advisory fee of $1,200,000 and a placement fee of $625,000 to Bankers Trust Corporation, ii) a credit arrangement and facility fee of $1,000,000 to Quest, iii) a commitment fee, closing fee and bank agent fee totaling $667,000 to First Bank, and iv) $599,170 for reimbursement of the legal and accounting fees of Bankers Trust, Quest and First Bank. *Id.* The court noted that Bankers Trust acted as Kroy's investment banker, but did not

the loan fees under § 162(a) of the Internal Revenue Code[14] as ordinary and necessary business expenses.[15]

The Internal Revenue Service (hereinafter "IRS") audited Kroy's tax returns for the tax years ending March 1986, 1987, 1988, 1989 and 1990, and disallowed Kroy's amortization deductions for the loan fees.[16] This disallowance resulted in a net tax deficiency for Kroy.[17] In 1990, Kroy voluntarily filed for bankruptcy under Chapter 11 of the Bankruptcy Code.[18] The government submitted a proof of claim[19] to the bankruptcy court for unpaid corporate income taxes.[20] Kroy objected to the deficiency claim and requested that the bankruptcy court[21] determine its tax liability under 11 U.S.C. § 505.[22] The parties submitted the dispute to the bankruptcy court on stipulated facts and cross motions for summary judgment.[23]

The bankruptcy court granted Kroy's motion for summary judgment, holding that the loan fees were ordinary and necessary business expenses which could be amortized and deducted under § 162(a) of the Internal Revenue Code.[24] The bankruptcy court determined that § 162(k) of the Internal Revenue Code, which disallows deduction of any expenses incurred "in

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loan funds to Kroy. *Id.* at 368 n.1.

14. *See supra* note 2 for the text of I.R.C. § 162(a).

15. *See Kroy*, 27 F.3d at 368.

16. *Id.*

17. *Id.* The IRS determined that Kroy owed a tax deficiency of $270,391 for the taxable year ending March 1988. *Kroy*, 1992 Bankr. LEXIS 1249, at *4. Additionally, the IRS determined that Kroy made overpayments to the IRS for 1983 and 1986 equaling $137,291. *Id.* In lieu of requesting a refund, Kroy applied that amount to the amount owing so that Kroy owed a balance of $133,640. *Id.* This amount plus accrued interest of $109,015 equalled $242,655 which was the total deficiency claimed by the government. *See id.* at *4-*5.

18. *See Kroy*, 27 F.3d at 368; 11 U.S.C. §§ 1101-63 (1988 & Supp. V 1993).

19. A proof of claim is a statement under oath filed in a bankruptcy proceeding by a creditor in which the creditor sets forth the amount owed and sufficient detail to identify the basis for the claim. BLACK'S LAW DICTIONARY 845 (6th ed. 1991).

20. *See Kroy*, 27 F.3d at 368.

21. United States Bankruptcy Court, District of Arizona.

22. *Kroy*, 27 F.3d at 368. Section 505 of the Bankruptcy Reform Act of 1978 provides that a bankruptcy court may determine a debtor's tax liability that has not been contested before or adjudicated by a judicial or administrative tribunal prior to a debtor's filing in bankruptcy. *See* 11 U.S.C. § 505 (1994).

23. *Kroy*, 27 F.3d at 368.

24. *See Kroy*, 1992 Bankr. LEXIS 1249, at *12.

connection with" a stock redemption, did not apply to the loan fees and, thus, would not preclude the deductions.[25] The court reasoned that the loan fees were not incurred "in connection with" the stock redemption within the meaning of § 162(k), but, instead, were incurred in a separate borrowing transaction.[26] The government appealed to the district court.[27]

On appeal, the district court[28] reversed and disallowed Kroy's deductions for the loan fees.[29] The district court held that § 162(k) applied to the loan fees and precluded their deduction.[30] The court reasoned that the loan fees were incurred "in connection with" a stock redemption because Kroy paid the loan fees to secure debt capital which was used to repurchase the stock.[31] Kroy appealed to the Ninth Circuit.[32]

III. BACKGROUND

Whether § 162(k) of the Internal Revenue Code[33] applies to and, thus, precludes deduction of expenses that a corporation incurs in securing a loan to finance a stock redemption has implications for most LBO and stock redemption completed since the enactment of the statute in 1986.[34] There are hundreds of millions of dollars, and perhaps billions of dollars, at stake in amortization deductions for fees that companies pay to investment bankers, financial institutions, lawyers, and accountants to handle the buyback of their stock.[35]

The courts[36] and the IRS[37] have previously determined

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25. *See id.*
26. *See id.* at *10.
27. *Kroy*, 27 F.3d at 368.
28. United States District Court, District of Arizona.
29. *Kroy*, 27 F.3d at 368.
30. *See Kroy*, 1992 U.S. Dist. LEXIS 17169, at *13.
31. *See id.* at *10.
32. *See Kroy*, 27 F.3d at 368.
33. *See supra* note 4 for the text of I.R.C. § 162(k).
34. *See* Thomas Pratt, *Court Rules LBO Debt Fees Non-Deductible*, MERGERS AND ACQUISITIONS REPORT, Nov. 30, 1992, at 1.
35. Claudia MacLachlan, *Conflict Emerges In Rulings On Fee Deductions; The Supreme Court May Have to Settle a Split Over Deducting Fees Paid In LBO Financings*, NAT'L L.J., Sept. 12, 1994, at A7.
36. *See, e.g.*, Detroit Consol. Theaters Inc. v. Comm'r, 133 F.2d 200 (6th Cir.

that a corporation may amortize and deduct fees and expenses related to acquiring a loan over the life of the loan as ordinary and necessary business expenses under § 162(a).[38] However, the enactment of § 162(k) raises a question as to whether fees incurred to finance a redemption of corporate stock are subject to this treatment.[39] Section 162(k) provides an exception to the general rule of § 162(a) that ordinary and necessary business expenses are deductible.[40] By its terms, § 162(k) denies a deduction for "any amount paid or incurred by a corporation in connection with the redemption of its stock."[41]

Congress enacted § 162(k) to address the deductibility of "greenmail" payments.[42] "Greenmail" payments are payments that a corporation makes to repurchase its stock from shareholders intent on a hostile takeover of the repurchasing corporation.[43] A corporation's payment for repurchase or redemption of its own stock had long been viewed as a capital expense with the consequence that both the repurchase payments and the legal, brokerage, and accounting fees incurred incident to the transaction could not be deducted.[44] However, during the

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1942) (per curiam) (finding that commissions paid during the taxable year which represented the cost to petitioner of securing two long-term loans were not deductible in full in the year when paid but should be spread ratably over the period of the loans). *See also* Anover Realty Corp. v. Comm'r, 33 T.C. 671, 675 (1960) (determining that it is proper for a taxpayer to amortize the expenses it incurred in securing the mortgage loans over the life of the loans).

37. *See, e.g.*, Rev. Rul. 86-67, 1986-1 C.B. 238 (expenses incurred to obtain a loan are capital expenditures that must be amortized over the period of the loan).

38. *See* Glenn N. Goergen & Gus H. Vlahadamis, *Taxability of Fees in Financing a Stock Redemption*, THE TAX ADVISER, March 1993, at 74. *See supra* note 2 for the text of I.R.C. § 162(a).

39. *See* Goergen & Vlahadamis, *supra* note 38, at 74.

40. Lee A. Sheppard, *The Tax Treatment of LBO Fees*, TAX NOTES TODAY, Sept. 20, 1994, *available in* LEXIS, Fedtax Library, TNT File, at 94 TNT 185-5.

41. I.R.C. § 162(k). *See supra* note 4 for the text of I.R.C. § 162(k).

42. *See* S. REP. NO. 313, 99th Cong., 2d Sess. 223 (1986). The Senate Committee Report provides the following as the reason for enacting I.R.C. § 162(k):

> The [Senate] [C]ommittee understands that some corporate taxpayers are taking the [erroneous] position that expenditures incurred to repurchase stock from stockholders to prevent a hostile takeover of the corporation by such shareholders - so-called "greenmail" payments - are deductible business expenses.

S. REP. NO. 313, 99th Cong., 2d Sess. 223 (1986).

43. *See* BLACK'S LAW DICTIONARY 485 (6th ed. 1991).

44. Elliot Pisem, *Courts Split on Deductibility of Loan Fees*, N.Y.L.J., Sept. 1,

corporate takeover frenzy of the 1980s, corporate taxpayers relied upon *Five Star Manufacturing Co. v. Commissioner*[45] as authority to justify deduction of such stock repurchase or "greenmail" payments.[46] Consequently, Congress added a new provision, subsection (k) of § 162 of the Internal Revenue Code, to provide an explicit rule prohibiting deduction of "greenmail" payments, thereby reversing the effect of *Five Star*.[47]

However, the language and legislative history of § 162(k) indicate that the statute may transcend simple clarification of the law concerning "greenmail" payments.[48] Congress' use of the words "otherwise allowable"[49] to describe the deductions to which § 162(k) applies may suggest intent to cut off previously permissible deductions.[50] In other words, deductions that had previously been allowable in other contexts would no longer be allowable in the context of a stock redemption under § 162(k).[51] In addition, the Senate Committee Report, which the Conference Committee Report generally follows, states that § 162(k) is not limited to hostile takeover situations, but applies to any corporate stock redemption.[52] Notwithstanding

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1994, at 5 (citing STAFF OF THE JOINT COMMITTEE ON TAXATION, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 277 (1987)).

45. Five Star Mfg. Co. v. Comm'r, 355 F.2d 724 (5th Cir. 1966). In *Five Star*, the court held that a corporation could deduct as ordinary and necessary business expenses funds paid to redeem stock where such redemption was necessary for the survival of the corporation. *See* In re Kroy (Europe) Limited, 27 F.3d 367, 370 (9th Cir. 1994) (citing *Five Star*, 355 F.2d at 727).

46. *See* Pisem, *supra* note 44, at 5.

47. *See id.*

48. Fort Howard Corp. v. Comm'r, No. 6362-92, 1994 U.S. Tax Ct. LEXIS 63, at *26 (T.C. Aug. 24, 1994).

49. I.R.C. § 162(k) provides in pertinent part: "no deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred by a corporation in connection with the redemption of its stock." I.R.C. § 162(k).

50. *See* Sheppard, *supra* note 40, at 94 TNT 185-5.

51. *See id.*

52. *See* S. REP. NO. 313, 99th Cong., 2nd Sess. 223 (1986). The Senate Committee Report provides guidance as to the scope of Congress' intended application of I.R.C. § 162(k):

> The committee wishes to provide expressly that all expenditures by a corporation incurred in purchasing its own stock, whether representing direct consideration for the stock, a premium payment above the apparent stock value, or costs incident to the purchase, are nonamortizable capital expenditures. . . .
>
> This provision is not limited to hostile takeover

the Senate Committee Report, the intended scope of § 162(k) remains uncertain because the Conference Committee Report does not contain this statement.[53] Thus, the consequence of the statute's language and legislative history may be that § 162(k) is more than a mere clarification of the law concerning the deductibility of "greenmail" payments.[54] Section 162(k) may, in a broad and sweeping manner, have been intended to prevent the deduction of any redemption-related expenses.[55]

The United States Tax Court, in *Fort Howard Corp. v. Commissioner*,[56] considered whether § 162(k) precludes a corporate taxpayer from amortizing and deducting the costs and fees which were paid to obtain debt capital used in an LBO.[57] The tax court held that § 162(k) is applicable in these circumstances and that amortization and deduction of the costs and fees are, thus, precluded.[58] The tax court found that the language[59] and legislative history[60] of § 162(k) support a broad

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> situations, but applies to any corporate stock redemption. The committee intends that amounts subject to this provision will include amounts paid to repurchase stock, premiums paid for the stock, legal, accounting, brokerage, transfer agent, appraisal and similar fees incurred in connection with the repurchase and any other expenditure that is necessary or incident to the repurchase. . . .

S. REP. NO. 313, 99th Cong., 2nd Sess. 223 (1986).

53. *See, e.g.*, In re Kroy (Europe) Limited, 27 F.3d 367, 370 (9th Cir. 1994) (finding that § 162(k) is a codification and clarification of existing law concerning "greenmail" payments, although the court did not use the term "greenmail."). *But see* Fort Howard Corp., 1994 U.S. Tax Ct. LEXIS 63, at *26-*27 (stating that § 162(k) is more than a mere clarification of the law concerning "greenmail" payments and that § 162(k) overrides existing law where costs associated with any stock redemption are concerned).

54. *See* Sheppard, *supra* note 40, at 94 TNT 185-5.

55. *See id.*

56. Fort Howard Corp. v. Comm'r, No. 6362-92, 1994 U.S. Tax Ct. LEXIS 63 (T.C. Aug. 24, 1994).

57. *Id.* at *14. In *Fort Howard Corp.*, the corporate taxpayer, Fort Howard Corp., incurred expenses in obtaining loans to finance the repurchase of its stock in a leveraged buyout transaction. *See id.* at *11-*12. The corporate taxpayer amortized and deducted these expenditures on its 1988 income tax return. *See id.* at *12. The IRS disallowed these deductions on the ground that § 162(k) precludes such deductions. *See id.* at *2.

58. *See Fort Howard Corp.*, 1994 U.S. Tax. Ct. LEXIS 63, at *19.

59. The tax court reasoned that the words in a revenue act should be interpreted in their ordinary, everyday sense. *Id.* at *16. It noted that the phrase "in connection with" has been interpreted broadly and means "associated with, or related." *See id.* at *16-*17. Further, the tax court reasoned that events or ele-

interpretation of the statute and require its application to the fees paid to obtain debt capital for an LBO.[61]

IV. THE COURT'S ANALYSIS

In *In re Kroy (Europe) Limited,*[62] the Ninth Circuit first determined that § 162(k) of the Internal Revenue Code[63] did not apply to and, thus, would not preclude deduction of the loan fees.[64] Subsequently, the court made its determination that the loan fees could be amortized and deducted as ordinary and necessary business expenses under § 162(a) of the Internal Revenue Code.[65]

A. SECTION 162(K) DOES NOT PRECLUDE AMORTIZATION OF THE LOAN FEES

The court set the groundwork for its analysis by first addressing whether § 162(k) of the Internal Revenue Code precludes amortization and deduction of the loan fees in view of the fact that Kroy procured and used the loan to redeem its stock.[66]

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ments are "connected" when they are "logically related." *Id.* at *17. As a factual matter, the court found that Fort Howard Corp. used the debt capital obtained via the expenditures in question to finance the redemption. *Id.* The court, accordingly, concluded that there was a clear, logical relation between Fort Howard Corp.'s stock redemption, the corresponding need for financing, and the costs incurred to obtain that financing. *Id.* Thus, the tax court determined that the loan fees were incurred "in connection with" the stock redemption with the consequence that their deduction is precluded under § 162(k). *See id.* at *19.

60. The tax court cited the Conference Committee Report which provides in pertinent part: "the phrase 'in connection with a redemption' is intended to be construed broadly. . . ." *Id.* at *20 (citing H.R. CONF. REP. NO. 841, 99th Cong., 2d Sess. 168 (1986)).

61. *See Fort Howard Corp.*, 1994 U.S. Tax Ct. LEXIS 63, at *19.

62. In re Kroy (Europe) Limited, 27 F.3d 367 (9th Cir. 1994).

63. *See supra* note 4 for the text of I.R.C. § 162(k).

64. *See Kroy*, 27 F.3d at 370.

65. *See id. See supra* note 2 for the text of I.R.C. § 162(a).

66. *See* In re Kroy (Europe) Limited, 27 F.3d 367, 369 (9th Cir. 1994).

1. *Narrow Interpretation of § 162(k): Plain Meaning of § 162(k) Is Not Conclusive As To Its Application to the Loan Fees*

The Ninth Circuit first considered whether the plain meaning of § 162(k) of the Internal Revenue Code necessarily includes the loan fees because they stem from borrowings used to finance a share repurchase program.[67] The court found the statute's plain meaning to be inconclusive as to whether Kroy's loan fees are to be considered as incurred "in connection with" the stock redemption.[68]

After making the threshold determination that the plain meaning of § 162(k) does not require application of the statute to Kroy's loan fees, the Ninth Circuit considered two additional arguments made by the government which related to interpretation of the statute.[69] First, the court rejected the government's suggestion that the words "otherwise allowable,"[70] which Congress used to describe the deductions to which the statute applies, indicate that deductions which were allowable in other contexts are no longer allowable in the context of a stock redemption.[71] The Ninth Circuit dismissed this argument by reasoning that before § 162(k) can be applied, the court, nevertheless, must determine whether or not an expen-

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67. *See Kroy*, 27 F.3d at 368-69.

68. *See id.* at 369. The court rejected the government's principal contention that § 162(k) is to be interpreted to include the loan fees. *See id.* It found that this interpretation of § 162(k) requires that the business purpose for the use of the borrowed funds be ascertained to determine deductibility. *Id.* The court noted that under the government's theory, if the business purpose for borrowing the funds is to redeem stock, then the loan fees are not deductible. *Id.* However, if the funds are borrowed for some other business purpose, then the identical loan fees may be deductible. *Id.* The court concluded that this is the uncertainty which the Supreme Court rejected in *Woodward v. Commissioner* and *United States v. Gilmore*. *Id.* *See infra* notes 80, 84 and accompanying text for a discussion of *Woodward* and *Gilmore*. Further, the court found an expansive reading of § 162(k) unnecessary because it reasoned the statute to be a codification and clarification of existing law specifically concerning the treatment of funds paid to redeem stock in order to avoid a hostile takeover. *See Kroy*, 27 F.3d at 370. Accordingly, the court dismissed the government's argument that the plain meaning of the phrase "in connection with" the stock redemption necessarily includes the loan fees. *See id.* at 369.

69. *See id.* at 369 n.3.

70. *See supra* note 4 for the text of I.R.C. § 162(k).

71. *See Kroy*, 27 F.3d at 369 n.3.

diture was incurred "in connection with" a stock redemption.[72]

The government's second argument, which related to statutory interpretation, concerned the exception under § 162(k) which permits the deduction of interest expense[73] incurred in connection with a stock redemption.[74] The government suggested that the existence of this exception raised an inference that other loan-related costs, such as loan fees, could not be deducted.[75] The court refused to draw this inference.[76] The court reasoned that Congress did not need to specifically include an exception for expenditures such as loan fees because these expenditures had been deductible for many years.[77] An exception for loan fees would only be required if the loan fees were incurred "in connection with" a stock redemption.[78]

After the court concluded that a literal construction of § 162(k) failed to provide guidance as to whether the loan fees were incurred "in connection with" the stock redemption, it confronted the issue of determining which test to apply.[79]

2. *Selection of the Origin of the Claim Test to Determine Whether or Not the Loan Fees Were Incurred In Connection With the Stock Redemption*

The court concluded that the "origin of the claim" test established by the United States Supreme Court in *United States v. Gilmore*[80] was the proper legal inquiry for determin-

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72. *See id.*

73. *See supra* note 4 for the text of I.R.C. § 162(k).

74. *See Kroy*, 27 F.3d at 369 n.3.

75. *See id.*

76. *See id.*

77. *See id.*

78. *See Kroy*, 27 F.3d at 369 n.3. The court concluded that the interest exception was included in § 162(k) to provide deductibility in the situation where a corporation pays interest on a promissory note issued to a shareholder whose stock was repurchased. *Id.* Absent the exception, § 162(k) would preclude deduction of such interest expense. *Id.*

79. *See id.* at 369.

80. United States v. Gilmore, 372 U.S. 39 (1963). In *Gilmore*, the issue was whether litigation expenses incurred by the husband in divorce proceedings were deductible as a business expense, rather than nondeductible as a personal expense. *See id.* at 40. The husband argued that the litigation expenses were incurred to resist the wife's claim to his assets which included controlling stock interests in

ing whether or not the loan fees were incurred "in connection with" the stock redemption[81] within the meaning of § 162(k).[82] Under the "origin of the claim" test, a court examines the origin and character of the taxpayer's expenditure, but does not consider the taxpayer's motives or purposes in incurring the expenditure.[83] The Ninth Circuit adopted this approach on the ground that the Supreme Court has relied on this test to determine the nature and, thus, the deductibility of taxpayer expenditures.[84] Moreover, the court noted that the

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three General Motors automobile dealerships. *See id.* at 40-41. The husband was the president and principal managing officer of the three dealerships. *See id.* at 41. The Supreme Court held that the "origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal' and, hence, whether it is deductible or not. . . ." *Gilmore*, 372 U.S. at 49. Consequently, the court found that the origin of the husband's expenditures was in the divorce proceedings and, therefore, the expenditures were personal and nondeductible even though they had been incurred for a business purpose. *Kroy*, 27 F.3d at 370 (citing *Gilmore*, 372 U.S. at 51-52).

81. *Contra* Fort Howard Corp. v. Comm'r, No. 6362-92, 1994 U.S. Tax Ct. LEXIS 63, at *33-*40 (T.C. Aug. 24, 1994) (reasoning that the appropriate test for determining applicability of § 162(k) to the loan fees is found in the language of the statute itself and that application of the origin of the claim test is unnecessary).

82. *See Kroy*, 27 F.3d at 369.

83. *See Gilmore*, 372 U.S. at 49.

84. *See Kroy*, 27 F.3d at 369-70 (citing *Gilmore*, 372 U.S. at 49; Woodward v. Comm'r, 397 U.S. 572, 578 (1970)). The origin of the claim test was used to characterize an expenditure as either business or personal in *Gilmore* and to determine whether taxpayer expenditures were deductible business expenses or nondeductible capital expenditures in *Woodward*. *See Kroy*, 27 F.3d at 369-70. In *Woodward*, the taxpayers were majority stockholders of an Iowa corporation who had voted in favor of a perpetual extension of the corporate charter and had, consequently, incurred the obligation to purchase stock owned by dissenting shareholders at its real value. *See Woodward*, 397 U.S. at 573. As the two parties could not agree on the real value of the stock, appraisal litigation ensued in which the taxpayers incurred $25,000 in expenses. *See id.* at 573-74. The taxpayers deducted these expenses as ordinary and necessary business expenses on their federal income tax returns. *See id.* at 574. The Internal Revenue Service disallowed the deduction because the fees "represented capital expenditures incurred in connection with the acquisition of capital stock of a corporation." *Id.* The Supreme Court found that the proper inquiry for determining whether the fees were deductible business expenses or nondeductible capital expenditures was the "origin of the claim" test. *See id.* at 578. Significantly, the Court rejected the "primary purpose" test which required examining the business purpose for which the expenditure was incurred. *See Woodward*, 397 U.S. at 577. The Supreme Court noted that the "primary purpose" test was "uncertain and difficult" and that a test based upon the taxpayer's purpose for the expenditure would encourage resort to "formalisms and artificial distinctions." *See Kroy*, 27 F.3d at 370 (citing *Woodward*, 397 U.S. at 577). Accordingly, the Supreme Court applied the "origin of the claim" test and

"origin of the claim" test and § 162(k), when interpreted narrowly, yield consistent results.[85] Expenditures which have their "origin" in a stock redemption transaction are nondeductible, while those expenditures having their "origin" in a separate, although related, transaction remain deductible as ordinary and necessary business expenses under § 162(a).[86]

3. *Application of the Origin of the Claim Test to the Loan Fees*

The Ninth Circuit applied the "origin of the claim" test to Kroy's loan fees and found that the origin of Kroy's liability for the loan fees was the borrowing transaction and not the stock redemption transaction.[87] For federal income tax purposes, the court reasoned that the stock redemption was a transaction separate and distinct from the borrowing transaction.[88] The court found that the loan fees were incurred as compensation for services provided to Kroy by its investment banker and lenders in the loan transaction.[89] Thus, the Ninth Circuit held that § 162(k) does not apply as the loan fees were not incurred "in connection with" the stock redemption.[90]

B. LOAN FEES ARE AMORTIZABLE AND DEDUCTIBLE BUSINESS EXPENSE UNDER § 162(A)

The court subsequently considered whether the loan fees could be amortized and deducted under § 162(a) of the Internal Revenue Code.[91] The courts and the IRS have traditionally

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concluded that the fees were properly treated as part of the cost of the stock and were nondeductible capital expenditures. *See Woodward*, 397 U.S. at 579. The origin of the claim was the acquisition of the capital stock. *See id.* The fees were incurred in establishing a purchase price which is clearly part of the acquisition process. *See id.*

85. *See Kroy*, 27 F.3d at 369.

86. *See id.*

87. *See* In re Kroy (Europe) Limited, 27 F.3d 367, 369 (9th Cir. 1994).

88. *See id.* at 370.

89. *Id.*

90. *See id.*

91. *See* In re Kroy (Europe) Limited, 27 F.3d 367, 368 (9th Cir. 1994). The government did not argue that a corporation could not amortize and deduct under § 162(a) expenses which it incurred to borrow funds for purposes not covered by § 162(k). *See id.*

treated loan fees as amortizable over the life of the related loan.[92] Because the loan fees at issue were incurred as compensation for services provided to Kroy by its investment banker and lenders in connection with securing a loan, the court found that the loan fees could be amortized and deducted as ordinary and necessary business expenses under § 162(a) of the Internal Revenue Code.[93]

V. CRITIQUE

Stripped of all nuance, the opinions of the Ninth Circuit and the United States Tax Court disagree over how broadly the words "in connection with a redemption"[94] are to be interpreted.[95] The Ninth Circuit view in *In re Kroy (Europe) Limited*[96] was that § 162(k)[97] does not reach loan fees incurred in financing a stock redemption, whereas, the tax court view in *Fort Howard Corp. v. Commissioner*[98] was that the statute should be read broadly to encompass all expenses with a nexus to the redemption transaction.[99]

Commentators[100] have suggested that § 162(k) is not to be reduced, as the Ninth Circuit and the tax court have done,

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92. *See* Glenn N. Goergen & Gus H. Vlahadamis, *Taxability of Fees in Financing a Stock Redemption*, THE TAX ADVISER, March 1993, at 74. *See supra* notes 36-38, and *infra* note 104, and accompanying text for a discussion of the treatment of loan fees by the courts and the IRS.

93. *See Kroy*, 27 F.3d at 370.

94. *See supra* note 4 for the text of I.R.C. § 162(k).

95. Richard W. Bailine and Christine W. Booth, *Kroy: 'Bungling' Ninth Circuit Still Got It Right*, TAX NOTES TODAY, Nov. 2, 1994, *available in* LEXIS, Fedtax Library, TNT File, at 94 TNT 215-62.

96. In re Kroy (Europe) Limited, 27 F.3d 367 (9th Cir. 1994).

97. *See supra* note 4 for the text of I.R.C. § 162(k).

98. Fort Howard Corp v. Comm'r, No. 6362-92, 1994 U.S. Tax Ct. LEXIS 63 (T.C. Aug. 24, 1994). *See supra* notes 56-61 and accompanying text for a discussion of *Fort Howard Corp. v. Comm'r.*

99. *See* Bailine & Booth, *supra* note 95, at 94 TNT 215-62.

100. *See, e.g.,* Bailine & Booth, *supra* note 95, at 94 TNT 215-62 (recognizing that the crucial preliminary inquiry under § 162(k) is whether the expenses at issue are "deductions otherwise allowable"). *See also* Lee A. Sheppard, *The Tax Treatment of LBO Fees*, TAX NOTES TODAY, Sept. 20, 1994, *available in* LEXIS, Fedtax Library, TNT File, at 94 TNT 185-5 (stating that the words "in connection with a stock redemption" used in § 162(k) are important, but the words "no deduction otherwise allowable under this chapter shall be allowed" may be more important).

to the five words "in connection with a redemption" when determining whether or not the statute applies to an expenditure.[101] A faithful reading of the statute would include the crucial preliminary inquiry of whether the expenses at issue are "deduction[s] otherwise allowable."[102] In other words, no inquiry about whether a particular expense was incurred "in connection with a redemption" can be undertaken until it is first determined that the expense at issue is an "otherwise allowable deduction."[103]

Application of this two-step inquiry to determine if § 162(k) applies to and, thus, precludes deduction of Kroy's loan fees yields the following result. If an expense is a loan fee, it will be a "deduction otherwise allowable" because of long-standing precedent which permits amortization deductions for loan fees over the lives of the related loans.[104] Consequently, the loan fees will next be subject to the "in connection with a redemption" inquiry.[105] However, if the expense is a loan fee, then it must have been incurred in connection with a loan, and not "in connection with a redemption."[106] Therefore, although the loan fee will be within the universe of expenses to which § 162(k) applies (it is a "deduction otherwise allowable"), it will not be affected by the proscriptive language of the statute because it is not "in connection with a redemption."[107] Consequently, § 162(k) does not preclude Kroy from amortizing and deducting the loan fees.[108]

On the other hand, an expense that is a redemption expense will be treated differently under § 162(k). Redemption expenses are not, and never have been, "deductions otherwise

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101. *See* Bailine & Booth, *supra* note 95, at 94 TNT 215-62.

102. *See id.*

103. *Id.*

104. *See id. See, e.g.,* Cagle v. Comm'r, 539 F.2d 409, 416 (5th Cir. 1976) (stating that the costs of obtaining a loan are capital expenditures which should be capitalized and deducted pro rata over the life of the loan); Enoch v. Comm'r, 57 T.C. 781, 794-795 (1972) (finding that a loan fee is compensation for services rendered in obtaining a loan and that a loan fee is a capital expenditure amortizable over the life of the loan).

105. *See* Bailine & Booth, *supra* note 95, at 94 TNT 215-62.

106. *Id.*

107. *Id.*

108. *See id.*

allowable."[109] Thus, for redemption expenses, the proscriptive language of § 162(k) would never come into play and redemption expenses would continue to be treated as non-deductible capital expenditures.[110]

Application of § 162(k) in this two-step manner to expenditures in question yields sensible results. It does not alter the practice of permitting the amortization of loan fees over the lives of the related loans.[111] Nor does it affect the long-standing custom of treating redemption expenses as non-deductible capital expenditures.[112] Moreover, § 162(k) viewed in this manner does achieve its principal legislative goal of clarifying the treatment of "greenmail" payments.[113] Section 162(k) removes any doubt about the possible validity of *Five Star Manufacturing v. Commissioner*[114] as support for deducting "greenmail" payments.[115]

Even though the Ninth Circuit correctly held that § 162(k) did not apply to Kroy's loan fees and, thus, would not preclude their deduction under § 162(a), a more satisfying analysis would have included consideration of the important initial text of § 162(k) which contains the words "deductions otherwise allowable."[116] By failing to consider these words, the court missed an opportunity to provide a sound analytical framework for courts deciding questions arising under § 162(k).

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109. *Id.* (citing Five Star Mfg. v. Comm'r, 355 F.2d 724 (5th Cir. 1966) as a single exception). The general rule governing share repurchases and associated legal, accounting, and banking costs is that such expenditures are to be capitalized. *See* Sheppard, *supra* note 100, at 94 TNT 185-5.

110. *See* Bailine & Booth, *supra* note 95, at 94 TNT 215-62.

111. *See id.*

112. *See id.*

113. *See id.*

114. Five Star Mfg. v. Comm'r, 355 F.2d 724 (5th Cir. 1966). *See supra* note 45 and accompanying text for a discussion of *Five Star*.

115. Bailine & Booth, *supra* note 95, at 94 TNT 215-62. Enactment of § 162(k) by Congress took an expense (a "greenmail" payment) that arguably, under *Five Star*, had become an "allowable" deduction and returned it to its historical status, a non-deductible capital expenditure. *See id.* Under the initial inquiry, "greenmail" payments, perhaps, had become "deductions otherwise allowable" on the authority of *Five Star*. *See id.* However, under the second step of the inquiry, the proscriptive language of § 162(k) would preclude deduction of "greenmail" payments because they were clearly made "in connection with a redemption." *See id.*

116. *See* Bailine & Booth, *supra* note 95, at 94 TNT 215-62.

VI. CONCLUSION

The Ninth Circuit held that a corporation could deduct fees which it incurred in obtaining debt capital used to redeem stock even though § 162(k) disallows deduction of any expenses incurred "in connection with" a stock redemption.[117] The court reasoned that the fees were incurred in a separate borrowing transaction which was not "in connection with" the stock redemption and, thus, allowed amortization and deduction of the loan fees as ordinary and necessary business expenses under § 162(a).[118]

So far, the Ninth Circuit is the only United States Circuit Court of Appeals to decide whether § 162(k) applies to fees incurred in obtaining loans to finance a stock redemption.[119] However, this could change. Fort Howard Corp. intends to appeal the United States Tax Court decision in *Fort Howard Corp. v. Commissioner*[120] to the Seventh Circuit.[121] If the Seventh Circuit were to affirm the tax court decision, a conflict between the Ninth Circuit and the Seventh Circuit would result, leaving the question to be resolved by the United States Supreme Court.[122]

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117. In re Kroy (Europe) Limited, 27 F.3d 367, 370 (9th Cir. 1994).

118. *See id.*

119. *See* Claudia MacLachlan, *Conflict Emerges In Rulings On Fee Deductions; The Supreme Court May Have to Settle a Split Over Deducting Fees Paid In LBO Financings*, NAT'L L.J., Sept. 12, 1994, at A7.

120. Fort Howard Corp. v. Comm'r, No. 6362-92, 1994 U.S. Tax Ct. LEXIS 63 (T.C. Aug. 24, 1994).

121. MacLachlan, *supra* note 119, at A7. *See supra* notes 56-61 and accompanying text for a discussion of *Fort Howard Corp. v. Comm'r.*

122. *See* MacLachlan, *supra* note 119, at A7.

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