IRS Makes Changes to Regs on Retroactive Intangibles Amortization Election

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In March of 1994, the IRS published guidance concerning the time and manner of making retroactive elections to apply the intangibles amortization rules under Section 197. (T.D. 8528; See Wood, "Making the Section 197 Intangibles Election," Vol. 2, No. 9 *M&A Tax Rep't* (April 1994), p. 1.) The election to apply Section 197 retroactively can apply to property that was acquired after July 25, 1991 and on or before August 10, 1993. In response to comments on those rules, the Service has now announced, in Notice 94-40, modifications to those rules that will be incorporated into the final regulations under Section 197.

While there is a notification requirement as part of the election procedure, commentators queried whether an electing common parent of a consolidated group would have to notify each member of the consolidated group, and whether an electing brother corporation must notify each member of a consolidated group of which its sister corporation is the common parent. Here, the Notice provides no relief. Consequently, a taxpayer that makes the retroactive election (or shareholders that make the election on behalf of a foreign corporation) must provide written notification of the retroactive election (on or before the election date) to each taxpayer that is under common control with the electing taxpayer. See Reg. Section 1.197-1T(c)(6)(i). Thus, the Service answers this concern by making this notice requirement explicit, justifying it by pointing out that the notification is necessary to ensure that there is consistent application of the retroactive election by taxpayers under common control.

Another concern was the scope of the notification requirement in certain situations in which an electing U.S. person is under common control with a foreign person. Here, the IRS indicated that it would limit the notification in the final regulations. An

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were outstanding. Therefore, they could not be characterized as rent for the use of funds and, in fact, were viewed as fees for services.

Looking Forward

If the Tax Court decision is upheld on appeal (*Fort Howard* is appealable to the Seventh Circuit), a conflict between the Circuit Courts will be created. This sets the stage for a Supreme Court resolution of this issue and suggests that taxpayers will be subject to a period of uncertainty pending the ultimate adjudication of this matter. Further, although these cases each dealt with LBOs, the issue is much broader. In fact, the relevance of the decisions extends to any debt-financed buyback of shares, not merely those associated with LBO-type buybacks. A debt-financed purchase of stock from a retiring shareholder in a family company, for example, could be affected.

There will also be questions of characterization. In both *Kroy* and *Fort Howard*, the taxpayer made arguments about some of the fees really constituting interest. In *Fort Howard*, for example, the taxpayer argued that $26,000,000 of the $40,000,000 paid to Morgan Stanley really represented interest on the bridge loan outstanding for eight days until the permanent LBO financing was put in place. The Tax Court, however, determined that everyone concerned regarded this $26,000,000 (and indeed the entire $40,000,000) as compensation for services, payable up front and contingent only upon completion of the buyout.

Going forward, however, one wonders whether fee arrangements could be carefully structured to achieve a different result. True, in a case such as *Fort Howard*, the amounts that reasonably could be viewed as interest for a short period of time may be small. Nonetheless, this is an avenue that advisers will likely be reviewing in the future. Just as advisers became sensitive to bifurcating fees in the wake

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electing taxpayer is not required to notify a foreign person of the election when, for any tax year beginning in 1990, 1991, 1992 or 1993, all of the following conditions are met: (1) the foreign person has no shareholders or beneficial owners who are U.S. persons; (2) the foreign person is not engaged in a U.S. trade or business; and (3) the taxable income or earnings and profits of the foreign person cannot affect the U.S. tax liability of any U.S. person.

Limited Relief

Perhaps most significantly, Notice 94-40 states that the final regulations will not look too harshly on a taxpayer who fails to satisfy the notification requirements of Section 1.197-1T(c)(6)(i). Any taxpayer, whether foreign or domestic, that fails to give the required notice, or that gives it improperly, will not be considered to have made an *invalid* retroactive Section 197 election if it can be shown to the Service's satisfaction that the failure was due to reasonable cause. While this is hardly a blanket OK for fouling up the retroactive election, it at least imports the plethora of authority from other contexts dealing with what constitutes reasonable cause.

Effective Date

The effective date of the changes announced by Notice 94-90 is March 15, 1994, the date the temporary regulations concerning the retroactive election were originally published in the Federal Register. ■