Legal Fees in an Applicable Asset Acquisition

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Lawyers are obsessed with discussing legal fees, and with good reason. But collecting legal fees and considering their tax treatment are two different things. M&A TAX REPORT readers are well versed in the line between deductible and capitalizable fees, and that issue comes up time and again. Indeed, *see Hither and Yon: Allocating Merger Transaction Costs*, this issue.

Last year, the Tax Court decided *West Covina Motors, Inc.*, 96 TCM 263, Dec. 57,564(M), TC Memo. 2008-237, providing a nice window into the vicissitudes of legal fee deduction disputes. [*See* Wood, *Shouldn't All Legal Fees Be Deductible?*

M&A TAX REP., Feb. 2009, at 4.] In another bite at the apple, the Tax Court has decided a second iteration of *West Covina Motors*, TC Memo. 2009-291. Like its predecessor, this case too provides guidance about legal fees that is worth noting.

Common Facts

West Covina Motors had purchased the assets of Clippinger Chevrolet, an established new car dealership. The legal fees on this acquisition totaled $116,293 in 1999, paid to Clippinger's counsel. Most of these fees were for drafting loan documents and leases related to the seller financing arrangement being used for the assets. West Covina also paid $2,958 to Chrysler Financial and $9,564 to its own law firm (Cooksey Howard).

These fees were for document review and other services related to the inventory financing. West Covina paid $9,550 related to the overall acquisition as well as physical inventory of the vehicles.

All in all, the legal fees on this deal were quite modest. But the legal issues would be the same if millions of dollars were involved.

Obvious Treatment

Legal fees paid to acquire another company have traditionally been required to be capitalized. In the first *West Covina* case, the court ruled that the legal fees here were nondeductible capital expenditures because they were incurred in connection with the purchase of capital assets. The purchase agreement had required West Covina to assume the seller's legal expenses. Complying with the agreement, West Covina had paid over $100,000 in fees to the seller's counsel.

The Tax Court had an easy time concluding that these were capital-related legal fees. However, West Covina had argued that the bulk of the purchase price was related to inventory. Being traceable directly to inventory, they had to be ordinary! Unfortunately, the Tax Court concluded that less than 40 percent of the purchase price was allocable to inventory. Discounting self-serving and uncorroborated testimony, the Tax Court ruled that all of the legal expenses had to be capitalized.

New Stipulations

In the second *West Covina* case, West Covina worked out stipulated facts and accompanying exhibits with the IRS, and went back to Tax Court for a second bite at the acquisition apple. Based on these new documents, the Tax Court ruled that the legal fees paid to Chrysler Financial and Cooksey were attributable to inventory financing. It also found that West Covina paid $6,675 to Rogers Clem for services related to physical inventory of the vehicles.

The Tax Court therefore allowed these legal fees as part of the cost of goods sold. As to the remaining legal fees paid to Rogers Clem, they were not specifically related to inventory. Instead, they had to be amortized over the useful life of the assets to which they related. As to the Hoffman legal fees, they were incurred in furtherance of the seller financing arrangement. That meant they were only related to the assets purchased under the purchase agreement.

Code Sec. 1060

Readers of the M&A TAX REPORT should be no strangers to Code Sec. 1060. An applicable asset acquisition is any direct or indirect transfer of assets constituting a trade or business in which the transferee's basis is determined wholly by reference to the consideration paid for the assets. In general, a written agreement will be binding as to the allocation of the consideration or the fair market value of any of the assets.

However, if the parties do not allocate all of the consideration, the residual method is used to determine both the purchaser's basis in the transferred assets, as well as the seller's gain or loss from that transfer.

For applicable asset acquisitions after January 5, 2000, there are seven classes of assets:

- Class I (cash and cash equivalents)
- Class II (actively traded personal property)
- Class III (certain mark-to-market assets and debt instruments)
- Class IV (stock in trade and inventory)
- Class V (all assets not in any other class)
- Class VI (all Code Sec. 197 intangibles except goodwill or going-concern value)
- Class VII (goodwill and going-concern value)

Fair-Market Values

As one might expect, there is an overall fair-market value limitation. The amount of consideration allocated to an asset (except for Class VII assets) cannot exceed the fair market value of that asset on the beginning of the date

after purchase date. Any residual consideration not allocated to other assets must be allocated to Class VII assets.

Interestingly, the Tax Court concluded in the second *West Covina* case that legal fees did not have to be allocated under Code Sec. 1060. Instead, the legal fees were to be allocated proportionately to the assets with which they were associated. The IRS had argued that West Covina's cost basis (including legal fees paid to third parties) had to be allocated under the fair-market value of limitations of Code Sec.1060.

The Tax Court rejected this notion. After all, the Tax Court said, the parties had *stipulated* the cost of each asset. Code Sec. 1060 was designed to prevent abuses in the absence of an agreement between the parties. The residual allocation method prevents parties from taking inconsistent positions for individual tax advantages. Stipulated provisions, however, took care of that problem.

As a result, the Tax Court took the legal fees paid to Hoffman and allocated them *pro rata* among the assets that were acquired (4.1 percent to fixed assets, 57.9 percent to goodwill and 38 percent to used vehicles and parts). The balance of the legal fees paid to Rogers Clem was allocated proportionately among all assets purchased (2.03 percent to fixed assets, 28.44 percent to goodwill, 18.69 percent to used vehicles and parts and 50.84 percent to new and demonstrator vehicles).

Dividing the Spoils

Detailed bills go a long way toward helping to categorize the bills into different asset classes. One of the earliest and most persistent of the lessons of *INDOPCO* was to bifurcate fees and to allocate them appropriately. Documentary evidence, checks, bills, pleadings, correspondence, declarations and so on should go a long way toward trying to maximize the advantages you gain from legal bills. And the sooner you do such allocations, the better.

Try not to wait until you are on the Tax Court steps, particularly for the second time.