When Deductible Fees Become Capital Contributions

By Robert W. Wood • Wood & Porter • San Francisco

With the current prevalence of flow-through entities, acquisitions are often accomplished by and through LLCs and partnerships. Take the case of *Canterbury Holdings LLC,* 98 TCM 60, Dec. 57,894(M), TC Memo. 2009-175 (2009). It represents a useful reminder of the ubiquitous nature of flow-through entities. It is also a reminder that a business name does not a business make.

Canterbury was an investment firm that sought to acquire LWR, an apparel company in New Zealand. Canterbury first formed a New Zealand corporation ("Holdings") as a subsidiary. Canterbury reached an agreement with BIL, which held two-thirds of LWR's stock. Canterbury acquired the rest of LWR's stock on the New Zealand Stock Exchange. At the time Holdings had acquired two-thirds of the LWR shares, it held an option to purchase the remainder.

Understandably, the partners of Canterbury wanted to ensure a smooth transition in LWR's operations. Accordingly, Holdings signed an agreement with BIL to share LWR management with BIL until Holdings was firmly in control. The idea was that LWR would pay for BIL's management services. Holdings guaranteed LWR's obligation to BIL.

Still, with Canterbury's capital all spent on acquiring the stock of LWR, it was Canterbury's partners who were actually guaranteeing LWR's obligation. In effect, the Canterbury members promised to pay the management fees to BIL, by promising to inject capital into Holdings if necessary to complete the deal. Although Holdings owed BIL the management fees, Canterbury itself actually paid the fees to BIL directly.

Eventually, Holdings exercised its option and acquired the remaining BIL shares. Canterbury claimed what it thought were ordinary and necessary business expense deductions for management fees and interest, which the

IRS disallowed. In Tax Court, the Tax Court had little difficulty finding the fees to be nondeductible capital contributions.

Canterbury's payment of the fees, the Tax Court found, primarily enhanced the value of its indirect investment in LWR. When Canterbury made the payment, Holdings already had a 34-percent interest in LWR from the tender offer. Clearly, Holdings wanted to complete the acquisition. The payments were directly tied to the purchase of the LWR shares, which the Tax Court found to be a separate and distinct asset.

The court rejected the argument that these management fees were ordinary and necessary expenses of Canterbury's *own* trade or business. After all, Canterbury itself didn't directly benefit from BIL's management of LWR, the court found. Although it was true that LWR received services, the court found Canterbury benefited only indirectly. An indirect benefit could be found in the fact that the services presumably improved LWR's value, increasing the value of CNZ's LWR stock and option to buy.

Whose Expense?

Canterbury argued that some cases have allowed a deduction to an owner of a business who pays his company's expenses. The Tax Court, however, found these cases inapposite. In such cases, the owner himself typically has an independent operating business or a high-profile reputation requiring the goodwill of the public to sustain sales. In this case, the Tax Court found that Canterbury's ability to otherwise promote its own business (wholly apart from that of its subsidiary, Holdings) didn't measure up.

During the years in question, the court found that Canterbury itself had no actual business itself apart from acquiring and managing Holdings. It didn't have an operating business, credit standing or a pre-existing reputation to maintain. The desire by Canterbury to build a future reputation was hardly sufficient grounds to support a current deduction based on protecting and promoting its own trade or business.

The court similarly rejected Canterbury's argument that Holdings was merely its agent or nominee, whose separate business and existence could be ignored. Holdings was hardly a passive dummy without any business purpose, said the court.

Yours or Mine?

We all know, of course, that voluntary contributions by a shareholder for any corporate purpose are nondeductible capital expenditures. [*See* Reg. §1.263(a)-2(f).] Nevertheless, sometimes a shareholder will be successful, arguing that he is allowed deductions for ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business. Yet the shareholder must show that his purpose was to protect or promote his *own* business, and that the expenses paid were ordinary and necessary to that business.

One of the classic cases on this point is *J.L. Lohrke*, 48 TC 679, Dec. 28,570 (1967). Mr. Lohrke received significant royalty income from licensing a patent on a process used in the synthetic fiber industry. He also had a significant interest as a shareholder in a company that used this process. The company made a shipment of defective fiber, and Mr. Lohrke graciously agreed to assume personally any loss to the buyer resulting from the bad shipment. Lohrke later sent his personal check for $30,000 to cover the loss.

Although we today may regard Mr. Lohrke's actions as both honorable and full of business savvy, the IRS didn't think so. The IRS denied Lohrke's deduction for the payment, asserting that it was not his business, and therefore a deduction was simply unavailable. The Tax Court went through considerable factual twists and turns concerning the history of the textile industry, particular products and Mr. Lohrke's own considerable history in it.

Lohrke had consistently received quite significant royalty income. In fact, his royalty income averaged more than several hundred thousand dollars a year. Although the Tax Court didn't put it quite this way, the illustrious and successful history of Lohrke as an inventor and patent-holder in the textile field made it clear that the $30,000 was quite a small portion of the quite substantial monies Lohrke had been receiving.

The Tax Court framed the question as "whether one person can deduct the expenses of another person."

Good Neighbor?

Lohrke argued that he made the payment in order to protect and further his trade or business of licensing the use of the patent. Accordingly, he argued, the $30,000 payment was an ordinary and necessary expense of that business, deductible by him. The Tax Court reviewed a brace of authorities.

Indeed, to anyone facing this issue, the *Lohrke* decision contains a helpful who's-who of the case law in this area. Ultimately, although the IRS was arguing that Lohrke was endeavoring to disregard the corporate entity (nonsense, said the Tax Court), the Tax Court sided with Lohrke. The Tax Court summarized a lengthy opinion with a common sense notion that it found Lohrke's primary motive in making the payment was the protection of his licensing business.

That business, after all, was providing him with quite substantial income. The Tax Court believed Lohrke when he said he needed to protect it. Interestingly, the flipside of this analysis was that the arguably "proper" taxpayer here (the textile company that had shipped the defective merchandise) was not making money and was in need of additional capital. It is unclear exactly how this second line of analysis stands up to the primary one (the notion that Lohrke made the payment with respect to his *own* trade or business). In Lohrke's case, he achieved victory on both these points.

This question of whether the right taxpayer is paying, or whether whoever pays can legitimately claim the most advantageous tax result, actually comes up less frequently than readers might expect. One recurring setting where it does arise with some frequency, though, is with litigation settlements. See cases collected in Robert W. Wood, TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS (Tax Institute 4th ed. 2009). Fortunately, the IRS and the courts have not been too exacting, except perhaps where blatant shareholder/personal benefits are concerned.

Conclusion

The identity of the payor is important, and it's not easy for a shareholder to succeed with a deduction that in most respects really isn't his. To begin with, though, you need your own trade or business, and your own rationale why the expense in question has an ordinary and necessary connection to it.

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