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Tax Court ruling

Can you deduct a subsidiary's expenses?

In a 2009 decision, the U.S. Tax Court held that a company couldn't deduct expenses it had paid on a subsidiary's behalf, because they weren't ordinary and necessary to *its own* trade or business. The court's opinion in *Canterbury Holdings LLC v. Commissioner* provides a useful guide for distinguishing between deductible expenses and capital contributions.

When business heads south

The facts surrounding *Canterbury* are complex, but a brief summary can illuminate the primary issue. Several partners formed Canterbury, a limited liability company, for the purpose of acquiring and turning around undervalued companies in the sports-apparel industry.

As a general rule, a shareholder that pays a corporation's expenses isn't entitled to a deduction.

To acquire a struggling New Zealand company, LWR Industries, Canterbury formed a New Zealand corporation called Canterbury Holdings (Canterbury NZ) as its wholly owned subsidiary. Canterbury NZ acquired one-third of LWR's shares and an option to acquire the remaining two-thirds from BIL, the target's largest shareholder. Part of



the deal called for Canterbury NZ to pay BIL management fees for managing LWR until the option was exercised. But a dispute arose over the management fees — which Canterbury NZ was unable to pay — and BIL sought to “unhitch itself from LWR.”

The parties negotiated a settlement under which the option price was substantially reduced, and BIL accepted \$4 million as payment in full of its management fees. Even though Canterbury NZ was the entity responsible for the fees, Canterbury paid BIL directly, converted the payments into U.S. dollars and deducted them on its tax returns as a business expense.

Protecting the investment

Under Internal Revenue Code Section 162, companies are permitted to deduct all of the ordinary

and necessary expenses they pay or incur in carrying on a trade or business. As a general rule, a shareholder (including the parent of a subsidiary) that pays a corporation's expenses isn't entitled to a deduction. The shareholder is treated as an investor rather than as being directly engaged in the corporation's trade or business.

In *Canterbury*, the Tax Court found that the corporation's payments on behalf of Canterbury NZ looked like nondeductible loans or capital contributions. But Canterbury invoked an exception to the general rule, which allows a shareholder to deduct expenses paid on behalf of a corporation "if those expenses are also ordinary and necessary to *his own* trade or business."

Canterbury relied on a line of cases that permitted shareholders to deduct corporate expenses they paid to protect or promote their own businesses. In particular, courts in several cases have allowed these deductions when a parent's payment of a subsidiary's expenses helped protect its own business reputation and credit. (See "Investing in reputation" at right.)

Hole in the argument

Canterbury's argument ran into a snag, however. During the years in question, it had "no actual business apart from stitching together a deal for, and then managing, LWR." In fact, the terms of the company's operating agreement restricted its business activities to the investment in LWR. Unlike the parent corporations in cases where similar deductions were allowed, Canterbury had no operating business, credit standing or preexisting reputation to maintain apart from its subsidiary, Canterbury NZ.

The company argued that the deal was an attempt to get its foot in the door and promote its business in New Zealand and that its reputation would have suffered had it not paid the management fees to BIL. But the Tax Court found that the company's "desire to build a future reputation is simply not enough for us to grant its current deductions as 'protecting and promoting its trade or business.'"

Investing in reputation

Several U.S. Tax Court cases support the proposition that a parent company may deduct payments it makes on behalf of a subsidiary as "ordinary and necessary" business expenses if doing so will protect the parent's own reputation and credit and thus promote its own business.

In *Coulter Electronics v. Commissioner*, for example, the court permitted a parent corporation to deduct reimbursements it had made to its wholly owned Canadian subsidiary — Coulter Electronics Canada, or CEC — for the cost of warranty services. The court noted that the parent had carefully built and maintained a reputation for providing excellent service for its products, which favorably affected its sales in Canada. Therefore, "a failure by CEC to provide similar services in Canada would adversely affect [Coulter's] future sales in both Canada and the United States."



The court also rejected Canterbury's argument that Canterbury NZ was simply its nominee or agent. The subsidiary was not a mere "passive dummy," but served a significant business purpose by giving Canterbury's U.S. investors a "New Zealand" presence. The court observed that the only plausible explanation for Canterbury's payment of the management fees (as opposed to further capitalizing its subsidiary so it could meet its obligations) was that Canterbury's owners had more use for the tax deductions than did Canterbury NZ.

Court's conclusions

The Tax Court concluded that the management fees weren't deductible expenses to Canterbury. Rather, they were capital contributions designed to enhance the value of Canterbury's investment in LWR stock and its option to buy the rest. This distinction was relevant because the subsidiary was a foreign corporation, and therefore not part of a consolidated return filing with Canterbury.

A separate issue in the case involved the deductibility of interest payments Canterbury made on a loan from BIL to Canterbury NZ. As with the management fees, the court found that the

interest payments didn't serve to protect Canterbury's own trade or business and, therefore, weren't deductible.

Certain circumstances

Although the taxpayer lost in *Canterbury*, the case supports the notion that a corporation may deduct a subsidiary's expenses under certain circumstances. The Tax Court suggested that the outcome might have been different if Canterbury had operated other businesses whose reputations or credit ratings would have suffered as a result of its failure to cover its subsidiary's obligations. ■

Management buyouts demand board vigilance

Courts often are deferential to directors in cases involving mergers and company sales. But, as a 2009 decision by the Delaware Chancery Court demonstrates, that deference has a limit. *Louisiana Municipal Police Employees' Retirement System v. Fertitta* underscores the need for boards to take an active role in negotiations — particularly when a controlling shareholder is involved.

Buyout gone bad

Fertitta involved Landry's Restaurants, a Houston-based Delaware corporation operating restaurants in 28 states. Landry's CEO, Tilman Fertitta, owned 39% of the company's common stock, and, in January 2008, offered to acquire the remaining stock for \$23.50 per share (representing a 41% premium over the market price). Landry's board formed a special committee of independent directors to evaluate the offer.



In June, the company entered into a cashout merger agreement with an entity Fertitta controlled. The agreement called for a price of \$21 per share and required Fertitta to pay a \$24 million reverse-termination fee if he failed

to close the deal. Fertitta secured a debt commitment from several lenders to finance the buyout.

In September, Hurricane Ike damaged several of Landry's restaurants in the Galveston, Texas, area. Although press releases characterized the damage as minimal, Fertitta told the board that the lenders would likely deem the incident a "material adverse effect" and back out of the deal unless it were renegotiated. This would allow Fertitta to terminate the merger without penalty.

By failing to prevent a creeping takeover the board had breached its duty of loyalty.

The board agreed to lower the acquisition price to \$13.50 per share and to reduce the reverse-termination fee to \$15 million. In exchange, Fertitta and the lenders agreed not to claim a material adverse effect based on events known on the agreement date. Fertitta also obtained the lenders' commitment to refinance the company's existing debt should the deal fail. Meanwhile, he had been engaged in a "creeping takeover" by purchasing shares of Landry's stock in the open market and, by December, he had acquired a 56.7% interest.

After the agreement was signed, the SEC requested certain disclosures about the financing. The lenders inexplicably refused to consent, so the special committee terminated the merger to preserve the lenders' refinancing commitment. This relieved Fertitta from paying the \$15 million reverse-termination fee.

Three strikes

In the ensuing shareholder litigation, the plaintiffs claimed that Fertitta and the directors had breached their fiduciary duties and that the board had committed waste by failing to require Fertitta to pay the reverse-termination fee. The court denied the defendants' motion to dismiss.

Despite a history of showing deference to directors, the *Fertitta* court pointed to three key facts that "make it impossible to dismiss the complaint":

1. Fertitta's negotiation of the refinancing commitment on the company's behalf (and the board's acquiescence in his taking that role),
2. The board's "apparent and inexplicable impotence" to prevent Fertitta's creeping takeover, and
3. The board's agreement to terminate the merger, allowing Fertitta to avoid the \$15 million penalty.

Any one of these factors might "raise the eyebrows of the court to varying degrees." But together, the court said, they create a reasonable inference that Fertitta used his influence as controlling shareholder for his own benefit and the board knowingly preferred his interests over those of the corporation or the minority.

Even before Fertitta acquired a majority of the company's stock, the court found, he exercised actual control over the company by virtue of his 39% interest and his position as CEO and chairman. Thus, he owed a fiduciary duty to the corporation and its shareholders.

The court also found it reasonable to infer that by failing to prevent a creeping takeover the board had breached its duty of loyalty. Further, the board could have forced Fertitta to terminate the merger and pay the reverse-termination fee.

Exercising judgment

The business judgment rule creates a presumption that directors "act on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." In *Fertitta*, the CEO's domination of the corporation's activities raised questions as to whether the board's decisions constituted a rational exercise of business judgment. To avoid personal liability, directors must be vigilant when a transaction involves a controlling shareholder or corporate officer. ■

How to respond to an SEC comment letter

When it comes to anxiety-producing correspondence, a letter from the SEC ranks right up there with one from the IRS. Although you should notify your legal advisors and auditors right away, there's no reason to panic when you receive an SEC letter. And it's certainly no reason to restate your financial statements — at least not right away.

Steven Jacobs, an associate chief accountant with the SEC's Division of Corporation Finance, recently offered public companies some helpful tips on responding to SEC comment letters.

Explanation, please

Speaking at a conference sponsored by the New York State Society of CPAs, Jacobs observed that companies often rush to restate their financials after receiving a comment letter. In many cases, however, the reviewer is simply seeking an explanation. "Very rarely will you see us ask you to amend your filing right off the bat," Jacobs said. "A lot of times the disclosure is just not sufficient enough for us to understand what your accounting is."

Under the Sarbanes-Oxley Act of 2002, the SEC is required to perform some level of review of each reporting company at least once every three years. In addition, the agency performs selective reviews of transactional filings — documents related to public offerings, business combinations and proxy solicitations.

3 levels of review

After a preliminary review of each company's filings, the Division of Corporation Finance



selects certain filings for further review, based on criteria that aren't publicly disclosed. There are three possible levels of review:

1. A full, "cover-to-cover" review of the filing for compliance with applicable securities laws and regulations,
2. A financial statement review, which examines a company's financial statements and related disclosures, or
3. A targeted issue review, which focuses on one or more specific items.

If your company receives an SEC comment letter, Jacobs advises you to start a dialog with the SEC to be sure you understand what the agency's staff is looking for. Next, prepare a detailed explanation of the accounting issue in question, including a discussion of the relevant accounting literature. Keep in mind that a cursory response is unlikely to resolve the issue and may even raise suspicion.

Generally, you must respond to a comment letter within 10 days after you receive it, but if that's

not enough time, contact the SEC and ask for an extension. According to Jacobs, SEC staffers are more interested in receiving a thorough and complete response that's been through an appropriate level of review than an incomplete one within the 10-day window.

In some cases, the SEC doesn't require a company to amend a filing, but asks for revised disclosures in future filings. In that case, Jacobs

recommends that companies furnish a draft or template of the revised disclosure to be sure the SEC's staff is comfortable with it.

Pick up the phone

The SEC's message to companies that receive a comment letter is to "pick up the phone" and start a dialog with the agency's staff. In many cases, the SEC's concerns can be addressed informally, without the need for an immediate restatement. ■

Proxy disclosure rules are finalized

In December 2009, the SEC issued final proxy disclosure amendments. These include significant changes from the proposed rules that the SEC issued in July 2009. Among the most notable are changes related to:

Compensation policies. Public companies (except "smaller reporting companies") must discuss and analyze their overall compensation policies for risks that are *reasonably likely* to have a material *adverse* effect on the company. The July proposal, on the other hand, required disclosure if risks *may* have a material effect on the company. The new disclosures aren't part of the Compensation Discussion and Analysis (CD&A), as originally proposed.

Stock and option awards. As proposed, the compensation tables now require disclosure of the aggregate fair value of stock and option awards at the grant date rather than just the annual dollar amount recognized for financial statement purposes. Under the final rules, awards subject to performance conditions are valued at the grant date based on the probable outcome of such conditions — with the maximum potential value disclosed in a footnote.

Directors and nominees. The final rules expand disclosures regarding the experience and skills that qualify directors and nominees to serve on the board. But they drop a proposal to require similar disclosures for each committee on which a director serves.

The final rules also require companies to disclose directorships within the last five years and increase the disclosure period for legal proceedings involving directors and executives from five years to 10 years. And they expand the proposal's list of legal proceedings that must be disclosed.

Leadership structure and risk. The final rules require companies to disclose their board leadership structure and explain why that structure is appropriate. Although the July proposal referred to "company leadership structure," the SEC felt that term might cause confusion. The final rules also require companies to describe the board's role in risk *oversight*, as opposed to risk *management*, in the proposal.

Compensation consultants. Proposed disclosure requirements for fees paid to compensation consultants remain. But the final rules add a \$120,000 threshold as well as other exceptions.

Reporting of voting results. As proposed, the final rules require companies to report the results of shareholder votes on Form 8-K within four business days after the annual shareholder meeting. And they permit companies to report preliminary results within four days and final votes in an amendment filed within four days after they become available.

