IRB No. 2013-32
August 5, 2013

ACTION ON DECISION

Subject: Media Space, Inc. v. Commissioner, 135 T. C. 424 (2010), vacated, 477 Fed. Appx. 857 (2nd Cir. 2012)

Issues: 1) Whether taxpayer's forbearance payments to its preferred shareholders created a financial interest described in Treas. Reg. § 1.263(a)-4(d)(2) of the Treasury Regulations that must be capitalized under Treas. Reg. §§ 1.263(a)-4(d)(1) and 1.263-(4)(f)(3)?

2) Whether the forbearance payments were nondeductible distributions to the shareholders under section 301 of the Internal Revenue Code?

3) Were the forbearance payments nondeductible distributions to the shareholders under sections 162(k) or 361(c)?

Discussion: In 2003 the taxpayer issued shares of preferred stock shortly after its incorporation. The taxpayer's charter granted its preferred shareholders redemption rights which, if exercised triggered obligations by the taxpayer to pay the redemption amount. If the taxpayer was unable to pay the redemption amount, the taxpayer was required to pay interest on the redemption amount. Beginning in 2004, the taxpayer entered into several consecutive forbearance agreements whereby the preferred shareholders agreed to forgo their redemption rights in exchange for payments ("forbearance payments"). Each agreement covered twelve months or less.

Taxpayer reported the 2004 payment as an interest expense and the 2005 payment as an ordinary and necessary business expense. The Commissioner disallowed both deductions. In the Tax Court, the Commissioner argued that section 263(a) and Treas. Reg. § 1.263(a)-4, require the forbearance payments to be capitalized as amounts paid to create an intangible asset. In the alternative, the Commissioner argued that the payments were non-deductible distributions made to shareholders with respect to their stock under sections 301, 162(k), and 361(c).

The Tax Court characterized the forbearance payments as section 162 business expenses. The court held the forbearance payments were not required to be capitalized in 2004 but the 2005 forbearance payments must be capitalized under section 263(a). The court further found that there was neither a reacquisition or an exchange of stock to which either section 162(k) or section 361(c)(1) applied. The court also found the payments were not distributions under section 301.

The Commissioner appealed the Tax Court decision. While the appeal was pending in the Second Circuit, the taxpayer conceded that the 2004 payments were required to be capitalized under section 263(a). The Second Circuit concluded the Commissioner's appeal was moot and dismissed the appeal.

Issue 1: Under the general rule of Treas. Reg. § 1.263(a)-4(d)(1), a taxpayer must capitalize amounts paid to "create" an intangible described in Treas. Reg. § 1.263(a)-4(d)(2) through (d)(9). Stock in a corporation is among the "financial interests" described in Treas. Reg. § 1.263(a)-4(d)(2). The general rule of that section requires capitalization of amounts paid to "create, originate, enter into, renew or renegotiate" such an interest. The Tax Court correctly concluded that as amounts paid to renegotiate a financial interest, the forbearance payment, were subject to the general capitalization requirements applicable to created intangibles.

The court erred in holding that the "12-month rule" of Treas. Reg. § 1.263(a)-4(f)(1) exempts the forbearance payments from the general capitalization requirement applicable to intangibles because the payments effected a modification rather than a creation. That rule provides that an expenditure that gives rise to a benefit that lasts no more than 12 months need not be capitalized. But under Treas. Reg. § 1.263-(4)(f)(3), created financial interests are excepted from the 12-month rule. Consequently, the rule of capitalization should apply to the forbearance payments at issue. The Tax Court read the word "create" narrowly in Treas. Reg. § 1.263-(4)(f)(3), applying it inconsistently with the broader reading it gave the word in Treas. Reg. § 1.263(a)-4(f)(1). The Commissioner will continue to litigate the issue, taking the position that payments that affect a financial interest are excepted from the 12-month rule and must be capitalized. Treas. Reg. § 1.263(a)-4(f)(1).

Issue 2: Even if the forbearance payments are not non-deductible under Treas. Reg. § 1.263(a)-4(d)(2), the payments are nonetheless nondeductible distributions to the taxpayer's preferred shareholders under section 301. Under section 301, a distribution of property (including money) by a corporation to a shareholder with respect to its stock is either (a) a dividend, (b) a return of capital, or (c) treated as gain from the sale or exchange of property. The taxpayer's forbearance payments are either nondeductible distributions, expenditures to retain equity capital, or both. The corporate tax system comprises two levels of taxation, one at the corporation level and one at the shareholder level, the latter either upon receipt of corporate distributions or upon the shareholder's sale of the corporation's stock. Allowing deduction of the forbearance payments would impermissibly allow a corporation a deduction for its payment to a shareholder of a return on the shareholder's investment. That the corporation receives value for the forbearance payments, specifically, the retention of equity capital, does not remove the forbearance payments from the scope of section 301, because providing equity capital is a shareholders' function. Compensation to the shareholder for providing equity capital is not deductible. Furthermore, "[a] distribution to a shareholder in his capacity as such . . . is subject to section 301 even though it is not declared in formal fashion. "

Boulware v. United States, 552 U.S. 421, 429-430 (2008), citing B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 8.05[1], pp. 8-36 to 8–37 (6th ed. 1999). Also, it is not relevant to application of section 301 that the corporation may be in dire need of capital.

Issue 3: The forbearance payments are non-deductible distributions to the taxpayer's preferred shareholders under sections 162(k) and 361(c). The forbearance agreement is a significant enough modification to constitute a deemed exchange of the original preferred stock for new preferred stock and money (the forbearance payments). This argument is in accord with the case law principle regarding debt, eventually drafted into Treas. Reg. § 1.1001-3, that a significant modification of a debt instrument results in a deemed taxable exchange of the original debt instrument for a modified instrument. Before entering into the forbearance agreement, the preferred shareholders possessed the right at any time to force redemption and be paid in full if they, for instance, sensed that the corporation's finances may deteriorate. By entering into the forbearance agreement, however, the shareholders exchanged the right to demand redemption at any time for (a) the forbearance payment received (which is smaller than the redemption payment would be) and (b) only a postponed right to demand redemption. A right to demand redemption at any time is significantly different from a postponed right to demand redemption. The postponed right to demand redemption is less valuable because there is an additional risk that the corporation's finances will deteriorate and the corporation will not be able to pay at the postponed redemption date.

That there is a deemed exchange of old preferred stock for new preferred stock in turn leads to the conclusion that both section 162(k) (providing for non-deductibility of amounts paid or incurred in connection with reacquisitions of stock) and section 361(c)(1) (providing that a corporation a party to a reorganization, here a recapitalization under section 368(a)(1)(E), shall recognize no gain or loss on its distribution to shareholders of property in pursuance of the plan of reorganization) preclude deduction of the forbearance payments.

Recommendation: Nonacquiescence on Issues 1, 2 and 3.

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