

Capital or Ordinary Expense? The Proper Tax Treatment of a Target Corporation's Expenditures in an Acquisitive Reorganization

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I. INTRODUCTION

The tax treatment of corporate expenditures has been a longstanding point of contention between taxpayers and the Internal Revenue Service (Service).¹ This Note will examine a specific instance of this frequently recurring problem: determining whether a target corporation's expenditures incurred in connection with an acquisitive reorganization must be capitalized under section 263² or can be deducted under section 162³ as a business expense. This determination is sometimes very difficult.⁴ The failure of the Supreme Court, Congress, or the Service to articulate an exclusive, or at least certain, test to determine the issue has produced confusion, resulting in inconsistent holdings that are difficult to reconcile.⁵ Although this Note will discuss the capitalization issue generally, its primary purpose is to examine the tax treatment of a target corporation's costs incurred in an acquisitive reorganization.

Part II of this Note provides relevant background material on the distinction between capital and current expenditures and the ramifications of the distinction. Part III introduces the judicial tests used to characterize expenditures. This Part will also examine the contours of those tests and their limitations. In addition, *INDOPCO, Inc. v. Commissioner*,⁶ the Supreme Court's most recent attempt to clarify the doctrine, is evaluated.⁷ Part IV examines the case law applying *INDOPCO* to acquisitive reorganizations and evaluates those factors that control the capitalization determination. Part V examines what is left for corporations at the tax-planning level in light of the post-*INDOPCO* decisions.

¹ See *NCNB Corp. v. United States*, 684 F.2d 285, 287 (4th Cir. 1982).

² I.R.C. § 263 (1994).

³ I.R.C. § 162 (1994).

⁴ As the Supreme Court has noted, "the 'decisive distinctions' between current expenses and capital expenditures 'are those of degree and not of kind.'" *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 86 (1992) (quoting *Welch v. Helvering*, 290 U.S. 111, 114 (1933)).

⁵ See *id.* at 86; see also *Fall River Gas Appliance Co. v. Commissioner*, 349 F.2d 515, 516 (1st Cir. 1965) (stating that no set formula will govern all cases).

⁶ 503 U.S. 79 (1992).

⁷ See *infra* Part III.D.

II. THE DISTINCTION BETWEEN CAPITAL AND CURRENT EXPENDITURES

A. *Capital Expenditures*

Our tax system taxes net income—gross income less deductions.⁸ Under this system, each taxpayer is required to adopt an accounting method that results in a clear reflection of income.⁹ In addition, each taxpayer must maintain certain accounting records that will enable him to file an accurate return.¹⁰ An essential aspect in maintaining such records is determining the proper classification of expenditures as between capital and ordinary expense.¹¹ Current year deductions are not allowed for capital expenditures.¹² Internal Revenue Code (Code) section 263 defines capital expenditures as “[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.”¹³ In general, capital expenditures are those that cannot be deducted from gross income except through depreciation, amortization, depletion, cost of goods sold, an adjustment to property’s basis, or upon the disposition of the property to which the expenditure relates through a sale, exchange, or other disposition.¹⁴

The Code and Regulations have not, however, produced a bright-line test upon which taxpayers can rely. The courts’ attempts to articulate capitalization standards have not fared much better.¹⁵ In 1933, Justice Cardozo’s tussle with the question of capitalization led to the following oft-cited observation: “One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life.

⁸ See I.R.C. § 63 (1994).

⁹ See I.R.C. § 446 (1994); Treas. Reg. § 1.446-1(a)(2) (as amended in 1995).

¹⁰ See Treas. Reg. § 1.446-1(a)(4) (as amended in 1995). Those records include “the taxpayer’s regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return, as for example, a reconciliation of any differences between such books and his return.” *Id.*

¹¹ See Treas. Reg. § 1.446-1(a)(4)(ii) (as amended in 1995).

¹² See I.R.C. § 263 (1994).

¹³ I.R.C. § 263(a) (1994).

¹⁴ See Treas. Reg. § 1.263(a)-1 (as amended in 1994). The Treasury Regulations expound on the Code’s definition by including examples of capital expenditures. Capital expenditures include the following: the cost of acquisition, construction, or erection of buildings and machinery having a useful life beyond the taxable year; amounts expended for securing a copyright; the cost of defending or perfecting title to property; cost of an architect’s services; brokerage commissions paid in buying securities; shareholders’ voluntary contribution to the capital of the corporation for any corporate purpose. See Treas. Reg. § 1.263(a)-2 (as amended in 1987).

¹⁵ See *infra* Part III.

Life in all its fullness must supply the answer to the riddle."¹⁶ Unfortunately, the riddle has not been answered; apparently, life is not as full as Justice Cardozo expected.¹⁷ Some forty years after Justice Cardozo's observation, the Second Circuit characterized the law as being "in a state of hopeless confusion."¹⁸ It still is.

The fundamental principle behind capitalization—and a major objective of tax policy—is to match income and expense so as to clearly reflect taxable income.¹⁹ An expenditure has no inherent character for tax purposes; instead, expense recognition is tied to income recognition.²⁰ An expenditure is not deducted when paid or accrued, but in the year in which the cause of the expense makes its contribution to income. For example, take a machine costing \$100,000 that has the ability to produce 1,000 units over its economic life. Assume the company purchasing the machine uses it to produce 500 units the first year, 300 units the second year, and 200 units the third year. Further assume all the units are sold at \$250 per unit in the year produced. When should the cost of the machine be deducted?²¹ Fifty-thousand dollars should be deducted in year one, \$30,000 in year two, and \$20,000 in year three; the expense is deducted annually in the year it contributes to income, resulting in a clear reflection of income in each of the three years.²² The issue is essentially

¹⁶ *Welch v. Helvering*, 290 U.S. 111, 115 (1933).

¹⁷ See generally Peter L. Faber, *Indopco: The Still Unsolved Riddle*, 47 TAX LAW. 607 (1994).

¹⁸ *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 785 (2d Cir. 1973) (referring to this area of tax law as having no "reasonably clear criteria," an area in which answers will not be found save by "prayer and fasting"); see also *NCNB Corp. v. United States*, 651 F.2d 942, 958 (4th Cir. 1981), *vacated by NCNB Corp. v. United States*, 684 F.2d 285 (4th Cir. 1982).

¹⁹ See *Newark Morning Ledger Co. v. United States*, 507 U.S. 546, 565 (1993); *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 83–84 (1992); *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974); *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 214 (7th Cir. 1982); *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (11th Cir. 1982).

²⁰ See *Alphaco, Inc. v. Nelson*, 385 F.2d 244, 245 (7th Cir. 1967).

²¹ The answer to this question depends on the depreciation system that the taxpayer has elected. For purposes of this example, it is assumed that the taxpayer has elected to exclude the machine from the application of section 168 and is properly depreciating the property under the unit-of-production method. See I.R.C. § 168(f)(1) (1994); Treas. Reg. § 1.167(b)-0 (1960).

²² In this example, when income and expense are properly matched, the taxpayer has taxable income (gross income less deductions) of \$75,000, \$45,000, and \$30,000 in years one, two, and three, respectively. Compare that situation to one in which the entire cost of the machine is deducted in year one. In this latter situation, the taxpayer has taxable income of \$25,000 in year one, \$75,000 in year two, and \$50,000 in year three. In both situations

one of timing, *i.e.*, in what year the expense will be deducted, and not whether the expense is deductible. Due to the time value of money, the timing of deductions is not just an academic exercise resulting in an accurate reflection of taxable income. Instead, it is an issue of real dollars and cents.²³

taxable income is \$150,000 over the three year period; however, in the latter situation, the failure to match income and expense results in a distortion of each year's taxable income. This mismatching results in taxable income being understated in year one by \$50,000 and overstated in years two and three by \$30,000 and \$20,000, respectively. The capitalization rules are designed to prevent such distortions in taxable income.

The above is a simple example with an obvious, almost intuitive, answer. However, applying the capitalization rules to more complex, real life situations, is considerably more difficult. For example, when do advertising expenses make their contribution to income? Does it matter if the advertising is of short duration (such as a television commercial) or of long duration (such as a billboard advertisement)? What about research and development expenditures? Legal fees to defend a copyright? Legal fees in a successful defense of a hostile takeover attempt? An unsuccessful defense of a hostile takeover attempt? What about the salary of a CEO who has implemented strategic changes designed to restructure faltering operations? What if the strategic plan is later abandoned? The list could go on.

The above examples illustrate the myriad of complex determinations that are involved in making the capitalization decision. At the heart of the problem is the uncertainty in measuring when, if ever, an expenditure will make its contribution to income. For some expenditures, it is impossible to measure when they will make their contribution to income; for other expenditures, the cost to develop a system to accurately measure and capture such information is prohibitive. As a result, strict application of the capitalization rules is neither practical nor desirable. The measurement difficulties and administrative costs to both the Service and the taxpayer weigh against capitalizing all expenditures which benefit future years. Judge Posner explains the situation as follows:

If one really takes seriously the concept of a capital expenditure as anything that yields income, actual or imputed, beyond the period (conventionally one year) in which the expenditure is made, the result will be to force the capitalization of virtually every business expense. It is a result courts naturally shy away from. It would require capitalizing every salesman's salary, since his selling activities create goodwill for the company and goodwill is an asset yielding income beyond the year in which the salary expense is incurred. The administrative costs of conceptual rigor are too great.

Encyclopaedia Britannica, Inc., 685 F.2d at 217 (citations omitted).

²³ Hence, the huge number of taxpayers willing to litigate the issue. *See, e.g.*, *Colonial Am. Life Ins. Co. v. Commissioner*, 491 U.S. 244 (1989); *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974); *United States v. Mississippi Chem. Corp.*, 405 U.S. 298 (1972); *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345 (1971); *Woodward v. Commissioner*, 397 U.S. 572 (1970); *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970); *Commissioner v. Tellier*, 383 U.S. 687 (1966); *Commissioner v. Heininger*, 320 U.S. 467 (1943); *Interstate Transit Lines v. Commissioner*, 319 U.S. 590 (1943); *Welch v.*

B. Current Expenditures

To qualify as a current expenditure under section 162(a), the Supreme Court has held that the expenditure must meet the following requirements: (1) be an "ordinary" expense, (2) be a "necessary" expense, (3) be an "expense," (4) be "paid or incurred during the taxable year," and (5) be for "carrying on any trade or business."²⁴ All five of these requirements must be met to qualify the expenditure for a current deduction.

The "ordinary" requirement is typically the factor on which the determination between current and capital expenditure turns.²⁵ An ordinary expense is one that is "customary or usual."²⁶ That does not mean, however, that it is customary or usual to the taxpayer, but rather, it must be customary or usual in the taxpayer's trade, industry, or business community.²⁷ Indeed, the expenditure can qualify as ordinary even if it is the first and only time it is incurred.²⁸ It need not be "habitual or normal in the sense that the same taxpayer [has made it] often."²⁹ It is "a variable affected by time and place and circumstance."³⁰

Helvering, 290 U.S. 111 (1933); *Fishman v. Commissioner*, 837 F.2d 309 (7th Cir. 1988); *Hadley v. Commissioner*, 819 F.2d 359 (2d Cir. 1987); *Betson v. Commissioner*, 802 F.2d 365 (9th Cir. 1986); *Central Tex. Sav. & Loan Ass'n v. United States*, 731 F.2d 1181 (5th Cir. 1984); *Meridian Wood Prod. Co. v. United States*, 725 F.2d 1183 (9th Cir. 1984); *Keller v. Commissioner*, 725 F.2d 1173 (8th Cir. 1984); *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376 (11th Cir. 1982); *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212 (7th Cir. 1982); *NCNB Corp. v. United States*, 684 F.2d 285 (4th Cir. 1982); *Madison Gas & Elec. Co. v. Commissioner*, 633 F.2d 512 (7th Cir. 1980); *Cagle v. Commissioner*, 539 F.2d 409 (5th Cir. 1976); *Estate of Meade v. Commissioner*, 489 F.2d 161 (5th Cir. 1974); *Georator Corp. v. United States*, 485 F.2d 283 (4th Cir. 1973); *Anchor Coupling Co. v. United States*, 427 F.2d 429 (7th Cir. 1970); *United States v. Wehrli*, 400 F.2d 686 (10th Cir. 1968); *Fall River Gas Appliance Co. v. Commissioner*, 349 F.2d 515 (1st Cir. 1965); *Estate of Morgan v. Commissioner*, 332 F.2d 144 (5th Cir. 1964); *General Bancshares Corp. v. Commissioner*, 326 F.2d 712 (8th Cir. 1964).

²⁴ *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 352 (1971). The Court's language tracks that of section 162(a). That section provides the following: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C. § 162(a) (1994).

²⁵ See *Commissioner v. Tellier*, 383 U.S. 687, 689-90 (1966).

²⁶ See *Deputy v. du Pont*, 308 U.S. 488, 495 (1940).

²⁷ See *Welch v. Helvering*, 290 U.S. 111, 114 (1933).

²⁸ See *id.*

²⁹ *Id.*

³⁰ *Id.* at 113-14. Justice Cardozo provided the following example that helps illustrate what is "ordinary":

The second requirement is that the expenditure be "necessary." A necessary expenditure is one that is "appropriate and helpful" to the development of the taxpayer's business.³¹ Necessary does not mean indispensable. This requirement is minimal; the Supreme Court has indicated that federal courts should be slow to override the taxpayer's judgment that the expenditure was necessary.³² Accordingly, if there are reasonably evident business ends to be served and an intention to serve them by means of the expenditure, the court should uphold management's judgment that the expenditure was necessary.³³

The "expense" requirement simply means that the expenditure cannot be capital.³⁴ Thus expenditures failing the capitalization criterion should satisfy this requirement.

The fourth requirement merely requires cash basis taxpayers³⁵ to have actually made the payment.³⁶ For accrual basis taxpayers,³⁷ this requirement is

A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. Nonetheless, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.

Id. at 114.

Corporations defending against a hostile takeover often invoke this "defense against attack" doctrine to justify a current deduction. The rationale supporting this doctrine is that the corporation is merely protecting the status quo. The corporation is not obtaining any long-term benefits from the expenditures, it is merely protecting the assets and business organization it already had. More recently, however, companies facing hostile bidders have experienced little success arguing this position. Even though the courts have not expressly rejected the doctrine, recent decisions implicitly question its continued viability in the hostile takeover context. *See infra* note 170 and accompanying text.

³¹ *See Welch*, 290 U.S. at 113.

³² *See id.*

³³ *See B. Manischewitz Co. v. Commissioner*, 10 T.C. 1139, 1145 (1948) (citing *Smith v. Commissioner*, 3 T.C. 696, 703 (1994)).

³⁴ *See Jack's Cookie Co. v. United States*, 597 F.2d 395, 402 (4th Cir. 1979); Brian R. Greenstein & Mark B. Persellin, *Supreme Court's Ruling in INDOPCO Limits Deductibility of Takeover Expenses*, 70 TAXES 570, 572 (1992).

³⁵ Generally, under the cash basis method, taxpayers report all items which constitute gross income in the taxable year in which actually or constructively received and deduct expenditures in the taxable year when paid. *See* Treas. Reg. § 1.446-1(c)(1)(i) (as amended in 1993).

³⁶ *See id.*

³⁷ For accrual basis taxpayers, an income item is included in gross income "when all the events have occurred that fix the right to such income." Treas. Reg. § 1.446-1(c)(1)(ii) (as

satisfied when all events have occurred that establish the fact and amount of liability, and economic performance has occurred.³⁸

The fifth requirement—that the expenditure be incurred “in carrying on any trade or business”—means the expense must be motivated by an attempt to secure a profit for the business.³⁹ This requires a direct connection between the expenditure and the carrying on of the taxpayer’s trade or business.⁴⁰

The requirements for capital and current expenditures are easy to state and are manageable in the abstract. The practical difficulty in making the characterization, however, has made this area a major source of litigation between the Service and taxpayers.⁴¹

III. JUDICIAL TESTS FOR CHARACTERIZING EXPENDITURES

The federal courts use various approaches to determine whether a target corporation’s expenditures incurred in an acquisition must be capitalized. The discussion that follows outlines the courts’ approaches in applying sections 162 and 263 to the area of changing corporate control. In general, the test applied in a particular case will depend upon the court, the facts with which the court is faced, and the point in time when the case was decided.

A. One-Year Test

The “one-year” test is a longstanding approach the courts have used to determine the character of an expenditure. This test requires expenditures to be capitalized if they produce a benefit extending beyond the taxable year. Under

amended in 1993). Expenditures are deducted when “all the events have occurred that established the fact of the liability” giving rise to such deduction and when “the amount of the liability can be determined with reasonable accuracy.” *Id.* In addition, economic performance must also occur before an expenditure can be deducted. *See id.*; *see also* I.R.C. § 461(h) (1994).

³⁸ *See* Treas. Reg. § 1.446-1(c)(1)(ii) (as amended in 1993); *United States v. Hughes Properties*, 476 U.S. 593, 599–600 (1986).

³⁹ *See* Treas. Reg. § 1.162-1(a) (as amended in 1993); *Teitelbaum v. Commissioner*, 346 F.2d 266, 269 (7th Cir. 1965); *Porreca v. Commissioner*, 86 T.C. 821, 843 (1986); *Guzowski v. Commissioner*, 26 T.C.M. (CCH) 666, 671 (1967).

⁴⁰ *See* *Kornhauser v. United States*, 276 U.S. 145, 153 (1928); *Carroll v. Commissioner*, 51 T.C. 213, 218 (1968), *aff’d*, 418 F.2d 91 (7th Cir. 1969); *Henry v. Commissioner*, 36 T.C. 879, 884 (1961); Rev. Rul. 61-133, 1961-2 C.B. 35, 36. Essentially, this requirement denies deductions for personal, living, or family expenses, and limits deductible expenses to those designed to further the taxpayer’s business interests.

⁴¹ *See supra* note 23.

this test, an expenditure should be capitalized "if it brings about the acquisition of an asset having a period of useful life in excess of one year or if it secures a like advantage to the taxpayer which has a life of more than one year."⁴² This test has gained widespread acceptance⁴³ and has enjoyed renewed significance because of *INDOPCO v. Commissioner*;⁴⁴ nonetheless, it is a "mere guidepost for the resolution of the ultimate issue, not . . . an absolute rule requiring the automatic capitalization of every expenditure providing the taxpayer with a benefit enduring for a period in excess of one year."⁴⁵ Accordingly, courts view benefits extending beyond the taxable year as a significant but not

⁴² *Hotel Kingkade v. Commissioner*, 180 F.2d 310, 312 (10th Cir. 1950).

⁴³ See, e.g., *NCNB Corp. v. United States*, 684 F.2d 285, 288 (4th Cir. 1982); *Snyder v. United States*, 674 F.2d 1359, 1365 (10th Cir. 1982); *Jack's Cookie Co. v. United States*, 597 F.2d 395, 405 (4th Cir. 1979); *Bilar Tool & Die Corp. v. Commissioner*, 530 F.2d 708, 713 (6th Cir. 1976); *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185, 1191-92 (10th Cir. 1974); *Clark Oil & Ref. Corp. v. United States*, 473 F.2d 1217, 1219-20 (7th Cir. 1973); *E.I. du Pont Nemours & Co. v. United States*, 432 F.2d 1052, 1059 (3d Cir. 1970) (cost to restructure business in order to satisfy an antitrust decree held not deductible because it resulted in a benefit to the taxpayer that could extend to future years); *Paxman v. Commissioner*, 414 F.2d 265, 267 (10th Cir. 1969); *United States v. Wehrli*, 400 F.2d 686, 689 (10th Cir. 1968); *Darlington-Hartsville Coca-Cola Bottling Co. v. United States*, 393 F.2d 494, 496 (4th Cir. 1968) (soft-drink bottling company's payments to franchisor as part of a plan to increase future profits not currently deductible); *American Dispenser Co. v. Commissioner*, 396 F.2d 137, 138 (2d Cir. 1968); *Sears Oil Co. v. Commissioner*, 359 F.2d 191, 197-98 (2d Cir. 1966); *Richmond Television Co. v. United States*, 345 F.2d 901, 907 (4th Cir.), *vacated*, 382 U.S. 68 (1965); *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 713 (8th Cir. 1964) (cost incurred in issuing nontaxable stock dividends changed corporate structure for the benefit of future operations and thus not currently deductible); *Denver & Rio Grand W. R.R. v. Commissioner*, 279 F.2d 368, 375 (10th Cir. 1960); *United States v. Akin*, 248 F.2d 742, 744 (10th Cir. 1957); *McDonald v. Commissioner*, 139 F.2d 400, 401 (3d Cir. 1943) (campaign expenses not currently deductible because a benefit would be derived in the future), *cert. granted*, 321 U.S. 762 (1944), *and aff'd*, 323 U.S. 57 (1944); *Central Bank Block Ass'n v. Commissioner*, 19 B.T.A. 1183, 1185 (1930) (broker fee incurred in acquiring a lease not currently deductible because lease would contribute to income in the future); *Lovejoy v. Commissioner*, 18 B.T.A. 1179, 1181-82 (1930) (up front loan costs held not currently deductible because expenditure would produce future benefits); *Treas. Reg. § 1.461-1(a)(1)* (as amended in 1994) (leasehold improvements are not currently deductible because they have substantial value beyond the current year).

⁴⁴ 503 U.S. 79 (1992). The test used by the court in *INDOPCO*—the future benefits test—is fundamentally the same test as the one-year test: both tests focus on whether the expenditure provides any benefit beyond the year in which the expenditure was made. See *infra* discussion Part III.D.

⁴⁵ *United States v. Wehrli*, 400 F.2d 686, 689 (10th Cir. 1968). Note that a strict application of the one-year test would result in the capitalization of nearly all expenditures. See *supra* note 22.

controlling factor.⁴⁶

B. *Origin of the Claim Test*

In 1933, the Supreme Court set forth the principle that the “origin and character” of the asset acquired, rather than its potential effect on the taxpayer, should determine the character of the expenditure.⁴⁷ Under this test, an expense is capital if its origin is in the acquisition or disposition of a capital asset.⁴⁸ A finding that the acquired asset is a capital asset requires capitalization of expenditures incurred in its acquisition.⁴⁹ Accordingly, courts have limited the application of this test to characterize expenses arising out of corporate stock⁵⁰ acquisitions or defending title to capital assets.⁵¹

For example, in *United States v. Hilton Hotels Corp.*,⁵² Hilton Hotels (Hilton) agreed to merge with Hotel Waldorf-Astoria Corporation (Waldorf-Astoria), of which it already owned a ninety percent common stock interest.⁵³ However, dissident stockholders filed written objections to the merger with Waldorf-Astoria management and sued for a statutory appraisal.⁵⁴ As part of the appraisal litigation, Hilton hired consultants, lawyers, and other

⁴⁶ When applying the one-year test, no one factor is controlling. The courts make the determination upon a realistic evaluation of the facts and circumstances surrounding the expenditure, including, but not limited to, the purpose, nature, and extent of the expenditure, and in any event whether the expenditure resulted in a substantial increase in an asset's value. See *Wehrli*, 400 F.2d at 690.

⁴⁷ See *United States v. Gilmore*, 372 U.S. 39 (1963).

⁴⁸ See *Woodward v. Commissioner*, 397 U.S. 572, 577-79 (1970); *Estate of Meade v. Commissioner*, 489 F.2d 161, 166 (5th Cir. 1974).

⁴⁹ Code section 1221 defines a capital asset to include all assets held by the taxpayer except the following: (1) inventory, or other property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business; (2) depreciable property or real property used in a trade or business of the taxpayer; (3) trade accounts or notes receivable; (4) certain copyrights, literary, musical, or artistic compositions, and letters or memoranda held by persons whose personal efforts created them, and certain other specified holders of such property; (5) U.S. government publications acquired other than by purchase at the price at which they are sold to the general public. See I.R.C. § 1221 (1994).

⁵⁰ Stock is always a capital asset for all taxpayers except those who hold it as inventory for sale in the ordinary course of a trade or business—typically broker-dealers. See *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 222 (1988).

⁵¹ See, e.g., *Madden v. Commissioner*, 514 F.2d 1149 (9th Cir. 1975); *Jim Walter Corp. v. United States*, 498 F.2d 631 (5th Cir. 1974); *Great Lakes Pipe Line Co. v. United States*, 352 F. Supp. 1159 (W.D. Mo. 1972); *Mosby v. Commissioner*, 86 T.C. 190 (1986).

⁵² 397 U.S. 580 (1970).

⁵³ See *id.* at 581.

⁵⁴ See *id.* at 581-82.

professionals, and deducted the fees paid on its federal income tax return.⁵⁵

The Commissioner of Internal Revenue (Commissioner) disallowed the deduction on the ground that the expenditures were capital.⁵⁶ The Supreme Court affirmed the Commissioner's determination, holding that "expenses of litigation that arise out of the acquisition of a capital asset are capital expenses."⁵⁷ The nature of the appraisal litigation was to determine the purchase price of the Waldorf-Astoria stock—a capital asset.⁵⁸ The "origin" of the expense was in the acquisition of a capital asset. Accordingly, capitalization was the appropriate tax treatment of the appraisal litigation costs; those expenditures were simply a cost of acquiring the Waldorf-Astoria stock.

The origin of the claim test was another judicial attempt to deal with the capitalization issue. Taxpayers expecting this test to become a universal test were disappointed, however. The *Hilton Hotel* decision represents another failure of the Court: a failure to develop a consistent rationale when addressing the capitalization issue and a failure to provide taxpayers with some measure of certainty.

C. *Separate and Distinct Asset Test*

In 1971, *Commissioner v. Lincoln Savings & Loan Ass'n*⁵⁹ was decided. *Lincoln Savings* established the "separate and distinct asset" test for determining the character of an expenditure.⁶⁰ Some courts hailed this decision as creating a new test that replaced prior tests.⁶¹

In *Lincoln Savings*, the issue was the treatment of additional insurance premiums paid to the Federal Savings and Loan Insurance Corporation.⁶² The additional premiums went into a "Secondary Reserve" fund in which the

⁵⁵ See *id.*

⁵⁶ See *id.*

⁵⁷ *Id.* at 583.

⁵⁸ See *id.* at 584.

⁵⁹ 403 U.S. 345 (1971).

⁶⁰ See *id.* at 354.

⁶¹ See, e.g., *NCNB Corp. v. United States*, 684 F.2d 285, 293 (4th Cir. 1982) (stating that because a separate and distinct asset was not created or enhanced, expenditures for feasibility studies and application to the Comptroller of the Currency were currently deductible); *Southland Royalty Co. v. United States*, 582 F.2d 604, 617 (Ct. Cl. 1978) (stating that because the expenditure did not create a separate asset, costs of oil and gas reserve studies were currently deductible even though they probably created future benefits); *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 782 (2nd Cir. 1973) (observing that *Lincoln Savings* "brought about a radical shift in emphasis," directing the inquiry towards determining whether the expenditure created or enhanced a "separate and distinct asset").

⁶² See *Lincoln Sav.*, 403 U.S. at 348-49.

taxpayer savings and loan association “had a distinct and recognized property interest.”⁶³ The association’s interest in the fund was recognized as an asset on its balance sheet,⁶⁴ and the payments made to the fund served to “create or enhance . . . what is essentially a separate and distinct additional asset.”⁶⁵ The “inevitable consequence” of the finding that a “separate and distinct asset” was created is that payments made to the fund are “capital in nature and not an expense.”⁶⁶ The Court stated that “the presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year” but are not capital.⁶⁷ With this statement, the Court appeared to reject the significance of analyzing whether an expenditure will yield income in future periods while directing the inquiry to the creation or enhancement of a separate and distinct asset.⁶⁸

Notwithstanding the Court’s matter-of-fact presentation, detecting the “creation or enhancement of a separate and distinct asset” is not always so simple. In the case of land, buildings, equipment, machinery, and other tangible assets, the determination seems relatively straightforward. On the other hand, with regard to intangible assets, *i.e.*, assets characterized by a lack of physical existence, “how do we know a separate and distinct asset when we see it—or, more literally, don’t see it?”⁶⁹ That is not an easy question to answer. Besides lacking physical existence, another distinguishing characteristic of intangible assets is the high degree of uncertainty concerning the future benefits that such

⁶³ *Id.* at 355.

⁶⁴ *See id.* at 356.

⁶⁵ *Id.* at 354.

⁶⁶ *Id.*

⁶⁷ *Id.*

⁶⁸ This is the broad reading of *Lincoln Savings* that some courts adopted. *See supra* note 61 and accompanying text. These courts saw the creation or enhancement of a separate and distinct asset as the sole factor bearing on the capitalization determination. As we found out some 20 years later when *Lincoln Savings* was “clarified” in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), this interpretation was wrong. *See infra* text accompanying notes 87–89.

⁶⁹ J. MARTIN BURKE & MICHAEL K. FRIEL, *TAXATION OF INDIVIDUAL INCOME* 240 (3d ed. 1994).

assets will generate.⁷⁰ To be certain, with intangible assets, the dividing line between capital and current expenditures “becomes imprecise.”⁷¹

D. *Future Benefits Test of* INDOPCO, Inc. v. Commissioner

Despite taxpayers' and courts' anticipation of a bright line test in *Lincoln Savings*, that opinion's lack of candor caused confusion.⁷² Adding to the confusion was the Court's decision the following year in *United States v. Mississippi Chemical Corp.*⁷³ In *Mississippi Chemical*, the Court ignored the separate and distinct asset test—the test that it first announced in *Lincoln Savings*—in deciding another capitalization question. Instead, the Court, in holding that the expenditures were capital, relied on the fact that the expenditures in question—incurred to purchase capital stock—would have value in more than one year.⁷⁴ The seeming inconsistency between *Lincoln Savings* and *Mississippi Chemical* perplexed the courts and taxpayers, resulting in a split among the circuits as to whether long-term benefits should be analyzed.⁷⁵ The Supreme Court granted certiorari in *INDOPCO, Inc. v. Commissioner*⁷⁶ in an attempt to resolve this “perceived conflict.”⁷⁷

⁷⁰ See DONALD E. KIESO & JERRY J. WEYGANDT, INTERMEDIATE ACCOUNTING 536 (6th ed. 1989). The uncertainty of future benefits stems from the fact that many intangible assets “(1) have value only to a given enterprise, (2) have indeterminate lives, and (3) are subject to large fluctuations in value because their benefits are based on competitive advantage.” *Id.*

⁷¹ Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 781 (2nd Cir. 1973).

⁷² See Melissa D. Ingalls, Note, *INDOPCO, Inc. v. Commissioner: Determining the Taxable Nature of a Target Corporation's Takeover Expenses*, 43 DEPAUL L. REV. 1165, 1175 (1994); Sarah R. Lyke, Note, *INDOPCO, Inc. v. Commissioner: National Starch Decision Adds Wrinkles to Capital Expenditure Issue*, 88 NW. U. L. REV. 1239, 1245-46 (1994).

⁷³ 405 U.S. 298, 311 (1972). The Court made no reference to the separate and distinct asset test announced 10 months earlier in *Lincoln Savings*.

⁷⁴ See *id.* at 310.

⁷⁵ Compare *National Starch and Chemical Corp. v. Commissioner*, 918 F.2d 426, 434 (3rd Cir. 1990) (holding that either the presence of a separate and distinct asset or the creation of a long-term benefit is sufficient to deny a current deduction), *cert. granted*, 500 U.S. 914 (1991), and *aff'd sub nom.* *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992); *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433 (8th Cir. 1979); and *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185 (10th Cir. 1974), with *NCNB Corp. v. United States*, 684 F.2d 285, 290-91 (4th Cir. 1982) (looking solely to the creation or enhancement of a separate and distinct asset); *Southland Royalty Co. v. United States*, 582 F.2d 604 (Ct. Cl. 1978); and *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2nd Cir. 1973).

⁷⁶ 503 U.S. 79 (1992).

⁷⁷ *Id.* at 83.

INDOPCO clarified the scope and application of *Lincoln Savings*. It involved the expenditures of a target corporation in a successful friendly acquisition by Unilever.⁷⁸ INDOPCO, Inc., formerly named National Starch and Chemical Corporation, was a public company listed on the New York Stock Exchange.⁷⁹ INDOPCO's largest shareholders, owning 14.5% of the shares, were opposed to the transaction unless the transaction could be completed as a tax-free exchange.⁸⁰ They were concerned about incurring capital gains tax on the sale of their stock to Unilever.⁸¹

In response, INDOPCO's and Unilever's attorneys devised a merger plan that would satisfy the shareholders' concerns.⁸² In addition, to discharge its fiduciary duties, INDOPCO's board of directors hired an investment banking firm to evaluate the transaction and render a fairness opinion.⁸³ As a result, INDOPCO incurred attorneys' fees of approximately \$490,000 and investment bankers' fees of approximately \$2.2 million.⁸⁴ It deducted the investment banking fees on its federal income tax return.⁸⁵

Upon audit, the Commissioner disallowed the deduction and issued a notice of deficiency.⁸⁶ Citing *Lincoln Savings*, INDOPCO argued that because the "disputed expenses did not 'create or enhance . . . a separate and distinct additional asset,' they . . . were deductible under [section] 162(a)."⁸⁷ The Court did not agree. It explained the holding of *Lincoln Savings*:

In short *Lincoln Savings* holds that the creation of a separate and distinct asset well may be a sufficient, but not a necessary, condition to classification as a capital expenditure. Nor does our statement in *Lincoln Savings* . . . that "the

⁷⁸ See *id.* at 80.

⁷⁹ See *id.*

⁸⁰ See *id.* at 80–81.

⁸¹ See *id.* The shareholders were elderly individuals who had huge unrealized capital gains on their shares. They wanted a tax-free transaction as part of accomplishing their estate plan. If they sold their shares to Unilever in a taxable sale, they would incur capital gains tax. However, if they could avoid a recognition event before their death, their heirs would receive a stepped-up tax basis, under section 1014, equal to the fair market value of the shares at the date of death. See I.R.C. § 1014(a) (1994). Section 1014 would wipe out all unrealized capital gains on their stock, thus avoiding substantial tax.

⁸² See *id.* at 81.

⁸³ See *id.* When addressing takeover bids, the board of directors' fiduciary duties include the duty to evaluate the offer to determine that the price is fair and that the sale of the corporation is in the best interest of the shareholders and corporation. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

⁸⁴ See *INDOPCO*, 503 U.S. at 82.

⁸⁵ See *id.*

⁸⁶ See *id.*

⁸⁷ *Id.* at 83 (citations omitted) (quoting *Lincoln Sav.*, 403 U.S. at 354).

presence of an ensuing benefit that may have some future aspect is not controlling" prohibit reliance on future benefit as a means of distinguishing an ordinary business expense from a capital expenditure. Although the mere presence of an incidental future benefit—"some future aspect"—may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization.⁸⁸

This statement clarified *Lincoln Savings*, acknowledged the continued viability of long-term benefits analysis, and rejected the separate and distinct asset test as an exclusive test. Instead, either the creation or enhancement of a separate and distinct asset or the creation of a long-term benefit is a condition sufficient for capitalization. Although the former should definitely be capitalized, the latter is not dispositive—only indicating that the expenditure may require capitalization.

Applying the long-term benefit test to the facts before it, the Court held that the expenditures were capital. It found that the expenditures and resulting merger created significant synergy between the two companies, resource-related benefits, and cost savings that accrued to INDOPCO.⁸⁹ The Court, quoting from INDOPCO's own "Progress Report," also found that INDOPCO would "benefit greatly from the availability of Unilever's enormous resources."⁹⁰ Moreover, the investment banker's report noted that INDOPCO's management "feels that some synergy may exist with the Unilever organization."⁹¹

In addition to those synergistic and resource-related benefits, the Court noted that INDOPCO's transformation from a public company to a wholly owned subsidiary of Unilever would produce benefits in the form of cost savings.⁹² For example, INDOPCO would no longer incur the "substantial' shareholder-relations expenses" of a public corporation, "including reporting

⁸⁸ *Id.* at 87 (citations omitted).

⁸⁹ *See id.* at 88-89.

⁹⁰ *Id.* at 88.

⁹¹ *Id.*

⁹² *See id.* at 88-89. It is a dubious assumption to conclude that long-term benefits will automatically accrue by transforming a publicly held company to a private company or wholly owned subsidiary. Although some cost savings may accrue to the company, there are significant disadvantages to being a private company. Private companies do not have access to the public markets for additional capital and do not provide the same liquidity for their shareholders. *See A.E. Staley Mfg. Co. v. Commissioner*, 105 T.C. 166, 219 (1995) (Laro, J., dissenting).

and disclosure obligations, proxy battles, and derivative suits.”⁹³ In the Court’s view, the combination of synergy, resource-related benefits, and the significant cost savings of going private were sufficient long-term benefits to justify capitalization.

The Court also suggested that the corporation’s purpose behind the expenditure may also be relevant to the capitalization determination.⁹⁴ The expenditures are capital because “the purpose for which the expenditure [was] made has to do with the corporation’s operations and betterment, . . . [providing benefits] for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year.”⁹⁵

The *INDOPCO* opinion, however, has solved little, save its interpretation of *Lincoln Savings*.⁹⁶ Its broad statements on “future benefits” and the “purpose of the expenditures” have left many questions unanswered, leaving taxpayers uncertain of *INDOPCO*’s future application and scope.⁹⁷ Many commentators argue that *INDOPCO* did not create any new law.⁹⁸ Essentially, they argue that *INDOPCO* was merely a clarification of *Lincoln Savings*, *i.e.*, that the separate and distinct asset test is not an exclusive test. This is the position that the Service has adopted.⁹⁹ One thing no one doubts is that *INDOPCO* created confusion and uncertainty, committing future taxpayers to litigate their capitalization cases on their own facts.¹⁰⁰

⁹³ *Id.* at 89.

⁹⁴ *See id.* at 89–90.

⁹⁵ *Id.* at 90 (quoting *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 715 (8th Cir. 1964)). The Court’s focus on the target corporation’s subjective purpose behind the expenditure is misplaced. The objective of capitalization is to clearly reflect a taxpayer’s income; accordingly, the subjective reason for incurring the expense should be irrelevant to the determination. *See infra* note 146.

⁹⁶ *See* Susan Jacobini, CPA, *Tax Treatment of Takeover Expenses Remains Unresolved*, 48 TAX’N FOR ACCT. 274, 278 (1992).

⁹⁷ *See* Faber, *supra* note 17, at 622; Jacobini, *supra* note 96, at 274; Richard M. Lipton et al., *Supreme Court Approves Focus on Long-Term Benefit in Takeover Expense Controversy*, 76 J. TAX’N 324, 329 (1992); Ingalls, *supra* note 72, at 1196–97; Lyke, *supra* note 72, at 1252.

⁹⁸ *See* Jacobini, *supra* note 96, at 278; Lee A. Shepard, *News Analysis: The INDOPCO Case and Hostile Defense Expenses*, 54 TAX NOTES 1458, 1458 (1992); Patrick Crawford, Note, *INDOPCO v. Commissioner: Form over Substance in the Judicial Regulation of the Market for Corporate Control*, 12 VA. TAX REV. 121, 133–34 (1992); Jeffrey Gates Davis, Comment, *INDOPCO, Inc. v. Commissioner: National Starch Isn’t the Only One “Stiffed” by the Supreme Court’s Decision*, 20 PEPP. L. REV. 1455, 1456 (1993).

⁹⁹ *See* I.R.S. Notice 96-7, 1996-6 I.R.B. 22 (stating “that the *INDOPCO* decision did not change the fundamental legal principles for determining whether a particular expenditure may be deducted or must be capitalized.”).

¹⁰⁰ *See* Ingalls, *supra* note 72, at 1198.

IV. THE POST-*INDOPCO* TAX TREATMENT OF A TARGET'S ACQUISITIVE REORGANIZATION EXPENDITURES

INDOPCO viewed Unilever's friendly acquisition as just another form of corporate restructuring.¹⁰¹ However, due to the uncertainty surrounding *INDOPCO*'s holding, its application to corporate acquisitions other than friendly acquisitions was, and is still, not altogether clear. At stake is the current deductibility of costs incurred by the target corporation in connection with the acquisition. Those costs may include, inter alia, legal and accounting fees for advice relating to the transaction and for document preparation; costs of proxy solicitations; costs of negotiating the agreement; costs of document printing; and costs of holding shareholder meetings. These expenditures are often substantial, thereby increasing the importance of obtaining a current deduction.

A. *White Knight Transactions Not Consummated*

In *United States v. Federated Department Stores, Inc.* (In re *Federated Department Stores, Inc.*),¹⁰² the district court affirmed a bankruptcy court holding that allowed a deduction for fees incurred in an abandoned white knight merger transaction that was used to defend a hostile acquisition.

1. *Facts of Federated*

In 1988, Campeau Corporation (Campeau) launched a hostile takeover bid for Federated Department Stores (Federated) at \$47 per share.¹⁰³ Federated's board concluded the price was too low, and it feared Campeau would dismantle the company after the acquisition; accordingly, it recommended that shareholders reject the tender offer.¹⁰⁴

In the meantime, Federated courted a white knight, R.H. Macy & Company (Macy).¹⁰⁵ Macy offered to buy Federated shares for \$73.80.¹⁰⁶ Federated's agreement with Macy included a break-up fee provision that

¹⁰¹ See *INDOPCO*, 503 U.S. at 89.

¹⁰² 171 B.R. 603 (S.D. Ohio 1994).

¹⁰³ See *id.* at 606.

¹⁰⁴ See *id.*

¹⁰⁵ See *id.* A white knight represents a third company which management calls on to help it avoid the initial unwanted tender offer. See BLACK'S LAW DICTIONARY 1596 (6th ed. 1990). This invited suitor negotiates toward a merger directly with target management while the hostile bidder deals directly with shareholders. See *id.*

¹⁰⁶ See *Federated*, 171 B.R. at 606.

required Federated, if it merged with another entity, to pay all of Macy's expenses up to \$45 million, plus 25% of any excess consideration received by Federated's shareholders from the new acquirer.¹⁰⁷

Before Macy's offer was set to expire—and unbeknownst to Federated—“Campeau and Macy met privately and negotiated an agreement whereby Macy would withdraw its tender offer if Campeau would ensure that Federated would pay Macy the \$60 million in break-up fees.”¹⁰⁸ Having been jilted, Federated, now left with only Campeau's offer, recommended that its shareholders accept.¹⁰⁹ In accordance with the break-up fee provision, Federated paid Macy \$60 million and deducted it in full on its federal income tax return.¹¹⁰ Shortly after the transaction was consummated, Federated filed a petition to reorganize in bankruptcy.¹¹¹

2. Holding on Appeal

The bankruptcy court held that break-up fees associated with white knight transactions are deductible as an ordinary and necessary business expense or as a loss.¹¹² The bankruptcy court decision, however, was rendered six weeks before *INDOPCO*. Therefore, on appeal the district court had to reconsider the lower court's holding in light of *INDOPCO*.¹¹³

The court affirmed, holding that no future benefit was created.¹¹⁴ The court found the merger did not create synergy between the merged companies—the so called synergistic benefits in *INDOPCO*.¹¹⁵ The synergy in *INDOPCO* was due to the relationship of the merging companies. The *Federated* court, focusing on the dissimilarities of the companies, determined that no synergy was created. In *INDOPCO*, the merged companies were in a supplier-vendor relationship.¹¹⁶ In the Federated-Campeau merger, however, no such

¹⁰⁷ See *id.*

¹⁰⁸ *Id.*

¹⁰⁹ See *id.*

¹¹⁰ See *id.*

¹¹¹ See *id.*

¹¹² See *id.* at 608.

¹¹³ The district court interpreted *INDOPCO* to mean that capitalization is required “in two situations: 1) when a separate and distinct asset is created; or 2) when the taxpayer realizes benefits that are more than incidental in years after the expenditure was made.” *Id.* at 609.

¹¹⁴ See *id.*

¹¹⁵ See *id.* Without explanation, the court's long-term benefit analysis failed to consider the possible future cost savings of going private that the *INDOPCO* court found significant.

¹¹⁶ *INDOPCO* was a supplier of Unilever, the acquiring corporation. The amalgamation of the companies provided access to significant resources and distribution network which

relationship was present. Campeau had no prior relationship with Federated and was inexperienced in Federated's business, *i.e.*, large department store retailing.¹¹⁷ The merging companies had "wholly unrelated business operations," indicating a lack of synergy.¹¹⁸

In addition, the court accepted Federated's argument that the expenses were to defend the business from attack and thus currently deductible.¹¹⁹ The expenditures did not create or enhance a new asset, they only protected the existing corporate structure.¹²⁰

Alternatively, the court held the expenses deductible as a loss under section 165.¹²¹ The court found two separate and distinct transactions—one involving a white knight transaction and the other involving the merger with Campeau.¹²² The former was a failed merger, an abandoned capital transaction, and thus expenses associated with it constituted a deductible loss.¹²³ The white knight and Campeau transactions must be viewed separately: "[J]ust because a failed capital transaction has some effect on a later successful capital transaction does not prevent a deduction for a loss sustained in the failed transaction."¹²⁴ "Any effect that [the abandoned white knight transaction] had on the later merger with Campeau is irrelevant."¹²⁵

The court's holding with respect to section 162 is probably most significant. The rationale underlying that holding was that the white knight expense was incurred defending the corporation from attack, *i.e.*, preserving the status quo. More significantly, the court found that those expenses did not create any future benefits in the later merger with Campeau; *no synergy was created from the*

would provide significant benefits to INDOPCO. *See supra* text accompanying notes 89–93.

¹¹⁷ *See Federated*, 171 B.R. at 609.

¹¹⁸ *Id.*

¹¹⁹ *See id.* at 610; *see also supra* note 30 and accompanying text.

¹²⁰ *See Federated*, 171 B.R. at 610.

¹²¹ *See id.* at 613.

¹²² *See id.* at 611.

¹²³ *See id.* Courts have long held that costs incurred in abandoned capital transactions are currently deductible as a loss. A deduction for expenditures related to an abandoned transaction is allowed in the year abandoned because after the abandonment it is clear the expenditure will not have a future benefit to the taxpayer. *See, e.g.*, *El Paso Co. v. United States*, 694 F.2d 703 (Fed. Cir. 1982); *Picker v. United States*, 371 F.2d 486 (Ct. Cl. 1967); *Tobacco Prod. Export Corp. v. Commissioner*, 18 T.C. 1100 (1952), *modified*, 21 T.C. 625 (1954); *Sibley, Lindsay and Curr Co. v. Commissioner*, 15 T.C. 106 (1950); *Doernbecher Mfg. Co. v. Commissioner*, 30 B.T.A. 973 (1934), *aff'd*, 80 F.2d 573 (9th Cir. 1935); *Portland Furniture Mfg. Co. v. Commissioner*, 30 B.T.A. 878 (1934); *Rev. Rul. 79-2*, 1979-1 C.B. 98; *Rev. Rul. 74-104*, 1974-1 C.B. 70; *Rev. Rul. 73-580*, 1973-2 C.B. 86.

¹²⁴ *Federated*, 171 B.R. at 611.

¹²⁵ *Id.* at 611–12.

*merger of two companies with wholly unrelated business operations.*¹²⁶ This holding should signal future taxpayers to make their “no synergy” argument for a current deduction based on the dissimilarities of the merged companies’ operations.¹²⁷ The more dissimilar the companies’ operations, product lines, and markets, the more tenable the taxpayer’s no synergy argument will be. In *Federated*, Campeau’s lack of experience in department store retailing was enough difference to influence the court.

The court’s holding with regard to section 165 is also justified considering it found no future benefits from the merger. However, the court’s suggestion that the abandoned transaction’s effect on the later merger is “irrelevant” is surprising when viewed in light of *INDOPCO*. The court’s exhortation goes too far. Even though it may have been irrelevant in *Federated* because a lack of future benefits seems clear, the teaching of *INDOPCO* rejects such a broad statement. *INDOPCO* focused on an expenditure’s future benefit; it made no exception for an abandoned transaction that provides a future benefit in subsequent transactions. Following *INDOPCO*, it seems clear that if an expenditure related to an abandoned transaction provides a future benefit to a subsequent transaction, that effect is not irrelevant—in fact, if a future benefit is present, those expenditures related to the abandoned transaction should be capitalized. An abandoned white knight transaction may have the effect of driving up the acquiring company’s offer price, resulting in a benefit to the target company’s shareholders.¹²⁸ If this cause and effect holds true, the white knight expenses should be capitalized under *INDOPCO*.

This cause and effect relationship is not lost on the management of companies involved in acquisitive transactions; rather, it is one reason why white knights require, and target companies agree to pay, large break-up fees.¹²⁹ White knights realize that target management may be behaving

¹²⁶ See *id.* at 609.

¹²⁷ The courts, however, will most likely reject dissimilarity of operations standing alone. An additional factor in *Federated* was the lower court’s finding that Federated “fought tooth and nail to prevent the consummation of [the merger] with Campeau.” *In re Federated Department Stores, Inc.*, 135 B.R. 950, 959 (Bankr. S.D. Ohio 1992), *aff’d*, 171 B.R. 603 (S.D. Ohio 1994). Also, the district court attached significance to Federated’s petition in bankruptcy. See *Federated* 171 B.R. at 610.

¹²⁸ If the primary purpose is to benefit the shareholders, the expenditure should not be deductible at the corporate level. Instead, constructive dividend treatment is appropriate. This treatment prevents the company from deducting the expenditure now or in the future. See discussion *infra* Part IV.D.

¹²⁹ White knights typically require break-up fee provisions “as a condition to an agreement to acquire a company.” *In re Federated Department Stores, Inc.*, 135 B.R. at 954. Ostensibly, such fees are meant to reimburse the white knight for expenses incurred “to arrange financing, retain counsel and investment banking assistance, pay commitment fees

strategically, using the white knight strategy to force the acquiring company's hand and to enhance the target's own negotiating position with the original suitor.¹³⁰

B. Friendly Acquisitions

In *Victory Markets, Inc. v. Commissioner*,¹³¹ the taxpayer argued that professional fees incurred in connection with a hostile acquisition of its stock were currently deductible. It argued that, unlike the taxpayer in *INDOPCO*, its stock was acquired in a hostile takeover,¹³² that it did not anticipate any long-term benefits from the acquisition, and that its board of directors approved the takeover only because of its fiduciary duties to the stockholders.¹³³

The Tax Court rejected these arguments, finding that the offer was not hostile.¹³⁴ The court concluded that the events leading up to the merger were indistinguishable from *INDOPCO*.¹³⁵ Accordingly, the decision would rest on analyzing *INDOPCO*'s long-term benefit test as applied to the facts. In concluding that the merger created future benefits, the court found synergistic benefits, resource-related benefits, and future cost savings from the merger. First, the board approved the acquirer's offer—signaling to the court that the board had indeed determined the takeover was in the best interests of the corporation and stockholders.¹³⁶ In addition, *Victory Markets* announced the

and cover other substantial costs and expenses incurred in responding quickly in a hostile takeover situation." *Id.*

¹³⁰ See *infra* note 146.

¹³¹ 99 T.C. 648 (1992).

¹³² See *id.* at 661.

¹³³ See *id.* at 665.

¹³⁴ See *id.* at 661–62. The failure of the acquiring company to make a tender offer directly to *Victory Markets*'s shareholders and the failure of *Victory Markets*'s board to invoke its recently adopted poison pill supported the lack of hostility. See *id.* at 662. A poison pill is an antitakeover device used by a target company to repel an unwanted suitor. See BLACK'S LAW DICTIONARY 1156 (6th ed. 1990). This device is designed to make the target company's stock and financial condition less appealing. See *id.* For example, a poison pill may afford the target company's shareholders the right to purchase shares of the acquiring or target company at a substantial discount from the market price. See *Victory Markets*, 99 T.C. at 653. Poison pills discourage hostile takeover attempts with such "giveaway" provisions because they dilute the voting power and ownership of the effected company (either the target or suitor, depending on the plan provisions). See *id.* The *Victory Markets* court cast off the board's adoption of a poison pill defense as a thinly disguised "bargaining enhancement," and not a legitimate attempt to avoid the takeover. See *id.* at 662.

¹³⁵ See *id.* at 657 n.4.

¹³⁶ See *id.* at 663.

merger by issuing a press release that lauded the acquiring company's skill, expertise, personnel, and experience in the food business and announced that the acquisition would "strengthen Victory and put the company in an excellent position for further expansion."¹³⁷ Moreover, Victory Markets's rapid expansion after being acquired was partially financed by loans from the acquiring company.¹³⁸ Also, the court found Victory Markets's transformation from a publicly held corporation into a wholly owned subsidiary would produce significant future cost savings.¹³⁹ As in *INDOPCO*, the combination of synergistic benefits, resource-related benefits, and future cost savings from going private were sufficient to justify capitalization.

Victory Markets was the Tax Court's first post-*INDOPCO* decision involving a friendly acquisition. And despite interpretive difficulties surrounding that opinion, *Victory Markets* clearly indicates that under *INDOPCO* "expenses incurred by the target company in a friendly merger must be capitalized."¹⁴⁰ Although taxpayers involved in such mergers may be able to distinguish *INDOPCO*'s facts, arguing and proving no synergy, no resource-related benefits, and no cost savings, and thus, no long-term benefits, will be a difficult task.¹⁴¹

C. Hostile Acquisitions

1. *Is Life Full Enough to Supply the Answer?*

Are expenditures incurred to defend against a hostile acquisition currently deductible? *INDOPCO* failed to deliver an answer. *Victory Markets* rejected the taxpayer's claim that it was acquired in a hostile acquisition, and thus, it too failed to resolve the question. The Service has taken the position that the nature of the acquisition—whether it is hostile or friendly—is not determinative of the

¹³⁷ *Id.* at 663–64 (quoting from Victory Markets's press release announcing the merger).

¹³⁸ *See id.* at 664.

¹³⁹ *See id.* But see *supra* note 92.

¹⁴⁰ Paul D. Manca, Note, *Deductibility of Takeover and Non-Takeover Expenses in the Wake of INDOPCO, Inc. v. Commissioner*, 45 TAX LAW. 815, 818–19 (1992).

¹⁴¹ *See id.* A corporate board of directors's fiduciary duties engender problems for target corporations arguing that no long-term benefits are produced from merging the two entities. One treatise has suggested that the board's approval of the transaction may necessarily supply the Service with evidence of long-term benefits. *See infra* note 203. The court in *A.E. Staley Manufacturing Co. v. Commissioner*, 105 T.C. 166 (1995), relied heavily on the board's approval in denying a current deduction. This reliance may, however, be misplaced, at least concerning the board's duties under Delaware corporate law. *See infra* notes 182–85 and accompanying text.

deductibility of professional fees and other costs associated with such a transaction.¹⁴² Instead, the Service claims an analysis of the expenditures' long-term benefits is the proper focus, that labels should be disregarded, and that each case will turn on its own facts and circumstances.¹⁴³ Commentators, on the other hand, have argued that costs to defend against a hostile acquisition should be deductible "on the same basis as the cost of defending a proxy fight—that is, the expenses are incurred primarily to protect . . . corporate policy,"¹⁴⁴ and not for the purpose of obtaining any long-term benefits. Defending corporate policy is simply protecting the status quo, and therefore, regardless of the ultimate success or failure of the hostile acquisition, the expenditures should be currently deductible.¹⁴⁵ In addition, if the target company's board of directors determines that the hostile acquisition is not in the best interests of the corporation and stockholders and thus fails to approve the merger, the claim of no long-term benefit is strengthened.¹⁴⁶

¹⁴² See Tech. Adv. Mem. 91-44-042 (July 1, 1991).

¹⁴³ See *id.*

¹⁴⁴ BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 915.04, at 5-14 (5th ed. 1987); see also *Locke Mfg. Co. v. United States*, 237 F. Supp. 80 (D. Conn. 1964) (holding that expenses incurred in a proxy fight which involved a dispute in corporate policy were currently deductible because they were incurred based on management's good faith belief that it was in the best interests of the shareholders to resist); Rev. Rul. 67-1, 1967-1 C.B. 28 (deduction under section 162 allowed for an expenditure incurred in connection with a corporate proxy fight so long as dispute involves questions of corporate policy).

¹⁴⁵ Again, this essentially is the "defense against attack theory" articulated by Justice Cardozo in *Welch v. Helvering*, 290 U.S. 111, 114 (1933). See *supra* note 30.

¹⁴⁶ However, as the Tax Court noted in *Victory Markets*, some hostile acquisition defense measures are mere posturing, designed solely as a "bargaining enhancement" to leverage the target's negotiating position. See *Victory Markets*, 99 T.C. at 662. This point illuminates the difficulty with *INDOPCO's* insistence on examining the purpose of the expenditure. Examining the board's actions and inquiring into its subjective reasons for making an expenditure in order to determine the "long-term benefits" and "purpose" of the expenditure will most likely lead to results inconsistent with the economic reality of the transaction. Real-life actors, *i.e.*, the directors, will bargain strategically—asking for much, offering little, threatening to walk away from the deal—in an effort to maximize their economic rewards. This behavior exhausts candor, leaving the genuine "purpose" of the expenditure unknown to all except the most Freudian of courts. In *A.E. Staley Manufacturing Co. v. Commissioner*, 105 T.C. 166 (1995), the Tax Court realized the debility of analyzing "purpose" and summarily rejected it by noting: "If the purpose of the relevant Code provisions is to match expense with income, the directors' subjective reasons for making the expenditure are not significant to the analysis." See *id.* at 194. The court concluded that an objective determination must be made whether the services obtained from investment bankers and other professionals in a hostile transaction give rise to any long-term benefit. See *id.* at

So with this oracle-like guidance from commentators, courts, and the Service, tax medicine men are left to ponder the imponderable, parties interested in an answer to the “riddle” surrounding the deductibility of hostile acquisition costs had to wait. Wait for the second coming of Justice Cardozo to supply the answer? No, taxpayers simply had to “wait for life in all its fullness to supply the answer,”¹⁴⁷ hopefully an answer in the form of a court opinion in a pure hostile takeover situation. Taxpayers are still waiting; the courts have not yet decided such a case.

2. *Defense of a Hostile Acquisition Followed by a Board-Approved Transaction*

The question of *INDOPCO*'s application in hostile acquisition situations, which the Tax Court left unanswered in *Victory Markets*, was partially answered in *A.E. Staley Manufacturing Co. v. Commissioner*.¹⁴⁸ The Tax Court held that investment bankers' fees and printing costs incurred in an unsuccessful defense against a hostile acquisition were capital expenditures. Based partially on the fact that Staley's board ultimately approved the acquisition, the court concluded that the expenditures were related to long-term corporate betterment, were not used for current income production or the immediate needs of the corporation, and thus were not currently deductible.

a. *Facts of Staley*

Tate & Lyle PLC (Tate) launched a hostile bid for A.E. Staley Manufacturing Co. (Staley) at \$32 per share.¹⁴⁹ Staley engaged investment bankers First Boston and Merrill Lynch shortly thereafter for guidance in evaluating the offers.¹⁵⁰ After both investment bankers advised it that the offer was inadequate, Staley's board of directors advised shareholders to reject the offer.¹⁵¹

196.

¹⁴⁷ *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (quoting Cardozo, J.).

¹⁴⁸ 105 T.C. 166 (1995).

¹⁴⁹ *See id.* at 181.

¹⁵⁰ *See id.* The agreements with the investment bankers provided that they would undertake a study and analysis of Staley's business operations, financial condition, and prospects; assist in evaluating the hostile bid; evaluate strategic alternatives to the hostile bid; render a fairness opinion with respect to the hostile bid; assist in negotiations with the hostile bidder; and advise the company in the event a proxy contest developed. *See id.* at 174-75.

¹⁵¹ *See id.* at 181. The investment bankers advised the board of directors that the per share value of Staley, on an after-tax basis, was between \$35.83 and \$43.57. *See id.* at 175.

In the meantime, Staley, with advice from its investment bankers and legal counsel, considered alternative strategies to block the offer.¹⁵² Without solicitation from Staley, Tate increased its all-cash offer for Staley's stock to \$35 per share.¹⁵³ Again, Staley's board recommended that shareholders reject the offer.¹⁵⁴ The board continued pursuing alternatives to the tender offer.¹⁵⁵ When no attractive alternatives developed, Staley began formal negotiations with Tate; eventually the parties agreed on a per share price of \$36.50.¹⁵⁶

Staley deducted the \$23 million in legal fees, investment bankers' fees, and printing costs that it incurred in defending against the hostile bid and in evaluating alternatives to the acquisition.¹⁵⁷ The Service disallowed deductions for investment banking fees and printing costs totaling approximately \$14 million.¹⁵⁸

b. Application of INDOPCO to Staley

Staley claimed that no long-term benefits were anticipated from the expenditures incurred while defending against the hostile acquisition.¹⁵⁹ Those costs, it argued, were incurred simply to protect the business from attack.¹⁶⁰

¹⁵² See *id.* at 181. The investment bankers investigated various potential actions, including a recapitalization, a leveraged buy-out, a white knight transaction, the sale of a corporate division; placement of blocks of stock, a spin-off, a public stock offering; and a hostile bid for Tate & Lyle. See *id.* at 175.

¹⁵³ See *id.* at 181.

¹⁵⁴ See *id.* The board of directors unanimously determined that \$35 per share was inadequate, and that it was not in the best interests of the corporation and stockholders to accept the bid. See *id.* at 176-77. The board of directors also resolved that Staley should continue to explore and investigate, with its legal and financial advisors, the feasibility of alternative transactions. See *id.* at 177.

¹⁵⁵ See *id.* at 181.

¹⁵⁶ See *id.* at 181-82. The investment bankers advised the board that none of the more than fifty potential suitors that they contacted was interested in acquiring Staley and that a recapitalization or a leveraged buy-out were not realistic options. See *id.* at 178. Shortly thereafter, the board recommended the shareholders accept the offer at \$36.50 per share. See *id.*

¹⁵⁷ See *id.* at 180.

¹⁵⁸ See *id.* at 182.

¹⁵⁹ See *id.* at 187.

¹⁶⁰ See *id.* Staley claimed that, unlike the taxpayers in *Victory Markets* and *INDOPCO*, it never wanted to be taken over by Tate. See *id.* Tate announced that, if successful, it planned to discard Staley's management and business plan and to break up the company. See *id.* On the other hand, the acquiring companies in *Victory Markets* and *INDOPCO* planned no changes in the target's business plan or management. See *id.* Immediately after the merger, Tate did in fact replace Staley's senior management, including the chairman and chief

The ultimate success or failure of the hostile bid should not control deductibility when the corporation is merely preserving the status quo.¹⁶¹ Essentially, Staley argued that expenditures incurred *prior* to board approval are deductible under the “defense against attack” theory and expenditures incurred *after* the approval are deductible under *INDOPCO* because they provide no long-term benefit.

The court rejected Staley’s arguments. In its judgment, the initial characterization of the attack as hostile was immaterial.¹⁶² The Code provisions are designed to match income with expense, resulting in a clear reflection of income. The hostile or friendly nature of the acquisition, therefore, does not matter.¹⁶³ The inquiry must focus on whether the expenditures provided any continuing benefit to Staley.¹⁶⁴

After making such an inquiry, the court found the expenditures would benefit Staley’s operations for the indefinite future.¹⁶⁵ The court could not escape that conclusion based on the fact “that the board (1) approved a merger with Tate & Lyle and (2) recommended Tate & Lyle’s third offer to shareholders as ‘fair’ and in their ‘best interests.’”¹⁶⁶ Furthermore, the court concluded that Staley’s new owner would be amiss if it denied seeing synergistic opportunity in the acquisition.¹⁶⁷ In addition, echoing *INDOPCO* and *Victory Markets*, the court found Staley’s transformation from a publicly held corporation to a wholly owned subsidiary would relieve it from substantial shareholder-related expenses in the future.¹⁶⁸ The court found that “any

executive officer, chief financial officer, executive vice president, vice president for law and secretary of the board, treasurer and senior vice president, controller and vice president, and vice president for corporate relations. *See id.* at 179.

¹⁶¹ *See, e.g., Welch v. Helvering*, 290 U.S. 111, 114 (1933).

¹⁶² *See Staley*, 105 T.C. at 198. Apparently, the Tax Court was following the Service’s position announced in Tech. Adv. Mem. 91-44-042 (July 1, 1991). *See supra* notes 142-43 and accompanying text.

¹⁶³ *See Staley*, 105 T.C. at 194.

¹⁶⁴ *See id.* at 196.

¹⁶⁵ *See id.* at 197.

¹⁶⁶ *Id.* After *INDOPCO* and *Victory Markets*, it appears that the board of directors’ approval of the merger proposal will provide the court with sufficient evidence of long-term benefits to the corporation. *See infra* note 203.

¹⁶⁷ *See id.* at 198. This focus on the future benefits that the acquiring company anticipated in the acquisition seems misplaced. As Judge Cohen noted in dissent, “[t]he only benefits to the future operations of petitioner discussed in the majority opinion are those perceived by the offeror, Tate & Lyle, and not by the management that incurred the expenses.” *Id.* at 215 (Cohen, J., dissenting). Attributing the possible benefits accruing to the acquiring company to the target seems to violate a basic tenet underlying federal income taxation: the respect for the separate identity of corporate entities. *See Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438-39 (1943).

¹⁶⁸ *See Staley*, 105 T.C. at 198.

distinctions between this case, on the one hand, and [*INDOPCO*] and *Victory Markets*, on the other, are distinctions without a difference.”¹⁶⁹ The court’s determination that the transaction would produce synergistic benefits, resource-related benefits, and costs savings sealed Staley’s fate. The expenditures in question—investment banking fees and printing costs—were made pursuant to a change in corporate ownership. “[E]xpenditures incurred in reorganizing or restructuring the corporation are not deductible under section 162(a), no deduction is available for corporate expenditures made incident to a recapitalization or other reorganization even if the transaction is undertaken to protect the corporation against the threat of being acquired.”¹⁷⁰ The expenditures were not ordinary and necessary to carrying on the taxpayer’s trade or business, nor were they related to current income production or the present needs of the business.¹⁷¹ Rather, the expenditures “were incurred in connection with a change in ownership with indefinite and extended future consequences.”¹⁷²

c. *Deductibility of Abandoned Transactions Under Section 165*

Staley also claimed that when a plan of reorganization is abandoned the expenditures related to the abandoned transaction are currently deductible because at that point the transaction will not produce any future benefit.¹⁷³ It argued that all of the investment bankers’ fees were directed toward implementing a plan which, if successful, would have required capitalization. That plan was abandoned when it accepted Tate’s offer; thus, the costs of the abandoned plan were deductible as a section 165 loss.¹⁷⁴ The Tax Court agreed with Staley’s recitation of the law, but rejected Staley’s factual analysis as being devoid of proof.¹⁷⁵ Staley failed to prove that any amounts paid to investment bankers, or for printing fees, should be allocated to any separate and distinct

¹⁶⁹ *Id.*

¹⁷⁰ *Id.* at 194. This sweeping statement seemingly rejects the defense against attack theory of *Welch v. Helvering*, 290 U.S. 111, 114 (1933). Although the Supreme Court has not expressly overruled *Welch*, the *INDOPCO*, *Victory Markets*, *Staley* trilogy has eroded its significance in cases where the acquisition is successful. With the courts’ attention clearly focused on scrutinizing expenditures for long-term benefits, taxpayers should not expect *Welch*’s defense against attack argument to be a show stopper.

¹⁷¹ *See Staley*, 105 T.C. at 197.

¹⁷² *Id.*

¹⁷³ *See id.* at 200.

¹⁷⁴ *See id.* at 199.

¹⁷⁵ *See id.* at 200.

transactions that were abandoned.¹⁷⁶ Of the approximately \$14 million in investment banking fees, \$12.5 million was payable contingent on Tate's *successful* acquisition of 50% of Staley's common stock.¹⁷⁷ In addition, \$1 million was payable in any event. The fees were pegged to a *completed* stock sale, *not* a transaction that was abandoned.¹⁷⁸ Thus, no deduction under section 165 was allowed.¹⁷⁹

d. *Postmortem Examination of Staley*

Staley appears to have adopted a per se rule denying a deduction of the target's expenditures incurred in an acquisitive transaction that is ultimately successful. This rule arguably goes beyond the rule set forth in *INDOPCO*. Although this stringent rule may provide "certainty by requiring capitalization of all expenses relating to restructuring of stock ownership," it clearly goes beyond the rule provided by Congress and the Supreme Court.¹⁸⁰ Nevertheless, the clear signal from the *Staley* court is that labels—hostile or friendly—are not the issue when analyzing the long-term benefits of expenditures incurred in an acquisition transaction.¹⁸¹

In denying a current deduction, the court relied heavily on the fact that Staley's board ultimately approved the acquisition. Apparently the ultimate success of the acquisition coupled with board approval is sufficient evidence that long-term benefits are anticipated. This logic is troubling and may not

¹⁷⁶ See *id.* The court in *Federated* allowed a deduction under section 165 on the rationale that separate and distinct transactions that are abandoned provide no future benefits. See *supra* notes 121–25 and accompanying text.

¹⁷⁷ See *id.*

¹⁷⁸ See *id.*

¹⁷⁹ See *id.*

¹⁸⁰ *Id.* at 217 (Cohen, J., dissenting).

¹⁸¹ Judge Laro, in dissent, found the hostile nature of the takeover significant. He felt that the contextual differences between this case, on one hand, and *INDOPCO* and *Victory Markets*, on the other hand, warranted further examination. See *id.* at 218 (Laro, J., dissenting). In the latter cases, the target company's board anticipated benefits from the merger and thus worked toward a mutually agreeable transaction. See *id.* However, in this case, the takeover was hostile; Tate made a public tender offer directly to the shareholders and threatened to fire management and change Staley's business plan. See *id.* Staley was simply trying to defend itself from a takeover which it considered a threat to the long-term interests of the company. See *id.* However, Judge Laro does not suggest that labels are dispositive, but only that "a complete legal analysis" would address the issue for the purpose of determining whether any long-term benefits accrue from the transaction. *Id.* at 219. The presence of a hostile takeover is strong circumstantial evidence that no long-term benefits are anticipated from the transaction. See *id.* at 219–20.

reflect the underlying reason behind the board's decision. Under Delaware corporate law the board of directors has a fiduciary duty "to determine whether the [acquisition] is in the best interests of the corporation and its shareholders."¹⁸² To discharge this fiduciary duty, the board has the power to adopt defensive measures to thwart a change in ownership that it feels is detrimental to corporate policy and effectiveness.¹⁸³ This power, however, has a limit. It is limited by the requirement that adoption of defensive measures designed to protect the corporate enterprise be rationally related to the creation of some stockholder benefit.¹⁸⁴ In fact, when the acquisition of the company becomes inevitable, the board's role changes from the preservation of the corporate enterprise "to auctioneers charged with getting the best price for the stockholders."¹⁸⁵ Accordingly, under these standards, a board could determine that the acquisition would not result in long-term benefits to the corporate enterprise but still be required to approve the acquisition as being in the best interests of the stockholders.

Staley is significant in another respect: it rejected the notion, set forth in *INDOPCO*, that the purpose of the expenditure is relevant to the analysis.¹⁸⁶ In the court's view, the purpose of the Code provisions is to match income with expense so as to clearly reflect income.¹⁸⁷ Therefore, analyzing the purpose of the expenditure serves no end. Although this is unassailable logic, it certainly is not the rule set forth by the Supreme Court in *INDOPCO*. To what extent other courts will follow this "logic" is unclear.

With respect to section 165, the court's holding indicated that with proper expense allocation *Staley* may have been entitled to a loss deduction.¹⁸⁸ However, as the court noted, *Staley* failed to *prove* that any of its fees were

¹⁸² *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).

¹⁸³ *See id.* at 955.

¹⁸⁴ *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 176 (Del. 1986). This limit is designed to check the ever present prospect that board members may be acting for the primary purpose of entrenching themselves in office. *See Unocal*, 493 A.2d at 954.

¹⁸⁵ *Revlon*, 506 A.2d at 182.

¹⁸⁶ *See Staley*, 105 T.C. at 194. Both dissenting opinions in *Staley* criticized the majority's assertion that "purpose" is irrelevant. *See id.* at 216 (Cohen, J., dissenting); *id.* at 218 (Laro, J., dissenting). Judge Laro noted that *INDOPCO* emphasized that the analysis of long-term benefits should address whether the purpose of the expenditures was to change the corporate structure for the benefit of future operations. *See id.* at 220. He noted that in hostile acquisition situations such purpose will not be present: any defensive measures are designed merely to protect the corporate enterprise and are not designed to produce long-term benefits. *See id.*; *see also supra* note 30. *But see supra* note 146.

¹⁸⁷ *See Staley*, 105 T.C. at 194.

¹⁸⁸ *See id.* at 200.

associated with an abandoned transaction.¹⁸⁹ Certainly, it is unquestionable that Staley had expenditures relating to abandoned transactions. The facts indicate that Staley's investment bankers and legal advisors spent significant time investigating alternative plans that in the end were abandoned.¹⁹⁰ However, as the court noted, Staley failed to carry its burden of proof at trial, thus preventing a loss deduction under section 165.¹⁹¹

D. *Constructive Dividend Treatment: The Forgotten Argument*

For an expenditure to be currently deducted under section 162(a) it must, among other things, be motivated by an attempt to acquire profit for the business.¹⁹² This requires a direct connection between the expenditure and carrying on the business. It is on this basis that one can argue that expenditures incurred pursuant to a change in corporate ownership are constructive dividends to the target corporation's shareholders.¹⁹³ Constructive dividend treatment is appropriate when the primary purpose of the expenditure is to benefit the shareholders.¹⁹⁴ "The crucial concept in finding a constructive dividend is that the corporation conferred an economic benefit on the stockholder without the expectation of repayment."¹⁹⁵ Therefore, if the corporation incurs expenses in connection with the sale of stock by its stockholders, the primary purpose of the expenditures must be examined. When the primary purpose of a corporate expenditure is to sell the stockholder's stock, the primary benefit accrues to the shareholder, not the corporation. Accordingly, these expenditures should not be deductible at the corporate level on the same basis that cash dividends are not deductible. For example, when a target corporation incurs investment bankers' fees in connection with an acquisition attempt or incurs white knight break-up fees, the primary benefit accrues to the shareholders. If the purpose of incurring these fees is to drive up the price at which the stock is acquired, *i.e.*, to provide a benefit at the shareholder level, such expenditures should be treated as

¹⁸⁹ See *id.*

¹⁹⁰ See *supra* notes 150–55 and accompanying text.

¹⁹¹ See *Staley*, 105 T.C. at 200.

¹⁹² See *supra* notes 39–40 and accompanying text.

¹⁹³ For an excellent, comprehensive, well-reasoned discussion of the constructive dividend issue relating to corporate acquisitions, see Calvin H. Johnson, *The Expenditures Incurred by the Target Corporation in an Acquisitive Reorganization Are Dividends to the Shareholders: (Pssst, Don't Tell the Supreme Court)*, 53 TAX NOTES 463 (1991).

¹⁹⁴ See *Sammons v. Commissioner*, 30 T.C.M. (CCH) 626 (1971), *aff'd*, 472 F.2d 449 (5th Cir. 1972).

¹⁹⁵ *Gibbs v. Tomlinson*, 362 F.2d 394, 397 (5th Cir. 1966); see also BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS* ¶ 8.05, at 8-36 (6th ed. 1994).

constructive dividends to the shareholders and should not be deductible at the corporate level.¹⁹⁶

The same treatment should apply to attorneys' fees incurred in structuring a tax-free acquisition of a corporation's shares. For example, in *INDOPCO*, the target corporation incurred attorneys' fees in devising a merger plan that would satisfy its largest shareholders' demand for a tax-free exchange.¹⁹⁷ These fees were incurred for the sole purpose of avoiding a tax recognition event; thus, such fees allowed the largest shareholders to avoid capital gains tax. The entire purpose of the expenditure, not just the primary purpose, was to provide a shareholder benefit. Accordingly, constructive dividend would be the appropriate tax treatment.¹⁹⁸

Considering the large volume of acquisitions, the Commissioner's failure to aggressively pursue constructive dividend treatment for the target's acquisition expenditures is surprising. This approach, theoretically, would allow him to permanently deny a deduction at the corporate level and to pursue income inclusion of the expenditures at the shareholder level. The Commissioner could have his cake and eat it too. What's more, if the *Staley* opinion is any measure, the Tax Court appears receptive to such arguments.¹⁹⁹ Couple that fact with the federal government's insatiable appetite for tax revenue, and taxpayers should not be surprised if the Commissioner begins arguing for constructive dividend treatment in the near future.

¹⁹⁶ A constructive dividend, like all corporate dividends, is not deductible to the corporation. See I.R.C. § 311 (1994). Moreover, the amount of the constructive dividend theoretically should be includable in the income of the shareholders, assuming the corporation had earnings and profits from which to pay. See I.R.C. § 301 (1994). However, some commentators have noted that the Service is often content with disallowing the deduction at the corporate level and thus leaving the constructive dividend untaxed at the shareholder level. See BORIS I. BITTKER & JAMES S. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS* ¶ 7.05, at 7-33 (4th ed. 1979). *But see* Rev. Rul. 75-421, 1975-2 C.B. 108.

¹⁹⁷ See *supra* notes 80-82 and accompanying text.

¹⁹⁸ In Revenue Ruling 75-421, the Service reached a similar result. It held that a corporation's expenditures were constructive dividends to its shareholders when incurred to pay for a stock appraisal so that its shareholders could sell their stock at its maximum value. See Rev. Rul. 75-421, 1975-2 C.B. 108. The Service reasoned that the sale of stock held by a shareholder to a third party is an ownership issue and in substance does not involve the corporation. See *id.* The primary function of the sale is to effect a change in ownership of the target enterprise, *i.e.*, a shareholder issue, and not to affect the company's operations. See *id.*

¹⁹⁹ Judge Beghe's concurring opinion in *Staley* argued for constructive dividend treatment. In addition, the majority opinion alluded to this possibility. However, because the Commissioner only argued for nondeductibility under section 162, the court proceeded on the basis that the timing of the deduction, rather than the fact of the deduction, was the Commissioner's principle concern. See *Staley*, 105 T.C. at 193.

V. PLANNING OPPORTUNITIES AFTER STALEY

Staley's expansive holding appears to have put to rest many questions regarding the deductibility of a target corporation's expenditures. *Staley's* disallowance of deductions for any expenses related to a change in corporate ownership appears to have settled the issue in the Tax Court. The scope of the *Staley* opinion, however, is not clear. To what extent the district courts, bankruptcy courts, and Court of Claims will follow *Staley* or adopt similar positions has yet to be seen. So what is left for corporate tax planners after *Staley*?

A. Proper Analysis of Expenditures

The most straightforward approach that may avoid capital expenditure treatment after *Staley* is simple: perform a detailed analysis of expenditures involved in the acquisition. The corporation must clearly identify its costs and the purpose for them.²⁰⁰ When properly analyzed, certain of these expenditures incurred in the acquisition may prove deductible. Proper classification and analysis of the expenditures will allow the corporation to meet its burden of proof at trial.²⁰¹ As *Staley* indicated, a deduction under section 165 may be

²⁰⁰ There are many and varied expenses that can arise when transferring corporate ownership, including the following expenses: preliminary investigations and negotiations; preparing legal documents; appraisal, legal, and accounting fees related to financial statement preparation and SEC filing requirements; proxy and shareholder solicitations, shareholder meetings, disposition of unwanted assets; disposition of assets to survive antitrust challenges; preparation and filing of private letter rulings; and litigation-related costs. See BITTKER & EUSTICE, *supra* note 195 ¶ 15.06, at 5-55 to 5-56 (footnotes omitted). If the taxpayer expects to deduct any of these expenditures, accurate records of the transaction to which they relate and the facts and circumstances surrounding the expenditure must be maintained. See *id.* at 5-56. Attention to itemization will decrease the chances of losing on burden-of-proof grounds. *Id.*

²⁰¹ The type of evidence which is most useful in supporting a deduction includes the following: (1) itemized bills identifying the payee; (2) documentation supporting the amount remitted to payee and the date of payment; (3) a detailed description of the service provided; (4) documentation detailing the nature and purpose of the expenditure; (5) detail of time spent on each identifiable segment of the transaction; and (6) if the fee is not based on time charges, the nature of work performed and the factors which determine the fee. See J. Phillip Adams & J. Dean Hinderliter, *INDOPCO, Inc. v. Commissioner: Impact Beyond Friendly Takeovers*, 55 TAX NOTES 93, 99 n.57 (1992). In the final analysis, however, the deductibility of a particular expense will turn on several factors, including the following: (1) the nature of the expenditure; (2) the proximity of the expense to the takeover; (3) the form and structure of the transaction; (4) whether the takeover is successful; and (5) the ability to clearly identify

allowed if the taxpayer proves the expenditures were for separate and distinct transactions that were abandoned.²⁰²

Note that, with respect to section 162, this approach may have limited usefulness in the Tax Court. For one, *Staley*'s expansive holding appears to have adopted a per se rule requiring the target's expenditures to be capitalized. Additionally, *Staley* announced that purpose is irrelevant in analyzing the deductibility of such expenditures under section 162. Notwithstanding that fact, proving the purpose of the expenditure may be relevant outside the Tax Court as it is unclear if those courts will follow *Staley*. For example, if the target's engagement letter with its investment bankers or legal counsel indicates that the primary focus of the engagement is to defeat the tender offer, this evidence would go far towards proving that the purpose of the expenditures was not to secure long-term benefits. Outside the Tax Court, the target can make this argument whether or not the acquisition is eventually successful on the theory that, whether successful or unsuccessful, the corporation is not expecting long-term benefits from the defense, but it is merely protecting existing corporate policy.²⁰³

B. Acquisition of Assets and Liquidation of the Target Entity

After *Staley*, target corporations seeking a current deduction for expenditures associated with a consummated transaction have a difficult burden to overcome. As the lengthy discussion above indicates, carrying that burden is a laborious undertaking with the resulting reward being doubtful. But note, if the acquisition is structured as an asset purchase *or* if the acquiring corporation purchases the target corporation's stock and makes a section 338 election,²⁰⁴

the expenditure to a specific transaction. See BITTKER & EUSTICE, *supra* note 195, at 5-55.

²⁰² See *Staley*, 105 T.C. at 200. This is the same basis upon which the *Federated* court allowed the deduction of the break-up fees paid to a white knight. See *supra* notes 121-25 and accompanying text.

²⁰³ Of course, this argument is strengthened if the board of directors did not eventually approve the merger. Based on *Victory Markets* and *Staley*, "it appears that corporate directors who recommend acceptance of a take-over proposal almost necessarily will supply the Service with evidence of the expectations of long-term benefits to the corporation." BITTKER & EUSTICE, *supra* note 195, at 5-54. When the defense is successful, the fact that the expenditures did not create any long-term benefits seems clear. The company has only avoided a detriment. Accordingly, the defense against attack doctrine of *Welch* should support a deduction. When the takeover is ultimately *successful*, however, this doctrine has recently met with limited success. See *supra* note 170.

²⁰⁴ The effect of a section 338 election is two-fold: (1) the target corporation is deemed to have sold all of its assets in a complete liquidation, and (2) the target corporation is treated as a new corporation that purchased all of its assets the day after the acquisition from the old

the effect of *INDOPCO* and its progeny can be minimized. The result under both scenarios should be the same: a current tax recovery of the target corporation's acquisition-related expenditures. This result can be reached under either one of two alternative rationales. First, a corporation that has terminated its economic existence as a going concern through the sale of all of its assets cannot realize any long-term benefits from acquisition-related expenditures.²⁰⁵ The target corporation no longer exists; therefore, even under *INDOPCO* such expenditures should be currently deductible on the corporation's final tax return.

Alternatively, the corporation can recover the expenditures through a decrease in its corporate level gain or in an increase in its corporate level loss on the deemed asset sale.²⁰⁶ The amount of the nondeductible acquisition expenditures is either added to the basis of the disposed assets or treated as a reduction in the selling price of the disposed assets.²⁰⁷ In either case, the nondeductible acquisition expenditures will decrease the target's gain or increase its loss recognized on the disposition; the tax effect is therefore the same as an immediate deduction.²⁰⁸ For example, assume that Acquiring Company (A) offers Target Company (T) \$150,000 for all of its assets. Further assume that T incurs \$10,000 in costs associated with this transaction, has a basis of \$100,000 in its assets, and has taxable income before this transaction of \$90,000. Under either rationale T will have taxable income of \$130,000.²⁰⁹

target corporation. See I.R.C. § 338(a) (1994).

²⁰⁵ See Manca, *supra* note 140, at 817.

²⁰⁶ See MARTIN D. GINSBURG & JACK S. LEVIN, *MERGERS, ACQUISITIONS, AND BUYOUTS* § 402.10.2 (1996). Note that in the case of an acquisition structured as an asset purchase it is an "actual" disposition of assets and not a "deemed" disposition. *Id.*

²⁰⁷ See *id.*

²⁰⁸ See *id.* Section 338 is not a free lunch, however. While making the election will allow the target to recover its acquisition expenditures, the target will incur a taxable gain or loss on the deemed asset sale. And while the nondeductible acquisition expenditures will reduce the gain (or increase the loss), the election may result in a net gain and thus *increase* the target's taxable income. Obviously, the decision to make a section 338 election requires careful consideration and should not be made solely to recover acquisition expenditures. For a comprehensive treatment of the tax ramifications and issues surrounding section 338 election, see *id.* §§ 205 & 206; BITTKER & EUSTICE, *supra* note 195, ¶ 10.42, at 10-89 to 10-105.

²⁰⁹ If it is ruled that the expenditures are currently deductible on the corporation's final tax return, the corporation will have a \$50,000 gain on the sale of the assets and a \$10,000 deductible expense. Therefore, its taxable income after the transaction is \$130,000—\$90,000 pretransaction taxable income plus \$50,000 less \$10,000. Under the alternative rationale, the \$10,000 is either added to the asset's basis or treated as a reduction in the sale's proceeds. This will produce a gain on the sale of assets of \$40,000 and taxable income after the transaction of \$130,000—\$90,000 plus \$40,000 gain on the sale of assets.

Structuring the transaction in the above fashion thus has the potential to shorten the reach of *INDOPCO*'s future benefit analysis.

VI. CONCLUSION

The disputes between taxpayers and the Service outlined in this Note are likely to continue. The cost to taxpayers of not continuing is too great. Depending on the size of the transaction, the target's expenditures in an acquisitive reorganization can run into the millions of dollars. For example, in *INDOPCO*, the expenditures at issue were \$2.2 million.²¹⁰ In *Federated* they were \$60 million.²¹¹ In *Victory Markets* they were \$1.5 million.²¹² And in *Staley* they were \$23 million.²¹³ These big dollars translate into the potential for big tax savings and hence continued litigation over the proper treatment of these expenditures.

Staley's per se capitalization rule has left taxpayers in the Tax Court with few options, maybe only the two suggested in Part V of this Note, *i.e.*, rigorous expenditure analysis and an asset purchase or a section 338 election. Of course, it has yet to be seen if courts outside the Tax Court will prescribe *Staley*'s harsh treatment for taxpayers. Until they do, it may be wise to litigate in the district court or Claims Court, if possible. This will leave taxpayers with additional arrows to sling and provide the best chance for success.

²¹⁰ See *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 82 (1992).

²¹¹ See *United States v. Federated Department Stores, Inc. (In re Federated Department Stores, Inc.)*, 171 B.R. 603, 606 (S.D. Ohio 1994).

²¹² See *Victory Markets, Inc. v. Commissioner*, 99 T.C. 648, 649 (1992).

²¹³ See *A.E. Staley Manufacturing Co. v. Commissioner*, 105 T.C. 166, 180 (1995).