

Louisiana Law Review

Volume 54 | Number 2
November 1993

The Supreme Court Attempts to "Iron Out" the Wrinkles in National Starch

John Paul LeBlanc

Repository Citation

John Paul LeBlanc, *The Supreme Court Attempts to "Iron Out" the Wrinkles in National Starch*, 54 La. L. Rev. (1993)
Available at: <https://digitalcommons.law.lsu.edu/lalrev/vol54/iss2/8>

This Note is brought to you for free and open access by the Law Reviews and Journals at LSU Law Digital Commons. It has been accepted for inclusion in Louisiana Law Review by an authorized editor of LSU Law Digital Commons. For more information, please contact kreed25@lsu.edu.

NOTES

The Supreme Court Attempts to "Iron Out" the Wrinkles in *National Starch*

One of the most anxious experiences in the life of any tax practitioner or tax attorney is waiting for the United States Supreme Court to rule on a controversial tax issue. *Indopco, Inc. v. Commissioner* (formerly *National Starch & Chemical Corp. v. Commissioner*)¹ is one of the Court's most recent decisions in the tax area. This decision signals a change in the test for determining the deductibility of expenditures.² *Indopco* has resulted in confusion for taxpayers and tax attorneys, who are unsure what test applies to determine the deductibility of expenditures. As a result of the broad test announced by the Court, the Internal Revenue Service (Service) may attempt to alter business behavior by disallowing current expense deductions for items which were once deductible, but may now have to be capitalized in light of *Indopco*.³ These items include both takeover and non-takeover related expenses, such as repairs, advertising, start-up costs,⁴ and hazardous waste removal costs.⁵

This casenote outlines the events in the corporate takeover area which preceded *Indopco*, and includes an analysis of the decisions and alternative rulings which the Supreme Court could have used to reach the same result in *Indopco*. Although *Indopco* results in unfavorable tax treatment for the taxpayer, it is the Court's broad holding and lack of adherence to the *stare decisis* doctrine that is problematic. This casenote also discusses the decision's potential impact in both takeover and non-takeover related areas, in addition to how the ruling in *Indopco* should be limited in future decisions.

Copyright 1993, by LOUISIANA LAW REVIEW.

1. *National Starch & Chem. Corp. v. Commissioner*, 93 T.C. 67 (1989), *aff'd*, 918 F.2d 426 (3d Cir. 1990), *aff'd sub nom Indopco, Inc. v. Commissioner*, 112 S. Ct. 1039 (1992).

2. The previous test followed by the Court had been established in *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 91 S. Ct. 1893 (1971).

3. See Robert A. Rizzi, *Corporate Organizations and Reorganizations*, 17 J. Corp. Tax'n 169 (1990). See generally Paul D. Manca, Note, *Deductibility of Takeover and Non-Takeover Expenses in the Wake of Indopco, Inc. v. Commissioner*, 45 Tax Law. 815 (1992).

4. I.R.C. § 195(c)(1) (1988) defines start-up expenditures as amounts:

(A) paid or incurred in connection with (i) investigating the creation or acquisition of an active trade or business, or (ii) creating an active trade or business, or (iii) any activity engaged in for profit and for production of income before the date on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and

(B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

5. For purposes of this casenote, the primary focus will be on these particular areas. However, the *Indopco* decision could potentially impact many other tax areas, and this will be discussed generally.

I. *INDOPCO, INC. v. COMMISSIONER*

In *Indopco* the Supreme Court addressed the deductibility of expenditures that National Starch incurred during a friendly takeover, which transformed it from a publicly-held corporation to a wholly owned subsidiary.⁶ To resolve this matter, the Court had to unravel the conflict among the circuits concerning the differing interpretations of its ruling in *Commissioner v. Lincoln Savings & Loan Ass'n.*⁷

In October 1977, Unilever Corporation expressed an interest in acquiring National Starch, one of its suppliers. Because National Starch's two largest shareholders were concerned about the estate tax implications of the takeover,⁸ the directors requested a private letter ruling from the Service. The Service subsequently issued a ruling that the transaction would be tax-free.⁹ The director's counsel also informed them that under Delaware law the directors owed a fiduciary duty to their shareholders to ensure that the proposed transaction would be fair. Therefore, Morgan Stanley & Co., an investment banking firm, was engaged to evaluate the stock and to issue a fairness opinion.

National Starch incurred the following expenditures during this period: (1) Morgan Stanley charged National Starch \$2,200,000 in fees, plus \$7,586 for out-of-pocket expenses and \$18,000 for legal fees; (2) counsel charged \$490,000 in fees, plus \$15,069 for out-of-pocket expenses; and (3) \$150,962 in miscellaneous expenses—accounting, printing, proxy solicitation, and S.E.C. fees. During the

6. 112 S. Ct. 1039 (1992). The National Starch & Chemical Corporation became Indopco after the ownership of National Starch was transferred to Unilever pursuant to a friendly takeover. *Id.* at 1041.

7. 403 U.S. 345, 91 S. Ct. 1893 (1974). See also *infra* notes 54-76 and accompanying text for a discussion of the conflict among the circuits prior to the *Indopco* decision.

8. Frank Greenwall, 81 years old, and his wife, 79 years old, were the largest shareholders of National Starch, owning 14.5% of the outstanding shares. In the agreement with Unilever, the Greenwalls agreed to voluntarily dispose of their stock holdings only if the transaction would be tax-free. *National Starch & Chem. Corp. v. Commissioner*, 93 T.C. 67, 69 (1989). By deferring any potential capital gain from this transaction, the Greenwalls' appreciation in their stock would escape income tax upon their deaths through section 1014, which provides for a stepped-up basis in the assets of the deceased to the fair market value on the date of death (assuming no alternate valuation date). Although no income tax on this appreciated stock would be assessed to the Greenwalls upon their deaths, the fair market value of the stock would be includible in their gross estates for estate tax purposes. I.R.C. § 1014 (1988).

9. Priv. Ltr. Rul. 78-39-060 (June 28, 1978). The transaction obtained tax-free status through section 351 of the Internal Revenue Code. The acquisition of National Starch by Unilever was effectuated by the formation of a new subsidiary, which was to be controlled by Unilever. Approximately 79% of the National Starch shareholders who desired cash for their stock contributed their National Starch stock to the subsidiary in return for \$380 million in cash. The remaining shareholders who wanted to avoid tax on the gain realized received \$97 million in nonvoting, nonmarketable preferred stock of the newly-formed subsidiary in exchange for the National Starch stock. See Calvin 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, 465 (October 28, 1991).

audit of National Starch's 1978 federal tax return, the Service disallowed a deduction for these expenses.¹⁰ The Tax Court held that the expenditures were not deductible under Internal Revenue Code section 162(a) because of the future benefits the expenditures would generate, and the Third Circuit affirmed.¹¹

The Supreme Court began its reasoning by discussing a few tax axioms: the issue of deductibility versus capitalization concerns the timing of the cost recovery for the expenditure;¹² the Internal Revenue Code attempts to match expenses with the accompanying revenues; and "an income tax deduction is a matter of legislative grace and . . . the burden of clearly showing the right to the claimed deduction is on the taxpayer."¹³ National Starch argued that the expenditures incurred in its transaction with Unilever should be deductible because they did not result in the "creation or enhancement of an asset," the test for deductibility established by the Court in *Lincoln Savings*.¹⁴ The *Indopco* opinion rejected National Starch's contention that the "creation or enhancement of an asset" was a prerequisite to capitalization and concluded that National Starch had "overread" *Lincoln Savings*.¹⁵

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 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.¹⁶

After establishing and applying the tax principles relevant to this particular case, the Court affirmed the lower courts in holding that National Starch had "not demonstrated that the . . . costs it incurred in connection with Unilever's acquisition of its shares are deductible as ordinary and necessary business expenses under § 162(a)."¹⁷ The Court further stated that the facts in the record

10. *National Starch & Chem. Corp. v. Commissioner*, 93 T.C. 67, 72 (1989).

11. *National Starch & Chem. Corp. v. Commissioner*, 918 F.2d 426, 434 (3d Cir. 1990). See *infra* notes 68-76 and accompanying text for a further discussion of the Tax Court and Third Circuit decisions. See generally Johnson, *supra* note 9, at 463 (explaining that when a company pays shareholder expenses like those incurred in *Indopco*, or when the benefit is primarily for the shareholders in their individual capacity, the payments should be treated as dividends).

12. *Indopco, Inc. v. Commissioner*, 112 S. Ct. 1039, 1042 (1992).

13. *Id.* at 1043 (quoting *inter alia* *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593, 63 S. Ct. 1279, 1281 (1943)). But see generally Erwin N. Griswold, *An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace*, 56 Harv. L. Rev. 1142, 1143-47 (1943) (discussing the origin of this jurisprudential rule of interpretation).

14. *Indopco*, 112 S. Ct. at 1044.

15. *Id.*

16. *Id.* (emphasis added) (citation omitted) (quoting *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 354, 91 S. Ct. 1893, 1899 (1971)).

17. *Id.* at 1045.

supported the conclusion that the benefits accruing to National Starch extended beyond the tax year. Additionally, the Court cited cases and commentators that classified expenses incurred in reorganizing or restructuring the corporate entity as nondeductible and explained that "[t]he rationale behind these decisions applies equally to the professional charges at issue in this case."¹⁸ The Court held that whether the expenditures created or enhanced a separate and distinct additional asset was "not controlling" and that the "acquisition-related expenses bear the indicia of capital expenditures and are to be treated as such."¹⁹

II. BACKGROUND PRECEDING THE *INDOPCO* DECISION

A. *Current Expenses vs. Capital Expenditures*²⁰

One of the most fundamental concepts in taxation is that current expenses are deductible in the year incurred, while costs incurred in acquiring a capital asset are nondeductible capital expenditures and are generally ratably depreciated or amortized over the useful life of the asset.²¹ Deducting expenses currently from income produces immediate tax benefits to taxpayers, while capital expenditures result in the deferral of tax benefits. By matching these costs with the future income they generate, taxpayers therefore report both income and deductions by a method which more accurately reflects their "true" income.²²

18. *Id.* at 1046.

19. *Id.*

20. Treas. Reg. § 1.446-1(a)(4)(ii) (1978) states that "[e]xpenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account."

21. The time value of money dictates that a taxable business would rather have a deductible expense today, rather than capitalize the expenditure (and later recover the costs ratably over its useful life through depreciation or amortization deductions which may offset future income—the matching principle). Absent other circumstances, income-producing businesses would rather obtain tax savings in the form of current expense deductions today and invest the savings immediately, rather than deferring the tax benefit of recovering the costs of the capital expenditures over several tax years. "This deferral is the equivalent of an interest-free loan from the government, the economic benefits of which can be very significant." John W. Lee & Nina R. Murphy, *Capital Expenditures: A Result in Search of a Rationale*, 15 U. Rich. L. Rev. 473, 474 n.10 (1981) (quoting Staff of the Joint Committee on Internal Revenue Taxation, *Tax Shelters* 6 (1976)).

Capital expenditures may be depreciated or amortized if allowed by the Internal Revenue Code. For example, section 167 allows as a depreciation deduction "a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) (1) of property used in the trade or business, or (2) of property held for the production of income." I.R.C. § 167(a) (1988). Section 195, as defined in *supra* note 4, allows such deferred expenses to be a "deduction prorated equally over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the active trade or business begins)." I.R.C. § 195(b)(1) (1988).

22. The matching principle is fundamental to both tax and financial accounting. "Mismatching is a sin of tax accounting, as much as it is in financial accounting." See Johnson, *supra* note 9, at

Although these concepts are easily applied mathematically given the amount of the expenditure, the difficulty lies in determining when to apply each of the two concepts: "neither [the] courts nor the accounting profession have devised a universal, foolproof method of distinguishing current expenses from capital costs."²³ Consequently, the question of whether an expense may be deducted or must be capitalized continues to be an area of major litigation between the taxpayers and the Service.²⁴

Section 162(a) of the Internal Revenue Code allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."²⁵ Under the Court's earlier test, an expense is deductible under section 162(a) if: (1) it is paid or incurred during the taxable year, (2) for carrying on any trade or business, and (3) is an expense (4) that is both necessary and (5) ordinary.²⁶ The term "necessary," as interpreted by the courts, implies "only the minimal requirement that the expense be appropriate and helpful for the development of the [taxpayer's] business."²⁷ To be "ordinary," the expense must relate to a transaction "of common or frequent occurrence in the type of business involved."²⁸ Courts typically focus on the

473; Alan Gunn, *The Requirement that a Capital Expenditure Create or Enhance an Asset*, 15 B.C. Indus. & Comm. L. Rev. 443, 452-54 (1974). I.R.C. § 446(b) requires the taxpayer to use a method of accounting which "clearly reflect[s] income."

Also, Treas. Reg. § 1.461-1(a)(1) (1967) provides that "[i]f an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made." This does not mean that capitalization issues are always to be decided upon whether "capitalization is necessary in order to clearly reflect income." However, this regulation should be applicable at least when an expenditure creates an asset. See Gunn, *supra*, at 452-53.

23. *NCNB Corp. v. United States*, 684 F.2d 285, 287 (4th Cir. 1982). Compare *Zimmern v. Commissioner*, 28 F.2d 769 (5th Cir. 1928) (taxpayer was allowed a business expense deduction for refurbishing a sunken barge) with *P. Dougherty Co. v. Commissioner*, 159 F.2d 269 (4th Cir. 1946) (taxpayer required to capitalize the costs of rebuilding the stern of barge that had rotted). To help understand these cases, consider that the deductible expense was allowed because of the sudden loss caused by the storm, while the costs incurred to repair the damaged barge caused by gradual deterioration were capitalized.

One of the most well-known answers to this elusive question was offered by Justice Cardozo: "The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle." *Welch v. Helvering*, 290 U.S. 111, 115, 54 S. Ct. 8, 9 (1933).

24. See Thomas F. Quinn, *Takeover Expenses Incurred by the Acquired Corporation—Not Just Another Ordinary Deduction*, 10 J.L. & Com. 167, 168 (1990).

25. I.R.C. § 162(a) (1988).

26. *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 352, 91 S. Ct. 1893, 1898 (1971).

27. *Indopco, Inc. v. Commissioner*, 112 S. Ct. 1039, 1044 (1992) (quoting *Welch*, 290 U.S. at 113, 54 S. Ct. at 8).

28. *Id.* (quoting *Deputy v. DuPont*, 308 U.S. 488, 496, 60 S. Ct. 363, 367 (1940)).

term "ordinary" to assist practitioners in determining whether costs are currently deductible or constitute a capital expenditure.²⁹

Section 162(a) must be read *in pari materia* with section 263(a)(1), which disallows a deduction for "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."³⁰ Thus, business expenditures which do not qualify as currently deductible under the section 162(a) test, notwithstanding that they may be deductible under some other code provision, are generally treated as capital expenditures under section 263(a).³¹ "The purpose of § 263 is to reflect the basic principle that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable . . . to later tax years when the capital asset becomes income producing."³² Although capitalized, generally all of the cost of the capital expenditures will be deductible through depreciation or amortization if some provision of the Internal Revenue Code authorizes the deduction.³³

Nevertheless, while some intangible assets with a determinable useful life, such as patents and copyrights, may be amortized, other intangibles which have no determinable useful life, such as goodwill, may not be depreciated or amortized.³⁴ Therefore, as a practical matter, capital expenditure items which are not deductible through depreciation or amortization have little, if any, tax value to the taxpayer.³⁵ Thus, even if in-house accountants follow generally accepted accounting principles by deducting the cost of an item on its books, which under section 263(a) was required to be capitalized, the business entity will still receive no tax benefit from this accounting entry.³⁶ In this event, a tax

29. *Commissioner v. Tellier*, 383 U.S. 687, 689-90, 86 S. Ct. 1118, 1119-20 (1966).

30. I.R.C. § 263(a)(1) (1988).

31. Section 263 is used as a heading under which to place the capital expenditure cases. Nevertheless, section 263 is both too narrow and too broad to satisfactorily explain all of the capitalization requirements: That section is both too narrow and too broad to explain satisfactorily all capitalization requirements—"[T]oo narrow because its reference to 'new buildings or . . . permanent improvements' suggests that capitalization is limited to the costs of new, tangible property, which is clearly not the case; too broad because there are costs, such as those for some repairs, which are represented by permanent improvements but which have always been considered deductible." *Gunn*, *supra* note 22, at 448 (footnote omitted).

32. *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16, 94 S. Ct. 2757, 2766 (1974).

33. *See, e.g.*, I.R.C. §§ 167, 168, 195 (1988).

34. *Treas. Reg. § 1.167(a)-3*, 25 Fed. Reg. 11402 (1960).

35. Capital expenditures which have no statute authorizing depreciation or amortization deductions generate no current tax benefit to the taxpayer. For example, the expenditures incurred in *Indopco* fall within this category "because the benefit to the company has no ascertainable useful life." *National Starch & Chem. Corp. v. Commissioner*, 918 F.2d 426, 434 (3d Cir. 1990). However, these expenditures may be added to the basis of the acquired asset and generate tax benefits in the year of disposition by offsetting the later gain on the sale of the asset.

36. *See Quinn*, *supra* note 24, at 170. The increase in tax basis of assets resulting from capitalization helps to reduce the subsequent tax gain on the sale. As a practical matter, it may be more efficient for large corporations to separate their tax and general accounting ledgers.

adjusting entry will be required to convert the corporation's accounting book net income to taxable income.

B. Takeover Expenses Before Indopco

During the 1980s the financial world experienced a flurry of corporate takeovers, mergers, and acquisitions.³⁷ Due to the increased frequency of these transactions and their resulting exorbitant costs, the tax treatment of these items became of great importance to taxpayers.³⁸ Not surprisingly, the Service was close behind, offering guidance to taxpayers on how to report these complex transactions. Technical Advice Memorandum (TAM)³⁹ 85-16-002 issued December 14, 1984, focused on the issue of whether expenses incurred by a corporation in opposing an unsuccessful stock tender offer were deductible business expenses under section 162(a) or nondeductible expenditures for the benefit of the shareholders. In this TAM, the Service ruled that the litigation costs incurred by the defending corporation in *resisting* the tender offer were currently deductible—a ruling consistent with prior Supreme Court decisions.⁴⁰ Additionally, the investment banking expenses incurred by the defending corporation in trying to find a “white knight”⁴¹ were only conditionally deductible in the year of abandonment of the plan, contrary to the general rule that reorganizational expenses were capital expenditures.⁴² Also, the expenses incurred by the corporation in appealing to its stockholders to oppose the tender offer were held to be deductible, since these expenses were analogous to deductible proxy expenses.⁴³

Subsequently, on March 27, 1989, the Service issued TAM 89-27-005, which addressed the deductibility of expenses incurred in *successfully* resisting

37. See *id.* at 167. Hostile takeovers became the most popular means of acquiring target corporations in the 1980s. See Rizzi, *supra* note 3, at 169.

38. See Mark B. Persellin, *Takeover Defense Expenditures: Deductibility Not Necessarily Precluded* by National Starch, 42 Tax. Exec. 159 (1990). One of the reasons the government sought certiorari was because the Internal Revenue Service had sixty-seven pending cases involving about \$547 million in tax liabilities concerning mergers and acquisitions. See Manca, *supra* note 3, at 815 n.6.

39. TAM's are I.R.S. weekly releases from the National Office to its field personnel, and they offer the Service's determination of an issue encountered during an audit. TAM's are binding on the district or Appeals Office level that requested the advice, if the outcome is favorable to the taxpayer. However, if the outcome is unfavorable to the taxpayer, the TAM's are not binding on the Appeals Office. Michael I. Saltzman, I.R.S. Practice and Procedure, ¶ 3.04[2][d] (2d ed. 1991).

40. See Tech. Adv. Mem. 85-16-002 (Dec. 14, 1984). The TAM was referring to *Commissioner v. Tellier*, 383 U.S. 687, 86 S. Ct. 1118 (1965) and *Commissioner v. Heininger*, 320 U.S. 467, 64 S. Ct. 249 (1943).

41. The primary purpose of searching for a “white knight” is for the target corporation to be acquired by a friendly corporation to prevent future hostile attacks. See Manca, *supra* note 3, at 820-21; Rizzi, *supra* note 3, at 169.

42. See Rev. Rul. 67-125, 1967-1 C.B. 31.

43. See Tech. Adv. Mem. 85-16-002 (Dec. 14, 1984).

a hostile takeover, in addition to successfully locating a "white knight" purchaser. In ruling that the expenditures were deductible, the Service applied the "origin and character of the claim" test⁴⁴ and the rationale from TAM 85-16-002. The "ordinary and necessary" expenditures pertained to carrying on a trade or business because the board of directors had a fiduciary responsibility to oppose tender offers that were detrimental to its corporation. Furthermore, the expenditures were not subject to the general rule of capitalization for reorganizational costs⁴⁵ because the costs were not incurred pursuant to an alteration in the capital structure of the corporation. To the contrary, the costs were incurred in furtherance of the directors' fiduciary duty to resist tender offers not beneficial to the corporation. The Service stated: "We do not believe that section 263(a) of the Code applies to the expenses incurred by X because the Directors of X were attempting to insure the continued profitability of the business and to protect the interests of the shareholders"⁴⁶

The Tax Court reversed this trend in the takeover area when it decided *National Starch & Chemical Corp. v. Commissioner of Internal Revenue*⁴⁷ (which involved a friendly takeover) on July 24, 1989. The Tax Court concluded that the fulfillment of a fiduciary duty in this case was not controlling. Instead, the court held that the expenses incurred were to be capitalized because the "directors determined that it would be in petitioner's long-term interest to shift ownership of the corporate stock."⁴⁸ One week later, in light of this new Tax Court decision supporting a more favorable outcome for the government, the Service revoked TAM 89-27-005 by issuing TAM 89-45-003.⁴⁹ To explain this revocation, the Service simply stated:

The court's reasoning [in *National Starch*] applies with equal force in the case of a hostile takeover that is successfully resisted by locating a white knight. There is no less a *long term benefit* to the target of the hostile takeover in this situation than there is to the target of a friendly takeover as in the *National Starch* case.⁵⁰

Subsequently, on July 9, 1990, the Service issued TAM 90-43-003, which was a detailed analysis for its revocation of TAM 89-27-005 in light of *National*

44. "It is 'the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, [which] is the controlling basic test'" Tech. Adv. Mem. 89-27-005 (Mar. 27, 1989) (quoting *United States v. Gilmore*, 372 U.S. 39, 49, 83 S. Ct. 623, 629 (1963)).

45. See Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 5.06, at 5-36 (5th ed. 1987).

46. Tech. Adv. Mem. 89-27-005 (Mar. 27, 1989) (making no reference to the rule stated in *Lincoln Savings* as a basis for rejecting the capitalization of the expenses).

47. 93 T.C. 67 (1989).

48. *Id.* at 75.

49. Tech. Adv. Mem. 89-45-003 (Aug. 1, 1989) (emphasis added).

50. *Id.*

Starch.⁵¹ The Service concluded on reconsideration: (1) generally, expenses incurred by a corporation directly related to the resistance of a hostile takeover were deductible under section 162; and (2) expenses incurred to find a white knight and to facilitate either a merger or sale of the stock of the target corporation were to be capitalized because they create a long-term benefit to the corporation.⁵² In essence, the Service stated that the deductibility of the expenses incurred during the transaction would be determined based upon the corporation's purpose for incurring such costs. TAM 91-44-042 also concluded that the nature of the takeover, whether friendly or hostile, was "not determinative of the proper tax treatment afforded to expenditures for professional fees Each case will turn on its own specific set of facts and circumstances."⁵³

C. Conflict in the Circuits over Lincoln Savings

The foregoing discussion focused on the pre-*Indopco* deductibility of expenses under section 162 in the corporate takeover area, the same type of expenses litigated in *Indopco*. However, the Supreme Court granted certiorari in *Indopco* not only because of the confusion surrounding the deductibility of takeover-related expenses under section 162(a), but more importantly because of the conflict among the federal circuits in applying the section 162(a) deductibility test as set forth in *Commissioner v. Lincoln Savings & Loan Association*.⁵⁴

In *Lincoln Savings*, the Court was faced with the question of whether additional compulsory premiums paid by a state-chartered savings and loan association to the Federal Saving & Loan Insurance Corporation ("F.S.L.I.C.") were deductible under section 162(a). These payments were made to a Secondary Reserve that paid only those losses not covered by the F.S.L.I.C. The Court held that three out of the five requirements under section 162(a) were met, namely that the premiums were (1) paid or incurred in the taxable year, (2) made in carrying on a trade or business, and (3) necessary because the payment was

51. Tech. Adv. Mem. 90-43-003 (July 9, 1990).

52. *Id.*

53. Tech. Adv. Mem. 91-44-042 (July 1, 1991). See *Victory Markets, Inc. v. Commissioner*, 99 T.C. 648 (1992), where the taxpayer argued that the expenditures should be deductible because they were incurred in a hostile takeover. In this case, the taxpayer, the target corporation, incurred over \$500,000 in professional fees paid to lawyers and investment bankers for consulting and a fairness opinion. Although Victory's Board of Directors adopted a "poison pill" plan (*i.e.*, offering stock rights to existing corporate shareholders to purchase its stock at a substantial discount to ward off a hostile takeover), this plan was never effectuated. The acquiring corporation, LNC, stated that it was prepared to take its offer directly to Victory's shareholders but did not actually do so. Victory's directors also made an effort to locate a white knight before it finally accepted LNC's offer.

The Tax Court found that the takeover was "friendly," rather than "hostile," as the taxpayer argued. Also, because the facts in the case were generally not distinguishable from *Indopco*, the court did not consider whether *Indopco* would apply to hostile takeovers.

54. 403 U.S. 345, 91 S. Ct. 1893 (1971).

compelled by the provisions of the National Housing Act.⁵⁵ The two remaining requirements, (4) that the payment be an "expense" and (5) be "ordinary" within the meaning of section 162(a), were in doubt.⁵⁶ Lincoln Savings argued that the possibility of a future benefit from the payment did not necessarily make the payment capital in nature.⁵⁷ Holding that the premium payment was not deductible under section 162(a), the Court stated:

[T]he 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.

What is important and controlling, we feel, is that the . . . payment serves to create or enhance for Lincoln what is essentially a *separate and distinct additional asset* and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a)⁵⁸

Thus, to determine whether the premium payment was a capital expense, the Court focused on whether a "separate and distinct additional asset" was created, rather than determining whether future benefits existed. The Court further emphasized that whether a payment is compulsory "does not in and of itself make that payment an ordinary and necessary expense within the meaning of § 162(a)."⁵⁹

Some courts have interpreted this language from *Lincoln Savings*, requiring that the expenditure result in a "separate and distinct additional asset," as a prerequisite to capitalization. In *Briarcliff Candy Corp. v. Commissioner*,⁶⁰ the Second Circuit considered the deductibility of payments incurred to create a wholesale franchise division by soliciting drugstores to act as retail sellers of its product. The Tax Court held that the expenditures (mostly travel, promotions, and advertising) were capital because their benefits (revenues) extended beyond

55. *Id.* at 354, 91 S. Ct. at 1899.

56. *Id.*

57. *Id.*

58. *Id.* (emphasis added). Before the *Lincoln Savings* decision, the converse of this rule was well-established—expenditures which did not create or enhance an asset were currently deductible, even though they were related to income for future years. This clear statement by the Supreme Court increased the attention given to the search for assets in capitalization cases. See *Gunn, supra* note 22, at 444-45.

59. *Lincoln Savings*, 403 U.S. at 359, 91 S. Ct. at 1901. It is interesting to note that in countering the government's argument that Lincoln Savings would receive future benefits from the premium payments, Justice Douglas stated, in dissent, that these payments are "not used for losses, and will never be used except in the *event of a national catastrophe*." *Id.* at 361, 91 S. Ct. at 1902 (Douglas, J., dissenting) (emphasis added). Ironically, this is the same Lincoln Savings and Loan whose insolvency and scandals in the wake of a "national catastrophe" figures to cost the taxpayers (at the latest figures) approximately \$2.5 billion. Lee A. Sheppard, *National Starch Decision Fails to Remove Wrinkles from Capital Expense Issue*, 44 Tax Notes 652, 653 (August 7, 1989).

60. 475 F.2d 775 (2d Cir. 1973).

the year in which they were incurred.⁶¹ The Second Circuit held that these expenditures for the protection of the taxpayer's existing business, by expanding into a new geographic territory, were deductible expenses.⁶² The Second Circuit reasoned that the effect of the payments was no different from what commission-paid salesmen would have achieved, which clearly would have been deductible under section 162.⁶³ Furthermore, the court cited *Lincoln Savings* and offered the following commentary: "[Lincoln Savings] has brought about a radical shift in emphasis and directs the inquiry . . . to the question whether . . . [the taxpayer] 'created or enhanced for [itself] . . . essentially a separate and distinct additional asset.'"⁶⁴

Noting that the corporation in the instant case had not acquired any "new separate and distinct additional asset in these agreements,"⁶⁵ the court found that the decision of the Tax Court was manifestly wrong. Consequently, the court read the "controlling" language in *Lincoln Savings* to require the presence of a "separate and distinct additional asset" before the expenditure must be capitalized.⁶⁶ A literal interpretation of *Lincoln Savings* would mandate that absent a "separate and distinct additional asset," the expenditures should not be capitalized. Although the Court in *Lincoln Savings* did not specifically discuss deductibility in cases involving no "separate and distinct additional asset," later courts, including the *Briarcliff* court, held that the presence of such an asset is a prerequisite to capitalization.⁶⁷

61. *Briarcliff Candy Corp. v. Commissioner*, 31 T.C.M. (CCH) 171 (1972).

62. *Briarcliff Candy*, 475 F.2d at 787.

63. *Id.* at 783.

64. *Id.* at 782.

65. *Id.* at 787.

66. The *Briarcliff* court probably overstated the significance of this language in *Lincoln Savings*. 1 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, ¶ 20.4.4, at 20-84 n.61 (2d ed. 1990).

67. See *Central Texas Sav. & Loan Ass'n v. United States*, 731 F.2d 1181, 1184 (5th Cir. 1984) (stating that "[the] question, therefore, is whether [it] create[d] a separate and distinct additional asset" in capitalizing the costs incurred in starting up new branches). *But see* *NCNB Corp. v. United States*, 684 F.2d 285 (4th Cir. 1982) (allowing current deductions for the costs expended in locating new locations and feasibility studies).

Also, in *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185 (10th Cir. 1974), the bank sought to currently deduct the expenses incurred in participating in a new charge card system. The court adopted the rationale of *Briarcliff* in allowing the deduction because the bank's expenditures did not create a separate asset:

The start-up expenditures here challenged did not create a property interest. They produced nothing corporeal or salable. They are recurring. At the most they introduced a more efficient method of conducting an old business. The government suggests no way in which they could be amortized. The government's theoretical approach ignores the practicalities of the situation, and permits a distortion of taxpayer's financial situation. If an expenditure, concededly of temporal value, may be neither expensed nor amortized, the adoption of technological advances is discouraged.

Id., at 1192. Moreover, the Ninth Circuit in *First Sec. Bank v. Commissioner*, 592 F.2d 1050 (9th Cir. 1979), adopted the Tenth Circuit's opinion in *Colorado Springs*.

This interpretation of the *Lincoln Savings* rule was at issue when the Third Circuit heard the appeal from the Tax Court's decision in *National Starch*.⁶⁸ In the Tax Court, National Starch argued that because no "separate and distinct additional asset" was created, the bright-line test of *Lincoln Savings* applied and the costs consequently should be deductible.⁶⁹ Despite National Starch's argument, the Tax Court decided that given the absence of a "separate and distinct additional asset" in this case, the *Lincoln Savings* test was inapplicable.⁷⁰ Because no other acceptable theory of capitalization (i.e., recapitalization, merger, or reorganization) applied to National Starch, the Tax Court created a different test.⁷¹ Accordingly, the Tax Court required the expenditures incurred by National Starch to be capitalized because "petitioner's directors determined that [the expenditures] would be in petitioner's long-term interest."⁷²

On appeal to the Third Circuit, National Starch argued that the Tax Court's approval of the future benefit test was specifically rejected by the Court in *Lincoln Savings* and that *Lincoln Savings* had established a "new and exclusive test for distinguishing between deductible expenses and nondeductible capital expenditures under which expenses are not to be capitalized unless they result in the creation or enhancement of a separate and distinct asset."⁷³ National Starch reasoned that if the expenditures did not result in the creation of a "separate and distinct asset," then that was the end of the inquiry—the expenditures would be deductible under *Lincoln Savings*.⁷⁴ In other words, National Starch contended that the presence of a "separate and distinct asset" was a condition precedent to requiring the capitalization of expenditures. The Third Circuit, in affirming the Tax Court, concluded that no single factor should control this complex issue and that the lack of a *Lincoln Savings* asset alone did not necessarily ensure that an expenditure would be an "ordinary and necessary"

One of the most concise explanations of *Lincoln Savings* and the one-year rule was stated in *Nagy v. Commissioner*, 37 T.C.M. (CCH) 1326, 1328 (1978), where the Tax Court stated, "[T]he controlling issue is whether the expenditure serves to create or enhance a separate and distinct asset which lasts beyond the end of the taxable year." See *Lee & Murphy*, *supra* note 21, at 479-80; *Lynne A. Schewe et al., How to Establish Deductions for Friendly Takeover Costs by Limiting National Starch*, 74 J. Tax'n 146, 148 (1991).

68. *National Starch & Chem. Corp. v. Commissioner*, 918 F.2d 426, 428 (3d Cir. 1990).

69. *National Starch & Chem. Corp. v. Commissioner*, 93 T.C. 67, 77 (1989).

70. *Id.*

71. *Id.* at 76.

72. *Id.* (emphasis added). The Tax Court relied on cases prior to *Lincoln Savings*, such as *E.I. duPont de Nemours & Co. v. United States*, 432 F.2d 1052, 1059 (3d Cir. 1970); *Falstaff Beer, Inc. v. Commissioner*, 322 F.2d 744, 745-46 (5th Cir. 1963), *aff'd* 37 T.C. 451 (1961); *McDonald v. Commissioner*, 139 F.2d 400, 401 (3d Cir. 1943), *aff'd*, 323 U.S. 57, 65 S. Ct. 96 (1944); and *Clark Thread Co. v. Commissioner*, 100 F.2d 257, 258 (3d Cir. 1938), *aff'd* 28 B.T.A. 1128 (1933).

73. *National Starch & Chem. Corp. v. Commissioner*, 918 F.2d 426, 429 (3d Cir. 1990) (emphasis added).

74. *Id.*

deduction under section 162(a).⁷⁵ The Supreme Court granted certiorari to resolve the conflict among the circuits on this issue.⁷⁶

III. THE ERROR OF *INDOPCO*

Two major problems belie the Supreme Court's analysis in *Indopco*. First, although courts can overturn their prior precedents when necessary, the Supreme Court could have reached the same result in *Indopco* without ignoring the rule of *stare decisis*. Second, the Court inconsistently relied on the facts of the case as found by the Tax Court. The Tax Court found that the transaction did not result in a reorganization;⁷⁷ therefore, the Court should have followed this finding of fact unless it was clearly erroneous.⁷⁸ In contrast, the Court gave deference to the Tax Court's finding that National Starch actually did receive long-term benefits from the transaction with Unilever.⁷⁹

A. *The Non-Application of Stare Decisis*

In *Lincoln Savings*, Justice Blackmun stated that "the presence of an ensuing benefit that may have some future benefit is *not controlling*."⁸⁰ Roughly twenty-one years later in *Indopco*, however, he noted that his statement in *Lincoln Savings* did not "prohibit reliance on future benefit as a means of distinguishing an ordinary business expense from a capital expenditure."⁸¹ How could the Court change the test by *relying* on a factor today which the same Court twenty-one years earlier had determined was *not controlling*?⁸² Under a formal application of the doctrine of *stare decisis*, the Court should have been bound by its earlier precedent in *Lincoln Savings*. Nevertheless, the *Indopco* Court unequivocally resolved the conflict among the circuits by stating that "National Starch has overread *Lincoln Savings*" and holding that the creation or

75. *Id.* at 431.

76. *Indopco, Inc. v. Commissioner*, 111 S. Ct. 2008 (1992).

77. *See National Starch & Chem. Corp. v. Commissioner*, 918 F.2d 426, 428 (3d Cir. 1990) ("The Tax Court rejected the IRS' contention that the expenditures were nondeductible because they were incurred incident to a recapitalization, merger, or reorganization, concluding essentially that the form and structure of the transaction was (sic) selected primarily for administrative convenience.").

78. *Id.*

79. *Indopco, Inc. v. Commissioner*, 112 S. Ct. 1039, 1045 (1992).

80. *Lincoln Sav. & Loan Ass'n v. Commissioner*, 403 U.S. 345, 354, 91 S. Ct. 1893, 1899 (1971) (emphasis added).

81. *Indopco*, 112 S. Ct. at 1044.

82. Justice Cardozo's statement in *Welch v. Helvering*, 290 U.S. 111, 115, 54 S. Ct. 8, 9 (1933), that the answer to the riddle is "a way of life," seems to foresee the changing concepts of what factors should be considered in determining the deductibility of expenditures. He certainly did not mean to suggest, however, that the rule should change with the vicissitudes of life. Notwithstanding the *stare decisis* caveats, the potential tax liability implications of this retraction will have to be dealt with not only by large corporations engaged in mergers and acquisitions, but also by taxpayers with small businesses.

enhancement of an asset was not a prerequisite to capitalization.⁸³ As the case appears to have been ultimately decided on other grounds, it was not necessary for the resolution of this issue for the Court to retract this problematic language in *Lincoln Savings*.

Indopco could have been decided under the "origin of the claim" or "dominant aspect" doctrine, in which expenditures from a transaction are characterized by focusing on the origin or dominant aspect of the transaction.⁸⁴ The Tax Court discussed the "dominant aspect" theory, but concluded that the "dominant aspect" of the transaction was the transfer of the stock, not the fiduciary duty of the directors as argued by National Starch.⁸⁵ If the directors' fiduciary duty was the dominant aspect of the transaction, then arguably the attributable expenditures should have been allowed as deductible expenses under section 162.⁸⁶ According to the Tax Court, the relevant facts indicated that National Starch incurred the expenditures when its counsel advised the directors of their fiduciary duty under Delaware law to examine the fairness of the transaction. National Starch retained Morgan Stanley & Co. "primarily to value the stock, to render a fairness opinion [generally pursuant to the directors' fiduciary duty], and to stand ready to assist if there was a hostile tender offer."⁸⁷

By focusing on the "origin of the claim" and not the eventual results or consequences of the expenditures, the Tax Court should have taken into account that the obligations arising under a state law fiduciary duty were separate and distinct from the actual transfer of the stock. Furthermore, procurement of a fairness opinion for the transaction did not necessarily indicate that the board would ultimately accept the transaction.⁸⁸ Consequently, the Supreme Court would have had some support had it chosen to allow a deduction for only those expenditures actually incurred pursuant to the fiduciary duty.⁸⁹ Also, to buttress its decision to deny the deduction, the Court could have held that the "dominant aspect" of the transaction was the transfer of stock, which alone was a sufficient

83. *Indopco*, 112 S. Ct. at 1044.

84. *National Starch & Chem. Corp. v. Commissioner*, 93 T.C. 67, 77-78 (1989).

85. *Id.* at 77. Costs incurred to facilitate the transfer of stock are capital by nature and are nondeductible for that reason alone. See also Jack Wilk & Howell Bramson, *Are Takeover Costs Deductible After National Starch?*, 71 J. Tax'n 364, 367-68 (1989).

86. See Wilk & Bramson, *supra* note 85, at 368 n.13 (citing *Locke Manufacturing Cos.*, 237 F. Supp. 80 (D.C. Conn. 1964)) (proxy contest costs were deductible in defending the corporate policy against attack by a dissident shareholder); *Central Foundry Co.*, 49 T.C. 234 (1967) (proxy fight expenditures for dissident shareholders were deductible under section 162).

87. *National Starch*, 93 T.C. at 70.

88. See Wilk & Bramson, *supra* note 85, at 368.

89. Nevertheless, the Third Circuit Court of Appeals and the Supreme Court might have been correct in affirming the Tax Court's decision because "[t]he line between capital and current expenses is often a difficult one to draw, and the Courts of Appeals should not overturn decisions of the Tax Court on this question unless they are 'manifestly wrong.'" *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 782 (2d Cir. 1973) (citing *Seas Shipping Co. v. Commissioner*, 371 F.2d 528, 532 (2d Cir.), *cert. denied*, 387 U.S. 943, 87 S. Ct. 2076 (1967)).

reason to disallow a deduction.⁹⁰ With this analysis, the Supreme Court could have avoided retracting its language from *Lincoln Savings* that the existence of future benefits was not controlling.

Taxpayers should have a bright-line test to follow when reporting their taxes. The Service does not send each taxpayer an annual notice for his tax liability. The United States employs a self-assessment tax system in which taxpayers should be able to correctly report their tax liability by applying clear and understandable rules established by Congress. Particularly for tax matters, the courts should be available to decide unresolved tax issues and to interpret the Internal Revenue Code. Courts should not be available, however, to instruct each taxpayer how he should have reported his taxes during the taxable year. Thus, when a taxpayer follows the established bright-line tests, he is assured that his position on the particular tax issue is conservative and reasonable. On the other hand, when a taxpayer decides to depart from the established bright-line tests, he is aware that his position is contrary to the general rules and can anticipate being audited. In other words, bright-line tests allow taxpayers to choose their own tax fate.⁹¹

Moreover, the Service should also favor a bright-line test, especially one that is skewed in its favor. For instance, some courts have held that the finding of an "asset" was a prerequisite to capitalization.⁹² Since an asset is "flexible and amorphous," the Service should have remained content with the flexible "asset" test and simply argued that an asset existed, leaving it to the trier of fact to decide.⁹³

The Service, however, did not argue to the Tax Court that an "asset" existed; consequently, the Tax Court did not address whether an "asset" could have existed in the *National Starch* case. Thus, the factual conclusion that "no asset existed" could not be overturned on appeal unless the finding was held to be "clearly erroneous."⁹⁴

One commentator suggests that it was possible to find that an "asset" existed in *Indopco*.⁹⁵ Therefore, the expenditures would have been capitalized under the "separate and distinct asset" test as established in *Lincoln Savings*.⁹⁶ He explains that the "asset" could have been characterized as goodwill or improved

90. See *Wilk & Bramson*, *supra* note 85, at 368. Such a holding is comparable to the Tax Court's treatment of this issue.

91. See *Johnson*, *supra* note 9, at 470.

92. See, e.g., *Briarcliff Candy*, 475 F.2d 775 and *supra* notes 60-67 and accompanying text.

93. The Supreme Court also recognized the flexible and amorphous characteristics of an asset in *Indopco, Inc. v. Commissioner*, 112 S. Ct. 1039, 1045 n.6 (1992).

94. See *supra* note 77-79 and accompanying text.

95. See *Johnson*, *supra* note 9, at 478. The commentator further discusses how the courts should have characterized the payments as constructive dividends to the shareholders. As such, the shareholders would have had to report these shareholder-level expenditures as income, while *National Starch* also would not be allowed a deduction for these expenditures, since they were in essence constructive dividends.

96. *Id.*

corporate structure: "if the court needs an 'asset' to find capitalization, then, all it needs to say is 'Poof, there is an asset.' It is indeed that simple."⁹⁷ If the Court or the Service (in litigating this issue) had followed this suggestion, then the *Indopco* expenditures possibly could have been characterized as capital, thereby avoiding the necessity of retracting the problematic language in *Lincoln Savings*.⁹⁸

B. *The Inconsistent Use of Factual Findings of the Tax Court*

The second flaw in the Court's analysis is its inconsistent references to the Tax Court's findings of fact. In response to the Service's argument that the expenses were nondeductible because they were incurred incident to a recapitalization, merger, or reorganization, the Tax Court made the following factual findings:

- (1) The amendment to the Certificate of Incorporation that changed the authorized preferred shares from 6,563,000 to 1,000 shares of common stock was "merely for administrative convenience and simplicity. Accordingly, it [was] not relevant to the deductibility issue" and not evidence of recapitalization;
- (2) The merger was incidental to the transaction, as supported by the letter ruling, and did not cause the expenditures to be capital; and
- (3) The transaction was not similar to a § 368(a)(1)(B) reorganization that would have caused the expenditures to be capital.⁹⁹

Nevertheless, the Third Circuit resolved this legal issue by stating that even though the "Tax Court rejected the Commissioner's argument that the transaction was essentially a *reorganization* . . . [that] does not preclude consideration of the general rationale behind requiring capitalization of the expenses for *restructuring*."¹⁰⁰ The Third Circuit offered no relevant support for this conclusion of law, citing instead cases involving reorganizations. On the contrary, the Third Circuit found that the Tax Court's finding of the long-term benefits to National Starch was not "clearly erroneous."¹⁰¹

97. *Id.*

98. On the other hand, creating an asset in this case might have been futile because the costs capitalized in this particular case were nonamortizable. See Sheppard, *supra* note 59, at 654.

99. *National Starch & Chem. Corp. v. Commissioner*, 93 T.C. 67, 74-75 (1989).

100. *National Starch & Chem. Corp. v. Commissioner*, 918 F.2d 426, 433 (3d Cir. 1990) (emphasis added). For a further analysis discussing the Tax Court's finding that no reorganization existed, see Quinn, *supra* note 24, at 177-79.

101. *National Starch*, 918 F.2d at 434; see also *Rudolph v. United States*, 370 U.S. 269, 270, 82 S. Ct. 1277, 1278 (1962); *Anderson v. Bessemer City*, 470 U.S. 564, 573, 105 S. Ct. 1504, 1511 (1985), for a discussion of the "clearly erroneous" standard in tax cases. In *National Starch*, the Third Circuit cited *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 715 (8th Cir. 1964), written by Justice Blackmun while on the Eighth Circuit, which held that expenses incurred for issuing nontaxable stock dividends were to be capitalized.

Addressing this issue, the Supreme Court stated that the expenses “incurred for the purpose of *changing the corporate structure* . . . are not ordinary and necessary business expenses.”¹⁰² The Tax Court, however, had found that National Starch’s business continued as before, with the same directors and officers and with no changes in the operation or in the acquisition of any technological or financial assistance; only the ownership of the company changed.¹⁰³ The Supreme Court’s findings were contrary to the Tax Court’s factual findings, were unsupported, and, unless the Tax Court’s findings were held to be “clearly erroneous,” should not have superseded those of the Tax Court. In *National Starch*, because the Tax Court could not find a reorganization, merger, restructuring expenditure, or an “asset,” the Court explored other avenues for a rule that would require capitalization of the expenses involved.¹⁰⁴ Thus, the Court established the “future benefit” test, which would result in capitalization through the principle of matching expenses with the income they produce.¹⁰⁵

Furthermore, a reasonable person could have easily reached conclusions contrary to the Tax Court’s factual findings. The Tax Court’s holding that the transaction was in the taxpayer’s *long-term* interests was based on its consideration of several factors:

Because petitioner’s directors approved the takeover, they *must have* determined that it was in the best interest of [National Starch] and its shareholders. Second, petitioner’s 1978 annual report said that [National Starch] would benefit from the availability of . . . enormous resources, and . . . that [the] affiliation . . . would create the opportunity for “synergy.”¹⁰⁶ There is no evidence of an immediate benefit from the affiliation, but we believe that this is immaterial. The lack of benefits in the short term does not imply their absence in the long term Third, the very availability of the resources . . . was an immediate, as well as a long-term benefit because it broadened petitioner’s opportunities.¹⁰⁷

102. *Indopco, Inc. v. Commissioner*, 112 S. Ct. 1039, 1045 (1992) (emphasis added) (quoting *General Bancshares*, 326 F.2d at 715). See Quinn, *supra* note 24, at 177 (discussing the Judgment on the Merits of the Tax Court decision, the author stated that “the court could find no evidence to support characterization of the transaction as [a] reorganization” and that “[d]espite rejecting the characterization of the expenditures as capital expenditures pursuant to a reorganization, the court still found the expenditures to be capital.”).

103. *National Starch*, 93 T.C. at 71.

104. See Persellin, *supra* note 38, at 160.

105. See Johnson, *supra* note 9, at 473.

106. Synergy, from the Greek *synergos* (“working together”), means combined action or operation. Schewe, *supra* note 67, at 147 n.1.

107. *National Starch*, 93 T.C. at 76 (emphasis added).

That the directors approved the takeover did not necessarily prove that the takeover was in the taxpayer's *long-term* interests. One of the primary incentives for approving the transaction was the resulting estate tax benefits for the elderly majority shareholders.¹⁰⁸ This immediate tax benefit for the Greenwalls did not necessarily indicate that the corporation would receive any correlative benefit.

Another factor indicating National Starch received long-term benefits was the availability of enormous resources and the opportunity for "synergy." The court found there was "no evidence of an immediate benefit,"¹⁰⁹ but concluded that this was immaterial. It justified this conclusion by stating that "the lack of benefits in the short term does not imply their *absence* in the long term."¹¹⁰ The court did not discuss the possibility that the opposite hypothesis also could be true: that the lack of benefits in the short term did not necessarily imply their presence in the long term. Furthermore, the Third Circuit noted that Morgan Stanley & Co. reported "that the National Starch '[m]anagement also feels that some synergy may exist with the Unilever organization.'"¹¹¹ The Tax Court neither found that "synergy" actually existed, nor offered mitigating factors to explain why such a statement from management could have been made to Morgan Stanley & Co.¹¹² Without some other tangible evidence as support, reasonable reliance on this factor is dubious.¹¹³

Finally, the Court's holding in *Indopco* did not rely on its decision that an "asset" was not a prerequisite to capitalization, or on its newly revived reliance on the "future benefit" test. To the contrary, after citing *General Bancshares Corp. v. Commissioner*¹¹⁴ and other cases which involved reorganizing and restructuring expenses, the Court held that "[t]he rationale behind these decisions applies equally to the professional charges at issue in this case. . . . [T]he acquisition-related expenses bear the indicia of capital expenditures and are to be treated as such."¹¹⁵ Therefore, it seems that the Court rested its decision on the foregoing language, even though National Starch did not acquire any property

108. *Id.* at 69.

109. *Id.* at 76.

110. *Id.* (emphasis added).

111. *National Starch & Chem. Corp. v. Commissioner*, 918 F.2d 426, 432 (3d Cir. 1990).

112. One reason for the statement by National Starch's directors that "some synergy may exist" could be that under state law they had a fiduciary duty to take action in the best interests of the shareholders. If the directors were sued by the shareholders in a derivative lawsuit, their statements to Morgan Stanley & Co. would be evidence of their intentions to transact in the best interests of the shareholders. Thus, it was in their self-serving interests to show that there was an "opportunity for 'synergy.'" *National Starch*, 93 T.C. at 76.

113. An example of other tangible evidence would be a *pro forma* financial statement for the company providing real evidence of long-term benefits. The court may have overemphasized the impact of the 1978 annual report, which is often merely a means of advertising to potential shareholders.

114. 326 F.2d 712 (8th Cir. 1964).

115. *Indopco, Inc. v. Commissioner*, 112 S. Ct. 1039, 1046 (1992). See also Bittker & Eustice, *supra* note 45, ¶ 5.06, at 5-36 (While the expenses incurred by the *target* corporation in an acquisitive reorganization were generally nondeductible, the proper treatment was unclear.).

or services in the transaction. If the Tax Court had reached these same conclusions (i.e., that the expenditures were reorganizing or restructuring-related and should therefore be capitalized), the Court would probably have not granted certiorari because the issue in *Lincoln Savings* would not have arisen. This inconsistent treatment of the Tax Court's factual findings placed the Court in the awkward position of retracting its statement from *Lincoln Savings*.

IV. THE IMPACT AND LIMITATIONS OF *INDOPCO*

The nondeductibility of expenditures has been explained "as a reflection of the requirement that a taxpayer account for income and deductions in a manner that clearly reflects his income."¹¹⁶ In determining the tax treatment of expenditures, sometimes this requirement was substituted for those which required the creation or enhancement of an asset or that the useful life extend beyond the current year. For example, applying the latter criteria rigorously would require the capitalization of several small items, such as minor repairs, an accountant's pen, a carpenter's screwdriver, and a welder's goggles.¹¹⁷ However, these expenditures are deductible because the deduction does not materially distort the reporting of the taxpayer's income.

If the broad holding in *Indopco* was applied to its full extent, many of these minor items would require capitalization. "If every cost contributing to the profits of future periods were to be disallowed, it would be necessary to divide almost every salary and advertising expense between its immediate impact on the customer and its contribution to the company's long-lived goodwill."¹¹⁸ Therefore, a reasonable and practical application of this rule is essential.¹¹⁹ In *Lincoln Savings*, the Supreme Court recognized this by holding 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."¹²⁰

In applying *Indopco* to future capitalization cases, the following considerations are relevant:

- (1) The Supreme Court resolved the conflict among the circuits and held that "the fact that the expenditures do not create or enhance a separate and distinct additional asset is not controlling."¹²¹ Therefore, this factor should not be determinative of the tax treatment of the expenditures.

116. Gunn, *supra* note 22, at 452.

117. See Bittker & Lokken, *supra* note 57, ¶ 20.4.1, at 20-67 to 20-68.

118. *Id.* at 20-68.

119. *Id.*

120. *Lincoln Sav. & Loan Ass'n v. Commissioner*, 403 U.S. 345, 354, 91 S. Ct. 1893, 1899 (1971) (emphasis added).

121. *Indopco, Inc. v. Commissioner*, 112 S. Ct. 1039, 1046 (1992).

(2) In affirming the Third Circuit's decision in *National Starch*, the Supreme Court tacitly approved of the statement that "the common characteristic of expenses that have been found to be capital, in fact the *sine qua non* of capitalization, is the presence of a *not insignificant* future benefit that is more than merely incidental."¹²² The Supreme Court followed this lead when it stated, "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."¹²³ *Lincoln Savings* held that the future benefits were "not controlling" in that case.

Consequently, the *Indopco* decision emphasized that *Lincoln Savings* did not "prohibit reliance" on the presence of future benefits; in particular, those expenses having a significant material future benefit should be capitalized.¹²⁴ Thus, if the future benefits produced by an expenditure were "insignificant" (presumably, in comparison with the transaction as a whole) and merely "incidental," then *Indopco* should not prevent the deduction. Additionally, because capitalization cases are extremely fact sensitive, in future decisions, although "not controlling," a future benefits analysis should be an "undeniably important"¹²⁵ factor in the test for capitalization.

(3) As the issue in most of these cases is the "timing" of the deduction, the possible distortion of the taxpayer's income should also be considered in making this determination. This focus on the distortion of the taxpayer's income may be approached either by considering the distortion on taxpayers in general or on the particular taxpayer involved.¹²⁶

(4) *Indopco* involved expenditures incurred in a friendly takeover. In the absence of a clear signal from the Supreme Court, this broad holding should be limited to the takeover area.¹²⁷

Because of the potential impact of this decision, taxpayers will be forced either to discount anticipated future benefits resulting from their transactions or to capitalize the expenditures.¹²⁸ The following discussion focuses on

122. *National Starch & Chem. Corp. v. Commissioner*, 918 F.2d 426, 431 (3d Cir. 1990) (emphasis added).

123. *Indopco*, 112 S. Ct. at 1044-45.

124. *National Starch*, 918 F.2d at 431.

125. *Indopco*, 112 S. Ct. at 1044-45.

126. See Gunn, *supra* note 22, at 455.

127. This proposition is supported by scholarly opinion. See, e.g., Manca, *supra* note 3, at 825; Sheppard, *supra* note 59, at 655.

128. See Manca, *supra* note 3, at 815.

Indopco's uncertain impact on takeover-related expenses (as were incurred in *Indopco*), as well as non-takeover related expenses such as repairs, advertising, section 195 start-up costs, and hazardous waste removal costs.

A. Takeover-Related Expenses

The *Indopco* decision involved expenses incurred in a friendly takeover. The Service last addressed these expenses in TAM 91-44-042.¹²⁹ According to this ruling, the nature of the takeover, whether friendly or hostile, was "not determinative" of the deductibility of the expenditures.¹³⁰ However, the Court's holding that these "anticipated" benefits amounted to a substantial future benefit, implied that any expenses incurred by acquired corporations in a friendly takeover involved a substantial future benefit.¹³¹ Furthermore, the Court rejected the taxpayer's argument that the "dominant aspect" of the expenditures was the fulfillment of the fiduciary duty, even though expenses incurred in obtaining fairness opinions were generally thought to be deductible because they were related to the directors' fiduciary duty. Consequently, expenditures of successful friendly takeovers will be capitalized after *Indopco*, unless the case can be distinguished or otherwise limited.¹³²

In an attempt to weaken the *Indopco* holding, an acquired corporation could separate the costs incurred in fulfillment of its directors' fiduciary duty from the costs related to the transfer of stock.¹³³ By incurring these purported "fiduciary duty" expenses before board approval of the transaction, "a more tenuous nexus [exists] between the expenditures and any long-term benefits resulting from the ownership change."¹³⁴ Also, the taxpayer could argue that it did not anticipate any showing of "synergy."¹³⁵ Even though National Starch had not yet experienced any signs of synergy, its annual report indicated that the directors "anticipated" the company to benefit from the "availability of the Unilever Group's enormous resources."¹³⁶ Future taxpayers' success or failure in similar transactions will depend upon whether the transaction generates synergy and whether this benefit is "more than insignificant."¹³⁷

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

130. *Id.*

131. See Manca, *supra* note 3, at 817.

132. Unsuccessful friendly takeover expenses are most likely deductible because, generally, they generate no long-term benefits to the target corporation. Although it may be argued that the target has received some benefit, it will only be a short-term benefit, as the target remains unprotected from potential takeovers. See Manca, *supra* note 3, at 819 n.31.

133. *Id.* at 817 n.17.

134. *Id.* at 817 n.20.

135. Four factors should be analyzed to determine whether "synergy" exists: (1) form of the acquisition or transaction, (2) nature of the target corporation's business operations, (3) nature of the acquiring entity, and (4) events subsequent to the transaction. Schewe, *supra* note 67, at 149-50.

136. National Starch & Chem. Corp. v. Commissioner, 93 T.C. 67, 76 (1989).

137. Schewe, *supra* note 67, at 150. Furthermore, section 338 acquisitions could be

On the other hand, expenses incurred to defend against a hostile takeover might continue to be deductible after *Indopco*.¹³⁸ Requiring capitalization might not be necessary if the target corporation incurred expenses in defending itself from an outside attack that produced no future benefits to the target corporation. These expenses were incurred merely to maintain the status quo and to allow the corporation to continue as a "going concern." By incurring expenses to ward off a hostile takeover, a corporation does not anticipate future benefits from synergy, does not transform the corporation, and does not acquire resources.¹³⁹

Expenses incurred to locate a "white knight" were not deductible even before *Indopco* because they created a long-term benefit to the corporation.¹⁴⁰ Most white knights provide target corporations with synergistic benefits, in addition to protection against future hostile takeover attempts.¹⁴¹ Therefore, the taxpayer must rebut the implicit presumption that the benefits flow from the white knight if it intends to deduct these costs. Nevertheless, if the target is able to separate the costs incurred to facilitate a takeover by a white knight from expenses incurred in defending against a hostile takeover, the expenses incurred for the latter should still be deductible.

By denying any tax benefit for the expenditures incurred in such transactions, *Indopco* may represent an attempt by the Supreme Court to restrict the reorganization, merger, and acquisition frenzy of the 1980s. However, National Starch was a *target* corporation, and such a restrictive policy aimed directly at *target* corporations does not apparently deter *acquiring* corporations from locating and taking over *target* corporations.¹⁴² The amounts spent by National Starch in obtaining a fairness opinion for its shareholders and in evaluating the offer were nondeductible capitalized expenditures. Denying the deduction of such expenses discourages directors of corporations from fulfilling their fiduciary duty to determine that the transaction is in the shareholders' best interest. Also, that hostile takeover expenses are deductible (in contrast to expenses like those incurred in the friendly takeover in *Indopco*) may encourage corporations to "snarl" at each other—to feign the hostile nature of the transaction to obtain favorable tax treatment.

distinguished from *Indopco* because in those situations the acquired corporation does not receive any long-term benefit since it is subsequently liquidated. I.R.C. § 338 (1988).

138. See Tech. Adv. Mem. 90-43-003 (July 9, 1990) and Tech. Adv. Mem. 91-44-042 (July 1, 1991).

139. See Manca, *supra* note 3, at 819.

140. See Tech. Adv. Mem. 90-43-003 (July 9, 1990).

141. See Manca, *supra* note 3, at 820-21.

142. However, this policy would be furthered in the situation in which both companies initially sought to merge with each other.

B. Non-Takeover Related Expenses

1. Repair Versus Replacement

Because of its broad holding, *Indopco* may preclude deductions for expenses that generate future benefits and are incurred in transactions not involving corporate takeovers, such as repairs, advertising, start-up costs, and hazardous waste removal costs. With respect to the deductibility of expenses incurred to repair an asset, the law before *Indopco* seemed to be settled. Treasury Regulation Section 1.162-4 provides that "incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense . . ."¹⁴³ Also, Treasury Regulation Section 1.263(a)-2(a) states that "[t]he cost of acquisition, construction, or erection of buildings, machinery and equipment . . . and similar property having a useful life substantially beyond the taxable year"¹⁴⁴ are examples of capital expenditures.

In analyzing repair/replacement cases, one must remember that the issue is one of fact.¹⁴⁵ Any expenditures falling into any of the following categories must be capitalized:

- (1) Expenditures which materially add to the value of property,¹⁴⁶

143. Treas. Reg. § 1.162-4, 25 Fed. Reg. 11402 (1960).

144. Treas. Reg. § 1.263(a)-2(a), 52 Fed. Reg. 10060 (1987).

145. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. . . . Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements, or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.

Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103, 106 (1926). See also *Bittker & Lokken*, *supra* note 66, ¶ 20.4.8, at 20-93.

146. This factor is closely related to the rule requiring capitalization for expenditures which create or enhance an asset with a useful life beyond the taxable year. For example, in *Hotel Kingkade v. Commissioner*, 180 F.2d 310 (10th Cir. 1950), the court capitalized the costs of carpets, refrigerators, repairs, and other rehabilitation expenditures incurred to replace a hotel's worn-out equipment. In capitalizing the expenditures, the court stated that "[s]ome were for repairs of a permanent nature which materially added to the value of the property and appreciably prolonged its life as an operating hotel; and others were for replacements of furnishings and equipment having a useful life in excess of one year." See *Lee & Murphy*, *supra* note 21, at 529 (quoting *Hotel Kingkade*, 180 F.2d at 312).

Courts have allowed the deduction of major expenditures for unexpected outlays when caused by casualties, as distinguished from replacing assets that have become obsolete or exhausted from normal use. See, e.g., *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333 (1962) (cement lining of water pipes deductible to reduce invasion by "aggressive" waters); *Midland Empire Packing Co. v. Commissioner*, 14 T.C. 635 (1950) (oil-proofing of basement with concrete lining deductible to

- (2) Expenditures which appreciably extend the life of property,¹⁴⁷
- (3) Repairs in the nature of replacements,¹⁴⁸ and
- (4) Adaptation to a new or different use.¹⁴⁹

On the other hand, incidental repairs or items which maintain the ordinary, efficient operating condition of property are deductible as repairs. Such repairs must not be incurred to upgrade the property to ordinary efficient operating condition, but rather to maintain it in that condition.¹⁵⁰

Consequently, it is unlikely that *Indopco's* broad future benefits test will have a great impact on the test for repair/replacement, given that the pre-*Indopco* test also focused on the amount and duration of the future benefits resulting from the expenditure.

2. Advertising Expenses

Long-term benefits are the main objective when a business incurs advertising costs. Nevertheless, the Service has continually acquiesced in allowing a deduction for these costs,¹⁵¹ and Congress has implicitly sanctioned this deduction by its silence. Treasury Regulation Section 1.162-1(a) provides that

prevent sudden seepage of oil from adjacent oil refinery).

147. In *Jones v. Commissioner*, 24 T.C. 563 (1955), *aff'd*, 242 F.2d 616 (5th Cir. 1957), the court concluded that the expenditures incurred to renovate a historic building in the French Quarter of New Orleans were capital because they gave the building a new useful life. See also *Lee & Murphy*, *supra* note 21, at 532-33 ("[T]he most important fundamental test which may determine the character of a repair is whether the repair appreciably extends the estimated remaining useful life of the property . . . before the repairs were made."); John B. Cook, *Repairs Expense Versus Capital Expenditures*, 13 Tax L. Rev. 231, 235 (1958).

148. The replacement of a roof, floor, or wall has been held to be capital because it is in the nature of an improvement or a replacement of a major unit. See, e.g., *Phillips & Easton Supply Co. v. Commissioner*, 20 T.C. 455 (1953); *Alexander Sprunt & Son, Inc. v. Commissioner*, 24 B.T.A. 599 (1931), *rev'd on other grounds*, 64 F.2d 424 (4th Cir. 1933); *Georgia Car & Locomotive Co. v. Commissioner*, 2 B.T.A. 986 (1925). Other cases focus upon whether a substantial amount of structural work was done, thereby becoming a replacement or improvement. See *Honigman v. Commissioner*, 55 T.C. 1067 (1971), *rev'd in part on other grounds*, 466 F.2d 69 (6th Cir. 1972). See also *Farmers Creamery Co. v. Commissioner*, 14 T.C. 879 (1950) (allowing a deduction where less than half of a wall or floor was replaced).

The primary criterion in these cases was whether a major portion of the property had been replaced. See *Denver & Rio Grande W.R.R. v. Commissioner*, 279 F.2d 368 (10th Cir. 1958). See also *Lee & Murphy*, *supra* note 21, at 534.

149. The expenditure does not have to result in a separate improvement which renders the property more valuable as long as the property is adapted for a different use. "The rationale of these decisions is that the adaptation of a piece of equipment or an entire property to the taxpayer's use is analogous to a taxpayer's purchase of a new asset, in which event the purchase price must be capitalized." *Lee & Murphy*, *supra* note 21, at 535.

150. See, e.g., *Stoeltzing v. Commissioner*, 266 F.2d 374 (3d Cir. 1959); *Jones v. Commissioner*, 24 T.C. 563 (1955), *aff'd*, 242 F.2d 616 (5th Cir. 1957).

151. See Tech. Adv. Mem. 81-35-031 (May 29, 1981). See also *Manca*, *supra* note 3, at 825.

advertising costs are included in business expenses which are deductible as "ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business."¹⁵² Treasury Regulation Section 1.162-20(a)(2) allows for the deductibility of "good will" advertising "which keeps the taxpayer's name before the public."¹⁵³ As a result, advertising expenses were deductible, even if "long-term benefits [were] the taxpayer's primary objective."¹⁵⁴

The Service specifically addressed this post-*Indopco* issue in Revenue Ruling 92-80 and held that *Indopco* did not affect the deductibility of advertising costs.¹⁵⁵ However, this is only the Service's interpretation of *Indopco* on this issue. A technical application of *Indopco*'s future benefit test would cause these expenditures to be capitalized. Nevertheless, taxpayers should continue to deduct advertising expenses, even though it would be more difficult for taxpayers after *Indopco* to overcome their burden of establishing the currently deductible portion of these expenditures. Assuming the Service "went on the warpath by disallowing current deductions for advertising,"¹⁵⁶ taxpayers could lose this battle, especially if the present benefit was "not [an] insignificant future benefit that [was] more than merely incidental."¹⁵⁷ However, as long as the regulations and the Service's position remain constant, advertising costs should remain deductible, despite *Indopco*.

3. Section 195 Start-Up Costs

The analysis of *Indopco*'s impact on section 195 start-up expenditures is more complex. Section 195 provides:

Except as otherwise provided in this section, no deduction shall be allowed for start-up expenditures Start-up expenditures may be . . . treated as deferred expenses . . . and prorated equally over such period of not less than 60 months "[S]tart-up expenditure" means any amount paid or incurred in connection with investigating . . . or creating an active trade or business . . . and which . . . would be

152. Treas. Reg. § 1.162-1(a), 53 Fed. Reg. 9881 (1988) and § 1.162-20(a)(2), 34 Fed. Reg. 835 (1969).

153. Treas. Reg. § 1.162-20(a)(2), 34 Fed. Reg. 835 (1969).

154. Bittker & Lokken, *supra* note 66, ¶ 20.4.5, at 20-88. *But see* Best Lock Corp. v. Commissioner, 31 T.C. 1217 (1959) (cost of catalogues with useful life of more than one year must be capitalized).

155. Rev. Rul. 92-80, 1992-39 I.R.B. 7. Revenue rulings, which are published in the Internal Revenue Bulletin (I.R.B.), are official interpretations of tax laws by the Service on a specific set of facts to inform and advise taxpayers. Because they are only interpretations by one party in a lawsuit, these interpretations should not be given great weight. Furthermore, revenue rulings are not binding on the courts. *See* Saltzman, *supra* note 39, ¶ 3.03[2], at 320.

156. *See* Bittker & Lokken, *supra* note 66, ¶ 20.4.5, at 20-87.

157. *See supra* notes 122-125 and accompanying text.

allowable as a deduction for the taxable year in which paid or incurred.¹⁵⁸

This section is viewed as a codification of *Briarcliff Candy Corp. v. Commissioner*.¹⁵⁹ In *Briarcliff*, the Second Circuit held that expenditures must be capitalized only when they result in the creation of a separate and distinct additional asset. Despite the future benefits created by these expenditures, the court held that "expenditures for the protection of an existing investment or the continuation of an existing business . . . are ordinary and necessary within the meaning of section 162 and not capital in nature."¹⁶⁰ Consequently, that these expenses did not create an asset under the "separate and distinct asset" test was the impetus behind section 195 allowing the sixty-month amortization deduction of these expenses, even though they were intended to generate substantial future benefits.¹⁶¹ By denouncing the "separate and distinct asset" test, *Indopco* frustrated the predominant rationale for deductibility under section 195.¹⁶²

The court in *NCNB Corp. v. United States*¹⁶³ held that the costs of developing branch banks were deductible because the taxpayer was already in the banking business; the costs not related to specific assets were deductible. The court further held: "[C]osts incurred in expanding a business are not considered capital costs unless they meet the *Lincoln Savings & Loan* 'separate and distinct additional asset' test. And this test holds whether or not the expenditures have benefits beyond the current taxation period."¹⁶⁴

To qualify as start-up expenditures, section 195(c)(1)(B) requires that the costs be "allowable as a deduction for the taxable year in which paid or incurred."¹⁶⁵ If the courts no longer rely on the "separate and distinct asset" test (which was rejected in *Indopco*) and focus instead on the presence or absence of future benefits, then start-up costs previously deductible under section 195 would appear to be nondeductible after *Indopco*. A literal application of *Indopco* would seem to result in the capitalization of these expenditures because, arguably, they generate a "not insignificant future benefit that is more than merely incidental."¹⁶⁶ On the other hand, through the enactment of section 195, Congress sought to correct the unfairness of distorting the taxpayer's income and to provide an incentive to expand businesses.¹⁶⁷ Therefore,

158. I.R.C. § 195(a)-(c) (1988).

159. 475 F.2d 775 (2d Cir. 1973). See George B. Javaras & Todd F. Maynes, *Do Briarcliff Candy and Code Section 195 Stiff National Starch?*, 49 Tax Notes 1223, 1227 (Dec. 10, 1990). See also *supra* notes 60-67 and accompanying text.

160. *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 787 (2d Cir. 1973).

161. See Manca, *supra* note 3, at 823.

162. *Id.*

163. 684 F.2d 285 (4th Cir. 1982).

164. *Id.* at 291.

165. I.R.C. § 195(c)(1)(B) (1988).

166. *National Starch & Chem. Corp. v. Commissioner*, 918 F.2d 426, 431 (3d Cir. 1990).

167. See Javaras & Maynes, *supra* note 159, at 1223.

because the *Indopco* Court did not specifically mention section 195 in its decision, presumably the Court did not intend to abrogate that section. Given that "income tax deductions are a matter of legislative grace,"¹⁶⁸ section 195 deductions should continue to be allowable because of the prior congressional mandate found in the code.

4. Hazardous Waste Removal Costs

Indopco may also have implications in a new area of tax law concerned with the deductibility of costs incurred in the removal of hazardous waste.¹⁶⁹ Considering the high cost of asbestos removal, a significant disparity in one's tax liability may exist, depending upon whether the costs are treated as a deduction or capitalized. In TAM 92-40-004,¹⁷⁰ the Service interpreted *Indopco* to require capitalization of the costs of replacing asbestos insulation.¹⁷¹ In response to state and federal mandates and to maintain the health and safety of its workers, the corporate taxpayer decided to implement an asbestos abatement program. The taxpayer had two alternatives to combat the asbestos located in its manufacturing equipment: (1) continuously monitor and encapsulate in case the fibers became disturbed, or (2) remove the asbestos insulation completely from the equipment and replace it with alternative insulation. The taxpayer chose the latter, more expensive, but more cost-effective alternative. The taxpayer argued that these expenditures were deductible repairs, while the Service relied on the future benefits resulting from the "governmental decree in the replacement of the asbestos insulation . . . [and] that the taxpayer's property has . . . been improved because the government, in its infinite wisdom, demanded the adjustment."¹⁷²

The taxpayer had the support of case law to establish that even the cost of extensive repair work, (e.g., asbestos removal), could be deducted, provided that the asset remained in "essentially the same operating condition."¹⁷³ In *Midland Empire Packing Co. v. Commissioner*,¹⁷⁴ federal meat inspectors ordered the taxpayer to either oil-proof its basement or close down its plant after it was discovered that oil leaking from an adjacent refinery presented a fire hazard to its plant. Although the Service contended that the expenditures to oil-proof its basement were capital improvements, the Tax Court held that the costs neither

168. *Indopco, Inc. v. Commissioner*, 112 S. Ct. 1039, 1043 (1992) (emphasis added).

169. This area's focus is primarily on cases involving extensive repairs. See *supra* notes 143-150 and accompanying text.

170. Tech. Adv. Mem. 92-40-004 (June 29, 1992).

171. See Lee A. Sheppard, *Is the IRS Abusing Indopco?*, 56 Tax Notes 1110 (August 31, 1992).

172. *Id.* at 1113.

173. *Id.* at 1111 (citing *Midland Empire Packing Co. v. Commissioner*, 14 T.C. 635 (1950) (where in response to Federal meat inspector's threats, the taxpayer oil-proofed his basement where cured hams were stored and subsequently was allowed to deduct his costs)).

174. 14 T.C. 635 (1950).

increased the value of the property, nor appreciably extended the life of the property in comparison to its status before the expenditures.¹⁷⁵ Instead, the costs were incurred merely to maintain the plant operating efficiently. Applying an analysis similar to the one employed in *Indopco*, the *Midland Empire* court looked at the future benefits generated by these expenditures and concluded that they were not sufficient to justify capitalization.¹⁷⁶ Therefore, it is unlikely that the *Indopco* decision would adversely impact this decision.

Similar to the situation in the TAM, removing the asbestos did not increase the economic value of the equipment or extend its useful life;¹⁷⁷ rather, it merely kept the business in efficient operating condition. In fact, the new insulation was ten percent less efficient than the asbestos.¹⁷⁸ However, in requiring the capitalization of these expenditures, the Service emphasized that the taxpayer now benefitted from "operating efficiencies," such as no longer having to perform expensive and time-consuming precautions to avoid the asbestos.¹⁷⁹

In *Midland Empire*, the Tax Court relied on *American Bemberg Corp. v. Commissioner*.¹⁸⁰ In *American Bemberg*, the taxpayer's plant was damaged because it was located above a geographic fault. The taxpayer incurred expenses in drilling through the floor of its plant and filling cavities in the soil to repair the damages. The Service in *American Bemberg* (like the drafters of the TAM) argued that the expenditures resulted in permanent improvements. In concluding that the expenditures were deductible, the Tax Court considered three factors: (1) the purpose of the work was not to improve, better, or replace the plant, but rather to avoid abandoning the plant and to keep it operating efficiently; (2) the physical nature of the work did not create anything new; and (3) the effect of the work gave the taxpayer assurance that similar damage would not occur in the future.¹⁸¹ Future reliance on this second factor might be doubtful in light of *Indopco*'s rejection of the "separate and distinct additional asset" test. However, unless the Service has evidence of a "not insignificant future benefit that [was] more than merely incidental,"¹⁸² hazardous waste removal costs should be deductible under this reasoning.

Furthermore, in *Mt. Morris Drive-In Theatre Co. v. Commissioner*,¹⁸³ the cost of adding a drainage system had to be capitalized because it was reasonably

175. *Id.* at 641.

176. However, in light of *Indopco*, it is uncertain whether the *Midland Empire* court would refer to the future benefits as "more than merely incidental."

177. Although the property did not increase in value economically, surely the property was more marketable after the asbestos had been removed. See Susan C. Duffy, *Asbestos Removal Costs May be Currently Deductible*, 70 J. Tax'n 290, 293 (1989).

178. Tech. Adv. Mem. 92-40-004 (June 29, 1992).

179. *Id.* at 4.

180. 10 T.C. 361 (1948), *aff'd*, 177 F.2d 200 (6th Cir. 1949).

181. See Eric R. Fox & Michael F. Solomon, *Who Incurs Environmental Clean-Up Costs—And Why—May Determine Deductibility*, 76 J. Tax'n 12, 13-14 (1992).

182. *National Starch & Chem. Corp. v. Commissioner*, 918 F.2d 426, 431 (3d Cir. 1990).

183. 25 T.C. 272, *aff'd*, 238 F.2d 85 (6th Cir. 1956).

foreseeable that the lack of such a system would cause water to drain onto neighboring land. The Tax Court held that the drainage system should have been part of the original plan and thus would have been capitalized if included in the original construction. In the TAM, the replacement of the asbestos insulation was not foreseeable by the taxpayer.¹⁸⁴

Despite the above reasons why the *Indopco* decision should not result in the capitalization of hazardous waste removal costs, its broad holding should at the least be limited and not extended to influence this area; *Indopco* has “[n]othing to do with it.”¹⁸⁵ Additionally, if corporations do not receive any tax benefits in the form of current tax deductions for their efforts, corporations will not be encouraged to comply amicably with federal environmental regulations that require expensive remedial measures.

CONCLUSION

Whether an expenditure is capitalized or currently deducted is of great importance to a taxpayer. Deducting expenses currently from income results in lower taxable income, and thus a lower tax liability. On the other hand, capital expenditures generate not current tax savings, but rather deferred tax savings when these expenditures will be matched with the income they produce. Properly characterizing major expenditures into these two categories is essential, as this determination will have a profound effect on both the taxpayer's tax liability and its immediate cashflow.¹⁸⁶

Before the *Indopco* decision, the taxpayer looked to the test found in *Lincoln Savings* to determine whether a given expenditure should be deducted or capitalized. Although circuit courts interpreted this rule differently, the taxpayer was certain that the determining factor was the creation of a separate and distinct additional asset. *Indopco* has certainly caused confusion for taxpayers, because now they are unsure as to the appropriate test to apply in determining the deductibility of expenditures—creation of a separate and distinct additional asset or the presence of a future benefit.

184. Many others between the 1920s and the 1970s, besides the taxpayers in this TAM, have been liable for not foreseeing the harmful effects of asbestos, which has subsequently resulted in the need for legislative action. See, e.g., Asbestos Hazard Emergency Act of 1986 (AHERA), 15 U.S.C. §§ 2601-2671 (1986). See also Duffy, *supra* note 177, at 290.

185. See Sheppard, *supra* note 171, at 1111 (referring to the application of *Indopco* to this area).

186. The initial outlay for the expenditure will have the same effect on the current cashflow of the taxpayer, regardless of whether it is capitalized or deducted from income. However, items which are currently deductible from taxable income produce current tax savings by decreasing the tax liability, and consequently, more cash remains for the taxpayer to use in the current period. On the other hand, capitalized expenditures produce tax savings ratably as depreciation or amortization deductions are allowed to offset taxable income in future periods. Thus, in the current period, the taxpayer would have a greater tax liability, and less cash on hand, as compared to the situation in which it was allowed a current deduction.

Generally, takeover expenses incurred in a friendly takeover, like the expenses incurred in *Indopco*, should be capitalized unless the case is distinguishable from *Indopco*. On the other hand, expenses incurred in a hostile takeover should be deductible, even though the Service in TAM 91-44-042 stated that the nature of the takeover was not determinative of the deductibility of the expenditures. Moreover, the Service and the courts should continue to allow deductions for repairs, advertising, and start-up costs, even though these expenditures generate future benefits for the taxpayers. However, with respect to the new issue of the deductibility of hazardous waste removal costs, the Service seems determined to use *Indopco* to disallow these deductions, despite relevant jurisprudence allowing these deductions.

The Service, which has traditionally sought to increase revenues by whatever means available, appears quite anxious to use *Indopco* as a windfall to fill its coffers. However, Congress should not passively look on as corporations, to maintain current cashflows and positive earnings for their shareholders, haphazardly respond to federal regulations that demand costly remedial measures. If the Service continues its current trend of using *Indopco* as a revenue-enhancer, either Congress should respond with equitable legislation, or courts should read *Indopco* narrowly, limiting it strictly to the takeover area.

John Paul LeBlanc