DEDUCTIBILITY OF LEGAL EXPENSES INCURRED IN CORPORATE STOCK REDEMPTIONS, PARTIAL LIQUIDATIONS, AND SEPARATIONS

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I. INTRODUCTION

A substantial consideration for any corporation preparing to undergo a change in its organizational structure is the treatment for federal income tax purposes of the legal fees[1] incurred in developing and implementing the plan of alteration. Typically, the company will attempt to characterize these fees as "ordinary and necessary business expenses" in order to deduct the amount from its gross income in the year the fees are paid, under section 162 of the Internal Revenue Code.[2] The federal government, on the other hand, will generally argue that such structural adjustments benefit the corporation for a period beyond the taxable year, and that the expenses attendant thereto are more properly treated as capital investment.[3] Given the importance of this determination to corporate planning, it is surprising that the law remains unsettled with respect to such relatively common trans-

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1. Although most of the authorities discussed in this Article deal with legal expenses, the principles involved are also generally applicable to other costs attendant to a corporate restructuring, such as accountants' fees.

2. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . . INT. REV. CODE OF 1954, § 162(a).

Corporate counsel will also be interested in having his fees characterized as deductible expenses since this will amount to a federal subsidy of his bill to the extent of the corporate tax rate.

3. Section 263(a)(1) of the Code denies a deduction for "[a]ny amount paid out . . . for permanent improvements or betterments made to increase the value of any property . . . ."

Expenditures which must be capitalized can, however, be used to reduce taxable income either by depreciation, if the asset has a determinable life, section 167(a)(1), or by increasing the basis which will be used in determining gain or loss upon subsequent disposition of the asset. Sections 165(a), 165(c)(1)(2). *See* McDonald, *Deduction of Attorneys' Fees for Federal Income Tax Purposes*, 103 U. PA. L. REV. 168 (1954); Note, *The Deductibility of Attorneys' Fees*, 74 HARV. L. REV. 1409, 1409-12 (1961). *See generally* Krane, *Deducting Legal and Accounting Fees: Selected Problems*, 44 TAXES 7 (1966); Note, *The Characterization of Legal Fees as Deductible Expenses or Capital Expenditures—A Need for Clarification in the Law*, 21 SYRACUSE L. REV. 926 (1970).

actions as stock redemptions, partial liquidations, and corporate separations.

The most common approach taken by the courts in determining the deductibility of legal expenses incurred in a stock redemption or partial liquidation is to seek an analogy to some other kind of transaction for which the tax treatment of attendant expenses is more certain.[4] More specifically, the courts have attempted in each case to determine whether the particular transaction more closely resembles a corporate reorganization, the expenses of which require capitalization,[5] or a complete corporate liquidation, the expenses of which are immediately deductible.[6] Unfortunately, the case law which has developed through

4. This group of cases has been termed the "partial liquidation" line. D. HERWITZ, BUSINESS PLANNING 540-43 (1966). *See* DeCastro, *Recent Cases Show Liberal Trend in Allowing Deductions for Legal Fees*, 23 J. TAX. 224, 227 (1965).

5. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 5.07 (3d ed. 1971); Maier, *Deductibility of Expenses Incurred in Corporate Reorganizations and Liquidations*, U. SO. CAL. 1968 TAX INST. 253, 254-58; Weissman, *Allowable Deductions on the Formation, Reorganization and Liquidation of a Corporation*, 53 NW. U.L. REV. 681, 687-702 (1959); Winokur, *Deductibility of Legal Expenses and Other Professional Fees*, U. SO. CAL. 1963 TAX INST. 457, 461-64.

The capitalization requirement for reorganization expenses is consistent with and derived from the rule that expenses incurred in organizing a corporation are capital expenditures. Estate of George B. Leonard Holding Corp., 26 B.T.A. 46, 47 (1932); Appeal of F. Tinker & Sons Co., 1 B.T.A. 799, 803 (1925). The rationale for current nondeductibility of organization and reorganization expenses appears to be that the corporation by such expenditures acquires an intangible asset, the cost of which in matching revenues and expenditures cannot properly be charged to the revenues of any one year, because it has a useful life coexistent with the indefinite life of the corporation itself. Mills Estate, Inc. v. Commissioner, 206 F.2d 244, 246 (2d Cir. 1953). *See* D. HERWITZ, *supra* note 4, at 540-41; 4A J. MERTENS, LAW OF FEDERAL INCOME TAXATION ¶ 25.35, at 174 (rev. ed. 1972). Such expenses are deductible as losses when the corporate existence is terminated, since at that time the intangible asset is of no further value. Malta Temple Ass'n, 16 B.T.A. 409 (1929). In addition, a corporation can elect to amortize its organization expenses (but not reorganization expenses) over a period of five years. INT. REV. CODE OF 1954, § 248.

6. Lanrao, Inc. v. United States, 422 F.2d 481 (6th Cir.), *cert. denied*, 398 U.S. 928 (1970); United States v. Morton, 387 F.2d 441 (8th Cir. 1968); United States v. Mountain States Mixed Feed Co., 365 F.2d 244 (10th Cir. 1966); Commissioner v. Wayne Coal Mining Co., 209 F.2d 152 (3d Cir. 1954); United States v. Arcade Co., 203 F.2d 230 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953); Rite-Way Prods., Inc., 12 T.C. 475 (1949), *acquiesced in*, 1949-2 CUM. BULL. 3; Pacific Coast Biscuit Co., 32 B.T.A. 39 (1935), *acquiesced in*, 1954-1 CUM. BULL. 6; *see* J. MERTENS, *supra* note 5, ¶ 25.35, at 182; Winokur, *supra* note 4, at 464-66.

Two rationales have been advanced for the current deductibility of liquidation expenses. In Pacific Coast Biscuit Co., 32 B.T.A. 39 (1935), the court stated that "liquidation and dissolution are in the nature of a final accounting of the results of the taxpayer's business rendered to its stockholders and the state." *Id.* at 43. This rationale appears entirely adequate when one considers the reason for requiring that certain expenditures be capitalized: accurate accounting requires that revenues and expenditures

the use of these analogies is inconsistent and often poorly reasoned.[7] It is the contention of this Article that this result is directly attributable to the uncertainty inherent in the analogizing process, and that the analogy principle should therefore be discarded in favor of a functional approach to the particular circumstances of each case.

A stock redemption, for example, is analogous to a reorganization in that it is generally accompanied by a change in the corporate capital structure as a result of the reduction in the number of outstanding shares. A legitimate comparison can also be made with a complete liquidation, however, since a distribution of corporate assets is a principal component of both transactions. The fundamental difficulty is apparent: because there is no convincing basis for choosing between the

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be appropriately matched during the existence of an ongoing enterprise. When the enterprise has terminated, there is obviously no further need for such matching.

Later cases, however, developed a somewhat different rationale, emphasizing that no tangible or intangible asset is acquired when expenditures are made in connection with a complete liquidation. *See, e.g.*, United States v. Mountain States Mixed Feed Co., 365 F.2d 244, 245 (10th Cir. 1966). As one commentator has pointed out, this second rationale, since it is not based upon the matching principle, does not require a complete termination of corporate activity and is therefore applicable to a partial liquidation situation. Cohen, *The Deductibility of Stock Redemption Expenses*, 24 CASE W. RES. L. REV. 431, 439 n.47 (1973).

7. Some of the difficulty experienced by the courts can be attributed to the semantic confusion caused by a revision of the Code sections dealing with the treatment of a shareholder's gain or loss upon the repurchase of his shares by the issuer. Under the 1939 Code, shareholders were afforded "sale or exchange" treatment (resulting in a capital gain or loss) on "amounts distributed in partial liquidation." INT. REV. CODE OF 1939, § 115(c). A "partial liquidation" was defined simply as

> a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock. *Id.*, § 115(i).

This single section, therefore, encompassed both pro rata and non-pro rata stock repurchases.

The 1954 Code, however, treats "stock redemptions" as distinct from "partial liquidations." Section 302, captioned "Distributions in Redemption of Stock," essentially provides that a non-pro rata distribution shall be deemed a "sale or exchange" of the shareholder's stock. Section 346, on the other hand, is labelled "Partial Liquidations Defined," and primarily governs pro rata stock repurchases (although some non-pro rata distributions are also covered). "Sale or exchange" treatment is given only to those repurchases which result in a corporate contraction. *See* B. BITTKER & J. EUSTICE, *supra* note 4, at 9-45 to 9-57.

There has been some indication that the courts, relying on the analogy to liquidations, are moving toward limiting the deductibility of expenses incurred in stock repurchases to those transactions which qualify as "partial liquidations." *See, e.g.*, Transamerica Corp. v. United States, 254 F. Supp. 504 (N.D. Cal. 1966); Cohen, *supra* note 6, at 487-88. Neither section 302 nor section 346, however, makes mention of the proper treatment of the expenses incident to the transactions they govern, and it will be argued herein that, for the purpose of determining such treatment, "partial liquidations" and "stock redemptions" are essentially similar. See text accompanying notes 82-87 *infra*.

available analogies, the result in any particular case cannot be predicted with confidence.

This Article will first examine the leading cases in which the analogy approach has been used in order to illustrate the problems which have arisen. Next, an alternative approach used in a limited number of cases and arguably sanctioned by the Supreme Court will be discussed. Finally, a revised method for dealing with the question will be proposed, emphasizing the need for courts to redirect their attention to the process of "matching" corporate expenditures with the revenues which these expenditures produce.[8] It is believed that closer scrutiny of the functional aspects of a restructuring will lead to a more realistic assessment of its impact on the corporation. In the long term, the application of such scrutiny in individual cases will foster the development of more consistent general rules.

II. The Analogy Approach: Application in the Cases

The primary question posed by most courts in attempting to determine the deductibility of the legal expenses of a particular transaction is whether the transaction more closely resembles a complete liquidation or a corporate reorganization. In a line of court of appeals cases, the analogy approach was utilized to determine the tax treatment of expenses incurred in each of the transactions under consideration here: partial liquidations, stock redemptions, and corporate separations.

The first such case was *Mills Estate, Inc. v. Commissioner*[9] in which a corporation withdrew from one of its principal activities, the management of real estate, by selling the property and distributing the proceeds pro rata to its shareholders. The mechanics of the plan involved the distribution of cash to the shareholders in exchange for part of their stock, the amendment of the corporate charter to reduce the authorized stock by the amount retired on the exchange, and the issuance of new capital stock under the amended charter in exchange for the remaining capital stock outstanding.[10] The corporate taxpayer de-

8. This matching process, whereby revenues realized during a specified period are reduced by the costs of operation applicable to that period, is a fundamental principle of accounting and provides the primary rationale for the sections of the Code dealing with deductions and capital expenditures. *See* E. Faris, Accounting for Lawyers 69, 75-85, 345-46 (rev. student ed. 1964); W. Karrenbrock & H. Simons, Intermediate Accounting 6-7 (1958); J. Mertens, *supra* note 5, ¶ 25.35 at 173-74.

9. 206 F.2d 244 (2d Cir. 1953), *rev'g in part* 17 T.C. 910 (1951); *see* Comment, *Attorneys' Fees for Partial Liquidation: Business Expense or Capital Asset?*, 6 Stan. L. Rev. 368 (1954).

10. *See* Mills Estate, Inc., 17 T.C. 910, 911-12 (1951).

ducted the legal fees incident to this plan as an "ordinary and necessary business expense" under section 162 of the Code.[11] The Tax Court allowed only part of the legal expenses to be deducted, allocating them between capital expenditures and currently deductible items.[12] Amounts attributable to amending the charter and reducing the authorized capital stock were considered to be capital expenditures by analogy to reorganization costs, since they provided for the acquisition and retirement of outstanding stock. However, amounts attributable to "the actual distribution of assets in partial liquidation" were held deductible by virtue of the similarity between such distribution and a complete liquidation.[13]

The Second Circuit reversed.[14] Although it disapproved of the allocation of expenses, the court did not suggest that the Tax Court had been incorrect in attempting to draw a parallel between the instant transaction and either a reorganization or a liquidation.[15] Making its own application of the analogy principle, the Second Circuit reached an opposite result, concluding that the corporation had undergone "a recapitalization to give itself a capital structure it determined was best suited to carrying on that part of the business it was to continue." This altered capital structure was viewed as an intangible asset which would be of long-term benefit to the corporation; consequently, the expenses incurred in undertaking this transaction had to be capitalized.[16]

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11. See note 2 *supra.*

12. 17 T.C. at 915. The Tax Court had allowed expenses of repurchase transactions on an allocated basis in some prior cases. *See, e.g.*, Tobacco Prods. Export Corp., 18 T.C. 1100 (1952), *not acquiesced in*, 1955-2 CUM. BULL. 11 (§ 346 type pro rata distribution). Following the reversal of its decision in *Mills Estate* by the Second Circuit, 206 F.2d 244 (2d Cir. 1953), however, the Tax Court was considerably less amenable to this approach. *See, e.g.*, Farmers Union Corp., 19 CCH Tax Ct. Mem. 941 (1960), *aff'd*, 300 F.2d 197 (9th Cir. 1962); Standard Linen Service, Inc. v. Commissioner, 33 T.C. 1 (1959), *acquiesced in*, 1960-2 CUM. BULL. 7; Cohen, *supra* note 6, at 434-36. *But see* Stephen L. Morrow, 26 CCH Tax Ct. Mem. 1222, 1243-44 (1967) (intimating that a portion of the expenses of a bootstrap redemption would be deductible if the court were able to allocate expenses between the redemption and the immediate resale of the stock).

13. 17 T.C. at 915. Although the taxpayer had apparently not provided proof upon which to sustain an allocation, the court allowed one on the authority of Cohau v. Commissioner, 39 F.2d 540 (2d Cir. 1930), treating one half as a deductible expense and the other half as a nondeductible capital expenditure. 17 T.C. at 915. A dissent argued that all of the expenditures were "incident to the reorganization of a continuing corporation" and therefore capital expenditures. *Id.* (Turner, J., dissenting).

14. 206 F.2d 244 (2d Cir. 1953).

15. *Id.* at 246.

16. *Id.* The court did not explicitly acknowledge its reliance on the analogy principle, nor did it elaborate on its conclusions, which were presented in summary fashion. Nonetheless, the essence of the opinion was clearly the rejection of the analogy drawn by the Tax Court and the substitution of that favored by the reviewing court.

The *Mills Estate* court's premise that the expenses of a transaction which results in the corporation's acquisition of a durable asset must be capitalized is a matter of established law,[17] and its treatment of the altered capital structure as such an asset initially appears reasonable. By holding that the presence of such an alteration is determinative of the matter, however, the court seems to have lost sight of the fact that the transaction caused the corporation to be divested of a considerable portion of its assets.[18] It is quite possible that whatever long-term benefits were derived from the restructuring were offset by this contraction of the firm's activities. The court could just as reasonably have concluded that the transaction was in effect a "liquidation" of a portion of the company and that the restructuring of capital was merely incidental to this change. It is the presence of such uncertainty which causes the most concern to tax planners.

The next case in this line of authority was *Gravois Planing Mill Co. v. Commissioner*,[19] in which legal expenses were incurred in developing a plan for the withdrawal of a majority shareholder from the business.[20] Under the plan finally agreed upon, the retiring share-

17. *See* United States v. Akin, 248 F.2d 742, 744 (10th Cir. 1957), *cert. denied*, 355 U.S. 956 (1958):

> [A]n expenditure should be treated as one in the nature of a capital outlay if it brings about the acquisition of an asset having a period of useful life in excess of one year, or if it secures a like advantage to the taxpayer which has a life of more than one year.

See also Treas. Reg. § 1.263(a)-2 (1958); J. MERTENS, *supra* note 5, at ¶ 25.26.

18. The court in fact stated that whether or not the transaction qualified as a "partial liquidation" under section 115(i) of the 1939 Code was irrelevant. 206 F.2d at 246.

19. 299 F.2d 199 (8th Cir. 1962), *rev'g* 19 CCH Tax Ct. Mem. 639 (1960).

20. The majority shareholder had consulted the same attorneys about the transaction and arguably some of their services could have been construed as having been rendered for his personal benefit. However, the court found "nothing in this record to justify a conclusion that any part of these was for the benefit of [the majority shareholder] personally." 299 F.2d at 209. This was in spite of an explicit finding of fact by the Tax Court that part of the attorney's charge had been for rendering advice to the retiring shareholder. 19 CCH Tax Ct. Mem. at 643. This illustrates a potentially difficult question—for whom are the services of the attorney rendered in such a circumstance? Certainly the attorney handling the transaction would have to determine the tax effects on the retiring shareholder, often the most significant single consequence of a redemption. The services may be characterized as for the shareholder's benefit, and the costs therefore not deductible by the corporation (if it pays the fee) because incurred for the benefit of another. *See* J. Gordon Turnbull, 41 T.C. 358 (1963), *aff'd*, 373 F.2d 91 (9th Cir. 1967). On the other hand, there are also serious legal ramifications for the corporation in a redemption. Query whether the attorney should allocate his fee, charging part to the corporation and part to the redeemed shareholder? This raises the possibility of deduction of the legal fee by the shareholder under section 212. At least one case has allowed such a deduction in similar circumstances. Kauffmann v. United States, 227 F. Supp. 807 (W.D. Mo. 1963). In *Gravois*, the court seemed to gloss over the whole question, assuming that all the services were rendered for the corporation, apparently even those attributable to determining tax consequences to the redeemed share-

holder sold some of his shares to one of the three remaining shareholders in order to equalize their holdings. The residue was sold to the corporation in exchange for cash and various items of real and personal property. The retiring shareholder then leased the real property back to the corporation.[21]

The Eighth Circuit, in an opinion by then Judge Blackmun, allowed the deduction of the expenses incident to the transaction.[22] The court acknowledged that the stock redemption was accompanied by a change in the corporation's capital structure and that this factor argued for capitalization of the expenses.[23] Viewing the transaction as a whole, however, the court found that:

> the dominant aspect . . . was the liquidation of the [majority stockholder's] shares and not the recapitalization. . . . Although there was, of course, a desire on the part of all to keep the organization going, the basic problem with which they struggled was that of the disposition of the outstanding [majority] stock and was not one directed to the change or any desired improvement in the form of the corporate structure. Stock retirement, that is, partial liquidation, was the problem and it was the essence of what transpired.[24]

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holder. Another problem raised by this situation is that the parties have adverse interests, presumably bargaining at arms' length over terms of the transaction, and an attorney handling the entire transaction would be under an obligation at least to advise the parties of the potential conflict of interest. *See* ABA CANONS OF PROFESSIONAL ETHICS No. 5.

21. 299 F.2d at 201. The transaction came within the 1939 Code definition of "partial liquidation," see note 7 *supra*, and would probably be treated as a section 302 stock redemption under the 1954 Code.

22. 299 F.2d at 206. The Tax Court, 19 CCH Tax Ct. Mem. 639 (1960), had accepted the Commissioner's argument that the charges were "capital expenditures made in connection with the corporation's acquisition of part of its own shares of stock and for amendment to its articles of incorporation to reflect the redemption of such stock." *Id.* at 644. This argument appears to be similar to that accepted in cases such as Atzingen-Whitehouse Dairy, 36 T.C. 173 (1961) (see notes 56-58 *infra* and accompanying text).

23. 299 F.2d at 208-09. The court analyzed four decisions: the lower and appellate court opinions in Mills Estate, Inc., 17 T.C. 910 (1951), and 206 F.2d 244 (2d Cir. 1953); Tobacco Prods. Export Corp., 18 T.C. 1100 (1952), *modified*, 21 T.C. 625 (1954); and Standard Linen Serv., Inc., 33 T.C. 1 (1959). It then assumed that they expressed the applicable law, which was stated as follows:

> Legal fees and other expenses of a partial liquidation may be deductible, within the statutory definition, as ordinary and necessary expenses paid in carrying on the business. Mills Estate (Tax Court), Tobacco Products, Standard Linen. Where, however, a partial liquidation is accompanied by the corporation's recapitalization or reorganization, the transaction is to be viewed as a whole and its dominant aspect is to govern the tax character of the expenditures. Mills Estate (2d Cir.), Standard Linen. Thus, where one has what is essentially "a change in the corporate structure for the benefit of future operations," there is no deduction. Mills Estate (2d Cir.). 299 F.2d at 208.

See note 16 *supra* and accompanying text.

24. 299 F.2d at 209.

As in *Mills Estate*, the Eighth Circuit adopted the analogy approach. The selection of the appropriate analogy, however, was predicated on an analysis which went beyond the initial finding that a reorganization in the form of an alteration in the firm's capital structure had occurred.

But in spite of the depth of the analysis, the court's conclusion that the transaction was more closely analogous to a liquidation is far from self-evident. Although the corporation's assets were depleted to the extent of the cash paid and the value of the property transferred, the scope of the firm's corporate activity had not been materially diminished because of the sale and leaseback agreement with respect to the real property. Moreover, the court's use of the term "liquidation" was questionable in that the reference was apparently to the elimination of the shareholder's stock and not to a disposal of corporate assets.[25]

The *Gravois* opinion's potential for confusion could have been minimized had the court simply stated as a general rule that the costs of a redemption of a retiring shareholder's stock are ordinary and necessary business expenses.[26] Aside from the obvious appeal of a consistent approach, such a result would be entirely reasonable. In the typical situation where a stockholder wishes to retire from a business, the corporation derives no continuing long range benefit in the nature of an asset from the transaction. It is merely enabled to continue in operation without the retiring shareholder; indeed, the transaction quite often takes place at the shareholder's behest, as it did in *Gravois*. Even where the redemption occurs in order to remove a dissident shareholder, however, the transaction is basically one which is undertaken to enable the corporation to continue in its normal operation, rather than one which brings about an added benefit or improvement requiring capitalization.

Two cases have extended the analogy approach to the expenses of corporate separations.[27] In *United States v. Transamerica Corp.*[28]

25. *Id.*

26. See text accompanying notes 82-84 *infra*.

27. A corporate separation is a device by which a corporation reduces the scope of its activities by transferring a part of its assets to another corporation in exchange for the stock of the transferee corporation. This stock is then distributed to the shareholders of the transferor corporation. A separation may be undertaken for a number of reasons, including compliance with legal restrictions on the firm's activities (*e.g.*, antitrust considerations), resolution of a dispute among the transferor corporation's shareholders, or the achievement of management efficiencies. *See* J. MERTENS, *supra* note 5, ¶ 20.91; Rubin & Midler, *Split-Off and Split-Up Reorganizations*, 17 FORDHAM L. REV. 246 (1948). The Code contains provisions which enable both the transferor corporation and its shareholders to avoid recognition of any gain realized on the exchange. INT. REV.

and *United States v. General Bancshares Corp.*,[29] the taxpayer corporations acted to divest themselves of certain non-banking assets as required by the Bank Holding Company Act of 1956.[30] Under provisions of the Code enacted to facilitate compliance with the Act,[31] the corporations transferred assets to newly formed subsidiaries and then distributed the subsidiaries' stock pro rata to their shareholders, thereby effecting a separation of the prohibited assets.[32]

In each case, the court of appeals accepted the taxpayer's characterization of the transaction as a partial liquidation and, by analogy to a complete liquidation, allowed the deduction.[33] The courts reasoned that, although the transaction did not fit within the framework of section 346 of the Code, it did involve corporate contraction, since substantial corporate assets had been divested by the taxpayer corporation.[34] The original firm obtained no offsetting long-term benefit, other than compliance with the law,[35] since the transaction did not involve any change in its proportionate shareholder interests.

Once again, however, in grasping for a defensible analogy, the courts overlooked the pragmatic significance of the transaction under consideration. On the surface, the corporation in each case derived no long-term benefit from the divestment and underwent a contraction of its activities. The courts concluded from these facts that the dominant aspect of the transactions was a "partial liquidation."[36] Upon

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CODE OF 1954, §§ 355, 361(a) and 368(a)(1)(D); *see* B. BITTKER & J. EUSTICE, *supra* note 5, at ¶ 13.01-.15; 223-2d BNA TAX MGT. PORTFOLIOS (1974).

28. 392 F.2d 522 (9th Cir. 1968), *aff'g* 254 F. Supp. 504 (N.D. Cal. 1966).

29. 388 F.2d 184 (8th Cir. 1968), *aff'g* 258 F. Supp. 502 (E.D. Mo. 1966).

30. 12 U.S.C. §§ 1841-49 (1956), *as amended*, 12 U.S.C. §§ 1841-50 (1970).

31. INT. REV. CODE OF 1954, §§ 1101-03.

32. These tax free transactions were similar in nature to a corporate separation under § 368(a)(1)(D). *See* United States v. General Bancshares Corp., 388 F.2d 184, 189 (8th Cir. 1968); Transamerica Corp. v. United States, 254 F. Supp. 504, 513 (N.D. Cal. 1966), *aff'd*, 392 F.2d 522 (9th Cir. 1968).

33. *Transamerica*, 392 F.2d at 523; *Bancshares*, 388 F.2d at 191. The Commissioner had contended at the district court level of each case that the legal expenses of effectuating these separations were capital expenditures, because the transactions were in substance corporate reorganizations. *Bancshares*, 258 F. Supp. at 506; *Transamerica*, 254 F. Supp. at 507. The arguments presented in the text following note 36 *infra* reflect the Commissioner's reasoning.

34. In *Bancshares*, the court explicitly stated that the rule allowing deduction of expenses of a partial liquidation "is not limited only to those expenditures incident to a distribution meeting the requirements of a section 346 partial liquidation." 388 F.2d at 191.

35. The courts in both cases specifically noted that the fact that the expenditures were incurred in order to comply with the law did not affect their nature as capital expenditures or currently deductible expenses. *Bancshares*, 388 F.2d at 187; *Transamerica*, 254 F. Supp. at 508.

36. Although *Gravois* was cited as authority by the court in each case, the factual

closer scrutiny, however, it is apparent that the courts might reasonably have found that what had really occurred was a pro rata corporate division which resulted in the same shareholders holding their investment in the original proportions in an altered corporate form. This conforms to the fundamental characteristics of a reorganization.[37] From this perspective, there had been no true divestiture of assets by the taxpayer corporations. The courts could well have concluded that this change in corporate structure was the very essence rather than a mere incident of the transactions. Such a finding would have required that the expenses of the reorganization be capitalized. The point, of course, is not that either conclusion is significantly more compelling than the other, but that both are entirely defensible. Judicial inconsistency and consequent uncertainty for the corporate tax planner are therefore inevitable.

The most recent case employing this analogy approach, *Bilar Tool and Die Corp. v. Commissioner*,[38] involved a non-pro rata corporate separation. Friction between the corporation's two coequal shareholders led the board of directors to adopt a resolution calling for "a plan of reorganization" whereby the assets of the business would be divided equally between the shareholders.[39] The corporation thereafter formed a subsidiary and exchanged approximately one half of its assets for all of the stock of the newly organized corporation. This stock was then distributed to one of the shareholders in exchange for all of his stock in the original corporation.[40]

The Tax Court, in a reviewed opinion, found that although the transaction might qualify as a reorganization under section 368(a)(1)(D) of the Code,[41] the corporation had "acquired nothing that would

situations were substantially different from that in *Gravois*. In *Gravois* the transaction was a non-pro rata distribution in termination of a shareholder's interest. See notes 19-21 *supra* and accompanying text. In *Bancshares* and *Transamerica*, by contrast, there was no retirement of shares and the distribution was pro rata. *See* 388 F.2d at 186; 254 F. Supp. at 506.

37. *See* Helvering v. Southwest Consol. Corp., 315 U.S. 194, 202 (1942).

38. 530 F.2d 708 (6th Cir. 1976), *rev'g* 62 T.C. 213 (1974).

39. 530 F.2d at 710-11. The corporation separation apparently conformed to a non-pro rata type D reorganization. *Id.* at 713; *see* INT. REV. CODE OF 1954, § 368(a)(1)(D).

40. The parties stipulated that all of the events pursuant to the resolution of the board of directors were "part of a single unified plan," and that the taxpayer had incurred legal and accounting fees of $11,500 "in connection with the plan." 530 F.2d at 709-10.

41. 62 T.C. 213, 220 (1974). The court indicated that the term "reorganization" as used in this context is conclusory. That is, its application to describe a transaction simply denotes that the court has concluded it "affected [sic] a change in the corporate structure for the benefit of future operations." *Id.* If the transaction effects such a change, it is denominated a reorganization; however, analysis of the transaction must precede its denomination, and not vice versa.

be of any benefit to it in its future operations."[42] The dominant aspect of the transaction, according to the court, was "a partial liquidation in the sense that [the original corporation] divested itself of part of its assets in return for part of its stock and continued in business on a reduced basis."[43] The attendant expenses, therefore, were held deductible under *Transamerica* and *General Bancshares*.[44]

The Sixth Circuit reversed,[45] finding that the Tax Court's conclusion that the corporation had obtained no future benefit was "clearly erroneous."[46] Quoting extensively from testimony indicating that the division was necessary for the continued existence of the taxpayer's business, the court stated:

> When a plan of reorganization of a corporation which is going "down the drain" produces two viable corporations by the equal division of the assets of the doomed (or threatened) corporation, we believe value has clearly been added to the capital structure of both the original corporation and the successor corporations. Such was the dominant purpose and result of the reorganization plan as this record clearly establishes.[47]

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42. *Id.*

43. *Id.*

44. *Id.* at 218-21. See notes 28-35 *supra* and accompanying text. Five members of the Tax Court dissented, stating that "the ultimate purpose and effect of the various steps in the plan were to bring about a reorganization of the form and operations of the business." 62 T.C. at 222.

45. 530 F.2d 708 (6th Cir. 1976).

46. *Id.* at 710.

47. *Id.* at 711, *citing Mills Estate*. Further on, the court added that

> [the attorney fees] were of benefit to the whole of the original corporation because they served the purpose of terminating the dissension which threatened to wreck it. They were likewise of capital benefit to both successor corporations, since they were essential to making both possible. *Id.* at 713.

Similar reasoning was applied in Thompson & Green Mach. Co. v. United States, 327 F. Supp. 1128 (M.D. Tenn. 1971), where the court, in disallowing deduction for expenses of a non-pro rata corporate separation whereby subsidiary stock was distributed to shareholders in exchange for stock and notes of the parent, said:

> It appears . . . from . . . all of the evidence that the motivating and dominant reason for the recited activities was the maintaining of the Caterpillar franchise and its continued value to [the parent]. If this is so, then the corporate reorganization was effected "for the improvement of a tangible or intangible asset." *Id.* at 1130.

Thompson is distinguishable from *Bilar* in that in *Thompson* the preservation of a specific asset was involved—a sales franchise—rather than preservation of the existence of the entire business, and the court deemed the expenses to have been made for the "improvement" of that asset by making it more secure. This would not be the case in the usual non-pro rata separation undertaken to effectuate a split of shareholder interests and not to protect any specific asset. Similarly, in E.I. Dupont de Nemours & Co. v. United States, 432 F.2d 1052 (3d Cir. 1970), the court denied deduction of expenses of a complex corporate realignment involving a divisive reorganization carried out to comply with the antitrust laws on the ground that "the expenditures resulted in a benefit

Unlike the courts in *Transamerica* and *General Bancshares*,[48] then, the Sixth Circuit viewed the transaction from the standpoint of both the original taxpayer corporation and the newly formed corporate entity. From this perspective, the scope of business activity remained the same, and the proportionate interest of each shareholder in the whole enterprise was likewise unchanged. A strong argument can be made, however, that it was inappropriate for the court to look at the impact of the transaction on both corporations. After the separation, each shareholder held stock in a corporation which was fundamentally different from that in which he had previously had an interest. Instead of owning a half interest in all of the assets, each now owned a total interest in one half of the assets; company-shareholder relations had been fundamentally altered. It would have been equally reasonable, therefore, for the court to emphasize the lack of formal continuity between the two corporations and to analyze the transaction solely from the viewpoint of the original firm.

The court's decision to take the broader view can perhaps be traced to the constraints imposed by the analogy approach. The original corporation had undergone a substantial change—the withdrawal of one of its two shareholders, accompanied by a divestiture of half of its assets. Viewed from the perspective of the original corporation alone, then, the situation resembles that presented in *Gravois*.[49] In both cases a shareholder terminated his investment in the company, in both the corporations found it advantageous to cooperate with the shareholder in this goal, and in both the net result of the transaction was that the corporation continued in business with reduced assets. It would seem, therefore, that the most appropriate result would have been to follow *Gravois* and allow the deduction of attendant expenses by analogy to a complete liquidation.[50]

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to the taxpayer which could be expected to produce returns for many years in the future." *Id.* at 1059.

48. See notes 28-35 *supra* and accompanying text. The court attempted to distinguish *Bancshares* and *Transamerica* on the ground that in those cases the divestiture of the assets was compelled. 530 F.2d at 712. However, it appears to be an established principle that the mere fact that an expenditure is compelled by law does not affect its characterization as either capital or ordinary and necessary. *See* E.I. Dupont de Nemours & Co. v. United States, 432 F.2d 1052, 1059 (3d Cir. 1970); Woolrich Woolen Mills v. United States, 289 F.2d 444 (3d Cir. 1961); RKO Theaters, Inc. v. United States, 163 F. Supp. 598 (Ct. Cl. 1958). This principle was expressly recognized in both *Transamerica*, 254 F. Supp. 504, 508 (N.D. Cal. 1966), *aff'd*, 392 F.2d 522 (9th Cir. 1968), and *Bancshares*, 388 F.2d 184, 187 (8th Cir. 1968).

49. See notes 19-21 *supra* and accompanying text.

50. The court did, however, attempt to distinguish *Gravois* on the rather spurious ground that there the company's president and major shareholder was retiring and wished to withdraw his capital, whereas "[n]o such retirement and withdrawal of capital

The court was understandably reluctant to draw an analogy to a complete liquidation, however, since the transaction had the effect of allowing the original corporation to remain in business. It was suggested in the opinion that an expenditure which averts a threat to a business' existence must of necessity produce a benefit which extends beyond the taxable year and, therefore, should be capitalized.[51] The court's dilemma is apparent. Had the analogy approach been applied in the most straightforward fashion, that is, from the viewpoint of the original corporation alone, the *Gravois* reasoning would have dictated the analysis and result. That result, however, would have been inconsistent with the court's view of the realities of the transaction. The only way to reconcile the desired result with the use of the analogy approach was to consider the status of both corporations and draw the more tenuous reorganization analogy.

Curiously, the court's strongly held view of the nature of the transaction is contrary to a line of cases which has generally held that expenses incurred to defend a threatened business are ordinary and necessary.[52] For example, in the earliest case to consider the specific issue of deductibility of legal fees incurred in connection with a corporate stock redemption, *General Pencil Co.*,[53] the Tax Court held that fees paid to an attorney in order to protect a corporation from a shareholder's threat to throw the firm into receivership were deductible as ordinary and necessary business expenses.[54] Had the *Bilar* court been

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is involved in our instant case and there is both beneficial change and improvement shown in the instant plan." 530 F.2d at 712. The court also seemed to be influenced by the fact that in *Gravois* the parties styled their plan a "liquidation" while in *Bilar* they called it a "reorganization." *Id.*

51. *Id.* at 713.

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

> A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.

53. 3 CCH Tax Ct. Mem. 603 (1944).

54. *Id.* at 604. In this, the earliest decision squarely on point, the court allowed a deduction in a case where the corporate capital structure was changed by a repurchase of the corporation's own stock, and the corporation had thereby obtained a benefit similar to that envisaged by the *Bilar* court, apparently without a corporate contraction. In so doing the court did not utilize the analogy to complete liquidation, nor did it consider the repurchased stock to be a capital asset in the hands of the repurchasing corporation.

A few cases have gone so far as to recognize allowability of a deduction for the repurchase payment itself when the existence of the business is threatened. The most notable of these is Five Star Mfg. Co. v. Commissioner, 355 F.2d 724 (5th Cir. 1966). There a corporation owned a valuable patent right. In order to retain that right and to protect itself against liquidation as a result of a receivership suit by one of its two 50 percent shareholders, the corporation repurchased that shareholder's stock. The court

influenced by this line of authority, it might not have found the more obvious analogy to a complete liquidation so incongruous with the fact that the transaction was undertaken to preserve the corporate existence.

What emerges once again is not a strong sense that the court's result was clearly right or wrong, but a realization that a number of viewpoints are supportable. The *Bilar* case, therefore, is perhaps most significant as another indication of the inadequacy of the analogy approach. Since the judicial treatment of expenses has been less than consistent under this approach, the courts in future cases should not hesitate to attempt new analyses. In fact, another method of dealing with these kinds of situations has already been developed and has arguably been sanctioned by the Supreme Court. Prior to suggesting a new approach, therefore, it is first necessary to examine this second line of cases and to determine whether the Supreme Court has settled the issue.

III. THE SUPREME COURT AND THE "STRAIGHT REDEMPTION" CASES

In a second line of cases, the courts have viewed a corporation's redeemed stock as a capital asset and the expenses of the redemption as simply a part of the cost of acquiring that asset.[55] *Atzingen-Whitehouse Dairy, Inc. v. Commissioner*[56] is an often cited and typical case

held that the entire amount paid to purchase the stock was deductible on the ground that it was necessary to protect the business, *id.* at 727, since liquidation would have been inevitable otherwise. This did not result in acquisition of a capital asset, but was merely an expenditure which would permit the corporation to use its assets for income production. *Id. Cf.* United States v. Smith, 418 F.2d 589 (5th Cir. 1969) (deductibility of payment made to discharge debt of shareholder assumed by corporation dependent upon whether payment is determined to be a constructive dividend). *Contra*, White Star Drive-In Laundry, Inc. v. United States, 1972-2 U.S. Tax Cas. ¶ 9683 (N.D. Ill. 1972), in which the court rejected the taxpayer corporation's attempt to deduct the amount paid to redeem 50 percent of its own stock from one of its two shareholders in settlement of a suit for dissolution, saying:

> The Circuit Court suit in question sought the dissolution of the corporation, the appointment of a receiver, and a distribution of the proceeds from a sale of the assets. It is difficult to imagine a claim which is more capital in nature. *Id.* at 86,586.

The Fifth Circuit later limited its *Five Star* holding to "situations where a payment to purchase a capital asset, though capital in nature, is necessary to the taxpayer's survival." Jim Walter Corp. v. United States, 498 F.2d 631, 639 (5th Cir. 1974). *See also* H & G Indus., Inc. v. Commissioner, 495 F.2d 653, 657 (3d Cir. 1974).

55. These cases have been termed "Straight Redemption" cases by two authors, D. HERWITZ, *supra* note 4, at 543; DeCastro, *supra* note 4, at 227, and "Simple Acquisition" cases by another, Cohen, *supra* note 6, at 444.

56. 36 T.C. 173 (1961); *accord*, Annabelle Candy Co., 20 CCH Tax Ct. Mem. 873 (1961), *aff'd on other grounds*, 314 F.2d 1 (9th Cir. 1962).

adopting this approach. A corporation incurred legal expenses in the development of a plan to eliminate friction among its three shareholders by redeeming the shares held by two of them. The Tax Court disallowed the corporation's deduction of the legal fee as an ordinary and necessary business expense, stating, without citation of authority, that the fee was "a capital expenditure which should have been treated as part of the cost of the stock purchased."[57] That the redemption was motivated by a desire to eliminate friction among the shareholders was deemed immaterial.[58]

The argument that a corporation purchases an "asset" when it reacquires its own stock in a redemption transaction seems unsound. From a financial accounting standpoint, when a corporation redeems stock the shares are generally either cancelled or held as treasury stock.[59] In the first case, they go out of existence entirely; in the second, while they remain on the corporate books as issued, they are no longer considered outstanding.[60] In either event they add nothing of value to

57. 36 T.C. at 183. There is broad support available for this proposition. Its earliest expression apparently came in a brief administrative pronouncement, O.D. 852, 4 CUM. BULL. 286, which provided in its entirety:

> The expenses, exclusive of the purchase price, incurred by a company in purchasing its own stock for the purpose of retirement or holding as treasury stock, are not such expenses as can be classified as ordinary and necessary expenses incurred in carrying on the business, and hence are not deductible from gross income. These expenses are to be considered part of the purchase price of the stock retired.

O.D. 852 was superseded by Rev. Rul. 69-561, 1969-2 CUM. BULL. 25, which, however, applied the same principle, holding that brokerage fees paid by a corporation in purchasing its own stock "are part of the purchase price of the stock so acquired," and citing *Atzingen*. The Service took a different approach but reached the same result in Rev. Rul. 67-125, 1967-1 CUM. BULL. 31, 32, where it ruled that expenses of planning a redemption are capital in nature because they "operate to change the capital structure for a period of indefinite duration." Subsequently in Rev. Rul. 74-266, 1974-1 CUM. BULL. 73, 74, the Service cited both of these rulings in holding that costs of redemptiou of preferred stock are not chargeable against earnings and profits, but rather are "properly chargeable to capital account" under section 312(e).

The principle received its earliest judicial recognition in Commerce Photo Print Corp., 6 CCH Tax Ct. Mem. 386 (1947). There, as a result of stockholder friction, the corporation redeemed all the shares of one of two shareholders in a transaction that could conceivably have qualified as either a non-pro rata redemption or a corporate contraction. The Tax Court rejected the corporation's claim to deduction of the related attorneys' fees because "[the amount] paid in connection with petitioner's acquisition of its own shares of stock . . . was an expenditure for the acquisition of property. . . ." *Id.* at 392; *accord*, Southern Eng'r & Metal Prods. Corp., 9 CCH Tax Ct. Mem. 93 (1950); *cf.* Colonial Eng'r Co., 22 CCH Tax Ct. Mem. 1476 (1963) (court assumed that expenses of redeeming stock were "a part of the purchase price").

58. 36 T.C. at 183.

59. *See* 11 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5088 at 38 (M. Wolf rev. ed. 1971).

60. *See id.*

the corporation, representing merely a balance sheet adjustment of the corporate capital structure, and listing them as an asset may be not only inaccurate, but also misleading.[61] Secondly, under the 1954 Code, a corporation does not recognize gains or losses resulting from dealings in its own stock,[62] thus indicating that, for tax purposes, such transactions are not to be considered as typical acquisitions of capital assets.[63] Finally, cases such as *Atzingen* have, of course, virtually disregarded the principal line of circuit court authority rejecting the notion that redeemed stock is a capital asset and requiring that the dominant aspect of the transaction as a whole be used to determine the deductibility of attendant expenses.[64]

In spite of these arguments against the *Atzingen* approach, it is the only case on this topic to receive mention by the Supreme Court—albeit for a limited purpose.[65] It is necessary, therefore, to examine the Court's decisions in the area to determine whether the deductibility question has effectively been settled.

In *Woodward v. Commissioner*[66] and *United States v. Hilton Hotels Corp.*,[67] the Supreme Court applied the "origin and character" test developed in *United States v. Gilmore*[68] to determine whether costs

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61. *See* SEC Regulation S-X, Rule 3-14, 17 C.F.R. § 210.3-14 (1976):

> Reacquired shares not retired shall be shown separately as a deduction from capital shares, or from the total of capital shares and other stockholders' equity, or from stockholders' equity, at either par or stated value, or cost, as circumstances require.

See also AICPA, ACCOUNTING OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD No. 6 at 40 (October, 1965).

62. INT. REV. CODE OF 1954, § 1032:

> (a) *Nonrecognition of Gain or Loss*—No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.

63. There was, however, some basis for this notion under pre-1954 Code law. *See generally* 2 S. SURREY, W. WARREN, P. MCDANIEL & H. AULT, FEDERAL INCOME TAXATION 191-95 (1973).

64. See notes 9-47 *supra* and accompanying text. This situation can conceivably be attributed to the manner in which the cases are indexed. For example, in Mertens' treatise, *Atzingen* is cited for the proposition that "the cost of . . . redeeming capital stock" must be capitalized, while *Gravois* furnishes authority for the proposition that expenses of a "partial liquidation" may be deductible. *Compare* J. MERTENS, *supra* note 5, ¶ 25.35 n.53 *with id.* n.72.3. The cases are likewise grouped under different headings in the CCH and Prentice-Hall services.

65. *See* Woodward v. Commissioner, 397 U.S. 572, 578 (1970). *Atzingen* was cited as general support for the limited proposition that the expenses incurred in determining the price at which stock will be redeemed must be capitalized. *Id.*

66. 397 U.S. 572 (1970).

67. 397 U.S. 580 (1970).

68. 372 U.S. 39 (1963). In *Gilmore*, a taxpayer had successfully defended against his wife's assertions of a community property interest in assets which provided him with

incurred in appraising the stock of dissenting shareholders are current expenses or capital expenditures. In *Woodward* the stockholders of a corporation which was about to expire voted to extend the corporate existence perpetually. A minority stockholder dissented, and under state law was entitled to have his shares purchased by the stockholders voting for renewal. The parties, however, could not agree on the value of his stock, and appraisal litigation ensued. The majority shareholders subsequently claimed a deduction under section 212 of the Code[69] for the legal expenses incurred as a result of this litigation.

The Supreme Court found that the "origin" of these expenses was the purchase of the dissenter's shares by the individual taxpayers and therefore applied the rule that "the cost of acquisition . . . of . . . property having a useful life substantially beyond the taxable year" is a capital expenditure.[70] The costs of litigation were deemed analogous to the cost of negotiating a purchase price for the minority stock which, the Court said, would no doubt have been a capital expenditure.[71] Since *Woodward* involved the acquisition of the stock of one individual by another individual, its result appears sound. It should be emphasized, however, that the case did not involve the purchase of stock by a corporation or a change in corporate organization.

In *Hilton Hotels*, however, the Court faced a factual situation more closely analogous to a redemption or partial liquidation and used *Wood-*

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much of his income. If the wife had obtained the asserted interest in certain stock the husband would have been in danger of losing corporate positions which were his principal sources of income; additionally, he might have lost his automobile dealer franchises if certain of the charges made by his wife had been proven. He was not allowed to deduct his attorney's fees under section 23(a)(2) of the 1939 Code (predecessor of section 212), on the ground that the expenditures were personal in nature rather than related to income-producing activity or property. The taxpayer's purpose of protecting his income-producing assets and positions was not considered to be relevant to allowance of the deduction. Rather, the Court established the so-called "origin and character" test:

> [T]he 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, is the controlling basic test of whether the expense was "business" or "personal" and hence whether it is deductible or not under § 23(a)(2). *Id.* at 49.

Since the origin of the claim with respect to which the legal fees were incurred was the marital relationship, the expenses were held to be personal in nature, even though the result of the taxpayer's losing his claim may well have been the loss of considerable income.

69. In the case of an *individual*, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year:
(1) for the production or collection of income;
(2) for the management, conservation, or maintenance of property held for the production of income . . . . INT. REV. CODE OF 1954, § 212 (emphasis added).

70. 397 U.S. at 575-76, *quoting* Treas. Reg. § 1.263(a)-2(a) (1958).

71. 397 U.S. at 577-78.

ward as a basis for analysis of the transaction. The dissenters in this case were shareholders of the Hotel Waldorf-Astoria Corporation who objected to the corporation's proposed merger with Hilton, which already owned 90 percent of the Waldorf stock. Once again, litigation was required in order to appraise the dissenters' shares. Hilton claimed a deduction under section 162 of the Code[72] for legal and other expenses incurred in connection with this procedure.[73]

The Supreme Court regarded *Hilton* as simply a variation of the *Woodward* situation, stating that it "presents a similar question involving the tax treatment of appraisal litigation expenses."[74] The origin of these expenses was the acquisition by Hilton of the Waldorf stock; therefore, capitalization was required. Again, the Court's opinion appears sound if the transaction is perceived as involving nothing more than the purchase by the taxpayer corporation of shares of another corporation. Under such an analysis, the case has only limited applicability to a transaction involving only one corporation. Even if the transaction in *Hilton* is viewed as a corporate merger, perhaps a more realistic approach, the Court reached the correct result in holding that the attendant expenses must be capitalized.[75] This result likewise has little effect on the existing law since the expenses of corporate mergers and other reorganizations are generally capital expenditures.[76]

The argument that *Woodward* and *Hilton* require capitalization of stock redemption and partial liquidation expenses,[77] therefore, is undercut by the substantial factual differences between those cases and

72. See note 2 *supra.*

73. 397 U.S. at 582.

74. *Id.* at 581. The Court apparently found insignificant the following factual differences: (1) *Woodward* involved a purchase of stock by individual shareholders from other individual shareholders, while *Hilton* involved payment by a corporation to dissenting shareholders of the corporation being merged into it; and (2) The basic underlying transaction in *Woodward* was the extension of the corporate charter while the transaction in *Hilton* was a corporate merger of a subsidiary into its parent. The Court did detect a distinction between the cases in that, under state law in *Hilton*, title to the dissenters' stock passed to the majority as soon as they formally registered their dissent to the merger, whereas in *Woodward* passage of title did not occur until after the price was settled in the appraisal proceeding. *Id.* at 583. This distinction, however, was not found substantial enough to require a different result. *Id.* at 584.

75. The district court determined that the transaction was essentially a corporate merger, but found that the appraisal expenses were incurred independent of the reorganization. It therefore did not require capitalization of these expenses. Hilton Hotels v. United States, 285 F. Supp. 617 (N.D. Ill. 1968), *aff'd*, 410 F.2d 194 (7th Cir. 1969), *rev'd*, 397 U.S. 580 (1970).

76. See note 23 *supra.*

77. *See* 17-5th BNA TAX MGT. PORTFOLIOS A-94 (1974); Cohen, *supra* note 6, at 472-82.

such transactions. Reasonably read, the Supreme Court cases simply reaffirm the settled rules that the expenses of acquiring stock in a corporation (other than the taxpayer corporation) must be capitalized and that the expenses of a corporate reorganization must be capitalized. This interpretation of these cases is supported both by the limited purpose for which the Court cited *Atzingen*[78] and by the fact that in *Bilar*, the most recent case in the redemption/partial liquidation area,[79] the Tax Court found little guidance in the Supreme Court decisions[80] and the Sixth Circuit on appeal failed even to mention them.

IV. An Alternative Approach

Since the current case law has not set forth a comprehensive scheme for determining the proper tax treatment of the legal expenses incurred in a partial liquidation, stock redemption, or corporate separation, it would be appropriate for the courts to explore alternative approaches in future cases. As a foundation for doing so, the courts should redirect their attention to the fundamental accounting concept that costs are to be "matched" against the revenues which they produce.[81]

On a superficial level, the suggested analysis is virtually indistinguishable from the analogy approach. In fact, the question of when the benefits of a transaction would accrue was posed at least implicitly in many of the cases discussed in the process of choosing the appropriate analogy. The critical distinction is one of focus. The results in the analogy cases have depended on the court's overall perception of the transaction. The relative emphasis to be given different aspects of the transaction has been entirely discretionary and largely unpredictable. The analysis proposed here would require that the decision be based instead on a single, functional criterion: a traditional accounting determination of which year's revenues particular expenses should be charged against. Admittedly, judicial flexibility would be sacrificed; complex analysis such as that employed in *Bilar* would be precluded. It is contended, however, that the significant gain in rational consistency would more than compensate for any constraints imposed on judicial discretion.

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78. See note 65 *supra*.

79. Bilar Tool & Die Corp. v. Commissioner, 62 T.C. 213 (1974), *rev'd*, 530 F.2d 708 (6th Cir. 1976). See notes 38-47 *supra* and accompanying text.

80. "In [*Woodward* and *Hilton*] there was no question that the underlying litigation or transaction was of a capital nature while our task here is to decide the underlying character or nature of the transaction." 62 T.C. at 219.

81. See note 8 *supra*.

One effect of such a change in focus would be to facilitate the establishment of definite, automatic procedures for treating expenses incurred in fairly common transactions. Certainty of treatment is clearly more desirable than purported rationality from the tax planner's perspective. The cases discussed above, however, provide little basis for formulating such rules of general applicability. An analysis of three typical transactions will show the utility of the matching principle in achieving a reasonable standardization in these types of cases.

A. Stock Redemption

The most consistent results reached under the reorganization/liquidation analogy approach have involved the deductibility of the expenses of a stock redemption. According to *Gravois*, a principal shareholder's retirement results in a "liquidation" of a portion of the firm, and, therefore, the transaction is analogous to a complete liquidation of the corporation.[82] It should be obvious, however, that an essential element of a complete liquidation—the termination of the corporate existence—is not present in the situation under consideration. This fact largely undercuts the validity of the analogy since an important reason for permitting the deduction of liquidation expenses is the need to close out the firm's books.[83]

In spite of the weakness of the analogy, it was concluded above that the *Gravois* result is correct;[84] it should therefore be elevated to the status of a general rule to be applied in all comparable cases. Such certainty can be best achieved by discarding the inappropriate analogy to a complete liquidation and by focusing on the essential elements of the transaction. In this situation, the transaction can be broken down into a distribution of corporate assets and a restructuring of capital to reflect the withdrawal of a shareholder from the business.[85] The long-term impact of each of these elements should then be assessed. As a logical matter, it is difficult to view the reduction in corporate assets

82. See text accompanying note 24 *supra.*

83. See note 6 *supra.*

84. See notes 22-26 *supra* and accompanying text.

85. The Tax Court's analysis of the stock redemption in Mills' Estate, Inc., 17 T.C. 910 (1951), *rev'd in part*, 206 F.2d 244 (2d Cir. 1953), began with a similar functional breakdown of the transaction. The court then attempted to allocate the costs between the capital expenditures required to produce a new capital structure and the ordinary expenses incurred in distributing corporate assets. See notes 12-13 *supra* and accompanying text. It was at this stage that the court experienced difficulty, having to estimate roughly the proper allocation. See note 13 *supra.* Such problems of imprecision are avoided under the analysis proposed in this Article, since the functional breakdown is to be used only for generally evaluating the long-term impact of the whole transaction.

resulting from the distribution as anything but a detriment to the company's long-term prospects. Likewise, the removal of a shareholder and the restructuring of capital are not readily characterized as long-term corporate benefits.

These conclusions might be questioned in a situation in which the redemption was undertaken to eliminate shareholder friction. This latter view cannot, however, form the basis of an argument requiring capitalization, for it would be directly contrary to the general rule that costs incurred in eliminating a shareholder who poses a threat to the continuation of the business is a currently deductible expense. The rationale is apparent: the elimination of an impediment at a single point in time is far removed from the traditional concept of an asset of continuing value. Since neither of the essential elements of a stock redemption can be viewed as conferring a long-term benefit on the corporation, the expenses incurred in undertaking this change should, in every case, be matched against current income and treated as ordinary and necessary business expenses.

B. Partial Liquidation

Similar considerations apply in the partial liquidation context. The main components of a section 346 partial liquidation are a distribution of assets and an alteration of the corporation's capital structure in the form of a reduction in the number of shares outstanding.[86] According to *Mills Estate*, the latter feature compels the conclusion that the expenses of a partial liquidation must be capitalized, on the theory that a new capital structure is a long-term corporate asset.[87]

This approach grossly overstates the value of the future benefits against which the present transaction costs might be matched. The new corporate structure itself cannot be viewed as an asset of lasting value; rather, the restructuring confers on the corporation only the ephemeral benefit of being enabled to clear an existing hurdle and continue in business. The problem is compounded by the inadequate emphasis given to the distribution of assets in *Mills Estate*. When the detriment inherent in a contraction of corporate activities is weighed

86. Section 346(a) provides that:

> . . . a distribution shall be treated as in partial liquidation of a corporation if—
>
> (1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or
>
> (2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan . . . .

INT. REV. CODE OF 1954, § 346(a).

87. See notes 15-16 *supra* and accompanying text.

against whatever positive aspects the reorganization might have, it is difficult to view the entire transaction as anything more than a substantial and largely uncompensated expenditure necessary to meet current exigencies. An examination of the elements of the transaction from a matching perspective thus suggests a general rule of deductibility for the expenses of a partial liquidation.[88]

C. *Corporate Separation*

Under the reorganization/liquidation analogy approach, the treatment of the expenses of a corporate separation, a transaction in which the corporation transfers part of its assets to a newly formed corporation and distributes the shares of the new corporation to its own shareholders, apparently depends upon whether or not the distribution is made on a pro rata basis. In *Transamerica* and *General Bancshares*, the courts allowed the deduction of the expenses of a pro rata separation,[89] while the cost of the non-pro rata split in *Bilar* had to be capitalized.[90]

Under the approach suggested herein, the result would be precisely the opposite. Corporate separations involve the same two elements present in partial liquidations and stock redemptions: a corporate distribution and a change in the corporate capital structure. In fact, the analysis of a non-pro rata separation is essentially the same as that of a stock redemption. In each situation, the overall impact of the transaction is detrimental to the corporation since the depletion of assets will normally outweigh any benefit resulting from the change in capital structure necessary to reflect the withdrawal of a shareholder. Even assuming an overall beneficial effect, that benefit must again be characterized as immediate rather than continuing.

On the other hand, it would appear that the treatment of the expenses of a partial liquidation is determinative of the issue with regard to the expenses of a pro rata separation. In both situations, the original corporation suffers a substantial depletion of its assets. The benefits derived from the reorganization aspect of the separation, however, are considerable. As in all corporate reorganizations, the shareholders retain their proportionate investments in the same enterprise, but within a new corporate framework.[91] It can reasonably be assumed that the change was brought about because the new corporate structure was deemed more advantageous to the business as a whole. The preferred

88. See note 27 *supra*.
89. See notes 33-35 *supra* and accompanying text.
90. See notes 47-48 *supra* and accompanying text.
91. See note 37 *supra* and accompanying text.

new structure not only enables the enterprise to continue, but enables it to continue with improved prospects for success. It therefore confers on the corporation a continuing benefit, the attendant expenses of which are properly matched against future income.

V. CONCLUSION

The determination of the proper tax treatment of legal expenses incurred by corporations undertaking a partial liquidation, stock redemption, or corporate separation has resulted in conflicting lines of authority and conflicting decisions within the dominant line of authority. Since the treatment such expenses will receive may affect a corporation's decision to engage in one of these transactions, it is important that some certainty be brought to the area.

Thus far, most courts have attempted to analyze these transactions by drawing an analogy to either a reorganization or a liquidation. This approach, however, has led to an oversimplification of the analysis, as evidenced by the failure of the courts in many cases to make a realistic appraisal of the functional components of the transaction.

It is suggested that certainty of result can be better achieved by assessing the essential elements of each transaction in order to determine the overall impact which the change will have on corporate operations. Capitalization of expenses will thus be required only in those instances in which the true long-range benefit to the corporation derived from the transaction offsets whatever detrimental effect it may have. In this way, the treatment of these expenses will more accurately reflect the matching concept which underlies the expense/capital expenditure distinction for federal income tax purposes.