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**INDOPCO, INC. v. COMMISSIONER: DETERMINING THE TAXABLE NATURE OF A TARGET CORPORATION'S TAKEOVER EXPENSES**

**INTRODUCTION**

Determining whether a business expense should be currently deducted or capitalized is an issue which has continued to divide taxpayers and the Internal Revenue Service ("I.R.S." or "Service"). Taxpayers want current deductions which reduce their taxable income now, whereas the I.R.S. wants the expense to be capitalized in order to increase collectable taxes. The proper line between deduction and capitalization is difficult to draw, even more so when the result of an expenditure is not a tangible asset or a readily identifiable intangible asset.¹ In *INDOPCO, Inc. v. Commissioner,*² the Supreme Court had the opportunity to draw this line in the context of expenses incurred by a target corporation during a friendly takeover.³ The Court held that a corporate target must capitalize the legal and investment banking fees it incurs during a friendly acquisition.⁴ The Court reasoned that such expenditures produce a long-term benefit to the corporation and are therefore capital in nature.⁵

The Court’s assertion of a "long-term benefits" test,⁶ which it used to determine that the takeover expenses were capital in nature,
severely limited the "separate and distinct asset" test it had previously asserted in 1971 in Commissioner v. Lincoln Savings and Loan Ass'n.\(^7\) No longer is the presence of a separate and distinct asset a necessary condition for capitalization.\(^8\) Rather, the test focuses on whether an expense creates significant benefits which extend beyond the tax year in question.\(^9\)

Adding to the confusion, the I.R.S. has changed its way of dealing with takeover expenses several times since 1985, with the National Starch line of cases\(^10\) serving as its catalyst.\(^11\) In a recent Technical Advice Memorandum ("T.A.M."),\(^12\) the I.R.S. asserted its latest interpretation of the National Starch cases.\(^13\) Currently, all expenses incurred during takeovers, whether friendly or hostile,\(^14\) will be capitalized if the expenses produce a long-term benefit to the target corporation.\(^15\) Not only did the I.R.S. have a difficult time

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8. INDOPCO, 112 U.S. at 1044 (noting that the presence of a separate and distinct asset may be a sufficient condition to classification as a capital expenditure, but is not a necessary condition, and finding that even though INDOPCO's expenditures did not create a separate asset, the expenditures were still capital in nature).
9. Id. at 1045.
12. The I.R.S.'s National Office, through the Associate Chief Counsel, issues letter rulings called Technical Advice Memoranda, whereby advice or guidance about the interpretation and proper application of tax laws, regulations, and rulings is given in connection with the examination of a specific taxpayer's return or refund. I GERALD W. PADWE ET AL., OBTAINING IRS PRIVATE LETTER RULINGS 11-I (1989). Pursuant to I.R.C. § 6110(j)(3), Technical Advice Memoranda and Private Letter Rulings may not be used or cited as precedent. I.R.C. § 6110(j)(3) (West 1993) ("Unless the Secretary otherwise establishes by regulations, a written determination may not be used or cited as precedent."). They are, however, useful indications of the Service's position on a given issue and are frequently consulted by practitioners.
14. A tender offer is an offer by an acquirer to buy a certain amount or all shares tendered of a particular company at a particular price, usually above market price. The object is the takeover of that company. 19 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, at Glossary 26 (Perm. ed. 1988) [hereinafter FLETCHER CYCLOPEDIA]. A takeover is defined as a merger, acquisition, or other change in the controlling interest of a corporation. Id. A friendly takeover occurs when a corporation indicates an interest in purchasing a majority of stock in a target corporation and that offer is favorably accepted by the target. Id. § 3.145. A hostile takeover involves an unfair and coercive "tender offer" aimed at controlling a target corporation which does not want to accept the offer. Id.; see also infra notes 87-90 and accompanying text (discussing the use of a "white knight" as a defensive tactic by the target of a hostile takeover).
15. Tech. Adv. Mem. 91-44-042 (June 7, 1991) ("The revenue agent must make the factual
reaching this ultimate conclusion regarding takeover expenses, but the I.R.S. has since issued other rulings regarding other types of business expenses which place its policy rationales in question.\(^1\)

The taxable nature of takeover expenses will be examined in four parts. First, this Note examines the definitions of current deductions and capital expenditures. Part I also explains the tests used for distinguishing between capital and current expenses prior to the Supreme Court’s ruling in \textit{INDOPCO}, the I.R.S.’s treatment of takeover expenses, the I.R.S.’s treatment of other expenses, and recent developments which may influence this area of law. Second, this Note discusses the \textit{INDOPCO} case itself. Part III focuses on the Court’s opinion in light of the legal background in this area, including a critique of the Court’s reasoning, a prediction of the possible I.R.S. interpretations which may result, an argument regarding the inequitable tax consequences that may occur, and a proposed rule dealing with takeover expenses specifically. The final part of this Note discusses the impact of the \textit{INDOPCO} ruling both practically and from a policy standpoint. This Note concludes that the Court’s decision failed to provide much-needed, clearly-defined guidelines for distinguishing current from capital expenditures, especially when a target corporation’s takeover expenses are at issue.

\section*{I. Background}

\subsection*{A. Defining Capitalization and Deductibility}

Current deductions and capital expenditures lack a clear distinction, which explains the problems that the public, the courts, lawyers, and even the I.R.S. have understanding and differentiating these terms. In general, Internal Revenue Code ("I.R.C." or "Code") section 162(a) allows a taxpayer to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."\(^17\) Section 162(a) deduc-

\footnotesize{
\(^16\) See infra notes 133-48 and accompanying text (discussing the subsequent T.A.M. rulings).
\(^17\) I.R.C. § 162(a) (West 1993). Section 162(a) provides:

(a) 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, including—

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging
tions are matched against current income, and they reduce how much income will be taxed at the present time. However, under section 263, no deductions are allowed for "any amount paid out for permanent improvements or betterments made to increase the value of any property." Instead, such amounts are capitalized, or charged against income the expenditures help earn in the future, ratably over the useful life of the property. While the Code provides these guidelines, the sections must be more fully explained before they prove useful.

In theory, the key to achieving a more accurate calculation of net income for tax purposes is to match the revenues received during a taxable period with the expenses incurred to produce the revenues. Other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

Id.

18. See James J. Freeland et al., Fundamentals of Federal Income Taxation 355 (7th ed. 1991) (noting that expenditures made to enable the taxpayer to use the property for that expected period are immediately deductible).

19. I.R.C. § 263(a) (West 1993). Section 263(a) provides:

(a) No deduction shall be allowed for—

1. Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

2. Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

Id.

20. Freeland et al., supra note 18, at 355; see Treas. Reg. § 1.263(a)-1(b) (as amended in 1992) (providing that the amounts paid or incurred to add to the value or substantially prolong the useful life of plant or equipment, or to adapt property to a new or different use, are included under § 263(a)). This regulation also provides that "[a]mounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures . . . ." Id.

21. The Court apparently resolved the conflict between the two provisions by holding that the capitalization requirement takes precedence over the deductibility of ordinary and necessary expenses. Commissioner v. Idaho Power Co., 418 U.S. 1, 17-19 (1974). This Note points out that § 162(a) has indeed been construed narrowly and that the capital expenditures enumerated in the Code are not exhaustive.

22. See Dan L. Goldwasser, Generally Accepted Accounting Principles, in Accounting for Lawyers 1990, at 53 (1990) (noting that "under generally accepted accounting principles it would be inappropriate to recognize the revenues from a given transaction in one accounting period and to recognize the cost associated with that transaction in another accounting period"). Revenues are defined as "inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations"). Id. at 51. Expenses are defined as "outflows or other using up of assets or incurrences of liabilities (or a combination of both) from delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's ongoing major or central operations." Id.
However, not all expenditures which occur during a taxable period give rise to a deduction during that period. If instead an expenditure gives rise to a benefit which applies to one or more future periods, or brings about the acquisition of an asset having a useful life of longer than one year, the expenditure has to be capitalized. A capital expenditure is an outlay of capital that results in the acquisition of property or a permanent improvement in the property's value. If the capital expenditure results in a tangible asset, the capital expenditure is matched with income in the periods it benefits through depreciation. If the capital outlay results in an intangible asset with a determinable useful life, the capital expenditure made to acquire that asset is matched with income in the periods it benefits.

23. "Useful life" is defined in the Regulations as follows:
   For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Treas. Reg. § 1.167(a)-1(b) (as amended in 1972). Determining the length of a property's useful life is quite speculative and a subject of disagreement between the I.R.S. and taxpayers. Free-land et al., supra note 18, at 742.

24. See Hotel Kingkade v. Commissioner, 180 F.2d 310, 312 (10th Cir. 1950) (noting that this rule is commonly known as the "one year" rule of thumb); see also supra notes 19-20 and accompanying text (discussing capitalization and the Code section and regulation defining it).

25. Treas. Reg. §§ 1.263(a)-1(a), -2(a) (as amended in 1992); see Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103, 106 (1929) (noting that a taxpayer must capitalize the cost of renovations or permanent improvements to property and deduct that expenditure over the useful life of the property, and contrasting it with a repair made to maintain the property in its ordinary operating condition which is currently deductible under § 162); see also 5 Mertens Law of Federal Income Taxation § 25.39 (1989) [hereinafter Mertens] (noting that amounts paid or incurred to add to the value or substantially prolong the useful life of property, whether real or personal, or to adapt property to a new or different use, are capitalized under § 263).

26. Tangible assets include properties such as buildings, equipment, and machinery. See Treas. Reg. § 1.167(a)-2 (1956) (noting that the depreciation allowance for tangible property applies only "to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence").

27. 5 Mertens, supra note 25, § 23A.03 (1991). Depreciation is the gradual reduction in value of property, used in trade or business or held for production of income, not necessarily due to use or lapse of time. Id. § 23A.122. The taxpayer depreciates the cost over the useful life of the asset. The end sought by the depreciation allowance is to have the amount of money invested, or the basis, in a wasting asset returned to the taxpayer as a charge against the income earned by the asset, and thus avoid the taxing of a return of capital. Id.; see also Treas. Reg. § 1.1012-1(a) (as amended in 1990) ("In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property.").

28. Intangible property does not lend itself to precise definitions. Generally, intangibles enable the physical assets of the trade or business to produce income. For example, a copyright has no value apart from the material it covers and is therefore deemed an intangible asset. 5 Mertens, supra note 25, § 23A.124.
through amortization. However, intangible assets, like goodwill and going concern value, in that their useful life cannot be ascertained with reasonable accuracy, are not subject to the allowance for depreciation. Money spent on such assets will produce little or no tax benefit to the taxpayer since the taxpayer cannot recover the cost over time as with depreciable assets.

Because of the time value of money, money is worth more to the taxpayer now than if the taxpayer has it at some time in the future. Therefore, a deduction to reduce current taxable income is more advantageous than a deduction which will reduce future taxable income. If expenses incurred by a target corporation during a takeover, for example legal and investment banking fees which typically run into the millions of dollars, are treated as capital expenditures, they create an intangible asset. However, the useful life of the asset cannot be determined. Thus, no deductions for depreciation or amortization would be allowed. Consequently, the expenditures,
if capital in nature, have very little tax value. The only deduction given would be at the dissolution of the enterprise.\textsuperscript{36} However, that possible future deduction is virtually worthless when compared to the much larger tax benefit received if the expenses are treated as current deductions.

Despite the fact that they are basic elements of tax law and theory, the distinction between capital expenditures and current deductions remains difficult. Because of this difficulty, and the comparatively greater value of current deductions, taxpayers and the I.R.S. predictably dispute whether a payment is a deductible expense or a capital expenditure. As a result, judicial interpretation of I.R.C. section 162(a) and subsequent rulings have become the focus for a resolution.

\textbf{B. Judicial Interpretation of and Commentary on the Capital/Deductible Distinction}

\textbf{1. Judicial Interpretation of I.R.C. Section 162}

I.R.C. section 162(a) governs the deductibility of an expenditure.\textsuperscript{36} To qualify for a current deduction from income, five separate requirements must be satisfied. The expenditure must be: 1) paid or incurred during the taxable year; 2) for the carrying on of any trade or business; 3) an expense; 4) necessary; and 5) ordinary.\textsuperscript{37} The Supreme Court has provided some useful commentary on, and interpretations of, these requirements.\textsuperscript{38}

In determining whether an expense is incurred for the carrying on of any trade or business, the Court has noted that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of

\textsuperscript{35} INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1042 (1992). The amount of money spent during the takeover would be added to the basis of the enterprise. See \textit{supra} note 27 and accompanying text (defining basis). Upon dissolution, if the corporation is sold at a profit, the increased basis will create a smaller, taxable gain. See I.R.C. \S~1001 (West 1993) ("The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis . . . ."). This is the point at which the taxpayer will realize her tax benefit, although it will be substantially smaller than a benefit realized through deduction or depreciation.

\textsuperscript{36} See \textit{supra} note 17 and accompanying text (providing the full text of \S~162(a)).

\textsuperscript{37} Commissioner v. Lincoln Sav. \& Loan Ass'n, 403 U.S. 345, 352 (1971); I.R.C. \S~162(a) (West 1993).

\textsuperscript{38} However, in a not so useful but oft-quoted statement regarding the distinction between deductibility and capitalization, Justice Benjamin Cardozo wrote that "life in all its fullness must supply the answer to the riddle." Welch v. Helvering, 290 U.S. 111, 115 (1933).
the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal.'

This is known as the "origin of the claim" test for determining the taxable nature of an expenditure, assuming the other requirements are met, and is discussed later. "Necessary" expenses are those appropriate and helpful to the development of the taxpayer's business. Because "appropriate" and "helpful" are broad and subjective terms, almost any expense incurred in a taxpayer's business, from salaries to staples, will be deemed "necessary."

Historically, the "ordinary" requirement has been the Court's distinguishing factor between current and capital expenditures. "Ordinary" does not mean that the payment must be habitual, normal, or even frequently made; the situation giving rise to the expenditure may only happen once to a taxpayer, but will be considered "ordinary" if it is not uncommon to the taxpayer's industry.

Whether an expense is ordinary, and therefore deductible, in computing net income is affected by time, place, and circumstance. The taxable nature of an expense depends upon the kind of transaction and its normalcy in the particular business in which it was incurred. Once an acquisition is made, "the character of the item ac-

39. United States v. Gilmore, 372 U.S. 39, 49 (1963); see infra notes 72-81 and accompanying text (describing the "origin of the claim" test); see also Woodward v. Commissioner, 397 U.S. 572 (1970) (holding that determining whether litigation expenses must be capitalized turns on whether the "origin of the claim" litigated was in the process of acquiring a capital asset); Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir. 1965) (noting that the phrase "carrying on any trade or business" has been interpreted to mean that only an existing business, i.e., one that is fully operational, may take advantage of the provision).

40. See infra notes 72-81 and accompanying text (discussing the use of this test).

41. Commissioner v. Tellier, 383 U.S. 687, 689 (1966); Commissioner v. Heininger, 320 U.S. 467, 477 (1943); Welch, 290 U.S. at 113. The "necessary" test for deductibility is easy to satisfy because the definition is broad enough to encompass anything a business deems appropriate and helpful.

42. Tellier, 383 U.S. at 689-90 ("The principal function of the term 'ordinary' in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible, must be amortized over the useful life of the asset.").

43. Welch, 290 U.S. at 114; see also Deputy v. du Pont, 308 U.S. 488, 495-96 (1940) (noting that "ordinary has the connotation of normal, usual, or customary"); Tech. Adv. Mem. 91-44-042 (June 7, 1991) ("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 [sic], 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.").

44. DuPont, 308 U.S. at 496 (stating that "what is ordinary, though there must always be a strain of constancy within it, is none the less [sic] a variable affected by time and place and circumstance.") (quoting Welch, 290 U.S. at 113-14).

45. Id.
quired determines the tax treatment of the expenditures made to acquire it." As a general matter, the Court has observed that costs incurred to acquire a capital asset are deemed capital expenditures. Judicial interpretation alone, however, does not adequately solve the characterization problem. Various tests have also been developed to "aid" in this determination.

2. Judicial Tests for Determining Taxable Nature of Expenses

Despite the foregoing, the Supreme Court and circuit courts alike have also developed and applied various tests to help determine whether certain expenses are deductible under section 162, or are capital in nature under section 263. All courts, however, do appear to agree on three things: 1) that the determination of whether an expenditure is ordinary or capital is fact specific; 2) that "an income tax deduction is a matter of legislative grace;" and 3) that the burden of clearly showing the right to a claimed deduction is on the taxpayer. Overall, courts also agree that I.R.C. section 263 is not an exhaustive enumeration of nondeductible capital expenditures, but that it should serve as a means for distinguishing capital from current expenses. Because the courts view capital expenditures broadly, deductions are therefore strictly construed and allowed only if they are specifically provided for. Consequently, the

46. Central Texas Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1184 (5th Cir. 1984).
47. Woodward v. Commissioner, 397 U.S. 572, 575 (1980) ("It has long been recognized, as a general matter, that costs incurred in the acquisition . . . of a capital asset are to be treated as capital expenditures."); see also supra notes 19-20 and accompanying text (defining capital asset).
48. 6 MERTENS, supra note 25, § 25.37 (1992); e.g., DuPont, 308 U.S. at 496 (noting that each case turns on its special facts); Welch, 290 U.S. at 115 (pointing out that the distinction between capital expenditure and business expense is made by examining facts of each case); National Starch & Chem. Corp. v. Commissioner, 918 F.2d 426, 431 (3rd Cir. 1990) (agreeing that the determination of whether an expenditure is ordinary or capital is fact-specific), aff'd sub nom. INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1192 (10th Cir. 1974) (noting that in order to determine the taxable nature of an expense, each case must be individually analyzed); Iowa S. Utils. Co. v. Commissioner, 333 F.2d 382, 385 (8th Cir. 1964) (stating that in distinguishing between capital expenditures and business expenses, each case requires individual investigation and analysis).
51. See supra notes 19-20 and accompanying text (describing § 263(a) and noting that capital expenditures are defined in the negative).
53. DuPont, 308 U.S. at 493; New Colonial Ice, 292 U.S. at 440; see also supra text accompa-
burden of proving that an expense is immediately deductible is placed on the taxpayer desiring such tax treatment.\textsuperscript{64}

In cases prior to 1971, courts looked to the length of time that benefits from expenditures could be expected to last.\textsuperscript{66} In the corporate context, an expenditure was capital in nature if the expenditure bettered the corporation for: (1) the duration of its existence; (2) the indefinite future; or (3) longer than the current taxable year.\textsuperscript{65} Likewise, expenses incurred for the purpose of changing the corporate structure for the benefit of future operations were not considered ordinary and necessary business expenses, but were nondeductible capital expenditures.\textsuperscript{67}

However, in June of 1971, the Court altered this notion. In \textit{Commissioner v. Lincoln Savings & Loan Ass'n},\textsuperscript{68} a state-chartered savings and loan association sought to deduct an additional insurance premium which was required by the Federal Savings and Loan Insurance Corporation ("FSLIC") as part of the bank's annual insurance premium.\textsuperscript{69} This extra payment increased the FSLIC's "Secondary Reserve,"\textsuperscript{70} and federal law provided that an insured institution could recover this additional premium under certain circumstances.\textsuperscript{61} Lincoln Savings, the taxpayer, argued that this additional insurance premium was no different from a separate insurance payment that it was allowed to immediately deduct.\textsuperscript{62} The Court, however, concluded that these payments to the Secondary Reserve were nondeductible capital expenditures.\textsuperscript{63} The Court felt it important and controlling that the payment created or enhanced a separate and distinct additional asset.\textsuperscript{64} The Court also noted that

\textsuperscript{n}\textsuperscript{nying note 21 (noting the strict construction of current deductions).}
\textsuperscript{54} See supra note 50 and accompanying text (stating that the burden is clearly on the taxpayer, the one who benefits from § 162 treatment, to prove that an expense is not capital).
\textsuperscript{55} See, e.g., E.I. du Pont de Nemours & Co. v. United States, 432 F.2d 1052, 1059 (3rd Cir. 1970) (noting that when an expenditure resulted in a benefit to the taxpayer "which could be expected to produce returns for many years in the future," it was deemed capital and nondeductible).
\textsuperscript{56} General Bancshares Corp. v. Commissioner, 326 F.2d 712, 715 (8th Cir. 1964).
\textsuperscript{57} Id.
\textsuperscript{58} 403 U.S. 345 (1971).
\textsuperscript{59} Id. at 348.
\textsuperscript{60} Id. at 349. Each institution had a pro rata share in the Secondary Reserve. Id. at 350.
\textsuperscript{61} Id. at 350. The circumstances included the termination of the insured's status and the liquidation of the insured institution. Id.
\textsuperscript{62} Id. at 352-54.
\textsuperscript{63} Id. at 359.
\textsuperscript{64} Id. at 354 ("What is important and controlling . . . is that the . . . payment serves to create or enhance . . . what is essentially a separate and distinct additional asset and that, as an
"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." The Court seemingly created a new "separate and distinct asset" test for determining whether an expenditure should be capitalized, and apparently, every taxpayer hoped, rejected the test based on a long-term benefits analysis.

After Lincoln Savings, confusion followed. Some courts followed Lincoln Savings and applied the "separate and distinct asset" test for determining whether an expenditure had to be capitalized; others, including the Supreme Court, ignored Lincoln Savings and continued to use a "long-term benefits" type of analysis; while some, namely the Fifth Circuit, combined both analyses.

In Central Texas Savings & Loan Ass'n v. United States, the Fifth Circuit used the Lincoln Savings separate and distinct asset test to determine if the expenses at issue were ordinary, but also noted that the period of the benefits "remains a prominent, if not predominant," characteristic of a capital item. The court found that the expenses satisfied the Lincoln Savings test and were therefore capital in nature.

An alternative test, not used by the Court in INDOPCO, is the inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162.

65. Id. (emphasis added).
66. North Carolina Nat'l Bank Corp. ("NCNB") v. United States, 684 F.2d 285 (4th Cir. 1982) (concluding that expenses incurred in developing branch offices were currently deductible because such expenditures did not result in the creation of separate assets); Southland Royalty Co. v. United States, 582 F.2d 604 (Ct. Cl. 1978) (finding that a deduction was allowed for oil and gas reserve studies since such expenditures did not create a separate property interest, even though the data presumably provided some long-term benefit to the taxpayer.); Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973) (concluding that Lincoln Savings required a separate and distinct asset, identified by a property interest, before expenditures had to be capitalized).
67. See United States v. Mississippi Chem. Corp., 405 U.S. 298 (1972) (adhering to the rule that where a security is of value in more than one taxable year, it is a capital asset and the cost is nondeductible). The taxpayers in this case were required by the Farm Credit Act of 1955 to purchase a certain amount of stock in a bank in order to obtain a loan from the bank. The taxpayers sought to deduct such purchase prices as interest paid on a loan since it was required for the use of the borrowed money. The Court found the stock to be a capital asset. Id. In rendering its decision, the Court neither discussed nor explicitly rejected Lincoln Savings. Id. at 310.
68. 731 F.2d 1181 (5th Cir. 1984). In this case, Central Texas Savings sought to deduct several expenditures, including research fees and attorneys' fees, incurred in investigating and in starting up new branches of the bank. Id. at 1182.
69. Id. at 1183.
70. Id.
71. Id. at 1185.
“origin of the claim” test first introduced in *United States v. Gilmore.* This test has been used to determine whether legal fees incurred in particular situations are currently deductible. Under the origin of the claim test, in order to be deductible as ordinary and necessary business expenses, such expenditures may not have their origin in the acquisition or disposition of a capital asset. Further, if the expenditures do not have their origin in the taxpayer’s profit-seeking activities, the costs may not be deducted.

In *BHA Enterprises, Inc. v. Commissioner,* a radio station incurred legal expenses in connection with proceedings by the FCC to revoke the station’s broadcasting license. If the FCC had prevailed, the radio station would not have been able to operate its business. The Tax Court relied on *Madden, Woodward,* and Revenue Ruling 78-389 in concluding that such litigation arose because of the taxpayer’s business activities and did not result in the acquisition or disposition of a capital asset. Additionally, in determining that the litigation was directly connected with the radio station’s business activities, the Tax Court emphasized that the station’s legal expenses were deductible because, if the FCC had prevailed, the taxpayer would have been out of business.

By the time *National Starch* reached the Tax Court, there was no clear consensus as to what judicial test the court should apply in

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72. 372 U.S. 39 (1963); see supra notes 39-40 and accompanying text (discussing this test as the method for determining if expenses are business or personal and noting the language used by the Court).

73. E.g., *United States v. Hilton Hotels,* 397 U.S. 580 (1970) (using the test to conclude that expenses incurred to obtain legal and other services in connection with appraisal litigation arose out of the acquisition of a capital asset and were therefore capital); *Woodward v. Commissioner,* 397 U.S. 572 (1970) (using the test to find that attorneys’ and accountants’ fees incurred in connection with the appraisal of stock litigation were capital); *United States v. Gilmore,* 372 U.S. 39 (1963) (using the origin of the claim test in determining that legal expenses incurred in defending a divorce suit were capital since the claim against the taxpayer arose out of a personal relationship); *Madden v. Commissioner,* 514 F.2d 1149 (9th Cir. 1975) (using the test to find that litigation expenses that arose, not out of the taxpayer’s business, but out of the need of a government agency to use the taxpayer’s land were capital); *BHA Enters., Inc. v. Commissioner,* 74 T.C. 593 (1980) (using the test to determine that fees spent by a radio station to defend an action by the FCC were deductible).

74. *Woodward,* 397 U.S. at 577-79.

75. *Gilmore,* 372 U.S. at 48-49; *Madden,* 514 F.2d at 1151.

76. 74 T.C. 593 (1980).

77. Id. at 597.

78. Id. at 598.


80. *BHA Enters.,* 74 T.C. at 601-02.

81. Id. at 602.
determining whether National Starch's professional expenses incurred during a friendly takeover were capital or deductible. Unfortunately, the I.R.S.'s position on such expenses was of little assistance.

C. The I.R.S.'s Shifting Positions on the Treatment of Takeover Expenses

If, during the history prior to the Supreme Court's ruling in *INDOPCO* the courts were "divided" as to what test was appropriate in determining the taxable nature of certain business expenses, then the I.R.S. and its position were in absolute turmoil and of little help before and during the *National Starch* cases. In 1985, in T.A.M. 85-16-002,82 the I.R.S. outlined its position that expenses incurred to defend against a stock tender offer were deductible under section 162(a) of the I.R.C.83 However, the I.R.S.'s Corporate Tax Division initially took the position that these types of expenses were intended to protect the market value of the stock and therefore intended to create long-term benefits.84

Later in 1985, T.A.M. 85-16-002 was withdrawn by T.A.M. 86-26-001, in which the I.R.S. decided that "greenmail payments" were capital expenditures, as were attorney or broker's fees incident to the stock repurchase.85 But, the I.R.S. changed its mind and rein-stated T.A.M. 85-16-002, making the takeover expenses deductible once again.86 This, however, hardly settled the takeover expense dispute.

82. See *supra* note 12 and accompanying text (describing T.A.M.s, their purpose, and precedential value).


84. Gen. Couns. Mem. 39,352 (Dec. 31, 1984). The final decision of this memorandum was in accord with T.A.M. 85-16-002. Id. General Counsel Memoranda ("G.C.M.") are prepared by the Office of Chief Counsel to the I.R.S. in response to a formal request for legal advice from the Assistant Commissioner of Internal Revenue. A G.C.M. is used by the Assistant Commissioner to determine what position the I.R.S. will take on a proposed ruling, private letter ruling, or T.A.M. P-H Federal Taxes, Internal Memoranda of the IRS, IRS Mem. (P-H) ¶ 1 (1982).

85. Tech. Adv. Mem. 85-26-001 (Aug. 23, 1985). "Greenmail payments" are payments by a target company to a potential acquirer (aka "raider") in exchange for agreements not to pursue the takeover bid any further. Payment is usually accomplished by buying back the acquired shares at a premium. 19 *FLETCHER CYCLOPEDIA*, *supra* note 14, at Glossary 13. In the facts of the T.A.M., a "standstill" agreement, under which the raider agreed to refrain from further attempts to acquire the target company for a specified period of time, was also signed. Tech. Adv. Mem. 85-26-001 (Aug. 23, 1985).

1. The I.R.S.'s Position Pre-INDOPCO: Expenses Incurred to Fulfill Fiduciary Duties are Deductible

In 1989, the I.R.S. had occasion to address a different corporate takeover situation. It considered the taxable nature of expenses related to resisting a hostile takeover by finding a “white knight.”

A hostile takeover involves a tender offer, aimed at acquiring a majority of a corporation's stock and therefore obtaining control of the corporation. This offer is likely to be unfair and coercive to existing shareholders. If the target corporation believes that its acquisition by a hostile acquirer would not be in the best interest of its shareholders, the target corporation may defend itself against the acquirer's attempt by finding an alternative, acceptable buyer, termed a “white knight.”

In order to decide the issue, the I.R.S. considered these facts: in 1985, an acquirer, A, began a hostile effort to take over a target corporation, Tcorp, and acquire 51 percent of Tcorp's stock in order to exercise control over Tcorp. Believing that such action was not in the best interest of Tcorp, Tcorp's board of directors directed management to oppose A's attempt to acquire control of Tcorp. Management engaged an investment banker to assist Tcorp in its defense. The investment banker found an alternative buyer, a white knight, that would maximize the value received for all of Tcorp's shareholders' stock, and which had a strategic business plan which was be similar to that of Tcorp. An agreement was reached with A to cease its efforts to control Tcorp, and the acquisition of Tcorp by the white knight was approved by Tcorp's shareholders.

In the course of these events, Tcorp incurred expenses related to the retention of the investment banker and the reimbursement of A.

87. Tech. Adv. Mem. 89-27-005 (Mar. 27, 1989); see infra note 90 and accompanying text (defining a white knight as a takeover defense).
88. 19 Fletcher Cyclopedia, supra note 14, § 3:111.10 (Perm. Ed. Supp. 1992); see supra note 14 (discussing and defining tender offers and friendly and hostile takeovers).
89. See supra note 14 (defining a hostile takeover).
90. See 19 Fletcher Cyclopedia, supra note 14, at Glossary 29 (defining a white knight as a "company sought out by a takeover target in an unfriendly takeover to either acquire control of the target or otherwise thwart the would-be acquirer"); see also James C. Freund, Merger and Acquisitions: The Quintessence of Change, 1989-1990 Corp. Prac. Comm. 475 (discussing corporate takeovers and the defensive tactics employed by target companies during the 1980s).
92. Id.
93. Id.
94. Id.
95. Id.
for costs incurred in connection with A’s attempt to gain control of Tcorp.\textsuperscript{96} Tcorp asserted that the expenditures were incurred to enable the board of directors to carry out their fiduciary responsibilities and were currently deductible under I.R.C. section 162(a).\textsuperscript{97} The I.R.S. — called the District Director in these rulings — argued that the expenditures stemmed from a change in the capital structure of Tcorp and therefore should have been capitalized as costs of acquisition to the white knight purchaser.\textsuperscript{98}

The Associate Chief Counsel of the National Office decided that the expenditures were deductible current expenses.\textsuperscript{99} In applying the “origin of the claim” test, the expenses were found to be related to the carrying on of a trade or business since the board had the responsibility to oppose tender offers which may be detrimental to the company or its stockholders.\textsuperscript{100} The counsel relied on \textit{Gilmore} and the origin of the claim test, finding that it was clear that “the expenses at issue arose as a result of the business activites of [TCorp] that were designed to inform the Directors and protect the shareholders as well as the future business operations of [TCorp]. The expenses did not result in the creation of a capital asset.”\textsuperscript{101} The board’s fiduciary duty was the business activity out of which the expenditures originated.\textsuperscript{102} In T.A.M. 89-27-005, the I.R.S. also

\textsuperscript{96.} \textit{Id.}

\textsuperscript{97.} \textit{Id.} Boards of directors have a fiduciary duty to shareholders to determine if any tender offers are in the best interest of the given company. \textit{See} Northwest Industries, Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (N.D. Ill. 1969) (noting that management has the responsibility to oppose tender offers which it deems detrimental to the company or its stockholders); \textsc{William E. Knepper & Dan A. Bailey, Liability of Corporate Officers and Directors § 15.02, at 483 (4th ed. 1988)} (noting that it has been widely accepted that directors, pursuant to their duty of care, have an obligation to adequately inform themselves of all material facts prior to any decision, including takeover proposals).

There are several new fundamental principles which clearly apply to directors who respond to a takeover proposal:

1) The board of directors must make a thorough, well-documented investigation before acting;
2) Any defensive measure adopted by the board must be reasonable in relation to the reasonably perceived threat posed by the takeover bid; and
3) If control of the corporation is to be sold, the board must not interfere with the open, unrestrained bidding process.

\textsc{Knepper & Bailey, supra, § 15.01, at 481-82.}

\textsuperscript{98.} \textit{Id.}

\textsuperscript{99.} \textit{Id.}

\textsuperscript{100.} \textit{Id.}

\textsuperscript{101.} \textit{Id.; see supra} notes 72-81 and accompanying text (discussing the origin of the claim test in \textit{Gilmore}).

\textsuperscript{102.} \textit{Id.}
found the expenditures to be ordinary and necessary: "To say that this course of conduct and the expenses which it involved were extraordinary and unnecessary would be to ignore the ways of conduct and the forms of speech prevailing in the business world." In T.A.M. 89-27-005 the I.R.S. also rejected treating the expenses in accordance with the general rule that requires capitalization of reorganization expenditures because no changes had occurred to the capital structure of Tcorp.

The Counsel for the National Office concluded that fees paid by a target corporation to a bank for planning a defensive strategy that included a friendly takeover by a "white knight," and to a corporate raider in preventing a proxy fight, were currently deductible. Expenses that the target corporation incurred were deductible because the target's board of directors fulfilled their fiduciary duties by attempting to insure profitability and protect the shareholders.

However, in T.A.M. 89-45-003, the I.R.S.'s National Office revoked its ruling in T.A.M. 89-27-005 because it felt its position seemed more liberal than the Tax Court's position in the recently decided National Starch case. The Tax Court had held that investment banking fees and related expenses incurred by the acquired corporation in a friendly takeover were capital expenditures because the expenses produced long-term benefits for the corporation. The National Office reconsidered and further stated that "there is no less a long term benefit to the target of a hostile takeover in the [T.A.M. 89-27-005] situation" than in the friendly takeover situation of National Starch. The I.R.S. retreated to capitalizing all takeover expenses but still continued to reassess its rulings.

103. Id. (quoting Commissioner v. Heininger, 320 U.S. 467, 472 (1943)).
104. Id. "The well-established rule in this area is that amounts incurred to effectuate a corporate 'reorganization' (in the broad sense of a rearrangement resulting in a restructuring of the corporate entity ...) are not currently deductible as business expenses ..." Boris I. Bittker & James S. Eustice, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 5-33 (5th ed. 1987). Not only would a finding of a reorganization fall under this general rule, but the acquisition or disposition of capital assets would also violate the origin of the claim test. See supra notes 72-81 and accompanying text (discussing this test).
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2. The I.R.S.'s Position During INDOPCO: Expenses Incurred to Resist Hostile Takeovers Are Deductible

In July of 1990, in light of the Tax Court's decision in National Starch, the I.R.S.'s National Office once again reconsidered whether expenses incurred to resist a hostile takeover were deductible. In T.A.M. 90-43-003,109 which was based on the same facts as T.A.M. 89-27-005,110 the National Office concluded that expenses which were related to finding a white knight were indeed capital expenditures and nonamortizable.111 The expenses related to employing the white knight defense "were incurred with the intent to shift ownership, and did result in the shift of ownership. They were intended to lead to a benefit that could be expected to produce returns for many years in the future."112 However, those expenses which were directly related to resisting a hostile takeover were deductible as ordinary and necessary business expenses.113 The National Office once again pointed to the Gilmore "origin of the claim" test and noted that where litigation expenses arise in order to protect a business they are deductible ordinary and necessary business expenses under section 162.114

The National Office ruled, however, that finding a white knight required more than merely resisting a hostile tender offer.115 Such action was deemed to be a "permanent solution the components of which were a friendly acquisition by [the white knight] along with a standstill agreement that would effectively prohibit [the acquirer] from making any further attempts to acquire [TCorp] . . . ."116

110. See supra notes 91-98 and accompanying text (detailing the facts of T.A.M. 89-27-005).
112. Id.
113. Tech. Adv. Mem. 90-43-003, 90-43-004 (July 9, 1990). In each of these 1990 letter rulings, the National Office allocated the taxpayer's outlay between the costs of having itself acquired by a white knight, which were capital, and the costs of evaluating a tender offer and resisting it, which were deductible. Id. The National Office continued to rely on McCrory Corp. v. United States, 651 F.2d 828 (2d Cir. 1981), to support the allocation of costs between deductible and nondeductible purposes. In McCrory, the court required an allocation of expenditures between the capital-raising and asset acquisition aspects of two statutory mergers, thereby avoiding the "dominant aspect doctrine" which creates an all-or-nothing approach. Id.
114. Tech. Adv. Mem. 90-43-003 (July 1, 1990); see supra notes 72-81 and accompanying text (describing the origin of the claim test). Although the National Office did not mention it here, the Tax Court relied on the exact same reasoning in BHA Enterprises See supra notes 76-81 and accompanying text (discussing the decision in BHA Enterprises and the Tax Court's reasoning).
116. Id.; see supra note 85 (defining a standstill agreement). Because this shift of ownership was intended to lead to a benefit expected to produce returns in the future, these expenses were
In allocating the professional expenses, the taxpayer had the burden of establishing which litigation and other expenditures related to resisting the hostile takeover and were therefore deductible. If the taxpayer did not present sufficient evidence, all its expenses had to be capitalized.117

3. The I.R.S.'s Present Position on Takeover Expenses: Capitalize Them All

Approximately one year later, the I.R.S., bolstered by its National Starch victory in the Third Circuit Court of Appeals,118 changed its mind again. In T.A.M. 91-44-042, the National Office attempted to eliminate the distinction between hostile and friendly takeovers.119 This T.A.M. purportedly concerned Coastal Corporation's ("Coastal") hostile takeover attempt of Houston Natural Gas ("HNG") in 1984.120 To defend itself, HNG engaged investment bankers, lawyers, accountants, and public relations personnel to advise its board of directors on all financial matters relating to the tender offer.121 HNG's board of directors ultimately concluded that it should reject the takeover offer and defend itself against the takeover attempt.122 HNG made a counteroffer for Coastal's shares, a self-tender offer for HNG's shares, and other legal challenges.123

HNG claimed that its directors took these actions to discharge their fiduciary duty to protect HNG and its shareholders against the harmful takeover, and that the expenditures were therefore ordinary and necessary business expenses deductible under section 162(a).124 This reasoning was consistent with the National Office's previous position in T.A.M. 89-27-005.125 However, adopting the long-term benefits reasoning of the Third Circuit in National Starch,126 the
118. See infra notes 208-15 and accompanying text (discussing the Third Circuit's decision).
120. Richard M. Lipton et al., Supreme Court Approves Focus on Long-Term Benefit in Takeover Expense Controversy, 76 J. Tax'n 324, 328 (1992). For added clarity, Coastal in this T.A.M. is the same as acquirer A in the previous ones. HNG is TCorp.
121. Id. at 328 n.23.
122. Id.
124. Id.
125. See supra notes 91-105 and accompanying text (discussing both the rationale used in T.A.M. 89-27-005 to find that these expenses were deductible, and the fiduciary duty of the board of directors during takeover attempts).
126. See infra notes 208-15 and accompanying text (discussing the Third Circuit's reasoning).
National Office ruled that whether a taxpayer may deduct an expense depends on whether the taxpayer derives a long-term benefit from the expenditure, and not on whether the takeover is hostile or friendly. The office stated that the professional fees must be separately allocated; only then can an agent make the factual determination of whether long-term benefits will result. Thus, if the services performed are in connection with a transaction which results in a long-term benefit to the target corporation, the expenditures must be capitalized. In addition to the expenditures incurred to resist the takeover, the costs incurred by HNG in repurchasing its stock acquired by Coastal were also nondeductible capital expenditures. The National Office then used the “origin of the claim” test to assert that the origin was an acquisition of HNG stock, a capital expenditure, and thus one that failed this test. However, in some way qualifying the long-term benefits analysis, the National Office did acknowledge that there are situations where the Service has allowed a current deduction for expenses that provide a benefit beyond the current year, such as advertising costs.

In sum, the I.R.S.’s latest position on a target corporation’s takeover expenses is that the presence of a long-term benefit arising from the expense determines deductibility, regardless of the nature of the takeover. No clear cut lines are drawn by this position. Even though the I.R.S. purported to use the long-term benefits test from the National Starch cases, the National Office continued to make use of the “origin of the claim” test in analyzing away the directors’ fiduciary duty argument. The interrelation of the two tests is unclear from the language of the T.A.M.s. T.A.M. 91-44-042 is the I.R.S.’s current position regarding the taxable nature of a target corporation’s takeover expenses.

128. Id.
129. Id.
130. Id. None of the T.A.M.s discuss the practical differences between costs of resisting the takeover and the costs of employing certain actions which effectuate a successful resistance.
131. Id.; see supra notes 72-81 and accompanying text (discussing this test). The board’s fiduciary duty was not considered the origin of the claim but was simply the “purpose” of the repurchase. Tech. Adv. Mem. 91-44-043 (June 7, 1991); see also Woodward v. Commissioner, 397 U.S. 572, 577 (1970) (stating that the “primary purpose” test is uncertain and difficult and only applies to costs incurred in litigation affecting title to property).
4. Summary of the Treatment of Takeover Expenses

The following is a reference chart of the I.R.S.'s treatment of takeover expenses since 1989.

### TAX TREATMENT OF TARGET CORPORATION'S TAKEOVER EXPENSES

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<tr>
<th>TYPE OF TAKEOVER</th>
<th>PRE INDOPCO</th>
<th>DURING POST INDOPCO</th>
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<tr>
<td>FRIENDLY TAKEOVER</td>
<td>DEDUCTIBLE</td>
<td>CAPITAL</td>
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<tr>
<td>HOSTILE TAKEOVER</td>
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In order to clearly explain the Service’s policy decisions, the I.R.S.’s treatment of some other expenses is surveyed in the next section.

**D. I.R.S. Treatment of Other Expenses**

In order to evaluate the Service’s decisions with regard to takeover expenses from a policy standpoint, the consideration of the I.R.S.’s treatment of other expenses will be helpful. Two recent T.A.M.s will be discussed.

1. **T.A.M. 92-40-004**

T.A.M. 92-40-004, issued on June 29, 1992, did not deal with the issue of deductibility of professional fees; rather, the issue was whether a corporation could deduct the costs it incurred to remove and replace asbestos insulation in its manufacturing equipment in response to state and federal requirements regarding asbestos levels in the workplace. The taxpayer decided to replace the asbestos insulation instead of continuously monitoring the asbestos levels (the other regulatory option) because the corporation did not want work delayed due to violations or employee safety problems. The new insulation did not save energy or affect operating efficiencies, and the total cost was minor in relation to the assessed value of the equipment for property tax purposes. However, despite the taxpayer's argument that the cost should be currently deducted as an

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134. Id.
135. Id.
 incidental repair, the National Office denied the deduction.

The National Office believed that the costs were more like capital expenditures because the reduction of human health risks increased the value of the taxpayer's equipment. The National Office also noted that the new insulation was permanent, which is inconsistent with the nature of a repair. Oddly, the National Office seemed to indicate that if the taxpayer had only monitored the asbestos level and took precautions to protect the workers when they performed equipment maintenance, these costs would have been deductible. *INDOPCO* was mentioned in the ruling because, according to the National Office, the Supreme Court there "provided some guidance for distinguishing between deductions and capital expenditures." Under the long-term benefits test of *INDOPCO*, the asbestos removal costs had to be characterized as capital expenditures.

2. **T.A.M. 93-22-014**

In another ruling issued on March 8, 1993, the National Office considered whether attorneys' fees paid by B, a member of a legislative body, during an investigation of the legislator's relationship with a company, were deductible ordinary and necessary business expenses. B had retained attorneys to advise him of his legal rights, to assist in the preparation of his testimony, and to counsel him during the hearings held by the legislative body. In determining the taxable nature of the fees, the Office relied on the "origin of

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136. *Id.* The I.R.S. noted:

Section 1.162-4 of the Income Tax Regulations provides that the cost of incidental repairs that neither materially add value to the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the basis of the property is not increased by the amount of the expenditures.

*Id.*

137. *Id.*

138. *Id.*

139. *Id.* "In addition, the taxpayer chose to remove asbestos, in part, to reduce the time and expense of . . . [taking precautions] to protect its employees each time it performs regular equipment maintenance. By removing asbestos, the taxpayer increase[d] the value of its assets . . . ."

*Id.*

140. *Id.* (emphasis added).

141. See *infra* notes 216-31 and accompanying text (discussing the long-term benefits test used in *INDOPCO*).


144. *Id.* B was never disciplined.
the claim” test and Revenue Ruling 74-394.146 In this Revenue Ruling,146 the I.R.S. had used the origin of the claim test to determine that fees paid by a state judge to attorneys in connection with his defense of a misconduct charge were deductible ordinary and necessary business expenses since they had their origin in the conduct of the judge's official duties.147 The National Office followed this rationale and found that since the “matters investigated and the issues considered . . . arose out of B's conduct in carrying out the function of his office[,] . . . the attorney fees paid by [him] in connection with the investigation are ordinary and necessary business expenses deductible under section 162(a) . . . .”148 While these rulings are indicative of the I.R.S.'s policy rationales, a discussion of other legal developments will further develop the impending analysis of INDOPCO and follows in the next section.

E. Recent Developments

Briefly addressing some recent developments in the tax treatment of takeover expenses and other intangibles will also aid in an analysis of the INDOPCO ruling and its tax consequences. It is undisputed that expenses incident to an unsuccessful defense by the target of a hostile takeover are immediately deductible as abandonment losses under I.R.C. section 165(a).149 The I.R.S. acknowledged this fact in T.A.M. 85-61-002, in which the taxpayer was permitted to deduct break up fees it incurred when it unsuccessfully resisted a takeover attempt.150

In a recent bankruptcy court case, In re Federated Department Stores, Inc.,151 the I.R.S. tried to deny deductions by two corporations for break-up fees incurred while unsuccessfully resisting a hos-

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145. Id.
147. Id.
149. I.R.C. § 165(a) (West 1993) (“There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.”).
takeover which resulted in the bankruptcy reorganization of the companies. The I.R.S. argued that the expenses the target corporations incurred in resisting the takeover were capital in nature. The bankruptcy court, however, determined that the break-up fees were deductible losses under section 165(a) as costs incurred in connection with the failed mergers (abandoned transactions). The court went on to state that the target corporations engaged in "protracted and strenuous defensive tactics when faced, involuntarily, with the threat of [the hostile takeover]." The court continued that "the decision to engage in a 'white knight' defense was an established, common and accepted defensive move, and thus would be considered 'ordinary' in the context of a hostile takeover battle." The court also found that the expenses incurred to find a white knight were necessary. The court concluded that the break-up fees were also deductible under section 162(a) as ordinary, necessary business expenses. Of note is the court’s rejection of National Starch as controlling. The court said the case did not apply because National Starch "dealt with the denial of deductibility of expenses incurred in a successful friendly takeover." With the benefit of hindsight, the bankruptcy court was able to know that the failed mergers did not result in a long-term benefit, but rather ended in the antithesis of one — bankruptcy.

Also of note is the recently proposed addition to the Code, section 4501 of House Rule 4210. In the form of I.R.C. section 197, the proposal would allow an amortization deduction with respect to the capitalized costs of goodwill, going concern value, and certain other intangible property whose useful life is indeterminable that is acquired by a taxpayer and held in connection with the conduct of a

152. Id. at 958, 961.
153. Id. at 958.
154. Id. at 961.
155. Id.
156. Id.
157. Id.
158. Id. at 962.
159. Id. The court in In re Federated made the obvious factual distinction between this case and National Starch, which is just the first problem with the Court’s subsequent application of the INDOPCO rationale.
trade or business or any activity engaged in for the production of income. The amount of the deduction would be determined by amortizing the adjusted basis of the intangible asset ratably over fourteen years. But if such a code section never becomes a reality, the Supreme Court last year, in Newark Morning Ledger Co. v. United States, gave taxpayers the vehicle by which they may be able to amortize previously unamortizable intangible assets.

In an opinion by Justice Harry Blackmun, the Court put to rest the notion that under I.R.C. section 167 an asset that the I.R.S. considers to be goodwill is never depreciable. Newark Morning Ledger Co. was a newspaper publisher and successor to the Herald Company, with which it merged in 1987. In 1976, Herald had purchased all of the outstanding shares of Booth Newspapers, the publisher of daily newspapers in several parts of Michigan. Herald allocated $67.8 million of its adjusted basis in Booth's shares to the intangible asset "paid subscribers." This amount was Herald's estimate of future profits to be derived from these "at-will subscribers." Herald claimed depreciation deductions on its federal tax returns for the $67.8 million allocation. The I.R.S. disallowed the deductions because the concept of "paid subscribers" was indistinguishable from goodwill and therefore not depreciable.

The Court reversed the Third Circuit Court of Appeals and found that if a taxpayer is able to prove that a particular intangible asset can be valued and that it has a determinable useful life, the taxpayer may amortize the asset, regardless of how much it resembles goodwill. The Court stated: "The significant question for purposes of depreciation is not whether the asset falls 'within the core of the concept of goodwill,' . . . but whether the asset is capable of being amortized over a reasonable period of time."

161. Id. at 75,821.
162. Id.
163. 113 S. Ct. 1670 (1993).
164. Justice David Souter filed a dissenting opinion, in which Chief Justice William Rehnquist and Justices Byron White and Antonin Scalia joined.
165. See supra notes 29-31 and accompanying text (discussing § 167 and the regulations regarding the amortization of intangibles).
166. Newark Morning Ledger, 113 S. Ct. at 1672.
167. Id.
168. Id. There were 460,000 identified subscribers to the Booth newspapers. Id.
169. Id. at 1673.
170. Id.
171. Id.; see supra notes 29-31 and accompanying text (discussing the regulation which speaks to this notion and defining goodwill).
172. Newark Morning Ledger, 113 S. Ct. at 1680-81.
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valued and whether that value diminishes over time.' The tax implications that proposed section 197 and the Newark Morning Ledger decision may have for takeover expenses will be discussed in the Impact section. First, however, the facts, procedural history, and the Supreme Court's decision in INDOPCO must be considered.

II. SUBJECT OPINION: INDOPCO, INC. V. COMMISSIONER

A. The National Starch/Unilever Transaction

In October of 1977, representatives of Unilever United States, Inc., expressed interest in acquiring National Starch and Chemical Corporation, Inc. ("INDOPCO"), a manufacturer of primarily industrial chemical products and a supplier to Unilever, through a friendly takeover. Unilever intended to proceed with a tender offer only if National Starch's board of directors favored the offer and if Frank Greenwall, owner of the largest block of outstanding National Starch stock, would tender his shares. Greenwall and his wife Anna, who were then 81- and 79-years-old, respectively, owned approximately 14.4 percent of the 6,563,000 outstanding common shares; the balance was publicly held. The tender offer was designed to comply with the Greenwalls' desire that it be a tax-free transaction. Lawyers representing both sides devised a transaction that qualified as a tax-free exchange for the Greenwalls under I.R.C. section 351.

In November of 1977, Unilever made a formal proposal to Na-

173. Id. at 1681.
176. INDOPCO, 112 S. Ct. at 1041.
177. Id.
178. Id. Under the agreement, Unilever created two new corporations. One was National Starch & Chemical Holding ("Holding"), a subsidiary of Unilever, and the other was NSC Merger, Inc. ("NSC"), a subsidiary of Holding. Id. Pursuant to the tender offer, Holding exchanged one share of its nonvoting preferred stock for one share of National Starch common stock. Id. Holding then merged NSC into National Starch, converting any nontendered National Starch shares into cash. Id. The exchange qualified under I.R.C. § 351 as a tax-free transfer to a controlled corporation. Id. A favorable ruling was obtained by National Starch's counsel from the I.R.S.'s National Office providing that the formation of Holding's subsidiary, NSC Merger, Inc., and that the merger of NSC into National Starch would be disregarded for federal tax purposes. Tech. Adv. Mem. 78-39-060 (June 28, 1978).
tional Starch's board of directors. At that time, National Starch's council advised the directors that they had a fiduciary duty under Delaware law to ensure that the proposed transaction was fair to the shareholders. Out of concern that failure to obtain a valuation of the stock might be evidence of a breach of fiduciary duty, National Starch then engaged the investment banking firm of Morgan Stanley & Co., Inc., to value the stock, render a fairness opinion, and assist in the event that there should be a hostile or unsolicited tender offer. Negotiations resulted in a final offer of $73.50 per share, a figure Morgan Stanley found to be fair, and the transaction was consummated in August of 1978.

A Morgan Stanley report had said that National Starch's management believed that affiliation with Unilever would create opportunities for "synergy." National Starch's 1978 annual report had said that it would benefit from the availability of Unilever's enormous resources. However, Unilever never made any changes in the operation of National Starch, nor did it provide any significant financial or technological assistance. National Starch did not acquire any property or services from Unilever, nor did National Starch dispose of any of its assets or property. There was no material increase in National Starch's sales to the Unilever group.

In return for their services, Morgan Stanley billed National Starch for fees and expenses in excess of $2.2 million. Additionally, National Starch was charged approximately $500,000 by its legal counsel, and incurred other expenses related to the transaction of approximately $150,000.

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179. INDOPCO, 112 S. Ct. at 1041.
180. Id.
181. Id.
182. Id. Approximately 21 percent of National Starch common stock was exchanged for Holding preferred stock. The remaining 79 percent was exchanged for cash. Id. at 1041 n.2. As a result of the transaction, Holding acquired all of National Starch's outstanding common stock in exchange for over $380 million in cash and Holding preferred stock with an aggregate par value of over $96.5 million. National Starch & Chem. Corp. v. Commissioner, 93 T.C. 67, 71 (1989).
185. National Starch, 93 T.C. at 76.
186. Id.
187. Id.
188. INDOPCO, 112 S. Ct. at 1042.
189. Id. at 1042. No issue was raised as to the propriety or reasonableness of these charges.
On its federal income tax return for 1978, National Starch deducted the more than $2.2 million dollars paid to Morgan Stanley as ordinary and necessary business expenses under section 162(a). The I.R.S. disallowed the deduction and issued a deficiency notice. National Starch petitioned the Tax Court, claiming the right not only to deduct the fees paid to Morgan Stanley, but also to deduct its legal and miscellaneous expenses as well.

B. Procedural History

1. The Tax Court Decision

The Tax Court rejected several positions asserted by both National Starch and the Commissioner before concluding that National Starch's expenses incident to the Unilever takeover were non-deductible capital expenditures. The court could not find any evidence to support the Commissioner's assertion that National Starch's expenditures were nondeductible because they were incurred pursuant to a reorganization, whether as a part of a merger, recapitalization, or stock for stock exchange. However, the court still found the expenditures to be capital, based on its belief that National Starch derived a long-term benefit from its affiliation with Unilever. The affiliation did not create a separate and distinct asset under the test of Lincoln Savings, but rather the affiliation was "expected to produce returns for many years in the future."

The Tax Court specifically rejected National Starch's argument that Lincoln Savings permitted the deduction of the takeover expenditures because no separate and distinct asset was created. According to the court, since the Supreme Court failed to address the deductibility of expenditures which did not create or enhance a sep-

190. Id.; see supra notes 17-18 and accompanying text (discussing § 162(a) and providing the text of the section).
191. INDOPCO, 112 S. Ct. at 1042.
192. Id. On its federal income tax return, National Starch deducted the Morgan Stanley fees but did not deduct its counsel fees and other expenses. Id. No explanation is provided for this treatment; however, in its Tax Court petition, National Starch claimed overpayment because the counsel fees and other expenses had not been deducted. National Starch & Chem. Corp. v. Commissioner, 93 T.C. 67, 71 (1989).
193. National Starch, 93 T.C. at 74-75. "We are unwilling to hold, however, that the instant transaction is sufficiently similar to a reorganization under section 368(a)(1)(B) to cause the expenditures to be capital in nature." Id. at 75.
194. Id. at 75-76.
195. Id. at 75 (citation omitted); see supra notes 58-65 and accompanying text (discussing the Lincoln Savings test for requiring capitalization).
arate and distinct asset, *Lincoln Savings* was inapplicable.196 In dismissing *Lincoln Savings*, the court relied on authority predating *Lincoln Savings* which distinguished current from capital expenditures based on whether the expenditure benefitted the taxpayer for more than one year.197 The court also relied upon *General Bancshares v. Commissioner*198 for the proposition that expenditures may be capital in nature even if they do not result in the acquisition or increase of a corporate asset.199 The court also adopted the Fifth Circuit's position, taken in *Central Texas Savings & Loan Ass'n v. United States*, 200 that while "the period of the benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominant, characteristic of a capital item."201

As support for the court's conclusion that National Starch's expenditures were capital, the Tax Court pointed to three factors: 1) National Starch's board of directors must have determined that the takeover by Unilever would result in long-term benefits to National Starch in approving the acquisition;202 2) National Starch's 1978 Annual Report indicated that there would be long-term benefits, including the opportunity for synergy with Unilever and the future availability of Unilever's financial and business resources;203 and 3) that the availability of Unilever's resources was an immediate as well as long-term benefit to National Starch since it broadened the corporation's opportunities.204 The court, however, admitted that there was no evidence of an immediate benefit from the affiliation.205

196. *National Starch*, 93 T.C. at 77 (emphasis added).
197. *See E.I. du Pont de Nemours & Co. v. United States*, 432 F.2d 1052 (3rd Cir. 1970); Falstaff Beer, Inc. v. Commissioner, 322 F.2d 744 (5th Cir. 1963); McDonald v. Commissioner, 139 F.2d 400 (3rd Cir. 1943); Clark Thread Co. v. Commissioner, 100 F.2d 257 (3rd Cir. 1938).
198. 326 F.2d 712 (8th Cir. 1964).
199. *National Starch*, 93 T.C. at 76 (citing *General Bancshares*, 326 F.2d at 716).
200. 731 F.2d 1181 (5th Cir. 1984): see supra notes 68-71 and accompanying text (discussing this case).
201. *National Starch*, 93 T.C. at 76 (quoting the Fifth Circuit's opinion in *Central Texas Savings*).
202. *Id.*
203. *Id.*
204. *Id.* at 76-77; see Thomas F. Quinn, Note, *Takeover Expenses Incurred by the Acquired Corporation — Not Just Another Ordinary Deduction*: National Starch & Chemical Corp. v. Commissioner, 10 J.L. & Com. 167 (1990). Quinn criticized the Tax Court's conclusion as speculative. "Even if the long-term benefit test is the appropriate inquiry, Judge Clapp's application of the test relies on speculation rather than on competent evidence supporting the existence of a long-term benefit." *Id.* at 179.
205. *National Starch*, 93 T.C. at 76. However, the court noted that "the lack of benefits in the
The Tax Court also rejected National Starch's argument that the expenditures were deductible because they were incurred incident to its directors' fiduciary duty to its shareholders to determine if the takeover would be in the shareholders' best interests. The court felt that the dominant aspect of the expenditures was not the fulfillment of the fiduciary duty, but rather the transfer of National Starch's stock for the benefit of National Starch and its shareholders.

2. The Third Circuit Decision

On appeal, the Third Circuit again rejected the taxpayer's argument that the absence of a separate asset resulted in deductibility. The court did not find a new test announced in Lincoln Savings, nor did it believe that the Court "intended to create a new standard applicable irrespective of the factual context." Instead, the Third Circuit found that "no one factor alone can control this complex decision."

According to the court, the "sine qua non of capitalization" is the presence of a not insignificant future benefit that is more than merely incidental. Where a transaction produces such a benefit, the court concluded that a taxpayer must capitalize the expenses incurred to carry out the transaction.

The court then determined that the Tax Court's determination that both Unilever's enormous resources and the possibility of synergy arising from the transaction served the long-term betterment of National Starch was supported by adequate evidence and was not clearly erroneous. Additionally, the court briefly addressed a pro-

short term does not imply their absence in the long term . . . ." Id.

206. Id.
207. Id.; see supra note 113 (discussing the McCrory decision and the dominant aspect test).
209. National Starch, 918 F.2d at 430.
210. Id. ("[W]e find no statutory, regulatory, or decisional test which is dispositive. The issue [of the treatment of the challenged items] must be determined on the facts presented in the novel situation before us.") (quoting Colorado Springs National Bank v. United States, 505 F.2d 1185, 1192 (10th Cir. 1974)).
211. Id. at 431. Cf. NCNB Corp. v. United States, 651 F.2d 942, 965 (4th Cir. 1981) (Widener, J., dissenting) ("Even if the existence of a distinct and recognized property interest may not be a sine qua non of capitalization, nevertheless I suggest that it is an important factor in determining whether a separate and distinct asset exists . . . .").
212. National Starch, 918 F.2d at 432.
213. Id. at 432-33.
posal by the Commissioner, but left for another case the "consideration whether the benefits of restructuring ownership alone would be sufficient to require capitalization of the fees pertinent thereto."\textsuperscript{214} Finally, the Third Circuit agreed with the Tax Court that merely because the expenditures were necessary under Delaware law to fulfill the Board members' fiduciary obligation to the shareholders, their compulsory nature did not make them deductible.\textsuperscript{215} Fulfilling the easily-met "necessary" requirement was not enough to make them deductible. Accordingly, the expenses incurred by National Starch were capital in nature.

3. The Supreme Court Decision

The Supreme Court granted certiorari in order to resolve a "perceived conflict" among the Courts of Appeals concerning the application of \textit{Lincoln Savings}: namely, whether the creation of a separate and distinct asset is a necessary prerequisite for capitalization of an expenditure.\textsuperscript{216} National Starch maintained its position that, under \textit{Lincoln Savings}, the lack of creation of a separate and distinct asset results in deductibility.\textsuperscript{217} The Court believed National Starch had overread \textit{Lincoln Savings} and flatly rejected the corporation's interpretation of the case.\textsuperscript{218} The Court stated that \textit{Lincoln Savings} stands for "the simple proposition that a taxpayer's expenditure that 'serves to create or enhance . . . a separate and distinct' asset should be capitalized under § 263. It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized under § 263."\textsuperscript{219} In short, the Court found that \textit{Lincoln Savings} held that the creation of a sepa-

\textsuperscript{214} Id. at 433.
\textsuperscript{215} Id. at 434; see also E.I. du Pont de Nemours & Co. v. United States, 432 F.2d 1052, 1059 (3rd Cir. 1970) ("[T]he fact that the expenditures were involuntary . . . does not negative a requirement that they be capitalized, if they were in fact capital expenditures."); Woolrich Woolen Mills v. United States, 289 F.2d 444, 448 (3rd Cir. 1961) ("The involuntary nature of the expenditure . . . does not render deductible as expense an item which would otherwise be non-deductible as capital.").
\textsuperscript{216} \textit{INDOPCO}, Inc. v. Commissioner, 112 S.Ct. 1039, 1042 (1992). The Supreme Court implied that the conflict was between the Third Circuit's decision in \textit{National Starch} and the Fourth and Second Circuits' opinions in \textit{NCNB} v. United States, 684 F.2d 285 (4th Cir. 1982) and \textit{Briarcliff Candy Corp.} v. Commissioner, 475 F.2d 775 (2d Cir. 1973). \textit{INDOPCO}, 112 S. Ct. at 1042 n.3; see also supra note 66 and accompanying text (noting that \textit{NCNB} and \textit{Briarcliff} both followed the separate and distinct asset test of \textit{Lincoln Savings}).
\textsuperscript{217} \textit{INDOPCO}, 112 S. Ct. at 1044.
\textsuperscript{218} Id.
\textsuperscript{219} Id. (alterations in original).
rate and distinct asset may be a sufficient condition for classification as a capital expenditure, but not a necessary one.\footnote{220} The Court continued its analysis of Lincoln Savings by noting that its statement in that case that "the presence of an ensuing benefit that may have some future aspect is not controlling" does not prohibit reliance on future benefits as a means of distinguishing current from capital expenditures.\footnote{221} However, the Court did not say that the existence of a future benefit must always result in capitalization. Instead, the Court noted that "[a]lthough the mere presence of an incidental future benefit — 'some future aspect' — may \textit{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."\footnote{222}

Next, the Court examined the specific expenditures incurred by National Starch. The Court concluded that National Starch did not demonstrate that the fees it incurred incident to Unilever's acquisition were deductible.\footnote{223} The Court based its decision solely on the facts, finding ample support for the lower courts' conclusions that the transaction produced significant benefits to National Starch which extended beyond the tax year in question.\footnote{224} The Court pointed to the availability of Unilever's "enormous resources, especially in the area of basic technology,"\footnote{225} and to the possibility of "synergy" between National Starch and Unilever given the nature of Unilever's operations and its strong consumer products orientation.\footnote{226} The Court also believed that in addition to these "anticipated resource-related benefits," National Starch obtained benefits through its transformation from a publicly-held corporation to a private one.\footnote{227}

\footnote{220. \textit{Id}.}
\footnote{221. \textit{Id}.}
\footnote{222. \textit{Id}. at 1044-45 (second emphasis added); \textit{see} Lipton et al., \textit{supra} note 120, at 326 ("Although the Court's analysis of Lincoln Savings rebutted the oft-cited proposition by optimistic taxpayers that the absence of a separate asset permits deductibility, it did not answer the more significant question of whether capitalization \textit{always} follows the existence of a long term benefit.").}
\footnote{223. \textit{INDOPCO}, 112 S. Ct. at 1045.}
\footnote{224. \textit{Id}.}
\footnote{225. \textit{Id}.}
\footnote{226. \textit{Id}.}
\footnote{227. \textit{Id}. As to this factor, the Court indicated that National Starch acknowledged that it was subject to significant shareholder relations expenses, including reporting and disclosure requirements, proxy battles, and derivative suits. \textit{Id}. The Supreme Court also noted that the transac-
But the Court did not end its analysis with factual findings. It went on to justify its conclusion on the grounds that "[c]ourts long have recognized that expenses such as these, 'incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses.'"228 The Court also noted that other courts have characterized expenditures as capital items where the purpose for which they are made " 'has to do with the corporation's operations and betterment, sometimes with a continuing capital asset, for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year.' "229 The Court concluded that this rationale applied equally to the professional charges incurred by INDOPCO230 and stated that "the acquisition-related expenses [bore] the indicia of capital expenditures and [were] to be treated as such."231 With each court's rationale laid out, an analysis of the Supreme Court's decision and the I.R.S.'s position based on these decisions follows.

III. ANALYSIS

INDOPCO presented the Supreme Court with the opportunity to clearly define capital expenditures. In allowing the opportunity to slip through its fingers, the Court rendered an opinion that is mostly confusing and factually distinguishable for the taxpayer litigating a similar issue. This analysis points out that despite arriving at the correct result in INDOPCO, the Court did not provide a clear guideline for the future. This is made evident by the I.R.S.'s inability to make up its mind regarding the taxable nature of a target corporation's takeover expenses. Thus, this analysis takes a look at the I.R.S.'s fluctuation between the long-term benefits and origin of the claim tests as applied to friendly and hostile takeovers. Following this discussion is an examination of the I.R.S.'s continuing policy inconsistencies. Lastly, a bright line rule is proposed to eliminate the elusive distinction between capitalization and deductibility, at least

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228. Id. (quoting General Bancshares Corp. v. Commissioner, 326 F.2d 712, 715 (8th Cir. 1964)).
229. Id. at 1046 (quoting General Bancshares, 326 F.2d at 715).
230. Id.
231. Id.
with regard to takeover expenses.

A. The INDOPCO Decision — Friendly Takeover Expenses

1. The Undefined Long-Term Benefits Test

Instead of setting forth a bright-line test to resolve the question of proper treatment of expenditures that may produce a benefit in excess of one year (i.e., "Capitalization always follows the existence of a long-term benefit"), the Court’s opinion in INDOPCO merely indicated that the duration of the benefits derived from an expenditure is a factor, and possibly a controlling factor, in determining whether an expense is current or capital. In its conclusion, the Court stated that the expenditures had the "indicia of capital expenditures" and nothing more. There was no definition of such a characterization. Future disputes may devolve into listing various "indicia" relating to an expenditure to determine its taxable nature, a possibly lengthy, and definitely ambiguous, process.

On the other hand, INDOPCO may stand for the proposition that capitalization applies only to those expenditures that produce more than an "incidental" long-term benefit, although there is no way to know what that may be from the opinion itself. If it were clear what an "incidental" benefit was, perhaps a corporation could avoid capitalization of expenditures by denying that such benefits exist. Despite how wishful, or sneaky, that thinking may be, however, corporations cannot simply leave "incidental" benefits out of their takeover reports to the shareholders in order to increase the possibility of deductions. They must include them because of their fiduciary duty to inform the shareholders of the fairness of the takeover. Therefore, whether a benefit is incidental and the cost therefore deductible will be difficult to prove. In light of the Supreme Court’s sweep-

232. See supra note 221 and accompanying text (noting the Court’s language on this point).
233. INDOPCO, 112 S. Ct. at 1046.
234. Lipton et al., supra note 120, at 326.
235. See INDOPCO, 112 S. Ct. at 1044-45 (noting that the "mere presence of an incidental future benefit . . . may not warrant capitalization"); see also Lipton et al., supra note 120, at 327 n.14 ("The Court’s opinion does not provide any guidance as to the treatment of expenses that may benefit a corporation for a period substantially less than the existence of the corporation but longer than one year, i.e., 13-24 months.").
236. See supra note 97 and accompanying text (describing the fiduciary duty of the board of directors when evaluating a tender offer).
ing language, it would be difficult for a taxpayer to prove that a
deduction is deserved.\textsuperscript{237}

2. The Decision is Factually Distinguishable

The Court's decision may also be viewed as simply an affirmance
based upon the factual findings of the Tax Court and Third Circuit.
Those courts determined that National Starch reaped significant
long-term benefits from the expenditures incurred incident to the
takeover, even though no separate additional asset was created.\textsuperscript{238}
For example, much of the lower courts' analysis focused on the op-
portunities for synergy resulting from the takeover, and National
Starch's access to Unilever's resources.\textsuperscript{239} Implicit in this factual
analysis is that the two corporations had an existing relationship and
compatible business operations.\textsuperscript{240} The Court's approach may be of
little use where such benefits and resulting synergy do not exist. For
example, many corporations engage in takeovers or mergers, not to
make inroads into new product lines or markets by developing their
own products, but to achieve such ends through diversification. If a
corporation merges with an existing business for this purpose, and
that business is wholly unrelated to existing business operations, the
I.R.S. will find it difficult to point to the type of synergy that existed
between National Starch and Unilever and thus will be unable to
justify capitalization on such grounds.\textsuperscript{241} Because the Supreme
Court failed to articulate a bright line rationale, future taxpayers
will have to litigate their takeover cases, or merger cases, on their
unique facts, distinguishing themselves from National Starch and
Unilever. However, no taxpayer is going to know what it has to
show that is so vastly different from "synergy" as to prove that no
long-term benefit exists. This lack of guidance illustrates how unde-
efined the long-term benefits test remains.

\textsuperscript{237} See supra note 50 and accompanying text (noting that the burden is on the taxpayer to
show that a deduction is allowed).

\textsuperscript{238} See supra notes 193-215 and accompanying text (noting the rationales of these two
courts).

\textsuperscript{239} National Starch & Chemical Corp. v. Commissioner, 93 T.C. 67, 76 (1989) (holding that
National Starch's affiliation with Unilever would create opportunities for synergy and access to
resources, despite the lack of any immediate benefit).

\textsuperscript{240} Prior to the takeover, National Starch was a supplier to Unilever, and continued to sell its
products to Unilever following the takeover. See supra notes 174-92 and accompanying text (dis-
cussing the facts of the case).

\textsuperscript{241} See Lipton et al., supra note 120, at 329 (noting this example as a way for a taxpayer to
factually distinguish itself from the INDOPCO case).
3. Misplaced Corporate Structure Analysis

The Court further complicated matters by noting that courts have long ruled that expenditures for changing corporate structure are not deductible under I.R.C. section 162. However, there was no change in the corporate structure of National Starch. The cancellation of the authorized preferred stock and the reduction of the number of outstanding common shares were not the type of transactions that have been considered "corporate structure" changes in the cases cited by the Court. The INDOPCO case merely involved a shifting of stock ownership. Even the Third Circuit did not find favor in the I.R.S.'s argument for capitalization due to changing National Starch from a publicly-held corporation to a privately-held one, though the Supreme Court found this to be a long-term benefit to National Starch. The Court's analysis of INDOPCO as a corporate restructuring was wholly misplaced and tends to decrease the

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242. INDOPCO, 112 S. Ct. at 1045.
243. See also supra notes 193, 215 and accompanying text (noting that both the Tax Court and the Third Circuit Court of Appeals found that no structural change of National Starch took place).
244. Lipton et al., supra note 120, at 327; see also National Starch & Chem. Corp. v. Commissioner, 93 T.C. 67, 75 (1989) (holding that the National Starch transaction was not sufficiently similar to a reorganization under I.R.C. § 368(a)(1) to cause the expenditures to be capital).
245. For an interesting discussion on the treatment of National Starch's expenses as dividends to the selling shareholders, see Calvin H. Johnson, The Expenditures Incurred By the Target Corporation in an Acquisition Reorganization Are Dividends to the Shareholders: (Psst, Don't Tell the Supreme Court), 53 TAX NOTES 463 (1991). Johnson believes the expenditures were neither capital nor current:
They are not corporate investments because they do not give future value nor generate future taxable income for the corporation. They are plausibly not costs of deferred gain sales because National Starch . . . did not sell any assets. They are not costs of improving National Starch's corporate structure or operations because National Starch corporate structure and operations did not change. What did change was ownership. . . . The fees benefited the shareholders, not the corporation. They are not even capital expenditures, they are dividends.
Id. at 479.
Another commentator noted in opposition to this view that because the investment banking fees were incurred solely to fulfill the board of director's fiduciary obligation, the fees are more appropriately viewed as costs of doing business, and not dividends. Lipton et al., supra note 120, at 327 n.16. However, the Tax Court in National Starch and the National Office in T.A.M. 91-44-042 (June 7, 1991) both used the "origin of the claim" test to conclude that the fees were not incurred solely for those reasons but were incurred for the transfer of National Starch's stock and for the benefit of the shareholders. See supra notes 130-31, 207 and accompanying text (discussing the National Office's rationale in T.A.M. 91-44-042 and the Tax Court's reasoning in National Starch).
strength of the Court's overall rationale in determining that the professional fees produced long-term benefits.

4. No Discussion of the Origin of the Claim Test

In further failing to provide a clear guideline, the Supreme Court did not use the "origin of the claim" test in any way during its determination that National Starch's professional expenses were capital. In fact, the only court during the National Starch litigation to address a related test was the Tax Court when it decided that the board of directors' fiduciary duty to the shareholders was not the "dominant aspect" of incurring the professional fees. The Supreme Court did not even address the fiduciary duty argument. It seems unusual that the Court did not use the origin of the claim test to address this argument when this particular test had been used by the I.R.S.'s National Office in all of its T.A.M.s regarding takeover expenses, and had at least been acknowledged by the Tax Court.

One explanation may be that National Starch only argued that the Lincoln Savings separate and distinct asset test made the expenditures deductible. The Supreme Court persuasively dismissed this hopeful assertion by National Starch. Another, more logical explanation may be that the T.A.M.s dealt with hostile takeovers and the target corporation's defensive tactics, whereas the Supreme Court was faced solely with a friendly takeover. This may mean that the Supreme Court's rationale is not applicable to hostile takeovers, although the National Office believes that it does apply. The next section considers the Court's rationale as applied to hostile takeovers and the I.R.S.'s inconsistency as a reaction to the National Starch cases.

247. See supra notes 113, 207 and accompanying text (discussing the dominant aspect test and the Tax Court's view of the argument).

248. See supra notes 87-132 and accompanying text (discussing the T.A.M.s in detail).

249. See supra notes 194-96 and accompanying text (discussing National Starch's arguments for deducting the professional fees).

250. See supra notes 218-20 and accompanying text (discussing the Supreme Court's rationale in rejecting the applicability of Lincoln Savings).

251. See supra notes 174-92 and accompanying text (discussing the National Starch/Unilever transaction).

252. See supra notes 118-32 and accompanying text (discussing T.A.M. 91-44-042).
B. The I.R.S.'s Inconsistent Reaction Regarding Hostile Takeover Defense Expenses

The *INDOPCO* case dealt with a friendly takeover only. In fact, none of the courts had occasion to address the situation of a hostile takeover. However, in each of the T.A.M.s discussed earlier, the National Office made decisions regarding takeover expenses incurred in resisting a hostile takeover. The discussion of hostile takeover expenses remains necessary even though very few corporations and persons have access to the capital needed to attempt a takeover; the tax years of the merger and acquisition binge of the 1980s are still open.

The I.R.S. has addressed the hostile takeover issue several times, culminating in its position articulated in T.A.M. 91-44-042. There are two arguments against capitalizing takeover expenses incident to a hostile takeover. The first follows from the preceding factual distinction: namely, that the I.R.S. will have difficulty finding synergy among corporations when the target corporation finds itself in a worse position than before the takeover attempt. The other argument is that a corporation defending against a hostile takeover is merely trying to defend its business, not create a new benefit for itself.

The difference in the two arguments is the tests which have been applied to address them. In the first case, the National Office and the courts in *National Starch* have used the long-term benefits test to make a factual determination in each takeover situation. In the second case, the National Office and various courts have employed the origin of the claim test to determine from where the incurred expenses originated. This section will consider each test with regard to hostile takeovers.

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253. A recent case in front of the Tax Court concerned a target corporation which attempted to deduct expenses incident to what it felt was a hostile takeover. Victory Markets, Inc. v. Commissioner, 99 T.C. 648 (1992). The court found that because the target corporation's board of directors did not activate its dividend rights plan and the acquirer did not try to circumvent the directors by making a tender offer directly to the shareholders, the takeover was a friendly takeover. *Id.* at 661-62. The court found *INDOPCO* applicable but did not address whether *INDOPCO* would apply to expenses incurred in a hostile takeover. *Id.* at 662.


255. See *supra* notes 118-32 and accompanying text (discussing this ruling).

256. See Lipton et al., *supra* note 120, at 329 ("The many debt laden victims of the past decade's merger fever illustrate this.").
1. Long Term Benefits of Hostile Takeovers

Even though the courts in the National Starch line of cases used the long-term benefits analysis, none had the opportunity to address the professional expenses a target corporation incurred during a hostile takeover. The National Office's use of the test in T.A.M.s 90-43-003 and 91-44-042 has become the only strong source for analyzing the test's use in hostile takeover situations.

In T.A.M. 90-43-003, the National Office applied the long-term benefits test to the portion of the transaction that involved resisting a hostile takeover by finding a white knight buyer. However, the National Office noted that because this was a "permanent solution" and a "friendly acquisition" which had long-term benefits, the costs associated with finding a white knight had to be capitalized. What is unclear, however, is exactly how Tcorp in the hostile situation was expected to resist, consequently get deductions, and be successful at doing so without finding a white knight buyer or using some other defensive measure. In response, at least one court, the bankruptcy court in In re Federated, stated that "the decision to engage in a 'white knight' defense was an established, common and accepted defensive move" and found it to be ordinary and necessary and thus deductible under section 162(a).

In T.A.M. 91-44-042, the National Office again used the long-term benefits analysis to capitalize all expenses incurred defending against a hostile takeover which result in a long-term benefit. Like T.A.M. 90-43-003, no clear-cut lines were drawn by this position. Since no distinction between expenses related to finding a white knight, or utilizing other defense tactics like those of HNG in T.A.M. 91-44-042, and purely resisting a hostile takeover exists, it appears that based on a long-term benefits analysis that any and all expenses incurred to resist a hostile takeover will be capitalized. Because the long-term benefits test is ambiguous to begin with, the

257. See supra notes 109-32 and accompanying text (discussing the T.A.M.s).
260. Id. at 961; see supra notes 154-58 and accompanying text (noting the bankruptcy court's language and rationale).
262. Id.
263. See supra notes 121-23 and accompanying text (discussing the defensive tactics employed by HNG).
future benefits could be very speculative. If the board's decision to maintain present ownership is a long-term benefit, then expenditures to maintain that ownership would have to be capitalized as well.

However, as the In re Federated court noted, National Starch did not address a hostile takeover situation.264 The use of the long-term benefits test in hostile situations by the National Office appears misplaced, especially when defensive measures to protect a business are involved.

2. The Origin of the Claim Test

Because National Starch did not deal with the hostile takeover situation, the National Office should not have so quickly changed its mind to employ the long-term benefits test. The "origin of the claim" test had historically been used to determine whether legal fees are deductible or not.265 Using this test, the Tax Court in BHA Enterprises266 found that when litigation expenses arise out of the taxpayer's business activities, and do not result in the acquisition or disposition of a capital asset, the expenses are deductible.267

Obviously, the professional expenses incurred by a target corporation in resisting a hostile takeover arise out of the corporation's business. The National Office agreed when it used the "origin of the claim" test in T.A.M. 89-27-005268 to determine that because the board of directors had the duty to oppose detrimental tender offers, the expenses were related to carrying on a trade or business.269 The National Office went on to find the expenditures ordinary and necessary, stating that "'[t]o say that this course of conduct and the expenses which it involved were extraordinary and unnecessary would be to ignore the ways of conduct and the forms of speech prevailing in the business world.'"270 This reasoning is right in line with the reasoning of the bankruptcy court in In re Federated. The "origin of the claim" test, when applied to hostile takeover expenses, shows expenditures to be business expenses. Based on the definitions of or-

265. See supra notes 72-81 and accompanying text (describing the "origin of the claim" test).
266. BHA Enters., Inc. v. Commissioner, 74 T.C. 593 (1980).
267. Id. at 601-02.
269. Id.; see also supra notes 99-103 and accompanying text (discussing the National Office's rationale in this T.A.M.).
ordinary and necessary, the expenses should therefore be deductible under section 162(a) of the Code.

Of course, there is one catch: based on the definition of the "origin of the claim" test, which states that the expenses cannot result in the acquisition or disposition of a capital asset, any defensive tactic which has such a result—i.e., the buy back of the target corporation's stock from the acquirer—would fall under this exception. Therefore, those costs would have to be capitalized. Otherwise, all other costs associated with defending a business against a hostile takeover should be deductible under the "origin of the claim" test.

3. Policy Rationales

In BHA Enterprises, the Tax Court also pointed to a policy reason for allowing the radio station to deduct the expenses incurred in defending its business. The court emphasized that the expense of defense should be deductible because, if the FCC had prevailed, the taxpayer would have been out of business. Considering the policy implications of these decisions regarding takeover expenses is important. The Internal Revenue Code has become a tool for Congress in implementing certain policies and promoting certain behavior. It is therefore not solely a revenue-raising body of legislation. From a policy standpoint, allowing a target corporation to deduct its defense expenses is consistent with BHA Enterprises. If the target corporation is successful, it should be able to deduct the expense under section 162(a), since if it had not incurred the costs, it would be out of business. If the target corporation is unsuccessful, then the costs are deducted as break-up fees pursuant to section 165.

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271. See supra notes 36-47 and accompanying text (discussing judicial interpretation of § 162(a)).
272. See supra notes 72-81 and accompanying text (describing and defining the origin of the claim test).
273. See supra notes 121-23 and accompanying text (describing HNG's defensive tactics in T.A.M. 91-44-042).
274. BHA Enters., Inc. v. Commissioner, 74 T.C. 593 (1980).
275. Id. at 602; see supra notes 76-81 and accompanying text (discussing the decision in BHA Enterprises).
276. PHILLIP S. ASHLEY, SELECTED READINGS IN TAX POLICY 1 (1992) ("Congress has come to use the tax code as a tool to do much more than raise revenue; it is used for such varied things as furthering social goals such as 'fairness' and redistribution of wealth to stimulating capital formation and economic growth.").
Additionally, it would bode well for the I.R.S. to promote more logical policies. As seen in T.A.M.s 92-40-004 and 93-22-014, the I.R.S. appears to make tax policy decisions which are inconsistent with social policies promoting positive behavior. Instead of promoting asbestos clean-up and rewarding environmentally sound corporations with deductions, the National Office, in T.A.M. 92-40-004, capitalized the taxpayer's expenses. However, had the same taxpayer not removed and replaced the asbestos, it appears that the I.R.S. would have given the taxpayer current deductions. Then, in T.A.M. 93-22-014, the National Office allowed a legislator, under investigation for wrongdoing, to deduct the legal fees associated with defending himself. Whether or not the legislator had been found guilty would have been of no consequence. He still would have been allowed to currently deduct the fees.

These outcomes promote behavior contrary to what should be promoted. Surely, society is more concerned with protecting the environment than with subsidizing legislators through deductions. Treating friendly and hostile takeover expenses in exactly the same manner ignores the differences in the transactions. Allowing hostile takeover target corporations to deduct their defense expenses promotes the policy of businesses defending and protecting themselves when it is in their best interests. Without spending the money, the business would probably no longer exist. And if that were desirable, then the takeover would have been friendly, and the expenses would have been capitalized under the long-term benefits test. Based on the foregoing legal and social analysis, the following is a proposed rule which would deal directly with a target corporation's takeover expenses.

C. Proposed Rule for Treatment of Takeover Expenses

1. Friendly Takeovers

Although the Supreme Court's reasoning in INDOPCO was flawed in some ways, the long-term benefits test is a historically
accepted test and can be appropriately applied to friendly takeover situations. The outcome in the National Starch cases was correct. By virtue of the term "friendly" takeover, such a transaction is ostensibly desirable and beneficial to the parties involved. Long-term benefits must exist or the takeover would not be welcomed. Even though its application remains somewhat ambiguous, if future taxpayers know that expenses incurred during a friendly takeover are capital, they will hopefully not look to litigate in court. This would avoid the listing of various "indicia" of capital expenditures and would promote consistency for taxpayers.

2. Hostile Takeovers

Because the future benefits of defending against a hostile takeover are so speculative, the "origin of the claim" test is the better way to determine the taxable nature of the expenditures. While a corporation is in the process of defending itself, it is not sure whether it will be successful. The benefit of hindsight should not determine whether the expenses are deductible. In defending against a hostile takeover, the related expenses arise from the board of director's fiduciary duty and are used to protect and defend a business. The expenses therefore originate from the taxpayer's business, and as was noted, are ordinary and necessary. The taxpayer is then allowed to deduct these defense costs under section 162(a). The one exception to this rule will be those costs related to acquiring an asset, i.e. buying back stock, which would be capitalized under the definition of the "origin of the claim" test. This rule promotes sound policy and does not give the target corporation a windfall for acquiring a capital asset.

284. Arguably, rather than providing a long-term benefit, the "successful takeover defense simply maintains the status quo." Sheppard, supra note 150, at 1459.

285. See supra notes 151-59 and accompanying text (discussing the In re Federated decision and the court's benefit of hindsight in finding no long-term benefits).

286. See supra notes 263-69 and accompanying text (noting that some courts and the National Office found the defense expenses to be ordinary and necessary in the business).

287. See BHA Enters., Inc. v. Commissioner, 74 T.C. 593 (1980) (using the "origin of the claim" test to determine that fees spent by a radio station to defend against an action by the FCC were deductible); see also In re Federated Dept. Stores Inc., 135 B.R. 950, 961 (Bankr. S.D. Ohio 1992) ("Costs incurred to defend a business against attack have been considered ordinary and necessary business expenses, and thus fully deductible under section 162, under a long line of decisions.") (citations omitted).
IV. Impact

The long-term impact of *INDOPCO* will mostly depend on what the courts, the I.R.S., and the taxpayers do with the decision. To date, no case which has dealt with hostile takeover defense expenses has been litigated.\(^\text{288}\) The problem with one finally coming before a court is that there is no precedent for the decision except for *INDOPCO*.\(^\text{289}\) As the analysis has pointed out, *INDOPCO* really is not on point for a hostile takeover defense case.\(^\text{290}\) The long-term benefits test, ambiguous as it is, does provide "some guidance"\(^\text{291}\) and sets a precedent for friendly takeover cases, but does not provide a guideline for *all* cases in this area.

The I.R.S. has attempted to broaden the *INDOPCO* rationale and has applied the long-term benefits test to hostile takeover defense expenses in T.A.M.s 90-43-003 and 91-44-043.\(^\text{292}\) The I.R.S. even argued in *In re Federated* that bankrupt corporations should have to capitalize all of their takeover defense expenses.\(^\text{293}\) If the long-term benefits test stands as it does now, and because capitalization is of such benefit to the I.R.S. with regard to raising revenue, the I.R.S. may push to have other now deductible expenses capitalized. For example, advertising costs are currently deductible under section 162.\(^\text{294}\) If *INDOPCO* is read broadly, the I.R.S. could justify the capitalization of any expenditure that results in long-term benefits to the taxpayer, which advertising costs obviously do.\(^\text{295}\)

As it stands now, taxpayers like *INDOPCO*, or even Tcorp in T.A.M.s 90-43-003 and 91-44-043, receive virtually no tax benefit from incurring all of the takeover expenditures. Because the *INDOPCO* Court, and the lower courts, found that no separate asset

\(^{288}\) See supra note 253 (discussing the *Victory Markets* case in which the taxpayer argued that it was the target of a hostile takeover, but the Tax Court found it to be a friendly one).

\(^{289}\) See supra note 12 and accompanying text (discussing the precedential value of Technical Advice Memoranda).

\(^{290}\) See supra notes 251-53 and accompanying text (analyzing the applicability of *INDOPCO* to hostile takeover defense cases).


\(^{292}\) See supra notes 109-32 and accompanying text (discussing these T.A.M.s).

\(^{293}\) See supra notes 151-59 and accompanying text (discussing the *In re Federated* decision).

\(^{294}\) Treas. Reg. § 1.162-1(a); see supra note 132 (noting the Revenue Rulings which have held that advertising costs are deductible).

\(^{295}\) Much of advertising is directed at building goodwill for the brand or the company rather than toward the purchase of a specific product. Sheppard, supra note 150, at 1459; see also Lipton et al., supra note 120, at 327 (noting that the "I.R.S. may . . . attack a host of expenses that traditionally have been deductible, even though such expenses created a benefit extending beyond one year").
was created by these expenses, the character of the asset that is created is still undetermined. The Supreme Court noted in *INDOPCO* that intangible assets without a determinable useful life are deducted only upon dissolution. Apparently, the Court thought that these expenses should be capitalized into an account of their own, and added to the basis of the corporation. Any tax benefit is then only realized upon dissolution or liquidation. This “benefit” is minimal compared to current deductions or depreciation deductions.

Taxpayers could look to proposed section 197, if it or a comparable code section is ever passed, and *Newark Morning Ledger* for at least depreciation relief, but it would be futile. Section 197 would have allowed amortization, over fourteen years, of the capitalized expenditures; however, the proposed rule would only have applied to acquired intangibles, reserving self-created intangibles — which describes takeover expenses — to be governed by current law. Therefore, the legal and investment banking fees incurred by a target would not have been amortizable under this rule.

The taxpayer’s next move in attempting to get depreciation deductions would be to show that the asset to which the expenses were capitalized has a determinable useful life under *Newark Morning Ledger*. Realizing that it is difficult to even characterize this asset, proving that it has a known useful life would be nearly impossible. Neither proposed section 197 nor *Newark Morning Ledger* will aid the taxpayer in his fight to find beneficial tax consequences stemming from the expenditures related to either friendly or hostile takeovers.

The proposed guideline obviously gives a tax benefit to target corporations of hostile takeovers. The problem inherent in this is that if a merger or takeover is in the best interest of the shareholders, target corporations may somehow attempt to make the transaction appear more like a hostile takeover in order to obtain the tax benefit. The courts, and the fiduciary duty of the board of directors,

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296. See supra notes 193-231 and accompanying text (discussing the opinions of each court in the *National Starch* litigation).


298. See supra notes 160-62 and accompanying text (discussing the proposed House rule).


300. *Sheppard*, supra note 150, at 1460.

301. 113 S. Ct. 1670 (1993); see supra notes 163-73 and accompanying text (discussing the *Newark Morning Ledger* decision).

302. But see supra note 253 (discussing the *Victory Markets* decision, in which the Tax Court
will hopefully safeguard against this downfall of the proposed guideline.

V. CONCLUSION

Because the Supreme Court in \textit{INDOPCO} did not clearly define a guideline for the ambiguous long-term benefits test, taxpayers whose cases are factually different from \textit{INDOPCO} have little, if any, help in determining the taxable nature of their takeover expenses. The Court did not reveal what results would be deemed long-term benefits to the target corporation, beyond "synergy" and "opportunities." Taxpayers, who have the burden of proving that their expenses did not result in long-term benefits, really do not know what will satisfy that burden.\textsuperscript{303} Even though the Court's conclusion in \textit{INDOPCO} was correct, its ambiguity and misplaced reasoning are only going to cause more confusion.

Because capitalization of the professional fees incurred incident to a takeover has very little tax benefit to the taxpayer, taxpayers and the I.R.S. are going to continue their battles in this area. The proposed rule may limit the amount of litigation; of course, by virtue of the fact that taxpayers and the I.R.S. rarely see eye to eye, the war will continue. The distinction between current deductions and capital expenditures remains elusive. If the courts are unable to clarify it, perhaps the only solution will be for legislators to address this problem.

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\textsuperscript{303} Note that in \textit{In re Federated}, the I.R.S. had the burden of persuasion despite its arguments to the contrary. \textit{In re Federated Dept. Stores, Inc.}, 135 B.R. 950, 957 (Bankr. S.D. Ohio 1992).