The Not So Friendly Takeover Expenses: Indopco, Inc. v. Commissioner

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# THE NOT SO “FRIENDLY TAKEOVER” EXPENSES: *INDOPCO, INC. v. COMMISSIONER*

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>I.</td>
<td>INTRODUCTION</td>
<td>279</td>
</tr>
<tr>
<td>II.</td>
<td>STATEMENT OF THE CASE</td>
<td>281</td>
</tr>
<tr>
<td>III.</td>
<td>PRIOR CASE LAW</td>
<td>282</td>
</tr>
<tr>
<td>A.</td>
<td>Lincoln Savings</td>
<td>283</td>
</tr>
<tr>
<td>B.</td>
<td>Circuit Courts’ Interpretations of Lincoln Savings</td>
<td>284</td>
</tr>
<tr>
<td>IV.</td>
<td>THE INDOPCO DECISION</td>
<td>286</td>
</tr>
<tr>
<td>A.</td>
<td>The Indopco Court’s Interpretation of Lincoln Savings</td>
<td>286</td>
</tr>
<tr>
<td>B.</td>
<td>Significant Future Benefit Analysis</td>
<td>287</td>
</tr>
<tr>
<td>1.</td>
<td>Accounting Principles</td>
<td>288</td>
</tr>
<tr>
<td>2.</td>
<td>Language of the Code</td>
<td>290</td>
</tr>
<tr>
<td>3.</td>
<td>Case Law</td>
<td>290</td>
</tr>
<tr>
<td>C.</td>
<td>Factors Constituting a Significant Future Benefit</td>
<td>291</td>
</tr>
<tr>
<td>V.</td>
<td>RAMIFICATIONS OF THE INDOPCO DECISION</td>
<td>292</td>
</tr>
<tr>
<td>A.</td>
<td>Effect on Hostile Takeovers</td>
<td>292</td>
</tr>
<tr>
<td>B.</td>
<td>Effect on Currently Deductible Expenses that Provide Future Benefits</td>
<td>293</td>
</tr>
<tr>
<td>C.</td>
<td>Effect on Other Friendly Takeover Cases</td>
<td>294</td>
</tr>
<tr>
<td>VI.</td>
<td>CONCLUSION</td>
<td>296</td>
</tr>
</tbody>
</table>

## I. INTRODUCTION

Since corporate restructuring has become a common occurrence, it is surprising that the United States Supreme Court had not addressed until recently the issue of how to treat expenses incurred incident to corporate restructuring by way of a friendly takeover. In *Indopco, Inc. v. Commissioner*, the Court granted certiorari to resolve a dispute among the circuit courts regarding when such expenditures may be deducted.

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1. 112 S. Ct. 1039 (1992). In the Tax Court decision, Judge Clapp expressed surprise that, despite the prevalence of takeovers in the modern corporate world, the issue had not been previously litigated. National Starch & Chem. Corp. v. Commissioner, 93 T.C. 67, 72 (1989).
3. "Deduction" refers to "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." I.R.C. § 162(a) (1988).
and when they may be capitalized. A majority of circuit courts relied on the Supreme Court decision in Commissioner v. Lincoln Savings & Loan Ass’n, ruling that a separate and distinct additional asset must be created in order for an expense to be capitalized. However, in Indopco, the Supreme Court upheld the Third Circuit's decision that in a friendly takeover, the target corporation's associated expenses must be capitalized because they provide a significant future benefit, even though there may not be a separate and distinct additional asset created.

Critics have asserted the Supreme Court departed from the Lincoln Savings standard. However, the Supreme Court explained that the presence of a separate and distinct additional asset is only one means of distinguishing capital expenses from currently deductible expenses. Where an expense does not create a separate and distinct new asset, capitalization may be the correct treatment if the expense provides a significant future benefit. The Supreme Court limited its decision to "specific expenditures at issue in this case," thereby leaving unresolved whether other friendly takeover expenses must be capitalized.

Since it was decided in 1971, a majority of the lower courts have interpreted Lincoln Savings as requiring the creation of a separate and distinct asset in order to capitalize expenses. However, some lower courts have not adopted such a bright-line rule, but have distinguished between currently deductible expenses and capital expenses based on the extent of the benefit provided in the future. This confusion prompted the Supreme Court to review the Lincoln Savings decision, and Indopco afforded this opportunity. The Indopco Court confirmed that Lincoln Savings is applicable where an expense creates a separate and distinct

4. "Capitalization" means increasing the value of any property, in this instance, the target corporation's stock. Id. § 263(a). Any tax benefit from capitalized expenses is realized not in the current year, but either over many years, as in the case of depreciation or amortization deductions, or all in the year of disposition, in the form of reduced gain or increased loss resulting from the higher basis. Stand. Fed. Tax Rep. (CCH) at 13,602-05 (1991); see infra notes 84, 90-96 and accompanying text.
5. 403 U.S. 345 (1971).
6. See infra notes 49, 53, 57, 58, 61 and accompanying text.
7. 112 S. Ct. at 1046.
10. See infra notes 49, 53, 57, 58, 61 and accompanying text.
11. See infra notes 66, 100 and accompanying text.
asset and the asset is a sufficient but not a necessary condition for capitalization. The Court determined that where a separate asset was not created, the existence of a significant future benefit indicated the need for capitalization. The Court reasoned that a significant future benefit analysis was properly based on precedent, the language of the Internal Revenue Code (Code), and the rationale behind the accounting principles governing expenditures. In reaching this conclusion, the Supreme Court did not overrule, nor did it depart from, its Lincoln Savings rationale. Rather, the Court correctly expanded the Lincoln Savings decision to include a future benefit analysis.

II. STATEMENT OF THE CASE

National Starch & Chemical Corporation (National Starch), the taxpayer in Indopco, manufactured and sold adhesives, starches, and specialty chemical products. National Starch had approximately 3,700 common shareholders and was traded on the New York Stock Exchange. In 1977, Unilever Group, a purchaser of National Starch’s products, proposed a friendly takeover of National Starch. National Starch’s major shareholder, Frank Greenwall, in agreement with the other shareholders, favored the takeover. However, the Greenwalls insisted they would dispose of their stock in a tax-free transaction only. Consequently, Unilever and National Starch devised a “reverse subsidiary cash merger” which would produce a partially non-taxable exchange. Prior to the merger, National Starch’s attorneys advised the

13. Id. at 1044.
14. Id.
15. National Starch & Chemical Corporation was renamed Indopco, Inc. Id. at 1041.
17. Id.
20. Id. at 68. Frank Greenwall, chairman of the executive committee of the board of directors, together with his wife, owned 14.5 percent of National Starch’s outstanding common stock. Id. at 68-69.
21. See id. at 71.
22. Id. at 69; see also Thomas F. Quinn, Note, Takeover Expenses Incurred by the Acquired Corporation — Not Just Another Ordinary Deduction: National Starch & Chemical Corp. v. Commissioner, 10 I.L. & COM. 167, 172 (1990). Frank Greenwall organized National Starch in 1928. Id. at 172 n.31. In 1978, at the time of negotiating the takeover, the Greenwalls had a very low basis in their stock relative to the value of the company. Id. n.35. If the takeover were taxable, the large gain on the sale would result in a large income tax liability. See id. Because a stepped-up basis available at death would obviate any capital gain tax, the Greenwalls were interested in the non-taxable exchange. Id.
23. National Starch, 918 F.2d at 427. The reverse-subsidiary cash merger entailed, in part, exchanging stock for stock (tax free under Section 351 of the Internal Revenue Code). Id.; National
directors they had a fiduciary duty to ensure that the transaction would be fair to the shareholders. Counsel suggested the directors consult with an investment banking firm to obtain a valuation of National Starch. Morgan Stanley & Co., Inc. (Morgan Stanley) was retained for the valuation and gave a favorable report. The merger was approved and finalized on August 15, 1978. For National Starch’s short year ending August 1978, it deducted Morgan Stanley’s bill for services on its income tax return. The Internal Revenue Service (IRS) disallowed the deduction and National Starch contested the disallowance. The Tax Court, the Third Circuit, and the Supreme Court affirmed the Commissioner’s decision to capitalize the expenses.

III. PRIOR CASE LAW

Based on the language of the Code, the distinction between whether to deduct or capitalize an expense is readily apparent where a tangible or identifiable intangible asset exists. However, the distinction is less evident where expenses do not produce a tangible or readily identifiable intangible asset. The Supreme Court has determined whether to capitalize expenses.

Starch, 93 T.C. at 69. National Starch’s remaining stock would be purchased for cash by a special subsidiary formed by Unilever. National Starch, 918 F.2d at 427.
25. National Starch, 93 T.C. at 69-70. The attorneys advised that the directors of National Starch “should retain an outside independent investment banking firm which would assist in the valuation of [National Starch] and would be available in the event that either the Unilever Group or a third party made a hostile or unsolicited tender offer.” Id. at 70. The attorneys expressed further that National Starch’s “failure to retain such a firm might be evidence that they did not carry out their fiduciary responsibilities.” Id.
26. Id.
27. Id. at 71.
28. Id. at 72. Morgan Stanley’s bill for services was in the amount of $2,200,000.00. Id. In addition, its bill for out-of-pocket expenses and legal fees totalled $7,586.23 and $18,000.00, respectively. Id. National Starch’s attorneys submitted a bill for services in the amount of $490,000.00 and out-of-pocket expenses totalling $15,069.00. Id. National Starch also incurred other expenses totaling $150,000 in connection with the transaction. Id. On its 1978 income tax return, National Starch deducted the Morgan Stanley fee, but did not deduct the attorney fees or other expenses. Id.
29. Id. In addition, National Starch made a claim for the taxes attributable to the attorney fees and other expenses that it had not deducted. Id.
30. Indopco, 112 S. Ct. at 1040; National Starch, 918 F.2d at 426; National Starch, 93 T.C. at 78.
31. I.R.C. § 263(a)(1) (1988) (defining capital expense as “[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate”).
32. Ellis Banking Corp. v. Commissioner, 688 F.2d 1376, 1379 n.7 (11th Cir. 1982).
33. Id. at 1379 n.7. The National Starch expenses were neither tangible nor identifiable intangible assets. See National Starch & Chem. Corp. v. Commissioner, 918 F.2d 426, 430-31 (3d Cir. 1990).
currently deduct\textsuperscript{34} or capitalize\textsuperscript{35} some expenditures within this category. However, where there is no established Supreme Court precedent regarding other such expenditures, decisions vary.\textsuperscript{36}

A. Lincoln Savings

Prior to 1971, lower court decisions regarding capital expenditures and business expenses were confusing and inconsistent. Therefore, when the Supreme Court handed down its decision in \textit{Commissioner v. Lincoln Savings & Loan Ass'n},\textsuperscript{37} there appeared to be, at last, a paved road for the lower courts to follow.

The \textit{Lincoln Savings} dispute arose due to a new requirement that savings and loan associations pay a premium in addition to their primary deposit insurance premium.\textsuperscript{38} The issue was whether the additional premium was deductible as an ordinary and necessary business expense.\textsuperscript{39} The Court recognized that the primary premiums were ordinary and necessary business expenses\textsuperscript{40} and were currently deductible because they funded a primary reserve in which the savings and loan association had no property interest.\textsuperscript{41} However, the additional premium created a reserve refundable to the institution upon termination of its insured status, and, thus, the reserve constituted a capital asset.\textsuperscript{42} The Supreme Court concluded that "[w]hat is important and controlling . . . is that the . . . payment serves to create or enhance . . . what is essentially a separate and

\textsuperscript{34} \textit{See}, e.g., Commissioner v. Tellier, 383 U.S. 687 (1966) (holding that legal expenses incurred in defending against securities fraud charges were deductible under \$ 162 of the Internal Revenue Code); Commissioner v. Heininger, 320 U.S. 467 (1943) (holding that legal expenses incurred in disputing adverse postal designation are deductible as ordinary and necessary expenses).

\textsuperscript{35} \textit{See}, e.g., \textit{United States v. Hilton Hotels Corp.}, 397 U.S. 580 (1970) (holding that consulting, legal, and other professional fees incurred by acquiring firm in minority stock appraisal proceedings are capital expenditures); Woodward v. Commissioner, 397 U.S. 572 (1970) (classifying legal, accounting, and appraisal expenses incurred in purchasing minority stock interest as capital expenditures); \textit{Interstate Transit Lines v. Commissioner}, 319 U.S. 590 (1943) (holding that payment by parent company to cover subsidiary's operating deficit is not deductible as a business expense).

\textsuperscript{36} \textit{See}, e.g., \textit{Ellis Banking}, 688 F.2d at 1379 n.7; \textit{NCNB Corp. v. United States}, 651 F.2d 942 (4th Cir. 1981); First Nat'l Bank v. United States, 558 F.2d 721 (4th Cir. 1977); Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973); \textit{U.S. v. Akin}, 248 F.2d 742 (10th Cir. 1957); \textit{Southland Royalty Co. v. United States}, 582 F.2d 604 (Ct. Cl. 1978).

\textsuperscript{37} 403 U.S. 345 (1971).

\textsuperscript{38} \textit{Id.} at 345. Section 404(d) of the National Housing Act required this additional premium.

\textsuperscript{39} \textit{Id.} at 345-46.

\textsuperscript{40} \textit{See} \textit{id.} at 354.

\textsuperscript{41} \textit{Id.} at 349.

\textsuperscript{42} \textit{Id.} at 349-50.
distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense." 43 The question arose as to whether the creation of a separate and distinct additional asset is necessary or merely sufficient to compel capitalization of expenditures. 44

B. Circuit Courts' Interpretations of Lincoln Savings

Only one year after its Lincoln Savings decision, the Supreme Court again addressed the capitalization issue in United States v. Mississippi Chemical Corp. 45 There the Court determined that the expenses should be capitalized since they were "of value in more than one taxable year" 46 even though no identifiable separate and distinct additional asset was created. 47 The Mississippi Chemical decision would lead one to doubt that Lincoln Savings established a bright-line rule. The majority of circuit courts, however, virtually ignored the Mississippi Chemical decision. 48 Those courts illustrated their interpretation of Lincoln Savings as a bright-line rule by holding that a separate and distinct asset was necessary for capitalization.

In Briarcliff Candy Corp. v. Commissioner, 49 the Second Circuit, relying on Lincoln Savings, held "[t]he presence of an ensuing benefit that may have some future aspect is not controlling." 50 The court further held a separate and distinct additional asset is essential for capitalization. 51 The Briarcliff court stated that Lincoln Savings "brought about a radical shift in emphasis and directed the inquiry [to] . . . whether [the expenses] . . . 'created or enhanced . . . what [was] essentially a separate and distinct additional asset.'" 52 This statement clearly reflects the Second Circuit's interpretation of Lincoln Savings as a bright-line rule.

Both the Fourth and Fifth Circuits used the Lincoln Savings "test" but arrived at different conclusions due to divergent interpretations of

43. Id. at 354.
44. National Starch, 918 F.2d at 430.
45. 405 U.S. 298 (1972).
46. Id. at 310 (emphasis added).
47. Id. at 309.
48. The Tenth Circuit distinguished Mississippi Chemical on the basis that the "challenged start-up expenses were . . . incurred during the tax year." 50 Colorado Springs v. United States, 505 F.2d 1185, 1192-93 (10th Cir. 1974).
49. 475 F.2d 775 (2d Cir. 1973).
50. Id. at 782 (citing Lincoln Sav., 403 U.S. at 354).
51. Id. (citing Lincoln Sav., 403 U.S. at 354).
52. Id. (quoting Lincoln Sav., 403 U.S. at 354).
nearly identical facts. In *NCNB Corp. v. United States*, the Fourth Circuit held that amounts expended in creating a branch bank were currently deductible since the branch was only an expansion of NCNB's existing business and no separate additional asset was created. The court interpreted *Lincoln Savings* as "specifically reject[ing] the argument that the expenditure was not deductible simply because it had an effect beyond one year." This interpretation stemmed from the *Lincoln Savings* language that "the presence of an ensuing benefit that may have some future aspect is not controlling." The Fifth Circuit, relying on *Lincoln Savings*, concluded that the expenses associated with branch banking must be capitalized since the bank held a property interest in its separate branches.

In *Honodel v. Commissioner*, the Ninth Circuit also interpreted *Lincoln Savings* as creating a bright-line rule. There the court held that monthly, nonrefundable retainer fees which are based on a client's income level as well as his financial planning, tax advice and investment needs, should be capitalized. The court reasoned that "[A]n expenditure is a nondeductible capital outlay if it is made to acquire a capital asset."

In *Colorado Springs National Bank v. United States*, the Tenth Circuit permitted the taxpayer to deduct certain costs incident to establishing a credit card system since the bank's expenditures did not create a salable property interest. The court did, however, address its previous use of the one-year rule which provided that where expenses are a benefit realized in more than one year, they are capital. The court found the

53. 684 F.2d 285 (4th Cir. 1982).
54. Id. at 294.
55. Id. at 288.
56. Id. (quoting *Lincoln Sav.*, 403 U.S. at 354).
57. Central Texas Savings & Loan Ass'n v. United States, 731 F.2d 1181, 1184-85 (5th Cir. 1984).
58. 722 F.2d 1462 (9th Cir. 1984).
59. Id. at 1466.
60. Id. (citing *Lincoln Sav.*, 403 U.S. at 353).
61. 505 F.2d 1185 (10th Cir. 1974).
62. Id. at 1192. The court adopted the language in *Briarcliff* that expenses incurred in developing a new sales territory are deductible. Id. at 1190-91. The *Briarcliff* court had also adopted the *Lincoln Savings* separate and distinct asset test. *Briarcliff*, 475 F.2d at 782.
63. Id. at 1191-92 (citing United States v. Akin, 248 F.2d 742, 744 (10th Cir. 1957)).
one-year test to be "no more than a factor for consideration" in determining capital expenses, 64 and, therefore, based its decision on the Lincoln Savings bright-line rule. 65

Only the Eighth Circuit declined to interpret Lincoln Savings as a bright-line rule. In Iowa-Des Moines National Bank v. Commissioner, 66 the court looked at the extent of the benefit received and permitted the bank to take a current deduction for start-up costs incurred for a new credit card system, finding that any future benefits were slight. 67 Citing Lincoln Savings, the court stated "[t]he fact that there may be some ensuing benefit and future effect from the expenditure beyond the taxable year when paid is not controlling." 68 Additionally, the court found that the expenses did not "constitute a separate and new business undertaking." 69

IV. THE INDOPCO DECISION

The Supreme Court affirmed the Third Circuit's National Starch 70 decision under the name of Indopco, Inc. v. Commissioner, 71 holding that certain professional expenses incurred by a target corporation in the course of a friendly takeover are not deductible as "ordinary and necessary" business expenses, but rather should be capitalized. 72 The Court also addressed the Lincoln Savings controversy, and concluded that the creation of a separate and distinct additional asset is only one method for determining whether expenses should be capitalized. 73 If expenses do not create a separate asset, they should still be capitalized if they provide a significant future benefit. 74 The Court reasoned that the Indopco expenses did provide a significant future benefit and, therefore, held that they were capital expenses. 75

A. The Indopco Court's Interpretation of Lincoln Savings

Indopco expanded the Lincoln Savings rule "that a taxpayer's expenditure that 'serves to create or enhance . . . a separate and distinct' asset

64. Id. at 1192.
65. Id.
66. 592 F.2d 433 (8th Cir. 1979).
67. Id. at 436.
68. Id.
69. Id.
70. 918 F.2d 426 (3d Cir. 1990).
72. Id. at 1046 (citing I.R.C. § 162(a) (1988)).
73. Id. at 1044-45.
74. Id. at 1046.
75. Id. at 1045-46.
should be capitalized under § 263" by reasoning that there are other methods of distinguishing between currently deductible and capital expenses. The Court concluded that creation of a separate and distinct asset is not a prerequisite to classifying an expenditure as capital. Pointing out that *Lincoln Savings* addressed only the need for capitalization where a separate asset was created, the Court did not discuss how to treat an expenditure where no separate asset was created.

In explaining its *Lincoln Savings* decision, the Court had to contend with its own statement that "[w]hat is important and controlling . . . is that the [expenditure] serves to create . . . a separate and distinct additional asset." Moreover, in *Lincoln Savings* the Court had gone so far as to say that "the presence of an ensuing benefit that may have some future aspect is not controlling." The majority of circuit courts understandably concluded from this language that the possibility of the existence of a future benefit is ignored in identifying capital expenditures. However, the *Indopco* Court clarified its *Lincoln Savings* language, stating that *Lincoln Savings* does not "prohibit reliance on future benefit[s] as a means of distinguishing an ordinary business expense from a capital expenditure." The Court upheld and expanded its *Lincoln Savings* ruling that capitalization is appropriate where a separate asset is created.

### B. Significant Future Benefit Analysis

Basing its decision on underlying accounting principles, the language of the Internal Revenue Code, and prior case law, the Supreme Court determined that when significant future benefits exist, the expense should be capitalized.

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76. *Id.* at 1044 (quoting Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971)).
77. *See id.*
78. *Id.* at 1044 (citing General Bancshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir. 1964)).
79. *Id.*
81. *Id.* (emphasis added).
82. *See supra* notes 49, 53, 57, 58, 61 and accompanying text.
83. *Indopco*, 112 S. Ct. at 1044 (reasoning that if it ruled out the future benefit analysis and focused exclusively on a separate and distinct asset, this would still not produce the bright-line rule *Indopco* sought, due to the flexible and amorphous nature of an asset).
1. Accounting Principles

In discussing the accounting principles that underlie the determination of whether an expenditure should be currently deducted or capitalized, the Court stated that "[t]he primary effect of characterizing a payment as either a business expense or a capital expenditure [is that it determines] the timing of the taxpayer's cost recovery." 84 Additionally, the Code tries to achieve a more realistic calculation of net income for tax purposes by matching expenses to their related revenues. 85 The lower courts that interpreted Lincoln Savings as creating a bright-line rule failed to recognize these underlying accounting principles. 86

Accrual basis accounting, one of the basic concepts underlying financial reporting accounting, 87 requires that expenses be matched with income of the proper period. The notion of matching gives an accurate reflection of net income for financial purposes, as well as a precise net income figure for tax purposes. 88 Therefore, when determining how to treat expenditures, it is imperative to decide whether the expenses relate to the income of the current period alone or if they contribute to income of periods extending beyond the current period.

The Internal Revenue Code directs the allowance of deductions and capitalization with regard to certain expenditures. Section 162(a) provides that a deduction shall be allowed for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." 89 Section 263 requires capitalization of an expense

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84. Indopco, 112 S. Ct. at 1042; see also Lee A. Sheppard, National Starch Decision Falls to Remove Wrinkles From Capital Expense Issue, 89 TAX NOTES TODAY 160-68 (August 4, 1989) (discussing the Lincoln Savings rule being inconsistent with accounting theory, but explaining that accounting theory should not control tax results in every case. Business expenses are deductible in the year incurred, whereas capital expenditures are depreciated or amortized over the determinable useful life of the asset. Indopco, 112 S. Ct. at 1042. Additionally, capital expenditures where no specific asset or useful life can be ascertained are deducted only upon sale or dissolution of the enterprise. Id. (citing I.R.C. §§ 167(g), 336(a) (1988); Treas. Reg. § 1.167(a) (1991)).

85. Indopco, 112 S. Ct. at 1043 (citing Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974); Ellis Banking Corp. v. Commissioner, 688 F.2d 1376, 1379 (11th Cir. 1982)).

86. See supra notes 49, 53, 57, 58, 61 and accompanying text.

87. ACCOUNTING STANDARDS, Statement of Financial Accounting Concepts No. 6, ¶ 139-42 (Fin. Accounting Standards Bd. 1992). Some taxpayers report on a cash basis and some on accrual, but the matching principle of accrual accounting applies to both cash and accrual methods. Id.

88. CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, Statement on Accounting Principles No. 4, § 121 (Am. Inst. of Certified Pub. Accountants 1970) (stating that an accurate reflection of income depends upon current measurement of changes in economic resources and obligations rather than on a simple recording of receipts and payments).

when it results in the acquisition of property or a permanent improvement of the property's value.\textsuperscript{90} Under Section 263, expenses that produce tangible assets\textsuperscript{91} must be capitalized and depreciated over the useful life of the asset.\textsuperscript{92} Expenses that produce intangible assets\textsuperscript{93} must be capitalized and amortized over the useful life of the asset.\textsuperscript{94} However, if an intangible asset has no determinable useful life,\textsuperscript{95} then depreciation or amortization deductions are disallowed because the expense cannot be properly matched with the income of a certain period. Thus, expenditures associated with intangible assets with no determinable useful life cannot be recaptured by the taxpayer except through sale or dissolution.\textsuperscript{96}

Target corporations prefer takeover expenses to be currently deductible because the deduction would decrease net income in the period of the takeover, and, therefore, substantially reduce taxes in the current period. However, if the proper treatment is capitalization, where no separate asset with a determinable useful life is created,\textsuperscript{97} the expense associated with friendly takeovers could not be deducted until the acquiring corporation is dissolved or liquidated. The taxpayer’s desire for current deductions is understandable since it puts funds into the taxpayer's pocket immediately, rather than at some indeterminate future date. However, since underlying accounting principles support matching of expenses with revenues, the expense cannot be currently deducted if the expense provides a future benefit.

\textsuperscript{90} Id. § 263. Examples of expenditures which are capital in nature under § 263 include “[t]he cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.” Treas. Reg. § 1.263(a)-2(a) (1992).

\textsuperscript{91} Tangible assets include buildings, equipment and property. ROBERT K. ESKEW & DANIEL L. JENSEN, FINANCIAL ACCOUNTING 775-76 (2d ed. 1986).


\textsuperscript{93} Intangible assets with useful lives include patents and copyrights. See ESKEW & JENSEN, supra note 96 at 772.

\textsuperscript{94} See ACCOUNTING STANDARDS, supra note 92 at 142.


\textsuperscript{96} Treas. Reg. § 1.167(a)-3 (1992); Stand. Fed. Tax Rep. (CCH) at 13,602-05 (1991). A tax benefit occurs at sale through reduced taxable gain or increased deductible loss on the transaction because the expenses are not deducted, but rather, increase the basis of the asset to an amount closer to the amount realized from sale or dissolution. Stand. Fed. Tax Rep. (CCH) at 13,602-05 (1991).

\textsuperscript{97} There was never an issue concerning whether the expenses incurred incident to this friendly takeover created a separate asset. Neither the Court nor Indopco asserted that a separate asset was created.
2. Language of the Code

The Supreme Court construed the express language of Section 263 to determine if a future benefit analysis is proper. The Court stated that "the text of the Code's capitalization provision, Section 263(a)(1), which refers to 'permanent improvements or betterments,' itself envisions an inquiry into the duration and extent of the benefits realized by the taxpayer."998 The word "improvements" is defined generally as "everything that permanently enhances the value of the premises for general uses."999 It logically follows that if something is "permanently enhanced," it has value in future periods. This definition encompasses the creation of a separate asset; however, it extends further to include expenses where no separate asset is created, but where there is value provided in future years. The Court was correct in construing the language of the Code to apply to the duration of benefits received.

3. Case Law

Lower court opinions prior to Lincoln Savings reasoned that a future benefit is important in deciding whether to deduct or capitalize. In General Bancshares Corp. v. Commissioner,100 the Eighth Circuit stated that "it has been held that, where the expenditures have not resulted in the acquisition or increase of a corporate asset, . . . these expenditures are not, because of that fact, deductible as ordinary and necessary business expenses."101 This reasoning implies that even when no separate asset is created, the expenditure may still be capitalized. Therefore, the Eighth Circuit would likely agree with the Indopco future benefit analysis.

The Supreme Court also consulted its own opinions written subsequent to Lincoln Savings in formulating its future benefit analysis. In United States v. Mississippi Chem. Corp.,102 the Supreme Court found

98. Indopco, 112 S. Ct. at 1045.
99. 41 AM. JUR. 2D Improvements § 1 (1968).
100. 326 F.2d 712 (8th Cir. 1964).
101. Id. at 716 (citation omitted). The Eighth Circuit's reasoning is in line with the Indopco Court in this pre-Lincoln Savings opinion. However, subsequent to Lincoln Savings the Eighth Circuit, citing Lincoln Savings, stated that "[t]he fact that there may be some ensuing benefit and future effect from the expenditure beyond the taxable year when paid is not controlling." Iowa-Des Moines Nat'l Bank v. Commissioner, 592 F.2d 433, 436 (8th Cir. 1979).
102. 405 U.S. 298 (1972). Here the expenses were not friendly takeover expenditures, but instead were interest expenses paid on stock purchases required by the State of Louisiana. See id. at 299-300. These stock purchases were necessary under the Farm Credit Act of 1933 which provided that members with loans are required to purchase $100 par value Class C stock of the bank equal to but not less than 10% nor more than 25% of the amount of the quarterly interest that they paid to the bank on their loans. Id. The taxpayers claimed a $99 interest expense deduction for every $100 stock purchase required by the statute ($1 was treated as the cost of acquiring a capital asset). Id. at
that an expense which "is of value in more than one taxable year" is a nondeductible capital expenditure. The Court's authority in Mississippi Chemical was its own Lincoln Savings decision, which corrected any ambiguity regarding whether a separate asset must be created, or whether a future benefit is sufficient for capitalization. Clearly, the circuit courts that relied on Lincoln Savings should have applied the Mississippi Chemical analysis in rendering their decisions.

C. Factors Constituting a Significant Future Benefit

Once the Indopco Court established that the existence of a significant future benefit required capitalization of expenses incurred, the Court then discussed the factors it used in determining that a future benefit had in fact been created. A future benefit could be found where (1) a company would "benefit greatly from the availability of . . . enormous resources, especially in the area of basic technology," (2) the affiliation between the acquiring corporation and the target corporation would create the opportunity for synergy due to "the nature of the . . . operations," (3) the target corporation benefitted from transforming "from a publicly-held, free-standing corporation into a wholly-owned subsidiary of [the acquiring corporation]," and (4) the transaction allowed the target corporation "to eliminate previously authorized but unissued shares of preferred [stock] and to reduce the total number of authorized shares of common [stock]."

Even though the IRS's private letter ruling recognized that this transaction was not a reorganization but merely incidental to the stock exchange, the Supreme Court said the same analysis applies to a corporate reorganization as to this friendly takeover. This is because they both bear the indicia of capital expenditures due to being associated with the corporation's operations and betterment "for the duration of its

300. The district court and the Fifth Circuit found for the taxpayers. Id. The Supreme Court reversed, basing its decision on the fact that "the security is of value in more than one taxable year, [therefore] it is a capital asset within the meaning of § 1221 of the Internal Revenue Code, and its cost is nondeductible." Id. at 310 (quoting Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345 (1971); citing Old Colony R.R. v. United States, 284 U.S. 552 (1932); 26 C.F.R. § 1.461-1)).
301. Id. at 310.
302. Id.
304. Id.
305. Id.
306. See Lynne A. Schewe et al., How to Establish Deductions for Friendly Takeover Costs by Limiting National Starch, 74 J. TAX'N 146 (1991), for a full discussion on these factors and the arguments made to refute them.
307. Id. at 1045.
308. Id.
309. Id. at 1043.
existence or for the indefinite future or for a time somewhat longer than the current taxable year." Therefore, since the expenses incurred incident to corporate restructuring are to be capitalized, the friendly takeover expenses should also be capitalized.

V. RAMIFICATIONS OF THE INDOPOCO DECISION

A. Effect on Hostile Takeovers

Prior to Indopco, expenses associated with hostile takeovers were deductible. However, due to the Third Circuit's decision in National Starch, the IRS withdrew Technical Advice Memorandum (T.A.M.) 89-27-005, which allowed hostile takeover expenses to be deducted. This T.A.M. has been replaced with T.A.M. 90-43-003, which allows a deduction for expenses associated directly with resisting a hostile takeover. However, expenses incurred in obtaining a white knight, where

110. Id. at 1045-46 (quoting General Bancshares Corp. v. Commissioner, 326 F.2d 712, 715 (8th Cir. 1964)).
112. Tech. Adv. Mem. 89-27-005 (July 7, 1989); see also Corporate Takeovers — Expense Deductibility After National Starch and Chemical Corp. v. Comr., 23 TAX MGMT. (BNA) 311 (Nov. 6, 1989) (explaining the case in T.A.M. 89-27-005). This case dealt with a target corporation attracting a "white knight" to purchase the target corporation, thereby escaping the hostile takeover by an undesired corporation. Id. The T.A.M. allowed the amounts expended by the target corporation to resist the takeover to be deducted. Id. at 312. The T.A.M. reasoned that the expenditures were incurred in furtherance of the fiduciary duty to resist the takeover because the takeover was not in the best interest of the corporation or its shareholders. Id.
113. 49 TAX NOTES 637 (Nov. 5, 1990) (explaining that T.A.M. 89-27-005 was replaced with 89-45-003. T.A.M. 89-45-003 required expenses associated with hostile takeovers to be capitalized. Id.
114. See Tech. Adv. Mem. 90-43-003 (July 9, 1990); see also Hostile Takeover You Win; Friendly Takeover You Lose, 19 TAX'N FOR LAW. 242 (1991); (explaining the case in T.A.M. 90-43-003). This case dealt with a company attempting a hostile takeover of a target corporation. Id. The target corporation retained an investment banker to search for an alternative buyer with a similar strategic business plan. Id. A buyer was eventually found, and the hostile pursuer agreed in a mutual release to cease its efforts. Id.

The taxpayer contended that the dominant aspect of the transaction was defending the corporation against a hostile takeover, "and to protect its continuing policies and operations, and the expenses would not have been incurred" except for the hostile takeover attempt. Id. The district director argued "that the expenditures were attributable to a change in the taxpayer's capital structure." Id. It was found that the target corporation had two distinctly different strategies. Id. One was to directly oppose the takeover efforts, "while the other was to gain some long-term protection and stability through a friendly acquisition." Id. "Based on this, the expenses are to be examined individually to determine under which strategy they were incurred." Id.
115. When an acquiring corporation pursues a hostile takeover of a target corporation, the target corporation sometimes seeks another corporation, commonly known as a "white knight," to acquire the target. The target corporation obtains the white knight because it believes that the white knight
a successful defense follows, must be capitalized because a shift in ownership has occurred and the company will benefit in the future. Therefore, the expenses must be separated into hostile takeover defense expenses (which are deductible) and expenses associated with obtaining a white knight (which are to be capitalized).

Notwithstanding the most recent T.A.M., the expenses associated with obtaining a white knight could be characterized as incidental to the hostile takeover transaction and, therefore, deductible. In Indopco, the Tax Court concluded that expenses were incidental to the entire corporate restructuring. However, since the dominant aspect of the transaction was to be capitalized, the Court decided that the incidental white night expenses would be capitalized as well. Since expenses associated with a white knight are incidental to defending the corporation, and since expenses associated with defending a corporation are deductible, it follows that incidental white knight expenses should also be deductible.

However, the Supreme Court and the Code favor capitalization of expenses incurred in transactions where a future benefit is provided, regardless of whether the takeover is friendly or hostile. Thus, the Supreme Court and the IRS agree that where a significant future benefit is provided, the expense should be capitalized.

B. Effect on Currently Deductible Expenses that Provide Future Benefits

The Indopco decision makes possible the capitalization of expenditures which are currently deductible but provide a future benefit. Among these expenditures are advertising costs. There are, of course, costs associated with advertising that are clearly for a particular period. However, many advertising costs cannot be properly matched with a specific

is a better holder than the hostile pursuer. William L. Raby, Expenses That Benefit the Future: Indopco & The "White Knights", 54 Tax Notes 1648 (1992).
116. The IRS issued T.A.M. 89-43-003 in accordance with the National Starch decision, which gives the Supreme Court even greater incentive to uphold the Third Circuit's opinion. See 49 Tax Notes 637 (Nov. 5, 1990).
117. Id.
118. The taxpayer in T.A.M. 90-43-003 did, in fact, argue that the dominant aspet of the transaction was the hostile defense, however, the court rejected this argument. 49 Tax Notes 637 (Nov. 5, 1990). See also J. Phillip Adams & J. Dean Hinderliter, Indopco, Inc. v. Commissioner: Impact Beyond Friendly Takeovers, 55 Tax Notes 93 (1992).
120. Id. at 97.
121. 49 Tax Notes 637 (Nov. 5, 1990).
122. An example would be placing an advertisement in a local newspaper to announce a sale for a particular week.
period. For example, advertising promotes sales, thereby supplying the business with future profits and goodwill, both of which are future benefits. Therefore, advertising often provides a future benefit which, following Indopco's reasoning, would have to be capitalized. On the other hand, the counterargument is that such costs only provide a future benefit when they are significant enough to warrant capitalization.\textsuperscript{123}

C. Effect on Other Friendly Takeover Cases

A close review of the Supreme Court's decision reveals that capitalization occurs only when a significant future benefit is provided. The Court relied upon specific facts in the Indopco case to determine that the takeover produced significant future benefits, thus providing for capitalization. Therefore, the decision did not make such an overly-broad rule that all friendly takeover expenses must be capitalized.

In order to avoid the harsh ramifications of the capitalization of friendly takeover expenses, corporations should attempt to create a benefit the effects of which are seen immediately rather than at a future date. Four factors are important in determining if a future benefit will be obtained.\textsuperscript{124}

1. "Form of transaction"\textsuperscript{125}—This inquiry focuses on the different means of acquiring a corporation: taxable asset acquisitions, taxable stock acquisitions, tax-free reorganizations, stock purchases and redemptions, recapitalizations, a combination of the above, and deemed asset sales under Section 338 of the Code. In some instances a future benefit is apparent; however, in some acquisitions, the transaction lacks a long-term benefit.\textsuperscript{127}

2. "Nature of the target corporation"\textsuperscript{128}—This categorization relates to the mutual characteristics of the acquiring and target corporations.\textsuperscript{129} For example, in Indopco, the two corporations were in the same line of business.\textsuperscript{130} Therefore, Indopco stood to benefit in the future. However, the acquiring corporation in another case could merely be a

\textsuperscript{123} "[T]he mere presence of an incidental future benefit—'some future aspect'—may not warrant capitalization." Indopco, 112 S. Ct. at 1044.

\textsuperscript{124} Scheve et al., supra note 107 at 149-50.

\textsuperscript{125} Id. at 149.

\textsuperscript{126} Id.

\textsuperscript{127} Id. An example would be a Section 338 transaction where the target corporation sells all its stock to a new corporation as a taxable sale and then the target corporation completely liquidates subsequent to the sale. Id. In that case, the target corporation has no future benefit. Id.

\textsuperscript{128} Id.

\textsuperscript{129} Id.

\textsuperscript{130} Id.
financial investor not engaged in exactly the same business as the target corporation, or could be a totally unrelated business. In either case, the acquisition would not necessarily produce future benefits for the target corporation.

(3) "Nature of the acquiring entity"—This categorization deals with the characteristics of the acquiring entity. In *Indopco*, Unilever had large capital resources and other significant business activities which produced a synergistic opportunity for Indopco. However, not all acquiring corporations will provide such benefits.

(4) "Events following the acquisition"—This inquiry focuses on the status of the companies after the restructuring. In *Indopco*, Unilever did not sell or modify the target corporation or cause the target corporation to assume any significant debt obligations incident to the acquisition. However, in many other acquisitions, the acquiring entity resells part or all of the acquired corporation or causes the target corporation to assume significant debt obligations. This causes the acquiring corporation to experience significant financial problems after the acquisition which is obviously detrimental, not beneficial.

Some cases involving friendly takeover expenses might be distinguished from *Indopco* based on the significance of the future benefit. This is doubtful, however, due to the fact that benefits are inherent in the nature of friendly takeovers. Were they not expected to be beneficial, the transactions would likely not occur. Furthermore, the *Indopco* Court analogized friendly takeover expenses to reorganization expenses, giving the courts a clear avenue for capitalizing friendly takeover expenses in the future.

131. Id.
132. Id.
133. Id.
134. Id.
135. Id. at 149-50.
136. Id. at 150.
137. Id.
138. Id.
139. Id.
140. Id.
141. Id. at 151.
VI. CONCLUSION

The Supreme Court in Indopco did not create the hard and fast rule that the lower courts were seeking. Instead, it established the future benefit test which determines if an expenditure should be capitalized. In so holding, the Court did not overrule the Lincoln Savings decision, but instead expanded Lincoln Savings to include the capitalization of expenses which provide a significant future benefit where no separate and distinct asset is created.

Indopco could perhaps be applied to other expenses; however, the Supreme Court concluded its opinion by stressing that the expenses associated with friendly takeovers are comparable to those associated with corporate restructuring. Expenses associated with both have to do with the “corporation’s operations and betterment”142 and are not deductible. Therefore, the Court correctly limited the Indopco opinion to friendly takeovers that involve expenditures which produce a significant future benefit.

Stacy D. Ward

142. Indopco, 112 S. Ct. at 1046.