

NOTHING LEFT OF *INDOPCO*: LET'S KEEP IT THAT WAY!

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I.	INTRODUCTION.....	277
II.	THE DISTINCTION BETWEEN CURRENT DEDUCTION AND CAPITAL EXPENSE	279
III.	<i>INDOPCO</i> 'S FAMILY TREE	281
IV.	THE IRS'S AGGRESSIVE POST- <i>INDOPCO</i> POSITIONS	284
	A. <i>The IRS's Position in PNC Bancorp</i>	285
	B. <i>The IRS's Position in Wells Fargo</i>	285
	C. <i>The IRS's Position in Hostile Takeovers</i>	287
V.	THE IRS'S AGGRESSIVE POST- <i>INDOPCO</i> POSITIONS PROMOTE BAD POLICY....	287
	A. <i>The IRS's Positions Lack Rationale</i>	287
	B. <i>The IRS's Positions Violate the Matching Principle</i>	288
	C. <i>The IRS's Positions Ignore the Distinction Between Hostile and Friendly Acquisitions</i>	290
VI.	NOTHING LEFT OF <i>INDOPCO</i>	293
	A. <i>PNC Bancorp Places a Restriction on the Separate and Distinct Asset Test</i>	293
	B. <i>Wells Fargo Extends the "Origin of the Claim" Doctrine to Create the Direct/Indirect Test</i>	295
	C. <i>A.E. Staley Narrows INDOPCO to Friendly Acquisitions</i>	296
VII.	NOTHING LEFT OF <i>INDOPCO</i> : LET'S KEEP IT THAT WAY!.....	300
VIII.	CONCLUSION	301

I. INTRODUCTION

In 1992, the United States Supreme Court seemingly resolved the contentious issue of whether a target corporation could currently deduct the investment banking fees and costs it incurred when a friendly buyer acquired it. In *INDOPCO, Inc. v. Commissioner*,¹ the Court clearly held that target corporations cannot deduct current investment banking fees and costs when they obtain only *future benefits* in a merger.² After *INDOPCO*, taxpayers began to worry that the Internal Revenue Service (IRS) would require them to capitalize otherwise currently deductible business expenses simply because those expenses yielded some future benefit.³

Although the IRS initially confirmed taxpayers' fears when it began to extend *INDOPCO*'s holding, courts responded by limiting

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1. 503 U.S. 79 (1992).

2. *Id.* at 88. The Court held that the target corporation, National Starch, could not currently deduct investment banking fees and costs because it obtained future benefits from its merger with Unilever. *Id.* See also W. Curtis Elliot Jr., *Capitalization of Operating Expenses After INDOPCO: IRS Strikes Again*, 5 S.C. LAW. 29, 30 (1993).

3. Lee A. Sheppard, *The INDOPCO Case and Hostile Defense Expenses*, 54 TAX NOTES 1458, 1459 (1992) ("Read broadly, *Indopco* means that the taxpayer always loses; that many expenditures not encompassed by section 263 must be capitalized because they produce a future benefit.").

INDOPCO considerably. Initially, the IRS used *INDOPCO*'s "deductions are exceptions to the norm of capitalization"⁴ language in conjunction with the separate and distinct asset test⁵ to aggressively deny deductions for expenses that taxpayers had otherwise currently deducted. Recently, however, the Third Circuit, in *PNC Bancorp, Inc. v. Commissioner*,⁶ applied a stricter version of the separate and distinct asset test.⁷ Similarly, when the IRS began denying taxpayers' current deductions for expenses because those expenses created some type of future benefit, the Eighth Circuit, in *Wells Fargo & Co. v. Commissioner*,⁸ responded by applying a stricter version of the future benefit test than the Supreme Court applied in *INDOPCO*.⁹ Finally, when the IRS refused to distinguish between hostile and friendly takeovers, the Seventh Circuit, in *A.E. Staley Manufacturing Co. v. Commissioner*,¹⁰ ruled that it must.¹¹

However, because *INDOPCO* remains good law and many circuit courts have yet to address the numerous issues that it raises, taxpayers need additional protection from *INDOPCO*. Therefore, Congress should direct the Treasury to enact regulations that codify the Third, Seventh, and Eighth Circuit holdings to prevent the IRS from asserting its aggressive post-*INDOPCO* positions in other circuits.

Accordingly, this Comment posits that even though some courts have eased taxpayer concern by limiting *INDOPCO* to its facts, taxpayers need greater reassurance that other courts will not revive *INDOPCO*. Part II addresses the differences between current deductions and capital expenses. Part III discusses the law before *INDOPCO*, as well as the Supreme Court's *INDOPCO* opinion. Part IV recounts the IRS's aggressive positions after *INDOPCO*. Part V argues that these positions promote poor policy because they lack rationale, violate the matching principle, and ignore the important distinction between friendly and hostile transactions. Part VI describes how courts have contained the IRS's positions and limited *INDOPCO* to its facts. Finally, Part VII proposes treasury regulations that cod-

4. *INDOPCO*, 503 U.S. at 84.

5. *Comm'r v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 354 (1971) (espousing the separate and distinct asset test, which instructed taxpayers to capitalize an expense that creates or increases the value of a separate and distinct asset).

6. 212 F.3d 822 (3d Cir. 2000).

7. The court found that to be capitalizable, the expense must *create* a separate and distinct asset and not *merely be associated* with separate and distinct asset creation. *Id.* at 830.

8. 224 F.3d 874 (8th Cir. 2000).

9. The *Wells Fargo* court found that to be capitalizable, the expense must be not only related to a transaction that produces a future benefit, but also *directly* related to that transaction. *Id.* at 886.

10. 119 F.3d 482 (7th Cir. 1997).

11. *Id.* at 489.

ify the Third, Seventh, and Eighth Circuit holdings to ensure that other courts do not restore *INDOPCO*.

II. THE DISTINCTION BETWEEN CURRENT DEDUCTION AND CAPITAL EXPENSE

When a taxpayer incurs an expense, that taxpayer may treat it in one of three ways: (1) as a current deduction; (2) as a depreciable or amortizable capital expenditure; or (3) as a nondepreciable or nonamortizable capital expenditure. Each alternative has different tax consequences for the taxpayer. When a taxpayer treats an expense as a current deduction, that taxpayer may deduct the expense from his or her taxable income.¹² When a taxpayer treats an expense as a depreciable or amortizable capital expenditure, he or she takes the expense and spreads it over the useful life of the asset to which it relates.¹³ When a taxpayer treats an expense as a nondepreciable or nonamortizable capital expenditure, a taxpayer takes the expense and adds it to the basis¹⁴ of the asset to which the expense relates.¹⁵ When a taxpayer sells the asset, he or she will recognize a gain on the amount realized minus the basis.¹⁶ Essentially, the taxpayer gets to deduct the expense when he or she sells the asset because the expense reduces part of the amount realized.¹⁷

The Internal Revenue Code (the Code) contains two main sections that helps the taxpayer determine which of the three treatments apply to a particular expense. The first section, § 162(a), states that “[t]here 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.”¹⁸ However, a second section of the Code, § 263(a), limits § 162(a). Section 263(a) states:

No deduction shall be allowed for—(1) [a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate . . . [or] (2) [a]ny amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.¹⁹

12. I.R.C. § 161 (1994); *Id.* § 162(a) (1994 & Supp. V 1999).

13. *Id.* §§ 167, 168 (1994 & Supp. V 1999).

14. An asset's basis is generally its cost. *Id.* § 1012 (1994).

15. *Id.* § 1016(a) (1994 & Supp. V 1999).

16. *Id.* § 1001(a) (1994).

17. *E.g.*, Treas. Reg. § 1.1016-2(b) (1960).

18. I.R.C. § 162(a) (1994 & Supp. V 1999).

19. *Id.* § 263(a) (1994 & Supp. V 1999).

Section 263(a) trumps § 162(a).²⁰ Therefore, a taxpayer may still have to treat an expense that falls under § 162(a) as a capital expense if the expense also falls under § 263(a).²¹

To receive a current deduction, taxpayers strive to fall under § 162(a) and stay outside of § 263(a). Taxpayers favor current deductions because they allow taxpayers to reduce their taxable income currently rather than over time.²² The IRS, however, wants taxpayers to fall within § 263(a), which delays deductions and maximizes the IRS's current revenues.²³

If a taxpayer must treat an expense as a capital expenditure, however, he or she prefers to treat it as a depreciable or amortizable capital expenditure, rather than a nondepreciable or nonamortizable capital expenditure. When an expense is depreciable or amortizable, the taxpayer may take the expense and spread it over the life of the asset it relates to.²⁴ Therefore, instead of taking the entire expense and deducting it from taxable income in the first year, the taxpayer may take a portion of the expense and deduct it from taxable income every year over the related asset's life.²⁵ To do so, however, the taxpayer must know the life of the asset involved or determine the life based on industry standards.²⁶ When an asset's useful life is undeterminable, the expenses related to that asset are nondepreciable or nonamortizable capital expenditures.²⁷ In that case, the taxpayer cannot reduce his or her taxable income by *any* portion of the expense. Instead, the taxpayer must add the expense to his or her basis in the related asset.²⁸ When the taxpayer eventually sells the asset, he or she may deduct this cost from the sale price to arrive at his or her taxable gain.²⁹

Taxpayers prefer current deductions over depreciable or amortizable capital expenditures due to the value of money doctrine.³⁰ The time value of money doctrine states that a taxpayer would rather pay taxes later than sooner because a dollar today has greater value than

20. PNC Bancorp, Inc. v. Comm'r, 212 F.3d 822, 827 (3d Cir. 2000).

21. *Id.*

22. Melissa D. Ingalls, *INDOPCO, Inc. v. Commissioner: Determining the Taxable Nature of a Target Corporation's Takeover Expenses*, 43 DEPAUL L. REV. 1165, 1165 (1994).

23. *Id.*

24. I.R.C. §§ 167, 168 (1994 & Supp. V 1999).

25. When the related asset is a tangible asset (i.e., a building), this process is called depreciation. *Id.* § 167. When the related asset is an intangible asset, this process is called amortization. *Id.* § 197 (1994 & Supp. V 1999).

26. See Treas. Reg. § 1.167(a)-1(b) (as amended 1972).

27. Treas. Reg. § 1.263(a)-1 (as amended 1994).

28. I.R.C. § 1016(a) (1994 & Supp. V 1999).

29. Treas. Reg. § 1.1016-2(b) (1960).

30. See Ingalls, *supra* note 22, at 1170.

a dollar in the future.³¹ Therefore, a taxpayer would rather reduce his or her taxable income in year one rather than little by little in subsequent years. By the same token, a taxpayer would rather reduce his or her taxable income little by little in subsequent years than reduce his or her taxable income at the end of some unknown period of time.³²

To summarize, due to the time value of money, a taxpayer's expense categorization preferences rank in the following order: (1) current deductions; (2) depreciable or amortizable capital expenditures; and (3) nondepreciable or nonamortizable capital expenditures.³³ INDOPCO creates a problem by giving the IRS the potential to convert certain expenses from current deductions into nondepreciable or nonamortizable capital expenditures, thereby giving taxpayers a large economic jolt.³⁴

III. INDOPCO'S FAMILY TREE

In *Commissioner v. Lincoln Savings & Loan Ass'n*,³⁵ the U.S. Supreme Court characterized an expense as a capital expense because it created a "separate and distinct additional asset."³⁶ The taxpayer, Lincoln Savings and Loan Association, paid two premiums to the Federal Savings and Loan Insurance Corporation.³⁷ The first premium funded the primary reserve, which included a general insurance fund for all participants.³⁸ The "additional premium" funded the secondary reserve, of which Lincoln Savings held a pro rata share.³⁹ The issue in *Lincoln Savings* involved whether Lincoln Savings could deduct the additional premium that it paid to the Federal Savings

31. For example, if a taxpayer has a \$100 tax liability payable either this year or next year (assuming no penalty), he would rather pay it next year because if he invests \$90.91 today at a 10 percent rate of return he will have \$100 next year. Thus, by getting to pay his tax liability next year, he reduces his tax bill by \$9.09.

32. *Id.* However, taxpayers must balance their expected time value of money savings with the possibility that tax rates may increase. If tax rates increase, a taxpayer would rather defer his or her deduction to offset income in later years where tax rates are higher. On the other hand, if tax rates decrease, a taxpayer would prefer taking his or her deduction sooner because the current tax rate is higher than the future tax rate.

33. David J. Roberts, *Capitalizing the Target's Transaction Costs in Hostile Takeovers*, 73 WASH. L. REV. 489, 492 (1998) ("Because of both the time value of money and the fact that an immediate deduction can reduce taxable income for the current tax year, taxpayers generally consider immediate deductions more valuable than deductions taken gradually over a number of years.").

34. The *INDOPCO* Court realized this problem but provided no solution. See *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992) ("[W]here no specific asset or useful life can be ascertained, [the cost] is deducted upon dissolution of the enterprise.").

35. 403 U.S. 345 (1971).

36. *Id.* at 354.

37. *Id.* at 348.

38. *Id.*

39. *Id.* at 349-50.

and Loan Insurance Corporation as an ordinary and necessary business expense under section 162(a).⁴⁰ In holding that it could not, the Court stated:

[T]he presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year.

What is important and controlling, we feel, is that the . . . payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a)⁴¹

According to the Eighth Circuit, “[n]o less than five of the Federal Circuit Courts of Appeal[s] erroneously interpreted [the language above] to mean that the Supreme Court had adopted a new test for determining whether an expenditure was currently deductible or must be capitalized.”⁴²

Each of these Circuits, in response to the Lincoln Savings decision, adopted a new “separate and distinct additional asset” test, or some variation thereof. The new test permitted necessary business expenditures to be fully deducted during the taxable year unless the expenditure created or enhanced a separate and distinct additional asset.⁴³

This mischaracterization lasted until the *INDOPCO* decision, which disavowed the separate and distinct asset test as the exclusive test for distinguishing between deductible expenses and capital expenditures.⁴⁴

INDOPCO addressed whether a target corporation may currently deduct certain professional expenses incurred during a friendly takeover.⁴⁵ The target, *INDOPCO, Inc.*, formerly named National Starch and Chemical Corporation, was an adhesives, starches, and specialty chemical products supplier.⁴⁶ The acquirer, Unilever, was one of National Starch’s customers and wanted to buy it in a friendly transaction.⁴⁷ During the takeover negotiations, National Starch used Morgan Stanley “to evaluate its shares, to render a fairness opinion, and

40. *Id.* at 345-46.

41. *Id.* at 354.

42. *Wells Fargo & Co. v. Comm’r*, 224 F.3d 874, 881 (8th Cir. 2000). *See also* *Central Tex. Sav. & Loan Ass’n v. United States*, 731 F.2d 1181 (5th Cir. 1984); *NCNB Corp. v. United States*, 684 F.2d 285 (4th Cir. 1982); *First Sec. Bank of Idaho v. Comm’r*, 592 F.2d 1050 (9th Cir. 1979); *Colo. Springs Nat’l Bank v. United States*, 505 F.2d 1185 (10th Cir. 1974); *Briarcliff Candy Corp. v. Comm’r*, 475 F.2d 775 (2d Cir. 1973).

43. *Wells Fargo*, 224 F.3d at 881.

44. *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79, 86-87 (1992).

45. *Id.* at 80.

46. *Id.*

47. *Id.*

generally to assist [it] in the emergence of a hostile tender offer.”⁴⁸ Shortly after Morgan Stanley found the \$73.50 per share final offer to be fair, the parties consummated the transaction.⁴⁹

Morgan Stanley charged National Starch a fee of more than \$2.2 million, as well as \$7,586 for out-of-pocket expenses and \$18,000 for legal fees.⁵⁰ The Debevoise, Plimpton, Lyons & Gates law firm charged National Starch \$490,000 in legal fees and \$15,069 in out-of-pocket expenses.⁵¹ National Starch itself incurred \$150,962 in miscellaneous expenses such as accounting, printing, proxy solicitation, and SEC fees.⁵² On its federal income tax return, National Starch deducted the fees it paid Morgan Stanley, but did not deduct the fees and expenses it paid the Debevoise law firm or the other miscellaneous expenses it incurred.⁵³ The IRS disallowed National Starch’s deduction for Morgan Stanley’s fee.⁵⁴

National Starch sought a redetermination from the U.S. Tax Court and asserted its right to deduct its banking fees and expenses, as well as its legal and miscellaneous expenses.⁵⁵ The Tax Court, agreeing with the IRS, ruled that all of the expenses were capital expenses and therefore not deductible under § 162(a).⁵⁶ The court based its holding primarily on the merger’s long-term benefits to National Starch.⁵⁷ On appeal to the Third Circuit, National Starch contended that the disputed expenses were currently deductible because they did not create or enhance a separate and distinct additional asset.⁵⁸ But the Third Circuit rejected this argument and affirmed the tax court, agreeing that Unilever’s enormous resources and the transaction’s synergy prospects served National Starch’s long-term betterment.⁵⁹

The U.S. Supreme Court also rejected National Starch’s argument that *Lincoln Savings*’ separate and distinct asset test represented the exclusive test for distinguishing between currently deductible expenses and capital expenses.⁶⁰ Moreover, the Court made it a point to state that “deductions are exceptions to the norm of capitalization.”⁶¹

48. *Id.* at 81.

49. *Id.* at 81-82.

50. *Id.* at 82.

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. *Nat’l Starch & Chem. Co. v. Comm’r*, 93 T.C. 67, 73 (1989).

56. *Id.* at 75.

57. *Id.*

58. *Nat’l Starch & Chem. Co. v. Comm’r*, 918 F.2d 428-31 (1990).

59. *Id.* at 432-33.

60. *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79, 86-87 (1992).

61. *Id.* at 84.

Furthermore, the Court clarified that *Lincoln Savings* did not reject the future benefit test as a means of distinguishing an ordinary business expense from a capital expenditure.⁶² The Court held that although the mere presence of an incidental future benefit cannot 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.”⁶³

Applying the newly revived future benefit test to *INDOPCO*’s facts, the Court determined that the benefits National Starch obtained included: (1) synergy, which the Court called “resource-related benefits”; (2) the transformation from a publicly held to wholly owned subsidiary, which included the advantage of swapping 3,500 shareholders for one and thus eliminating expenses related to reporting and disclosure obligations, proxy battles, and derivative suits; and (3) the administrative convenience and simplicity of eliminating previously authorized but unissued shares of preferred stock and reducing the total number of authorized shares of common stock from eight million to one thousand.⁶⁴

IV. THE IRS’S AGGRESSIVE POST-*INDOPCO* POSITIONS

The IRS viewed the Supreme Court’s ruling in *INDOPCO* as “a green light to seek capitalization of costs that had previously been considered deductible in a number of businesses and industries.”⁶⁵ After *INDOPCO*, the IRS could use the Supreme Court’s holding that “deductions are exceptions to the norm of capitalization”⁶⁶ when applying *Lincoln Savings*’s separate and distinct asset test⁶⁷ to aggressively deny deductions for expenses that the IRS had previously allowed taxpayers to currently deduct. *INDOPCO* also favored the IRS by lifting the “separate and distinct asset barrier” that five circuits had placed on the IRS.⁶⁸ *INDOPCO* also allowed the IRS to deny current deductions in cases where the expense created some type of future benefit for the taxpayer even though it did not create a separate and distinct asset. Finally, because the Supreme Court in *INDOPCO* did not limit its holding to friendly acquisitions, the IRS could freely deny current deductions for expenses related to both friendly and hostile acquisitions. This section explores how the IRS took advantage of all that *INDOPCO* offered.

62. *Id.* at 87.

63. *Id.* at 87. This language revived the future benefit test.

64. *Id.* at 88-89.

65. PNC Bancorp, Inc. v. Comm’r, 212 F.3d 822, 824 (3d Cir. 2000).

66. *INDOPCO*, 503 U.S. at 84.

67. Comm’r v. Lincoln Sav. & Loan Ass’n, 403 U.S. 345, 354 (1971).

68. See *supra* note 42 and accompanying text.

A. *The IRS's Position in PNC Bancorp*

After *INDOPCO*, the IRS used *Lincoln Savings's* separate and distinct asset test and *INDOPCO's* “deductions are exceptions to the norm of capitalization” language to deny current deductions for costs it had always allowed taxpayers to currently deduct. For example, in *PNC Bancorp, Inc. v. Commissioner*,⁶⁹ the Commissioner took the position that the taxpayer had to capitalize marketing, researching, and loan originating expenses over certain loans' lives.⁷⁰

PNC Bancorp addressed whether a bank could currently deduct the following: (1) payments that the bank made to third parties for activities that helped it determine whether to approve a loan (i.e., credit screening, property reports, and appraisals); (2) the security interest recording costs associated with secured loans; and (3) the internal costs associated with loan marketing, loan origination, and completing and reviewing loan applications.⁷¹

In the late 1980s, the Financial Accounting Standards Board (FASB)⁷² promulgated Statement of Financial Standards 91 (SFAS 91), which required banks to separate these types of costs and recognize them over a loan's life for financial accounting and reporting purposes.⁷³ Although First National Pennsylvania Corporation (FNPC) and United Federal Bancorp, Inc., (UFB)⁷⁴ complied with SFAS 91, both banks continued to currently deduct those costs for tax purposes.⁷⁵ Contrary to its earlier practices, the IRS disallowed these deductions.⁷⁶ Apparently, the IRS viewed *INDOPCO's* “deductions are exceptions to the norm of capitalization” language as a “green light” to piggyback onto SFAS 91 and deny deductions for expenses that taxpayers had previously been able to currently deduct.

B. *The IRS's Position in Wells Fargo*

The IRS also exploited *INDOPCO's* future benefit test to deny current deductions for *all* costs associated with merger activity, in-

69. 212 F.3d 822 (3d Cir. 2000).

70. *Id.* at 824. “Emboldened by a U.S. Supreme Court case, and a change in private sector financial accounting standards, the IRS aggressively attempted to squash the deductibility of bank loan costs, casting them out from under the ‘ordinary and necessary’ business expense Code designation, into a quagmire of capitalization.” Mary Ann Fenicato, *PNC Prevails Over IRS: Loan Expense Deductibility Upheld*, 2 No. 19 LAW. J. 3, 13 (2000).

71. *PNC Bancorp*, 212 F.3d at 826.

72. *Id.* The FASB is “an independent private sector organization that establishes standards for financial accounting and reporting.” *Id.* at 825 n.1.

73. *Id.* at 825.

74. *Id.* PNC was a bank holding company and the petitioner in the case. FNPC and UFB merged into PNC in 1992 and 1994, respectively, and PNC succeeded to both companies' liabilities. *Id.*

75. *Id.* at 826.

76. *Id.* at 827.

cluding all “in house” costs. For example, in *Wells Fargo & Co. v. Commissioner*,⁷⁷ the IRS tried to deny a deduction for the portion of the target’s officers’ salaries attributable to their work on a friendly acquisition, even though the target did not hire any of them specifically for that task.⁷⁸

Wells Fargo concerned a bank merger between Davenport, an Iowa state bank, and Norwest, a bank holding company and owner of Bettendorf Bank.⁷⁹ Davenport’s management became concerned that banks of its size would be unable to compete when Iowa adopted interstate banking legislation that allowed banking institutions located in states next to Iowa to acquire Iowa banks.⁸⁰ In July 1991, Davenport’s board met to consider a transaction in which Davenport and Bettendorf would merge to form New Davenport, a national bank that Norwest would wholly own.⁸¹ The parties consummated the deal in January 1992.⁸²

Prior to July 1991, Davenport spent \$83,450 in investigating Norwest’s and Bettendorf’s products, services, and reputation to ascertain whether Norwest and Bettendorf would be a good business fit for Davenport and whether the proposed transaction would benefit the Davenport community.⁸³ Davenport spent another \$27,820 in fees related to the investment bankers’ services, which included “negotiating price, working on the fairness opinion, advising [Davenport]’s board with respect to fiduciary duties, [and] satisfying securities law requirements.”⁸⁴

During 1991, some of Davenport’s officers worked on various aspects of the transaction.⁸⁵ Davenport, however, did not hire any of them specifically for that task.⁸⁶ Instead, it hired them to conduct Davenport’s day-to-day banking business.⁸⁷ Moreover, Davenport’s participation in the transaction had no effect on the officers’ salaries.⁸⁸ “Of the salaries paid to the officers in 1991, \$150,000 was attributable to services performed in the transaction.”⁸⁹ But when Davenport deducted the salaries, including the \$150,000 deduction attributable to the transaction, the Commissioner disallowed the de-

77. 224 F.3d 874 (8th Cir. 2000).

78. *Id.* at 880.

79. *Id.* at 876-77.

80. *Id.* at 877.

81. *Id.* at 874.

82. *Id.* at 879.

83. *Id.*

84. *Id.*

85. *Id.* at 879-80.

86. *Id.* at 880.

87. *Id.*

88. *Id.*

89. *Id.*

duction.⁹⁰ The IRS took the position that because the salaries were attributable to a merger transaction that yielded future benefits, the taxpayer needed to capitalize them.⁹¹ Previously, taxpayers could currently deduct salaries as ordinary and necessary business expenses. But as it did in *PNC Bancorp*, the IRS in *Wells Fargo* aggressively tried to stop those current deductions.

C. *The IRS's Position in Hostile Takeovers*

Finally, the IRS exploited the fact that the *INDOPCO* court failed to limit its holding to friendly acquisitions by denying deductions for hostile acquisition defense costs, despite the fact that these costs yield no future benefit.⁹² For example, in one case, a target expended \$65 million in legal and investment banking fees and \$6.5 million in executive compensation to resist a hostile takeover.⁹³ However, when one bidder successfully acquired the target and tried to deduct its hostile acquisition defense costs, the IRS disallowed its deduction.⁹⁴

V. THE IRS'S AGGRESSIVE POST-*INDOPCO* POSITIONS PROMOTE BAD POLICY

The IRS's aggressive post-*INDOPCO* positions discussed in Part IV are bad from a policy perspective for at least three reasons. First, the Service's opportunistic and aggressive positions lack substantive rationale. Second, they violate the matching principle. Finally, they ignore the difference between hostile and friendly acquisitions.

A. *The IRS's Positions Lack Rationale*

The IRS's aggressive position in *PNC Bancorp* was bad from a policy perspective because it lacked substantive rationale. In that case, the IRS opportunistically tried to piggyback onto SFAS 91 to require banks to capitalize costs that it had previously allowed banks to currently deduct.⁹⁵ The court in *PNC Bancorp* determined that "the reasons for SFAS 91's requirement that loan origination costs be deferred are reasons wholly specific to the realm of financial accounting, and thus those financial accounting standards do not affect our tax analysis."⁹⁶

90. *Id.*

91. *Id.*

92. The Commissioner took this position in *A.E. Staley Mfg. Co. v. Comm'r*, 119 F.3d 482 (7th Cir. 1997). See *infra* Part VI.C.

93. Sheppard, *supra* note 3, at 1458 (discussing Gulf Oil's attempts to resist the Mesa Petroleum and Chevron takeovers).

94. *Id.*

95. See *supra* Part IV.A.

96. *PNC Bancorp, Inc. v. Comm'r*, 212 F.3d 822, 832 (3d Cir. 2000).

The court continued, “[i]n fact, . . . the IRS’s wholesale importation of the line drawn by the financial accounting standards creates tax consequences that the Commissioner appears not to have considered.”⁹⁷ Apparently, if banks had to capitalize the loan origination costs, they would have to include these costs in each loan’s basis. Such inclusions represented a departure from current practice, as the bank’s basis in a loan had always been equal to the money the bank advanced, irrespective of origination costs.⁹⁸ Therefore, the court saw the IRS’s failure to consider these and other tax ramifications as an indication that the IRS lacked independent tax analysis and had simply bootstrapped financial accounting standards into the tax arena.⁹⁹

B. *The IRS’s Positions Violate the Matching Principle*

The IRS’s aggressive post-*INDOPCO* positions also led to *significant* matching principle violations. The primary purpose of distinguishing between expenses that a taxpayer must treat as current deductions versus those that he or she must treat as capital expenditures is to “match expenses with the revenues of the taxable period to which they are properly attributable.”¹⁰⁰ This achieves a more accurate net income calculation for tax purposes.¹⁰¹ For example, when a taxpayer purchases an asset with a useful life greater than one year, such as a building, he or she cannot deduct the entire cost of the building in the purchase year because he or she would underestimate income in the purchase year and overestimate income in subsequent years. The matching principle requires a taxpayer to spread the purchase cost over the life of the asset. Problems with this requirement, as previously discussed in Part II, arise when a taxpayer cannot ascertain the asset’s useful life and must add the cost to the asset’s basis. The requirement creates trouble when the “taxpayer cannot justify a useful life for the intangible asset, leaving the taxpayer with a capitalized cost but no amortization deduction to match with the income supposedly resulting from the expenditure.”¹⁰²

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

97. *Id.* at 832 n.16.

98. *Id.* at 833.

99. *Id.* at 834.

100. *INDOPCO, Inc. v. Comm’r*, 503 U.S. 79, 83-84 (1992).

101. *Id.*

102. W. Eugene Seago & D. Larry Crumbley, *INDOPCO: A Tiger, a Pussycat, or a Creature Somewhere in Between?*, 94 J. TAX’N 14, 15 (2001).

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. 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.¹⁰³

For example, the IRS's aggressive position in *Wells Fargo* violated the income matching principle because it forced the corporation to immediately pay its officers the portion of the salaries attributable to the merger (\$150,000), but refused to allow a corresponding deduction for that expense until the enterprise's dissolution.¹⁰⁴ By that time, the time value of money would render the deduction worthless. Therefore, the IRS's position currently overstates the taxpayer's income because the taxpayer cannot deduct the salary cost even though it must pay it currently. Furthermore, no portion of the salaries can be deducted over future years, unlike a tangible asset where the taxpayer can spread the cost of the asset over its useful life. Rather, the taxpayer may only take the deduction at the enterprise's dissolution, which may occur at some unknown point in time, if at all.

The inability to deduct current expenses until the enterprise's dissolution creates a unique problem because it leads to a *significant* matching principle violation. This matching principle violation creates a greater problem than permitted matching principle violations like accelerated depreciation deductions because of the uncertainty regarding the time of dissolution. For example, accelerated depreciation deductions violate the matching principle because they allow taxpayers to take bigger depreciation deductions at the beginning of the corresponding asset's useful life rather than forcing taxpayers to spread these deductions evenly over the asset's useful life. Therefore, the taxpayer's income will be understated in the asset's earlier years and overstated in its later years.¹⁰⁵ However, this situation differs from the situation where a taxpayer pays salaries currently but cannot deduct them until the enterprise's dissolution, because the taxpayer's income will be overstated in the year it pays the salary, without knowing whether it will be understated in a future year to correct the initial overstatement. Also, if the enterprise eventually dissolves, that dissolution is so remote that the time value of money renders that deduction worthless. Although the government loses *some* revenue due to the time value of money in the case of an accelerated depreciation deduction, it does not lose *all* of its revenue. In the scenario created by *INDOPCO*, however, if the taxpayer does not

103. Ingalls, *supra* note 22, at 1170-71.

104. See *Wells Fargo & Co. v. Comm'r*, 224 F.3d 874 (8th Cir. 2000).

105. Accelerated depreciation benefits taxpayers due to the time value of money.

dissolve its enterprise, it loses its *entire* deduction. Furthermore, a taxpayer must dissolve its enterprise to determine how much of its deduction was lost due to the time value of money. The government, on the other hand, loses a quantifiable amount of money. Therefore, being unable to deduct current expenses until the enterprise's dissolution is a unique problem because it leads to a *significant* matching principle violation.¹⁰⁶

C. The IRS's Positions Ignore the Distinction Between Hostile and Friendly Acquisitions

The IRS's aggressive positions also ignore the distinction between hostile and friendly acquisitions. Unlike expenses connected to friendly acquisitions, hostile acquisition defense costs do not create a future benefit.¹⁰⁷ They merely maintain a corporation's status quo.¹⁰⁸ Because hostile acquisition defense costs do not enrich a taxpayer and because the income tax is geared toward taxing wealth, a taxpayer should not have to pay income taxes on hostile acquisition defense costs.¹⁰⁹ Finally, courts can detect which costs are associated with hostile versus friendly acquisitions. Thus, drawing this distinction creates no danger. Taking all of these factors into consideration, the IRS's refusal to distinguish between hostile and friendly acquisitions lacks substantive rationale.

First, expenses related to defending a business from a hostile takeover fit squarely into § 162(a)'s definition of a current deduction.¹¹⁰ To qualify under § 162(a), an item must be: (1) paid or incurred during the taxable year; (2) used for carrying on any trade or business; (3) an expense; (4) a necessary expense; and (5) an ordinary expense.¹¹¹ An expense to defend against a hostile acquisition clearly represents an expense the taxpayer pays during the taxable year for the purpose of carrying on a trade or business.¹¹² Moreover:

[i]n light of [the duties the board of directors owes shareholders], it easily can be argued that expenditures made in defense of a hostile

106. One commentator argues that the matching principle is not a tax value but rather a financial accounting concept. Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL'Y 17 (1998). Geier's article, however, espouses the minority view. The matching principle is very much regarded as a "systematic tax benefit rule." See Julie A. Roin, *Unmasking the "Matching Principle" in Tax Law*, 79 VA. L. REV. 813, 814 (1993).

107. Heidi Kathryn Wambach, *The Deductibility of Business Expenses Incurred in a Hostile Takeover: Staley Rides Again*, 51 SMU L. REV. 1603, 1626 (1998).

108. *Id.*

109. Although one could argue that a future benefit exists in being a company that nobody can takeover, the IRS has never tried to make this argument. Moreover, this benefit seems more psychic than economic.

110. Wambach, *supra* note 107, at 1620.

111. *Comm'r v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 352 (1971).

112. Wambach, *supra* note 107, at 1626-27.

acquirer's bid should not be capitalized but rather deducted in the current year because such duties make the board's defenses "necessary." In addition, such defenses are "ordinary" in that any and every board would act in conformance with these fiduciary mandates.¹¹³

Furthermore, unlike friendly takeover expenses, § 263(a) does not apply to hostile acquisition defense costs because these costs do not provide a future benefit.¹¹⁴ Rather, they leave the company in the same position it found itself in before the attempted takeover.¹¹⁵ Because hostile acquisition expenses are inherently different from friendly acquisition expenses, the IRS should let taxpayers treat hostile acquisition expenses differently by allowing them to currently deduct hostile acquisition expenses while requiring them to capitalize friendly acquisition expenses.

Some commentators argue that allowing taxpayers to currently deduct defensive activities costs "amounts to a governmental subsidy to parties resisting tender offers."¹¹⁶ One commentator insists that because "allowing a deduction indicates Congress's willingness to permit or often encourage the activity that qualifies for the deduction,"¹¹⁷ allowing a current deduction for hostile acquisition expenses encourages "corporate taxpayers to push the limits of credulity and attempt to attribute as many expenses as possible to defensive measures devoid of any future benefit."¹¹⁸

Tax laws truly can have unintended effects on taxpayers. For example, assigning fair market value basis to property in decedents' estates¹¹⁹ creates an incentive for people to retain property rather than sell it and put it to its best use. This unintended effect, however, becomes neutralized by a tax objective, namely that estates pay taxes on a property's fair market value and not on the value of the decedent's basis in the property.¹²⁰ Similarly, although allowing a deduction for hostile acquisition defense costs may inadvertently encourage companies to engage in more hostile acquisition defense activities, another tax objective cancels this effect: the taxation of income

113. *Id.* at 1622.

114. Sarah R. Lyke, Note, *INDOPCO, Inc. v. Commissioner: National Starch Decision Adds Wrinkles to Capital Expenditure Issue*, 88 NW. U. L. REV. 1239, 1258-59 (1994) ("Like a repair, the defense is not an improvement and thus yields no continuing benefit.").

115. *Id.* at 1258 ("[S]uch costs, like repair costs, are incurred only to maintain the status quo.").

116. Roberts, *supra* note 33, at 513.

117. *Id.*

118. *Id.*; see also Sheppard, *supra* note 3, at 1460 ("[A]re not the parties just haggling about price? Expenses of resisting a hostile takeover could be viewed as part of a larger capital transaction.").

119. I.R.C. § 1014(a)(1) (1994 & Supp. V 1999).

120. *Id.* § 2031(a) (1994).

as a proxy to taxing wealth.¹²¹ Therefore, not taxing companies that have spent a lot of money defending themselves because they have little wealth and, consequently, cannot pay more taxes, overrides the *possible* unintended effect of encouraging companies to engage in more hostile acquisition defense activities.

To address this commentator's second point, judges are wise enough to know when taxpayers are trying to pull the wool over their eyes by disguising friendly acquisition costs as hostile acquisition costs. For example, in *Victory Markets, Inc. v. Commissioner*,¹²² the petitioner argued that its acquirer was unfriendly. However, the court determined the opposite.¹²³ Victory Markets was a publicly traded corporation in the over-the-counter market, where its common stock traded from \$15.50 to \$24.50 per share between May 1985 and May 27, 1986.¹²⁴ When LNC Industries Proprietary, Ltd. (LNC), began targeting Victory Markets on May 23, 1986, Victory Markets rejected LNC's initial \$30 per share offer.¹²⁵ However, on June 8, 1986, it agreed to merge with LNC for \$37 per share.¹²⁶

The court addressed whether Victory Markets could currently deduct the expenditures incident to LNC's acquisition.¹²⁷ Victory Markets argued that, unlike the acquirer in *INDOPCO*, LNC acquired Victory Markets in a hostile takeover and therefore *INDOPCO* did not apply.¹²⁸ However, the court found that "[w]hile petitioner had painstakingly attempted to characterize the nature of the takeover as hostile, the evidence does not support such a characterization or finding."¹²⁹ The court found the following facts indicated that the transaction was friendly: (1) Victory Markets entered into an agreement and plan of merger with LNC only sixteen days after LNC's initial contact with it;¹³⁰ (2) LNC's initial contact letter stated its desire to negotiate a mutually acceptable merger agreement and its hope that the "transaction can be completed on a mutually acceptable and friendly basis"¹³¹; (3) "at no time did LNC attempt to circumvent the board of directors by making a tender offer directly to petitioner's

121. See Alvin Warren, *Would a Consumption Tax Be Fairer Than an Income Tax?* 89 YALE L.J. 1081, 1081 (1980) ("Levying the tax on income is . . . simply a logical concomitant of the proposition that society in general has a claim on its annual product that is prior to the claim of its individual citizens.").

122. 99 T.C. 648 (1992).

123. *Id.* at 661-62.

124. *Id.* at 649.

125. *Id.* at 651, 654.

126. *Id.* at 655.

127. *Id.* at 657.

128. *Id.*

129. *Id.* at 661-62.

130. *Id.* at 655.

131. *Id.* at 662.

shareholders”¹³²; and (4) the board did not activate its dividend rights plan, one of its hostile takeover defenses.¹³³ Therefore, *Victory Markets* not only illustrates that courts can distinguish between friendly and hostile transactions, but it also outlines many factors that future courts can use as guidance to distinguish between different types of corporate transactions.

Commentators are also concerned by the fact that after the target unsuccessfully defends the acquisition, the acquirer becomes the party seeking the deductions for the target’s unsuccessful resistance costs.¹³⁴ This fact concerns commentators because the acquirer-taxpayer simultaneously capitalizes its own acquisition costs and currently deducts the former target’s defense costs.¹³⁵

Although this dichotomy seems like a bonus to the acquirer, it really is not. When an acquirer buys a corporation, it buys all of its assets and liabilities. Therefore, although the acquirer buys a company with currently deductible defense costs, it also buys a company with less assets because a portion of them paid for heavy investment banking fees.

VI. NOTHING LEFT OF *INDOPCO*

Displeased with the IRS’s aggressive positions, post-*INDOPCO* courts have limited *INDOPCO* considerably. The Third Circuit prevented the IRS from forcing taxpayers to capitalize previously deductible expenses without a valid tax rationale, despite *INDOPCO*’s “deductions are exceptions to the norm of capitalization” language, by placing an extra restriction on the separate and distinct asset test.¹³⁶ The Eighth Circuit prevented the IRS from forcing taxpayers to capitalize previously deductible expenses by severely restricting *INDOPCO*’s future benefit test.¹³⁷ Finally, using the business attack defense doctrine, the Seventh Circuit narrowed *INDOPCO*’s holding to apply only to friendly takeover acquisitions.¹³⁸

A. *PNC Bancorp Places a Restriction on the Separate and Distinct Asset Test*

Courts have limited *INDOPCO* by narrowly applying the separate and distinct asset test. For example, in *PNC Bancorp*, the court restricted the separate and distinct asset test by holding that to be

132. *Id.*

133. *Id.*

134. Roberts, *supra* note 33, at 513 n.161.

135. *Id.*

136. *PNC Bancorp, Inc. v. Comm’r*, 212 F.3d 822, 830 (3d Cir. 2000).

137. *Wells Fargo & Co. v. Comm’r*, 224 F.3d 874, 886 (8th Cir. 2000).

138. *A.E. Staley Mfg. Co. v. Comm’r*, 119 F.3d 482, 489 (7th Cir. 1997).

capitalizable, an expense must create a separate and distinct asset or be more than an expense associated with separate and distinct asset creation.¹³⁹ This clever distinction prevented the IRS from forcing banks to capitalize expenses it had always deducted.¹⁴⁰

PNC Bancorp addressed whether a bank could deduct certain marketing, researching, and loan originating expenses.¹⁴¹ The Third Circuit held these costs currently deductible and initially found that they were clearly ordinary and necessary business expenses under § 162(a).¹⁴² The court then addressed whether the banks incurred these costs for “betterments to increase the value of property in a way that would require these costs’ capitalization under § 263.”¹⁴³ The court applied *Lincoln Savings*’s separate and distinct asset test and concluded that the taxpayer’s marketing and origination activities were currently deductible because they did not actually “create” the banks’ loans in the same way that the activities in *Lincoln Savings* created the Secondary Reserve fund.¹⁴⁴ Although the expenses in question were either associated with the loans, incurred in connection with the acquisition of the loans, or “directly related to the creation of the loans,” they did not “create” the loans.¹⁴⁵ The court contrasted the way the payments themselves formed the Secondary Reserve corpus in *Lincoln Savings* with how the expenses in this case did not become part of the loan balance.¹⁴⁶

The Third Circuit in *PNC Bancorp* restricts the IRS’s aggressive position in two ways. First, it places an extra restriction on the separate and distinct asset test, which distinguishes between costs that create a separate and distinct asset versus costs associated only with a separate and distinct asset’s creation. Apparently, the court recognized that the IRS’s opportunistic pursuit of capitalization for previously deductible expenses lacked substantive rationale.¹⁴⁷

139. *PNC Bancorp*, 212 F.3d at 830.

140. *See id.* at 834-35.

141. *Id.* at 824. The *PNC Bancorp* tax court held that taxpayers cannot currently deduct these costs because banks incur them to create new loans, which are separate and distinct bank assets. Therefore, banks must capitalize these costs as though they created a separate and distinct asset. *PNC Bancorp, Inc. v. Comm’r*, 110 T.C. 349, 375 (1998), *rev’d*, 212 F.3d 822 (3d Cir. 2000).

142. *PNC Bancorp*, 212 F.3d at 829.

143. *Id.*

144. *Id.* at 829-30.

145. *Id.* (quoting *PNC Bancorp, Inc. v. Comm’r*, 110 T.C. 349, 366 (1998)).

146. *Id.* at 830.

147. *Id.* at 824-25.

Historically, the costs at issue have been deductible in the year that they are incurred; however, the Commissioner rejected this tax treatment by PNC. Why is the Commissioner now insisting upon capitalization of these costs? . . . [T]he IRS apparently viewed *INDOPCO* as a reason to pursue capitalization of the costs that SFAS 91 requires to be deferred.

Second, the *PNC Bancorp* court reduced *INDOPCO* to its facts by confining it to mergers.¹⁴⁸ The court used language such as “in the merger situation presented in *INDOPCO*,”¹⁴⁹ as well as “[i]n the *INDOPCO* context of a friendly takeover, the Court found”¹⁵⁰ These statements indicate that the court narrowly construed *INDOPCO*.

B. Wells Fargo Extends the “Origin of the Claim” Doctrine to Create the Direct/Indirect Test

The *Wells Fargo* court also prevented the IRS from forcing taxpayers to capitalize previously deductible expenses by severely restricting *INDOPCO*'s future benefit test. One commentator accurately predicted the IRS's position in *Wells Fargo*:

If “the existence of future benefits” is the key criterion for capitalization despite the capital transaction facts of *INDOPCO*, taxpayers may very well encounter nondeductibility of expenses that were heretofore believed to be currently deductible, including the following items: . . . Executive salaries and other expenses associated with strategic planning by middle level and upper level management in developing plans and techniques for business growth and expansion The rationale? A business's growth is a long term benefit. If the CEO and other senior executives of a corporation spend half their time in strategic planning and developing growth strategies, then perhaps an allocable one-half of their compensation must be capitalized.¹⁵¹

Indeed, in *Wells Fargo*, the IRS tried to deny a deduction of \$150,000, which represented the portion of the target's officers' salaries attributable to their work on the acquisition, even though the target did not hire any of them specifically for that task.¹⁵² Although the Tax Court sided with the IRS,¹⁵³ the Eighth Circuit held that the taxpayer need not capitalize the \$150,000.¹⁵⁴ The appellate court rea-

148. See Fenicato, *supra*, note 70, at 14 (“Since PNC's costs could not even remotely resemble a merger, the Court confined *INDOPCO* to its facts, reined-in the IRS, and pulled the plug on its broad interpretation of *INDOPCO*.”).

149. *PNC Bancorp*, 212 F.3d at 833.

150. *Id.*

151. Elliot, *supra* note 2, at 31.

152. *Wells Fargo & Co. v. Comm'r*, 224 F.3d 874, 880 (8th Cir. 2000).

153. *Norwest Corp. v. Comm'r*, 112 T.C. 89, 102 (1999), *rev'd sub nom. Wells Fargo & Co. v. Comm'r*, 224 F.3d 874 (8th Cir. 2000).

In sum, we hold that [the taxpayer] may not deduct any of the disputed costs because all costs were sufficiently related to an event that produced a significant long-term benefit. Although the costs were not incurred as direct costs of facilitating the event that produced the long-term benefit, the costs were essential to the achievement of that benefit.

Id.

154. *Wells Fargo*, 224 F.3d at 889.

soned that because the salary expenses related only indirectly to the merger, they were currently deductible.¹⁵⁵ Importantly, this holding recognized that to capitalize an expense, the expense not only must relate to a transaction that produces a future benefit, but also must *directly* relate to that transaction.

The *Wells Fargo* court arrived at this direct/indirect test by extending the “origin of the claim doctrine,” which it had originally used to distinguish personal expenses from business expenses and capital business expenses from ordinary business expenses.¹⁵⁶ In doing so, the *Wells Fargo* court restricted *INDOPCO*’s future benefit test. Applying this new version of the future benefit test, *Wells Fargo* distinguished itself from *INDOPCO* by finding that the costs in *INDOPCO* directly related to the acquisition, while *Wells Fargo*’s petitioner’s costs related indirectly to the acquisition because they originated from an employment relationship.¹⁵⁷ Accordingly, the taxpayer in *INDOPCO* had to capitalize its expenses, while the taxpayer in *Wells Fargo* did not. By placing an additional restriction on the future benefit test, the Eighth Circuit further limited *INDOPCO*.

C. A.E. Staley Narrows *INDOPCO* to *Friendly Acquisitions*

Finally, in *A.E. Staley Manufacturing Co. v. Commissioner*,¹⁵⁸ the Seventh Circuit severely restricted *INDOPCO*’s application by limiting it to friendly acquisitions. *A.E. Staley* addressed whether a target could currently deduct the investment banking fees it incurred while defending against a hostile takeover.¹⁵⁹ In holding that it could, the court reasoned that costs associated with hostile takeover defense costs differed from friendly acquisition costs because hostile takeover defense costs were considered business attack defense costs.¹⁶⁰ The “business attack defense” states that businesses can deduct expenses that they incur “for the protection of an existing investment, the continuation of an existing business, or the preservation of existing income from loss or diminution”¹⁶¹ *A.E. Staley* marked the first appellate court case to apply the business attack defense to a hostile takeover scenario.¹⁶² In *A.E. Staley*, the court found that taxpayers

155. *Id.* at 888.

156. *Id.* at 886.

157. *Id.* at 887-88.

158. 119 F.3d 482 (7th Cir. 1997).

159. *Id.*

160. *Id.* at 491-92.

161. *Id.* at 488 n.2 (quoting *NCNB Corp. v. United States*, 684 F.2d 285, 290 (4th Cir. 1982)).

162. The first court to apply the business attack defense to a hostile takeover scenario was a bankruptcy court. *In re Federated Dep’t Stores*, 171 B.R. 603 (S.D. Ohio 1994). That court found that *INDOPCO* did not undermine the earlier business attack defense decisions. *Id.* at 608-10. Furthermore, it found that hostile takeover cases are business attack

could assert the business attack defense in hostile acquisitions because *INDOPCO* neither abrogated nor addressed cases such as *NCNB Corp. v. United States*.¹⁶³

A.E. Staley involved a merger between a target, Staley Continental, Inc. and Subsidiaries (SCI), and an acquirer, Tate & Lyle.¹⁶⁴ When SCI began to fear the possibility of a hostile takeover, it hired a law firm to advise it on anti-takeover measures.¹⁶⁵ SCI also hired Merrill Lynch as its investment banker to prepare, advise, and assist SCI in the event of a hostile takeover.¹⁶⁶ Because Merrill Lynch suggested “that SCI identify friendly ‘white knight’ investors to acquire enough stock in SCI to block any future takeover attempt, SCI sought out Tate & Lyle and discussed the possibility of Tate & Lyle’s acquiring a 20 percent interest in SCI.”¹⁶⁷ But when Tate & Lyle acquired four percent of the company, SCI began to fear that Tate & Lyle would try to acquire the entire company.¹⁶⁸

Tate & Lyle confirmed SCI’s anxiety and turned from a white knight into a dark prince, making a \$32 per share tender offer directly to SCI’s stockholders.¹⁶⁹ Moreover, it sued SCI to enjoin its use of anti-takeover devices.¹⁷⁰ But because SCI’s board recognized it had a duty to evaluate the tender offer’s merits, it hired the investment

defense cases because they involve taxpayers who incur expenses to protect corporate policy and structure but not to acquire a new asset. *Id.*

163. 684 F.2d 285 (4th Cir. 1982). An issue in *NCNB* concerned whether North Carolina National Bank’s parent corporation, NCNB Corporation, could currently deduct the expenses incurred in developing and operating a statewide network of branch banking facilities. *Id.* at 290. In holding that it could, the court reasoned that such expenses were necessary to maintain NCNB’s position in the banking industry. *Id.* In other words, these expenses were currently deductible as business defense expenses. The court also discussed a case, *Comm’r v. Heininger*, 320 U.S. 467 (1943), in which the U.S. Supreme Court held that a taxpayer could currently deduct the legal fees he incurred in litigating against an order by the Postmaster General depriving his mail order business from use of the mails. *Id.* at 474. The Court reasoned that because the Postmaster General’s legal action threatened to destroy the taxpayer’s business, the taxpayer could deduct the costs as ordinary and necessary business expenses. *Id.* at 471. The *A.E. Staley* court also discussed a case, *Locke Mfg. Cos. v. United States*, 237 F. Supp. 80 (D. Conn. 1964), where the court held that a company could deduct its proxy contest expenses after successfully resisting a stockholder’s challenge, “including legal fees, proxy solicitor’s fees and public relations fees.” *A.E. Staley*, 119 F.3d at 488. The *A.E. Staley* court quoted a portion of *Locke* that discussed how “it was ordinary for a company to spend money ‘to defend the policies of its directors from attack by those who would oppose them.’” *Id.* at 488 (quoting *Locke*, 237 F. Supp. at 86-87).

164. *A.E. Staley*, 119 F.3d at 484.

165. *Id.*

166. *Id.*

167. *Id.*

168. *Id.* Evidence that Tate & Lyle would try to acquire the entire company included the fact that it would not sign a “standstill agreement” which would have limited the amount of SCI stock it could purchase. *Id.*

169. *Id.*

170. *Id.*

bankers for advice and assistance.¹⁷¹ SCI's board then unanimously voted to reject the \$32 per share offer and a subsequent \$35 per share offer.¹⁷² But when Tate & Lyle increased its tender offer to \$36.50 per share, the board voted to accept the offer because the investment bankers said it was fair and because no alternative acquirers surfaced.¹⁷³

By the time the parties consummated the transaction, SCI had paid the investment bankers \$12.5 million for services in connection with SCI's tender offers.¹⁷⁴ SCI attempted to deduct these costs as business expenses, but the Commissioner disallowed the deduction.¹⁷⁵ Because the Supreme Court failed to limit its *INDOPCO* holding to friendly acquisitions, the IRS attempted to make the taxpayer capitalize its hostile acquisition defense costs.¹⁷⁶ Moreover, the IRS tried to enforce a "per se transformation rule," which states that any transaction where a corporate taxpayer is transformed from a publicly held corporation to a single shareholder corporation involves a future benefit and, therefore, any expenses the taxpayer incurs with respect to such a transformation are capital expenditures.¹⁷⁷

The tax court sided with the IRS, although it tried to avoid adopting the per se transformation rule.¹⁷⁸ The court found that the taxpayer had to capitalize the hostile acquisition defense costs for the following reasons: the new owner saw synergy opportunities; the board eventually approved the transaction; and the same shareholder-related benefits that the Supreme Court looked at in *INDOPCO*, including the reduction in shareholder-related benefits, existed in this case.¹⁷⁹

However, as Judge Cohen's dissent stated, the only future benefits discussed in the majority opinion were those the acquirer perceived.¹⁸⁰ Moreover, the majority's statement about reduction of shareholder-related expenses made it seem as if it is always better for a corporation to be privately held rather than publicly held.¹⁸¹ But, as Judge Laro noted in his dissent, "[a] private company does not have access to the public markets for new capital and does not

171. *Id.*

172. *Id.* at 485.

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

177. *A.E. Staley Mfg. Co. v. Comm'r*, 105 T.C. 166, 191-92 (1995), *rev'd*, 119 F.3d 482 (7th Cir. 1997).

178. *Id.* at 200.

179. *Id.* at 198.

180. *Id.* at 215 (Cohen, J., dissenting).

181. *Id.*

have the same liquidity for its shareholders.”¹⁸² Thus, Judge Laro suggested that one cannot conclude that a company achieves a benefit in itself just by going private.¹⁸³

Convinced by the Tax Court’s dissents, the Seventh Circuit reversed the Tax Court.¹⁸⁴ It found that SCI’s hostile acquisition costs were costs associated with defending a business rather than costs associated with facilitating a capital transaction.¹⁸⁵ It reasoned that “SCI was defending against an unwanted acquisition in an effort to maintain and protect an established business.”¹⁸⁶ Therefore, SCI’s hostile acquisition defense costs were currently deductible.¹⁸⁷

Remarkably, this holding declined to follow *INDOPCO*, even though the *INDOPCO* opinion did not indicate that the “friendly” aspect of the transaction was dispositive or that the outcome would differ if the takeover were considered “hostile.”¹⁸⁸ Evidently, the court disagreed with the IRS’s aggressive post-*INDOPCO* positions and restricted the IRS by carving a big chunk out of *INDOPCO*. After the *A.E. Staley* decision, trial courts in the Seventh Circuit may only apply *INDOPCO* to friendly acquisitions.

Additionally, *A.E. Staley* provided target corporations with the § 165 safety net. Section 165 provides that “[t]here shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.”¹⁸⁹ Particularly, § 165 permits taxpayers to deduct costs associated with abandoned capital transactions.¹⁹⁰ Therefore, the court found that SCI could have deducted the investment banking fees and other costs it incurred while resisting Tate & Lyle’s takeover under this section also.¹⁹¹ The court seemed to tell taxpayers that if other circuits fail to respect the hostile versus friendly acquisition distinction, § 165 gives them another shield to protect themselves from the IRS’s aggressive positions.¹⁹²

182. *Id.* at 219 (Laro, J., dissenting).

183. *Id.*

184. *A.E. Staley Mfg. Co. v. Comm’r*, 119 F.3d 482, 493 (7th Cir. 1997).

185. *Id.* at 489-90.

186. *Id.* at 490.

187. *Id.* at 491.

188. Roberts, *supra* note 33, at 494 n.38.

189. I.R.C. § 165(a) (1994).

190. *A.E. Staley*, 119 F.3d at 490.

191. *Id.*

192. However, § 165 is less effective than the business attack defense because it does not cover successful defensive techniques such as a self-tender. Roberts, *supra* note 33, at 519.

VII. NOTHING LEFT OF *INDOPCO*: LET'S KEEP IT THAT WAY!

Although post-*INDOPCO* courts have severely restricted *INDOPCO*, it is still “the supreme law of the land.”¹⁹³ Furthermore, nine of twelve circuits still have not commented on the case. The circuits that have spoken on *INDOPCO* have each overturned tax court decisions that sided with the IRS.¹⁹⁴ Therefore, Congress should direct the Treasury to enact regulations that codify the Third, Seventh and Eighth Circuit holdings to unify the law in all circuits. If the Treasury does not enact such regulations, the IRS will continue to pursue its aggressive positions and use the ammunition provided by *INDOPCO* against taxpayers.¹⁹⁵ First, *INDOPCO* contains the following powerful and pro-IRS language: “deductions are exceptions to the norm of capitalization.” Second, *INDOPCO* favors the IRS by lifting the “separate and distinct asset barrier” that five circuits have used to confine the IRS. After *INDOPCO*, the IRS could deny current deductions in cases where the expense created some type of future benefit for the taxpayer, even though it did not create a separate and distinct asset. Finally, because the Supreme Court in *INDOPCO* did not limit its holding to friendly acquisitions, the IRS could freely deny current deductions for expenses related to both friendly and hostile acquisitions. Despite *A.E. Staley*'s holding, which limited *INDOPCO* to friendly acquisitions, “[t]he IRS has vowed to pursue capitalization in *Staley*-type issues in the future.”¹⁹⁶

Another justification for codification of the Third, Seventh and Eighth Circuit holdings relates to the poor policy that the IRS's aggressive post-*INDOPCO* positions promote. First, the Service's aggressive, opportunistic positions lack substantive rationale. Second, the Service's aggressive positions violate the matching principle. Finally, the Service's aggressive positions ignore the difference between hostile and friendly acquisitions. Therefore, the Treasury should promote a sound policy by enacting such regulations.

The Treasury should enact the suggested regulations by including them as “Types of Non-Capital Expenditures” under § 263(a)'s treasury regulations. The first type of noncapital expenditures the Treasury should include are expenses regularly incurred in the creation of

193. *INDOPCO* was also a unanimous decision.

194. *E.g.*, *Wells Fargo & Co. v. Comm'r*, 224 F.3d 874 (8th Cir. 2000), *rev'g* *Norwest Corp. v. Comm'r*, 112 T.C. 89 (1999); *PNC Bancorp, Inc. v. Comm'r*, 212 F.3d 822 (3d Cir. 2000), *rev'g* 110 T.C. 349 (1998); *A.E. Staley Mfg. Co. v. Comm'r*, 119 F.3d 482 (7th Cir. 1997), *rev'g* 105 T.C. 166 (1995).

195. *Seago & Crumbley*, *supra* note 102, at 14 (“The Supreme Court's decision in *INDOPCO* . . . created a new weapon for IRS agents and much uncertainty for tax practitioners.”) (citation omitted).

196. *Wambach*, *supra* note 107, at 1621.

separate and distinct assets.¹⁹⁷ Examples of these types of noncapital expenditures include the marketing, researching, and loan originating expenses at issue in *PNC Bancorp*.¹⁹⁸ The Treasury should also include expenses incurred in connection with, but not directly related to, a capital acquisition. An example of this type of noncapital expenditure is the portion of the target officers' salaries attributable to their work on a friendly acquisition, such as the one involved in *Wells Fargo*.¹⁹⁹ Finally, the Treasury should include expenses incurred to defend a business against a hostile acquisition. An example of this type of noncapital expenditure is the investment banking fees the target paid Merrill Lynch in *A.E. Staley*.²⁰⁰

Alternatively, the treasury regulations could enumerate the type of capital acquisition costs that are capitalizable and limit those costs to investment banking and legal fees associated with friendly acquisitions. The Treasury should also list factors to help courts distinguish between friendly and hostile acquisitions. For this purpose, the Treasury should borrow *Victory Markets'* factors.²⁰¹ Such factors include: (1) the number of days elapsed from initial contact to the parties' final agreement; (2) whether the acquirer went directly to the shareholders, thereby circumventing the board of directors; and (3) whether the target had anti-takeover devices, such as poison pills, but failed to use them.²⁰²

VIII. CONCLUSION

Although *INDOPCO's* reach initially frightened taxpayers, in the last decade courts have stepped in to ease some of these fears. Recognizing that the IRS's aggressive post-*INDOPCO* behavior promotes bad policy, courts have used a range of judicial doctrines to contain this behavior. However, because *INDOPCO* represents current law and many circuits have yet to touch upon the numerous issues it raises, taxpayers need more protection from *INDOPCO*. Therefore, Congress should direct the Treasury to enact regulations that codify the Third, Seventh and Eighth Circuit holdings to prevent the IRS from asserting its aggressive post-*INDOPCO* positions in other circuits.

197. The petitioner took this position in *PNC Bancorp*. 110 T.C. at 349.

198. *See id.* at 366.

199. *E.g.*, *Norwest Corp. v. Comm'r*, 112 T.C. 89, 102 (1999), *rev'd sub nom.* *Wells Fargo & Co. v. Comm'r*, 224 F.3d 874 (8th Cir. 2000).

200. *E.g.*, *A.E. Staley Mfg. Co. v. Comm'r*, 105 T.C. 166, 219 (1995), *rev'd*, 119 F.3d 482, 493 (7th Cir. 1997).

201. *See Victory Mkts., Inc. v. Comm'r*, 99 T.C. 648 (1992).

202. *Id.* at 655, 662.