The Deductibility of Business Expenses Incurred in a Hostile Takeover: Staley Rides Again

Heidi Katheryn Wambach

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I. INTRODUCTION

Controversy still abounds in the perennial debate over whether certain expenditures should be currently deducted as business expenses under section 162 of the Internal Revenue Code of 1986 (the Code) or capitalized under section 263. Nowhere is the debate more heated than in the area of mergers and acquisitions. Corporate taxpayers, the I.R.S., the United States Tax Court, and the Supreme Court have wrestled with the deductibility of expenses, such as investment banking fees and attorney's fees, incurred in takeover, merger, and reorganization contexts. In the area of friendly takeovers, the Supreme Court has put the issue of deductibility to rest in the landmark case of *INDOPCO v. Commissioner*, which established the capitalization of expenses incurred incident to a friendly merger.\(^2\) However, in the hostile takeover context, no clear cut line has been drawn. While the recent Seventh Circuit’s reversal of the controversial *A.E. Staley Manufacturing Co. v. Commissioner* case may have offered temporary relief to corporate taxpayers in the Seventh Circuit, the decision’s guidance is tenuous at best.\(^3\) Still, the decision has renewed the debate over the proper tax treatment such expenses should be given when incurred in a hostile takeover setting.

This Comment agrees with the recent position taken by the Seventh Circuit Court of Appeals in *Staley* that such expenses, especially those incurred by corporations defending against a hostile bidder, should be deductible in the current taxable year under section 162. First, it will examine the background of deductibility and capitalization in general, as well as the many factors articulated by the courts in determining whether an expenditure should be deducted or capitalized. Next, it will outline the historical tax treatment of expenses in takeover contexts, focussing

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3. 119 F.3d 482 (7th Cir. 1997) (reversing the previously controversial Tax Court ruling, 105 T.C. 166 (1995)).
especially on the controversial Staley decision. Finally, it will consider the many arguments in favor of current deductibility.

II. BACKGROUND

A. DEDUCTIONS IN GENERAL

A corporation's tax liability is determined by the amount of its taxable income in a given year, calculated as "gross income minus deductions ...." Deductions are generally allowed under section 161 of the Code as items specified in Part VI, subject to the general disallowance of deductions provided in section 261.

1. Characteristics and Treatment of Deductions

Deductions are "a matter of legislative grace." They are specifically enumerated in the Code and are therefore "subject to disallowance in favor of capitalization." In contrast, non-deductible capital expenditures are not exhaustively enumerated in the Code; rather than providing a "complete list of non-deductible expenditures," § 263 serves as a general means of distinguishing capital expenditures from current expenses. For these reasons, deductions are strictly construed and allowed only "as there is a clear provision therefore." Accordingly, deductions should be narrowly construed pursuant to statute.

Furthermore, the burden is on the taxpayer to prove the validity of a deduction under section 162. In the takeover context, "In allocating the professional expenses, the taxpayer has the burden of establishing which litigation and other expenditures relate to resisting the hostile takeover and are therefore deductible in the current taxable year. If the taxpayer does not present sufficient evidence, all its expenses have to be capitalized."

2. Purpose Behind Deductions

Proper allocation of deductible and non-deductible expenses is critical to one of Congress's long-standing goals—to provide a clear reflection of income. As such, "the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable,

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5. Id. § 63(a).
6. Id. § 161.
9. Id. (citations omitted).
11. See Interstate Transit, 319 U.S. at 593.
thereby resulting in a more accurate calculation of net income for tax purposes."13 Those expenditures that give rise to a benefit extending to one or more future periods, or those that result in the acquisition of an asset whose useful life is longer than one year, will be capitalized rather than deducted.14 For purposes of computation, "the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income."15 Furthermore, the Treasury Regulations explain that "[t]his period shall be determined by reference to [the taxpayer's] experience with similar property taking into account present conditions and probable future developments."16 Determining the useful life of an asset is subjective and speculative, and often serves as a point of contention between taxpayers and the I.R.S.17

3. Statutory Requirements for Business Deductions

Under section 162(a), a trade or business expense is deductible if it is (1) ordinary and necessary; (2) an expense rather than capital expenditure; (3) paid or incurred during the taxable year; and (4) made while carrying on any trade or business. The taxpayer must clearly show all four elements to obtain a deduction; otherwise, the expenditures will be capitalized.18

Determination of whether an expense meets the deductibility test outlined in section 162(a) usually revolves around the "ordinary and necessary" requirement. This requirement has been difficult to define, and the many cases that examine "ordinary and necessary" expenses have proven troublesome to harmonize, as they involve the "appreciation of particular situations" and "border-line conclusions."19

"Ordinary" can be described as that which is "normal, usual or customary"20 and is generally thought to encompass expenses "of common or frequent occurrence in the type of business involved."21 However, the Supreme Court has suggested that "[o]rdinary . . . does not mean . . .

13. INDOPCO, 503 U.S. at 84.
14. See Hotel Kingkade v. Comm'r, 180 F.2d 310, 312 (10th Cir. 1950).
15. Treas. Reg. § 1.167(a)-1(b) (as amended in 1972).
16. Id.
17. See Ingalls, supra note 12, at 1209 n.23.
19. Welch v. Helvering, 290 U.S. 111, 116 (1933). For expenses found to be "ordinary" see Commissioner v. People's Pittsburgh Trust Co., 60 F.2d 187 (3d Cir. 1932); American Rolling Mill Co. v. Commissioner, 41 F.2d 314 (6th Cir. 1930); Corning Glass Works v. Lucas, 37 F.2d 798 (D.C. Cir. 1929); Harris & Co. v. Lucas, 48 F.2d 187 (5th Cir. 1931). For expenses found not to be "ordinary" see Hubinger v. Commissioner, 36 F.2d 724 (2d Cir. 1929); Lloyd v. Commissioner, 55 F.2d 842 (7th Cir. 1932); One Hundred Five West Fifty-Fifth St. v. Commissioner, 42 F.2d 849 (2d Cir. 1930); Blackwell Oil & Gas Co. v. Commissioner, 60 F.2d 257 (10th Cir. 1932); and White v. Commissioner, 61 F.2d 726 (9th Cir. 1932).
21. Id. (citing Welch, 290 U.S. at 114).
habitual or normal in the sense that the same taxpayer will have to make them often... [Some events] may happen once in a lifetime." Courts have allowed deductions under section 162(a) as "ordinary and necessary," even though an event was unusual in the taxpayer's life. However, the unusualness or non-recurring nature of an item can lead to capitalization. In *Motion Picture Capital Corp. v. Commissioner*, the Second Circuit Court of Appeals considered legal fees and other expenses incurred in connection with a merger and found them to be non-deductible as they were unusual in the life of the corporation. The court reasoned:

While it is true that they were ordinary and necessary expenses of the merger and it may be true in broad concept that mergers are ordinary and necessary business occurrences, ... the expenses to be deductible must be incurred by a taxpayer in doing the ordinary and necessary things his business requires to be done [sic] done to make it function as such.

The term "necessary" requires that, at a minimum, the expense be "appropriate and helpful" for "the development of the [taxpayer's] business . . . ." However, because the terms "appropriate" and "helpful" are so broad, "almost any expense incurred in a taxpayer's business, from salaries to staples, will be deemed 'necessary.'" An expense need not be "indispensable" to be necessary.

B. CAPITAL EXPENDITURES IN GENERAL

"A capital expenditure is an outlay of capital that results in the acquisition of property or a permanent improvement in the property's value." Capital expenditures can be divided into two categories: those involving tangible assets and those involving intangible assets. The distinctive tax treatment of tangible and intangible assets can be described as follows:

24. See *Central Tex. Sav. & Loan Ass'n v. United States*, 731 F.2d 1181, 1183 (5th Cir. 1984) (one-time payment found to be a factor supporting capitalization).
25. 80 F.2d 872 (2d Cir. 1936).
26. *Id.* at 873-74.
30. *Ingalls*, supra note 12, at 1169.
31. Property considered to be tangible includes buildings, equipment, and machinery. See *Ingalls*, supra note 12, at 1209 n.26. The depreciation allowance for tangible property "applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence." Treas. Reg. § 1.167(a)-2 (1960).
32. Intangible property is more difficult to define. According to the Regulations, an intangible asset is one that "is known . . . to be of use in the business or in the production of income for only a limited period . . . ." Treas. Reg. § 1.167(a)-3 (1960). Examples of intangible assets include patents and copyrights. See *id.*
If the capital expenditure results in a tangible asset, the capital expenditure is matched with income in the periods it benefits through depreciation. If the capital outlay results in an intangible asset with a determinable useful life, the capital expenditure made to acquire that asset is matched with income in the periods it benefits through amortization. However, intangible assets, like goodwill and going concern value, in that their useful life cannot be ascertained with reasonable accuracy, are not subject to the allowance for depreciation. Money spent on such assets will produce little or no tax benefit to the taxpayer since the taxpayer cannot recover the cost over time as with depreciable assets.\footnote{33}

C. Distinguishing Between Currently Deductible Expenses and Capital Expenditures

The I.R.S. and taxpayers often dispute whether an item is a deductible expense or a capital expenditure. Section 263 serves as the general provision in distinguishing capital expenditures from current expenses. Generally, section 263(a)(1) provides that:

\[\text{No deduction shall be allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate} \ldots \text{[or any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made].}\]

Historically, “[i]n the corporate context, an expenditure was capital in nature if the expenditure bettered the corporation for: (1) the duration of its existence; (2) the indefinite future; or (3) longer than the current taxable year.”\footnote{35}

For the corporate taxpayer the timing of cost recovery is the key advantage of expense over capitalization. Expensing allows a taxpayer to immediately deduct an item to produce lower taxable income, which translates into more disposable income for a corporation in a given year. In addition, items characterized as expenses allow the taxpayer to take advantage of the time value of money.\footnote{36} Conversely, capitalization prevents “a taxpayer from utilizing currently a deduction properly attributable \ldots to later tax years when the capital asset becomes income producing.”\footnote{37} Rather the amounts are “amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise.”\footnote{38}

\begin{itemize}
\item \footnote{33. Ingalls, \textit{supra} note 12, at 1169-70.}
\item \footnote{34. I.R.C. § 263(a)(1) (1994 & Supp. 1997).}
\item \footnote{35. Ingalls, \textit{supra} note 12, at 1174.}
\item \footnote{36. See \textit{id.} at 1170 ("Because of the time value of money, money is worth more to the taxpayer now than if the taxpayer has it at some time in the future. Therefore, a deduction to reduce current taxable income is more advantageous than a deduction which will reduce future taxable income.").}
\item \footnote{37. \textit{Comm'r v. Idaho Power Co.}, 418 U.S. 1, 16 (1974).}
\item \footnote{38. \textit{INDOPCO v. Comm'r}, 503 U.S. 79, 83-84 (1992).}
\end{itemize}
In the context of takeovers, achieving deductibility over capitalization is particularly important.

If expenses incurred by a target corporation during a takeover, for example legal and investment banking fees which typically run into the millions of dollars, are treated as capital expenditures, they create an intangible asset. However, the useful life of the asset cannot be determined. Thus, no deductions for depreciation or amortization would be allowed. Consequently, the expenditures, if capital in nature, have very little tax value. The only deduction given would be at the dissolution of the enterprise. 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.39

III. FACTORS CONSIDERED IN DETERMINING CAPITALIZATION v. DEDUCTION

Because the Code fails to enumerate which expenses should be currently deducted and which should be capitalized, that determination has largely been left to the courts. In the past, courts have looked to a variety of factors in making this determination, including: the creation or enhancement of a separate and distinct asset; the existence of a future benefit; the primary purpose versus the origin of the claim; and the voluntary nature of the item.

A. CREATION OR ENHANCEMENT OF A SEPARATE AND DISTINCT ASSET

While some courts have considered the existence of a separate or distinct asset to be sufficient for a finding of capitalization, it is not a necessary element.40 It does not naturally follow that “only expenditures that create or enhance separate and distinct assets are to be capitalized under § 263.”41 In fact, deductibility has been allowed in cases where a separate asset was created. In Briarcliff Candy Corp. v. Commissioner, the Second Circuit Court of Appeals determined that expenses incurred in expanding a company’s existing business were deductible.42 Additionally, the Fourth Circuit Court of Appeals in NCNB Corp. v. United States found that deductible expenses were incurred in establishing a branch banking system.43

B. EXISTENCE OF A FUTURE BENEFIT

As emphasized earlier, capitalization applies to assets whose useful life

39. Ingalls, supra note 12, at 1170-71.
40. See INDOPCO, 503 U.S. at 87 (“[T]he mere presence of an incidental future benefit—some future aspect—may not warrant capitalization . . . .”).
41. INDOPCO, 503 U.S. at 86-87.
42. 475 F.2d 775, 782 (2d Cir. 1973).
43. 684 F.2d 285 (4th Cir. 1982). But see Central Texas Sav. & Loan Assoc. v. United States, 731 F.2d 1181 (5th Cir. 1984) (finding that a new bank branch created a new asset).
extends "substantially beyond the taxable year." The Treasury Regulations further provide that "[i]f an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made."

Courts have placed great weight on the existence of future benefits as a way of differentiating between items that should be deducted and those that should be capitalized. As the Supreme Court in INDOPCO emphasized, the realization of benefits beyond the taxable year is "undeniably important in determining whether the appropriate tax treatment is [an] immediate deduction or capitalization." Despite the Court's support of this "future benefits" test, the doctrine is "the source of much controversy on capitalization issues arising today."

The Service has outlined the role of the "future benefits" test, as it relates specifically to corporate takeovers, in the following way:

[T]he nature of a proposed corporate takeover (i.e., whether it is friendly or hostile) is not determinative of the proper tax treatment afforded to expenditures for professional fees. Rather, the proper inquiry to be made with respect to these expenditures is whether the target corporation obtained a long-term benefit as a result of making the expenditures. The burden is on the taxpayer to demonstrate that it did not obtain a long-term benefit. . . . Each case will turn on its own specific set of facts and circumstances.

Many of the facts and circumstances, however, lend themselves to a finding of capitalization. For instance, "[e]xpenses incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses" and, therefore, must be capitalized. Also, expenditures made with the corporation's operations and betterment in mind will likely be deemed capital expenditures, if their benefit is seen as extending beyond the taxable year.

It is important to note, however, that while the existence of a future benefit favors capitalization, such a finding is not dispositive or conclusive. Some argue that INDOPCO should not be read so broadly. Rather, "a narrow reading [would] allows courts to make distinctions in whatever way is politically expedient at the time."

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44. Treas. Reg. § 1.263(a)-2(a) (as amended in 1987).
46. INDOPCO v. Comm'r, 503 U.S. at 87.
47. MacNeil et al., supra note 1, at 617.
49. Farmers Union Corp. v. Comm'r, 300 F.2d 197, 200 (9th Cir. 1962), cert. denied, 371 U.S. 861 (1962).
50. See General Bancshares Corp. v. Comm'r, 326 F.2d 712, 715 (8th Cir. 1964).
52. See Lyke, supra note 29, at 1253 ("The [INDOPCO] Court never said that the existence of a future benefit must always result in capitalization . . . .").
53. Id. at 1256.
Also, the duration of the benefit is only one factor to consider. For example, some courts have found that incidental benefits should be excluded when considering the existence of long-term benefits. One Technical Advice Memorandum hinted that the fact that the determination of incidental benefit is subjective at best may be one reason for the exclusion.

C. PRIMARY PURPOSE V. ORIGIN OF THE CLAIM

Another factor examined by the courts early on was the "primary purpose" test. Under this approach, deductions were allowed if expenses were made to benefit all shareholders and in defense of corporate policy rather than for the benefit of particular shareholders or officers. In Sammons v. Commissioner the Fifth Circuit justified the "primary purpose" test in the following way:

"The line between shareholder benefit and corporate benefit is not always clear ... but this does not mean that where the primary or dominant motivation for a distribution was to benefit the shareholder rather than the corporation that the articulation of a concededly subordinate business justification should cause the entire transaction to be recharacterized for tax purposes."

Courts have approved the deductibility of expenses incurred "in a dispute over basic corporate policy" as opposed to disputes over personalities, as long as "the fees were reasonable in amount and were incurred for the benefit of all the shareholders ..." In 1970, however, the Supreme Court rejected the "primary purpose" test, instead favoring the "origin of the claim" test. In determining whether an item is a deductible expense or a capital expenditure, the "origin of the claim" test will look to the nature of the transaction and the subsequent expenditure in controversy. Unlike the "primary purpose" test, the "origin of the claim" test will not consider the taxpayer's motives.

54. See NCNB Corp v. United States., 684 F.2d 285, 289 (4th Cir. 1982).
59. Sammons, 472 F.2d at 452.
62. See Woodward, 397 U.S. at 578.
63. See id.
D. Voluntary Nature of the Item

Another factor influencing courts is the voluntary nature of the expense incurred. Under this approach, "[a] deduction is more likely to be allowed if the expense was forced upon the taxpayer against its will." Conversely, a deduction that is voluntarily incurred by the taxpayer will likely result in capitalization. However, as the case of Woolrich Woolen Mills v. United States illustrates, the voluntariness of the deduction is not conclusive. In Woolrich, the Third Circuit examined the issue of deductibility in the context of whether or not the expense was voluntary. There, the taxpayer was required, under threat of injunction, to build a wastewater filtration plant. Despite the involuntary nature of the expense, the taxpayer was forced to capitalize the costs associated with the project because the life of the asset created was more than one year.

IV. Historical Treatment of Deductibility in Takeover Contexts

A. Takeovers in General

A takeover can be described as a "change in the controlling interest in a corporation," whether by merger, acquisition, or other method, made in either a friendly or hostile manner. Unlike friendly takeovers, which involve corporate interest in and consent to the acquisition, hostile takeovers "almost invariably involve a market purchase of all or a sufficient amount of the targets companies' stock to insure control of the company . . . , [following which] the acquiring corporation will be able to control the operations of the company through its own board of directors. . . ." Such tactics are "often unfair and coercive to existing shareholders," and, thus, a target corporation will not be inclined to accept this type of unwelcome offer.

B. Friendly Takeovers: INDOPCO v. Commissioner

In INDOPCO v. Commissioner, the Supreme Court examined whether professional expenses incurred by a target corporation in the course of a friendly takeover, such as investment banking, attorney fees and other expenses, should be deductible by that corporation as "ordi-
nary and necessary" business expenses under section 162(a). In *INDOPCO*, Unilever United States, Inc. expressed interest in acquiring one of its suppliers, National Starch, in a friendly merger. Subsequently, Unilever's attorneys negotiated to purchase shares of National Starch in a "reverse subsidiary cash merger," under which "[t]wo new [transitory] entities would be created—National Starch and Chemical Holding Corp. (Holding), a subsidiary of Unilever, and NSC Merger Inc., a subsidiary of Holding . . . ." National Starch's board approved Unilever's final offer of $73.50.

On its short-year tax return, National Starch deducted investment banking, legal, and other expenses incurred in the friendly merger. After a later audit, the I.R.S. disallowed the deductions and assessed a deficiency.

In deciding this controversial case, the Supreme Court found that such expenses did not qualify as "ordinary and necessary," and were therefore not deductible in the current year because the "transaction produced significant benefits to National Starch that extended beyond the tax year in question." The Court cited increased resources, synergy, transformation to a wholly owned subsidiary of Unilever, and relief of substantial shareholder-related expenses, such as "reporting and disclosure obligations, proxy battles, and derivative suits" as long-term benefits derived from the acquisition. The Court ultimately concluded that the acquisition-related expenses were capital expenditures, not immediately deductible.

1. Regulatory Limitations on the *INDOPCO* Holding

The holding in *INDOPCO* was limited, however, by later Revenue Rulings. First, Revenue Ruling 92-80 expressly removed advertising expenses from *INDOPCO*'s reach. There, the Service turned to section 1.162-1(a) of the Regulations, which expressly provides that "advertising and other selling expenses" are to be included among the business expenses for which deductibility is allowed. The ruling explained that:

> These costs are generally deductible under [section 162] even though advertising may have some future effect on business activities, as in the case of institutional or goodwill advertising. . . . Only in the unu-

72. See id. at 80.
73. Id. According to the plan, Holding would exchange shares of its non-voting preferred stock for National Starch common stock received from National Starch shareholders. In addition, National Starch common shares not exchanged in such a manner would be "converted into cash in a merger of NSC Merger, Inc., into National Starch." Id.
74. Id. at 88.
75. Id. at 88-89.
76. See id. at 90. The I.R.S. viewed this holding as in-line with fundamental principles of capitalization. See Rev. Rul. 94-12, 1994-8 I.R.B. 5, 1 C.B. 36 (stating that *INDOPCO* did not change the fundamental principles governing capitalization); see also Rev. Rul. 94-77, 1994-2 C.B. 825; Rev. Rul 95-32, 1995-16 I.R.B. 5.
ual circumstances where advertising is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or goodwill advertising, must the costs of that advertising be capitalized.\textsuperscript{79}

Based on this reasoning, the I.R.S. concluded that the \textit{INDOPCO} decision did not alter the general deductibility of advertising costs as business expenses under section 162 of the Code.\textsuperscript{80}

Second, Revenue Ruling 94-77 limited \textit{INDOPCO}'s holding in relation to severance payments.\textsuperscript{81} There, the Service considered whether severance payments made during a period of business downsizing were deductible under section 162.\textsuperscript{82} Despite the fact that such payments could produce "some future benefits," the I.R.S. concluded that the payments "principally relate to previously rendered services" and therefore were deductible.\textsuperscript{83}

2. \textbf{Criticisms of INDOPCO}

The Supreme Court's decision in \textit{INDOPCO} has been criticized on a variety of grounds. First, some have noted that the Court misplaced its corporate structure analysis.\textsuperscript{84}

The [\textit{INDOPCO}] Court further complicated matters by noting that courts have long ruled that expenditures for changing corporate structure are not deductible under I.R.C. section 162. However, there was no change in the corporate structure of National Starch. The cancellation of the authorized preferred stock and the reduction of the number of outstanding common shares were not the type of transactions that have been considered "corporate structure" changes in the cases cited by the Court. The \textit{INDOPCO} case merely involved a shifting of stock ownership.\textsuperscript{85}

The author of this critique concluded that "[t]he Court's analysis of \textit{INDOPCO} as a corporate restructuring was wholly misplaced and tends to decrease the strength of the Court's overall rationale in determining that the professional fees produced long-term benefits."\textsuperscript{86}

Other criticisms of the decision include the Court's failure to address the fiduciary duty argument.\textsuperscript{87} In addition, one commentator cautions against an expansive interpretation of \textit{INDOPCO}, calling such a broad

\textsuperscript{80} See id.
\textsuperscript{82} See id.
\textsuperscript{83} Id.
\textsuperscript{84} See Ingalls, supra note 12, at 1199-1200. Ingalls also criticized the Court for not discussing the "origin of the claim" test, which the author thought to be valid. See id. at 1200.
\textsuperscript{85} Id. at 1199 (citations omitted).
\textsuperscript{86} Id. at 1199-1200.
\textsuperscript{87} See id. at 1200 (noting that the only court to address this issue was the Tax Court, which found that the "board of directors' fiduciary duty to the shareholders was not the 'dominant aspect' of incurring the professional fees."
Despite these criticisms, this Comment does not dispute the validity of the INDOPCO holding as it relates to friendly takeovers because it creates a certainty for taxpayers in what appears to be a rather clear-cut, non-deductibility situation. Rather, the main thrust of this Comment is focused on INDOPCO’s ill-application to the setting of hostile takeovers.

C. HOSTILE TAKEOVERS

1. The Service’s Waffling Stance

The I.R.S. has taken conflicting stances on the issue of deductibility in the hostile takeover context. These seemingly inconsistent opinions have left taxpayers confused and uncertain as to the deductibility of expenses they must incur in such situations.

Prior to the INDOPCO decision, the I.R.S. looked favorably upon the deductibility of expenses incurred in defending against a hostile takeover. In Technical Advice Memorandum 85-16-002, the I.R.S. found that expenditures made in defending against a stock tender offer were deductible. Interestingly, this memorandum was withdrawn by Technical Advice Memorandum 86-26-001, which found that greenmail payments, attorney’s and broker’s fees incident to a stock repurchase, were capital expenditures. The original Technical Advice Memorandum 85-16-002 was later reinstated, as the I.R.S. again changed its mind, making takeover expenses deductible in Technical Advice Memorandum 88-16-005.

Later, in Technical Advice Memorandum 89-27-005, the I.R.S. found that fees incurred in hiring an investment banker to locate a white knight in order to thwart hostile takeover attempts were made by the board of directors in fulfillment of their fiduciary duties and were therefore deductible. One commentator has explained the decision in the following way:

The I.R.S. found that the expenses were deductible because they were incurred to insure the continued profitability of the business and to protect the interests of the shareholders. The I.R.S. felt that the taxpayer’s expenditures were not made pursuant to an alteration

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89. See MacNeil et al., supra note 1, at 619.
93. Tech. Adv. Mem. 89-27-005 (Mar. 27, 1989). This memorandum addressed the following facts: an acquirer made unwelcome attempts to takeover a target corporation by acquiring 51% of the target's outstanding stock; the target's board of directors opposed the acquirer's attempts to gain control; in defending itself, the target hired an investment banker to assist in its defense; in its capacity, the investment banker found an alternative suitor, a white knight; the target reached an agreement with the acquirer, under which the acquirer would halt all further efforts to gain control of the target; and the white knight acquired the target via later shareholder approval. See id.
or change in the capital structure of the taxpayer for an extended period of time. Rather, the amounts expended by the taxpayer were in fulfillment of the Director’s fiduciary duties to it and to fight off what the Directors believed to be, a tender offer that was not in the best interests of the corporation or its shareholders to accept.\footnote{94} The ruling in this memorandum was later revoked by Technical Advice Memorandum 89-45-003\footnote{95} because the I.R.S. “felt its position seemed more liberal than the Tax Court’s position in the . . . [INDOPCO] case.”\footnote{96} Once again retreating from its earlier stance, the I.R.S. stated that “[t]here is no less a long-term benefit to the target of a hostile takeover” than to the target of a friendly takeover.\footnote{97}

Technical Advice Memorandum 90-43-003, which was based on a similar set of facts as Technical Advice Memorandum 89-27-005,\footnote{98} received a different treatment.\footnote{99} There, the Service concluded that expenses incurred in finding a white knight that were made “with the intent to shift ownership, and did result in the shift of ownership” were capital in nature.\footnote{100} In reaching this conclusion, the I.R.S. noted that this shift in ownership was “intended to lead to a benefit that could be expected to produce returns for many years in the future.”\footnote{101} Interestingly, however, the memorandum later found that those expenses directly relating to the target’s efforts to resist hostile takeover attempts were “ordinary and necessary” business expenses and were therefore deductible in the current year.\footnote{102}

After the \textit{INDOPCO} decision, the I.R.S. assessed tax deficiencies of millions of dollars against corporate taxpayers involved in mergers and acquisitions activity.\footnote{103} The I.R.S. argued that no relevant difference existed between friendly and hostile takeovers and extended \textit{INDOPCO} to situations of hostile takeovers long before the original \textit{Staley} decision.\footnote{104} In Technical Advice Memorandum 91-44-042, the I.R.S., acting consistently with \textit{INDOPCO}, found that costs incurred in resisting hostile takeover attempts were capital expenditures and therefore not deductible unless the corporation could show that no long-term benefit resulted.\footnote{105}

Specifically, the I.R.S. disallowed three types of fees: “those of the target for evaluating and resisting the tender offer, those that the corporation

\begin{footnotes}
94. MacNeil et al., \textit{supra} note 1, at 619-20.
96. Ingalls, \textit{supra} note 12, at 1180.
98. See \textit{supra} note 95 for an explanation of the facts of this memorandum.
100. \textit{Id}.
101. \textit{Id}.
102. See \textit{id}.
103. In one example, the I.R.S. assessed an $18 million deficiency against Chevron and disallowed deductions for legal and investment banking fees and additional executive compensation incurred in resisting an unsuccessful takeover attempt by Mesa Petroleum. These deductions would have totaled $70.5 million. See Lee A. Sheppard, \textit{The INDOPCO Case and Hostile Defense Expenses}, 54 Tax Notes 1458, 1458 (1992).
104. See \textit{id}.
\end{footnotes}
incurred in repurchasing its stock from the corporate raider, and the lump-sum reimbursement of the raider's expenses under a settlement agreement.\(^{106}\) In fact, "the I.R.S.'s latest position on a target corporation's takeover expenses is that the presence of a long-term benefit arising from the expense determines deductibility, regardless of the nature of the takeover. No clear cut lines are drawn by this position."\(^{107}\)

2. Victory Markets & Subsidiaries, Inc. v. Commissioner

In *Victory Markets, Inc. v. Commissioner*,\(^{108}\) the taxpayer argued that professional service fees incurred in connection with a hostile acquisition of stock were entitled to deductibility.\(^{109}\) While the taxpayer tried to distinguish its case from *INDOPCO*, the court declined to decide whether *INDOPCO*'s required capitalization of takeover expenses extended to the hostile takeover context.\(^{110}\) The Tax Court found that, in actuality, the Victory Markets takeover was not hostile and subsequently applied the *INDOPCO* framework.\(^{111}\)

3. Federated Department Stores

In a similar case, an Ohio bankruptcy court addressed whether Federated Department Stores, facing a hostile takeover, could deduct break-up fees and reached a different result.\(^{112}\) In an effort to avoid a corporate takeover by an unwelcome bidder, Federated Department Stores paid break-up fees to white knights. After the merger attempts failed, Federated claimed the expenses as deductions. The district court upheld the bankruptcy court's earlier holding that the deductions were allowable.\(^{113}\) In so deciding, the district court distinguished *Federated* from *INDOPCO* by noting that no benefit accrued beyond the year in which the expenditures were made.\(^{114}\) In addition, the court decided that failed merger transactions were distinct from successful takeovers.\(^{115}\) As such, abandoned transactions were found to be eligible for a section 165 loss deduction.\(^{116}\)

4. A.E. Staley Manufacturing Co. v. Commissioner

One the most controversial cases to come out of the United States Tax Court was *A.E. Staley Manufacturing Co. v. Commissioner*.\(^{117}\) This case directly addressed the issue remaining after *INDOPCO* of whether non-

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106. Lyke, supra note 29, at 1270 n.138.
107. Ingalls, supra note 12, at 1183.
109. Id.
110. See id. at 668 n.4.
111. See id.
114. See id. at 609.
115. See id. at 611.
116. See id. at 612-13.
117. 105 T.C. 166 (1995), rev'd, 119 F.3d, 482 (7th Cir. 1997).
deductibility of business expenses should be extended to situations involving hostile rather than friendly takeovers. The Tax Court, in a sharply divided decision, reluctantly answered in the affirmative. However, the Seventh Circuit Court of Appeals recently reversed the Tax Court's controversial decision.

a. Facts

On April 8, 1988, Tate & Lyle PLC, a publicly held United Kingdom corporation, made a public tender offer to Staley's shareholders for $32 per share of common stock "without the knowledge, endorsement, or encouragement of the management or board of directors of [Staley]." In response, Staley hired investment bankers First Boston and Merrill Lynch to advise it. The investment bankers, believing that the value of Staley's stock ranged from $35.83 to $43.57 per share, advised Staley that the $32 per share tender offer was inadequate. Staley's board of directors accordingly rejected the first tender offer. Then, on April 29, again without solicitation, Tate & Lyle made a second attempt, raising its tender offer to $35 per share. The second offer was again rejected by Staley's board as "inadequate," and "not in the best interests of . . . its shareholders."

Throughout the tender offer period, Staley continued to look for alternatives to the Tate & Lyle takeover. Unable to find "an alternative that would create value for [Staley's] shareholders greater than the price that Tate & Lyle was offering for the stock," the Staley board of directors entered into a merger agreement, whereby Tate & Lyle agreed to buy Staley for $36.50 per share of common stock.

On its short-year tax return, Staley deducted the investment banking fees and printing costs. The Service, determining these expenses to be non-deductible, assessed a deficiency of $3,544,166.

118. See id. at 200-01. Nine justices joined in the majority opinion, one of which concurred in result only. The remaining five justices filed dissenting opinions, arguing that the majority failed to properly distinguish Staley from INDOPCO. See id. at 210.

119. See A.E. Staley Mfg. Co. v. Comm'r, 119 F.3d 482 (7th Cir. 1997).

120. The company was first incorporated as A.E. Stanley Manufacturing Co. (AES) in 1906. In 1985, AES reorganized, forming Stanley Continental, Inc. (SCI), which served as the parent company of AES and the newly acquired CFS Continental, Inc. (CFS), a leading food service industry supplier. Following the acquisition, Tate & Lyle sold the CFS unit and changed SCI's name to A.E. Staley Manufacturing Co. For simplicity and clarification, this Comment will address the corporate entity as "Staley" in all references.

121. The offer was conditioned on:
(1) the nullification of the [Staley] shareholder rights plan; (2) the invalidity or inapplicability of the restrictions on business combinations of Del. CODE ANN. tit. 8, § 203 (1991) (Delaware anti-takeover statute); (3) the invalidity or inapplicability of the [Staley] benefit trust; (4) satisfaction of a super majority requirement contained in the certificate of incorporation of [Staley]; and (5) the shareholders of Tate & Lyle approving the offer.

Staley, 105 T.C. at 172.

122. Id. at 173.

123. Id. at 176-77.

124. Id. at 178.
b. The Tax Court Holding

In deciding whether such fees and costs were deductible, the Tax Court looked to the “nature of the transaction out of which the expenditures in controversy arose”125 and the primary beneficiary of the acquisition.126 In doing so, the sharply divided Tax Court found that regardless of Staley’s motives for defending itself (i.e., fear of hostile takeover), the transaction was still a corporate reorganization in nature.127 In addition, the court found that Staley received significant shareholder-related benefits such as “transformation from a publicly held corporation to a wholly owned subsidiary and relief from substantial shareholder-related expenses.”128

The court noted that the investment banking and printing fees were not “related to current income production or needs of the immediate present.”129 The court also found that Tate & Lyle acquired Staley with the intent of continuing its operations, not dissolving it.130 Finally, the court down-played the initial hostile nature of the takeover and instead focused on the board of director’s eventual acquiescence.131 In particular, the court emphasized the fact that the board “(1) approved a merger with Tate & Lyle and (2) recommended Tate & Lyle’s third offer to shareholders as ‘fair’ and in their ‘best interests.’”132 Correspondingly, the Tax Court determined that the expenses were “properly matched against revenues of a taxable period . . . longer than the taxable year during which such fees were incurred,” found the expenses to be capital expenditures rather than deductions, and assessed a deficiency against Staley.133

The majority was unpersuaded by Staley’s argument that Tate & Lyle’s announced plans to fire Staley’s management and break up the corporation distinguished this case from Victory Markets and National Starch, in which the acquirers promised to keep the company intact and retain management.134 Rather the court viewed Tate & Lyle’s attempts as part of a long-term plan to return Staley to its core businesses.135

In an interesting twist of events, the merger did not result in tangible future benefits to Staley. It could be argued that, on the contrary, the merger negatively affected the corporate entity. Following the acquisition, Staley’s senior management was replaced, 104 executives were fired, and the entire board of directors resigned.136 In addition, rather ironically, the surviving corporation inherited the indebtedness that Tate &

125. Id. at 195.
126. See id. at 206.
127. See id. at 197.
128. Id.
129. Id.
130. See id.
131. See id. at 198.
132. Id. at 197.
133. Id. at 198.
134. See id.
135. See id. at 199.
136. See id. at 179.
Lyle incurred in financing the acquisition. Finally, Tate & Lyle forced the sale of Staley's key food service supply division, a division that Staley had previously acquired in a planned diversification attempt.

c. The Seventh Circuit's Reversal

On July 2, 1997, the Seventh Circuit Court of Appeals reversed the Tax Court's controversial Staley decision. While admitting that distinguishing between expenses that are deductible under section 162 and those that require capitalization under section 263 is "not an easy task," the Seventh Circuit characterized the investment banking expenses as primarily defending the corporation against attack, thus facilitating deductibility rather than capitalization. While the investment bankers provided advice with respect to a variety of alternatives, including "recapitalization, a leveraged buy-out, a placement of blocks of stock, a spin-off, a public offering, and an offer to buy Tate & Lyle . . .," the court found that "[n]one of these tasks served to facilitate the Tate & Lyle acquisition." Furthermore, the court concluded that although the investment bankers did perform some facilitative tasks, "the bulk of costs at issue . . . related to SCI's defense of its business and its corporate policy and [were] therefore deductible under § 162(a).'' The court also distinguished the case at hand from that of INDOPCO in that, "unlike the taxpayer in INDOPCO, [Staley] did not obtain a long-term benefit as a result of making these expenditures" because the investment bankers' efforts to help the corporation defend itself against the takeover proved fruitless. As a result of these findings, the Seventh Circuit reversed the Tax Court's judgment and remanded the case to the Tax Court "to allocate a sum of the fees for capitalization to the facilitative activities of the investment bankers and printer that were performed in preparing the evaluation of SCI's stock and in facilitating the merger at the time of its consummation." In concluding its decision, the Seventh Circuit urged the I.R.S. to issue "precise regulations addressing this recurring problem in American corporate life."

137. See id. at 180.
138. See id.
139. A.E. Staley Mfg. Co. v. Comm'r, 119 F.3d 482, 493 (7th Cir. 1997).
140. See id. at 487.
141. Id. at 489 ("It is clear that SCI was engaged in the process of defending its business from attack.").
142. See id. at 488 (citing Allen v. Comm'r, 283 F.2d 785, 790-91 (7th Cir. 1960) ("[E]xpenditures by a taxpayer to protect an established business are fully deductible as ordinary business expense.").
143. Staley, 119 F.3d at 490.
144. The court made it clear that certain facilitative tasks, such as those that result in a successful and welcome merger, must be capitalized. See id. at 491.
145. Id. In addition, the court noted that the expenses were deductible under section 162. See id.
146. Id. at 492.
147. Id. at 492-93.
148. Id. at 493.
While corporate taxpayers, at least those in the Seventh Circuit, breathed a sigh of relief with the reversal of the Tax Court's decision in Staley, cause for concern should remain. Since the Seventh Circuit's decision, a number of criticisms have emerged. One commentator criticized the Seventh Circuit's reasoning as "out of left field," calling for the reversal of the decision by the Supreme Court.149 Another condemned the decision on several grounds, arguing that there is little meaningful distinction between a hostile and a friendly takeover150 and reasoning that "[i]n every successful takeover, the target and acquiring corporations are adverse as to price to be paid for the target shares, so every successful takeover has hostility at the start of the negotiations. To separate out a hostile part of the haggling over stock price in a single unitary takeover on the basis of corporate motive is a rule inviting abuse."151 In addition, the IRS has vowed to pursue capitalization in Staley-type issues in the future.152 David L. Crawford, a branch chief in counsel of the IRS recently remarked on the IRS's position post-Staley: "Our view of the world is not changed by Staley. We will continue to look at the facts, and if they indicate a substantial long-term beneficial consequence, we would argue capitalization."

V. ARGUMENTS IN FAVOR OF DEDUCTIBILITY

A. FIDUCIARY DUTIES IMPOSED ON DIRECTORS

In general, a board of directors functions for the benefit of the corporation's shareholders.153 In the context of a takeover, directors have a heightened fiduciary duty, which makes expenses incurred in responding to such a situation "necessary." In responding to a hostile takeover, a board of directors must show: 1) that it had reasonable grounds for believing that a genuine threat to corporate policy and effectiveness existed;154 and 2) that the response or defensive measure was "reasonable in relation to the threat posed."155 When a corporation undertakes a

149. Lee A. Sheppard, Will There Ever Be Another Friendly Takeover?, 76 TAX NOTES 461, 462 (1997). Sheppard also argues that "there is really no such thing as a hostile takeover." Id. at 461.
150. See Calvin H. Johnson, Snarling for the Cameras: Hostility and Takeover Expenses Deductions, 76 TAX NOTES 689 (1997). Johnson also criticizes the decision on the grounds that management hostility and failure to find a future benefit should not have been considered by the Seventh Circuit, and laments that the court "gave no considered judgment as to whether the shareholder benefits (or even the tax-exempt nature of the sale to the corporation) might disallow the deduction . . . ." Id. at 690.
151. Id.
155. Unocal Corp., 493 A.2d at 955. In determining whether a response is reasonable in relation to a posed threat, the board may look to the "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other
transaction that will cause a break-up of the corporate entity or that will cause a change in corporate control, however, the duties of directors must shift to maximizing shareholder wealth first and foremost. A sale of total control is not required to trigger such a shift; a change in management is enough. In addition, other principles guide a board of directors in responding to takeover proposals in accordance with their fiduciary duties:

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

But should the existence of a board’s fiduciary duties to the shareholder be weighed in favor of capitalization? Certainly not. In light of such duties, it easily can be argued that expenditures made in defense of a hostile 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.

B. Future Benefits Not Applicable

Existence of benefits extending beyond the taxable year was the key reason the Supreme Court rejected deductibility in *INDOPCO*. However, future benefits for a corporation in the process of defending itself against a hostile takeover are at best questionable. Because a merger conclusively generates income only in the year of the event, whether or not the merger continues to be profitable remains to be seen. Once purchased, the target company becomes the property of the acquirer who may either destroy the target company and liquidate its assets, resulting in no benefit for the corporation, or continue operating the company,

than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of non-consummation, and the quality of securities being offered in the exchange.” *Id.*

156. *See Revlon, Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173, 182 (Del. 1986). The court in *Revlon* noted that when it became apparent to all that the break-up of the company was inevitable, ... [t]he duty of the board had ... changed from the preservation of Revlon as a corporate entity to the maximization of the company’s value at a sale for the stockholders’ benefit. This significantly altered the board’s responsibilities under the *Unocal* standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders’ interests, from a grossly inadequate bid. ... The directors’ role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.

*Id.*


158. *See supra* notes 73-78 and accompanying text.
with continuing benefit to both the entity and its new owners. As one author noted:

Because the long-term benefits test is ambiguous to begin with, the future benefits could be very speculative. If the board’s decision to maintain present ownership is a long-term benefit, then expenditures to maintain that ownership would have to be capitalized as well. . . . The use of the long-term benefits test in hostile situations . . . appears misplaced, especially when defensive measures to protect a business are involved.159

Consider a situation such as that in Staley, where the hostile acquirer makes clear its intentions to fire the management and sell-off the corporation’s key business.160 While this situation did not convince the Tax Court in Staley to allow a deduction for the expenses incurred to defend against the takeover,161 the Seventh Circuit was persuaded that at least some of these expenditures were not “of value in more than the taxable year.”162

Additionally, the future benefits test depends on hindsight, only later determining whether or not a benefit has actually been sustained by a target corporation. This “hindsight-is-20/20” approach is unfair to a corporate taxpayer seeking certainty and should not be used to determine whether or not deductibility has been achieved, especially considering that the expenses were incurred at a time when attempts to defend were of paramount concern and no looking glass was available to determine the probability of success. In the words of one author, “[w]hile a corporation is in the process of defending itself, it is not sure whether it will be successful. The benefit of hindsight should not determine whether the expenses are deductible.”163

A special distinction must be made between successful and unsuccessful takeover attempts when discussing the future benefits test. In the case of successful takeover bids, INDOPCO’s synergy criteria may be difficult to apply.

The Court’s approach [in INDOPCO] may be of little use where such benefits and resulting synergy do not exist. . . . [M]any corporations engage in takeovers or mergers, not to make inroads into new product lines or markets by developing their own products, but to achieve such ends through diversification. If a corporation merges with an existing business for [that] purpose, and that business is wholly unrelated to existing business operations, the I.R.S. will find it difficult to point to . . . synergy . . . and thus will be unable to justify capitalization on such grounds.164

Thus, because “most corporations engage in takeovers as a means to diversify, . . . there will not be the same type of synergy found in [the IN-
As for unsuccessful takeover attempts, it can hardly be argued that any long-term benefit results from such a situation. Generally, section 165 allows a deduction for “any loss sustained during the taxable year and not compensated for by insurance or otherwise.”

For a loss to be deductible under section 165, “a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and . . . actually sustained during the taxable year.” In particular, subsection (f) addresses capital losses from sales or exchanges of capital assets, allowing deductions “only to the extent allowed in sections 1211 and 1212.”

Section 1211 limits corporate capital losses from sales or exchanges of capital assets to the amount of gain from such sales or exchanges. In addition, for corporate taxpayers capital losses may be carried back to each of the preceding three taxable years to the extent that “the carryback of such loss does not increase or produce a net operating loss (as defined in section 172(c)) for the taxable year to which it is being carried back.”

Capital losses may also be carried forward to each of the succeeding five years and “shall be treated as a short-term capital loss in each such taxable year.”

Specifically, section 165 loss deductions have been allowed for expenditures related to failed plans of reorganization and abandoned public offerings. In situations such as these, as well as in unsuccessful takeover attempts, deductions are justifiable in that they clearly produce no new synergies or future benefits for the corporation. The I.R.S. also seems to have conceded this fact in Technical Advice Memorandum 85-16-002, where it permitted a taxpayer to deduct break-up fees incurred in its failed attempts to resist a corporate takeover.

In addition, two of the earlier-mentioned cases suggest that section 165 arguments will receive favorable response from the courts. In In re Federated Department Stores, the taxpayer successfully argued that the break-up fees it had incurred qualified as deductible abandonment losses under section 165. The bankruptcy court noted that target corpora-

165. Lyke, supra note 29, at 1261-62.
169. Id. § 1211(a).
170. Id. § 1212(a)(1)(A)(ii).
171. Id. § 1212(a)(1)(B), (C)(ii).
172. See El Paso Co. v. United States, 694 F.2d 703, 712 (Fed. Cir. 1982); Sibley, Lindsay & Curr Co. v. Comm'r, 15 T.C. 106, 110 (1950) (where two out of three failed proposals for capital restructuring were found to be “separate and distinct suggestions” deserving of deductibility); Rev. Rul. 79-2, 1979-1 C.B. 98; Rev. Rul. 73-580, 1973-2 C.B. 86.
173. See Ingalls, supra note 12, at 1186 (“It is undisputed that expenses incident to an unsuccessful defense by the target of a hostile takeover are immediately deductible as abandonment losses under I.R.C. section 165(a).”).
176. 135 B.R. 950, 958, 960 (Bankr. S.D. Ohio 1992). The court also found that these break-up fees were deductible under section 162(a) as “ordinary and necessary.” See id. at
tions utilize “protracted and strenuous defensive tactics when faced, involuntarily, with the threat of [a hostile takeover].”

In so deciding, the bankruptcy court found it particularly important that no future benefits had resulted and that the expenses had not been reimbursed by insurance. In addition, the bankruptcy court found that expenses incurred by the target to find a white knight were deductible under section 162(a) as “necessary.” It determined that “the decision to engage in a ‘white knight’ defense was an established, common and accepted defensive move, and thus would be considered ‘ordinary’ in the context of a hostile takeover battle.”

One author has noted that the bankruptcy court rejected the INDOPCO decision as controlling because it “dealt with the denial of deductibility of expenses incurred in a successful friendly takeover.”

In addition, the taxpayer in Staley, while initially unsuccessful in its argument based on section 165, prevailed in the Seventh Circuit’s review of the case. There, the court looked at the numerous failed attempts by the investment bankers to engage in alternative capital transactions in determining that section 165(a) permitted deductions for such costs as abandoned capital transactions.

Some have argued that a pure long-term benefits test should not be applied to hostile takeover defense costs whether or not the takeover attempt is successful. In arguing for current deductibility of these expenses regardless of outcome, one author stated:

If the defense is successful, the costs should be deductible both because it is well established that the costs of defending a business from

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961. However, there is evidence that the IRS does not agree with this position as illustrated in a recent Tax Advice Memorandum, where the Service ruled against the taxpayer. See Tech. Adv. Mem. 94-02-004 (Sept. 10, 1993). There, the taxpayer tried to deduct the losses for six-sevenths of professional fees incurred in an eventually abandoned merger. The I.R.S. found that such expenditures were not deductible because they were part of a single plan of merger. See id.

177. In re Federated Dep’t Stores, 135 B.R. at 961.
178. See id.
179. But see Lyke, supra note 29, at 1260.

[1] If the defense mechanism involves a so-called “white knight,” it should be more difficult for the taxpayer to avoid capitalizing the defense costs. White knights bring potential benefits to target companies such as synergy and security from future hostile takeover attempts. Even in these cases, however, costs might be deducted because the benefit is indirect and incidental and not the primary purpose of the takeover defense.

Id.

180. In re Federated Dep’t Stores, 135 B.R. at 961.
181. Ingalls, supra note 12, at 1187 (quoting In re Federated Dep’t Stores, 135 B.R. at 962).
183. See A.E. Staley Mfg. Co. v. Comm’r, 119 F.3d 482, 490 (7th Cir. 1997).
184. See id. (“SCI contemplated numerous capital transactions that were later abandoned... when SCI agreed to the merger with Tate & Lyle. The fees paid to the investment bankers in connection with those abandoned transactions are therefore deductible as abandonment loss under § 165(a).”).
185. See Lyke, supra note 29, at 1258.
attack are ordinary expenses and because such costs, like repair costs, are incurred only to maintain the status quo. If the defense is unsuccessful, the costs should also be currently deductible because they should be considered part of an abandoned transaction that did not produce long-term benefits.\textsuperscript{186}

C. DEFENDING AGAINST A HOSTILE TAKEOVER AS MAINTENANCE

One group of commentators has suggested that takeover expenses "seem to be deductible under [the] well-established precedent that expenditures to maintain one's property in efficient operating condition or to protect one's business are deductible. . . . [C]osts are incurred simply to maintain the status quo with any future benefit being a by-product of that objective."\textsuperscript{187} In so suggesting, proponents cite Revenue Ruling 94-12, which holds that incidental repair expenditures are deductible when spent to keep property in ordinary, efficient operating condition, despite the fact that the expenditure might result in a future benefit.\textsuperscript{188} Revenue Ruling 73-226 also supports this argument, holding that expenditures to protect business reputation and goodwill were deductible even though such expenditures helped a related corporation's \textit{continuing business}.\textsuperscript{189} The rationale behind applying the maintenance argument to the hostile takeover context can be explained as follows:

A corporation defending against a hostile takeover is trying to protect its current management structure and business practices—to maintain the status quo—rather than create a new benefit. Like a repair, the defense is not an improvement and thus yields no continuing benefit; it merely enables the corporation to continue its operations as before. The defense does not enhance the value of the corporation. Indeed, it may even reduce the value of the corporation in the short term by diverting resources from normal business operations. Target corporations that successfully resist takeovers often find themselves in an even worse position than before the takeover attempt due to the debts they took on in defending themselves.\textsuperscript{190}

The dissent in the Tax Court's \textit{Staley} decision noted that a target corporation will not likely view a hostile takeover as an opportunity for long-term benefits.\textsuperscript{191} In fact, "[d]efensive measures are not intended to produce lasting improvements; . . . [they] are designed to prevent, not facilitate, a change in corporate structure."\textsuperscript{192}

\textsuperscript{186} Id.
\textsuperscript{187} MacNeil et al., \textit{supra} note 1, at 621-22; see also Lyke, \textit{supra} note 30, at 1259.
\textsuperscript{188} See Rev. Rul. 9-12, 1994-8 I.R.B. 5.
\textsuperscript{190} Lyke, \textit{supra} note 30, at 1259.
\textsuperscript{192} Lipton, \textit{supra} note 88, at 26.
D. Defending Business Reputation as Justification

Despite the negative treatment of business expenses incurred in a hostile takeover, the Service has ruled favorably on expenses incurred in defending business reputation. In a series of Revenue Rulings, the I.R.S. found that such expenses should be immediately deductible despite the existence of long-term benefits.\(^{193}\)

Courts also have found such expenses to be deductible. In *BHA Enterprises, Inc. v. Commissioner*, the taxpayer, a radio station, was subject to revocation proceedings by the Federal Communications Commission (FCC).\(^{194}\) The proceedings resulted in the revocation of the taxpayer's license, from which it appealed.\(^{195}\) On appeal, the FCC reversed, and the taxpayer subsequently deducted its legal fees.\(^{196}\) The Tax Court found that "[t]he legal fees were reasonable in amount and necessarily incurred in defense of petitioner's position in the proceedings. Success by the FCC in prosecuting its suit against petitioner would have prohibited further operation of petitioner's business."\(^{197}\) As such, the legal fees incurred in defense of the suit were deductible because they "did not result in the acquisition or disposition of a capital asset."\(^{198}\)

E. Defense Against Attack Doctrine

Traditionally, threats to a corporation have been considered currently deductible under the "defense against attack" doctrine as espoused by the Supreme Court in *Welch v. Helvering*.\(^{199}\) There, the court explained:

A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose . . . are the common and accepted means of defense against attack.\(^{200}\)

In *Commissioner v. Heininger*,\(^{201}\) the taxpayer hired an attorney to successfully defend his business against government charges that would have ruined his business. In upholding the deduction, the Supreme Court found that the taxpayer's defense "was the response ordinarily to be expected . . . [having been] placed in a position in which not only his selling methods but also the continued existence of his lawful business were threatened with complete destruction."\(^{202}\) The Court further concluded that "[t]o say that this course of conduct and the expenses which it in-

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195. See id. at 596.
196. See id.
197. Id.
198. Id. at 596-97.
199. 290 U.S. 111 (1933).
200. Id. at 114.
201. 320 U.S. 467 (1943).
202. Id. at 471-72.
volved were extraordinary or unnecessary would be to ignore the ways of conduct and the forms of speech prevailing in the business world.\textsuperscript{203}

In a situation similar to a hostile takeover, courts have found that costs incurred by a corporation defending against minority shareholder attempts to seize control are deductible.\textsuperscript{204} This analysis may be applied in the takeover context given the similarities between the two situations. Like hostile takeover bidders, minority shareholders attempt to acquire voting control in order to direct the corporation's affairs.\textsuperscript{205} In addition, both the hostile tender offer and minority shareholder seeking control are unwanted by management.\textsuperscript{206}

F. Public Policy Reasons in Support of Deductibility

Congress has used the Internal Revenue Code as a tool to implement policies and promote behaviors. In fact, "Congress has come to use the tax code as a tool to do much more than raise revenue; it is used for such varied things as furthering social goals such as 'fairness' and redistribution of wealth to stimulating capital formation and economic growth."\textsuperscript{207} As a keeper of policy concerns "it would bode well for the I.R.S. to promote more logical policies,"\textsuperscript{208} rather than those that are "inconsistent with social policies promoting positive behavior."\textsuperscript{209}

Treating friendly and hostile takeover expenses in exactly the same manner ignores the differences in the transactions. Allowing hostile takeover target corporations to deduct their defense expenses promotes the policy of businesses defending and protecting themselves when it is in their best interests. Without spending the money, the business would probably no longer exist. And if that were desirable, then the takeover would have been friendly, and the expenses would have been capitalized under the long-term benefits test.\textsuperscript{210}

In sum, allowing hostile takeover targets to deduct expenses incurred in their defenses "promotes sound policy and does not give the target corporation a windfall for acquiring a capital asset."\textsuperscript{211}

VI. Conclusion

The issue of deductibility versus capitalization continues to be at the forefront of many tax debates. Specifically, expenditures incurred by a target corporation defending itself against a hostile acquirer have been

\textsuperscript{203} Id. at 472.
\textsuperscript{204} See Locke Mfg. Cos. v. United States, 237 F. Supp. 80 (D. Conn. 1964); Central Foundry Co. v. Comm'r, 49 T.C. 234 (1967). \textit{But see} Stokely-Van Camp, Inc. v. United States, 974 F.2d 1319 (Fed. Cir. 1992) (holding that premiums paid to shareholders to re-deem shareholders' common stock are not deductible).
\textsuperscript{205} See Lyke, \textit{supra} note 29, at 1259.
\textsuperscript{206} See id.
\textsuperscript{207} PHILLIP S. ASHLEY, SELECTED READINGS IN TAX POLICY 1 (1992).
\textsuperscript{208} Ingalls, \textit{supra} note 12, at 1205.
\textsuperscript{209} Id.
\textsuperscript{210} Id.
\textsuperscript{211} Id. at 1206.
the subject of special controversy, especially as of late given the controversial *Staley* case. Despite the favorable Seventh Circuit decision and the many powerful arguments supporting deductibility, corporate taxpayers must tread cautiously through the uncertain tax waters when characterizing their hostile takeover expenses.