INDOPCO, Inc. v. Commissioner: National Starch Isn't the Only One "Stiffed" by the Supreme Court's Decision

Jeffrey Gates Davis

INDOPCO, Inc. v. Commissioner: National Starch Isn't the Only One "Stiffed" by the Supreme Court's Decision

I. INTRODUCTION

In *INDOPCO, Inc. v. Commissioner*,[1] the United States Supreme Court addressed the issue of whether the target corporation may deduct expenditures incurred for professional services in a friendly takeover as "ordinary and necessary" business expenses under section 162(a) of the Internal Revenue Code.[2] A unanimous Court,[3] affirming the Third Circuit Court of Appeals, disallowed claimed expense deductions for legal and investment banking fees incurred in a friendly takeover by INDOPCO's predecessor, National Starch and Chemical Corporation (National Starch), and required that such expenditures be capitalized under section 263 of the Internal Revenue Code because they provided a long-term benefit to National Starch.[4]

Although National Starch ultimately lost its bout with the Commissioner of Internal Revenue in *INDOPCO*, National Starch is not the only one "stiffed" by the Supreme Court's ruling. *INDOPCO's* impact is already being felt in areas unrelated to corporate acquisitions. The Internal Revenue Service (IRS) has sought to expand the scope of *INDOPCO*'s rationale[5] and is currently relying on *INDOPCO* as authority for the proposition that certain expenses, which a taxpayer previous-

---

1. 112 S. Ct. 1039 (1992), *aff'g* National Starch and Chem. Corp. v. Commissioner, 918 F.2d 426 (3d Cir. 1990) [hereinafter *National Starch II*], *aff'g* National Starch and Chem. Corp. v. Commissioner, 93 T.C. 67 (1989) [hereinafter *National Starch I*].

2. *Id.* at 1041; *see* I.R.C. § 162(a) (1988). For the relevant portion of Internal Revenue Code § 162(a), see *infra* note 23.

3. Justice Blackmun wrote the opinion of the Court. *INDOPCO*, 112 S. Ct. at 1041.

4. *Id.* at 1046; *see* I.R.C. § 263(a) (1988). For the relevant portion of Internal Revenue Code § 263(a), see *infra* note 24.

5. The IRS, however, says that the *INDOPCO* decision has not changed either traditional tax accounting principles or the IRS's view of historically accepted deductions such as ordinary repairs and advertising. Aaron Pressman, *IRS Plans to Give Guidance Following* INDOPCO *Ruling*, MERGERS & ACQUISITIONS REP., Aug. 3, 1992, at 14, 14. *But see infra* notes 178-289 and accompanying text.

ly might have been able to deduct under traditional tax principles, cannot be deducted if they result in a long-term benefit that extends beyond the current tax year.[6]

The following classic example helps to illustrate the point: Traditionally, the cost of painting an apartment building was immediately deductible, while the cost of installing a new roof on that same building was capitalized. Under *INDOPCO*, however, the IRS may argue that the cost of painting the apartment building is not immediately deductible because the paint, which could reasonably be expected to last a number of years, provides a long-term benefit extending beyond the current year.[7]

The Court's opinion, however, is narrow and addresses a specific set of facts with a limited holding.[8] This article suggests that *INDOPCO* does not establish a new standard for determining the deductibility of business expenses under section 162, even though the *INDOPCO* decision itself rejects the traditional "separate and distinct asset" test in favor of a very general future benefit test.[9]

Differences of opinion as to the possible scope and meaning of the Court's ruling in *INDOPCO*, and its broad-reaching ramifications,[10] pres-

---

6. *See* Tech. Adv. Mem. 92-40-004 (June 29, 1992) (denying a deduction for costs incurred in removing asbestos insulation from manufacturing equipment and requiring the taxpayer to capitalize the costs because the expenditures provided a long-term benefit). For a general discussion surrounding that release, see *infra* notes 231-51 and accompanying text.

7. This proposition is arguably contrived in that the IRS is not likely to challenge such an expenditure, but it serves to illustrate the logical extreme to which one could theoretically stretch this argument. *But see infra* note 69.

8. McGee Grigsby & Cabell Chinnis, Jr., INDOPCO v. Commissioner: *The Supreme Court Takes National Starch to the Cleaners*, THE TAX EXECUTIVE, Mar.-Apr. 1992, at 85, 86.

> The opinion of Justice Blackmun, from beginning to end, makes two points very clear. First, the opinion addresses a very narrow set of facts: the proposed disallowance of professional charges incurred by a target company in the context of a friendly takeover. Second, the central holding is equally narrow: such charges must be capitalized when they result in a significant long-term benefit.

Id. For a part-by-part critical analysis of the Court's opinion, see *id. passim*.

9. *See INDOPCO*, 112 S. Ct. at 1042-46. Courts have generally accepted the "separate and distinct asset" test as a bright-line rule in determining the deductibility of expenditures since its articulation in Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971). In *INDOPCO*, however, the Supreme Court applied the long-term benefit test despite INDOPCO's argument in favor of the separate and distinct asset test. *INDOPCO*, 112 S. Ct. at 1044-46. For a general discussion of the separate and distinct asset test, see *infra* notes 73-83 and accompanying text.

10. Takeover-related expenditures are not the only category of expenses that the *INDOPCO* decision will affect. Grigsby & Chinnis, *supra* note 8, at 85; *see infra*

ent great uncertainty for tax practitioners.[11] The decision "'casts doubt on deductions people have taken for years.'"[12] As a result, *INDOPCO* leaves tax experts contemplating the limits of the Court's analysis, how the IRS and lower courts may attempt to apply the decision,[13] and whether the decision changes the ground rules for determining the deductibility of expenses.[14]

This article reviews the *INDOPCO* decision and its ramifications. Section II describes the pre-*INDOPCO* distinction between deductibility and capitalization and the inconsistent positions the IRS has taken with respect to the specific issue addressed in *INDOPCO*.[15] Sections III and IV review the background of *INDOPCO* itself, including the lower courts' decisions[16] and the arguments made to the Supreme Court.[17] Section V provides an analysis of the Court's opinion and outlines the issues it addresses.[18] Section VI points out the uncertainty resulting from the application of *INDOPCO* in areas outside of the corporate takeover arena—specifically in the areas of advertising and repair expenditures—and provides a description of the recent guidance offered on the subject by the IRS.[19] Finally, section VII argues that the decision

---

notes 190-289 and accompanying text.

11. *See* Paul D. Manca, *Deductibility of Takeover and Non-takeover Expenses in the Wake of* INDOPCO, Inc. v. Commissioner, 45 TAX LAW. 815 (1992); *see infra* notes 178-289 and accompanying text.

12. *The Agents Run Riot*, FORBES, Nov. 9, 1992, at 144, 144 (quoting Ken Jones, a tax specialist with the accounting firm of KPMG Peat Marwick).

13. It will be up to the courts to finally interpret *INDOPCO*, but until they do, taxpayers will be at the mercy of the IRS. IRS officials have indicated that *INDOPCO* does not change their thinking on deductibility issues. Tax practitioners, however, feel that the IRS is clearly getting more aggressive in interpreting the decision. Juliann Avakian-Martin, *IRS to Move Carefully in Releasing* INDOPCO *Guidance*, TAX NOTES TODAY, July 27, 1992, at 152, 152. One tax attorney has stated, "'Agents have seized the offensive and are running riot.'" *The Agents Run Riot*, *supra* note 12, at 144 (quoting Lydia Kess, an attorney with the law firm of Davis Polk & Wardwell in New York City).

14. Lee A. Sheppard, *Is the IRS Abusing* INDOPCO?, 56 TAX NOTES 1110, 1110 (1992); *The Agents Run Riot*, *supra* note 12, at 144; Scott R. Schmedel, *Asbestos Removal: Pay for It Now, But Deduct It Later, the IRS Declares*, WALL ST. J., Sept. 9, 1992, at A1.

15. *See infra* notes 21-93 and accompanying text.

16. *See infra* notes 94-145 and accompanying text.

17. *See infra* notes 146-53 and accompanying text.

18. *See infra* notes 154-77 and accompanying text.

19. *See infra* notes 178-289 and accompanying text.

should be limited to its facts, despite the IRS's recent application of the case to non-takeover situations.[20]

II. THE CENTRAL ISSUE: DEDUCTIBILITY VS. CAPITALIZATION

The sole issue addressed in *INDOPCO, Inc. v. Commissioner*[21] was whether certain takeover-related expenditures were deductible as business expenses or were required to be capitalized.[22] Section 162 of the Internal Revenue Code allows a deduction for the "ordinary and necessary expenses" of a business.[23] In contrast, section 263 disallows a deduction for any expenditure that is capital in nature.[24]

---

20. *See infra* notes 290-305 and accompanying text.

21. 112 S. Ct. 1039 (1992).

22. *Id.* at 1014; *see National Starch II*, 918 F.2d 426, 428 (3d Cir. 1990); *National Starch I*, 93 T.C. 67, 72 (1989). For additional background information on the distinction between deductible business expenses and nondeductible capital expenditures, see generally 6 JACOB MERTENS, JR., MERTENS LAW OF FEDERAL INCOME TAXATION §§ 25.34-25.69 (1992); John W. Lee & Nina R. Murphy, *Capital Expenditures: A Result in Search of a Rationale*, 15 U. RICH. L. REV. 473 (1981); Alan Gunn, *The Requirement that a Capital Expenditure Create or Enhance an Asset*, 15 B.C. INDUS. & COMM. L. REV. 443 (1974); Note, *Income Tax Accounting: Business Expense or Capital Outlay*, 47 HARV. L. REV. 669 (1934).

23. I.R.C. § 162(a) (1988). Section 162(a) provides in relevant part: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." *Id.* If an item is allowed as a deduction, the effect is that the deduction reduces the taxpayer's taxable income by the amount of that item. *See id.*; I.R.C. § 62 (1988).

24. I.R.C. § 263(a)(1) (1988). Section 263(a) provides in relevant part: "No deduction shall be allowed for . . . [a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate . . . ." *Id.* The Supreme Court stated in *Commissioner v. Idaho Power Co.* that "[t]he purpose of section 263 is to reflect the basic principal that a capital expenditure may not be deducted from current income. It serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing." Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974).

Expenditures that are capital in nature, the deduction of which is disallowed by § 263, may sometimes be recovered through amortization or depreciation. *See, e.g.*, I.R.C. § 167(a) (1988) ("There shall be allowed as a depreciation deduction a reasonable allowance for . . . exhaustion, wear and tear . . . ."). Amortization, which refers to the loss in value of an asset due to the mere passage of time, usually applies to intangible assets. 5 MERTENS, *supra* note 22, § 23.A124. *See generally* Michael R. Schlessinger, INDOPCO *& Newark: Defining the Intangible "Asset" in the Larger Cost Recovery Context*, TAXES, Dec. 1992, at 929, 929. It also applies to business start-up costs that the taxpayer has elected to capitalize and treat as deferred expenses under § 195. *See* I.R.C. § 195 (1988).

Conversely, depreciation, which describes the reduction in value of property due to physical deterioration, applies to tangible assets. 5 MERTENS, *supra* note 22, § 23A.27. For example, the cost of an automobile, which is a depreciable asset with

A. *Purpose of Distinction*

The primary purpose of distinguishing between expenses that are currently deductible and expenditures that must be capitalized is to match expenses with revenues in order to avoid a distortion of net income.[25] This purpose is reflected in section 162 of the Internal Revenue Code,[26] which requires that an expense be "ordinary" in order to be deductible.[27] It is further reflected in section 263,[28] which prohibits "a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing."[29]

The rationale behind the deductibility-capitalization dichotomy seems logical and simple enough. Making the distinction between business expenses and capital expenditures, however, is not so simple; it has troubled tax practitioners and courts for many years.[30]

---

an ascertainable useful life, may be recovered through depreciation deductions over the life of such automobile. *Id.*; *see* I.R.C. § 167 (1988) (depreciation of property not subject to § 168); I.R.C. § 168 (1988) (accelerated depreciation method used for virtually all property placed in service after 1981); *see also* Treas. Reg. § 1.167(a)-3 (allowing amortization deduction for patents and copyrights because they have a definite, ascertainable life). Capital expenditures which provide a benefit for the life of the business are not depreciable and cannot be recovered until the property is disposed of. *See* I.R.C. §§ 167(a), 168(a) (1988); *see also* Treas. Reg. § 1.167(a)-3 (disallowing amortization deduction for goodwill because it has a continuing, indefinite useful life).

25. *INDOPCO*, 112 S. Ct. at 1043. "[T]he Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes." *Id.* (citing *Idaho Power Co.*, 418 U.S. at 16; Ellis Banking Corp. v. Commissioner, 688 F.2d 1376, 1379 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983)); *accord* NCNB Corp. v. United States, 651 F.2d 942, 948 (4th Cir. 1981) ("Our system of income taxation attempts to match income and expenses of the taxable year so as to only tax net income."), *vacated*, 684 F.2d 285 (4th Cir. 1982) (en banc); *see also* I.R.C. § 446 (1988) (requiring the use of a tax accounting method which clearly reflects income).

26. For the relevant text of § 162(a), see *supra* note 23.

27. *See* I.R.C. § 162(a) (1988); Commissioner v. Tellier, 383 U.S. 687, 689-90 (1966) (stating that the principal purpose of the "ordinary" requirement is to clarify the distinction "between those expenses that are currently deductible and those that are in the nature of capital expenditures"); *see also infra* notes 50-54.

28. For the relevant text of § 263(a), see *supra* note 24.

29. Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974).

30. Steven J. Greene, Note, *Distinguishing Between Capital Expenditures and Ordinary Business Expenses: A Proposal for a Universal Standard*, 19 U. MICH. J.L.

B. The Basic Requirements of Deductibility Under Section 162

The Supreme Court has had many opportunities to explore the relationship between deductible business expenses under section 162 and capital expenditures under section 263.[31] The landmark case dealing with the requirements for deductibility is *Commissioner v. Lincoln Savings & Loan Ass'n.*[32] In *Lincoln Savings*, the Court held that to qualify as a deduction under section 162, "an item must (1) be 'paid or

---

REF. 711, 712 (1986) ("Distinguishing ordinary and necessary business expenses from capital expenditures has proven to be a difficult task for the courts."). *Compare* Mt. Morris Drive-In Theatre Co. v. Commissioner, 25 T.C. 272, 274-75 (1955) (holding that the cost of installing a drainage system at an outdoor theatre site was a capital expenditure because it was foreseeable at the time the theatre was constructed) *with* Midland Empire Packing Co. v. Commissioner, 14 T.C. 635, 642-43 (1959) (holding that the cost of lining the basement of a meat-packing plant was a deductible repair expense because the expenditure was made to keep the property in normal working condition). For humorous relief on the amorphousness of the "expense, capital expenditure dichotomy," see CASES AND MATERIALS ON FUNDAMENTALS OF FEDERAL INCOME TAXATION 353-56 (James J. Freeland et al. eds., 7th ed. 1991). The Third Circuit, which had no trouble disallowing the deductibility of the expenditures at issue in *INDOPCO*, *see National Starch II*, 918 F.2d 426, 434 (3d Cir. 1990), had previously noted that "[t]he line of demarcation between deductible repairs and additions to capital is, of course, obscure." Stoeltzing v. Commissioner, 266 F.2d 374, 376 (3d Cir. 1959) (citing United States v. Akin, 248 F.2d 742 (10th Cir. 1957), *cert. denied*, 355 U.S. 956 (1958); Repplier Coal Co. v. Commissioner, 140 F.2d 554 (3d Cir.), *cert. denied*, 323 U.S. 736 (1944)).

31. INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1043 (1992). The Court, however, has not always been consistent in its approach. For a digest of deductibility cases decided by the Supreme Court prior to *INDOPCO*, see *INDOPCO*, 112 S. Ct. at 1043 n.5.

32. 403 U.S. 345 (1971). In *Lincoln Savings*, the taxpayer, a state-chartered savings and loan, was required by federal statute to pay to the Federal Savings and Loan Insurance Corporation an "additional premium" to fund a secondary reserve. *Id.* at 347-48. The secondary reserve provided depositors with additional protection against institutional failure. *Id.* at 350. Each insured institution retained a pro rata share in the secondary reserve which the institution could obtain as a refund upon the termination of its insured status. *Id.* The taxpayer argued that the additional premiums were deductible under § 162(a) as ordinary and necessary business expenses. *Id.* at 352, 354. The Commissioner of Internal Revenue (the Commissioner) contended that the additional premiums were capital expenditures under § 263(a). *Id.* at 352.

The Supreme Court began its analysis of § 162(a) by enumerating the five requirements of an allowable § 162(a) deduction. *Id.* at 352-53. For a brief discussion of those five requirements, see *infra* notes 33-56 and accompanying text. The Court stated that in determining the deductibility of an expenditure, "the presence of an ensuing benefit that may have some future aspect is not controlling." *Lincoln Sav.*, 403 U.S. at 354. It held that the expenditures at issue were capital in nature because they "serve[d] to create or enhance . . . a separate and distinct additional asset." *Id.* Therefore, "the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a)." *Id.*

incurred during the taxable year,' (2) be for 'carrying on any trade or business,' (3) be an 'expense,' (4) be a 'necessary' expense, and (5) be an 'ordinary' expense."[33]

The first requirement, that the item be paid or incurred during the taxable year, is self-explanatory and rarely controversial.[34] It requires that the expense be actually paid, if the taxpayer uses the cash method for tax accounting,[35] or incurred, if the taxpayer uses the accrual method for tax accounting.[36] In addition, the benefit derived from the expense must be expended during the current taxable year, not some past or future taxable year.[37]

The second criterion, that the item be for carrying on the taxpayer's trade or business, requires that a proximate relationship exists between the expense and the carrying on of the trade or business.[38] The ex-

---

33. *Lincoln Sav.*, 403 U.S. at 352. The *INDOPCO* Court cited several cases in which it considered one or more of these requirements. *INDOPCO*, 112 S. Ct. at 1043; *see, e.g.*, Commissioner v. Tellier, 383 U.S. 687, 689 (1966) (the "necessary" requirement simply means "that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business'") (quoting Welch v. Helvering, 290 U.S. 111, 113 (1933)); Deputy v. Du Pont, 308 U.S. 488, 495 (1940) (the term "ordinary" requires that the expenditure relate to a transaction "of common or frequent occurrence in the type of business involved").

34. Brian R. Greenstein & Mark B. Persellin, *Supreme Court's Ruling in* INDOPCO *Limits Deductibility of Takeover Expenses*, TAXES, Aug. 1992, at 570, 572; *see* I.R.C. § 162(a) (1988).

35. JOYCE STANLEY & RICHARD KILCULLEN, FEDERAL INCOME TAX LAW § 162(a), at 84 (6th ed. 1974). A taxpayer on the cash method will deduct expenses in the year in which they are actually paid. *Id.*

36. *Id.* A taxpayer on the accrual method will "deduct[] expenses in the year in which they accrue, which is the year when the liability to pay becomes fixed and certain and the amount of the liability is either known or can be estimated with reasonable accuracy." *Id.*

37. Central Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1183 (5th Cir. 1984) (stating "an item must be paid or incurred and the benefit exhausted during the taxable year to be deductible"); *see* I.R.C. § 162(a) (1988).

38. *See* Sholund v. Commissioner, 50 T.C. 503, 508 (1968); Henry v. Commissioner, 36 T.C. 879, 884 (1961); Reed v. Commissioner, 35 T.C. 199, 202 (1960); Long v. Commissioner, 32 T.C. 511, 513 (1959), *aff'd*, 277 F.2d 239 (8th Cir. 1960). Courts most often discuss this criterion in the context of deductions related to personal activities such as hobbies and recreation. *See, e.g.*, Teitelbaum v. Commissioner, 346 F.2d 266, 269 (7th Cir. 1965) (disallowing the costs of operating a date ranch which never made a profit but provided luxurious residential accommodations for the taxpayer); Guzowski v. Commissioner, 26 T.C.M. (CCH) 666 (1967) (denying deductions for expenditures related to the singing activities of an office worker because she had no intention to make a profit). Courts also discuss this criterion in the context of

pense must in some way relate to, or be incident to, the production of income in the taxpayer's trade or business.[39]

The third requirement, that the item be an "expense," means that the payment is not required to be capitalized under section 263.[40] Determining whether an expenditure is deductible under section 162(a) requires consideration of "'the nature of the expenditure itself, which in turn depends on the extent and permanency of the work accomplished by the expenditure.'"[41] The taxpayer must devote the amount paid to current income production to qualify as an expense.[42] If an expenditure contributes to a corporation's betterment or will provide a benefit beyond the current taxable year, the taxpayer must capitalize the amount of the expenditure.[43]

The last two requirements—"necessary" and "ordinary"—are the most common sources of controversy.[44] An expense is "necessary" if it is

---

litigation costs. *See, e.g.*, Kornhauser v. United States, 276 U.S. 145, 153 (1928) (stating that "where a suit or action against a taxpayer is directly connected with, or, as otherwise stated, proximately resulted from, his business, the expense incurred is a business expense") (citing Appeal of F. Meyer & Brother Co., 4 B.T.A. 481, 482 (1926); Appeal of Backer, 1 B.T.A. 214, 216 (1924)).

39. Carroll v. Commissioner, 51 T.C. 213, 218 (1968) (stating "before expenses will be considered ordinary and necessary under section 162, it must be established that they bear a proximate and direct relationship to the taxpayer's trade or business") (citing *Kornhauser*, 276 U.S. at 153), *aff'd*, 418 F.2d 91 (7th Cir. 1969); STANLEY & KILCULLEN, *supra* note 35, § 162(a) (stating that "an activity must be entered into with at least the *expectation* of making a profit"); *see* Greenstein & Persellin, *supra* note 34, at 572 (stating that some "nexus" must exist between the expenditure and the taxpayer's business).

40. Greenstein & Persellin, *supra* note 34, at 572. The requirement that an expenditure be an "expense" is often confused with the conclusion that an expenditure is a deductible business expense, and the terms are often used interchangeably. An item which is an "expense" may or may not qualify for deductibility depending on whether the four other requirements of § 162(a) are satisfied. *See* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 352-53 (1971). Under a technical application of the elements enumerated in *Lincoln Savings*, it is the expense requirement that should be used to draw the distinction between capital expenditures and deductible expenses. *Id.* The expense requirement, however, has been merged with the ordinary requirement. For a discussion of the confusion between the "ordinary" and "expense" requirements, see *infra* note 52.

41. E.I. du Pont de Nemours & Co. v. United States, 432 F.2d 1052, 1059 (3d Cir. 1970) (disallowing deduction for legal expenses incurred in reorganization, which was expected to produce benefits for many years) (citing 4A MERTENS, *supra* note 22, § 25.20).

42. General Bancshares Corp. v. Commissioner, 326 F.2d 712, 715 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964).

43. *Id.*; *see* I.R.C. § 263(a)(1). For the relevant text of § 263(a), see *supra* note 24.

44. For the historical origin of the terms "ordinary" and "necessary," see Bernard Wolfman, *Professors and the "Ordinary and Necessary" Business Expense*, 112 U. PA. L. REV. 1089, 1092 n.15 (1964).

"appropriate and helpful" in carrying out the taxpayer's trade or business.[45] The expense need not be "indispensable" so long as it is "appropriate and helpful"[46] and is "intended to result in some benefit to the taxpayer's business."[47] In the context of takeovers, the board of directors has a fiduciary duty to the corporation's shareholders.[48] Thus, expenses incurred in investigating tender offers to determine whether they are in the best interest of the corporation and shareholders are generally deemed necessary.[49]

An expense is "ordinary" if it is common and generally accepted in a particular trade or business community.[50] The expense need not be

---

45. *See, e.g.*, Commissioner v. Tellier, 383 U.S. 687, 689 (1965) (allowing deduction for expenses necessary to enable the taxpayer to stay in business); Commissioner v. Heininger, 320 U.S. 467, 471 (1943) (same); Welch v. Helvering, 290 U.S. 111, 113 (1933) (requiring capitalization of payments made to creditors of former business); *see also* Blackmer v. Commissioner, 70 F.2d 255, 256 (2d Cir. 1934) (finding that entertainment expenditures of an entertainer were necessary to enhance his career); Cannon Valley Milling Co. v. Commissioner, 44 B.T.A. 763, 768 (1941) (concluding that expenditures incurred to avoid threatened litigation were necessary); Miller v. Commissioner, 37 B.T.A. 830, 832 (1938) (stating that expenditures to protect or promote a taxpayer's business are necessary); Alverson v. Commissioner, 35 B.T.A. 482, 487-88 (1937) (holding that expenditures for statistical research were necessary for one in the business of trading stocks); MERTENS, *supra* note 22, §§ 25.01, 25.13, 25.18.

46. Carbine v. Commissioner, 83 T.C. 356, 363 (1984), *aff'd*, 777 F.2d 662 (11th Cir. 1985).

47. MERTENS, *supra* note 22, § 25.18. The taxpayer must reasonably believe that such anticipated benefits will actually occur. Levitt & Sons, Inc. v. Nunan, 142 F.2d 795, 797-98 (2d Cir. 1944) (stating that the "reasonable expectation" of benefit must be "well grounded").

48. *See* Northwest Indus., Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (N.D. Ill. 1969) ("[M]anagement has the responsibility to oppose [tender] offers which, in its best judgment, are detrimental to the company or its stockholders."); *see also infra* note 110.

49. *See* 3 WILLIAM M. FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 838 (perm. ed. 1986); *see also Northwest Indus.*, 301 F. Supp. at 712-13.

50. Welch v. Helvering, 290 U.S. 111, 113 (1933); *see also* MERTENS, *supra* note 22, §§ 25.01, 25.13, 25.15. In *Welch*, the taxpayer, in order to strengthen his own credit and reputation, paid the debts of a discharged bankrupt corporation with which he had been associated as an officer and shareholder. *Welch*, 290 U.S. at 112. The Commissioner ruled that the payments were not deductible because they were capital expenditures made to develop goodwill. This ruling was upheld by the Tax Court, the Eighth Circuit Court of Appeals, and the Supreme Court. *Id.* at 113. Justice Cardozo, writing for the Court, reasoned that the payments were not "ordinary" because they were not "common and accepted" in the taxpayer's particular trade or business community. *Id.* at 114. For a criticism of the *Welch* opinion, see MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION ¶ 6.03 (6th ed. 1991).

common for the particular taxpayer so long as it is common and accepted within that taxpayer's trade or business community.[51] As illustrated by *INDOPCO*, it is the "ordinary" requirement that is usually applied to distinguish those expenses the taxpayer may deduct from those expenditures the taxpayer must capitalize.[52] In the context of defend-

---

51. *Welch*, 290 U.S. at 114. Justice Cardozo stated that the word "ordinary" does not require "that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often." *Id.* Instead, it is "a variable affected by time and place and circumstance." *Id.* at 113-14. For an illustration of Justice Cardozo's position, see *infra* note 53.

52. *See* INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1043-44 (1992); *see also* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) (stating that the principal function of the "ordinary" requirement is to distinguish between expenses which are currently deductible and expenditures which are capital in nature); Commissioner v. Tellier, 383 U.S. 687, 689-90 (1966) (same).

Since the 1933 case of Welch v. Helvering, 290 U.S. 111, 113-16 (1933), where Justice Cardozo used the term "ordinary" as shorthand for distinguishing capital expenditures from deductible expenses, lower courts have merged the "ordinary" requirement and the expense-capitalization dichotomy. *See* Ryman v. Commissioner, 51 T.C. 799, 801-03 (1969); Carl Reimers Co. v. Commissioner, 19 T.C. 1235, 1239 (1953), *aff'd*, 211 F.2d 66, 68 (2d Cir. 1954); Grace Nat'l Bank of N.Y. v. Commissioner, 15 T.C. 563, 565 (1950). Using the "ordinary" requirement to make this distinction is erroneous, and it makes the "expense" requirement superfluous, thereby spawning confusion in an area of tax law that is already rife with uncertainty. *See Lincoln Sav.*, 403 U.S. at 352-53.

Judge Wisdom's explanation of the requirements, as enumerated in *Ellis Banking Corp. v. Commissioner*, is helpful:

> Although the Supreme Court set out five separate requirements, the third requirement is subsumed in the fifth. The word "ordinary" in the statute distinguishes deductible expenses from expenditures that must be capitalized and, if deductible at all, amortized over the life of the resulting asset. The term "expense" as a term of art in accounting refers only to items that meet the requirement of ordinariness.

688 F.2d 1376, 1378 n.4 (11th Cir. 1982) (citations omitted).

In *National Starch I*, the Tax Court stated that the current "expense" requirement was the only requirement in dispute. *National Starch I*, 93 T.C. 67, 73 (1989) ("Given our disposition of the case, we need consider only the [current expense] requirement[]."). This approach is contrary to the approach taken by the Supreme Court in *Welch*, where the Court focused on the "ordinary" requirement to make the distinction between deductibility and capitalization. *Welch*, 290 U.S. at 113-15. In *National Starch II*, however, the Third Circuit stated that the "ordinary expense" requirement was the only one in dispute. *National Starch II*, 918 F.2d 426, 428 (3d Cir. 1990). It further stated that the distinction between deductible expenses and capital expenditures is made by applying the "ordinary" requirement. *Id.* at 428-29 (citing Commissioner v. Tellier, 383 U.S. 687, 689-90 (1966)); *see also Lincoln Sav.*, 403 U.S. at 353 (citing *Tellier*, 383 U.S. at 689-90).

It is no wonder that Justice Cardozo, describing the "ordinary" requirement in 1933, wrote, "One struggles in vain for any verbal formula that will supply a ready touchstone." *Welch*, 290 U.S. at 115. As *National Starch I* and *National Starch II* illustrate, the courts have yet to consistently announce that verbal formula. For guidelines ing a business, an expense is "ordinary," not because it is "habitual or normal," but because it is a "common and accepted means of defense against attack."[53] A corporation incurring investment banking and legal fees for defensive tactics clearly satisfies this definition of "ordinary."[54]

In addition, it is generally accepted that the term "ordinary and necessary" impliedly requires that the deduction be reasonable in amount.[55] The determination of whether an expenditure is deductible as "ordinary and necessary," however, is a question of fact that must be determined on a case-by-case basis.[56]

C. *Guidelines Used to Make the Ordinary vs. Capital Distinction*

As previously mentioned, the principal function of the "ordinary" requirement, as the lower courts interpret it, is to distinguish expenses that are currently deductible from those that must be capitalized.[57] Courts have developed additional criteria to aid in making the distinction between ordinary and capital expenditures.[58] The most commonly

---

used to aid in the ordinary versus capital distinction, see *infra* notes 57-88 and accompanying text.

53. *Welch*, 290 U.S. at 114. Justice Cardozo drew an interesting analogy to legal fees incurred by a taxpayer involved in litigation to protect her business. *Id.* The fees would be ordinary, even if a lawsuit "may happen once in a lifetime" because "payments for such a purpose . . . are the common and accepted means of defense against attack." *Id.* The word "ordinary" must be interpreted "according to the ways of conduct and forms of speech prevailing in the business world." *Id.* at 115.

54. Greenstein & Persellin, *supra* note 34, at 572.

55. *See, e.g.*, United States v. Haskel Eng'g & Supply Co., 380 F.2d 786, 788-89 (9th Cir. 1967) (stating that the requirement that an expense be reasonable in amount is an inherent limitation of the "ordinary and necessary" concept); Commissioner v. Lincoln Elec. Co., 176 F.2d 815, 817-18 (6th Cir. 1949) (concluding that Congress intended that an expense be reasonable in amount to be deductible), *cert. denied*, 338 U.S. 949 (1950); *cf.* Treas. Reg. § 1.212-1(d) (stating that nonbusiness expenses under § 212 must be "reasonable in amount" to be deductible).

56. *Welch*, 290 U.S. at 114. As Justice Cardozo stated, the distinctions between ordinary and extraordinary expenditures

> are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

Id. at 114-15.

57. For an analysis of the error of this interpretation, see *supra* note 52.

58. Greene, *supra* note 30, at 714.

used guidelines are the "one-year" test,[59] the "separate and distinct asset" test,[60] and the "origin-of-the-claim" doctrine[61].

1. The One-Year Test

The classic test for determining the deductibility of an expenditure is the one-year test.[62] The Tenth Circuit, in *United States v. Akin*,[63] first established the one-year test, which distinguishes between deductible expenses and capital expenditures based on the period for which the expenditures provide a benefit.[64] Under *Akin*, an expenditure is considered capital "if it brings about the acquisition of an asset having a period of useful life in excess of one year or if it secures a like advantage to the taxpayer which has a life of more than one year."[65]

This test appropriately eliminates from capital treatment those expenditures that provide no future benefits to the taxpayer.[66] The one-year test, however, is not without criticism. Because some courts improperly focus on the future benefit alone, they justify exceptions to the rule of nondeductibility based on considerations of expediency or pragmatism.[67]

---

59. *See infra* notes 62-72 and accompanying text.

60. *See infra* notes 73-83 and accompanying text.

61. *See infra* notes 84-88 and accompanying text.

62. The one-year test, or the future benefit test, has found broad acceptance in the courts. *See, e.g.*, Bonaire Dev. Co. v. Commissioner, 679 F.2d 159, 161 (9th Cir. 1982); E.I. du Pont de Nemours & Co. v. United States, 432 F.2d 1052, 1058-59 (3d Cir. 1970); American Dispenser Co. v. Commissioner, 396 F.2d 137, 138 (2d Cir. 1968); Sears Oil Co. v. Commissioner, 359 F.2d 191, 197 (2d Cir. 1966); General Bancshares Corp. v. Commissioner, 326 F.2d 712, 715 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964); Farmers Union Corp. v. Commissioner, 300 F.2d 197, 200 (9th Cir.), *cert. denied*, 371 U.S. 861 (1962); Mills Estate, Inc. v. Commissioner, 206 F.2d 244, 246 (2d Cir. 1953).

63. 248 F.2d 742 (10th Cir. 1957), *cert. denied*, 355 U.S. 956 (1958).

64. G. Edward Hinshaw, Note, *Income Tax—Costs of Expanding an Existing Business: Current Deductions Versus Capital Expenditures*—North Carolina National Bank Corp. v. United States, 18 WAKE FOREST L. REV. 1127, 1135 (1982).

65. United States v. Akin, 248 F.2d at 744 (citing Hotel Kingkade v. Commissioner, 180 F.2d 310 (10th Cir. 1950) (delineating the one-year test)); *accord* Fall River Gas Appliance Co. v. Commissioner, 349 F.2d 515, 516-17 (1st Cir. 1965) ("a capital expenditure is one that secures an advantage to the taxpayer which has a life of more than one year"); *see also* United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968) (same); American Dispenser Co. v. Commissioner, 396 F.2d 137, 138 (2d Cir. 1968) (same); Richmond Television Corp. v. United States, 345 F.2d 901, 907-08 (4th Cir.) (same), *vacated*, 382 U.S. 68 (1965).

66. *See* Jack's Cookie Co. v. United States, 597 F.2d 395, 405 (4th Cir.), *cert. denied*, 444 U.S. 899 (1979). "The one-year rule is useful because it serves to segregate from all business costs those which cannot possibly be considered capital in nature because of their transitory utility to the taxpayer." *Id.* (finding that a rental payment was not currently deductible because it might result in future benefit).

67. John W. Lee, *Doping Out the Capitalization Rules After* INDOPCO, 57 TAX

Today, however, courts generally view the one-year test as a guideline rather than a rule.[68] The Supreme Court has considered other factors because many concededly deductible expenditures have benefits that endure beyond the current year.[69]

The one-year test is roughly the test applied by the Supreme Court in *INDOPCO*,[70] and it has taken on greater significance as a result of that decision.[71] While *INDOPCO* does not require that courts apply the one-year test exclusively, it does declare that "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."[72]

NOTES 669, 671 (1992) (citing Fishman v. Commissioner, 837 F.2d 309, 311 (7th Cir.), *cert. denied*, 487 U.S. 1235 (1988); NCNB Corp. v. United States, 651 F.2d 942, 962 (4th Cir. 1981) ("not-worth-the-trouble exception"), *vacated*, 684 F.2d 285 (4th Cir. 1982) (en banc)).

68. *See Wehrli*, 400 F.2d at 689. In *Wehrli*, the Tenth Circuit, which originally announced the "'one-year' rule of thumb," stated that "[the rule] was intended to serve as a mere guidepost for the resolution of the ultimate issue, not as an absolute rule requiring the automatic capitalization of every expenditure providing the taxpayer with a benefit enduring for a period in excess of one year." *Id.*

69. Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971) ("[M]any expenses concededly deductible have prospective effect beyond the taxable year."). In NCNB Corp. v. United States, the court stated, "One need not consider further than the case of the corporate executive who spends a significant, though indeterminable, amount of his time on future planning to realize that universal application of the one year rule is impossible and that it has not been so applied in such cases." 684 F.2d at 289. According to the court in *Wehrli*, "Certainly the expense incurred in the replacement of a broken windowpane, a damaged lock, or a door, or even a periodic repainting of the entire structure, may well be treated as a deductible repair expenditure even though the benefits endure quite beyond the current year." *Wehrli*, 400 F.2d at 689.

70. *See* INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992); *see also infra* notes 163-75 and accompanying text.

71. *See infra* notes 178-289 and accompanying text.

72. *INDOPCO*, 112 S. Ct. at 1044-45 (emphasis added). The *INDOPCO* Court cited United States v. Mississippi Chemical Corp., 405 U.S. 298, 310 (1972), and Central Texas Savings & Loan Ass'n v. United States, 731 F.2d 1181, 1183 (5th Cir. 1984). In *Mississippi Chemical*, the Court determined that the expenditure incurred by a cooperative association to purchase securities in a bank for cooperatives was a nondeductible capital asset because the expenditure was "of value in more than one taxable year." 405 U.S. at 310.

In *Central Texas Savings & Loan*, the Fifth Circuit held that the taxpayer's expenditures for permits in starting new branches of its savings and loan were not deductible because they created "separate and distinct assets." 731 F.2d at 1185. However, the court stated:

2. The Separate and Distinct Asset Test

Another test less frequently applied in determining the deductibility of an expenditure is the "separate and distinct asset test," which the Supreme Court enumerated in *Commissioner v. Lincoln Savings & Loan Ass'n.*[73] In *Lincoln Savings*, the Supreme Court held that the controlling factor in determining the deductibility of an expenditure is whether "the . . . payment serves to create or enhance for [the taxpayer] what is essentially a separate and distinct additional asset."[74]

Lincoln Savings, however, did not address the case where the expenditures do not "create or enhance . . . a separate and distinct additional asset."[75] While some lower courts have recognized this apparent limita-

---

> While the period of benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominant, characteristic of a capital item. We still consider, therefore, that the continuation of the permit's value to the taxpayer for a period exceeding one year is evidence that the permit or its cost of acquisition are capital items.

Id. at 1183 (citations omitted). Thus, while the court decided the issue of deductibility under the "separate and distinct asset" test, it recognized that the duration of the benefit is a significant factor to consider. *Id.*

73. 403 U.S. at 354.

74. *Id.* Justice Blackmun, who authored the majority opinion, wrote:

> [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 [the taxpayer] 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) in the absence of other factors not established here.

Id. It is noteworthy that the expenditure at issue in *Lincoln Savings* provided a future benefit to the taxpayer and, accordingly, could have been classified as a nondeductible capital expenditure under the one-year test. *See id.*; *cf. Mississippi Chem.*, 405 U.S. at 310 ("Since the [asset] is of value in more than one taxable year, it is a capital asset within the meaning of § 1221 of the Internal Revenue Code, and its cost is nondeductible.").

It is interesting to compare this opinion with the opinion in *INDOPCO*, which Justice Blackmun also authored. In *Lincoln Savings*, Justice Blackmun stated that the creation of a separate and distinct asset is controlling, and that the presence of some future benefit is not controlling. *Id.* In contrast, in *INDOPCO*, Justice Blackmun stated that a future benefit is "undeniably important." *INDOPCO*, 112 S. Ct. at 1044-45. He determined the outcome of the case based on this "noncontrolling" characteristic, in the face of the taxpayer's argument to the contrary. *Id.* Justice Blackmun reasoned that the opinion in *Lincoln Savings* was limited to the specific situation before the Court. *Id.*; *see infra* note 300 and accompanying text.

75. *Lincoln Sav.*, 403 U.S. at 354.

tion to the *Lincoln Savings* holding,[76] other courts have concluded that if the expenditures do not create a separate and distinct asset they are necessarily deductible—that is, the creation or enhancement of an asset is a prerequisite to capitalization.[77]

Since *Lincoln Savings*, most courts that have employed the "separate and distinct asset" test[78] have adopted the view that it is only one of many factors to consider.[79] Courts cannot agree, however, as to how much weight to give each of the tests as factors within the classification.[80] At least one circuit has recognized that the separate and distinct

76. *See, e.g.*, Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 225 (1985).

> All the [*Lincoln Savings* holding] states is that in the particular case what was decisive was that Lincoln's payment of the additional premiums had acquired for it a separate and distinct additional asset . . . and hence the payment had to be capital in nature and not an expense. It does not state . . . that if the separate and distinct asset test is not met the payment is a necessary and ordinary expense.

Id.

77. *See, e.g.*, Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 787 (2d Cir. 1973). In *Briarcliff Candy*, the taxpayer incurred "promotional expenses" to develop a new distribution channel for its products. *Id.* at 777-78. Because the expenditures did not create or enhance a separate and distinct additional asset, the court held that they were currently deductible as ordinary and necessary business expenses. *Id.* at 787.

That is the same argument INDOPCO made to the Supreme Court. INDOPCO contended that *Lincoln Savings* "announced an exclusive test for identifying capital expenditures, a test in which 'creation or enhancement of an asset' is a prerequisite to capitalization." *INDOPCO*, 112 S. Ct. at 1044.

78. *See, e.g.*, *Briarcliff Candy*, 475 F.2d at 786-87; *see also* Honodel v. Commissioner, 722 F.2d 1462, 1465-66 (9th Cir. 1984); Seligman v. Commissioner, 84 T.C. 191, 201-02 (1985), *aff'd*, 796 F.2d 116 (5th Cir. 1986).

79. *See, e.g.*, Jack's Cookie Co. v. United States, 597 F.2d 395, 404-05 (4th Cir.), *cert. denied*, 444 U.S. 899 (1979). In *Jack's Cookie Co.*, the court, in resolving a perceived conflict between the one-year rule and the separate and distinct asset test, noted that "[i]n the abstract many costs incurred by an on-going business can be viewed as producing some type of benefit beyond the taxable year, but we have never indicated that capitalization of an item is required on that basis alone." *Id.* at 404; *see also* Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1191-92 (10th Cir. 1974).

80. *Compare* NCNB Corp. v. United States, 684 F.2d 285, 293 (4th Cir. 1982) (finding that the expenditures incurred by a bank in connection with developing a branch network were deductible because they did not create or enhance a "separate and distinct additional asset") *with* Central Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1185 (5th Cir. 1984) (holding similar expenditures must be capitalized because they were the cost of acquiring branch offices which were separate and dis-

asset test necessarily incorporates the one-year rule.[81]

The *INDOPCO* decision explicitly endorses the contention that courts should not view the separate and distinct asset test as dispositive in all cases, but rather, as a condition sufficient to justify capitalization.[82] The *INDOPCO* decision may have greatly reduced the significance of the separate and distinct asset test because of its broad application. In addition, it highlights the different results obtained under the one-year test and the "separate and distinct asset" test.[83]

3. The Origin-of-the-Claim Doctrine

The origin-of-the-claim doctrine is another approach to the classification of expenditures that looks to the origin and character of the expenditure.[84] This test originated in the Supreme Court's decision in *Woodward v. Commissioner*.[85] Since *Woodward*, courts have applied this test almost exclusively in the context of litigation costs.[86] This ap-

---

tinct assets). These cases, which are seemingly at odds, are reconciled by considering the importance that each court attached to the future benefit aspect of the respective expenditures. For a detailed discussion of the conflicting results in *NCNB* and *Central Texas*, see David F. Webb, Note, *The Deductibility of Bank Branching Expenditures:* Central Texas Savings & Loan Association v. United States: *A Weak Rebuttal to* NCNB Corp. v. United States, 19 U. RICH. L. REV. 147 (1984). *See also* Hinshaw, *supra* note 64, at 1139-44.

81. *Jack's Cookie Co.*, 597 F.2d at 405 ("one integral characteristic of the 'separate and distinct' asset which is 'created or enhanced' by the outlay, is that it will serve the taxpayer in subsequent years" (footnote omitted)).

82. *See* INDOPCO Inc. v. Commissioner, 112 S. Ct. 1039, 1044-45 (1992); *see also* Greene, *supra* note 30, at 723 & n.83; Steven A. Middleton, Commissioner v. Lincoln Savings & Loan Association: *"Separate and Distinct Asset" as a Condition Sufficient for Capitalization*, 2 VA. TAX REV. 315, 334-35 (1982); *supra* note 79 and accompanying text.

83. *INDOPCO*, 112 S. Ct. at 1044-45.

84. Soelling v. Commissioner, 70 T.C. 1052, 1055 (1978); MERTENS, *supra* note 22, § 25.37.

85. 397 U.S. 572 (1970).

86. *See, e.g., id.* at 575-76 (holding that expenditures incurred during dissenting stockholder appraisal litigation were not deductible); United States v. Hilton Hotels Corp., 397 U.S. 580, 583 (1970) (companion case) (same); *see also* United States v. Gilmore, 372 U.S. 39, 46-48 (1963) (using the origin-of-the-claim test to determine whether litigation costs were deductible under § 212, a provision similar to § 162 which governs deductions for nonbusiness expenses); Sharples v. United States, 533 F.2d 550, 553 (Ct. Cl. 1976) (finding that expenditures incurred to determine foreign tax liability were deductible under the origin-of-the-claim test).

In theory, the origin-of-the-claim test is "applicable to a variety of corporate expenditures." Greene, *supra* note 30, at 726; *see also* Honodel v. Commissioner, 722 F.2d 1462, 1467 (9th Cir. 1984) (expenditures for tax advice rendered pursuant to a capital acquisition); Great Lakes Pipe Line Co. v. United States, 352 F. Supp. 1159, 1172 (W.D. Mo. 1972) (expenditures incurred in conjunction with disposition of a proach replaces the primary purpose test, which was previously applied by the Tax Court.[87] Generally, the origin-of-the-claim doctrine requires capitalization if there is an integral relationship between an expenditure and the acquisition of a capital asset.[88]

There are other tests, such as the dominant aspect test,[89] that courts occasionally employ in other circumstances. The three tests discussed above, however, are the most commonly applied.[90]

---

capital asset).

87. *See Woodward*, 397 U.S. at 577.

88. *See id.* at 576; *see also* Madden v. Commissioner, 514 F.2d 1149, 1151 (9th Cir. 1975), *rev'g* 57 T.C. 513 (1972) (expenditures incurred in controversy relating to sale and acquisition of land were not deductible under the "origin and character" standard), *cert. denied*, 424 U.S. 912 (1976); Mosby v. Commissioner, 86 T.C. 190, 196-98 (1986) (legal expenses incurred in inverse condemnation suit were not deductible under the origin-of-the-claim test). In *Woodward*, the Supreme Court addressed the issue of whether the costs incurred by the majority stockholders of a corporation in litigation brought to appraise the minority interest were deductible. 397 U.S. at 573. The Court applied the origin-of-the-claim test in deciding that the litigation expenditures were not deductible and should be "treated as part of the cost of the stock that the taxpayers acquired." *Id.* at 577-79.

89. The dominant aspect test, however, is not really a test, but rather, an acknowledgement that where a transaction has aspects of both a business expense and a capital expenditure, courts will weigh both aspects to determine which is dominant, then characterize all costs according to that determination. *See* Mills Estate, Inc. v. Commissioner, 206 F.2d 244, 246 (2d Cir. 1953) (stating that an "entire proceeding must be viewed as a single transaction" in determining whether the expenditures relating to the proceeding are deductible); *see also* Gravois Planing Mill Co. v. Commissioner, 299 F.2d 199, 208 (8th Cir. 1962) (citing *Mills Estate*, 206 F.2d at 246) (concluding that in a corporate reorganization "the transaction is to be viewed as a whole and its dominant aspect is to govern the tax character of the expenditures"). *But see* McCrory Corp. v. United States, 651 F.2d 828, 836 (2d Cir. 1981) (allocating expenditures to avoid all-or-nothing approach); United States v. General Bancshares Corp., 388 F.2d 184, 191-92 (8th Cir. 1968) (allowing deduction for costs incurred in divestment of assets but disallowing deduction for costs incurred to change corporate name); Larchfield Corp. v. United States, 373 F.2d 159, 166-67 (2d Cir. 1966) (stating that expenditures must be allocated to determine which amounts are properly deductible); General Bancshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964).

90. *See supra* notes 62-88; *see also*, McCrory Corp. v. United States, 651 F.2d 828, 835-36 (2d Cir. 1981). In *McCrory*, the court allocated the expenditures because they did "not lend themselves to treatment on the basis of what courts and commentators have called the 'dominant aspect' of the transaction." *Id.* at 836. The court commented in a footnote that "[t]he 'dominant aspect' approach has not been free from criticism." *Id.* at 836 n.12 (citing Note, *The Deductibility of Attorneys' Fees*, 74 HARV. L. REV. 1409, 1409-11 (1961); Comment, *Attorneys' Fees for Partial Liquidation: Business Expense or Capital Asset?*, 6 STAN. L. REV. 368 (1954)).

D. *The Internal Revenue Service's Shifting Position*

Since it first addressed the deductibility of takeover-related expenses in late 1984,[91] the IRS has shifted its position on the issue several times,[92] which indicates the uncertainty with which the IRS views the deductibility of such expenditures. The IRS's current position is that the taxpayer can deduct takeover-related expenditures if the taxpayer can show that it did not derive a long-term benefit from the expenditures.[93] The Supreme Court's decision in *INDOPCO* might remove the uncertainty relating to takeover-related expenditures, but it transplants that uncertainty to other areas.

III. BACKGROUND OF *INDOPCO, INC. V. COMMISSIONER*

A. *Facts of* INDOPCO

INDOPCO, Inc., formerly National Starch, was a Delaware corporation engaged in the manufacture and sale of starches and specialty chemical products.[94] In October 1977, Unilever United States, Inc.

---

91. *See* Tech. Adv. Mem. 85-16-002 (Dec. 14, 1984) (conceding that a taxpayer could deduct expenses incurred to oppose a stock tender offer).

92. For a detailed chronology of the IRS's shifting position, see Karen R. Irby, *Current Status of the Deductibility of Expenses Incurred During Takeovers*, 10 TAX MGMT. WKLY. REP. 1384, *passim* (1991).

To summarize, Technical Advice Memorandum 85-16-002 found that a taxpayer could deduct expenditures incurred to oppose a stock tender offer. Tech. Adv. Mem. 85-16-002 (Dec. 14, 1984). Technical Advice Memorandum 86-26-001 withdrew Technical Advice Memorandum 85-16-002 within a year of its issuance, Tech. Adv. Mem. 86-26-001 (Aug. 23, 1985), but Technical Advice Memorandum 88-16-005 reinstated it eighteen months later, Tech. Adv. Mem. 88-16-005 (Feb. 13, 1987).

Technical Advice Memorandum 89-27-005, issued only months prior to the Tax Court's decision in *National Starch I*, confirmed the deductibility of takeover-related expenditures. Tech. Adv. Mem. 89-27-005 (Mar. 27, 1989). However, Technical Advice Memorandum 89-45-003, which the IRS issued within a week of the Tax Court's decision in *National Starch I*, expressly revoked Technical Advice Memorandum 89-27-005 as being inconsistent with the Tax Court's decision. Tech. Adv. Mem. 89-45-003 (Aug. 1, 1989); *see National Starch I*, 93 T.C. 67, 78 (1989).

Technical Advice Memorandum 90-43-003, which replaced Technical Advice Memorandum 89-27-005, determined that costs directly associated with resisting a hostile takeover were deductible, but costs incurred to locate a white knight and effect a change of ownership were not. Tech. Adv. Mem. 90-43-003 (July 9, 1990). Technical Advice Memorandum 91-44-042, which the IRS issued only seven months after the Third Circuit's decision in *National Starch II*, contains the IRS's latest position and concludes that such costs are deductible only if the taxpayer can show that it did not derive a long-term benefit. Tech. Adv. Mem. 91-44-042 (July 1, 1991).

93. *See* Tech. Adv. Mem. 91-44-042.

94. INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1041 (1992).

(Unilever)[95] approached Frank Greenwall, National Starch's largest shareholder[96] and a member of its board of directors,[97] to propose the acquisition of National Starch by Unilever in a friendly takeover.[98] Greenwall indicated he would sell his shares to Unilever only if the transaction could be structured in such a manner as to be tax-free to him.[99] Furthermore, Unilever was only interested in the acquisition if it could be consummated as a friendly takeover.[100]

Attorneys for both parties devised a "reverse subsidiary cash merger,"[101] which would give the shareholders the option of disposing their

---

95. Unilever United States, Inc. was a holding company. *Id.* at 1041 n.1. A holding company is a corporation which owns securities by which it is able to control the management of other companies in a particular enterprise. 6A FLETCHER, *supra* note 49, § 2821 (perm. ed. 1989) (quoting North Am. Co. v. Securities & Exch. Comm'n, 327 U.S. 686, 701 (1946)).

In 1977, the principal subsidiaries of Unilever were Lever Brothers Co. and Thomas J. Lipton, Inc. *INDOPCO*, 112 S. Ct. at 1041 n.1. Unilever was a wholly owned subsidiary of Unilever, N.V., a Netherlands corporation. *National Starch II*, 918 F.2d 426, 426-27 (3d Cir. 1990).

96. Frank Greenwall, together with his wife, was National Starch's largest shareholder, owning approximately 14.5% of the company's stock. *Id.* National Starch, which was listed on the New York Stock Exchange, had over 6,563,000 shares outstanding and approximately 3700 shareholders. *Id.*

97. Greenwall was the chairman of the executive committee of National Starch's Board of Directors. *National Starch I*, 93 T.C. 67, 69 (1990).

98. *INDOPCO*, 112 S. Ct. at 1041. Unilever was interested in acquiring National Starch, one of its suppliers, to increase its United States revenues in relation to its total revenues. *National Starch II*, 918 F.2d at 426-27.

99. *INDOPCO*, 112 S. Ct. at 1041. Mr. and Mrs. Greenwall, who were 81 and 79 years old, respectively, required the transaction to be tax-free to them for estate planning reasons. *National Starch I*, 93 T.C. at 69. If the Greenwalls disposed of their shares in a taxable sale, they would recognize a taxable gain on the appreciation. *See* I.R.C. § 1222 (1988) (requiring recognition of capital gain or loss on the sale of an asset). However, by postponing recognition until after their deaths through the use of a tax-free exchange, the Greenwalls could obtain a step-up in basis to the fair market value of the shares upon their deaths. *See* I.R.C. § 1014 (1988) (providing for stepped-up basis on property passed from a decedent).

100. *National Starch II*, 918 F.2d at 427. For reasons which are not given, Unilever indicated that it would initiate the tender offer only if both National Starch and the Greenwalls favored the transaction. *National Starch I*, 93 T.C. at 69.

101. The "reverse subsidiary cash merger" that the parties employed was similar to a reverse triangle merger with an option to make a transfer for cash. *See* 11 MERTENS, *supra* note 22, § 43.48. A reverse triangle merger is where a parent corporation's subsidiary merges into a target corporation, which becomes the surviving corporation. *Id.* In this type of merger, stock of the subsidiary's parent is given to the shareholders of the target corporation in exchange for their shares. *Id.*

shares in a tax-free exchange[102] or a taxable sale.[103] As part of the plan, two new corporations were formed.[104] The first was National Starch and Chemical Holding Corporation (Holding), which was a subsidiary of Unilever.[105] The other was NSC Merger, Inc. (NSC), a subsidiary of Holding and a second-level subsidiary of Unilever with a transitory existence.[106] Under the terms of the plan, Holding would exchange its nonvoting preferred stock for National Starch's common stock.[107] Unilever would purchase for cash any National Starch stock not exchanged in the merger of NSC into National Starch.[108] As a result of the arrangement, NSC would be merged into National Starch, which would become a wholly-owned subsidiary of Holding.[109]

Because of the merger negotiations, counsel for National Starch advised the board of directors that it had a fiduciary duty to guarantee that the transaction would be fair to its shareholders.[110] As a result,

---

To qualify as a reverse triangle merger, the surviving corporation must own substantially all of its and the subsidiary's assets. *Id.* In addition, the shareholders of the target corporation must receive voting stock of the parent in exchange for control of the target. *Id.* After the merger is complete, the target becomes a subsidiary of the parent of the merged subsidiary. *Id.*

The National Starch merger differed from the reverse triangle merger in two relevant ways. First, the shareholders of National Starch, the target, could exchange their shares for the *nonvoting* preferred stock in Unilever, the parent, as opposed to voting stock. Second, the shareholders had the option of receiving cash instead of stock for their shares.

102. *See* I.R.C. § 368(a) (1988). A corporation must meet one of the seven categories of transactions under § 368(a) of the Internal Revenue Code to qualify as a "reorganization" as defined for tax purposes. *Id.* A reorganization is a form of corporate acquisition, division, or other restructuring that is not taxed at the corporate or shareholder level because the shareholders retain an equity interest in the reorganized corporation. *See id.*; Treas. Reg. § 1.368-1.

Once a transaction is termed a "reorganization," it must fit within the provisions of § 354, 355, 356, or 361 to be entirely or partially tax-free. I.R.C. §§ 354-356, 361. While the exchange is commonly termed "tax-free," that phrase is somewhat misleading. The exchange itself is tax free, but it results only in deferred recognition of capital gains realized on the transaction. *See id.* §§ 354, 355, 1221, 1231.

103. *INDOPCO*, 112 S. Ct. at 1041. If the transaction does not qualify as a tax-free reorganization, it will be treated as a taxable sale. Thus, the shareholder will be taxed on the capital gain in the year the sale takes place. I.R.C. § 368(a); *see supra* note 102.

104. *National Starch I*, 93 T.C. at 69.

105. *INDOPCO*, 112 S. Ct. at 1041.

106. *Id.*

107. *Id.*

108. *Id.*

109. *See National Starch I*, 93 T.C. at 69.

110. *INDOPCO*, 112 S. Ct. at 1041. Under Delaware law,

> [w]hen a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its

National Starch engaged an investment banking firm to provide professional guidance for the transaction.[111] The investment bankers were to render a fairness opinion and evaluate the stock, as well as defend National Starch in the event the takeover attempt turned hostile.[112] In addition, the investment banking firm prepared a report that indicated that the acquisition would create "synergy" and that National Starch would benefit from Unilever's vast resources.[113]

After some negotiations, the parties agreed on a price and executed a merger agreement contingent upon a private letter ruling from the IRS[114] approving the tax-free merger.[115] In June of 1978, the IRS issued a letter ruling approving the transaction as a tax-free reorganization under section 351 of the Internal Revenue Code.[116]

In August of 1978, the transaction was carried out pursuant to the plan.[117] National Starch paid its investment bankers $2,225,586 in fees

---

> shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment.

Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (citation omitted). National Starch's counsel advised the directors that the failure to retain an investment banking firm to ensure the fairness of the transaction could be evidence of a failure of the directors to fulfill their fiduciary duties to the shareholders. *National Starch I*, 93 T.C. at 69-70.

111. *INDOPCO*, 112 S. Ct. at 1041.

112. *Id.*

113. *National Starch I*, 93 T.C. at 71. The report "noted that National Starch management 'feels that some synergy may exist with the Unilever organization given a) the nature of the Unilever chemical, paper, plastics and packaging operations . . . and b) the strong consumer products orientation of Unilever United States, Inc.'" *INDOPCO*, 112 S. Ct. at 1045 (quoting Brief for Petitioner at 77-78 (No. 90-1278)).

114. A private letter ruling is a statement issued by the IRS to the taxpayer advising the taxpayer in advance of the tax treatment it can expect from a transaction based on the IRS's interpretation and application of the tax laws. BLACK'S LAW DICTIONARY 1196 (6th ed. 1990).

115. *National Starch I*, 93 T.C. at 70.

116. *Id.* at 70-71. The transaction was formally approved by the IRS in Revenue Ruling 84-71. Rev. Rul. 84-71, 1984-1 C.B. 106. In that ruling, which revoked Revenue Rulings 80-284 and 80-285, the IRS concluded that the fact that a "purported section 351 exchange" fails to meet the requirements for a tax-free reorganization does not preclude the applicability of § 351 to transfers which are part of a "larger acquisitive transaction." *Id.* Section 351(a) provides, "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation." I.R.C. § 351(a) (1988). For a basic discussion of tax-free exchanges, see *supra* note 102.

117. *INDOPCO*, 112 S. Ct. at 1041. About 21% of the common stock was exchanged

for services and expenses,[118] and paid its attorneys $505,069 for legal fees and expenses.[119] National Starch incurred an additional $150,962 in miscellaneous expenses.[120]

National Starch filed a federal income tax return for its final taxable year and claimed a business expense deduction for $2,225,586 paid to its investment bankers but not the $505,069 paid to its attorneys.[121] The IRS issued a notice of deficiency, denying the claimed deduction.[122] National Starch filed a petition in the United States Tax Court contesting the disallowance of the investment banking fees and further contending that the legal fees and miscellaneous expenses were also deductible.[123]

B. *The Tax Court's Decision*

The United States Tax Court held that the takeover-related expenses were not deductible under section 162(a).[124] The Tax Court primarily relied on *E.I. du Pont de Nemours & Co. v. United States*[125] for the

---

for preferred stock in Holding, and the remaining 79% of the common stock was transferred for cash. *Id.* at 1041 n.2. Subsequently, National Starch amended its charter to reduce the authorized common stock to 1000 shares and to eliminate the preferred stock entirely. *National Starch II*, 918 F.2d at 427.

118. *INDOPCO*, 112 S. Ct. at 1042. The $2,225,586 paid to the investment banking firm was comprised of $2,200,000 in fees for services, $18,000 for legal fees, and $7586 for out-of-pocket expenses. *Id.*

119. *Id.* The $505,069 included $490,000 in legal fees and $15,069 for out-of-pocket expenses. *Id.*

120. *Id.* These expenditures were for Securities and Exchange Commission fees, proxy costs, accounting fees, and printing costs associated with the merger. *Id.*

121. *Id.* at 1043.

122. *Id.* at 1042. The IRS claimed a $1,068,281 deficiency as a result of the disallowed deduction. *National Starch II*, 918 F.2d at 427.

123. *INDOPCO*, 112 S. Ct. at 1042. National Starch claimed a refund of $706,079 for the expenses it asserted should have been deducted. *National Starch II*, 918 F.2d at 428.

124. *National Starch I*, 93 T.C. at 75.

125. 432 F.2d 1052, 1059 (3d Cir. 1970). In *E.I. du Pont de Nemours & Co.*, the taxpayer deducted legal expenses incurred in severing its joint interest in a public corporation. *Id.* at 1058. The court held that the expenses, which were analogous to reorganization costs, were not chargeable against a single year's income because they could be expected to produce benefits for many years. *Id.* at 1059.

The Tax Court cited several other decisions as well. *See* Falstaff Beer, Inc. v. Commissioner, 322 F.2d 744, 746-47 (5th Cir. 1963) (holding that expenditures for goodwill in the acquisition of a going concern were not deductible as ordinary and necessary business expenses), *aff'g* 37 T.C. 451 (1961); McDonald v. Commissioner, 139 F.2d 400, 401 (3d Cir. 1943) (finding costs of an unsuccessful campaign for elected office were not deductible because of the capital nature of the outlay), *aff'd*, 323 U.S. 57 (1944); Clark Thread Co. v. Commissioner, 100 F.2d 257, 258 (3d Cir. 1938) (concluding that an expenditure made to eliminate competition was not a rule that expenditures resulting in a long-term benefit are capital in nature and thus not deductible as ordinary and necessary business expenses.[126] The court concluded that the expenditures were capital in nature because the expenditures would lead to long-term benefits.[127] The court set forth three specific findings to support its conclusion.[128]

First, because of its fiduciary obligation, the board of directors must have felt the takeover was in the best interest of the corporation, otherwise it would not have approved the takeover offer.[129] Second, the investment banker's report stated that the merger would create "synergy," and National Starch's annual report indicated that the corporation would benefit from the availability of Unilever's enormous resources.[130] Third, National Starch would benefit from broadened opportunities, both immediately and long-term, by the availability of Unilever's resources.[131]

The Tax Court rejected National Starch's argument that the dominant purpose of the expenditures was to fulfill the directors' fiduciary obliga-

---

deductible business expense because the benefits were not confined to the year of the expenditure), *aff'g* 28 B.T.A. 1128 (1933).

126. *National Starch I*, 93 T.C. at 75. Interestingly, the Tax Court noted, "'While the period of the benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominate, characteristic of a capital item.'" *Id.* (quoting Central Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1183 (5th Cir. 1984)). The court found that *Lincoln Savings* was inapplicable because it addressed only expenditures that created a separate and distinct asset. *Id.* at 77.

127. *Id.* at 78.

128. *See id.* at 76-77.

129. *Id.* at 76 (citing Unocal Corp. v. Mesa Petroleum Corp., 493 A.2d 946, 954 (Del. 1985) (stating that the board has an "obligation to determine whether the [takeover] offer is in the best interests of the corporation and its shareholders")). *See supra* note 110 and accompanying text. The court failed to explain why or how it concluded there was a long-term benefit based on the mere fact that the takeover might have been in the best interest of the corporation. *See National Starch I*, 93 T.C. at 76.

130. *National Starch I*, 93 T.C. at 76. While the court acknowledged that there was "no evidence of an immediate benefit from the affiliation," it determined that the absence of short-term benefits did not preclude the possibility of long-term benefits. *Id.* The court further stated that expenditures made with the expectation of a long-term benefit must be capitalized even when that expectation is not fulfilled. *Id.* (citing Union Mut. Life Ins. Co. v. United States, 570 F.2d 382, 392 (1st Cir.), *cert. denied*, 439 U.S. 821 (1978); Radio Station WBIR, Inc. v. Commissioner, 31 T.C. 803, 813-14 (1959)).

131. *Id.* at 76-77. The court does not, however, provide any examples of what those opportunities might be. *Id.*

tion to the shareholders.[132] Instead, the court erroneously focused on the dominant aspect of the transaction—the transfer of National Starch's stock.[133] The Tax Court concluded that the expenditures were not deductible because they related more to National Starch's "permanent betterment, and hence were capital in nature, than to the carrying on of daily business and production of income."[134]

C. *The Third Circuit Affirmed*

The Third Circuit Court of Appeals affirmed the Tax Court's decision.[135] After reciting the facts and procedural history, the Third Circuit focused its discussion on the Supreme Court's ruling in *Commissioner v. Lincoln Savings & Loan Ass'n.*[136] In discussing the five requirements enumerated by the Supreme Court in *Lincoln Savings*,[137] the court emphasized that only the "ordinary expense" requirement was in dispute.[138] The purpose of that requirement "is to distinguish between expenses currently deductible and capital expenditures which, if deductible at all, must be amortized over the useful life of the asset."[139]

National Starch argued that *Lincoln Savings* created a "new and exclusive test," which meant that expenditures are deductible if they do not create a separate and distinct asset.[140] While the court agreed that *Lincoln Savings* dictated that an expenditure that creates a separate

---

132. *Id.* at 78.

133. *Id.* The court stated, "We would let the tail wag the dog if we were to view the stock transfer as the incidental aspect and the fiduciary duty that arose from the stock transfer as the dominant aspect." *Id.*

134. *Id.*

135. *National Starch II*, 918 F.2d at 434. The case was argued before Judges Sloviter, Becker, and Stapleton. *Id.* at 426. Judge Sloviter authored the opinion for the Third Circuit. *Id.*

136. *See id.* at 428-31. The Third Circuit focused on National Starch's argument that *Lincoln Savings* "created a new test to determine deductibility under section 162(a) that looks to whether a separate and distinct additional asset is created, rather than the length of the period of the benefits." *Id.* at 428 (citing *National Starch I*, 93 T.C. at 77). The Tax Court summarily rejected that same argument, stating that *Lincoln Savings* "did not address the deductibility of expenditures which do not create or enhance a separate and distinct asset." *National Starch I*, 93 T.C. at 77. For a recitation of the facts and holding in *Lincoln Savings*, see *supra* note 32.

137. For a discussion of the five requirements, see *supra* notes 32-54 and accompanying text.

138. *National Starch II*, 918 F.2d at 428 (citing Commissioner v. Lincoln Sav. and Loan Ass'n, 403 U.S. 345, 352 (1971)).

139. *Id.* at 428-29 (citing Commissioner v. Tellier, 383 U.S. 687, 689-90 (1966)); *see supra* text accompanying note 52.

140. *National Starch II*, 918 F.2d at 428-29. The court concluded that "no one factor can control this complex decision." *Id.* at 430-31.

and distinct asset must be capitalized,[141] it refused to read *Lincoln Savings* as having created a "new bright-line test."[142]

The Third Circuit then turned its attention to the nature of the expenditures that National Starch incurred, an inquiry the court described as "particularly difficult."[143] The court concluded that the Tax Court's finding that the expenditures created a long-term benefit to National Starch was amply supported by the record.[144] Accordingly, the Third Circuit affirmed the Tax Court's decision that National Starch could not deduct, under section 162(a) of the Internal Revenue Code, the investment banking fees, legal fees, and related expenditures incurred in the merger.[145]

IV. THE SUPREME COURT HEARS THE CASE

The Supreme Court granted certiorari[146] "to resolve a perceived conflict" among the circuit courts[147] arising from different interpretations

141. *Id.* at 429 (citing *Lincoln Sav.*, 403 U.S. at 354).

142. *Id.* at 430. The court noted that after *Lincoln Savings*, courts employed standards other than the separate and distinct asset test to determine the deductibility of expenditures. *Id.* The court cited United States v. Mississippi Chemical Corp., 405 U.S. 298 (1972), a case decided the year after *Lincoln Savings*, to support the point that *Lincoln Savings* did not represent a "radical shift and a new bright-line test for capitalization." *National Starch II*, 918 F.2d at 430. For a brief description of the central holding in *Mississippi Chemical*, see *supra* note 72.

143. *National Starch II*, 918 F.2d at 431. The issue was particularly difficult because the expenditures "resulted in neither a tangible asset nor a readily identifiable intangible asset." *Id.* (citing Ellis Banking Corp. v. Commissioner, 688 F.2d 1376, 1379 n.7 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983)). The court stated that "the common characteristic of expenses that have been found to be capital, in fact the *sine qua non* of capitalization, is the presence of a not insignificant future benefit that is more than merely incidental." *Id.*

144. *Id.* at 432. The court agreed that the availability of Unilever's resources was a benefit to National Starch. *Id.* In 1976, Unilever owned assets worth nearly five and one-half billion dollars and had an operating profit of more than one billion dollars. *Id.* In contrast, for the same year, National Starch had assets of $241 million and operating income of $48 million. *Id.*

145. *Id.* at 434.

146. INDOPCO, Inc. v. Commissioner, 111 S. Ct. 2008 (1991).

147. INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1042 (1992). The Fourth Circuit, in *NCNB Corp. v. Commissioner*, held that a bank's expenditures for feasibility studies related to expansion plans were deductible as ordinary and necessary expenses because they did not "create or enhance separate and identifiable assets." 684 F.2d 285, 293-94 (4th Cir. 1982). Similarly, in *Briarcliff Candy Corp. v Commissioner*, the Second Circuit suggested that *Lincoln Savings* made capitalization de-

of the *Lincoln Savings* decision.[148] At oral argument, the Commissioner of Internal Revenue (the Commissioner) argued that National Starch must capitalize the takeover costs because they provided a long-term benefit to National Starch, INDOPCO's predecessor.[149] INDOPCO argued that the "pragmatic" approach advocated by the Commissioner would result in "an unpredictable 'case-by-case' determination of what is a capital expenditure."[150] INDOPCO vigorously urged the Court to apply the separate and distinct asset test instead of the long-term benefit test.[151] It argued that the expenditures at issue were deductible because no separate asset was created.[152]

---

pendent on whether a separate and distinct asset was created by the expenditure. 475 F.2d 775, 782 (2d Cir. 1973).

Both of these decisions indicated that the separate and distinct asset test was exclusive, and thus were in conflict with the Third Circuit's decision in *National Starch II*. *See National Starch II*, 918 F.2d at 428-31. In *National Starch II*, the court held that while the "presence of a separate and distinct asset is sufficient to treat an expenditure creating or enhancing that asset as capital, the lack of such an asset does not necessarily mean that an expenditure is ordinary and necessary under section 162(a)." *Id.* at 431.

148. *INDOPCO*, 112 S. Ct. at 1042 n.3. For a brief discussion of *Lincoln Savings*, see *supra* note 32.

149. Lee A. Sheppard, *Supreme Court Hears Arguments on Accounting for Takeover Fees*, 53 TAX NOTES 761, 761 (1991). In response to the Commissioner's argument, counsel for INDOPCO ironically was forced to argue that the professional services conferred no long-term benefit to National Starch. *Id.*

150. *Counsel Debate Appropriate Test for Capitalization of Expenditure*, U.S.L.W., Nov. 13, 1991. A similar argument was made by the Tax Executives Institute in its brief submitted as amicus curiae in support of INDOPCO. *See* Brief of Tax Executives Institute, Inc. as Amicus Curiae in Support of Petitioner, INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992) (No. 90-1278). The Tax Executives Institute argued that disallowing the deduction would "threaten[] to strip away the relative certainty that taxpayers and the government have found under *Lincoln Savings*" resulting in confusion and the unnecessary disruption of the tax system. *Id.*

151. Sheppard, *supra* note 149, at 761-62.

152. *Id.* Sheppard wrote that the parties on both sides of the controversy might have missed the point. *Id.* at 762. She echoed the argument of University of Texas Law Professor Calvin Johnson that the takeover-related expenditures should be treated as constructive dividends because they primarily benefitted the shareholders of National Starch. *Id.* (citing Calvin H. Johnson, *The Expenditures Incurred by the Target Corporation in an Acquisitive Reorganization are Dividends to the Shareholders: (Pssst, Don't Tell the Supreme Court)*, 53 TAX NOTES 463 (1991) (arguing that, under the primary-benefit test, the professional fees involved in *National Starch II* should be treated as dividends because they primarily benefitted the corporation's ownership rather than its operations)).

Sheppard felt that the most interesting moment at the oral argument of *INDOPCO* came when Justice Stevens realized that the primary beneficiaries of the expenditures were the shareholders. Sheppard, *supra* note 149, at 762. The dividend issue, however, was not before the Court. *Id.*

On February 26, 1992, the Supreme Court announced its decision in *INDOPCO.*[153] The anxiously awaited ruling, however, has left many seeking further guidance as to the meaning of *INDOPCO.*

V. Analysis of the Supreme Court's Decision

The Supreme Court prefaced its analysis with the "'familiar rule' that 'an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.'"[154] The Court stated that deductions, which are specifically enumerated in the Internal Revenue Code, are "exceptions to the norm of capitalization" and are "strictly construed and allowed only 'as there is a clear provision therefor.'"[155]

The Court then turned to a discussion of the requirements of a deductible expenditure as delineated in *Lincoln Savings.*[156] In reviewing the interrelationships between the Internal Revenue Code's provisions for deductibility[157] and capitalization,[158] the Court noted that the "'decisive distinctions' between current expenses and capital expenditures 'are those of degree and not of kind,' and that because each case 'turns on its special facts,' the cases sometimes appear difficult to harmonize."[159]

INDOPCO argued that "*Lincoln Savings* changed these familiar backdrops and announced an exclusive test for identifying capital expenditures."[160] The new test, INDOPCO argued, was a bright-line test requiring the "'creation or enhancement of an asset'" as a prerequisite to

153. *INDOPCO,* 112 S. Ct. 1039.

154. *Id.* at 1043 (quoting Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593, *reh'g denied,* 320 U.S. 809 (1943)). *Contra* Erwin N. Griswold, *An Argument Against the Doctrine that Deductions Should be Narrowly Construed as a Matter of Legislative Grace,* 56 Harv. L. Rev. 1142 (1943). The Court devoted a full paragraph of the opinion to emphasize the point that deductions are the exception rather than the norm. *See INDOPCO,* 112 S. Ct. at 1042-43.

155. *INDOPCO,* 112 S. Ct. at 1043 (quoting New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934)).

156. *Id.* at 1043-41 (citing Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 352 (1971)). For a discussion of these five requirements, see *supra* notes 32-56 and accompanying text. For a brief discussion of *Lincoln Savings,* see *supra* note 32.

157. *See* I.R.C. § 162(a) (1988).

158. *See* I.R.C. § 263(a) (1988).

159. *INDOPCO,* 112 S. Ct. at 1044 (citations omitted); *see supra* note 30 and accompanying text.

160. *INDOPCO,* 112 S. Ct. at 1044.

capitalization.[161] The Court rejected this argument, stating that the creation of a "separate and distinct asset," while sufficient to require capitalization, was not a necessary condition for capitalization of an expenditure.[162]

Next, the Court stated that the *Lincoln Savings* decision did not preclude reliance on any future benefit as a factor in distinguishing deductible expenses from capital expenditures.[163] Instead, the pres-

---

161. *Id.* (quoting Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 347-48 (1971)).

162. *Id.* The Court provided the following explanation:

> *Lincoln Savings* stands for the simple proposition that a taxpayer's expenditure that 'serves to create or enhance . . . a separate and distinct' asset should be capitalized under § 263. It by no means follows, however, that *only* expenditures that create or enhance separate and distinct assets are to be capitalized under § 263. We had no occasion in *Lincoln Savings* to consider the tax treatment of expenditures that, unlike the additional premiums at issue there, did not create or enhance a specific asset, and thus the case cannot be read to preclude capitalization in other circumstances. In short, *Lincoln Savings* holds that the creation of a separate and distinct asset well may be a sufficient but not a necessary condition to classification as a capital expenditure.

Id. (quoting *Lincoln Sav.*, 403 U.S. at 354) (emphasis in original); *see supra* note 74.

On its face, Justice Blackmun's explanation is convincing. However, in effect, the explanation means this: If an expense creates a separate and distinct asset it must be capitalized; if it does not, it still must be capitalized if it provides a long-term benefit for the taxpayer. Thus, the IRS now gets two bites at the apple.

163. *INDOPCO*, 112 S. Ct. at 1044. The Court explained that "the statement in *Lincoln Savings* that 'the presence of an ensuing benefit that may have some future aspect is not controlling' [does not] prohibit reliance on future benefit as a means of distinguishing an ordinary business expense from a capital expenditure." *Id.* (quoting *Lincoln Sav.*, 403 U.S. at 354). At this point, it appears that the Court was backpedaling in an attempt to limit the application of its previous statement in *Lincoln Savings* to those situations where there is the creation of a separate and distinct asset. *See supra* note 162 and accompanying text.

The Court's use of the word "prohibit" in this statement makes it clear that the absence of a separate asset does not automatically make an expenditure deductible. *See INDOPCO*, 112 S. Ct. at 1044. It leaves unresolved, however, the question of whether the existence of a long-term benefit always mandates capitalization. The Court did state that "[a]lthough the mere presence of an incidental future benefit—'*some* future aspect'—may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization." *Id.* at 1044-45. The issue then becomes one of defining "incidental" and establishing the temporal limits of the word "future" in the context of a future benefit that does not warrant capitalization, keeping in mind, however, the next phrase, which referred to the "realization of benefits beyond the year in which the expenditure is incurred" as an important factor in determining the proper treatment of the expenditure. *See id.*

ence of a future benefit is "undeniably important" in determining whether an expenditure warrants capitalization.[164]

The Court then applied those principles to the investment banking fees, legal fees, and other costs that National Starch incurred in connection with the Unilever merger.[165] The Court rejected INDOPCO's arguments and concluded that the specific expenditures at issue were not deductible under section 162(a) because INDOPCO failed to demonstrate the right to the claimed deduction.[166]

INDOPCO argued that any future benefits of the merger were "entirely speculative."[167] The Court rejected this argument and found ample support for both the Tax Court[168] and Third Circuit's[169] conclusions that the transaction produced significant benefits extending beyond the taxable year in question.[170] The Court enumerated several long-term benefits that formed the basis of its opinion.[171]

First, the Court noted two resource related benefits.[172] National Starch would benefit from the availability of Unilever's vast resources, and management had indicated that the merger would create "syner-

---

164. *INDOPCO*, 112 S. Ct. at 1044-45 (citing United States v. Mississippi Chem. Corp., 405 U.S. 298, 310 (1972); Central Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1183 (5th Cir. 1984)); *see supra* note 72 and accompanying text.

165. *INDOPCO*, 112 S. Ct. at 1045.

166. *Id.* Regardless of whether deductions are broadly or narrowly construed, the taxpayer has the burden of showing the right to any claimed deduction. *See supra* note 154 and accompanying text.

167. *INDOPCO*, 112 S. Ct. at 1045. INDOPCO argued that the Third Circuit recognized that "many deductible expenses produce future benefits for the taxpayer, but it would restrict deductibility to those expenses producing a 'merely incidental' future benefit. Any expenses generating a future benefit that is 'more than merely incidental,' and, in addition, is 'not insignificant,' would have to be capitalized." Petitioner's Brief at 39-40, INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992) (No. 90-1278). INDOPCO furthered that argument by pointing out that "[t]he 'not insignificant' future benefit attributed to National Starch was entirely speculative." *Id.*

168. *See supra* notes 124-34 and accompanying text.

169. *See supra* notes 135-45 and accompanying text.

170. *INDOPCO*, 112 S. Ct. at 1045.

171. *Id.* For an argument that the expenditures at issue in *INDOPCO* should be deductible because a long-lived asset was not created by the shift of the stock ownership to Unilever and that the acquisition costs did not create any additional value, see Charles A. LoFaso, *An Argument for the Current Deductibility of a Target's Expenses in a "Friendly" Takeover*, 38 BUFF. L. REV. 801 (1990) (discussing *National Starch I*, 93 T.C. 67 (1989)).

172. *INDOPCO*, 112 S. Ct. at 1045.

gy."[173] In addition, the Court pointed out the benefit involved in transforming the publicly held corporation into a wholly owned subsidiary.[174] National Starch exchanged more than 3500 shareholders for a single shareholder and, therefore, would no longer have the expenses incurred for shareholder relations.[175] Because the expenditures were not, in the Court's view, "ordinary and necessary," the Court ruled in favor of the Commissioner, holding that INDOPCO could not deduct these expenditures of National Starch under section 162(a) of the Internal Revenue Code.[176]

National Starch, however, in its battle against the IRS, is not the only one "stiffed" by the Supreme Court's decision in *INDOPCO.* The *INDOPCO* decision marks a significant victory for the IRS which, if applied in other areas, could greatly reduce the business deductions allowable under section 162(a) of the Internal Revenue Code.[177]

VI. THE IMPACT OF THE *INDOPCO* DECISION: UNCERTAINTY

The Tax Executives Institute, in its amicus curiae brief for *INDOPCO,* pointed out that the Third Circuit's language "is at once so broad and nebulous that it undermines the 'ordinary and necessary' character of expenses long been held to be currently deductible."[178] The Institute warned that the Supreme Court would jeopardize the deductibility of many categories of expenses by affirming the Third Circuit, which would create further uncertainty in an area that is already riddled with difficult distinctions.[179] The brief specifically referred to repair expenses, advertising costs, and employee training costs.[180] The Supreme Court, however, affirmed the Third Circuit and almost entirely adopted

173. *Id.*

174. *Id.*

175. *Id.* The Court pointed out that as a wholly owned subsidiary, National Starch would not incur expenses for carrying on proxy battles, maintaining shareholder derivative lawsuits, or complying with reporting and disclosure requirements. *Id.*

176. *Id.* at 1046.

177. What is particularly troubling about *INDOPCO* is the rationale requiring capitalization of the professional service fees because they provided a benefit beyond the taxable year. *See id.* at 1045-46. Reading the case broadly and applying the rationale to its limits, the presence of *any* future benefit would require capitalization.

178. Brief of Tax Executives Institute, Inc. as Amicus Curiae in Support of Petitioner, INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039 (1992) (No. 90-1278).

179. *Id.* The brief of the Tax Executives Institute stated, "The beauty of *Lincoln Saving's* [sic] separate and distinct additional asset test lies in its bringing some order to an area where 'hopeless confusion' was often the norm. In contrast, the Third Circuit's skewing of the test to distinguish between 'incidental' and 'not insignificant' future benefits will only spawn confusion." *Id.* (citation and footnote omitted).

180. *Id.*

its reasoning, despite the amicus brief filed by the Tax Executives Institute.[181]

As a result, the Tax Executives Institute's warning has come to pass. Armed with the *INDOPCO* decision in its arsenal of weapons against the corporate taxpayer, the IRS is taking a hard-nosed stand against many types of business expenditures other than takeover related costs.[182] The IRS is, to the fullest extent possible, taking advantage of this "license . . . to disallow all manner of normal business deductions."[183] Tax professionals, concerned about the impact of *INDOPCO*, have been asking the IRS for additional guidance on the future application of the *INDOPCO* decision.[184]

Just as the IRS was uncertain about the treatment of takeover-related expenditures before the Supreme Court ruled in *INDOPCO*,[185] the IRS has been uncertain about what guidance it will provide relating to the

181. *See* INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1042-46 (1992); *cf. National Starch II*, 918 F.2d 426, 432-33 (3d Cir. 1990).

182. Ray A. Knight & Lee G. Knight, *The Point of No Return for Tax Deductions of Acquisition Costs*, MERGERS & ACQUISITIONS, Sept.-Oct. 1992, at 41, 41 (stating that the IRS is fighting "more aggressively against tax deductions"). Tax professionals are "up in arms" as a result of the IRS's usage of what has been termed the "absurdly broad language the justices used to rule in the government's favor." *The Agents Run Riot*, *supra* note 12, at 144.

183. *The Agents Run Riot*, *supra* note 12, at 144. As Lydia Kess, a partner at the New York law firm of Davis Polk & Wardwell put it, "'Agents have seized the offensive and are running riot.'" *Id.*; *see also* Avakian-Martin, *supra* note 13, at 152 (stating that "because there are no bright-line standards out there, IRS agents are being aggressive and are denying deductions without any hard-and-fast reasoning").

Cabell Chinnis, Jr., a tax attorney in the Washington, D.C. office of Latham & Watkins, sees a gap between the approach taken by field agents on audit and the approach of the IRS's national office. INDOPCO *Guidance, Due By Year's End, Said Likely to Target Specific Areas*, SECURITIES REG. AND L. REP., July 31, 1992, at 1155, 1155. Chinnis stated that "'in the field, it does look like the agents continue to employ a black hole theory of capitalization; under a black hole approach, expenditures within two solar systems of a capital transaction are capital.'" *Id.*

184. *E.g.*, John J. Huber, *PMAA Says Cleanup Costs Should be Deductible*, 57 TAX NOTES 1633 (1992) (requesting guidance for petroleum marketers on treatment of environment remediations).

After the release of the IRS's guidance in the advertising area, *see* Rev. Rul. 92-80, 1992-39 I.R.B. 1, Former Commissioner of the IRS Lawrence Gibbs commented, "'The IRS leadership has acted responsibly on the advertising issue, but a lot of money is at stake. We need more guidance soon.'" *The Agents Run Riot*, *supra* note 12, at 144.

185. For a discussion of the inconsistent positions taken by the IRS, see *supra* notes 91-93 and accompanying text.

future application of *INDOPCO*. Initially, at a July 24, 1992 bar luncheon, the IRS took the position that the standards for deduction had not significantly changed.[186] At that time, the IRS indicated that rather than provide a general statement of the law, it would offer guidance in specific areas.[187] Since that time, the IRS has offered guidance in the areas of repair expenditures, in the form of a Technical Advice Memorandum,[188] and advertising costs, in the form of a Revenue Ruling.[189] The guidance offered is far from adequate, but at least it is a start at shedding some light on deductibility issues in a post-*INDOPCO* environment.

A. *Application of* INDOPCO *to Repair Expenditures*

1. Existing Body of Law

The cost of repairs made to property or assets used in the taxpayer's trade or business is a properly deductible business expense under section 162(a) of the Internal Revenue Code,[190] provided the five requirements set forth in *Lincoln Savings* are satisfied.[191] A repair is defined as an expenditure made merely to keep the property in "an ordinary efficient operating condition."[192] It does not add to the value of the property or prolong its life[193] beyond that which was expected before the repair.[194] In contrast, expenditures made for improvements, replacements, alterations, additions, or reconditioning are not deductible if they increase the property's value or prolong its useful life.[195] They

186. Avakian-Martin, *supra* note 13, at 152.

187. *Id.* Debra L. Carlisle, an attorney-advisor for the IRS Office of Chief Counsel (Income Tax and Accounting), said that advertising, repairs, and employee training expenses were areas that were likely to be addressed. *Id.*

188. *See* Tech. Adv. Mem. 92-40-004 (June 29, 1992).

189. *See* Rev. Rul. 92-80, 1992-39 I.R.B. 1.

190. I.R.C. § 162(a) (1988). For the relevant text of § 162(a), see *supra* note 23.

191. *See* Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 352 (1971). For the five requirements, see *supra* text accompanying note 33.

192. Treas. Reg. § 1.162-4 (1960). Treasury Regulations § 1.162-4 provides as follows: "The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinary efficient operating condition, may be deducted as an expense . . . ." *Id.*

193. *Id.*

194. Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962), *nonacq.*, 1964-2 C.B. 8; Midland Empire Packing Co. v. Commissioner, 14 T.C. 635, 641 (1950).

195. *Plainfield-Union*, 39 T.C. at 338; *Midland Empire*, 14 T.C. at 641; Illinois Merchants Trust Co., 4 B.T.A. 103, 105-07 (1926). Treasury Regulations § 1.162-4 provides as follows: "Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with section 167 or charged against depreciation reserve if such an account is kept." Treas. Reg. § 1.162-4.

must be capitalized pursuant to Internal Revenue Code section 263(a).[196]

The deductibility is determined by the nature of the expenditure and the purpose for which it was made.[197] For example, an expenditure for repairs is not deductible if it is "necessary to put, rather than to 'keep,' the building in an 'ordinarily efficient operating condition.'"[198] In addition, if the expenditure is of a recurring nature and serves to maintain the condition of the property, the expenditure generally will be deductible to assure the proper matching of income and expenses.[199]

As with all capitalization issues, the dividing line between deductible repairs and capital improvements is not clear.[200] In *Illinois Merchants Trust Co.*,[201] the seminal case on deductible repairs, the Board of Tax Appeals required that a repair not increase the property's value, prolong the property's life, or make the property suitable for a new use.[202]

196. I.R.C. § 263(a) (1988). For the relevant text of § 263(a), see *supra* note 24.

197. Munroe Land Co. v. Commissioner, 25 T.C.M. (CCH) 3 (1966) (allowing a deduction for costs incurred in replacing the insulation in the roof of a building); *see also Illinois Merchants*, 4 B.T.A. at 106 ("In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made.").

198. Stoeltzing v. Commissioner, 266 F.2d 374, 376 (3d Cir. 1959); *see also* Moss v. Commissioner, 831 F.2d 833, 841-42 (9th Cir. 1987) (costs for repairs to a hotel must be capitalized when made as part of a remodeling plan with a five-year life).

199. *See* I.R.C. § 446(b) (1988); *supra* notes 25-30 and accompanying text; *see also* Colorado Springs Nat'l Bank v. United States, 405 F.2d 1185, 1192-93 (10th Cir. 1974).

200. *See* United States v. Akin, 248 F.2d 742, 744 (10th Cir. 1957); *see also Midland Empire*, 14 T.C. at 640 ("It is none too easy to determine on which side of the line certain expenditures fall so that they may be accorded their proper treatment for tax purposes.").

201. 4 B.T.A. 103 (1926).

202. *Id.* at 106. The Board pronounced the following oft-quoted language:

> To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements, or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.

Id.

There is a long line of cases that elaborate on these criteria.

First, as stated in *Illinois Merchants*, the repair must "not add to the value of the property."[203] It is well established that "any properly performed repair adds value as compared with the situation existing immediately prior to that repair."[204] Furthermore, cases indicate that the "value" to be considered is the value of the property for use in the taxpayer's business.[205]

Second, the repair must not "appreciably prolong" the property's useful life.[206] Courts again seem to rely on whether the repair has increased the useful life of the property over the normal, useful, expected life before the occurrence of the condition necessitating the expenditure.[207]

In *Plainfield-Union Water Co. v. Commissioner*,[208] the Tax Court announced that "[t]he proper test is whether the expenditure materially enhances the value, use, life expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure."[209] In that case, the taxpayer, a public utility, was allowed a deduction for the cost of cleaning approximately 7400 feet of tar-lined pipe and replacing the tar with cement to restore the pipe's carrying capacity.[210] The work served to restore the pipe to its preexisting condition, and the expense did not make the pipe more valuable or long-lived, nor did it result in an additional use for the pipes.[211] The court stated that "[a]n expenditure which returns property to the state it was in before the situation prompting the expenditure arose, and

---

203. *Id.*

204. Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962).

205. *See* Black Hardware Co. v. Commissioner, 39 F.2d 460, 460 (5th Cir.), *cert. denied*, 282 U.S. 841 (1930) (determining that the cost of raising the taxpayer's building above sea level was a capital investment because it made the building more valuable in the taxpayer's business); Hotel Sulgrave, Inc. v. Commissioner, 21 T.C. 619, 619 (1954) (finding that the cost to install a sprinkler system in a hotel constituted a capital expenditure because it made the property more valuable in the taxpayer's business); Midland Empire Packing Co. v. Commissioner, 14 T.C. 635, 639-641 (1950) (allowing a deduction for the cost of oilproofing a basement because the oilproofing did not "make the building more valuable for any purpose than it had been before the oil had come into the basement").

206. Illinois Merchants Trust Co., 4 B.T.A. 103, 107 (1926); *see also* Buckland v. United States, 66 F. Supp. 681, 682 (D. Conn. 1946).

207. *See Plainfield-Union*, 39 T.C. at 338; *Midland Empire*, 14 T.C. at 641; *Illinois Merchants*, 4 B.T.A. at 107.

208. 39 T.C. 333 (1962).

209. *Id.* at 338.

210. *Id.* at 335. A process known as tuberculation had reduced the pipe's carrying capacity. *Id.* The cement lining was not permanent, but it would eliminate the tuberculation problem. *Id.* at 336-37.

211. *Id.* at 338.

which does not make the relevant property more valuable, more useful, or longer-lived, is usually deemed a deductible repair."[212]

In *Midland Empire Packing Co. v. Commissioner*,[213] the taxpayer's meat-packing operation was threatened by oil escaping from a neighboring refinery and seeping into the basement of the taxpayer's plant.[214] Because federal meat inspectors threatened to shut down the plant if the taxpayer did not oilproof the basement, the taxpayer sealed the basement walls and floor with a concrete lining.[215] While the lining served its purpose by effectively sealing out the oil, the expenditure "did not add to the value or prolong the expected the life of the property over what they were before" the oil seepage occurred.[216] The Tax Court held that the expenditure was a deductible expenditure because it was a repair that kept the property in working condition without increasing its life or value.[217]

Cases further indicate that the repair must have been incurred to correct a condition that is not reasonably foreseeable.[218] It appears, however, that an expenditure made to correct a current defect will be deductible even if it diminishes or forestalls future repairs.[219] In *American Bemberg Corp. v. Commissioner*,[220] the Tax Court allowed a deduction for expenditures to stop cave-ins of soil that threatened the taxpayer's manufacturing plant.[221] The expenditures did not cure the

212. *Id.* at 337.

213. 14 T.C. 635 (1950).

214. *Id.* at 636-37. There had been water seepage into the taxpayer's basement for years, but the seepage was not a hazard until oil began seeping into the basement after the oil refinery expanded its operations. *Id.* at 636.

215. *Id.* at 637-39.

216. *Id.* at 641. The court noted that the basement was satisfactory for its intended purpose prior to the oilproofing. *Id.* The oilproofing did not enlarge the basement nor make it more desirable for its intended purpose. *Id.*

217. *Id.* at 642-43. The court observed that "[t]he repairs merely served to keep the property in an operating condition over its probable useful life for the purpose for which it was used." *Id.* at 641.

218. *See* Mt. Morris Drive-In Theatre Co. v. Commissioner, 25 T.C. 272, 275 (1955) (denying a deduction for repairs which were obviously necessary when the property was placed into service).

219. *See* Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962) (allowing a deduction for the cost of installing lining in water pipe that eliminated the need for periodic cleanings); Kansas City S. Ry. Co. v. United States, 112 F. Supp. 164, 165 (Ct. Cl. 1953) (permitting a deduction for the cost of repairs thought to produce benefits for fifteen years); American Bemberg Corp. v. Commissioner, 10 T.C. 361, 377 (1948), *aff'd*, 177 F.2d 200 (6th Cir. 1949).

220. 10 T.C. 361 (1948).

221. *Id.* at 376, 378. The taxpayer's rayon-spinning plant experienced repeated floor

geological defect but merely "forestalled imminent disaster" by dealing with its "intermediate consequences."[222] The repair expenditures were deductible as ordinary and necessary business expenses because the purpose of the expenditures "was not to improve, better, extend, or increase the original plant, nor to prolong its original useful life."[223]

The repair cannot make the property adaptable for a different use[224] or suitable for any substantial new or additional uses other than the use to which the property was put before the repair.[225] A common factor among repair cases, the significance of which is unclear, is that the repair was necessitated by the introduction of an exogenous force.[226] However, whether the repair was made pursuant to a government dictate or other legal compulsion, which is in some sense an exogenous force, is irrelevant in determining deductibility.[227]

Illinois Merchants Trust Co. and its progeny illustrate that the deductibility of repair expenditures is well-settled.[228] But the IRS recently attempted to sidestep this line of cases in a Technical Advice Memorandum by relying on *INDOPCO* to deny a deduction under section 162 for the cost of replacing asbestos insulation in the taxpayer's manufacturing equipment,[229] thus injecting uncertainty into this "age-old question."[230]

---

cave-ins caused by cavities in the limestone bedrock underlying the plant. *Id.* at 369. The taxpayer's engineers recommended drilling into the bedrock, filling the cavities with grout, and continuously evaluating the cavities in the bedrock. *Id.* at 371.

222. *Id.* at 377.

223. *Id.* at 376.

224. Illinois Merchants Trust Co., 4 B.T.A. 103, 106 (1926).

225. *See* Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962); Midland Empire Packing Co. v. Commissioner, 14 T.C. 635, 642 (1950).

226. *See Midland Empire*, 14 T.C. at 642 (oil leaks from neighboring refinery); American Bemberg Corp. v. Commissioner, 10 T.C. 361, 369 (1948), *aff'd*, 177 F.2d 200 (6th Cir. 1949) (soil cave-ins caused by bedrock cavities). *But see infra* note 238.

227. Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 358 (1971) (holding that legal compulsion is irrelevant in determining whether a payment is a capital expenditure or an ordinary and necessary business expense); E.I. du Pont de Nemours & Co. v. United States, 432 F.2d 1052, 1059 (3d Cir. 1970) (holding that a mandatory conversion from D.C. to A.C. electricity is a capital expenditure); Teitelbaum v. Commissioner, 294 F.2d 541, 544 (7th Cir. 1961) (noting that legal compliance increased the value of the property, thereby creating a capital expenditure); Hotel Sulgrave, Inc. v. Commissioner, 21 T.C. 619, 619 (1954) (stating that installation of fire sprinklers mandated by law was a capital expenditure); International Bldg. Co. v. Commissioner, 21 B.T.A. 617, 621 (1930) (determining that a mandatory elevator safety improvement was a capital expenditure).

228. *See Illinois Merchants*, 4 B.T.A. 103; *see also Plainfield-Union*, 39 T.C. 333; *Midland Empire*, 14 T.C. 635; *American Bemberg*, 10 T.C. 361.

229. *See* Tech. Adv. Mem. 92-40-004 (June 29, 1992).

230. Sheppard, *supra* note 14, at 1110. In describing the issue presented in Technical Advice Memorandum 92-40-004, Sheppard wrote, "It is a plain vanilla question of

2. Technical Advice Memorandum 92-40-004

Technical Advice Memorandum 92-40-004 involved the removal of asbestos from manufacturing equipment because of health concerns.[231] The taxpayer replaced the asbestos with another insulating material which was less thermally efficient than the asbestos and did not save energy or increase operating efficiencies.[232]

The taxpayer deducted the costs to remove the asbestos insulation and the costs to install an alternative insulating material.[233] The taxpayer relied on *Plainfield-Union Water Co. v. Commissioner*[234] to support its argument that the costs should be deductible because the new insulation did not increase the value of the equipment.[235]

The IRS rejected the taxpayer's reliance on *Plainfield-Union* on several grounds.[236] First, the IRS concluded that *Plainfield-Union* was "relevant only in situations where repairs are necessary because the property has progressively deteriorated."[237] While *Plainfield-Union* addressed an expenditure incurred to remedy a gradually occurring condition, the court strongly implied that the suddenness of the condition requiring repair is irrelevant in determining deductibility.[238]

---

whether a significant physical change to equipment should be considered an improvement, the costs of which must be capitalized, or a repair, the costs of which may be immediately deducted." *Id.*

231. *Id.* In July of 1986, the Occupational Safety and Health Administration (OSHA) issued an order lowering the standard for concentrations of airborne asbestos fibers allowed in the workplace. *Id.* The state in which the taxpayer's facility was located required employers to monitor the airborne asbestos levels to ensure that they did not exceed certain concentrations. *Id.*

232. *Id.* The taxpayer also pointed out that while the cost of removal was significant, it was minor in comparison to the manufacturing facility's total repair costs and the equipment's assessed value for property tax purposes, which would indicate that the cost did not significantly add to the value of the equipment. *Id.*

233. *Id.*

234. 39 T.C. 333 (1962). For a general discussion of *Plainfield-Union*, see *supra* notes 208-12 and accompanying text.

235. Tech. Adv. Mem. 92-40-004.

236. *See id.*

237. *Id.* This reasoning is weak, at best, because the deductibility of a repair expenditure does not turn on whether the condition requiring repair occurred gradually or suddenly. *See infra* note 238.

238. In *Plainfield-Union*, the Commissioner argued that every case the court cited supporting deductibility was distinguishable because each involved expenditures that "resulted from an unexpected happening or unusual circumstance." 39 T.C. at 340.

Second, the IRS discussed whether the expenditures increased the property's value, which was the central issue of *Plainfield-Union.*[239] The IRS correctly stated that the test for determining the deductibility of the asbestos removal expenditures was whether the expenditure extended the life or increased the value of the machinery.[240] The IRS misconstrued the facts, however, and concluded that the costs must be capitalized because the value of the equipment had increased based on several subjective factors.[241] The conclusion that the equipment was more valuable is not supported by any evidence that the value of the equipment itself had been increased or that any claimed increase in value was attributable to the asbestos removal.[242]

The court responded that the deductibility of an expenditure does not "require[] a relatively sudden, unexpected, or unusual external factor which results in casualty damage." *Id.* Instead, the court made it clear that deductibility is determined by the purpose served by the repair itself, that is, whether it increased the value or life of the property beyond that of the property before the repair. *Id.* at 337-38.

In many cases, however, courts have allowed deductions for repair expenses because the repairs were made necessary by sudden or extraordinary events. *See, e.g.*, Illinois Merchants Trust Co., 4 B.T.A. 103, 106-07 (1926) (allowing a deduction for the costs of inserting concrete piles to support a building's foundation when "the *sudden* lowering of the water level" exposed its supporting piles to dry rot) (emphasis added).

239. Tech. Adv. Mem. 92-40-004.

240. *Id.*; *see Plainfield-Union*, 39 T.C. at 337; Midland Empire Packing Co. v. Commissioner, 14 T.C. 635, 641 (1950); American Bemberg Corp. v. Commissioner, 10 T.C. 361, 376-78 (1948).

241. Tech. Adv. Mem. 92-40-004. Among the factors noted by the IRS were safer working conditions, a reduced chance of suspended operations due to excessive asbestos concentrations, lower risk of liability for the corporation, and increased marketability. *Id.* In *Plainfield-Union*, however, the court did not specifically endorse the subjective "value added" argument on which the IRS relied. *See Plainfield-Union*, 39 T.C. at 338; Sheppard, *supra* note 14, at 1112 (stating that the IRS misread *Plainfield-Union* to endorse the value added argument and that the taxpayer "was justified in relying on *Plainfield-Union* for the argument that an adjustment undertaken to avoid a continuing repair obligation is itself a repair"). Any repair to property, however, adds some value to such property—at least relative to the condition of the property immediately prior to the repair. *See, e.g.*, *Plainfield-Union*, 39 T.C. at 338 (allowing the deductibility of a repair expense which did not make the property more valuable than it was *prior to the occurrence of the condition which made the repair necessary*) (emphasis added).

242. *See* Tech. Adv. Mem. 92-40-004; *cf. American Bemberg*, 10 T.C. at 361. The expenditure "did not leave the taxpayer with equipment which was functionally any better than before. In fact, it was worse. Replacing the insulation was not an improvement." Sheppard, *supra* note 14, at 1110.

In addition, the IRS stated that because the expenditure resulted in a significant change to the property and was not remedial, it was a capital expenditure which must be capitalized under Internal Revenue Code § 263. Tech. Adv. Mem. 92-40-004 (distinguishing *American Bemberg*, 10 T.C. at 376-78 (allowing a deduction for costs of drilling and filling land to prevent cave-in caused by geological defect)).

After rejecting well-established case law on point, the IRS turned to the "guidance" provided by the Supreme Court in *INDOPCO*.[243] The IRS stated that the taxpayer's asbestos removal costs were not deductible under *INDOPCO* because they created long-term benefits that accrued beyond the year in which the costs were incurred.[244] It is the IRS's position that the "benefits include safer working conditions for employees . . . [and] reduced risk of liability for owners and investors."[245]

The term "benefit," however, when used in the context of repair expenditures, should be limited to improvements or betterments in the physical plant, equipment, or property, and not some general benefit to the taxpayer.[246] The IRS misapplied the facts to the law to find a "benefit" in order to bolster its argument for nondeductibility. The IRS acknowledged, however, that the purpose of the expenditures was not to return the equipment to an operable condition, but merely to maintain its current level of operation with increased safety.[247]

243. Tech. Adv. Mem. 92-40-004.

244. *Id.* (citing INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1044-45 (1992)).

245. *Id.*

246. *See* Treas. Reg. § 1.162-4; *see also* Hotel Sulgrave, Inc. v. Commissioner, 21 T.C. 619 (1954). In *Hotel Sulgrave*, the court required capitalization of the cost of installing a sprinkler system in a hotel because "the property became more valuable for use in the petitioner's business by reason of compliance with the city's order." *Id.* at 619; *cf.* Commissioner v. Tellier, 383 U.S. 687, 688-89 (1966) (allowing a deduction for legal expenses incurred by a securities dealer in defending against securities fraud prosecution where an effective defense was necessary for the securities dealer to stay in business); Commissioner v. Heininger, 320 U.S. 467, 471-72 (1943) (allowing a deduction for legal expenses incurred by a dentist in defending against a fraud order issued by the Postmaster General that would destroy the dentist's mail order business). *Tellier* and *Heininger* make clear that the taxpayer's ability to stay in business as a result of the expenditures, which is clearly a benefit, is not the type of benefit which mandates capitalization of the expenditures. *See Tellier*, 383 U.S. at 688-89; *Heininger*, 320 U.S. at 471-72; *see also* Welch v. Helvering, 290 U.S. 111, 114 (1933) (stating hypothetically that the expenses associated with a "lawsuit affecting the safety of a business" would be ordinary and currently deductible). Instead, the expenditures must result in a benefit that directly affects a particular asset. *See Hotel Sulgrave*, 21 T.C. at 619. In *Tellier*, as well as *Heininger*, the expenditures were deductible because they were incurred to defend against a plaintiff's cause of action, which inevitably would have put the taxpayer out of business. *See Tellier*, 383 U.S. at 688-89; *Heininger*, 320 U.S. at 471-72. Likewise, the costs of asbestos removal should have been deductible because they were incurred to forestall future legal costs a fortiori.

247. Tech. Adv. Mem. 92-40-004. Such a finding would have been sufficient for deductibility under Midland Empire Packing Co. v. Commissioner, 14 T.C. 635, (1950).

Most commentators believe that the analysis in this Technical Advice Memorandum is flawed.[248] The drafters of this release used *INDOPCO* to change the outcome and deny the deduction which, as the foregoing analysis illustrates, arguably would have been deductible under traditional principles.[249] The IRS's flawed analysis and misplaced reliance on *INDOPCO* suggest that the IRS is improperly using *INDOPCO* to indiscriminately deny deductions for any expenditure that arguably has some long-term benefit.[250] The result is uncertainty because under the IRS's application of *INDOPCO*, "virtually no expense will be deductible because most of them will probably be of a significant benefit to taxpayers extending well into future years."[251]

B. Application of INDOPCO *to Advertising Expenditures*

1. Existing Body of Law

Expenditures incurred for advertising to promote the sale of a taxpayer's product or service are deductible in the year paid or incurred as business expenses under Internal Revenue Code section 162(a).[252]

See supra notes 213-17 and accompanying text; *see also* Treas. Reg. § 1.162-4 (1958) (an expenditure is deductible as a repair if it is made to keep an asset in "ordinary efficient operating condition"). It further indicates that the repair did not benefit the equipment itself. *See supra* note 246.

248. *E.g.*, Sheppard, *supra* note 14, at 1110; *IRS Determines Asbestos Removal is Capital Expenditure*, 77 J. TAX. 202 (Dan L. Mendelson & Burton M. Mirsky eds., 1992); *IRS Urged to Reconsider Ruling Requiring Capitalization of Asbestos Removal Costs*, DAILY REPORT FOR EXECUTIVES (Sept. 29, 1992). In addition, the outcome is bad tax policy in that it discourages businesses from implementing an asbestos removal plan because the expenditures are not deductible. *IRS Determines Asbestos Removal is Capital Expenditure*, *supra*; *IRS Urged to Reconsider Ruling Requiring Capitalization of Asbestos Removal Costs*, *supra*.

249. *See* Sheppard, *supra* note 14, at 1110 (arguing that the IRS used *INDOPCO* to change the outcome of the Technical Advice Memorandum).

250. *IRS Urged to Reconsider Ruling Requiring Capitalization of Asbestos Removal Costs*, *supra* note 248; *IRS Determines Asbestos Removal is Capital Expenditure*, *supra* note 248, at 202; Sheppard, *supra* note 14, at 1110. An IRS official stated that traditional legal principles, rather than *INDOPCO*, dictated the outcome of the Technical Advice Memorandum. *Id.* However, even if the IRS relied on traditional legal principles, the analysis is erroneous because the facts were misconstrued. *See supra* note 241 and accompanying text. The IRS had to misapply traditional legal principles in order to reach its strained application of *INDOPCO*, which the IRS argued provided additional support for denying the deduction. *See* Tech. Adv. Mem. 92-40-004.

251. *IRS Determines Asbestos Removal is Capital Expenditure*, *supra* note 248, at 203.

252. Treas. Reg. § 1.162-1(a); Porterfield Distrib. Co. v. United States, 63-1 U.S.T.C. (CCH) ¶ 9230 (W.D. Va. 1961) (allowing a deduction for trade selling expenses designed to promote the taxpayer's business in the current year); *see* Colonial Ice Cream, Co. v. Commissioner, 7 B.T.A. 154, 156-57 (1927) (stating that advertising ex-

Advertising costs are deductible even though the advertising produces benefits that extend beyond the current year.[253] The expenditures may have to be capitalized, however, if there is a definite period over which the benefits can be amortized.[254] Costs incurred for business promotion are also deductible provided they relate to an existing business.[255]

Institutional or "good will" advertising, which is advertising aimed at keeping the taxpayer's name before potential customers, is deductible provided the expenditures properly relate to the taxpayer's business.[256] The advertising need not promote the taxpayer's product or service directly,[257] but it must relate to patronage reasonably expected in the future.[258] A factor in determining whether the expenditure is deductible is "the purpose of such expenditure and whether the taxpayer was

---

penses must be deducted in the year paid and cannot be treated as deferred expenses).

253. *See, e.g.*, Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 787 (2d Cir. 1973) (allowing an expense deduction for the costs incurred to solicit "franchises" even though the resulting contracts were effective for up to five years); Consolidated Apparel Co. v. Commissioner, 17 T.C. 1570, 1582 (1952) (finding an error by the Commissioner in disallowing a deduction in the year paid for a contribution to a merchants association which would provide advertising over a five year period), *aff'd in part & rev'd in part*, 207 F.2d 580 (7th Cir. 1953).

254. Rev. Rul. 68-283, 1968-1 C.B. 63; *see also Colonial Ice Cream*, 7 B.T.A. at 156-57.

255. Rev. Rul. 56-181, 1956-1 C.B. 96; Rodgers Dairy Co. v. Commissioner, 14 T.C. 66 (1950) (finding that expenditures for the ownership and use of horses by a restaurant for promotional purposes were deductible as advertising expenses). Expenditures incurred in starting a new business, however, are not deductible. Rev. Rul. 73-421, 1973-2 C.B. 33.

256. Treas. Reg. § 1.162-20; MERTENS, *supra* note 22, § 25.90. The Treasury Regulations provide as follows: "Expenditures for institutional or 'good will' advertising which keeps the taxpayer's name before the public are generally deductible as ordinary and necessary business expenses provided the expenditures are related to the patronage the taxpayer might reasonably expect in the future." Treas. Regs. § 1.162-20(a)(2). While costs to create goodwill are deductible advertising expenses, costs to purchase or acquire goodwill must be capitalized. Hubble v. Commissioner, 22 T.C.M. (CCH) 395 (1963) (discussing expenditures incurred for the purchase of a business name), *acq.* 1956-2 C.B. 4.

257. *See* Sanitary Farms Dairy, Inc. v. Commissioner, 25 T.C. 463, 467 (1955) (allowing deduction for the cost of big game hunt in Africa because the resulting publicity "provided extremely good advertising at a relatively low cost").

258. *See* Sutter v. Commissioner, 21 T.C. 170, 174 (1953) (holding that the taxpayer could deduct entertainment expenditures which were "apparently a means of enhancing petitioner's prestige and the future possibility of expanding his clinical business so as to be the means of creating a capital asset comparable to good will").

looking more to future than present sales and whether in fact the expenditure produced immediate rather than prospective benefits."[259]

In *Briarcliff Candy Corp. v. Commissioner*,[260] Loft Candy Corporation, the taxpayer, set up a franchise division to solicit and enter into contracts with storekeepers to sell Loft's candies in urban areas.[261] The contracts were effective and remained in operation for a period of one to five years.[262] In 1961, Loft embarked upon an advertising campaign to solicit additional outlets, and Loft deducted its advertising expenditures.[263]

The Commissioner concluded that the advertising expenditures were nondeductible capital assets consisting of the franchise contracts.[264] The Tax Court held that Loft could not deduct the advertising expenditures because many of the contracts continued in effect for longer than one year, and thus were not "ordinary."[265] The Second Circuit reversed the Tax Court, holding that the expenditures were deductible under section 162.[266] The court specifically rejected the Commissioner's argument that the contracts were capital assets because they were effective for more than one year.[267]

Briarcliff Candy stands for the proposition that advertising expenditures can provide benefits that extend beyond the current tax year and still be deductible as ordinary and necessary business expenses.[268] *Briarcliff Candy* is often cited for that proposition in cases dealing with expenditures other than advertising.[269] The Supreme Court in *INDOPCO*, while not expressly overruling *Briarcliff Candy*,[270] refused

---

259. MERTENS, *supra* note 22, § 25.90 (citing Colonial Ice Cream Co. v. Commissioner, 7 B.T.A. 154 (1927)).

260. 475 F.2d 775 (2d Cir. 1973), *rev'g* T.C. Memo 1972-43.

261. *Id.* at 777.

262. *Id.*

263. *Id.*

264. *Id.* at 780.

265. *Id.* at 782.

266. *Id.* at 787.

267. *Id.* at 786. The court pointed out that, under *Lincoln Savings*, "the factor that an ensuing benefit may have some future aspect is not controlling." *Briarcliff*, 475 F.2d at 786 (citing Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345 (1971)); *cf.* United Profit-Sharing Corp. v. United States, 66 Ct. Cl. 171, 182-83 (1928) (requiring that expenditures to obtain contracts be capitalized and amortized because they were equivalent to the acquisition of assets).

268. *See Briarcliff*, 475 F.2d at 786.

269. *E.g.*, Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1190-91 (10th Cir. 1974) (expenditures incurred by a bank in developing and starting up a credit card system).

270. *Briarcliff Candy* established the conflict among the circuits which the Court resolved adversely in *INDOPCO*. INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1042 n.3, 1046 (1992); *see supra* note 147 and accompanying text. Thus, while

to extend that decision beyond the realm of advertising expenditures.[271]

Courts and the IRS have long recognized the deductibility of expenditures incurred for advertising.[272] *INDOPCO*, however, brought uncertainty into the advertising arena. As a form of guidance in the application of *INDOPCO* to the deductibility of advertising expenditures, the IRS recently issued Revenue Ruling 92-80.[273]

2. Revenue Ruling 92-80

In Revenue Ruling 92-80, the IRS held that "[t]he *INDOPCO* decision does not affect the treatment of advertising costs under section 162(a) of the [Internal Revenue] Code."[274] The ruling notes that advertising "costs are generally deductible . . . even though advertising may have some future effect on business activities, as in the case of institutional or good will advertising."[275] The costs of advertising must be capitalized "[o]nly in the unusual circumstance where advertising is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional or good will advertising."[276]

Thus, the ruling makes clear that the IRS is not changing its position on the *rules* relating to the deductibility of advertising costs.[277] But the ruling does not offer any guidance as to which advertising expenditures

Briarcliff Candy was not expressly overruled, its validity is now questionable. *See id.*

271. *INDOPCO*, 112 S. Ct. at 1044-45.

272. MERTENS, *supra* note 22, § 25.89.

273. Rev. Rul. 92-80, 1992-39 I.R.B. 7 (Sept. 11, 1992).

274. *Id.* at 2.

275. *Id.* at 2-3 (citing Treas. Reg. § 1.162-1(a); Treas. Reg. § 1.162-20(a)(2)). This statement of the ruling is entirely consistent with well-established rules allowing deductibility of costs even though they provide some benefit that extends beyond the current year. *See id.*; *see also supra* note 253 and accompanying text.

276. Rev. Rul. 92-80, at 3 (citing Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220 (1975) (requiring capitalization of advertising costs incurred to allay opposition to a nuclear project because it was not to be built for at least four years)). The language used in the ruling—"advertising *directed towards* obtaining future benefits"— indicates that the IRS will continue to look to the purpose of the expenditures in determining whether they will be deductible. *See id.*; *see also supra* text accompanying note 259.

277. *See* Rev. Rul. 92-80, at 2-3.*But see* Tech. Adv. Mem. 92-40-004 (arguably wrong result achieved because the facts were incorrectly applied to traditional legal principles).

are not deductible because they are among those "unusual circumstances where advertising is directed towards obtaining future benefits."[278]

The ruling cites *Cleveland Electric Illuminating Co. v. United States*[279] to support the "unusual circumstance" criterion.[280] In that case, however, the Claims Court disallowed the deduction, not because the expenditures were directed towards obtaining future benefits, but because the expenditures served "the predominant purpose of contributing to the acquisition of a capital asset" which, as with most capital assets, would have "value over an extended period beyond the taxable year."[281]

It appears from the ruling that the IRS does not view *INDOPCO* as changing the treatment of advertising expenditures,[282] but the IRS does not make that view entirely clear.[283] The IRS does not, however, believe that *INDOPCO* overturned *Briarcliff Candy*.[284] This indicates that while the deductibility of advertising costs remains unchanged, the manner in which the IRS classifies advertising that is directed towards obtaining a substantial future benefit may control the outcome of a particular case.[285]

C. *Application of* INDOPCO *to Other Areas*

Repair and advertising expenditures are just two of the more obvious

---

278. *See* Rev. Rul. 92-80, at 2-3.

279. 7 Cl. Ct. 220 (1975).

280. *See* Rev. Rul. 92-80.

281. 7 Cl. Ct. at 231. In *Cleveland Electric*, the taxpayer implemented a public relations program to educate the public about the benefits of the nuclear power plant which the taxpayer was planning to build. *Id.* at 230. Because the court found that the advertising and public relations "had as an important purpose the mitigation of roadblocks and delays in the issuance of the construction permit and operating license," it concluded the expenditures were capital in nature and could not be deducted in the year incurred. *Id.* at 232-33.

282. *See* Rev. Rul. 92-80. The ruling states, "The *INDOPCO* decision does not affect the *treatment* of advertising costs under section 162(a) of the Code." *Id.* (emphasis added).

283. The ruling could be interpreted to say the following: Advertising expenditures will receive traditional treatment once they are categorized, but the method of categorization is different under *INDOPCO*.

284. Pressman, *supra* note 5, at 14 (quoting Debra Carlisle, an attorney with Internal Revenue Office of Chief Counsel, who was the principal author of Revenue Ruling 92-80); *see also supra* note 270.

285. The determination would be fact based. Under this approach, expenditures that might have been deductible pre-*INDOPCO* may not be deductible now because the focus of the IRS is now more directly centered on the future benefit aspect. *See* Rev. Rul. 92-80. In addition, the IRS seems more inclined to misconstrue the facts in order to reach the desired result. *See supra* note 241 and accompanying text.

examples that illustrate the potential impact of the *INDOPCO* decision in categories of expenditures other than takeover-related expenditures. Other areas where *INDOPCO* could be, or is being, applied or cited for authority include the following: Employee training expenditures, take-or-pay obligations,[286] payments for not-to-compete covenants,[287] payments by an insurance company to use the service mark of a manufacturer's representative,[288] and other kinds of corporate reorganizations including both friendly and hostile takeovers.[289]

VII. THE POST-*INDOPCO* ISSUE: DOES *INDOPCO* ESTABLISH A NEW RULE FOR DETERMINING THE DEDUCTIBILITY OF EXPENDITURES?

The issue thus becomes whether *INDOPCO* establishes a new rule for determining the deductibility of expenditures that have some future benefit aspect. The IRS, as mentioned above, seems to think so.[290] The IRS, as expected, reads the case broadly and construes the Court's opinion to announce a new test, which is to be applied to a broad spectrum of deductibility issues.[291]

Tax professionals, on the other hand, believe that *INDOPCO* should be read narrowly.[292] The language and architecture of the opinion indicate that the opinion should be limited to the specific facts of the case and that the holding should be limited to the specific situation where

---

286. Tech. Adv. Mem. 92-53-002 (Sept. 22, 1992).

287. Priv. Ltr. Rul. 92-40-010 (June 30, 1992).

288. Tech. Adv. Mem. 92-25-003 (Feb. 28, 1992).

289. Grigsby & Chinnis, *supra* note 8, at 92-93; Greenstein & Persellin, *supra* note 34, at 576.

290. *See supra* notes 182-83 and accompanying text. The IRS, however, denies that it is using *INDOPCO* to change the rules of deductibility. An IRS official

> stressed that in the Service's view *INDOPCO* was "not a new revolutionary concept" that changed the tax landscape. "If we were not to challenge a particular expenditure prior to *INDOPCO* on grounds of traditional Section 263 notions, it seems unlikely to me that we would challenge the expense now simply by virtue of *INDOPCO*."

Accounting, IRS Not Planning More Broad Guidance on INDOPCO, *Official Says*, DAILY REPORT FOR EXECUTIVES, Oct. 26, 1992 (corrected by *Correction*, DAILY REPORT FOR EXECUTIVES, Oct. 27, 1992, at 208) (quoting David Crawford, Branch 5 Chief, Assistant IRS Chief Counsel (tax and accounting)).

291. *See* Sheppard, *supra* note 14, at 1110 (suggesting that the IRS abused *INDOPCO* to achieve a favorable result in Technical Advice Memorandum 92-40-004); *see also INDOPCO*, 112 S. Ct. at 1042-46.

292. *See, e.g.*, Grigsby & Chinnis, *supra* note 8, at 86.

expenditures result in a *significant* long-term benefit.[293] For example, "the Court's repeated emphasis on the proper matching of revenues and expenditures is inconsistent with requiring capitalization based on the existence of only a slight continuing benefit."[294] To conclude that *INDOPCO* requires capitalization of expenditures such as advertising and repairs, which have been deductible under matching concepts despite their continuing benefits, would require a gross overreading of the opinion.[295]

Further support for this view is found in more than just the language and architecture of the opinion.[296] First, *INDOPCO* is not a radical departure from existing case law and the Court's long-term benefit analysis is not unlike that of previous circuit court decisions.[297] A good argument for nondeductibility could have been made under traditional tax principles.

Second, the opinion of the Court was delivered by Justice Blackmun,[298] the same Justice who authored the *Lincoln Savings* opinion.[299] As Justice Blackmun stated, *INDOPCO* is not inconsistent with *Lincoln Savings* because *Lincoln Savings* did not address the situation where there was no creation of a separate and distinct asset.[300] This indicates that *Lincoln Savings* was not overruled by *INDOPCO's* long-term benefit analysis, and that *Lincoln Savings'* separate and distinct asset test is still viable.

---

293. *Id.*; *see supra* note 8. "The intention to render a decision in a narrow factual context is made unequivocal by the architecture of the opinion." Grigsby & Chinnis, *supra* note 8, at 86-87.

294. Grigsby & Chinnis, *supra* note 8, at 88.

295. *Id.*

296. See Grigsby & Chinnis, *supra* note 8, at 86 for a critical analysis of the opinion itself.

297. *See* INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1042-46 (1992); E.I. du Pont de Nemours & Co. v. United States, 432 F.2d 1052, 1058-59 (3d Cir. 1970); General Bancshares v. Commissioner, 326 F.2d 712, 715 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964); Farmers Union Corp. v. Commissioner, 300 F.2d 197 (9th Cir.), *cert. denied*, 371 U.S. 861 (1962); Mills Estate, Inc. v. Commissioner, 206 F.2d 244, 246 (2d Cir. 1953); *see also* Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974); Ellis Banking Corp. v. Commissioner, 688 F.2d 1376 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983).

298. *INDOPCO*, 112 S. Ct. at 1041.

299. Commissioner v. Lincoln Sav. & Loan Ass'n, 403 U.S. 345, 345 (1971); *see supra* note 74.

300. *INDOPCO*, 112 S. Ct. at 1044. Instead, it seems that lower courts over-read some poorly drafted *Lincoln Savings* language in ways not anticipated by the Court. *See, e.g.*, Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, (2d Cir. 1973). For Justice Blackmun's reconciliation between *Lincoln Savings* and *INDOPCO*, see *supra* notes 162-64 and accompanying text.

While the long-term benefit test and the separate and distinct asset test are not mutually exclusive,[301] when one compares the language of the *INDOPCO* opinion with the language of the *Lincoln Savings* opinion, it seems less likely that the Court intended to announce a new test that would apply to new situations and change the traditional rules of capitalization.

Third, the opinion was that of a unanimous court.[302] There were neither dissents nor concurrences.[303] It seems unlikely that the Supreme Court, which is dominated by conservatives,[304] would unanimously join in an opinion so broad that it would make a sweeping reform of tax law—especially in light of the substantial cost to corporate America. The unanimous opinion could be interpreted to indicate that the eight other justices understood that the case was intended to be limited to its specific facts.[305]

For these reasons, in addition to the language and architecture of the opinion, the decision in *INDOPCO* should be interpreted narrowly and not applied except to similar factual scenarios.

VIII. CONCLUSION

In *INDOPCO*, the Supreme Court rejected the argument that *Lincoln Savings* requires a separate and distinct asset as a prerequisite for capitalization. Further, the Court required the capitalization of expenditures incurred incident to a friendly takeover because they provided a long-term benefit to the taxpayer. The opinion, however, left unresolved the scope of the type of "long-term benefit" that requires capitalization. The result is that in the same decision, the Court both clarified the deductibility issue with respect to corporate takeovers, and injected further uncertainty into other areas of business expenditures.

The Court's opinion is narrow and fact specific, and its analysis should be limited accordingly. The IRS, however, is reading *INDOPCO*

301. In fact, some courts consider the long-term benefit test to be a necessary part of the separate and distinct asset test. *See supra* note 81 and accompanying text.

302. *INDOPCO*, 112 S. Ct. at 1041.

303. *See id.*

304. *See, e.g.*, DAVID SAVAGE, THE MAKING OF THE REHNQUIST SUPREME COURT (1992).

305. This argument is weakened, however, by the absence of any limiting language in the opinion, especially considering the warning of the Tax Executives Institute that the result could be far reaching. *See supra* notes 178-80 and accompanying text; *see also supra* note 8 and accompanying text.

broadly and is using its rationale as a sword to carve away at traditionally deductible categories of expenses. Only future cases will decide what type of benefit is sufficiently substantial to constitute a long-term benefit that must be capitalized. Until then, taxpayers must bear the increased risk of taking a deduction for an expenditure which provides any future benefit.

JEFFREY GATES DAVIS