No. 90-1278-CFX
Status: GRANTED

Title: INDOPCO, Inc., Petitioner
v.
Commissioner of Internal Revenue

Docketed:
February 11, 1991

Court: United States Court of Appeals
for the Third Circuit

Counsel for petitioner: Hiegel,Richard J.

Counsel for respondent: Solicitor General

Complete

40 nonconforming copies recd. 2/11; 40 conforming copies recd. 2/13.

Entry	Date	Note	Proceedings and Orders
1	Feb 11 1991	G	Petition for writ of certiorari filed.
3	Mar 14 1991		Order extending time to file response to petition until April 17, 1991.
4	Apr 17 1991		DISTRIBUTED. May 9, 1991
5	Apr 18 1991	X	Brief of respondent Commissioner of Internal Revenue in opposition filed.
6	May 13 1991		Petition GRANTED.
			**
7	Jun 27 1991		Joint appendix filed.
8	Jun 27 1991		Brief of petitioner INDOPCO, Inc. filed.
9	Jun 27 1991		Brief amicus curiae of Tax Executives Institute, Inc. filed.
11	Jul 16 1991		Order extending time to file brief of respondent on the merits until August 14, 1991.
12	Aug 12 1991		Brief of respondent Commissioner of Internal Revenue filed.
14	Aug 20 1991		Record filed.
		*	Received orginal Tax Court record and exhibits; and certified copy of pleadings filed with USCA 3.
13	Aug 21 1991		CIRCULATED.
15	Sep 5 1991		SET FOR ARGUMENT TUESDAY, NOVEMBER 12, 1991. (1ST CASE)
16	Sep 16 1991	X	Reply brief of petitioner INDOPCO, Inc. filed.
17	Nov 12 1991		ARGUED.

Petition

90-1278

No. 90-

IN THE

Supreme Court Of The United States

October Term, 1990

INDOPCO, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTION PRESENTED FOR REVIEW

Whether the Court of Appeals (a) erred in creating a square conflict with decisions in other Circuits by refusing to follow the test established by this Court in *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971), which requires an expenditure to be capitalized for income tax purposes only where it creates or enhances a "separate and distinct additional asset", and (b) thus erroneously decided that petitioner's expenses were nondeductible capital expenditures even though, as the Court of Appeals determined, they "resulted in neither a tangible asset nor a readily identifiable intangible asset".

PARTIES TO THE PROCEEDING

All parties to this proceeding are shown in the caption of the case. At the present time, petitioner is named INDOPCO, Inc. It is wholly owned by Unilever United States, Inc., a Delaware corporation, which in turn is owned 75 percent by Unilever N.V., a publicly held Netherlands corporation, and 25 percent by Unilever PLC, a publicly held United Kingdom corporation. Petitioner's nonwholly owned subsidiaries are the following:

Adhesives y Gomas De Venezuela C.A.
Aranal, S.A.
Aromaticos Petroquimicos, S. de R.L.
Interamericana de Escencias, S.A.
IPCO - National, Ltd.
Lorenz-National Industrial Ltda.
Lyckeby-National Starkelse AB
Norda Aromaticos, S.A.
Norda S. de R.L.
Pacific Pure-Aid Company
Quinor, S.A.
Sabores y Fragancias, S.A.
Western Australian Polymers Pty. Ltd

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IN THE

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v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

INDOPCO, Inc., formerly named National Starch and Chemical Corporation ("National Starch"), respectfully petitions for a writ of certiorari to review the decision of the United States Court of Appeals for the Third Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals (App. 1a-18a) is reported at 918 F.2d 426. The opinion of the United States Tax Court (App. 19a-31a) is reported at 93 T.C. 67.

JURISDICTION

The judgment of the Court of Appeals was entered on November 13, 1990. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

The relevant portions of Sections 162(a), 167(a), 168(a), 195, 263(a), 446 and 461(a) of the Internal Revenue Code of 1954, as amended (26 U.S.C.; the "Code"), and of Sections 1.162-5(a), 1.263(a) and 1.461-1(a) of the Treasury Regulations on Income Tax (26 C.F.R.) are set forth at App. 32a-38a.

STATEMENT OF THE CASE

This case presents a fundamental and recurring issue in the administration of the federal income tax laws—namely, what principle should be applied in determining whether an expenditure is capital (and hence not currently deductible) or ordinary (and thus currently deductible if other requirements are met). As the cases, rulings and Internal Revenue Service memoranda hereinafter discussed illustrate, this basic issue arises in a wide variety of factual contexts and affects a multitude of taxpayers. The context in which the issue arises here is an acquisition of petitioner's stock by another corporation, and the expenditures in question were made to assist petitioner's board of directors in carrying out its fiduciary duty to stockholders in connection with that transaction. The deductibility of such expenditures in this context has already become a matter of dispute between the Internal Revenue Service and taxpayers other than petitioner, and, given the unprecedented level of corporate acquisition activity in the 1980's, will increasingly be brought before the courts in future years.

1. *Material Facts.* On August 15, 1978, all the stock of National Starch (until then a publicly held company) was acquired from its stockholders by a newly formed U.S. subsidiary of the Unilever Group.[1] National Starch itself was

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1 About 79 percent of the National Starch stock was purchased for cash (at a price of $73.50 per share), and the rest was acquired in exchange for preferred stock of the acquiring corporation (of an equivalent par value).

unchanged by the transaction—it did not sell or otherwise dispose of any stock or assets, nor did it acquire any stock or assets. All that happened was that its existing stockholders disposed of their stock. Moreover, the transaction did not alter National Starch's capital structure (its debt and equity securities) in any relevant respect.[2] After the transaction, National Starch's management (its directors and officers) remained in place, its key employees entered into employment contracts with the company, and its business (adhesives, starches and specialty chemical products) continued in the same way as before. Unilever did not make any changes in National Starch's operations, did not provide National Starch with any significant technological or financial assistance or legal, administrative or accounting services, and did not materially increase its purchases of National Starch products. (App. 19a-20a, 22a-23a)

Shortly after Unilever representatives initiated discussions with National Starch regarding an acquisition of its stock, National Starch's counsel advised its board of directors that the board had a fiduciary duty to ensure that any such transaction would be fair to the company's stockholders. Counsel further advised that National Starch should retain an independent investment banking firm to assist the board in valuing the company, to render an opinion on the fairness

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To ensure that 100 percent of the National Starch stock was acquired, the cash purchase was accomplished by forming, and then immediately merging, a transitory subsidiary of the acquiror into National Starch pursuant to a merger agreement that provided for the conversion into cash of all National Starch stock not exchanged for preferred stock. (App. 22a-23a) The Commissioner agrees that this so-called "reverse cash merger" is to be disregarded and the transaction is to be treated for tax purposes as a direct purchase of stock from the National Starch stockholders. (App. 3a, n.2)

2 For purposes of administrative convenience and simplicity, National Starch's certificate of incorporation was amended to eliminate its previously authorized but unissued shares of preferred stock and to reduce the number of its authorized shares of common stock to 1,000. The Tax Court held that this amendment was not relevant to the deductibility of the expenses at issue (App. 26a), and the Commissioner did not dispute that holding in the Court of Appeals.

of the transaction to the stockholders and to be available in the event of a hostile takeover attempt. Counsel also advised the board that failure to retain such a firm might be evidence that it had not properly carried out its fiduciary duty. (App. 21a)

The board heeded this advice, and National Starch engaged the investment banking firm of Morgan Stanley & Co. After analyzing National Starch's business prospects and valuing its stock, Morgan Stanley advised the board that Unilever's offer was "fair and equitable" to the National Starch stockholders "from a financial point of view". Subsequently, the board recommended that Unilever's offer be accepted by the stockholders. (App. 21a-22a)

Morgan Stanley's fee for its services (in the amount of $2.2 million) was disallowed as a deduction by the IRS on the ground that it constituted a capital expenditure by National Starch rather than an ordinary and necessary business expense deductible under Section 162(a) of the Code. This disallowance resulted in a deficiency in National Starch's federal income tax of $1,068,281. National Starch contested the deficiency in the Tax Court and also claimed a refund of tax on the ground that it was entitled to deduct (but had not deducted in its tax return) the legal fee and other customary expenses that it had incurred in connection with the transaction.[3] (App. 23a-24a)

2. *The Decisions Below.* The Tax Court upheld the IRS disallowance and denied the claimed refund, and the Court of Appeals affirmed, on the ground that the Morgan Stanley fee and other expenses were nondeductible capital expenditures because they were incident to a transaction that conferred on National Starch "a not insignificant future benefit that . . . [was] more than merely incidental".[4] (App. 12a, 27a-

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3 A refund of tax in excess of $257,444 with respect to the legal fee and other expenses is barred by the statute of limitations. (App. 4a, n.3)

4 None of the other requirements for deductibility of expenses under Section 162(a) of the Code is in dispute. (App. 6a)

28a) Such a future benefit, the courts said, had two aspects: "the availability of Unilever's enormous resources" to the company, and "the opportunity for synergy created by Unilever's association with National Starch".[5]

The Court of Appeals (as well as the Tax Court) dismissed National Starch's argument that, under this Court's decision in *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971), expenses are not capitalizable unless they create or enhance a separate and distinct asset that produces a long-term benefit to the taxpayer. In support of this argument, National Starch had cited cases in six other Circuits that followed the *Lincoln Savings* "separate and distinct asset" test. *See infra*, pp. 11-13. The Third Circuit acknowledged that National Starch's expenditures "resulted in neither a tangible asset nor a readily identifiable intangible asset" (App. 11a) and that "some Courts of Appeals have indeed construed *Lincoln Savings* to have created a new standard such as that proffered by National Starch" (App. 9a), but it refused to follow those decisions. Instead, it attempted to distinguish *Lincoln Savings* on the ground that since a separate and distinct asset had been found to exist in that case, "the absence of such an asset is not addressed in the opinion". (App. 8a) Having thus rejected the *Lincoln Savings* test and created a clear conflict in the Circuits, the

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5 The Tax Court's factual finding of a twofold future benefit—which was held by the Court of Appeals to be not clearly erroneous (App. 12a)—was based solely on the following: (i) its view that Delaware law required the National Starch board of directors to determine whether the transaction would be in the best interest of the company as well as its stockholders; (ii) a statement in a 1978 annual report of National Starch to the effect that the company would benefit from the availability of Unilever's resources; and (iii) a statement in a Morgan Stanley report to the board to the effect that National Starch's affiliation with Unilever would create an opportunity for synergy. (App. 28a) The Court of Appeals also said that the Unilever transaction provided National Starch with an opportunity to avoid the effect of the "'estates problems'" of Mr. and Mrs. Frank Greenwall, the company's largest stockholders (who were then 81 and 79 years of age, respectively), that were "'overhanging the market'". (App. 15a, quoting from the record) The Tax Court, in its decision, made no finding that any such "overhang" existed.

Court of Appeals acknowledged that "the appropriate treatment of National Starch's payments . . . [represents] a particularly difficult inquiry". (App. 11a) It nevertheless proceeded to hold that National Starch's expenses were capitalizable merely because, in the Court of Appeals' view, they conferred a not insignificant future benefit on National Starch. The Court of Appeals acknowledged that its decision denied any deduction to National Starch for the expenses until its business is sold, since, it said, those expenses "are not susceptible to depreciation or amortization". (App. 16a-17a)

REASONS FOR GRANTING THE WRIT

The Court of Appeals' decision reopens a fundamental and pervasive issue of federal income tax law that this Court resolved in *Lincoln Savings* almost 20 years ago. Until now, the "separate and distinct asset" test established in that case has been consistently followed by the Courts of Appeals for other Circuits. Moreover, not only has the Court of Appeals failed to follow this Court's mandate and created a conflict in the Circuits, it has also adopted an approach that, by its own admission, is both difficult to apply and fails to implement the principle of matching revenues with expenses that the capitalization rule is meant to embody. Furthermore, despite the consistent application of the *Lincoln Savings* test by the Courts of Appeals prior to this case, the IRS has vacillated for years regarding the import of *Lincoln Savings*, thereby treating similarly situated taxpayers inconsistently with respect to the distinction between ordinary and capital expenditures, and has also taken conflicting positions on the proper treatment of the particular type of expenses involved here. Certiorari should therefore be granted to reaffirm this Court's decision in *Lincoln Savings*, to resolve the conflict in the Circuits created by the Court of Appeals and to provide uniform guidance to taxpayers, the IRS and the courts on this important and recurring issue.

1. *The Decision Below Fails To Apply the "Separate and Distinct Asset" Test Established by This Court in Lincoln*

Savings. In *Lincoln Savings,* this Court articulated a general principle to be applied in distinguishing between deductible ordinary expenses and nondeductible capital expenditures. It held:

> "[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 . . . ." 403 U.S. at 354.

Thus, if an expenditure creates or enhances a separate and distinct asset of the taxpayer, the expenditure must be capitalized. Conversely, if an expenditure may produce a future benefit, but does not create or enhance a separate and distinct asset, it is allowable as a deduction (provided the other requirements for deductibility are met). A review of *Lincoln Savings,* and the factual context in which it was briefed and argued, confirms both aspects of this holding; all the members of this Court—both the majority and dissenting Justices—as well as the Commissioner, were of the view that capitalization requires not simply a future benefit, but rather the creation or enhancement of an asset producing a future benefit.

Lincoln Savings involved the deductibility of premiums paid by a savings and loan association to the Federal Savings and Loan Insurance Corporation ("FSLIC") that were "'in the nature of a prepayment with respect to future premiums'" for insurance coverage of the association's deposit accounts. 403 U.S. at 348 (quoting 12 U.S.C. § 1727(d)). These premiums were paid by the association in addition to those required for current insurance coverage, and thus the benefit that they provided was primarily (or even solely) a future benefit. The association pointed out, in its brief, that "many expenses are deductible though they produce benefits in future years", and it gave a number of examples of such expenses.[6] The Commissioner did not attempt to contravene that point by arguing that the insurance premiums had to be capitalized simply because they produced a future benefit. He contended, instead, that the premiums were "nondeductible capital outlays" because they "result[ed] in the *creation of an asset* having a useful life which extends substantially beyond the close of the taxable year'" (quoting Sections 1.461-1(a)(1) and (2) of the Treasury Regulations, *infra* App. 35a-36a; emphasis added). In support of this contention, the Commissioner emphasized that the association had retained "significant rights" and had acquired a "capital interest in FSLIC" which was an "income-producing capital asset". Brief for Petitioner in *Lincoln Savings*, pp. 13-16.

In recognizing that many concededly deductible expenses have prospective effect beyond the taxable year, this Court explicitly referred to the association's argument mentioned above. 403 U.S. at 354. It then undertook a detailed inquiry into the question whether the additional premiums gave the association a "recognized property interest", 403 U.S. at 355-56, an inquiry that would have been totally unnecessary if a significant future benefit had been all that was considered necessary for capitalization. After concluding that

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6 These examples included the legal expenses for defenses against criminal and fraud charges held to be deductible by this Court in *Commissioner v. Tellier*, 383 U.S. 687 (1966), and in *Commissioner v. Heininger*, 320 U.S. 467 (1943); the employment-related education expenses allowed as a deduction by Treas. Reg. § 1.162.5(a) (*infra* App. 33a-34a); and the advertising expenses allowed as a deduction in *E. H. Sheldon & Co. v. Commissioner*, 214 F.2d 654 (6th Cir. 1954), and other cases. Brief for Respondent in *Lincoln Savings*, pp. 18-20, 25-26. In *Tellier* the legal expenses saved the taxpayer from incarceration and in *Heininger* they averted a threatened destruction of the taxpayer's business, thus producing an obvious long-term benefit to the taxpayers in both cases. Nevertheless, as this Court stated in *Tellier*, the "legal expenses . . . were not capital expenditures. They were incurred in . . . [the taxpayer's] defense against charges of past criminal conduct, *not in the acquisition of a capital asset*". 383 U.S. at 690 (emphasis added).

the premiums did result in such a property interest, this Court held that they were capital expenditures. 403 U.S. at 356.

Similarly, Justice Douglas, in his dissenting opinion, endorsed the principle that the presence of an asset is a prerequisite for capitalization. He would have allowed the claimed deductions, however, because he was of the view that, on the facts, the Commissioner had "not established an *asset* for future benefit". 403 U.S. at 362 (emphasis added). He said: "It is true that premiums paid in 1963 may result in a reduction in premiums in later years. But labeling this the *creation of an asset* proves too much, for it invalidates the deduction of the . . . [current] premiums as well." Id. (emphasis added).

Thus, all concerned in *Lincoln Savings*, unlike the Court of Appeals in this case, recognized that future benefit, without more, is insufficient to require capitalization.[7]

The Court of Appeals' assertion (App. 8a) that if this Court in *Lincoln Savings* mandated a separate and distinct asset as a requirement for capitalization it implicitly overruled its prior decisions in *Welch v. Helvering*, 290 U.S. 111 (1933), and *Deputy v. duPont*, 308 U.S. 488 (1940), is manifestly wrong. In each of those cases this Court denied the deductions, not because the expenditures were capital in nature, but because they were found not to be normal, usual or customary—*i.e.*, they were not "ordinary" in the secondary

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7 The Court of Appeals said that this Court in *Lincoln Savings* did "not suggest that the presence of a significant future benefit is not a legitimate factor to consider". (App 8a) That is certainly true, since the separate and distinct asset test necessarily contemplates an asset that provides a long-term benefit to the taxpayer. *See Jack's Cookie Co. v. United States*, 597 F.2d 395, 405 (4th Cir. 1979). The Court of Appeals also said, however, that its reading of *Lincoln Savings* led it "to conclude that no one factor alone can control this complex decision". (App. 11a) But the Court of Appeals did not identify any factor other than future benefit to support its conclusion that the expenses in question were capital in nature, and it indicated that its decision would have been different if a finding of a separate and distinct asse had been required. (*Id.*) It thus held, contrary to *Lincoln Savings*, that a significant future benefit is not just one factor but is controlling.

meaning of that term as used in Section 162(a) of the Code.[8] Thus, the payment of another person's debts in *Welch* was considered to be "in a high degree extraordinary", 290 U.S. at 114,[9] and the carrying charges on short sales to benefit a stockholder's company in *duPont* was not considered "normal, usual or customary" for a person who was not "an active trader in securities", 308 U.S. at 495.

Also plainly wrong is the Court of Appeals' assertion (App. 9a) that this Court in *United States v. Mississippi Chemical Co.*, 405 U.S. 298 (1972), one year after *Lincoln Savings*, ignored the separate and distinct asset test. In *Mississippi Chemical*, the taxpayer was required to purchase shares in a Bank for Cooperatives in order to continue its membership in the Bank and thereby be entitled to borrow money from the Bank. The taxpayer claimed that the stock (which was clearly a separate and distinct asset) had no value and therefore the amount paid for it was in substance interest on the taxpayer's loans from the Bank. This Court rejected that claim, finding instead that the stock was valuable because, among other things, it provided the taxpayer with "an opportunity for more patronage and surplus dividends, an ultimate right of redemption, and an *asset* that may be used as a set-off in case of a default on a loan." 405 U.S. at 309 (emphasis added). This Court then concluded that, since the stock was "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. Cf. *Commissioner* v. *Lincoln Savings & Loan Assn.*, 403 U.S. 345 (1971) . . . ." 405 U.S. at 310 (emphasis added). Since the *Lincoln Savings* test contemplates not just an asset but one with a value extending

8 In *Tellier* this Court stated that the "principal function" of the term "ordinary" in Section 162(a) is to distinguish between currently deductible expenses and capital expenditures. 383 U.S. at 689.

9 It was in regard to the secondary meaning of "ordinary" that this Court in *Welch* made the well-known statement, described in *Lincoln Savings* as "elusive", that "life in all its fullness must supply the answer to the riddle" of the meaning of Section 162(a). 290 U.S. at 115; quoted at 403 U.S. at 353.

beyond the taxable year, this Court's decision in *Mississippi Chemical* represents an endorsement, not a repudiation, of that test.[10]

2. *The Decision Below Creates a Conflict in the Circuits Which This Court Should Resolve.* The Courts of Appeals for six other Circuits have previously followed the *Lincoln Savings* separate and distinct asset test. Thus, the Second Circuit held that the *Lincoln Savings* decision "directs the inquiry . . . to the question whether or not [the taxpayer] . . . 'created or enhanced for [itself] what [was] essentially a separate and distinct additional asset.'" *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d at 775, 782 (2d Cir. 1973). The Fourth Circuit held that, in light of the "unmistakable language in *Lincoln Savings & Loan* that 'the presence of an ensuing benefit . . . is not controlling'", "costs incurred in expanding a business are not considered capital costs unless they meet the *Lincoln Savings & Loan* 'separate and distinct additional asset' test. And this test holds whether or not the expenditures have benefits beyond the current taxation period." *NCNB Corp. v. Commissioner*, 684 F.2d 285, 289, 291 (4th Cir. 1982).[11] The Fifth Circuit described *Lincoln Savings*

10 Similarly, *Lincoln Savings* is entirely consistent with this Court's earlier decisions in *Woodward v. Commissioner*, 397 U.S. 572 (1970), and *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970). In each of those cases appraisal fees were held to be capital expenditures because they were incurred by an *acquiring* corporation (not by the *acquired* corporation, as in the National Starch transaction) in connection with its acquisition of another corporation's stock, clearly a separate and distinct asset of the taxpayer with a value extending beyond the taxable year. *Lincoln Savings* is also consistent with *General Bancshares Corp. v. Commissioner*, 326 F.2d 712 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964), in which then Circuit Judge Blackmun, writing for the Court of Appeals for the Eighth Circuit, rejected the taxpayer's argument for deductibility of expenditures relating to a stock dividend on the ground that such expenditures were "'needed to give the corporation an intangible asset which we may call its altered corporate structure'". 326 F.2d at 715 (quoting *Mills Estate, Inc. v. Commissioner*, 206 F.2d 244, 246 (2d Cir. 1953)).

11 *See also J. . k's Cookie Co. v. United States*, 597 F.2d 395, 405 (4th Cir. 1979) (holding payments into a rental reserve fund to be capital

as "stat[ing] the test for distinguishing an ordinary expense from a capital expenditure" and framed the issue before it as "whether the establishment of a new branch office creates a separate and distinct additional asset". *Central Texas Savings & Loan Ass'n v. United States*, 731 F.2d 1181, 1184 (5th Cir. 1984).[12] The Eighth Circuit cited *Lincoln Savings* for the proposition that "the fact that there may be some ensuing benefit and future effect from the expenditure beyond the taxable year when paid is not controlling". *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979). The Tenth Circuit described *Lincoln Savings* (and other cases) as involving "acquisitions of, or improvements to, a distinct and recognizable property interest" and decided that the expenditures in question were deductible because, unlike the *Lincoln Savings* expenditures, they "did not create a property interest" and "produced nothing corporeal or salable". *Colorado Springs Nat'l Bank v. United States*, 505 F.2d at 1185, 1192 (10th Cir. 1974). And the Ninth Circuit "adopt[ed] the decision of the Tenth Circuit in *Colorado Springs National Bank, supra*, as the law of . . . [the Ninth] circuit." *First Security Bank of Idaho v. Commissioner*, 592 F.2d 1050, 1052 (9th Cir. 1979).

In each of the six cases, deductibility turned on whether a separate and distinct asset had been created, since all the expenses had been incurred with the expectation that they would improve the future profitability of the taxpayer's business, and thus conferred on the taxpayer a "not insignificant future benefit". In five of the cases, no such asset was found to exist and the claimed deductions were allowed: *Briarcliff*

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expenditures because such fund "was essentially a 'separate and distinct asset'" which "had an ascertainable and real value to the taxpayer"); *First Nat'l Bank of South Carolina v. United States*, 558 F.2d 721, 723 (4th Cir. 1977) (holding a membership fee paid by a bank to join a credit card system to be deductible because "[m]embership . . . is not a separate and distinct additional asset").

12 *See also Campbell Taggart, Inc. v. United States*, 744 F.2d 442, 445 (5th Cir. 1984) (holding an expense to be deductible because, unlike the premiums involved in *Lincoln Savings*, it was "not related to a specific asset").

Candy Corp. (expenses incurred to develop a suburban retail distribution network for the taxpayer's candy products); *NCNB Corp.* (expenses incurred to establish bank branches in new locations); *Iowa-Des Moines Nat'l Bank Colorado Springs Nat'l Bank* and *First Security Bank of Idaho* (expenses incurred to participate in new credit card systems). In the sixth case (*Central Texas Savings & Loan*), on facts virtually identical to those involved in *NCNB Corp.*, expenses incurred to establish bank branches were required to be capitalized because, under the Fifth Circuit's view of the applicable state law, they created a property right that amounted to a separate and distinct asset within the meaning of *Lincoln Savings.*

There is no doubt that the Court of Appeals for the Third Circuit adopted a different approach than the courts in these cases; it conceded as much. (App. 9a-10a) If this conflict is not resolved by this Court, it will result in disparate treatment of taxpayers in a wide range of circumstances with respect to this important and recurring issue.

3. *The IRS Has Taken Conflicting Positions on This Issue, and This Court Should Resolve That Confusion.* For almost 20 years, the IRS has wrestled with the meaning of *Lincoln Savings.* In the decade immediately following the decision, the IRS disagreed with the judicial decisions described above, claiming that future benefit alone was still sufficient for capitalization.[13] At the same time, however, the IRS National Office applied the *Lincoln Savings* test in General Counsel Memoranda ("GCM") and Technical Advice Memoranda ("TAM") issued in connection with audits of other tax-

13 This assertion was repeatedly made in Actions on Decision ("AOD") setting forth the IRS' litigating position regarding those decisions. *See, e.g.*, unnumbered AOD (Apr. 25, 1973) (saying that the Second Circuit in *Briarcliff Candy Corp.* "misconstrued ... [*Lincoln Savings*] as discounting the factor of future benefit in considering whether an expenditure is capital in nature"); AOD CC-1976-341 (May 28, 1976) (saying that this Court in *Lincoln Savings* "did not state ... that a 'separate and distinct additional asset' is required in every instance as a prerequisite for capitalization").

payers.[14] Then, in 1980, the IRS abandoned its litigating position "in view of the practical considerations involved, including the lack of sympathetic appeal of our position due to the total denial of deductions [*i.e.*, no amortization or depreciation] and the continued losses in the circuit courts." GCM 38410 (June 18, 1980). Subsequent Technical Advice Memoranda issued by the IRS National Office adhered to the view that "a mere showing that a future benefit has been established is not determinative. There must be an asset or a property interest that relates to the expenditures." TAM 8202010 (Sept. 28, 1981); *see also* TAM 8423005 (Feb. 8, 1984).

The only Revenue Ruling on this subject published by the IRS after *Lincoln Savings*—Rev. Rul. 83-66, 1983-1 C.B. 43—is internally contradictory in its statement of the applicable law, saying in one paragraph that the "determination whether the reserve premium constitutes a capital expenditure and thus must be capitalized under section 263 of the Code depends on whether the reserve premium creates, enhances, or is part of the cost of acquiring or defending a separate and distinct asset or property interest," and in a different paragraph that "the insurance payments constitute ordinary and necessary business expenses under section 162 of the Code, unless the reserve premium creates a benefit that extends beyond the tax year in which paid or the reserve premium results in the creation, permanent improvement, or betterment of an asset." The IRS went on to hold, however, that the insurance premium was deductible despite the "expectancy that a refund may be forthcoming in a future tax

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14 *See, e.g.*, GCM 35681 (Feb. 19, 1974) (allowing the claimed deduction because the "mere expectation ... [that] the servicing rights [will produce future income] does not satisfy the definition of a capital asset as that term is commonly understood"); TAM 8041001 (Oct. 24, 1979) (allowing the claimed deduction because "four Circuit Courts and the Tax Court have adopted the view that in determining whether a cost should be capitalized under section 263 of the Code, one must look to whether the expenditure created or enhanced what is essentially a separate and distinct asset having an economically useful life beyond the taxable year of acquisition").

year", because such an expectancy "does not create an asset in the hands of the taxpayer", 1983-1 C.B. at 44-45, thus apparently applying the *Lincoln Savings* test.

In 1985, after the United States Claims Court in *Cleveland Electric Illuminating Co. v. United States*, 7 Cl. Ct. 220 (1985), appeared to endorse the view that either the creation of a separate asset or a future benefit is sufficient to require capitalization, the IRS reverted to that approach. *See* TAM 8611005 (Nov. 26, 1985); GCM 39483 (Mar. 6, 1986). Two years later, however, the IRS again rejected that approach in favor of a strict application of the *Lincoln Savings* test. In GCM 39669 (Oct. 9, 1987), which involved expenses incurred to establish the taxpayer's right to receive social security benefits, the IRS acknowledged that the expenses "created a benefit which has some future aspect", but nevertheless permitted the deduction because the benefit did not "rise to the level of the type of asset or property interest for which capitalization of related expenses would be required under section 263".

Finally, in 1989 and 1990, the IRS National Office confronted the *Lincoln Savings* question in a series of three Technical Advice Memoranda issued in connection with a tax audit of a corporation the stock of which had been acquired by another corporation, as occurred in the instant case. The IRS first held that the investment banking fee and other expenses incurred by that corporation both in resisting a hostile takeover attempt and in consummating a friendly acquisition by a "white knight" were deductible because they did not result in the corporation's acquisition of an asset or an improvement of property within the meaning of Section 263 of the Code, and also were not incurred "pursuant to an alteration or change in the capital structure" of the corporation. TAM 8927005 (Mar. 27, 1989). One week after the Tax Court's decision in the instant case, the IRS revoked TAM 8927005 in TAM 8945003 (Aug. 1, 1989) and held that all the expenses of the corporation were capital in nature. Then, in TAM 9043003 (July 9, 1990), the IRS reconsidered its revocation of TAM 8927005 and held that the expenses incurred by the corporation in resisting the hostile takeover attempt were deductible, but its expenses relating to the friendly acquisition by a white knight were required to be capitalized. This distinction was based on the notion that the expenses of resisting the takeover attempt were incurred to "protect" the corporation and were thus analogous to the expenses held to be deductible by this Court in *Tellier* and *Heininger*, whereas the expenses relating to the white knight's acquisition were "intended to lead to a benefit that could be expected to produce returns for many years in the future".[15]

The IRS' frequent reversals of position regarding *Lincoln Savings* have obviously caused great confusion among taxpayers and have resulted in inconsistent treatment of similarly situated taxpayers. This Court's reaffirmation of the principle set forth in *Lincoln Savings* is needed to correct such confused and inconsistent administration of the tax laws.

4. *The Court of Appeals' Approach Is Unworkable and Will Create Further Confusion for Taxpayers and the IRS.* The future benefit approach followed by the Court of Appeals, in addition to its failure to conform to this Court's decision in *Lincoln Savings,* is deficient in several critical respects.

First, this approach is deficient for the same reason this Court found it to be 20 years ago. It fails to accommodate the types of expenses, such as those for legal defenses, advertising and employment-related education, that were discussed in *Lincoln Savings* and are concededly deductible even though

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15 This dichotomy—that expenses to preserve the corporate status quo are deductible but expenses to change the status quo are not—is directly contrary to the IRS' long-standing acquiescence in *Central Foundry Co. v. Commissioner*, 49 T.C. 234 (1967), *acq.*, 1968-2 C.B. 2, in which the Tax Court held that expenses incurred by insurgent stockholders in their successful effort to unseat incumbent management in order to change corporate policies for the future benefit of the corporation are deductible by the corporation. Thus, such expenses are on the same footing as those incurred by incumbent management to retain its position, which are also deductible. *See Locke Manufacturing Cos. v. United States*, 237 F. Supp 80 (D. Conn. 1964), followed by the IRS in Rev. Rul. 67-1, 1967-1 C.B. 28.

they entail a significant future benefit. *See supra*, note 6, and accompanying text. Must all similar expenses now be capitalized by taxpayers in the Third Circuit? If not, what is the principle that permits such expenses to be deducted despite their obvious future benefit whereas the type of expenses incurred by National Starch must be capitalized by it and other taxpayers in the Third Circuit?[16]

Second, in many cases it will be extremely difficult to draw the line between an "incidental" and a "not insignificant" future benefit, as must be done under the Court of Appeals' approach. Drawing this line requires the taxpayer to make a prediction about the impact of intangible factors on the fortunes of its business, an inherently subjective and speculative exercise, and it can be expected that different taxpayers, acting reasonably and in good faith, will draw the line in different places. Similarly, it can be expected that different IRS auditors will draw the line in different places, thereby engendering uncertainty, thwarting the goal of consistent treatment of taxpayers in similar situations and inviting resort to the courts on a case-by-case basis. The courts in such cases will be required to review the facts in detail and make difficult factual judgments, and there will inevitably be inconsistent results in the resolution of such controversies. In contrast, the *Lincoln Savings* test, with its focus on a recognized and valuable property interest, promotes an objective inquiry into matters that are more readily ascertainable by taxpayers and the IRS, thereby fostering more certain and uniform administration of the tax laws and reducing the need for resort to the courts.[17]

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16 The Court of Appeals said that the determination whether an expenditure is capital or ordinary is "fact-specific" (App. 10a, citing 6 Mertens, *Law of Federal Income Taxation* § 25.27 (1988), at which cases involving repairs to tangible property are collected). There must, however, be some general principle to be applied to the facts of each case if courts are to make a rational and even-handed decision on the issue and if taxpayers, in filing their returns, and the IRS, in auditing those returns, are to follow the dictates of the law.

17 The Second Circuit in *Briarcliff Candy Corp.* expressed great relief that this Court had adopted an objective test in *Lincoln Savings*; it said that previously the standard was "anybody's guess" and, in the "realm of

Third, judging by where the line was drawn by the Court of Appeals in the instant case, the evidence needed to find a significant future benefit may be flimsy indeed. National Starch obviously had no control over Unilever and could not compel it to provide capital or other resources or buy more of National Starch's products. At most, National Starch had a mere hope or expectancy of future assistance, which, as the courts below admitted (App. 4a, 23a), remained unfulfilled in the nine years from acquisition to the time of trial.[18] Although the Court of Appeals was impressed by Unilever's "gargantuan" size (App. 13a), it failed to explain why a large parent, particularly one engaged in a different line of business, is any more likely to be beneficial to an acquired subsidiary than a small parent. Thus, pure speculation about future benefit, without any evidence of actual benefit, seems to be sufficient in the Third Circuit.[19] That a finding of significant

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intangibles", in particular, "the rulings and decisions ... [were] in a state of hopeless confusion." 475 F.2d at 783, 785.

18 On the other hand, National Starch clearly received in the current taxable year the principal benefits to be derived from the services for which it paid the investment banking and legal fees at issue. As a result of those fees, National Starch's board of directors received advice as to its legal obligations and the expert assistance that it needed to value the company's stock and determine the fairness of the proposed transaction to the company's stockholders; the board could thus carry out its fiduciary duty in a prudent manner. Moreover, as a result of the fees, National Starch received protection from a potential hostile takeover attempt. Thus, the allowance of a current deduction to National Starch for those fees would not distort its income, but, rather, would conform to the matching principle intended to be served by the statutory rules. *See infra*, pp. 20-21.

19 That the IRS will draw the line even beyond the point where the Court of Appeals drew it is illustrated by TAM 9043004 (July 9, 1990), in which the IRS held that substantially all the expenses incurred by an acquired corporation had to be capitalized. In that case, the corporation allowed itself to be acquired by a white knight only as an alternative to being taken over by a hostile raider; it would have much preferred to have remained independent. Unlike TAM 8927005, none of the stated facts indicated that any capital or other resources or assistance were provided or intended to be provided to the corporation by the white knight after the acquisition, or were otherwise potentially available to the corporation. The IRS nevertheless concluded that a long-term benefit had been created by the shift in stock ownership and required capitalization.

future benefit should be based on such speculation is questionable. There can be no doubt, however, that such a speculative benefit does not rise to the level of a "recognized property interest", as required by *Lincoln Savings*.

Fourth, and most importantly, the *Lincoln Savings* test conforms to congressional intent, as reflected in the language of the relevant Code provisions and long-standing Treasury Regulations, and also serves the basic purpose sought to be achieved by capitalizing expenditures—the matching of revenues with the costs of producing them—whereas the Court of Appeals' approach does not.

As the Court of Appeals recognized, the "ordinary" requirement of Section 162(a) "must be interpreted in tandem with section 263" (App. 6a), which requires the capitalization of amounts paid for "permanent improvements or betterments made to increase the value of any property or estate", *infra* App. 34a. The Treasury Regulations promulgated under Section 263 also refer to "property or estate" and give a number of examples of capital expenditures, all of which relate to betterments to property. Treas. Reg. §§ 1.263(a)-1 and 1.263(a)-2, *infra* App. 36a-37a. Sections 167 and 168 of the Code allow deductions for amortization and depreciation of "property", *infra* App. 32a. And the Treasury Regulations under Section 461 of the Code, which implement the requirement of Section 446(b) that the methods of accounting used by taxpayers "clearly reflect income", disallow a deduction to both cash and accrual basis taxpayers for expenditures that create an "asset". Treas. Reg. §§ 1.461-1(a)(1) and 1.461-1(a)(2), *infra* App. 37a-38a. All these provisions, in addition to Section 162(a), address various aspects of the tax accounting treatment of expenditures—*i.e.*, the timing of the recognition of expenditures for purposes of reflecting properly the taxpayer's net income subject to tax in a given period. Since they all have the same basic objective, they should be construed in a consistent manner, and the reference to "property" or "asset" in each instance suggests that Congress intended to draw the line between a currently deductible ordinary expense and a non-deductible (but generally amortizable or depreciable) capital expenditure only where, as *Lincoln Savings* said, a recognized property interest is created or enhanced.

That Congress views the line between an ordinary expense and a capital expenditure in a manner consistent with this Court's separate and distinct asset test was most recently confirmed by the enactment of Section 195 of the Code in 1980 and its amendment in 1984. Section 195 permits five-year amortization of "start-up" expenditures "paid or incurred in connection with (i) investigating the creation or acquisition of an active trade or business, or (ii) creating an active trade or business, . . . which, if paid or incurred in connection with the operation of an existing trade or business . . . would be allowable as a deduction for the taxable year in which paid or incurred." (App. 32a-34a) Thus, the Code permits amortization of only those start-up costs that would be deductible under Section 162(a) by a hypothetical taxpayer already engaged in carrying on the same trade or business as that being started up. Section 195 cannot operate if a future benefit test is imposed upon Section 162(a) because most, if not all, start-up expenditures produce significant future benefits. Indeed, future benefits are their avowed goal. Since Section 195 amortization cannot be elected for expenditures that would not qualify for current deductibility under Section 162(a), a future benefit test would negate the operation of Section 195—a consequence that Congress could not have intended.[20]

The separate and distinct asset test better serves the purpose of the capitalization requirement—matching

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20 The interaction between Sections 162(a) and 195 was considered by the Fourth Circuit in *NCNB Corp.*, *supra*. The court, sitting *en banc*, rejected a future benefit test and applied the separate and distinct asset test, in part, because "[a]n interpretation by us as to the contrary would render § 195 meaningless for it would obliterate the reference point in the statute." 864 F.2d at 291.

revenues with the costs of producing them—than the Court of Appeals' approach. This Court stated in *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974): "The purpose of § 263 is to reflect the basic principle 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." *See also Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983) ("The function of these rules is to achieve an accurate measure of net income for the year by matching outlays with the revenues attributable to them and recognizing both during the same taxable year.") By rejecting the amorphous concept of future benefit and requiring instead the identification of a separate and distinct asset, the *Lincoln Savings* test furthers the matching principle, since it focuses the inquiry on whether a specific source of revenue exists and, if so, allows the costs of creating or enhancing that source of revenue to be amortized over its useful life (if shown to be of limited duration) or to be deducted when it is disposed of by the taxpayer.

The Court of Appeals acknowledged that under its future benefit approach the expenditures at issue here cannot be recovered by National Starch short of its liquidation. (App. 16a-17a) Whether by amortization or by recovery upon disposition, cost recovery for tax purposes requires tax basis, and tax basis can only attach to an item of property, an asset. A regime that predicates capitalization on a future benefit rather than an existing asset both denies the taxpayer a current deduction and the means of recovering its costs.[21] Such a regime would frustrate the clear reflection of income.

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21 Several courts have rejected a future benefit test, in part, because it provides no apparent method of recovery, to the detriment of tax fairness and clear reflection of income. In *Colorado Springs Nat'l Bank, supra*, the Tenth Circuit emphasized that the "government's theoretical approach. . . permits a distortion of taxpayer's financial situation" because under it, expenditures of only "temporal value. . . may be neither expensed nor amortized." 505 F.2d at 1192. In *First Nat'l Bank of South Carolina*, the District Court stressed that under the future benefit test, a "taxpayer has no

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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Feburary 11, 1991

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saleable asset from which it could ever recoup the assessments which the government says it must capitalize but would be unable to depreciate or amortize." *First Nat'l Bank of South Carolina v. United States*, 413 F. Supp. 1107, 1111 (D.S.C. 1976), *aff'd*, 558 F.2d 721 (4th Cir. 1977).

APPENDIX

UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

No. 89-1923

NATIONAL STARCH AND CHEMICAL CORPORATION,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE

Argued March 16, 1990

Decided November 13, 1990

As Amended November 28, 1990

Before: SLOVITER, BECKER, and STAPLETON, Circuit Judges

OPINION OF THE COURT

SLOVITER, Circuit Judge.

This is an appeal by National Starch and Chemical Corporation (National Starch) from a decision of the Tax Court affirming the disallowance by the Internal Revenue Service (IRS) of the investment banking fee, legal fees and related expenses incurred by National Starch's Board of Directors in deciding whether to acquiesce in a takeover by Unilever United States, Inc. National Starch contends that these were ordinary and necessary business expenses deductible under section 162(a) of the Internal Revenue Code. The Tax Court agreed with the Commissioner of Internal Revenue that all of the fees were nondeductible capital expenditures. This appeal presents, as far as we can tell, an issue of first impression.

I. *Facts and Procedural History*

The facts are largely undisputed and are in the record as a result of a stipulation between the parties.

In 1977, Unilever approached National Starch, one of Unilever's suppliers, to gauge its interest in being the target of a friendly takeover. All of the stock of Unilever United States, Inc. is owned by Unilever N.V. (jointly referred to as Unilever), a publicly held Netherlands Corporation.[1] Unilever was interested in increasing its United States revenues relative to its overall revenues.

Unilever expressed its interest in National Starch to, *inter alia,* Frank Greenwall, a member of National Starch's Board of Directors, who along with his wife was the largest stockholder, holding approximately 14 1/2 percent of the stock. The Greenwalls decided to sell their shares to Unilever if the transaction could be arranged to be tax-free to them so that they could defer capital gains for estate planning purposes. Unilever, which was interested only in a friendly takeover, would proceed only if the Greenwalls were willing to sell their shares.

To satisfy the Greenwalls, the merger was arranged as a "reverse subsidiary cash merger" under which Unilever created a subsidiary, National Starch and Chemical Holding

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1. Unilever United States, Inc. is a holding company whose principal subsidiaries in 1977 were Lever Brothers Co. and Thomas J. Lipton, Inc., both of which manufacture and sell primarily foods and detergents.

(Holding),[2] which offered to either purchase the shares of National Starch's shareholders with money contributed by Unilever or exchange them for preferred stock of Holding. Subsequently, this arrangement received the desired ruling from the Internal Revenue Service that shareholders who exchanged National Starch stock for Holding stock could do so without adverse tax consequences.

When the plan was presented to National Starch's Board of Directors for consideration, the corporation's legal counsel advised the directors that they had a duty to ensure that the transaction "would be fair to the shareholders and that that would involve valuations of the company." App. at 91. Counsel suggested "as a practical matter that it would be extremely useful for the board to have a firm of outside independent investment bankers . . . to assist in the valuations of the company to ensure fairness of any transaction," *id.*, and that it was also wise from a legal standpoint in carrying out the Board's fiduciary duties. App. at 92. When it appeared likely that a favorable ruling would be forthcoming from the IRS, National Starch engaged Morgan Stanley & Co. (Morgan Stanley) to do a preliminary analysis, review National Starch's alternatives, make a valuation judgment after studying National Starch, render a fairness opinion, and coordinate the technical details of the merger.

Morgan Stanley prepared and delivered a report to the Board on the fairness of the offer. Unilever had originally proposed a price of $65 to $70 for each share of National Starch, which Morgan Stanley concluded was fair. Unilever thereafter offered $70 a share. National Starch's management suggested a price of $80 a share, which Morgan Stanley relayed to Unilever on the Board's behalf. Morgan Stanley thereafter reported back a Unilever offer of $73.50 a share, the price ultimately agreed upon.

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2. Holding then created a subsidiary, NSC Merger (Merger), which was immediately merged into National Starch. The government concedes that this merger was "an incidental aspect of the transaction that should be disregarded." Brief for Appellee at 18 n.7.

After the sale of the stock, National Starch retained its former management, and it did not materially increase the sale of its products to Unilever. The management at National Starch viewed the transaction as "swapping approximately 3500 shareholders for one." App. at 141. As a matter of administrative convenience, it changed its charter to eliminate its authorized and unissued preferred stock and decreased its authorized common stock to 1,000 shares.

National Starch's tax return for the year that ended August 15, 1978 (the date of acquisition) treated the $2,225,586 Morgan Stanley fee as a deduction for an ordinary and necessary business expense under section 162(a) of the Internal Revenue Code. The IRS disallowed the deduction and issued a notice of deficiency in the amount of $1,068,281. National Starch filed a petition in the United States Tax Court contesting the disallowance. It also claimed a refund, asserting that it had overpaid its 1978 taxes in the amount of $706,079 because it had not deducted, and was entitled to deduct, ancillary expenses which included its attorneys' fees, costs associated with the proxies, and the SEC fees which it incurred with respect to the merger plan.[3] The Tax Court upheld the disallowance by the IRS. 93 T.C. 67 (1989).

The Tax Court rejected the IRS' contention that the expenditures were nondeductible because they were incurred incident to a recapitalization, merger, or reorganization, concluding essentially that the form and structure of the transaction was selected primarily for administrative convenience. On the other hand, the Tax Court concluded that these were nondeductible capital expenditures because National Starch's directors determined that it would be in National Starch's "long-term interest to shift ownership of the corporate stock to Unilever" and "[t]he expenditures in issue were incurred incident to that shift in ownership. . . ." *Id.* at 75. Accordingly, it believed those expenditures "lead to a benefit 'which could be expected to produce returns for many

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3. A refund in excess of $257,444 is barred by the statute of limitations.

years in the future.'" *Id.* (quoting *E. I. du Pont de Nemours and Co. v. United States,* 432 F.2d 1052, 1059 (3d Cir. 1970)). Such a benefit is "capital in nature" because its purpose has to do with the corporation's betterment for the indefinite future. *Id.* at 75. The court noted that National Starch's 1978 annual report stated that it would benefit from the availability of Unilever's enormous resources, and that Morgan Stanley's report stated that National Starch's affiliation with Unilever would create the opportunity for synergy. *Id.* at 76.

The Tax Court rejected National Starch's argument that the Supreme Court's decision in *Commissioner v. Lincoln Savings & Loan Ass'n,* 403 U.S. 345, 91 S.Ct. 1893, 29 L.Ed. 2d 51? (1971), 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. 93 T.C. at 77. It also rejected National Starch's contention that the dominant aspect of the transaction was the fiduciary duty the Board of Directors owed to the shareholders and not the transfer of the stock, finding instead that "the dominant aspect was the transfer of petitioner's stock for the benefit of [National Starch] and its shareholders." *Id.* at 78.

National Starch has appealed from the Tax Court's decision. We have jurisdiction pursuant to 26 U.S.C. § 7482. Our review of the Tax Court's construction of the Code is plenary; we review its factual findings and inferences for clear error. *Pleasant Summit Land Corp. v. Commissioner,* 863 F.2d 263, 268 (3d Cir. 1988).

II. *Ordinary and Necessary Business Expenses*

A. *Effect of Lincoln Savings*

[1] The issue before us is whether National Starch's expenditures for investment banking and legal fees can be deducted under section 162(a) of the Internal Revenue Code as ordinary and necessary business expenses or whether they must be capitalized under section 263. Section 162 provides:

"[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." 26 U.S.C. § 162(a) (1988). This provision must be interpreted in tandem with section 263, which prohibits deductions 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." 26 U.S.C. § 263(a)(1) (1988).

The Supreme Court has enumerated five separate requirements for deductibility under section 162(a). The item must (1) be paid or incurred during the taxable year (2) for carrying on any trade or business, and (3) be an expense (4) that is "necessary" and (5) "ordinary." *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 352, 91 S.Ct. 1893, 29 L.Ed. 2d 519 (1971). Only the "ordinary expense" requirement is in dispute here. The Court has stated, in somewhat circular fashion, that the principal function of the term "ordinary" 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. *See Commissioner v. Tellier*, 383 U.S. 687, 689-90, 86 S.Ct. 1118, 1119-20, 16 L.Ed. 2d 185 (1966).

Tax deductions are a matter of legislative grace. *See Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593, 63 S.Ct. 1279, 1281, 87 L.Ed. 1607 (1943). Thus, the burden is on the taxpayer to show that the expenses are deductible. *See E. I. du Pont de Nemours and Co. v. United States*, 432 F.2d 1052, 1059 (3d Cir. 1970).

Before 1971, this court held that when an expenditure resulted in a benefit to the taxpayer "which could be expected to produce returns for many years in the future," the expenditure was deemed capital and therefore nondeductible. *Id.* at 1059 (legal expense in devising plan to satisfy antitrust decree which involved restructuring of the enterprise not deductible); *see also McDonald v. Commissioner*, 139 F.2d 400, 401 (3d Cir. 1943) (campaign expenses not deductible as ordinary expenses because benefit sought to be derived putatively spread over ten-year term), *aff'd*, 323 U.S. 57, 65 S.Ct. 96, 89 L.Ed. 68 (1944).

National Starch argues that the legal standard employed by the Tax Court in this case, which looked to the presence of a future benefit to determine that the expenditures were ordinary and necessary business expenses, was specifically rejected by the Supreme Court in *Commissioner v. Lincoln Savings & Loan Ass'n*. It argues that *Lincoln Savings* established a new and exclusive test for distinguishing between deductible expenses and nondeductible capital expenditures under which expenses are not to be capitalized unless they result in the creation or enhancement of a separate and distinct asset.

The issue before the Supreme Court in *Lincoln Savings* was whether an additional premium required by federal statute to be paid by a savings and loan association to the Federal Savings and Loan Insurance Corporation (FSLIC) was deductible as an ordinary and necessary business expense under section 162(a). The Court accepted the distinction made by the IRS between premiums paid by Lincoln for the FSLIC's Primary Reserve, the general reserve for the expenses and insurance losses in which the insured institutions had no property interest, and its Secondary Reserve, on which those institutions were credited a return and in which they owned a pro rata share to be refunded upon termination of their insured status. Premiums paid for the Primary Reserve were deductible as ordinary and necessary expenses, but the Court held that payments to the Secondary Reserve were nondeductible capital expenditures. The Court stated:

> [w]hat is important and controlling . . . is that the . . . payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a) in the absence of other factors not established here.

403 U.S. at 354, 91 S.Ct. at 1899.

In the course of determining that the expenses were capital, the Court stated that "the presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year." *Id.* National Starch relies on this language to support its argument that expenditures which do not create or enhance a separate and distinct asset are to be treated as deductible ordinary expenditures.

We do not read *Lincoln Savings* as broadly as does National Starch. The language upon which National Starch relies does not create a new bright-line test. Although the opinion clearly holds that a payment that creates or enhances a separate asset is capital in nature, *see id.*, it does not necessarily follow that if no asset is created the expenditure is not capital in nature. The government aptly describes this argument as concluding that "because something made out of glass is fragile, all things fragile must be made out of glass." Brief for Appellee at 28 n. 13.

There is nothing in the *Lincoln Savings* opinion that announces a new test for the lower courts to apply or suggests that the Court intended to create a new standard applicable irrespective of the factual context. Although it is clear that the Court viewed the creation or enhancement of a separate and distinct asset as "important and controlling" in requiring the expense to be capitalized, the absence of such an asset is not addressed in the opinion. Further, although an incidental future benefit would plainly not be controlling, the Court does not suggest that the presence of a significant future benefit is not a legitimate factor to consider in determining deductibility.

If National Starch's interpretation were correct, the Court would have implicitly overruled without discussion its earlier precedent in which it held that expenses should be capitalized even though no separate asset was created or enhanced. *See, e.g., Deputy v. du Pont,* 308 U.S. 488, 60 S.Ct.

363, 84 L.Ed. 416 (1940) (holding nondeductible carrying charges on short sales of stock to corporation's executives made by shareholder to assist the corporation in preserving his investment). In fact, in *Lincoln Savings,* 403 U.S. at 353, 91 S.Ct. at 1898, the Court cited with approval *Welch v. Helvering,* 290 U.S. 111, 54 S.Ct. 8, 78 L.Ed. 212 (1933), a case holding that payments by a former officer of the corporation's discharged debts to strengthen his own credit and professional standing were capital outlays, even though there was no separate and distinct asset involved. Thus, the *Lincoln Savings* opinion itself undermines National Starch's interpretation.

Finally, in cases decided after *Lincoln Savings,* the Court has used tests other than the separate and distinct asset test to determine whether expenditures should be capitalized. For example, in *United States v. Mississippi Chemical Co.,* 405 U.S. 298, 92 S.Ct. 908, 31 L.Ed. 2d 217 (1972), decided the year after *Lincoln Savings,* the Court held that expenses associated with the acquisition of stock of the Bank of Cooperatives established by the Farm Credit Act of 1933 should be capitalized without making reference to any so-called *Lincoln Savings* test. Had it viewed *Lincoln Savings* as representing a radical shift and a new bright-line test for capitalization, it is unlikely that it would have ignored such a test the following year. Instead, the Court cited the *Lincoln Savings* precedent as support for its conclusion that "[s]ince the security is of value in more than one taxable year, it is a capital asset . . . and its cost is nondeductible." *Id.* 405 U.S. at 310, 92 S.Ct. at 915.

National Starch contends that every Court of Appeals that has faced this issue in the last eighteen years has held that where the expenses did not create or enhance a separate and distinct asset, the expenses were allowed as deductible under Section 162(a). Some Courts of Appeals have indeed construed *Lincoln Savings* to have created a new standard such as that proffered by National Starch. *See, e.g., Briarcliff Candy Corp. v. Commissioner,* 475 F.2d 775, 782 (2d Cir.

1973) (*Lincoln Savings* "brought about a radical shift in emphasis" and directs the inquiry to whether the expenditures created or enhanced what was essentially a separate and distinct asset); *see also NCNB Corp. v. United States*, 684 F.2d 285 (4th Cir. 1982) (en banc) (where expenditures of bank and its parent for metro studies, feasibility studies, and application to the Comptroller of the Currency do not create or enhance separate and identifiable assets but instead are used by parent to continually evaluate its market position, expenditures are ordinary and necessary.).

Of course, the determination whether an expenditure is ordinary or capital is fact-specific. 6 Mertens, Law of Federal Income Taxation § 25.27 (1988). Analytically inapposite are those cases which, while reading *Lincoln Savings* differently than we do, found that there was in fact a separate asset which required the capitalization of expenditures. *See, e.g., Central Texas Savings & Loan Ass'n v. United States*, 731 F.2d 1181 (5th Cir. 1984). Moreover, the cases cited by National Starch that involved the treatment of start-up costs for expansion projects of banks, *see, e.g., Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185 (10th Cir. 1974) (initial costs for computers, credit checks, and promotional activities in connection with participation in credit card system), are distinguishable. Banks, the *NCNB* court noted, are "unique" because a substantial portion of their assets must be readily available as cash to meet depositors' claims, and their books must accurately reflect their liquidity position. 684 F.2d at 293. Therefore, it found that the requirement by the Comptroller of the Currency that national banks treat such start-up costs as current expenses was presumptively controlling, but noted that the conservative accounting policy applicable to banks differed from that applicable to certain other federally regulated industries. *Id.* at 292.

Furthermore, at least three circuits continue to look to whether an ensuing benefit was created to determine whether the expense was ordinary and necessary. *See Central Texas Savings*, 731 F.2d 1181 (5th Cir. 1984); *Iowa-Des Moines Nat'l*

Bank v. Commissioner, 592 F.2d 433 (8th Cir. 1979); *Colorado Springs Nat'l Bank*, 505 F.2d 1185 (10th Cir. 1974).

In any event, our reading of the Supreme Court cases leads us to conclude that no one factor alone can control this complex decision. *See Colorado Springs Nat'l Bank*, 505 F.2d at 1192 ("[w]e find no statutory, regulatory, or decisional test which is dispositive. The issue [of the treatment of the challenged items] must be determined on the facts presented in the novel situation before us."). As Justice Cardozo noted in his oft-quoted statement about the ordinary and necessary determination:

> [h]ere . . . the decisive distinctions are those of degree and not 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.

Welch, 290 U.S. at 114-15, 54 S.Ct. at 9, quoted in *Lincoln Savings*, 403 U.S. at 353, 19 S.Ct. at 1898.

We conclude that although 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 alone does not necessarily mean that an expenditure is ordinary and necessary under section 162(a). We turn, therefore, to consider the appropriate treatment of National Starch's payments, a particularly difficult inquiry here because the expenditures at issue resulted in neither a tangible asset nor a readily identifiable intangible asset. *See Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 n.7 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207, 103 S.Ct. 3537, 77 L.Ed. 2d 1388 (1983).

B. *Treatment of National Starch's Expenses*

[2] Notwithstanding National Starch's protestations to the contrary, 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. The Court of Appeals' decision reversed in *Lincoln Savings* had failed to recognize that such a benefit always ensues when the expenses are used to create or enhance a capital asset. However, even post-*Lincoln Savings* cases acknowledge that the period of the benefit produced by the expenditure "remains a prominent, if not predominate, characteristic of a capital item." *Central Texas Savings*, 731 F.2d at 1183. As stated in *Ellis Banking*, "[t]he courts have uniformly interpreted [section 263] as denying a deduction for the cost of any long-lived asset." 688 F.2d at 1379 n.5. Moreover, as we previously noted, the Supreme Court itself considered the length of time a security would be of value to the taxpayer in concluding that its acquisition costs were not deductible. *Mississippi Chemical*, 405 U.S. at 310, 92 S.Ct. at 915.

In this case, the Tax Court held that the expenditures were not deductible in light of its determination that National Starch's directors concluded that it would be in the corporation's "long-term interest to shift ownership of the corporate stock to Unilever." 93 T.C. at 75. The Tax Court found that the transaction provided at least two inherently permanent benefits to National Starch: (1) the availability of Unilever's enormous resources, and (2) the opportunity for synergy created by Unilever's affiliation with National Starch. *Id.* at 76. These are factual findings of the Tax Court which we may not overturn unless clearly erroneous. *See Pleasant Summit Land Corp.*, 863 F.2d at 268.

In its discussion of the long-term benefits to National Starch as a result of the affiliation with Unilever, the Tax Court stated that "the very availability of the resources of Unilever was an immediate, as well as a long-term, benefit because it broadened [National Starch's] opportunities." 93 T.C. at 76-77. There is ample support in the record for this finding. National Starch had assets in 1976, the year before Unilever's approach, which were in excess of $241 million, App. at 373, and its operating income was $48 million. App. at 372. Unilever was gargantuan in comparison. It had combined assets in 1976 worth close to five and a half billion dollars, App. at 667, and its operating profit was in excess of one billion dollars. App. at 665.

National Starch recognized that Unilever's sheer wealth provided it with a significant benefit. National Starch's 1978 Annual Progress Report stated that, "We will benefit greatly from the availability of Unilever's enormous resources, especially in the area of basic technology." App. at 391. Although this was written after the takeover, there is no reason why it did not equally represent the view of the Board of Directors in agreeing to the takeover.

Of additional significance to the finding of long-term benefit was the Tax Court's subsidiary finding that even though there is no evidence of an immediate benefit from the affiliation, it created the opportunity for synergy. 93 T.C. at 76. National Starch primarily produces specialty starches, adhesives and related chemical products sold to a large number of industrial users for use in manufacturing a wide variety of consumer products and product packaging. App. at 608-14. Unilever describes itself as "one of the dozen largest businesses in the world by turnover — and the largest in consumer goods." App. at 415. The larger part of Unilever is in branded and packaged consumer goods: mainly foods, detergents, and toilet preparations. Significantly, Unilever listed other "important" activities as including chemicals, paper, plastics and packaging. *Id.*

It was undisputed that prior to the affiliation National Starch sold its products to Unilever and has continued to do so thereafter. App. at 142. National Starch emphasizes that there has been no material increase in the volume of such sales, but the Tax Court noted that "[t]he lack of benefits in the short term does not imply their absence in the long term, especially given the time it takes to plan and implement significant changes in a corporation's operations." 93 T.C. at 76.

Although Ned Bandler, Unilever's senior vice-president, testified there was no synergy "in the classic sense," App. at 70, this self-interested testimony may be discounted because it was in his company's interest to minimize the tax liabilities of National Starch. *See Riley v. General Mills, Inc.*, 346 F.2d 68, 72 (3d Cir. 1965). Moreover, Bandler admitted in the very same sentence that National Starch "was not a business that was alien to Unilever's activities." App. at 70.

Finally, as emphasized by the Tax Court, Morgan Stanley reported that the National Starch "[m]anagement also 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." App. at 624-25. National Starch's managers reported this view to Morgan Stanley before the tax consequence of the transaction was at issue. There is thus adequate evidence to support the Tax Court's findings that both Unilever's enormous resources and the possibility of synergy arising from the transaction served the long-term betterment of National Starch, and they are not clearly erroneous.

As an additional reason for nondeductibility, the Commissioner proposes that we adopt the rule that "*[a]ny* transaction in which a corporate taxpayer is transformed from a publicly-held corporation to a one-shareholder corporation involves an effective change in the taxpayer's corporate structure that will benefit future operations," and therefore expenses incurred with respect to such an ownership shift are capital expenditures. Appellee's Brief at 21-22 (emphasis in original). The Tax Court did not reach this issue. There is some plausibility in the Commissioner's argument that the elimination of the risk of proxy fights and shareholders' derivative suits, as well as of the costs of annual filings with the SEC and the solicitation of proxies, are long-term benefits arising from the radical change in the corporate enterprise which will last for the indefinite future. However, we need not decide whether to accept the absolute rule sought by the Commissioner. In this case, more than a mere change in corporate ownership was effected. Because the transaction entailed the affiliation of National Starch with Unilever which, as we have held above, sufficed to create the requisite long-term benefit, we will leave for another case consideration whether the benefits of restructuring ownership alone would be sufficient to require capitalization of the fees pertinent thereto.

On the other hand, it is important to note that the Board of Directors was motivated, at least in part, by concern for the future development of National Starch in the event of the death of the Greenwalls, the company's largest stockholders, who were ages 79 and 81 at that time. Oscar M. Reubhausen, Chairman of the Board of National Starch at the time of this litigation, testified that he told Morgan Stanley that the "estates problems" concerning the Greenwalls were "overhanging the market" and represented a "question mark — 'for National Starch Corporation for the future.'" App. at 203. He thus viewed the Unilever offer as a "particular opportunity put before National Starch." App. at 203-04.

Indeed, Morgan Stanley referred to that very concern in a letter to the Board summarizing its assignment. It stated that, "We understand that National Starch is interested in having Morgan Stanley review its strategic alternatives within the context both of the longer term situation of a 15% equity ownership in National Starch which at some point will be transferred from its present individual 'founding' owners and of an evaluation of an immediate proposed business combination involving Unilever." App. at 597. It is thus evident from the record that the National Starch directors viewed the Unilever offer as a transaction that would promote the long-term betterment of the corporation.

In addition, the fact that the Tax Court rejected the Commissioner's argument that the transaction was essentially a reorganization under section 368(a)(1)(B), for which expenditures must be capitalized, does not preclude consideration of the general rationale behind requiring capitalization of expenses for restructuring. As explained by Justice Blackmun, writing as a circuit judge (who, coincidentally, also authored *Lincoln Savings*), reorganization expenses are treated as capital because they relate to the corporation's operations and betterment into the indefinite future, as distinguished from income production or other current needs. *See General Bancshares Corp. v. Commissioner,* 326 F.2d 712, 715 (8th Cir. 1964); *see also El Paso Co. v. United States,* 694 F.2d 703, 709 (Fed. Cir. 1982) (expenses of "conception and implementation" involved in "a statutory reorganization . . . are generally to be capitalized on the theory that the altered capital structure will provide a future business benefit of intermediate duration"); *McCrory Corp. v. United States,* 651 F.2d 828, 832 (2d Cir. 1981) (reorganization expenditures, like organization expenditures, contribute to the creation of an intangible long-term asset — a change in the corporate structure for the benefit of future operations).

If capital expenditures were immediately deductible, the taxpayer's income would be distorted both in the current year and in later years when the benefits are in fact received. This policy is reflected in section 263 which expressly precludes deductions for permanent "betterments" made to increase the value of any property. In line with this analysis, the court in *Ellis Banking* held that expenses made in connection with the decision to acquire stock of another corporation were not immediately deductible because to do so would understate current net income. 688 F.2d at 1379 (function of capitalization rules is to achieve accurate measure of net income by avoiding the understatement of current income associated with immediate deductibility); *see also States Steamship Co. v. Internal Revenue Serv.,* 683 F.2d 1282, 1284 (9th Cir. 1982) (disallowing "substantial tax windfall" taxpayer sought "by bunching all the excess depreciation of three years into one year").

Although National Starch notes correctly that the fees and expenses at issue are not susceptible to depreciation or amortization because the benefit to the company has no ascertainable useful life, other courts have also concluded that section 263 requires denial of immediate deductibility in comparable situations. *See, e.g., Mills Estate v. Commissioner,* 206 F.2d 244, 246 (2d Cir. 1953) (costs of corporate reorganization not deductible even though intangible asset of "altered corporate structure" was not depreciable). In this respect, the expenses are analogous to the treatment of goodwill which is neither deductible nor depreciable until the business is sold, even though the benefits (increased profits) are obtained throughout the life of the business. *See* 5 Mertens, Law of Federal Income Taxation § 23A.141 (1985); *see also Thrifticheck Services Corp. v. Commissioner,* 287 F.2d 1 (2d Cir. 1961).

Finally, we consider whether the expenditures are deductible merely because they may have been necessary under Delaware law for the Board members to satisfy their fiduciary obligation to the shareholders. Precedent suggests otherwise. The Court in *Lincoln Savings* held that additional premium payments must be capitalized even though the governing statute required their payment by the taxpayer. 403 U.S. at 359, 91 S.Ct. at 1901. Similarly, in *du Pont,* 432 F.2d at 1059, we stated that "[t]he fact that the expenditures were involuntary . . . does not negative a requirement that they be capitalized, if they were in fact capital expenditures." *See also Woolrich Woolen Mills v. United States,* 289 F.2d 444, 448 (3d Cir. 1961) ("The involuntary nature of the expenditure . . . does not render deductible as expense an item which would otherwise be non- deductible as capital.").

In sum, we conclude that the Tax Court's finding that the opportunities that arose from the friendly takeover by Unilever created a long-term benefit to National Starch was not clearly erroneous. Its conclusion that the Morgan Stanley consulting fee, legal fees, and other related expenses incurred by National Starch are not deductible under section 162(a) of the Code is consistent with the general principles usually applied by courts in analyzing the deductibility or capitalization of corporate expenses.

III. *Conclusion*

For the reasons set forth above, we will affirm the decision of the Tax Court.

UNITED STATES TAX COURT

NATIONAL STARCH AND CHEMICAL CORP., PETITIONER *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 31669-84 Filed July 24, 1989.

CLAPP, *Judge:* Respondent determined a deficiency in petitioner's Federal income tax for the taxable year ended August 15, 1978, in the amount of $1,068,281. The only issue for our decision is whether petitioner, the acquired corporation in a friendly takeover, may deduct under section 162(a)[1] the expenditures it incurred incident to the takeover.

FINDINGS OF FACT

Most of the facts were stipulated and are so found. The stipulation of facts and attached exhibits are incorporated herein by this reference. At the time the petition was filed, the principal office of National Starch & Chemical Corp. (petitioner) was located in Bridgewater, New Jersey.

Petitioner is a Delaware corporation which uses the accrual method of accounting for Federal income tax purposes. The tax year in issue was a short year that ran from January 1 to August 15, 1978. Petitioner manufactures and sells adhesives, starches, and specialty chemical products in the United States and certain foreign countries. Immediately prior to August 15, 1978, petitioner's authorized capital stock consisted of 250,000 shares of preferred stock, none issued or outstanding, and 8 million shares of common stock, approximately 6,563,930 shares of which were issued and outstanding. Petitioner's common stock was publicly held by approximately 3,700 shareholders and was traded on the New York Stock Exchange. Petitioner's largest shareholder

[1]Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954 as amended and in effect for the year in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

was Frank K. Greenwall (Greenwall) who, together with his wife, owned approximately 14½ percent of petitioner's outstanding common stock.

Unilever United States, Inc. (Unilever U.S.), is a Delaware corporation whose principal office is located in New York City. It is a holding company whose principal subsidiaries prior to August 15, 1978, were Lever Brothers Co. and Thomas J. Lipton, Inc. These corporations manufacture and sell foods, detergents, and other products. All of the outstanding stock of Unilever U.S. is owned by Unilever N.V., a publicly held Netherlands corporation. Unilever N.V. and Unilever PLC (a publicly held United Kingdom corporation), along with companies directly or indirectly owned or controlled by them, comprise the Unilever Group.

On October 7, 1977, representatives of the Unilever Group indicated an interest in making a tender offer for all of petitioner's stock. This interest was expressed at a meeting with the chairman of petitioner's board of directors and with Greenwall (who was chairman of the executive committee of the board of directors). In the course of the subsequent discussions, Greenwall (who was 81 years old and his wife 79 years old) indicated that for estate planning reasons he and his wife would voluntarily dispose of their stock only in a tax-free transaction that would be available to the other shareholders. The Unilever Group said that it would proceed with the tender offer only if both Greenwall and petitioner favored the acquisition of the stock.

The law firm of Cravath, Swaine & Moore, counsel to Unilever U.S., and Debevoise, Plimpton, Lyons & Gates (Debevoise, Plimpton), counsel to petitioner and to the Greenwalls, devised a structure that was designed to satisfy Greenwall's concerns. This structure involved the formation of two new companies. One was National Starch & Chemical Holding Corp. (Holding), a Delaware subsidiary of Unilever U.S. The other, which would have only a transitory existence, was a subsidiary of Holding named NSC Merger, Inc. Pursuant to an exchange offer, Holding would exchange one share of its nonvoting preferred stock for each share of petitioner's common stock that it received from petitioner's shareholders. This transaction was intended to be tax free under section 351. Pursuant to an Agreement and Plan of Merger (merger agreement), any common stock of petitioner that was not acquired by Holding pursuant to the exchange offer would be converted into cash in a merger of NSC Merger, Inc. into petitioner. The structure of the proposed transaction was discussed with Internal Revenue Service officials in the ruling branch of the national office on November 3, 1977.

On November 7, 1977, petitioner's directors were told about the Unilever Group's interest in purchasing petitioner's stock and about the proposed structure of the transaction. At that meeting, Edward A. Perell, a partner at Debevoise, Plimpton, advised the directors that they had a fiduciary duty under Delaware law to ensure that the proposed transaction would be fair to the stockholders. In his judgment, the directors should retain an outside independent investment banking firm which would assist in the valuation of petitioner and would be available in the event that either the Unilever Group or a third party made a hostile or unsolicited tender offer. Perell told the directors that their failure to retain such a firm might be evidence that they did not carry out their fiduciary responsibilities.

On November 14, 1977, petitioner engaged the investment banking firm of Morgan Stanley & Co. Inc. (Morgan Stanley). Morgan Stanley was retained primarily to value the stock, to render a fairness opinion, and to stand ready to assist if there was a hostile tender offer.

The Unilever Group had originally proposed a price of $65 to $70 for each share of stock in petitioner and, after valuing petitioner, Morgan Stanley informed petitioner that such a price was fair. Subsequently, Morgan Stanley held discussions with the Unilever Group's representative and was offered a price of $70. The senior executives of petitioner felt that this price was too low and told the Morgan Stanley representative that they wanted $80. Morgan Stanley conveyed this information to the Unilever Group's representative and several days later Morgan Stanley reported that the Unilever Group had offered $73.50.

On December 11, 1977, a representative of Morgan Stanley submitted to petitioner's board of directors an oral report favorably evaluating the offer. On that same date, a letter of intent relating to the acquisition of petitioner's common stock was executed by petitioner and Unilever U.S.

On March 16, 1978, the board approved the execution of the merger agreement. Under the terms of that agreement, petitioner did not have to proceed with the transaction unless the Internal Revenue Service issued a favorable private letter ruling. Such a ruling letter was issued on June 28, 1978. This ruling letter held that the formation of Holding's subsidiary, NSC Merger, Inc., and the merger of that subsidiary into petitioner (a reverse subsidiary cash merger) would be disregarded for Federal tax purposes. The transaction would be a taxable sale to those shareholders who received cash and would be tax free under section 351 to shareholders who received Holding preferred stock. When the Internal Revenue Service issued the ruling letter, it did not know that petitioner would claim a deduction for its legal fees and for its Morgan Stanley fee.

On July 10, 1978, Morgan Stanley's written fairness opinion was delivered to the board. This opinion concluded that the terms of the proposed merger agreement and related exchange offer taken as a whole were fair and equitable to petitioner's shareholders from a financial point of view.

On August 15, 1978, a special meeting of petitioner's shareholders was held at which the merger agreement was approved. Later the same day, there was a closing of both parts of the transaction pursuant to the exchange offer and the merger agreement. In the transaction, 179 of petitioner's shareholders (holding approximately 21 percent of petitioner's common stock) voluntarily exchanged their stock on a share-for-share basis for 1,313,383 shares of Holding nonvoting preferred stock with a par value of $73.50 per share. The remaining shareholders exchanged their stock for $73.50 per share in cash. As a result of the transaction, Holding acquired all of petitioner's outstanding common stock in exchange for cash of $380,151,075 and Holding preferred stock with an aggregate par value of $96,533,650.

A Morgan Stanley report had said that petitioner's management believed that affiliation with Unilever would create the opportunity for "synergy," and petitioner's 1978 annual report had said that petitioner would benefit from the availability of the Unilever Group's enormous resources. However, petitioner's business continued as before following Holding's acquisition of its stock. Its directors and officers remained in office, and its key officers and employees executed employment contracts with it as required by the merger agreement. The Unilever Group did not make any changes in the operation of petitioner, nor did it provide petitioner with significant technological or financial assistance, nor with significant legal, administrative, or accounting services. Petitioner did not acquire any property or services from any member of the Unilever Group nor did petitioner dispose of any of its assets or property. There was no material increase in petitioner's sales to the Unilever Group. For purposes of administrative convenience and simplicity, petitioner's Certificate of Incorporation was amended to eliminate its previously authorized shares of preferred stock and to reduce the total number of its authorized shares of common stock to 1,000.

Morgan Stanley charged petitioner a fee of $2,200,000 for its services. This fee was reasonable in amount. Morgan Stanley also charged petitioner a fee of $7,586.23 for out-of-pocket expenses and $18,000 for the legal fees of its counsel. Debevoise, Plimpton charged petitioner $490,000 for the legal services rendered by it to petitioner and its board of directors, plus out-of-pocket expenses of $15,069. The services performed by Debevoise, Plimpton included advice given petitioner and its board of directors regarding their legal rights and obligations with respect to the transaction, preparation of the Internal Revenue Service ruling request, participation in negotiations, and preparation of documents. This fee was reasonable in amount. Petitioner also incurred other expenses totalling $150,962 in connection with the transaction. These expenses were reasonable in amount and were of a type customarily incurred in connection with similar transactions.

In the Federal income tax return for the year ending in 1978, petitioner deducted the Morgan Stanley fee but did not deduct the Debevoise, Plimpton fee or the other expenses. In his notice of deficiency, respondent disallowed the Morgan Stanley fee. In the petition, petitioner contested the deficiency determined by respondent and also claimed overpayment of taxes because the Debevoise, Plimpton fee and other expenses were not deducted.

OPINION

The only issue for decision is whether petitioner, the acquired firm in a friendly takeover, is entitled to deduct under section 162(a) the expenditures it incurred incident to the takeover. To our surprise, we find that this issue is one of first impression despite the prevalence of takeovers in the modern corporate world; however, we note that two highly respected commentators have stated, without citation of authority, that-

> The well-established rule in this area is that amounts incurred to effectuate a corporate "reorganization" (in the broad sense of a rearrangement resulting in a restructuring of the corporate entity or enterprise, even if not a technical "reorganization" as defined by section 368(a) * * * are not currently deductible as business expenses under section 162 by the person incurring such costs. [B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, par. 5.06.2, p. 5-33 (5th ed. 1987).]

Petitioner argues that it is entitled to take the deductions because the expenditures were ordinary and necessary within the meaning of section 162(a). Respondent argues that the expenditures are nondeductible because they either were capital expenditures or were constructive distributions to the shareholders.

Section 162(a) allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *." Five separate requirements must be satisfied before a deduction is allowed under this section. *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345 (1971). One requirement— that the expenditures be paid or incurred during the taxable year— clearly is satisfied. Respondent claims that none of the other requirements are satisfied. Those requirements are (1) that the expenditures were necessary, (2) that the expenditures were for the carrying on of a trade or business, (3) that the expenditures were ordinary, and (4) that the expenditures were current expenses, not capital expenditures. Given our disposition of the case, we need consider only the last of these requirements.

The distinction between a deductible current expense and a nondeductible capital expenditure can, at times, be unclear. When making the distinction, it must be kept in mind that deductions are a matter of legislative grace. *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934). Deduction statutes must be strictly construed. *Mills Estate v. Commissioner*, 206 F.2d 244, 246 (2d Cir. 1953), revg. in part on other grounds 17 T.C. 910 (1951). The taxpayer bears the burden of showing the right to the claimed deduction. *Interstate Transit Lines v. Commissioner*, 319 U.S. 590 (1943). A deduction is not allowed just because an expenditure possesses "some characteristics different from the more commonly accepted capital expenditures * * *." *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 716 (8th Cir. 1964), affg. 39 T.C. 423 (1962), cert. denied 379 U.S. 832 (1964).

The courts have determined that a number of expenditures are capital and, thus, nondeductible. These expenditures include, among others, those incurred incident to a merger into a parent company, *Denver & Salt Lake Railway Co. v. Commissioner*, 24 T.C. 709 (1955), dismissed pursuant to stipulation 234 F.2d 663 (10th Cir. 1956); a distribution to shareholders of subscription warrants for a subsidiary's stock, *Missouri-Kansas Pipe Line Co. v. Commissioner,* 148 F.2d 460 (3d Cir. 1945), affg. a Memorandum Opinion of this Court; a distribution of stock dividends, *General Bancshares Corp. v. Commissioner, supra,* a recapitalization, *Mills Estate Inc. v. Commissioner, supra,* a corporate reorganization, *Gravois Planing Mill Co. v. Commissioner,* 299 F.2d 199, 206 (8th Cir. 1962), revg. on other grounds a Memorandum Opinion of this Court; a bankruptcy reorganization, *Bush Terminal Buildings Co. v. Commissioner,* 7 T.C. 793, 818-819 (1946); and an increase in capitalization, *Fishing Tackle Products Co. v. Commissioner,* 27 T.C. 638, 645(1957).

Relying on cases such as these, respondent argues that petitioner's expenditures are nondeductible because they were incurred incident to a recapitalization, merger, or reorganization. As evidence of a recapitalization, respondent points to the amendment of petitioner's Certificate of Incorporation that eliminated the previously authorized shares of preferred stock and reduced the total number of authorized shares of common stock to 1,000. We note, however, that this amendment was done merely for purposes of administrative convenience and simplicity. Accordingly, it is not relevant to the deductibility issue.

As evidence of a merger, respondent points to the merger of NSC Merger, Inc. into petitioner. This merger, however, was incidental to the transaction, as illustrated by the Internal Revenue Service ruling letter which stated that the merger would be disregarded. Accordingly, the merger will not cause the expenditures to be characterized as capital expenditures.

Finally, respondent argues that from the standpoint of the corporation the transaction was essentially a reorganization under section 368(a)(1)(B). Respondent acknowledges that from the standpoint of the shareholders the transaction differed significantly from a section 368(a)(1)(B) reorganization, but argues that this is unimportant since we are focusing on the tax consequences to the corporation. We agree that the various definitions of section 368(a)(1) can be helpful when deciding whether from the corporate viewpoint an expenditure was incurred incident to a reorganization. *Bilar Tool & Die Corp. v. Commissioner,* 530 F.2d 708, 713 (6th Cir. 1976), revg. on factual grounds 62 T.C. 213 (1974). We are unwilling to hold, however, that the instant transaction is sufficiently similar to a reorganization under section 368(a)(1)(B) to cause the expenditures to be capital in nature.

Although we reject these specific arguments, we hold that the expenditures at issue are not deductible under section 162(a). We base our holding upon our judgment that petitioner's directors determined that it would be in petitioner's long-term interest to shift ownership of the corporate stock to Unilever. The expenditures in issue were incurred incident to that shift in ownership and, accordingly, lead to a benefit "which could be expected to produce returns for many years in the future." *E.I. duPont de Nemours & Co. v. United States,* 432 F.2d 1052, 1059 (3d Cir. 1970). An expenditure which results in such a benefit is capital in nature. *E.I. duPont de Nemours & Co. v. United States, supra* at 1059; *Falstaff Beer, Inc. v. Commissioner,* 322 F.2d 744, 745-746 (5th Cir. 1963), affg. 37 T.C. 451 (1961); *Clark Thread Co. v. Commissioner,* 100 F.2d 257, 258 (3d Cir. 1938), affg. 28 B.T.A. 1128 (1933); *McDonald v. Commissioner,* 139 F.2d 400, 401 (3d Cir. 1943), affd. 323 U.S. 57 (1944). The reason for the capitalization of such expenditures is "that the purpose for which the expenditure is made has to do with the corporation's operations and betterment, sometimes with a continuing capital asset, for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year, in contrast to being devoted to the income production or other needs of the more immediate present." *General Bancshares Corp. v. Commissioner, supra* at 715. "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." *Central Texas*

Savings & Loan Association v. United States, 731 F.2d 1181, 1183 (5th Cir. 1984). Expenditures may be capital in nature even if they do not result in the acquisition or increase of a corporate asset. *General Bancshares v. Commissioner, supra* at 716. If no capital asset is acquired, it does not follow that an expenditure is deductible. *Baltimore & Ohio Railroad Co. v. Commissioner,* 29 B.T.A. 368, 372-373 (1933), affd. 78 F.2d 460 (4th Cir. 1935); *Holeproof Hosiery Co. v. Commissioner,* 11 B.T.A. 547, 556 (1928).

Our judgment that petitioner's directors determined that it would be in petitioner's long-term interest to shift ownership of the corporate stock to Unilever is based upon several factors. First, "when a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interest of the corporation and its shareholders." *Unocal Corp. v. Mesa Petroleum Corp.,* 493 A.2d 946, 954 (Del. 1985). Because petitioner's directors approved the takeover, they must have determined that it was in the best interest of petitioner and its shareholders. Second, petitioner's 1978 annual report said that petitioner would benefit from the availability of the Unilever Group's enormous resources, and Morgan Stanley said that petitioner's affiliation with Unilever would create the opportunity for "synergy." There is no evidence of an immediate benefit from the affiliation, but we believe that this is immaterial. The lack of benefits in the short term does not imply their absence in the long term, especially given the time it takes to plan and implement significant changes in a corporation's operations. Besides, expenditures "made with the contemplation that they will result in the creation of a capital asset cannot be deducted as ordinary and necessary business expenses even though that expectation is subsequently frustrated or defeated * * *." *Union Mut. Life Ins. Co. v. United States,* 570 F.2d 382, 392 (1st Cir. 1978), *cert. denied* 439 U.S. 821 (1978); *Radio Station WBIR, Inc. v. Commissioner,* 31 T.C. 803, 813-814 (1959). Third, the very availability of the resources of Unilever was an immediate, as well as a long-term, benefit because it broadened petitioner's opportunities.

Petitioner argues for several reasons, however, that the expenditures in issue are deductible. First, it cites *Commissioner v. Lincoln Savings and Loan Association, supra* at 354, where it was said that "the presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year. 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 * * *." Petitioner accordingly argues that its expenditures are deductible because the expenditures did not create or enhance a separate and distinct additional asset. In *Lincoln Savings,* however, the Court did not address the deductibility of expenditures which do not create or enhance a separate and distinct asset. Thus, *Lincoln Savings* does not support petitioner's argument.

Petitioner next refers to several Court of Appeals cases that have cited *Lincoln Savings: Iowa-Des Moines Nat. Bank v. Commissioner,* 592 F.2d 433 (8th Cir. 1979), affg. 68 T.C. 872 (1977); *NCNB Corp. v. United States,* 684 F.2d 285 (4th Cir. 1982); *Colorado Springs National Bank v. United States,* 505 F.2d 1185 (10th Cir. 1974); and *Briarcliff Candy Corp. v. Commissioner,* 475 F.2d 775 (2d Cir. 1973). *Iowa-Des Moines Nat. Bank* merely cites *Lincoln Savings* for the proposition that a benefit with a future aspect is not controlling. The remaining cases each dealt with the narrow factual situation where a firm increased its business by, respectively, expanding a branch banking system, participating in a credit card system, and soliciting agents for the sale of candies. The court in each case held that the expenditures were ordinary and necessary expenses of doing daily business rather than capital expenditures. Each case depended on its facts, and we do not find them controlling here.

Petitioner also refers to several cases in which the "dominant aspect" of a transaction determined the deductibility of expenditures incurred incident to the transaction.

These cases involved transactions with some of the characteristics of a partial liquidation and some of the characteristics of a reorganization, merger, or recapitalization. In the cases in which the partial liquidation was the "dominant aspect" of the transaction, the expenditures were held to be deductible current expenses. *Gravois Planing Mill Co. v. Commissioner*, 299 F.2d 199, 209 (8th Cir. 1962), revg. a Memorandum Opinion of this Court; *United States v. General Bancshares Corp.*, 388 F.2d 184 (8th Cir. 1968); *United States v. Transamerica Corp.*, 392 F.2d 522 (9th Cir. 1968); and *El Paso Co. v. United States*, 694 F.2d 703 (Fed. Cir. 1982). In the cases in which the reorganization, merger, or recapitalization was the "dominant aspect," the expenditures were capital expenditures. *Mills Estate Inc. v. Commissioner*, 206 F.2d 244 (2d Cir. 1953), revg. in part on other grounds 17 T.C. 910 (1951). In one case, this Court determined that the dominant aspect was a partial liquidation and, thus, the expenditure was a deductible current expense, but the Court of Appeals held that the dominant aspect was a reorganization and, thus, the expenditure was a capital expenditure. *Bilar Tool & Die Co. v. Commissioner*, 62 T.C. 213 (1974), revd. on factual grounds 530 F.2d 708 (6th Cir. 1976).

Petitioner argues that the dominant aspect of its expenditures was the fiduciary duty its directors owed to its shareholders and, accordingly, that its expenditures are deductible because they were incurred incident to that fiduciary duty. The dominant aspect of the transaction was not the fiduciary duty. Instead, the dominant aspect was the transfer of petitioner's stock for the benefit of petitioner and its shareholders. 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.

We conclude that the expenditures in issue were related more to petitioner's permanent betterment, and hence capital in nature, than to the carrying on of daily business and production of income. Thus they were not ordinary and necessary within the meaning of section 162(a) and, accordingly, they are not deductible. We need not reach respondent's alternative argument that petitioner's expenditures were constructive distributions to its shareholders.

Decision will be entered for the respondent.

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

The Internal Revenue Code of 1954, as amended (26 U.S.C.), provides in pertinent part:

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) IN GENERAL.—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 . . . .

SEC. 167. DEPRECIATION.

(a) GENERAL RULE.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

SEC. 168. ACCELERATED COST RECOVERY SYSTEM.

(a) GENERAL RULE.—Except as otherwise provided in this section, the depreciation deduction provided by section 167(a) for any tangible property shall be determined by using—

(1) the applicable depreciation method,

(2) the applicable recovery period, and

(3) the applicable convention.

SEC. 195. START-UP EXPENDITURES [as originally enacted].

(a) ELECTION TO AMORTIZE.—Start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction ratably over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the business begins).

(b) START-UP EXPENDITURES.—For purposes of this section, the term "start-up expenditure" means any amount—

(1) paid or incurred in connection with—

(A) investigating the creation or acquisition of an active trade or business, or

(B) creating an active trade or business, or

(2) which, if paid or incurred in connection with the expansion of an existing trade or business (in the same field as the trade or business referred to in paragraph (1)), would be allowable as a deduction for the taxable year in which paid or incurred.

SEC. 195. START-UP EXPENDITURES [as amended in 1984].

(a) CAPITALIZATION OF EXPENDITURES.—Except as otherwise provided in this section, no deduction shall be allowed for start-up expenditures.

(b) ELECTION TO AMORTIZE.—

(1) IN GENERAL.—Start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses. Such deferred expenses shall be allowed as a deduction prorated equally over such period of not less than 60 months as may be selected by the taxpayer (beginning with the month in which the active trade or business begins).

(2) DISPOSITION BEFORE CLOSE OF AMORTIZATION PERIOD.—In any case in which a trade or business is completely disposed of by the taxpayer before the end of the period to which paragraph (1) applies, any deferred expenses attributable to such trade

or business which were not allowed as a deduction by reason of this section may be deducted to the extent allowable under section 165.

(c) DEFINITIONS.—For purposes of this section—

(1) START-UP EXPENDITURES.—The term "start-up expenditure" means any amount—

(A) paid or incurred in connection with—

(i) investigating the creation or acquisition of an active trade or business, or

(ii) creating an active trade or business, or

(iii) any activity engaged in for profit and for the production of income before the day on which the active trade or business begins, in anticipation of such activity becoming an active trade or business, and

(B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.

The term "start-up expenditure" does not include any amount with respect to which a deduction is allowable under section 163(a), 164, or 174.

SEC. 263. CAPITAL EXPENDITURES.

(a) GENERAL RULE.—No deduction shall be allowed for—

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

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) GENERAL RULE.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) EXCEPTIONS.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

SEC. 461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

(a) GENERAL RULE.—The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

The Treasury Regulations on Income Tax (26 C.F.R.) provide in pertinent part:

§ 1.162-5. Expenses for education.—(a) *General rule.* Expenditures made by an individual for education (including research undertaken as part of his educational program) which are not expenditures of a type described in paragraph (b)(2) or (3) of this section are deductible as ordinary and necessary business expenses (even though the education may lead to a degree) if the education—

(1) Maintains or improves skills required by the individual in his employment or other trade or business, or

(2) Meets the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation.

§ 1.263(a)-1. Capital expenditures; in general.—(a) Except as otherwise provided in chapter 1 of the Code, no deduction shall be allowed for—

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

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion.

(b) In general, the amounts referred to in paragraph (a) of this section include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. . . .

§ 1.263(a)-2. Examples of capital expenditures.—The following paragraphs include examples of capital expenditures.

(a) The cost of acquisition, construction or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

(b) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments. . . .

(c) The cost of defending or perfecting title to property.

(d) The amount expended for architect's services.

(e) Commissions paid in purchasing securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense.

(f) Amounts assessed and paid under an agreement between bondholders or shareholders of a corporation to be used in a reorganization of the corporation or voluntary contributions by shareholders to the capital of the corporation for any corporate purpose. Such amounts are capital investments and are not deductible. See section 118 and § 1.118-1.

(g) A holding company which guarantees dividends at a specified rate on the stock of a subsidiary corporation for the purpose of securing new capital for the subsidiary and increasing the value of its stockholdings in the subsidiary shall not deduct amounts paid in carrying out this guaranty in computing its taxable income, but such payments are capital expenditures to be added to the cost of its stock in the subsidiary.

(h) The cost of good will in connection with the acquisition of the assets of a going concern is a capital expenditure.

§ 1.461-1. General rule for taxable year of deduction.—(a) *General rule*—(1) *Taxpayer using cash receipts and disbursements method.* Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. . . .

(2) *Taxpayer using an accrual method.* Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be

determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. . . .