Amicus Brief

No. 90-1278

IN THE
Supreme Court of the United States

OCTOBER TERM, 1990

INDOPCO, INC.,
Petitioner,
v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

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BRIEF OF TAX EXECUTIVES INSTITUTE, INC. AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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INTEREST OF AMICUS CURIAE

Pursuant to Rule 37 of the Rules of this Court, Tax Executives Institute, Inc. respectfully submits this brief as *amicus curiae* in support of the Petitioner, Indopco, Inc. (formerly National Starch and Chemical Corporation).[1] Tax Executives Institute is a voluntary, non-profit association of corporate and other business executives, managers, and administrators who are responsible for the tax affairs of their employers. The Institute was organized in 1944 and currently has approximately 4,700 members who represent more than 2,000 of the leading

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[1] Tax Executives Institute has received the written consents of the Petitioner and Respondent to the filing of this brief; those consents have been filed with the Clerk of the Court.

corporations in the United States and Canada. The members of the Institute represent a cross-section of the business community in North America. The Institute is dedicated to promoting the uniform, systematic, and equitable interpretation and enforcement of the tax laws throughout the nation and to reducing the costs and burdens of administration and compliance to the benefit of both the government and taxpayers.

Members of Tax Executives Institute have a vital interest in this case, which involves the standard to be used in determining whether certain expenses are to be currently deductible or capitalized under the Internal Revenue Code. In denying Petitioner Indopco a deduction for expenses associated with the acquisition of its stock by another corporation, the U.S. Court of Appeals for the Third Circuit fashioned an opinion so broad that it threatens to overturn the deductibility of many types of ordinary and necessary expenses. By focusing solely on the future benefit obtained from an expenditure—to the exclusion of every other factor—the lower court's opinion imprudently calls into question the deductible treatment of other items (such as repairs, employee training, and advertising) that Congress, the courts, taxpayers, and the Internal Revenue Service [hereinafter "the IRS"] itself have long thought settled.

More fundamentally, the opinion's excessive scope and lack of administrable standards will rob taxpayers of certainty about the deductible status of many expenditures. That the uncertainty—and the IRS mischief it may breed—comes at a time when congressional tax writers and taxpayers are united in assigning high priority to tax simplification underscores the extent to which the Third Circuit's approach is at odds with sound tax principles. The unsettling effect of the Third Circuit's opinion on the tax system as a whole is a material concern to the Institute and all its members. As the individuals who must contend daily with the interpretation and administration of the nation's tax laws, the Institute's members have a vital interest in the proper disposition of this case.

SUMMARY OF ARGUMENT

Under the U.S. tax system, whether a particular cost is an ordinary and necessary business expense or a capital expenditure significantly affects its tax treatment. Ordinary and necessary business expenses are currently deductible for federal income tax purposes under section 162(a) of the Internal Revenue Code (26 U.S.C.); capital expenditures are deductible over the useful life of the asset to which they relate or at the time that asset is disposed of or sold.

In *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345 (1971), this Court squarely faced the issue whether an item of expense that had some future benefit was an ordinary and necessary expense or a capital expenditure. The Court brought much needed certainty to this area by crafting an objective standard to determine current deductibility. In doing so, the Court specifically recognized that "many expenses concededly deductible have prospective effect beyond the taxable year." *Id.* at 354. It forthrightly held that what was "important and controlling" was that the payment "serves to create or enhance . . . what is essentially a separate and distinct additional asset . . ." *Id.* Thus, although the Court in *Lincoln Savings* held that the particular expenditure was capital in nature, it unequivocally rejected the notion that a cost must always be capitalized if the benefit associated with it extends beyond the taxable year.

In this case, the U.S. Court of Appeals for the Third Circuit abandoned the test enunciated in *Lincoln Savings*, concluding that the absence of a separate and distinct additional asset did not preclude a finding that the expenditure is capital in nature. (App. 11a.)[2] The court held that the "common characteristic of expenses that have been found to be capital, in fact the *sine qua non* of capitalization, is the presence of a not insignificant future benefit that is more than merely incidental." (App. 11a-12a.) In so holding, the lower court misapprehended this Court's decision in *Lincoln Savings* and elevated to controlling status the ancillary criterion of a future benefit. The court also ignored the contrary opinions of six other courts of appeals and spawned tremendous uncertainty with respect to expenses that have unquestionably been held to be deductible under section 162(a).

The record in this case establishes that no separate and distinct additional asset was created or acquired by the taxpayer. The taxpayer incurred legal fees and other expenses to confirm the fairness of a proposed acquisition of its stock by a third party. Those expenses were not, and cannot be, associated with any distinct asset or future income stream. They added nothing of value to the taxpayer's assets that required them to be capitalized. In other words, they were ordinary and necessary business expenses. The Third Circuit's holding is therefore wrong as a matter of law.

This Court and others have long held that expenditures are deductible even though they produce a long-term benefit. Both before and after *Lincoln Savings*, the key has been the character of the transaction that gave rise to the payment. An examination of the genesis of the expenses at issue in this case underscores why they were not capital in nature. The "opportunity for synergy" and "availability of resources" found by the Third Circuit (App. 12a) were not assets but merely contributed to an expectation that a benefit might be conferred or

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[2] References to "App." are to the appendix filed with Indopco, Inc.'s Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit.

created in the future. Such an expectation cannot rise to the level of a capital asset.

Quite apart from its disregard of the *Lincoln Savings* separate and distinct additional asset test, the Third Circuit's holding conflicts with well-settled principles of income taxation. The opinion threatens to strip away the relative certainty that taxpayers and the government have found under *Lincoln Savings* and casts doubt on the deductible treatment of myriad expenditures. The language used by the court is so broad that it undermines the "ordinary and necessary" character of many expenses that have long been held to be deductible, including expenses for repairs, employee training, and advertising.

The Third Circuit's opinion also gives short shrift to a fundamental principle of U.S. income taxation: the matching of income with associated expenses on an annual basis. The result reached by the court distorts this principle by effectively precluding the taxpayer in this case from recovering its costs either currently or over time since no asset exists to be depreciated or amortized.

The Third Circuit's opinion will undoubtedly engender disputes between taxpayers and the Internal Revenue Service in areas that have long been settled. To prevent unnecessary disruption to the tax system, this Court should vivify the holding of *Lincoln Savings* by affirming the applicability of the separate and distinct additional asset test. It should confirm the current deductibility of ordinary and necessary expenses notwithstanding the presence of a future benefit. It should restore much needed certainty to this area of the tax law. It should reverse the Third Circuit's decision.

ARGUMENT

I.

This case involves the question whether expenses incurred by the Petitioner, Indopco, Inc., which were not related to the creation or enhancement of any asset, are currently deductible under section 162(a) of the Internal Revenue Code (26 U.S.C.) [hereinafter "the Code"]. These expenses included legal, accounting, and investment banking fees and other expenditures incurred by Indopco to confirm the fairness of a proposed acquisition of the company's stock by another corporation (the Unilever group). The answer depends upon the vitality of this Court's decision in *Commissioner v. Lincoln Savings & Loan Association*, 403 U.S. 345 (1971), and the basis on which ordinary and necessary expenses are to be differentiated from expenses required to be capitalized under the tax law.

Under section 162(a) of the Code, to be currently deductible, an item must be an ordinary and necessary expense that is paid or incurred during the taxable year in carrying on any trade or business. "Ordinary" expenses are those that are "normal, usual, or customary." *Deputy v. du Pont*, 308 U.S. 488, 495 (1940). The principal function of the term "ordinary" in section 162(a) is to clarify the distinction between those expenses that are currently deductible and those that are in the nature of a capital expenditure. *Commissioner v. Tellier*, 383 U.S. 687, 689-90 (1966). To be "necessary," an expense must only be "appropriate and helpful" in a taxpayer's business. *Welch v. Helvering*, 290 U.S. 111, 113 (1933).[3]

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[3] The amount of an expenditure is totally irrelevant to its current deductibility. What is key is that it be "ordinary and necessary." *Buckland v. United States*, 66 F. Supp. 681, 682-83 (D. Conn. 1946) (repairs amounting to 35 percent of the cost of the building held deductible).

The term "capital expenditure" is not specifically defined in the Code, though section 263(a)(1) (which is captioned "Capital Expenditures") denies a deduction for any amount expended for "permanent improvements or betterments made to increase the value of any property or estate." The purpose of the provision is to "prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing." *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974). Section 1.263(a)-2(a) of the Income Tax Regulations[4] lists as an example of a capital expenditure 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."

Whether a particular cost is an ordinary and necessary expense or a capital expenditure significantly affects its tax treatment. Whereas an ordinary and necessary expense is currently deductible for federal income tax purposes, a capital expenditure is deductible over the useful life of the asset to which it relates or at the time that asset is sold or otherwise disposed of. An overriding purpose of the distinction is to ensure the proper matching of expense items with their associated income—to clearly reflect the taxpayer's "net" income. *See* 26 U.S.C. § 446(b); Treas. Reg. § 1.446-1(a)(2); *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931).

In *Commissioner v. Lincoln Savings & Loan Association*, *supra*, a state-chartered savings and loan association deducted an additional premium paid to a "secondary reserve" maintained by the Federal Savings and Loan Insurance Corporation. In deciding whether the payment was a capital expenditure or a deductible expense, this

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[4] Provisions of the Income Tax Regulations (26 C.F.R.) are hereinafter cited as "Treas. Reg. §."

Court recognized that an expense may produce some future benefit and still be currently deductible:

> [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.

403 U.S. at 354 (emphasis added). It forthrightly held:

> What is *important and controlling*, we feel, is that the § 404(d) 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.

Id. (emphasis added). Thus, although the Court held in *Lincoln Savings* that the particular expenditure was capital in nature, it unequivocally rejected the notion that a cost must always be capitalized if the benefit associated with it extends beyond the taxable year. More is needed, the Court explicitly and properly held, than a future benefit.

In this case, the U.S. Court of Appeals for the Third Circuit abandoned the test enunciated by this Court in *Lincoln Savings*. The lower court concluded that although the presence of a "separate and distinct additional asset" is sufficient to treat an expenditure creating or enhancing that asset as capital, the absence of such an asset does not preclude a finding that the expenditure is capital in nature. (App. 11a.)

The court stated that the common characteristic of expenses that have been found to be capital—"the *sine qua non* of capitalization"—is the presence of a "not insignificant future benefit that is more than merely incidental." (App. 11a-12a.) It therefore affirmed the Tax Court's finding that the acquisition of taxpayer's stock by the Unilever group created a long-term benefit to the taxpayer and held that the consulting fees, legal expenses, and other costs incurred by the taxpayer in ensuring the fairness of the acquisition were nondeductible capital expenditures. (App. 17a-18a.)

In so holding, the Third Circuit misapprehended this Court's decision in *Lincoln Savings* and elevated to controlling status the ancillary criterion of a future benefit. The court also ignored the contrary opinions and sound reasoning of other courts, and spawned tremendous uncertainty with respect to expenses that have unquestionably been held to be deductible under section 162(a) of the Code.

II.

In its opinion, the Third Circuit rationalized its effort to read the separate and distinct additional asset test out of the law by glibly concluding that "because something made out of glass is fragile, [it does not follow that] all things fragile must be made out of glass." (App. 8a.) The court's logic, however, resembles more that of Lewis Carroll's Jabberwocky than of Aristotle: the Third Circuit constructed a false syllogism of straw (not glass) when it totally disregarded the absence of a separate and distinct additional asset. The Third Circuit facilely reduced the analysis to a single factor: the presence of a future benefit. In *Lincoln Savings*, however, this Court said that was not enough. In fact, it expressly found the presence of a separate and distinct additional asset "*important and controlling*" in determining whether an expenditure was an ordinary business expense or capital in nature. If such an asset were not required, it would have been unnecessary and illogical for the Court to have even addressed the issue. A finding of a future benefit would have been sufficient to render the expenditures nondeductible. This Court in *Lincoln Savings*, however, expressly rejected such a simplistic approach.

Six circuit courts agree that the test for capitalization set forth in *Lincoln Savings* requires the presence of a separate and distinct additional asset.[5] Thus, in *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973), the Second Circuit held that promotional expenditures made by the taxpayer to introduce its product into suburban areas were ordinary and necessary business expenses under section 162(a). Relying on *Lincoln Savings*, the court rejected the government's argument that the expenditures were capital in nature because their benefits extended into future years. The court found that the expenditures would be capital *only if* they served to create or enhance a separate and distinct additional asset. *Id.* at 782-84.

The reasoning of the Second Circuit in *Briarcliff Candy* was expressly adopted by the Fourth Circuit in *NCNB Corp. v. United States*, 684 F.2d 285, 290 (4th Cir. 1982) (*en banc*), where the court held that costs incurred by a bank in expanding its branches were deductible business expenses, and by the Tenth Circuit in *Colorado Springs National Bank v. United States*, 505 F.2d 1185, 1193 (10th Cir. 1974), where the court accorded similar treatment to costs incurred by a bank in establishing a credit card system. In both these cases, the courts found that no separate and distinct property interest was created by the expenditures. In the absence of such a

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[5] Indeed, until the Tax Court's decision in this case, the Internal Revenue Service itself acknowledged that a separate asset was required under *Lincoln Savings*. In Rev. Rul. 83-66, 1983-1 C.B. 43, the IRS ruled that reserve premiums under a medical malpractice liability insurance policy subject to a refund clause were deductible expenses in the year paid. The IRS reasoned that the determination whether the costs must be capitalized rested on whether the reserve premium created, enhanced, or was part of the cost of acquiring or defending a separate and distinct asset or property interest. *Id.* at 44. *See also* Tech. Adv. Mem. 8202010 (Sept. 28, 1981), in which the IRS held that, after *Lincoln Savings*, "[a] mere showing that a future benefit has been established is not determinative. There must be an asset or a property interest present that relates to the expenditures."

finding, the expenses were deemed to be currently deductible under section 162(a). *Accord First Security Bank of Idaho v. Commissioner*, 592 F.2d 1050, 1052 (9th Cir. 1979) (taxpayer participating in BankAmericard system did not acquire new, separate asset); *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979) (credit screening does not constitute a separate and new business undertaking); *Central Texas Savings & Loan Ass'n v. United States*, 731 F.2d 1181, 1185 (5th Cir. 1984) (adopting the *Lincoln Savings* test, the court held that a savings and loan association opening a new branch had created a property interest, or separate asset, under Texas law). As these courts all recognized, the presence of a future benefit is intended "to serve as a mere guidepost for the resolution of the ultimate issue, not as an absolute rule requiring the automatic capitalization of every expenditure providing the taxpayer with a benefit enduring for a period in excess of one year." *NCNB Corp. v. United States*, 684 F.2d at 289 (quoting *United States v. Wehrli*, 400 F.2d 686, 689 (10th Cir. 1968)).

No separate or additional asset or property interest was created or acquired by the expenditures at issue in this case. (App. 11a.) The taxpayer's legal, accounting, and investment banking fees were not, and cannot be, associated with any distinct asset or future income stream. The taxpayer acquired or created nothing in exchange for its money that it did not have before. The expenditures had one purpose and one purpose only: to confirm the fairness of the price offered by Unilever for the taxpayer's stock. The origin, purpose, and effect of these expenditures were to protect the Board of Directors from shareholder claims for breach of fiduciary duty. Contrary to the Third Circuit's opinion, the expenditures were not "more permanent than temporary" and did not partake "more of the character of an asset than an expense." *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. at

356. They added nothing of value to the taxpayer's assets that can be so "definitely ascertained" that they must be capitalized. *NCNB Corp. v. United States*, 684 F.2d at 293. They produced nothing corporeal or salable. *Colorado Springs Nat'l Bank v. United States*, 505 F.2d at 1192. In other words, they were ordinary and necessary, not capital, expenses.[6]

III.

Although *Lincoln Savings* established a clear and administrable rule for distinguishing currently deductible expenses from capital expenditures, the decision marked no radical shift in the law. Earlier decisions of this and other courts upheld the current deductibility of expenses using language and reasoning remarkably consistent with *Lincoln Savings*.

This Court has long permitted deductions for expenditures that have obvious continuing and substantial benefits. Thus, in *Commissioner v. Tellier*, *supra*, the Court sustained a deduction for legal fees paid in connection with criminal charges arising from the taxpayer's securities business. The Court reasoned that the expenses 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 689. Similiarly, *Commissioner v. Heininger*, 320 U.S. 467, 472 (1943), holds that costs

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[6] In many respects, the consulting fees and other expenses purchased a form of additional insurance for the Directors. The Board of Directors could have proceeded without the benefit of the "fairness" opinion, assuming the risk of any subsequent action against them. The legal fees in defending any such action would be clearly deductible. *Vermont Bank & Trust Co. v. United States*, 296 F. Supp. 682, 686 (D. Vt. 1969). The Directors could similarly have purchased additional insurance from a carrier to cover them against claims brought by such shareholders. The deductibility of the insurance premiums is also clearly established. Rev. Rul. 69-491, 1969-2 C.B. 22. *See* Rev. Rul. 76-277, 1976-2 C.B. 41 (liability insurance premiums deductible by employee).

incurred in countering an attack on the taxpayer's business are also currently deductible.[7]

Other courts have also held that the presence of a future benefit does not automatically require capitalization of the expenditure. For example, in *Commissioner v. Surface Combustion Corp.*, 181 F.2d 444, 447 (6th Cir. 1950), the court permitted the deduction of employer contributions to a health-care trust because "[t]he payments were made to preserve an existing asset rather than to acquire a new one, and should not be capitalized." In *Louisiana Land & Exploration Co. v. Commissioner*, 7 T.C. 507, 515 (1946), *acq.* 1946-2 C.B. 3, *aff'd*, 161 F.2d 842 (5th Cir. 1947), the Tax Court held that an expense is of a capital nature where it "results in the taxpayer's acquisition or retention of a capital asset" or in the "improvement or development of a capital asset in such a way that the benefit of the expenditure is enjoyed over a comparatively lengthy period of business operation."

A particularly apt case is *Snow v. Commissioner*, 31 T.C. 585 (1958), *acq.* 1959-1 C.B. 5, where the Tax Court considered the deductibility of operating losses by a law firm's partners. The partners had informally agreed to pay any deficit arising from the operations of a savings and loan association they had established. The court reasoned that—

> While capital expenditures ordinarily result in the acquisition of assets having periods of useful life in excess of 1 year, it does not follow that an expenditure must be deemed a capital outlay merely because the ultimate benefit may accrue in a year or years subsequent to the year of payment.

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[7] Contrary to the Third Circuit's rationale (App. 8a-9a), the adoption of a separate and distinct additional asset test in *Lincoln Savings* did not conflict with prior precedent. The expenses in *Welch v. Helvering*, *supra*, for example, were found nondeductible, not because they were capital, but because they were "in a high degree extraordinary." 290 U.S. at 114.

> In the instant case we recognize that the benefit derived . . . was not fully realized or exhausted within the taxable year. However, *petitioners have not acquired any specific asset in return for their payments* which made good the operating deficit of the Association.

Id. at 593 (citations omitted) (emphasis added).

In circumstances analogous to the taxpayer's in this case, courts have held that expenditures are deductible even though they produce a long-term benefit. For example, the deduction of proxy contest expenses has been sustained because the expenditures were "incurred for the benefit of all stockholders in the good faith belief on the part of management that [the fight for control of the corporation] was in the best interest of all stockholders." *Locke Manufacturing Cos. v. United States*, 237 F. Supp. 80, 85 (D. Conn. 1964), *acq.* Rev. Rul. 67-1, 1967-1 C.B. 28. *See Central Foundry Co. v. Commissioner*, 49 T.C. 234, 248 (1967) (expenses relating to election held by board of directors with respect to successful candidates and defeated incumbents deductible by corporation), *acq.* 1968-2 C.B. 2.

Why have deductions been permitted in these cases? "The decisive test is still the character of the transaction which gives rise to the payment." *Hales-Mullaly, Inc. v. Commissioner*, 131 F.2d 509, 511-12 (10th Cir. 1942). *Accord Mt. Morris Drive-In Theatre Co. v. Commissioner*, 25 T.C. 272, 275 (1955), *aff'd*, 238 F.2d 85 (6th Cir. 1956). Expenditures that do not create or enhance a separate and distinct additional asset are deductible because the origin of the expenditures is not capital in nature. *See United States v. Smith*, 418 F.2d 589, 596 (5th Cir. 1969) (trial court should focus on payment rather than obligation giving rise to payment).

Thus, the use of a separate and distinct additional asset test was not new at the time of this Court's decision in *Lincoln Savings*. The Court simply crystalized the standard to be applied. It established the "ready touchstone" sought in *Welch v. Helvering* for determining the deductibility of business expenses. *See Welch v. Helvering*, 290 U.S. at 115. It vindicated the principle that the presence of a nebulous future benefit for the taxpayer cannot in and of itself transmute ordinary and necessary expenses into nondeductible capital items. And it interjected greater certainty in an area where previously the answer "[came] forth by nothing, but by prayer and fasting." *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d at 785 (quoting *Matthew* 17:21).

An examination of the genesis of the legal fees and other expenditures at issue in this case underscores why the expenses were not capital in nature. They did not result in or facilitate the alteration of the capital structure of the taxpayer. Rather, the costs were incurred simply to confirm the fairness of Unilever's offer to purchase Indopco's stock and thereby to protect the Directors against claims for breach of fiduciary duty. The taxpayer derived nothing of lasting significance from the expenditures: no asset was any more valuable after the expenses were incurred than it was before. The "opportunity for synergy" and "availability of resources" cited by the lower court (App. 12a) did not constitute assets with which the expenses can properly be associated but merely contributed to an expectation that a benefit might be conferred or created in the future. Thus, the Third Circuit's reasoning that the presence of a future benefit—in and of iself—required capitalization is simply wrong. "[A]n expectation or hope cannot be considered as the purchase of an intangible capital asset." *Van Iderstine Co. v. Commissioner*, 261 F.2d 211, 213 (2d Cir. 1958).

IV.

More is at stake in this case than the current deductibility of expenses incurred by the taxpayer in connection with the acquisition of its stock by a third party. As the government itself acknowledged in its response to taxpayer's Petition for a Writ of Certiorari, "[t]he appropriate test for determining whether an expenditure is a capital expenditure or a currently deductible expense is a matter of basic importance in the administration of the tax laws, for it arises in virtually every area of business activity." Brief for the Respondent on Petition for Writ of Certiorari at 16. Regrettably, the Third Circuit's opinion does nothing to aid the orderly and principled administration of the tax laws. Indeed, the turbid standard it enounced should discomfit taxpayers, tax administrators, and the courts.

Quite apart from its disregard of the *Lincoln Savings* separate and distinct additional asset test, the Third Circuit's holding conflicts with well-settled principles of income taxation. The court incorrectly elevated the existence of a "future benefit" to the point that it virtually controls whether an expense is a capital expenditure. The Third Circuit held that "the common characteristic of expenses that have been found to be capital, in fact the *sine qua non* of capitalization, is the presence of a not insignificant future benefit that is more than merely incidental." (App. 11a-12a.) Although the court averred that no one factor is controlling, under its analysis the existence of a future benefit is the *only* factor to be considered under section 162(a). Thus, the court ignored this Court's teaching that "many expenses concededly deductible have prospective effect beyond the taxable year." *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. at 354.

The Third Circuit's opinion threatens to strip away the relative certainty that taxpayers and the government have found under *Lincoln Savings* and other cases and casts doubt on the treatment of myriad expenditures. Concededly, the line between a currently deductible expense and a capital expenditure may at times be difficult to draw. In some areas, the distinction may be obvious (*e.g.*, constructing a new building versus fixing a leaky faucet), whereas in others the rules are more difficult to apply. The beauty of *Lincoln Saving's* separate and distinct additional asset test lies in its bringing some order to an area where "hopeless confusion" was often the norm. *See Briarcliff Candy Corp. v. Commissioner*, 475 F.2d at 785. In contrast, the Third Circuit's skewing of the test to distinguish between "incidental" and "not insignificant" future benefits will only spawn confusion.[8]

As an organization dedicated to minimizing the costs and burdens of tax administration to the common benefit of government and taxpayers, *amicus* Tax Executives Institute is very much concerned about the long-term effect of the "future benefit" test adopted by the Third Circuit. Stated bluntly, in jettisoning the separate and distinct additional asset test (and offering only vague generalities in its stead), the Third Circuit was too clever by half: it would cast taxpayers and the government adrift and deprive the tax law of an extant administrable rule. As the Fourth Circuit has recognized:

> One need not consider further than the case of the corporate executive who spends a significant, though

[8] The situation has not been helped by the government's vacillation in applying the future benefit test. Thus, in Tech. Adv. Mem. 8927005 (Mar. 27, 1989), the IRS ruled that expenses incident to resisting a takeover attempt were ordinary and necessary business expenses deductible under section 162(a) of the Code. That ruling was subsequently revoked by Tech. Adv. Mem. 8945003 (Aug. 1, 1989), which ruled that the costs of finding a "white knight" must be capitalized. In Tech. Adv. Mems. 9043003 and 9043004 (July 9, 1990), the IRS again held that costs incurred in resisting a *hostile* takeover were deductible, but costs incurred in effecting a *friendly* takeover must be capitalized. The government's inability to adhere to a guiding principle (such as that articulated by the Court in *Lincoln Savings*) underscores the unworkable, roiling nature of a stand-alone future benefit test.

indeterminable, amount of his time on future planning to realize that universal application of the one year rule is impossible and that it has not been so applied in such cases.

NCNB Corp. v. United States, 684 F.2d at 289.

If the Third Circuit's definition of a capital expenditure as any expenditure yielding income substantially beyond the taxable year gains currency, then the manifest deductibility of untold ordinary and necessary expenses will be jeopardized. Indeed, the language used by the court in this case is at once so broad and nebulous that it undermines the "ordinary and necessary" character of expenses long been held to be currently deductible. These items include expenses for repairs, employee training, and advertising.

For example, Treas. Reg. § 1.162-5(a)(1) provides that expenditures made for education and employee training are deductible as ordinary and necessary business expenses if the education maintains or improves skills required by the individual in his employment. Employee training clearly yields a multi-year benefit to the employer, but it does not generate any separate and distinct asset. The regulations, which were adopted in 1967, recognize this and distinguish between those educational expenses that are "ordinary and necessary" expenses of an employer's trade or business and those that are personal to the employee and capital expenditures. Treas. Reg. § 1.162-5(b)(1); *Jungreis v. Commissioner*, 55 T.C. 581, 591 (1970). The Third Circuit's opinion threatens to blur that distinction.

With respect to repairs, Treas. Reg. § 1.162-4 provides that the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its life (but rather keep it in ordinarily efficient operating condition) is deductible. The seminal case in this area is *Illinois Merchants Trust Co.*, 4 B.T.A. 103, 106-07 (1926), which was decided more than 60 years ago and continues to be cited today. Because "any properly performed repair adds value as compared with the situation existing immediately prior to the repair," *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962), *nonacq.* 1964-2 C.B. 8, the Third Circuit's singular reliance on a fuzzy future benefit standard imperils the continued deductibility of repairs.

Expenses quite similar to repairs have also been held to be currently deductible. For example, the cost of restoring the taxpayer's property to its previous condition following a natural disaster or other catastrophe (such as a tornado, hurricane, or plant explosion) or the costs associated with removing hazardous materials such as asbestos or toxic chemicals clearly fall within the ordinary and necessary standard of section 162. *See Plainfield-Union Water Co. v. Commissioner*, 39 T.C. at 337 ("[a]n expenditure which returns property to the state it was in before the situation prompting the repair arose . . . is usually deemed a deductible repair").

With respect to advertising, Treas. Reg. § 1.162-1(a) provides that "advertising and other selling expenses" are generally deductible. *See also* Treas. Reg. § 1.162-20(a)(2) (permitting a deduction for institutional or goodwill advertising). As recently as 1987, Congress confirmed that costs relating to the advertising and promotion of a product are currently deductible. *See* Joint Committee on Taxation, *Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means* (JCS-17-87) at 138 (June 25, 1987).[9] Such expenditures, however, arguably have an effect in future years. *Id.* Proposals made in 1987 to require these expenses to be capitalized were not enacted. Since Congress has declined to act in this area, such a change should not be effectuated through the courts.

The foregoing litany of currently deductible expenses that could be adversely affected by the Third Circuit's

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[9] The IRS has also acknowledged that advertising and promotional expenses are currently deductible. Tech. Adv. Mem. 8135031 (May 29, 1981).

analysis is sweeping and might arguably be dismissed as a chimerical "parade of horribles." In view of the lower court's language, however, how are taxpayers to know? Indeed, *amicus* Tax Executives Institute has already received oral confirmation from IRS representatives that they anticipate broadly attacking taxpayer deductions on the basis of the Third Circuit's decision.[10]

Equally important, the Third Circuit's decision gives short shrift to a fundamental principle of the U.S. income tax system: the matching of income with associated expenditures on an annual basis. Because the Internal Revenue Code imposes a tax based on *net* taxable income (*i.e.*, the amount remaining when a taxpayer's deductible expenses are subtracted from its gross receipts), an annual accounting system is a "practical necessity if the federal income tax system is to produce revenue ascertainable and payable at regular intervals." *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 377 (1983) (citing *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 365 (1931)). The result reached by the Third Circuit distorts this matching principle by effectively precluding taxpayers from recovering their costs (either currently or over time) since no asset exists to be deprecited or amortized. Thus, the lower court's future benefit test vitiates the statutory requirement to clearly reflect income.

V.

Because tax considerations play an important role in business decisions, "there is a special interest in the orderly, certain, and consistent interpretation of the Internal Revenue Code." *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. at 416 (Stevens, J., dissenting). That interest is not served by the Third Circuit's decision.

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[10] Members of *amicus* Tax Executives Institute have reported that IRS examining agents have cited the lower court's opinion in disallowing deductions for expenses totally independent of any corporate restructuring or acquisition.

The Third Circuit's decision will undoubtedly reopen disputes between taxpayers and the Internal Revenue Service in areas that have long been settled. This is wrong because "[t]he taxpayer, who may be exposed to interest and penalties for guessing wrong, is entitled to reasonably clear criteria or standards to let him know what his rights and duties are." *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d at 785. It is also wrong because the lower court's enigmatic standard will undermine the sound tax principles to which this Court and other courts have long adhered.

To prevent unnecessary disruption to the tax system, this Court should vivify the holding of *Lincoln Savings* by affirming the applicability of the separate and distinct additional asset test. It should confirm the current deductibility of ordinary and necessary expenses notwithstanding the presence of a future benefit. It should restore much needed certainty to this area of the tax law. It should reverse the Third Circuit's decision.

CONCLUSION

For the foregoing reasons, the decision of the U.S. Court of Appeals for the Third Circuit should be reversed.

Respectfully submitted,

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