No. 90-1278

In the Supreme Court of the United States

OCTOBER TERM, 1991

INDOPCO, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

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

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether expenditures incurred by a corporation to facilitate its acquisition in a friendly takeover are deductible as "ordinary and necessary" business expenses under Section 162(a) of the Internal Revenue Code.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-18a) is reported at 918 F.2d 426. The opinion of the Tax Court (Pet. 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 petition for a writ of certiorari was filed on February 11, 1991, and was granted on May 13, 1991. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTE INVOLVED

Section 162(a) of the Internal Revenue Code, 26 U.S.C. 162(a), provides in relevant part:

> There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. * * *

STATEMENT

1. Petitioner manufactures and sells adhesives, starches, and specialty chemical products. Prior to August 1978, when petitioner was known as National Starch and Chemical Corporation, its common stock was widely held and was traded on the New York Stock Exchange. Petitioner's largest shareholder was Frank Greenwall, who, together with his wife, owned 14.5% of the common stock. Pet. App. 19a-20a.

In October 1977, representatives of the Unilever group of companies [1] met with National Starch, one of Unilever's suppliers, to express an interest in acquiring that company by means of a friendly tender offer. In these discussions, Greenwall indicated that he would transfer his block of stock to Unilever only if a tax-free transaction could be arranged. Pet. App. 2a, 20a; J.A. 17-18, 140-144.

To satisfy the Greenwalls, and to make sure that Unilever obtained 100% of the stock of National Starch, the acquisition was proposed as a "reverse subsidiary cash merger." The proposed transaction

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[1] Unilever United States, Inc. (Unilever U.S.) is a holding company whose principal subsidiaries (prior to the acquisition of National Starch) were Lever Brothers Co. and Thomas J. Lipton, Inc. All of the stock of Unilever U.S. is owned by Unilever N.V., a Netherlands corporation. Unilever PLC is a United Kingdom corporation. Unilever N.V. and Unilever PLC, along with companies controlled by them, are referred to as the Unilever group of companies. Pet. App. 2a & n.1, 20a; J.A. 13-14.

involved two stages. In the first stage, a corporation named National Starch and Chemical Holding Corporation (Holding) was to be formed as a new Unilever subsidiary. The shareholders of National Starch who desired a tax-free exchange under Section 351 of the Internal Revenue Code were to receive one share of Holding's nonvoting preferred stock for each share of National Starch stock they surrendered to Holding. In the second stage, a corporation named NSC Merger, Inc. (to be funded by Holding with sufficient cash to consummate the acquisition of National Starch) was to be formed as a subsidiary of Holding. NSC Merger, Inc., was then to merge into National Starch. As part of the merger, the former shareholders of National Starch who had *not* elected to take preferred stock from Holding were to receive cash for their shares in a taxable exchange. Pet. App. 2a-3a, 20a-21a. The existing stock of National Starch was then to be cancelled, the authorized number of shares was to be reduced from 8,000,000 to 1000, and the newly-authorized stock was to be issued to Holding as the sole surviving shareholder of National Starch. J.A. 13, 16.

The formation of NSC Merger, Inc., and the use of the "reverse subsidiary cash merger" were designed to eliminate the possibility that recalcitrant stockholders would not tender their stock in a voluntary exchange. The plan assured that Holding would obtain 100% of the stock of National Starch. J.A. 14-15.

2. In November 1977, this proposed plan was discussed with petitioner's board of directors. Petitioner's counsel advised the directors that they had a duty to ensure that the transaction was fair to the shareholders and advised the board to retain an independent investment banking firm to assist in val-

uation of the company. Pet. App. 3a, 21a. Petitioner hired the investment banking firm of Morgan Stanley and Co. to value the stock, render a fairness opinion, and coordinate the details of the merger. *Ibid.*; J.A. 47-56.

Unilever had originally proposed a cash price in the range of $65 to $70 per share for petitioner's stock, which Morgan Stanley concluded was fair. J.A. 20, 57-59. Petitioner's management, however, suggested a price of $80 a share, and Morgan Stanley conveyed that proposal to Unilever. Unilever thereafter increased its offer to $73.50, the price to which all parties ultimately agreed. Pet. App. 3a, 21a-22a.

On March 16, 1978, petitioner's directors approved the merger agreement, which was contingent upon obtaining a favorable private letter ruling from the Internal Revenue Service. On June 28, 1978, the IRS issued the desired favorable ruling, which stated that the transaction would be nontaxable under Section 351 of the Code to those shareholders who received preferred stock of Holding and would be a taxable sale for those shareholders who received cash for their shares. Pet. App. 22a. On July 10, 1978, Morgan Stanley delivered to petitioner's board its final fairness opinion, which concluded that the terms of the transaction were fair and equitable to petitioner's shareholders. *Ibid.*; J.A. 81-84.

The transaction was consummated on August 15, 1978. The Greenwalls and others holding a combined total of 21% of petitioner's stock exchanged their stock on a share-for-share basis for preferred stock in Holding with a par value of $73.50 per share. The remaining shareholders received $73.50 per share in cash. Pursuant to the terms of the merger, Holding's stock in NSC Merger, Inc., was converted into newly-issued stock of National Starch. After all steps of the transaction were concluded, National Starch (now known as Indopco, Inc.) became a wholly owned subsidiary of Holding. Pet. App. 22a-23a.

Petitioner paid Morgan Stanley a fee of $2,200,000 for its services in connection with the transaction. Morgan Stanley also received $7,586 for its out-of-pocket expenses and $18,000 for the legal fees of its counsel. Pet. App. 23a; J.A. 28, 125-127. Petitioner paid its own counsel a fee of $490,000 (plus $15,069 for out-of-pocket expenses) for legal advice concerning the duties of petitioner's directors, for preparation of the IRS ruling request, for assistance in negotiation of the transaction, and for preparation of related documentation. Pet. App. 23a-24a; J.A. 28, 128-138, 150, 185-186. Other expenses incurred by petitioner in connection with the transaction—such as accounting, printing, and SEC fees—totalled $150,962. Pet. App. 24a; J.A. 29-30.

On its 1978 federal income tax return, petitioner claimed a deduction from its current income for the $2,225,586 paid to Morgan Stanley, but did not deduct the $505,069 paid to its own attorneys or the other expenses of $150,962. Pet. App. 4a, 24a. The Commissioner disallowed the claimed deduction and determined a deficiency in petitioner's income tax for its taxable year ending August 15, 1978, in the amount of $1,068,281. J.A. 33-38. Petitioner sought redetermination of the deficiency in the Tax Court. In its petition in the Tax Court, petitioner asserted that it was entitled to deduct not only the Morgan Stanley charges, but also the amount it had paid to its attorneys and the other expenses related to the transaction. J.A. 3-9.

3. The Tax Court agreed with the Commissioner that the expenses in question are not deductible as "ordinary and necessary" business expenses under Section 162 of the Internal Revenue Code. Pet. App. 24a-31a. The court held that such expenditures, which result in benefits that could be expected to produce returns for many years in the future, are capital in nature. *Id.* at 27a. The court noted (*id.* at 23a, 28a) that petitioner's 1978 annual report had stated that the company would "benefit greatly from the availability of Unilever's enormous resources" (J.A. 43; see J.A. 46), and that a Morgan Stanley report had concluded that petitioner's affiliation with Unilever would create an opportunity for "synergy" for the two companies (J.A. 77-78). Moreover, the court found that "petitioner's directors [had] determined that it would be in petitioner's long-term interest to shift ownership of the corporate stock to Unilever." Pet. App. 28a. Since the expenditures incurred in connection with that shift in ownership "were related more to petitioner's permanent betterment" than to "the carrying on of daily business and production of income," the Tax Court concluded that the expenditures were "capital in nature" and not deductible. *Id.* at 30a-31a.

4. The court of appeals unanimously affirmed (Pet. App. 1a-18a). Petitioner contended that the Tax Court had applied an incorrect legal standard in determining whether these expenses were capital in nature. Petitioner asserted that, in *Commissioner* v. *Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971), this Court held that a payment is not a capital expenditure unless it creates or enhances a separate and distinct asset. Petitioner argued that the expenses at issue in this case were not capital expendi-

tures because they did not create or enhance a "separate and distinct asset." See Pet. App. 9a.

The court of appeals acknowledged that other circuits "have indeed construed *Lincoln Savings* to have created a new standard such as that proffered by [petitioner]." Pet. App. 9a.[2] The court concluded, however, that those circuits had misread *Lincoln Savings*: while *Lincoln Savings* "clearly holds that a payment that creates or enhances a separate asset is capital in nature, * * * it does not necessarily follow that if no asset is created the expenditure is not capital in nature." Pet. App. 8a. Noting that "the determination whether an expenditure is ordinary or capital is fact-specific" (*id.* at 10a) and that "no one factor alone can control this complex decision" (*id.* at 11a), the court of appeals concluded that "[t]here 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." *Id.* at 8a.

Turning to what it viewed as the appropriate inquiry in the circumstances of this case, the court of appeals stated that "the common characteristic of expenses that have been found to be capital, in fact the *sine qua non* of capitalization, is the presence of a not insignificant future benefit that is more than merely incidental." Pet. App. 11a-12a. The court upheld the Tax Court's finding that the Unilever acquisition of petitioner created long-term benefits for the company. *Id.* at 12a-14a. The court therefore concluded that the expenses incurred by petitioner to

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[2] See *Briarcliff Candy Corp.* v. *Commissioner*, 475 F.2d 775, 782 (2d Cir. 1973); *NCNB Corp.* v. *United States*, 684 F.2d 285, 288-289 (4th Cir. 1982) (en banc).

facilitate that transaction were not "ordinary and necessary" business expenses but were, instead, nondeductible capital expenditures (*id.* at 17a-18a).

SUMMARY OF ARGUMENT

Section 162(a) of the Internal Revenue Code authorizes a current deduction for all "ordinary and necessary" expenses paid "in carrying on any trade or business." Capital expenses incurred by a business are not, however, to be deducted in the year they are incurred. Instead, capital expenses either are to be amortized over their useful life or, if their life is indefinite, are to be recovered upon the termination of the enterprise. The practical issue presented when courts are asked to distinguish between capital and current business expenses is thus not *whether* a deduction is allowed, but *when* a deduction is allowed. In making this determination, the underlying objective is more accurately to reflect the taxpayer's income by associating the period of the deduction with the period of the benefit created by the expense.

The expenses incurred by petitioner in connection with its acquisition and reorganization effected a permanent change in its corporate structure for the long-term benefit of the corporation. Expenses incurred to alter the corporate structure are capital in nature because they are for "the indefinite future" rather than for "the income production or other needs of the more immediate present" (*General Bancshares Corp.* v. *Commissioner*, 326 F.2d 712, 715 (8th Cir.), cert. denied, 379 U.S. 832 (1964)). Courts have thus consistently denied a current deduction for expenses incurred by a corporation in connection with its acquisition and reorganization and have required such expenses to be included within the corporation's permanent capital accounts.

This Court's decision in *Commissioner* v. *Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971), does not conclude, as petitioner contends (Br. 14-25), that only expenses incurred to create or enhance a "separate and distinct additional asset" are to be capitalized. To be sure, as the Court held in *Lincoln Savings*, when a payment serves to create or enhance a "separate and distinct" asset, "as an inevitable consequence, the payment is capital in nature and not an expense." 403 U.S. at 354. But the "separate and distinct asset" test, although a conclusive test, is not an exclusive one.

As the author of *Lincoln Savings* concluded in his earlier opinion for the Eighth Circuit in *General Bancshares*, expenses incurred to facilitate a corporate restructuring are to be capitalized even "where the expenditures have not resulted in the acquisition or increase of a corporate asset" because such expenditures affect the corporation's operations "for the duration of its existence or for the indefinite future." 326 F.2d at 715, 716. Both before and after *Lincoln Savings*, this Court has made clear that the hallmark of a capital expense is that it creates "value in more than one taxable year." *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298, 310 (1972).

The expenses incurred by petitioner were designed to alter its structure for the permanent betterment of the corporation. The transaction realized long-term synergistic benefits for the corporation by joining petitioner with an international enterprise with large and widespread interests and resources. See note 1, *supra*. The transaction also altered petitioner from a public corporation with thousands of shareholders to a private corporation with only one. As the courts below correctly found, the benefits derived by petitioner from this transaction will extend many years into the future (Pet. App. 12a-14a, 27a-28a). The expenses associated with altering a corporation's capital structure are at the core of the concept of "capital" charges: they yield long-lived benefits to the taxpayer and are "not deductible currently." B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 5.06, at 5-36 (5th ed. 1987).

ARGUMENT

EXPENDITURES INCURRED BY A CORPORATION TO FACILITATE ITS ACQUISITION AND REORGANIZATION ARE CAPITAL EXPENDITURES THAT ARE NOT DEDUCTIBLE AS ORDINARY AND NECESSARY BUSINESS EXPENSES UNDER SECTION 162(a) OF THE INTERNAL REVENUE CODE

A. The Distinction Between Current Business Expenses And Capital Expenses Is Designed To Achieve A Clear Reflection Of Net Income For Each Taxable Year

Under the Internal Revenue Code, there are four basic alternative treatments for expenses incurred by businesses: (i) no deduction may be allowed (as where the expense has no legitimate business purpose); (ii) a deduction in the year of the expense for the full amount of the expense may be allowed (as where the expense is an "ordinary and necessary" expense paid "in carrying on" the business under Section 162(a)); (iii) the expense may be "capitalized" and amortized or depreciated over the determinable useful life of the benefit it creates (as where property acquired for use in a business is depreciated under Section 167(a)); and (iv) the expense may be capitalized and included within the basis of another asset or the capital structure of a business, to be deducted from the value received upon sale of the asset or upon liquidation of the business.

The practical question presented in cases involving the distinction between capital and current expenses is thus not *whether* an expense may be deducted, but *when* it may be deducted. In making this determination, the objective is to allocate the deduction to the period or periods in which the expense assists in the creation of income. When properly drawn, the distinction between current business expenses and capital charges will "achieve an accurate measure of net income for the year by matching [expenses] with the revenues attributable to them and recognizing both during the same taxable year." *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (11th Cir. 1982), cert. denied, 463 U.S. 1207 (1983). See *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974); *Hertz Corp. v. United States*, 364 U.S. 122, 126 (1960). The ultimate goal of these distinctions under the Code is to achieve a "method of accounting * * * [that] clearly reflect[s] income" (Section 446(b)).[3]

Section 162(a) of the Internal Revenue Code allows a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." To be deductible under Section 162, "an item must (1) be 'paid or

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[3] Section 446(b) of the Code requires that a taxpayer's accounting method "clearly reflect income." The regulations under Section 446 provide: "Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account." Treas. Reg. § 1.446-1(a)(4)(ii).

incurred during the taxable year,' (2) be for 'carrying on any trade or business,' (3) be an 'expense,' (4) be a 'necessary' expense, and (5) be an 'ordinary' expense." *Commissioner* v. *Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 352 (1971). A capital expenditure is similar to a business expense under Section 162(a): it differs primarily in that it is "a cost that will yield benefits in future years in the taxpayer's business or income producing activities." 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 20.4.1, at 20-65 (2d ed. 1989).[4] Because the benefits derived from capital expenses are more long-lasting in nature, this Court has stated that capital expenditures are not "ordinary" expenses within the meaning of Section 162(a):

> The principal function of the term "ordinary" in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset.

Commissioner v. *Tellier*, 383 U.S. 687, 689-690 (1966).

The terms "capital" expense and "ordinary and necessary" business expense are not "together all

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[4] Section 263(a)(1) of the Code provides that no deduction shall be allowed for "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." Section 263, however, does not provide a complete list of nondeductible capital expenditures. *Commissioner* v. *Lincoln Savings & Loan Ass'n*, 403 U.S. at 358. The purpose of Section 263 is "to reflect the basic principle that a capital expenditure may not be deducted from current income." *Commissioner* v. *Idaho Power Co.*, 418 U.S. at 16.

inclusive" of the various types of expenses that a corporation can incur. See *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 716 (8th Cir.), cert. denied, 379 U.S. 832 (1964). The contrast the cases draw between "capital" and "ordinary and necessary" expenses is designed to aid the inquiry into whether a current or deferred deduction of the expenses is appropriate. See *Commissioner v. Idaho Power Co.*, 418 U.S. at 10-11 (allocating "the expense of using an asset to the various periods which are benefited by that asset") (quoting *Hertz v. United States*, 364 U.S. at 126).

There is no readily available formula for determining in every context whether a particular expenditure is a deductible current expense or a nondeductible capital expenditure. This Court has long observed that "the decisive distinctions are those of degree and not of kind." *Welch v. Helvering*, 290 U.S. 111, 114 (1933).[5] See also *Deputy v. du Pont*, 308 U.S. 488, 495-496 (1940). Recognizing that the analysis properly focuses "on whether income will be better reflected by deducting or by capitalizing the amount in question" (1 B. Bittker & L. Lokken, *supra*, ¶ 20.4.1, at 20-69), the courts have employed a variety of general standards in this elusive, fact-intensive inquiry. See, *e.g.*, *Encyclopaedia Brittanica, Inc. v. Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982) ("The distinction between recurring and nonrecurring business expenses provides a very crude but perhaps serviceable demarcation between

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[5] As Justice Cardozo further explained for the Court in *Welch v. Helvering*, 290 U.S. at 115:

> 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.

those capital expenditures that can feasibly be capitalized and those that cannot be."); *E.I. du Pont de Nemours & Co. v. United States*, 432 F.2d 1052, 1059 (3d Cir. 1970) (capital expenditures are those that "result[] in a benefit to the taxpayer which could be expected to produce returns for many years in the future"); *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 715 (8th Cir.) (capital expenditures are those whose purpose is betterment "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") (Blackmun, J.), cert. denied, 379 U.S. 832 (1964).

B. Expenses Incurred By A Corporation To Facilitate Its Acquisition And Reorganization Are Capital Costs

Because the tax laws apply in an "area of limitless factual variations" (*National Muffler Dealers Ass'n v. United States*, 440 U.S. 472, 477 (1979) (quoting *United States v. Correll*, 389 U.S. 299, 307 (1967)), courts have been called upon to derive particular rules of decision distinguishing between capital and current business expenses in a wide variety of business settings.[6] In the particular context of the pres-

[6] Particularized rules have been adopted to resolve recurring questions that arise in specific areas of business activity. For example, the cost of repairs that are recurring in nature and that merely keep business property in an ordinarily efficient operating condition are currently deductible even though an individual item may last (and thus yield a benefit to the business) for more than a year, whereas improvements to the property or replacements that prolong the life of the property are nondeductible capital expenditures. See, *e.g.*, *Moss v. Commissioner*, 831 F.2d 833, 836-837 (9th Cir. 1987); *Hotel Kingkade v. Commissioner*, 180 F.2d 310, 312-313

ent case, courts have had little difficulty concluding that expenses incurred to facilitate the acquisition and reorganization of a corporation represent capital expenses that are not currently deductible under Section 162(a).

1. It has long been recognized that "costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures" and are not currently deductible business expenses under Section 162(a). *Woodward* v. *Commissioner*, 397 U.S. 572, 575 (1970). See *Spreckles* v. *Commissioner*, 315 U.S. 626 (1942); *Helvering* v. *Winmill*, 305 U.S. 79 (1958). All legal, brokerage, appraisal, accounting, and similar costs incurred in the acquisition of corporate stock are capital expenditures. *Woodward* v. *Commissioner*, 397 U.S. at 570-578; *United States* v. *Hilton Hotels Corp.*, 397 U.S. 580, 583-585 (1970); *Fireman's Insurance Co.* v. *Commissioner*, 30 B.T.A. 1004, 1014 (1934). Similarly, the costs incurred by a shareholder in the disposition of stock are capital expenditures, whether the stock is sold for cash (*Third Nat'l Bank* v. *United States*, 427 F.2d 343, 344 (6th Cir. 1970); *Helgerson* v. *United States*, 426 F.2d 1293, 1296 (8th Cir. 1970); see *Munson* v. *McGinnes*, 283 F.2d 333, 336-337 (3d Cir.), cert. denied, 364 U.S. 880 (1960)), or exchanged for other

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(10th Cir. 1950); *Illinois Merchants Trust Co.*, 4 B.T.A. 103, 106 (1926); Treas. Reg. § 1.162-4; cf. Treas. Reg. § 1.612-2; see generally 1 B. Bittker & L. Lokken, *supra*, ¶ 20.4.8. The recurring costs incurred by a going concern in expanding its existing business generally are deductible, but the costs of entering a new line of business are capital expenditures. See, *e.g.*, *Colorado Springs Nat'l Bank* v. *United States*, 505 F.2d 1185, 1190 (10th Cir. 1974); *Carl Reimers Co.* v. *Commissioner*, 211 F.2d 66, 68 (2d Cir. 1954); see generally 1 B. Bittker & L. Lokken, *supra*, ¶ 20.4.4.

stock (*Estate of McGlothlin* v. *Commissioner*, 370 F.2d 729, 732 (5th Cir. 1967); *Plym* v. *United States*, 338 F. Supp. 717, 719-720 (W.D. Mich. '71)).[7]

The same result applies when assets are acquired as a method of unifying two or more corporate enterprises. The costs incurred in acquiring all of the assets of a corporation are not deductible expenses. *Beneficial Indus. Loan Corp.* v. *Hardy*, 16 F. Supp. 110, 112-113 (D. Del. 1936), aff'd per curiam, 92 F.2d 74 (3d Cir. 1937). Conversely, the costs incurred by a corporation in selling all of its assets to another corporation are not deductible expenses. *Odorono Co.* v. *Commissioner*, 26 B.T.A. 1355, 1357-1358 (1932); cf. *Anchor Coupling Co.* v. *United States*, 427 F.2d 429, 431-434 (7th Cir. 1970) (amount paid in settlement of suit seeking specific performance of contract for sale of taxpayer's assets was nondeductible capital expenditure), cert. denied, 401 U.S. 908 (1971).[8]

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[7] There is an exception to these rules for dealers in securities. A dealer is one who as a merchant buys securities and sells them to customers. See *Kemon* v. *Commissioner*, 16 T.C. 1026, 1032-1033 (1951); Treas. Reg. § 1.471-5. Securities held by a dealer primarily for sale to customers in the ordinary course of his business do not constitute capital assets. 26 U.S.C. 1221(1). A dealer in securities may treat commission costs as a currently deductible expense. Treas. Reg. § 1.263 (a)-2.

[8] The costs incurred in acquiring property (including stock) are added to the taxpayer's basis in the property, and are taken into account for tax purposes either through depreciation or by reducing the capital gain (or increasing the loss) when the property is sold. *Woodward* v. *Commissioner*, 397 U.S. at 574-575. Costs incurred in disposing of property are taken into account as reducing the capital gain realized on the sale. *Munson* v. *McGinnes*, 286 F.2d at 333. Costs incurred in

2. It has long been recognized that "[e]xpenses incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses." *General Bancshares Corp.* v. *Commissioner*, 326 F.2d at 715 (quoting *Farmers Union Corp.* v. *Commissioner*, 300 F.2d 197, 200 (9th Cir.), cert. denied, 371 U.S. 861 (1962)). See *McCrory Corp.* v. *United States*, 651 F.2d 828, 832 (2d Cir. 1981); *Bilar Tool & Die Corp.* v. *Commissioner*, 530 F.2d 708, 712 (6th Cir. 1976); *E.I. du Pont de Nemours & Co.* v. *United States*, 432 F.2d 1052, 1958-1059 (3d Cir. 1970); *Mills Estate, Inc.* v. *Commissioner*, 206 F.2d 244, 246 (2d Cir. 1953); see also *El Paso Co.* v. *United States*, 694 F.2d 703, 709 (Fed. Cir. 1982). This rule has been applied to a wide variety of transactions involving a change in corporate structure.[9] These de-

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exchanging the property for other property in a tax-free transaction are added to the taxpayer's basis in the new property. *Estate of McGlothlin* v. *Commissioner*, 370 F.2d at 732.

[9] See *Bilar Tool & Die Corp.* v. *Commissioner*, 530 F.2d at 712 (split-off); *McCrory Corp.* v. *United States*, 651 F.2d at 832 (statutory merger); *E.I. du Pont de Nemours & Co.* v. *United States*, 432 F.2d at 1058 (creation of new subsidiary to hold one-half of the assets of former jointly-owned business); *General Bancshares Corp.* v. *Commissioner*, 326 F.2d at 715 (distribution of stock dividend); *Mills Estate, Inc.* v. *Commissioner*, 206 F.2d at 246 (recapitalization); *Jim Walter Corp.* v. *United States*, 498 F.2d 631, 638 (5th Cir. 1974) (payments to cancel old warrants); *Missouri-Kansas Pipe Line Co.* v. *Commissioner*, 148 F.2d 460, 462 (3d Cir. 1945) (distribution to stockholders of warrants to purchase subsidiary's stock); *Bush Terminal Building Co.* v. *Commissioner*, 7 T.C. 793, 818-819 (1946) (bankruptcy reorganization); *Borg & Beck Co.* v. *Commissioner*, 24 B.T.A. 995, 1004 (1931) (change from par value stock to no par stock); *Holeproof Hosiery Co.* v. *Commissioner*, 11 B.T.A. 547, 555-556 (1928) (increase in authorized capital stock).

cisions uniformly follow the principle 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 § 386(a) * * *) are not currently deductible as business expenses under § 162 by the person incurring such costs." B. Bittker & J. Eustice, *supra*, ¶ 5.06, at 5-33. The rationale for this rule, as explained by then-Judge Blackmun in *General Bancshares Corp.* v. *Commissioner*, 326 F.2d at 715, 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.

It is equally well established that the costs incurred by a corporation to facilitate its acquisition through merger with another corporation are not "ordinary and necessary" business expenses but are non-deductible capital charges. As the Second Circuit held in *Motion Picture Capital Corp.* v. *Commissioner*, 80 F.2d 872, 873-874 (1936), while it is true that such expenses

> were ordinary and necessary expenses of the merger and it may be true in broad concept that mergers are ordinary and necessary business occurrences, * * * expenses to be deductible must be incurred by a taxpayer in doing the ordinary and necessary things his business requires to be done to make it function as such. These expenses were incurred in connection with the tax-

> payer's business, but were not necessary in the ordinary course of its conduct.

Since the expenditures incurred in facilitating an acquisitive reorganization effect a restructuring of the circumstances of the enterprise with a resulting "betterment * * * for the indefinite future" and are not "devoted to the income production or other needs of the more immediate present" (*General Bancshares Corp.* v. *Commissioner*, 326 F.2d at 715), such expenditures are properly treated as capital, rather than current, expenses. See B. Bittker & J. Eustice, *supra*, ¶ 5.06, at 5-36 ("The *acquired* corporation's reorganization expenses in an acquisition reorganization transaction likewise are generally not deductible currently.").[10]

The court of appeals correctly applied these settled principles in its decision in this case. The expenditures claimed as "ordinary and necessary" business expenses by petitioner were incurred in a transaction that effected a radical change in its corporate enterprise. Petitioner was transformed from a publicly held, free-standing corporation to a corporation with a single shareholder that was part of a multinational conglomerate with large and widespread interests and resources, resulting in several permanent benefits to petitioner. To achieve that result, a merger was employed to eliminate recalcitrant shareholders, the stock of existing shareholders was cancelled, and the number of both authorized and outstanding shares was greatly reduced. As we will show in point E, *infra*, the general principles underlying the distinc-

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[10] The subsequent treatment of such capital charges, and the proper timing of any deduction relating to them, are discussed at pages 36-38, *infra*.

tion between capital and current expenses, as well as the particularized principles developed by the courts in the specific context of corporate acquisitions and reorganizations, require capitalization of the expenses involved in this case. First, however, we address petitioner's argument that in *Lincoln Savings* the Court established an all-encompassing, exclusive test for determining whether an expenditure is capital in nature.

C. *Lincoln Savings* Did Not Hold That An Expense Is Capital Only If It Creates Or Enhances A Separate And Distinct Asset

1. Petitioner asserts (Br. 14-18) that, in *Commissioner* v. *Lincoln Savings & Loan Ass'n*, 403 U.S. at 354, this Court announced a generally-applicable bright-line test that an expense is not capital in nature unless it "creates or enhances a 'separate and distinct additional asset'" (Br. i). The court of appeals (Pet. App. 7a-11a) and the Tax Court (*id.* at 29a) properly concluded, however, that *Lincoln Savings* established no such exclusive rule.

In *Lincoln Savings*, the Court was called upon to determine whether a premium that a savings institution was required to pay to the Federal Savings and Loan Insurance Corporation (FSLIC) for credit to the "Secondary Reserve" maintained by the FSLIC gave rise to a capital expenditure or an ordinary and necessary business expense under Section 162(a). As a member institution in the FSLIC's insurance program, Lincoln was required to pay two annual premiums. The regular premium, required by 12 U.S.C. 1727(b) (1964), was used by the FSLIC to cover its expenses and insurance losses for the year, with any excess flowing as part of FSLIC's net income into its Primary Reserve. The "additional premium," required by 12 U.S.C. 1727(d) (1964), was credited to FSLIC's Secondary Reserve. An insured institution such as Lincoln had no interest in the Primary Reserve, but held a pro rata share of the Secondary Reserve and, under certain circumstances, was entitled to a refund of that share. In addition, an institution was credited with interest on its share in that Reserve. In some circumstances, an institution's share of the Secondary Reserve could be applied toward payment of the regular premium. Lincoln claimed deductions under Section 162(a) for both premiums. The Commissioner allowed the deduction for the regular premium, but disallowed the deduction for the "additional" premium. The Tax Court sustained the Commissioner's determination, concluding that payment of the additional premium was a nondeductible capital expenditure. 51 T.C. 82 (1968). The Ninth Circuit reversed. 442 F.2d 90 (1970).

This Court concluded that payment of the "additional" premium was a capital expenditure and, hence, not deductible under Section 162(a). In the language relied on by petitioner, 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." 403 U.S. at 354. The Court stated that what was "important and controlling" in the circumstances of that case was that the payment in issue "serve[d] 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." *Ibid.*

Contrary to petitioner's assertion, however, the Court did not hold that a capital expenditure occurs *only* when a separate and distinct asset is involved. The Court held merely that when the expenditure clearly creates a separate and distinct asset, the expenditure is "inevitabl[y]" capital in nature, and any future benefit analysis is unnecessary. While the facts of *Lincoln Savings* involved expenses that created a separate asset (see 403 U.S. at 355-358), it does not follow that, if a "separate and distinct" asset is not created, the expenditure is conclusively not capital in nature.[11] As the court of appeals observed in this case, petitioner's argument is equivalent to concluding that "because something made out of glass is fragile, all things fragile must be made out of glass" (Pet. App. 8a (quoting Comm'r Br. 28 n.13)).[12]

Likewise erroneous is petitioner's assertion (Br. 16-18) that the Court in *Lincoln Savings* rejected the principle that expenditures that result in significant future benefits are capital expenditures. The Court held merely that the presence of a benefit with "some" future aspect is not controlling (403 U.S. at 354) because many expenses that historically have been treated as deductible expenses under Section 162—such as recurring expenses for advertising, re-

[11] Like the court of appeals, the Tax Court below recognized that *Lincoln Savings* "did not address the deductibility of expenditures which do not create or enhance a separate and distinct asset" (Pet. App. 29a). See also *Florida Publishing Co. v. Commissioner*, 64 T.C. 269, 282 (1975) (*Lincoln Savings* "did not redefine or otherwise alter the previously discussed, well-settled rules for determining whether an expenditure must be deducted or capitalized"), aff'd by unpublished order, No. 75-3404 (5th Cir. Apr. 25, 1977).

[12] See J. Copi, *Symbolic Logic* 19, 24 (3d ed. 1967) (referring to the "Fallacy of Denying the Antecedent").

pairs, and maintenance [13]—have some future, as well as current, benefits. The court of appeals correctly observed (Pet. App. 8a) that "although an incidental future benefit would plainly not be controlling, [*Lincoln Savings*] does not suggest that the presence of a significant future benefit is not a legitimate factor to consider in determining deductibility." "While the period of the benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominant, characteristic of a capital item." *Central Texas Savings & Loan Ass'n* v. *United States*, 731 F. 2d 1181, 1183 (5th Cir. 1984).

Petitioner's assertion that the Court in *Lincoln Savings* established a new "test" for determining whether expenditures are capital expenditures (Br. 14) certainly is not borne out by the Court's opinion. Nothing in the opinion suggests that the Court believed it was announcing a new test or creating a new standard. To the contrary, the Court stated clearly that it was applying familiar principles to the particular facts of that case. See 403 U.S. at 355-359.[14]

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[13] Recurring expenses that are designed to maintain the condition of capital—such as advertising, repairs, and maintenance—may create benefits that are long-lived, but the constant nature of their incurrence renders deferral and amortization of less significance in assuring that the taxpayer's method of accounting "clearly reflect[s] income" (Section 446(b)). See note 6, *supra*.

[14] Petitioner's suggestion that the Court in *Lincoln Savings* undertook to "clear[] up th[e] confusion" in the lower courts concerning the proper standard to be applied in distinguishing nondeductible capital expenditures and currently deductible expenses (Br. 15) is not borne out by the Court's opinion. The Court did not state that there was any conflict with regard to the correct legal standard and, moreover, did not cite any

The Court's opinion by Justice Blackmun in *Lincoln Savings* cites with approval his earlier decision on the Eighth Circuit in *General Bancshares.* See 403 U.S. at 358. *General Bancshares* held that a reorganization expense should be capitalized because it "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." 326 F.2d at 715 (emphasis added). The court observed in *General Bancshares* that the result is the same "where the expenditures have not resulted in the acquisition or increase of a corporate asset," and that for expenditures to be deductible under Section 162(a), "it is not enough to demonstrate that they possess some characteristics different from the more commonly accepted capital expenditures (such as those directed toward the acquisition of a recognizable and tangible corporate asset)." 326 F. 2d at 716. Nothing in his opinion for this Court in *Lincoln Savings* suggests any change in the views

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lower court opinions in discussing the general standards for deductibility under Section 162(a). See 403 U.S. at 352-354. Moreover, the petition and the briefs filed in *Lincoln Savings* show that no such conflict was alleged, much less resolved by the Court, in that case. See *id.* at 346-347.

Petitioner also contends that the Court's inquiry into whether the FSLIC premium created an asset "would have been totally unnecessary if a significant future benefit had been all that was considered necessary for capitalization" (Br. 18). Petitioner fails to recognize, however, that the questions whether the premium payment created an asset and whether there was a significant future benefit were inextricably linked: one of the Court's reasons for concluding that an asset was created was that the benefit derived from the premiums was "more permanent than temporary." 403 U.S. at 356.

earlier expressed by Justice Blackmun in *General Bancshares.*

Petitioner's assertion that a separate and distinct asset is a *necessary* element of a capital expenditure not only fails to find support in *Lincoln Savings*, but is at odds with the Court's seminal decision in *Welch* v. *Helvering*, 290 U.S. 111 (1933). In *Welch*, the former officer of a bankrupt corporation paid the debts of the corporation in order to strengthen his personal credit and professional standing. The Court agreed with the Commissioner's determination that these payments were "capital outlays." 290 U.S. at 115. While the Court acknowledged that the taxpayer's "reputation" may be conceived of as something "*akin*" to a capital asset (*ibid.* (emphasis supplied)), it could hardly be said (and the Court did not say) that a person's credit standing represents a "separate and distinct" financial asset of the type involved in *Lincoln Savings*. Rather, the description of "reputation" as being "akin" to a capital asset represented the verbal formulation of the Court's conclusion that expenditures designed to accomplish future benefits "c[o]me closer to capital outlays than to ordinary and necessary expenses" (290 U.S. at 115). See also *Commissioner* v. *Tellier*, 383 U.S. at 689-690 (requiring capitalization of expenses that are "in the nature of capital expenditures").[15] Peti-

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[15] Petitioner asserts that the decision in *Welch* was based not on the capital nature of the outlays but, rather, on the fact that the payments were not "normal, usual or customary" (Br. 18). But the view of the Commissioner with which the Court agreed was that "the payments in controversy came closer to capital outlays than to ordinary and necessary expenses in the operation of a business." 290 U.S. at 115. The courts and commentators have viewed *Welch* as a capital expenditure case. See, *e.g.*, *Carl Reimers Co.* v. *Commissioner*,

tioner's assertion that the Court established a new "separate and distinct asset" test in *Lincoln Savings* amounts to a contention that the Court in *Lincoln Savings* overruled *Welch sub silentio.* To the contrary, however, the Court in *Lincoln Savings* cited and quoted *Welch* with approval as a general statement of the distinction to be drawn between capital and current expenses. See 403 U.S. at 352-353.

The Court's subsequent decisions in capital expenditure cases further demonstrate that *Lincoln Savings* did not establish an exclusive "separate and distinct asset" test for capital expenses. In *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298 (1972), decided just one year after *Lincoln Savings,* and in *Commissioner* v. *Idaho Power Co.*, *supra,* decided three years after *Lincoln Savings,* the Court held that particular expenses were nondeductible capital expenditures. If *Lincoln Savings* had established an exclusive test for determining whether an expense is "in the nature of" of a capital expense (*Commissioner* v. *Tellier*, 383 U.S. at 690), then the Court presumably would have relied on the supposed new test in *Mississippi Chemical* and *Idaho Power.* In *Mississippi Chemical*, however, far from relying on a "separate and distinct asset" test, the Court's determination that the particular expenditure in that case was capital in nature was based upon the gen-

211 F.2d at 68; 1 B. Bittker & L. Lokken, *supra*, ¶ 20.4.7, at 20-91 (*Welch* "rests primarily on the conclusion that the expenditures were capital outlays rather than ordinary and necessary business expenses"). Petitioner errs in asserting that Treas. Reg. § 1.263(a)-2(h) treats "reputation" as "a separate and distinct asset" (Br. 19 n.12). The regulation merely provides that "[t]he cost of good will in connection with the acquisition of the assets of a going concern is a capital expenditure."

eral principle that the expense created "value in more than one taxable year." 405 U.S. at 310. See *id.* at 312 (expense capitalized because it yielded a "long term value" to the corporation). See also *Commissioner* v. *Idaho Power Co.*, 418 U.S. at 10 (capitalization and depreciation are "to reflect the distribution of [the expense] over the accounting periods affected").

2. Petitioner errs in asserting that six circuits "have previously followed the *Lincoln Savings* separate and distinct asset test" (Br. 25). Only two of the many decisions relied on by petitioner could fairly be said to adopt the extreme view that, in the absence of a "separate and distinct asset," a capital expense cannot be found. *Briarcliff Candy Corp.* v. *Commissioner*, 475 F.2d 775, 782 (2d Cir. 1973); *NCNB Corp.* v. *United States*, 684 F. 2d 285, 288-290 (4th Cir. 1982) (en banc).[16] The courts in

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[16] Decisions in other circuits relied on by petitioner (Br. 26-27) provide no support for its position. In *Colorado Springs Nat'l Bank* v. *United States*, 505 F.2d 1185, 1192 (10th Cir. 1974), the court held that the costs of a bank's entry into a credit card system were currently deductible, but noted that it could "find no statutory, regulatory, or decisional test which is dispositive. The issue must be determined on the facts presented in the novel situation before us." In *First Security Bank* v. *Commissioner*, 592 F.2d 1050, 1052 (9th Cir. 1979), the court reached a similar holding and adopted *Colorado Springs Nat'l Bank* "as the law of this circuit." In *Iowa-Des Moines Nat'l Bank* v. *Commissioner*, 592 F.2d 433 (8th Cir. 1979), the court held that the cost of credit checks on prospective bank customers was currently deductible. The court merely cited *Lincoln Savings* for the proposition that the fact that there may be some future benefit is not controlling, and observed that, due to "the short useful life of this credit information," the "prospective benefit is very slight." *Id.* at 436. In *Central Texas Savings & Loan Ass'n*, 731 F.2d at 1183-1185, the court held that expenditures the taxpayer in-

Briarcliff Candy and *NCNB*, like petitioner, have misread the *Lincoln Savings* opinion, and their opinions have received ample criticism as a result. See *NCNB Corp.* v. *United States*, 684 F. 2d 285, 294 (4th Cir. 1982) (Murnaghan, J., dissenting); *Cleveland Electric Illuminating Co.* v. *United States*, 7 Cl. Ct. 220, 223-225 (1985); 1 B. Bittker & L. Lokken, *supra*, ¶ 20.4.4, at 20-84 n.61 (statement in *Briarcliff Candy* that *Lincoln Savings* brought about a radical shift in emphasis "overstates the significance" of the use in *Lincoln Savings* of the phrase "a separate and distinct additional asset"). See also *Ellis Banking Corp.* v. *Commissioner*, 688 F. 2d at 1379-1380 n.7. Both *Briarcliff Candy* and *NCNB* involved the murky factual issue of whether a going concern is preparing to enter a new line of business or is merely expanding its existing business for "the preservation of existing income from loss or diminution." *Briarcliff Candy Corp.* v. *Commissioner*, 475 F. 2d at 787. See also *NCNB Corp.* v. *United States*, 684 F. 2d at 290. The results in the two cases may

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curred in establishing new branches created a separate asset and were therefore capital expenditures. The court did not address the deductibility of expenditures that do *not* create or enhance a separate asset. In *Campbell Taggart, Inc.* v. *United States*, 744 F.2d 442 (5th Cir. 1984), the question was not one of capitalizing an expenditure but whether shares of stock were capital assets. Those questions are unrelated. An expenditure for a building to be used in the taxpayer's business undoubtedly requires capitalization. 26 U.S.C. 263. But the building, by definition, is not a capital asset. 26 U.S.C. 1221(2). This Court subsequently made clear that corporate stock is a capital asset under Section 1221, regardless of a taxpayer's motivation in purchasing the stock (*Arkansas Best Corp.* v. *Commissioner*, 485 U.S. 212, 222-223 (1988)), and disapproved of the Fifth Circuit's contrary holding in *Campbell Taggart* (see 485 U.S. at 216 n.4).

be correct (see note 6, *supra*), but, as we have discussed above, the rationale utilized by those courts is erroneous.

Petitioner also errs in asserting (Br. 27-28) that the Commissioner embraced the "separate and distinct asset" test in Rev. Rul. 83-66, 1983-1 C.B. 43. In that ruling, the Commissioner concluded that reserve premiums paid under a medical malpractice insurance policy were deductible under Section 162 because the premiums "represented the actuarially determined cost of providing the insurance coverage for the policy year" and, therefore, did not create "an asset or property interest with a useful life in excess of one year." 1983-1 C.B. at 44. The Commissioner did not conclude that no asset was created. He simply concluded that the benefit, whether or not it could be characterized as an "asset or property interest," was too short-lived to constitute a capital expenditure.[17]

D. An Expenditure May Be Capital In Nature Even If It Does Not Create Or Enhance A Separate Asset

The capital expenditure inquiry should "focus on whether income will be better reflected by deducting or by capitalizing the amount in question." 1 B. Bittker & L. Lokken, *supra*, ¶ 20.4.1, at 20-69. Petitioner agrees (Br. 29-30) that the function of the rules

[17] Petitioner also cites various technical advice memoranda and general counsel's memoranda prepared by the IRS (Br. 28-29, 32 n.23). Such internal IRS memoranda, which do not undergo the intensive review process accorded to formal IRS rulings and procedures intended for guidance to the public, have no precedential force, and are thus irrelevant here. 26 U.S.C. 6110(j)(3); *Rowan Cos., Inc.* v. *United States*, 452 U.S. 247, 261 n.17 (1981); *American Ass'n of Christian Schools* v. *United States*, 850 F.2d 1510, 1515 n.6 (11th Cir. 1988).

distinguishing capital expenditures and current expenses "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" (*Ellis Banking Corp.* v. *Commissioner*, 688 F.2d at 1379). If an expenditure produces a permanent or long-term benefit to the taxpayer that will help generate income in future years, it hardly would reflect the taxpayer's income to allow a current deduction for the expenditure merely because the benefit or advantage cannot readily be described as creating or enhancing an "asset."

Indeed, the situation presented in this case provides a perfect example of the inadequacy of petitioner's "separate and distinct asset" test. Petitioner does not challenge the findings of the Tax Court (Pet. App. 30a) and the court of appeals (Pet. App. 12a) that the takeover transaction resulted in permanent benefits for petitioner. Application of the test urged by petitioner—under which outlays may be deducted in one year even though the benefits of the expense are reaped for many years in the future—would result in a distortion of petitioner's income. For this reason alone, petitioner's test should be rejected.

1. The courts have recognized many types of capital expenses that do not create or enhance any specific asset. 1 B. Bittker & L. Lokken, *supra*, ¶ 20.4.1, at 20-68. Most relevant are the "changed corporate structure" cases discussed at pages 17-19, *supra*. In these cases, as then-Judge Blackmun noted in *General Bancshares*, 326 F.2d at 716, even when the reorganization expenses "have not resulted in the acquisition or increase of a corporate asset, [they are treated as capital charges and] are not, because of that fact, deductible as ordinary and necessary business ex-

penses." Similarly, in *Holeproof Hosiery Co.* v. *Commissioner*, 11 B.T.A. 547 (1928), which was cited in *General Bancshares*, the court observed that "[i]t can be argued, and not without merit, that no capital asset is acquired when attorneys' fees are paid in connection with an increase in capitalization, but it does not follow that the payments are ordinary and necessary expenses of the year when made." 11 B.T.A. at 556. The mere fact that a corporation's structure is not a "separate and distinct asset" does not mean that expenses incurred to alter its structure for the permanent betterment of the corporation are not capital in nature.

There are many other examples of business expenditures that have long been recognized as capital in nature even though they do not create or enhance any specific asset. The cost of an educational program that qualifies the taxpayer to enter a new trade or business is a non-deductible capital expenditure. *E.g.*, *Weiszmann* v. *Commissioner*, 52 T.C. 1106, 1111 (1969), aff'd per curiam, 443 F.2d 29 (9th Cir. 1971); *Osborn* v. *Commissioner*, 3 T.C. 603, 605 (1944); see Treas. Reg. § 1.162-5(b)(1) and (3); 1 B. Bittker & L. Lokken, *supra*, ¶ 22.1.1, at 22-3. But education could not fairly be said to constitute a "separate and distinct asset." In some situations, a taxpayer expends funds to improve the property of another person because the improvement will indirectly benefit the taxpayer's own business. Courts have held that such expenditures are capital expenditures, notwithstanding the fact that the expenditures did not create or enhance any specific asset of the taxpayer. See *Fall River Gas Appliance Co.* v. *Commissioner*, 349 F.2d 515, 517 (1st Cir. 1965) ("It is not necessary that the taxpayer acquire ownership in a new asset, but merely that he may reasonably anticipate a gain that is more or less permanent.") (installation of leased gas appliances); *Colony Coal & Coke Corp.* v. *Commissioner*, 52 F.2d 923 (4th Cir. 1931) (railroad spur); *Kauai Terminal, Ltd.* v. *Commissioner*, 36 B.T.A. 893 (1937) (breakwater). The costs incurred in registering existing, outstanding stock with the SEC pursuant to 15 U.S.C. 78*l*(g) are nondeductible capital expenditures "even though the benefit derived therefrom does not take the form of value added to a capital asset." *Consumers Water Co.* v. *United States*, 369 F. Supp. 939, 945 (D. Me. 1974). Costs incurred by an advertising agency to obtain the "recognition" of a newspaper publishers association in order to place advertisements in newspapers are non-deductible capital expenditures (*Carl Reimers Co.* v. *Commissioner*, 211 F.2d 66, 68 (2d Cir. 1954)), even though such "recognition" hardly constitutes a "separate and distinct asset."

The "separate and distinct asset" test—like any other verbal formulation that one might attempt to apply to the infinite variety of our business transactions—is no panacea for resolving all capital expenditure questions. To be sure, the "separate asset" test is a useful tool in the capital expenditure inquiry: as the Court stated in *Lincoln Savings*, when a payment serves to create or enhance a lasting asset, "as an inevitable consequence, the payment is capital in nature and not an expense." 403 U.S. at 354. But the "separate asset" test, although a conclusive test, is not an exclusive one. Satisfaction of that test is a sufficient, but not a necessary, indicium of a capital expenditure. The conclusion that a "separate asset" has not been created does not mandate the further conclusion that the expenditure is an ordinary and necessary business expense, as petitioner erroneously contends.

In an effort to abbreviate analysis or to explain or justify conclusions, courts have on occasion taken an extremely broad view of what constitutes an asset. Indeed, in some of the "changed corporate structure" cases, the courts have characterized a change in corporate structure as creating an "intangible" asset. See *McCrory Corp.* v. *United States*, 651 F.2d 828, 832 (2d Cir. 1981) ("reorganization expenditures * * * contribute to the creation of an intangible long-term asset, namely 'a change in the corporate structure for the benefit of future operations' ") (quoting *Mills Estate, Inc.* v. *Commissioner*, 206 F.2d at 246). Courts have also characterized other items as "assets" that would not, in normal usage, be so described. Amounts paid by a business in order to eliminate competition are nondeductible capital expenditures, and, in reaching that conclusion, some courts have characterized the elimination of competition as an asset. *E.g.*, *American Dispenser Co.* v. *Commissioner*, 396 F.2d 137, 138 (2d Cir. 1968); *Houston Natural Gas Corp.* v. *Commissioner*, 90 F.2d 814, 816 (4th Cir.), cert. denied, 302 U.S. 722 (1937); *Newspaper Printing Co.* v. *Commissioner*, 56 F.2d 125, 127 (3d Cir. 1932). Other courts have treated the circulation of a newspaper or magazine as an intangible asset and held that costs incurred in increasing circulation are therefore capital expenditures. *E.g.*, *Meredith Pub. Co.* v. *Commissioner*, 64 F.2d 890, 891 (8th Cir.), cert. denied, 290 U.S. 646 (1933).[18] An attor-

[18] This rule was changed by statute. Section 173 of the Internal Revenue Code, which originated in Section 204(a) of the Revenue Act of 1950, ch. 994, 64 Stat. 906, generally provides that "[n]otwithstanding section 263, all expenditures

ney's license to practice law in a particular state (*Sharon* v. *Commissioner*, 66 T.C. 515, 527, 530-531 (1976), aff'd, 591 F.2d 1273 (9th Cir. 1978)) and a doctor's right to practice in a partcular hospital (*Walters* v. *Commisisoner*, 383 F.2d 922, 924 (6th Cir. 1967); *Wells-Lee* v. *Commissioner*, 360 F.2. 665, 670 (8th Cir. 1966)) have been treated as intangible assets to be capitalized by the taxpayer.

The concept of intangible assets is sufficiently flexible that any sort of advantage or benefit *could* be characterized as an asset. Petitioner (Br. 38-40) and the amicus (Amicus Br. 15-20) contend that an inquiry into whether an expenditure produces a significant, long-term benefit is too difficult. But since all sorts of future benefits arguably can be characterized as assets, adoption of petitioner's "separate asset" test would simply shift the difficult inquiry each case requires to a different set of words. Changing the vocabulary might tend to obscure, but would not alter, the necessary analysis.[19]

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* * * to establish, maintain, or increase the circulation of a newspaper, magazine, or other periodical shall be allowed as a deduction." See S. Rep. No. 2375, 81st Cong., 2d Sess. 63-64 (1950); see generally *Florida Publishing Co.* v. *Commissioner*, 64 T.C. at 276-278.

[19] In *Briarcliff Candy*, the Second Circuit stated that the requisite "asset" must have "an ascertainable and measurable value" (475 F.2d at 784) and be "convertible into cash" (*id.* at 786). This narrow view of what constitutes an asset is demonstrably wrong. The premium at issue in *Lincoln Savings* gave the taxpayer an interest in the FSLIC's secondary reserve. The taxpayer's interest, however, was not readily saleable or convertible into cash. The interest could be transferred only in a merger, consolidation, or similar transaction. See 403 U.S. at 350, 355. In *Mississippi Chemical*, the Court held that the taxpayer's cost incurred in buying stock in the Federal Farm Credit System was a nondeductible capital

2. Petitioner makes no serious attempt to contend that allowing it a current deduction for the expenses it has incurred would clearly reflect its income. The expenses were incurred not for "the income production or other needs of the more immediate present" but, rather, to facilitate a takeover that would provide benefits to petitioner "for the indefinite future" (*General Bancshares*, 326 F.2d at 715). Petitioner's real complaint (Br. 34) is that it cannot amortize and deduct those expenditures over a period of years. An intangible asset with a limited useful life the length of which can be estimated with reasonable accuracy may, pursuant to Treas. Reg. § 1.167(a)-(3), be the subject of a depreciation allowance. But an "intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation." *Ibid.* Contrary to petitioner's assertion (Br. 34-35), the reason that it is not entitled to depreciation or amortization deductions with respect to these expenditures is not that they do not represent an "asset" or benefit to the corporation.[20] Rather, as the

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expenditure. That stock was "transferable only between cooperatives and only under rare circumstances." 405 U.S. at 307-308. Moreover, the Court found no need to value the stock (*id.* at 311), indicating that there is no requirement that the value of the asset be ascertainable.

[20] The cost of such "assets" as an attorney's license to practice law (*Sharon* v. *Commissioner*, 66 T.C. at 530-531), and a doctor's right to practice in a particular hospital (*Wells-Lee* v. *Commissioner*, 360 F.2d at 672-673), have been allowed to be amortized over the estimated life of the asset. Other examples abound. For example, the costs incurred in obtaining a loan are amortizable over the term of the loan. See *Duffy* v. *United States*, 690 F.2d 889, 895 (Ct. Cl. 1982); *Lovejoy* v. *Commissioner*, 18 B.T.A. 1179, 1182-1183 (1930); Rev. Rul. 70-360, 1970-2 C.B. 103.

court of appeals correctly observed (Pet. App. 16a-17a), "the fees and expenses at issue are not susceptible to depreciation or amortization because the benefit to the company has no ascertainable useful life."

Petitioner errs in contending (Br. 35) that it is anomalous to capitalize an expense that cannot be amortized over a specific period of years. Prior to enactment of Section 248 of the Internal Revenue Code of 1954, the expenses of incorporation represented permanent capital charges that were not deductible unless the corporation's charter had a limited term, in which event they could be amortized and deducted over the life of the charter. See, *e.g.*, *Hershey Mfg. Co.* v. *Commissioner*, 43 F.2d 298, 300 (10th Cir. 1930); B. Bittker & J. Eustice, *supra*, ¶ 5.06, at 5-29. Section 248 now allows "organizational expenditures," *i.e.*, expenditures that are "incident to the creation of the corporation" (26 U.S.C. 248(b)), to be amortized over a period of 60 months. Section 248, however, does not apply to expenditures incurred in connection with a reorganization of a corporation or with other changes in the structure of the corporation, because such expenditures are not incident to the creation of a corporation. See *McCroy Corp.* v. *United States*, 651 F.2d at 832 n.5; Treas. Reg. § 1.248-1(b)(4); B. Bittker & Eustice, *supra*, ¶ 5.06, at 5-31. It has therefore consistently been held that expenditures "incurred for the purpose of changing the corporate structure for the benefit of future operations" (*General Bancshares*, 326 F.2d at 715) cannot be deducted over any specific period of years.[21]

[21] Petitioner also errs in contending that Section 195 of the Internal Revenue Code, which allows amortization of "start-up

Contrary to petitioner's claim (Br. 36), this does not mean that we contend that its capital expenditures will *never* be deductible. Permanent capital charges, such as organizational expenditures, are deductible as a loss at the time the corporation is dissolved. *Bryant Heater Co.* v. *Commissioner*, 231 F.2d 938, 940 (6th Cir. 1956); *Shellabarger Grain Products Co.* v. *Commissioner*, 146 F.2d 177, 185 (7th Cir. 1944). This rule is based on the premise that, when a corporation is completely dissolved, it loses

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expenditures," reflects congressional approval of the "separate and distinct asset" test (Br. 33-34). Section 195(b)(1) allows taxpayers to elect to amortize start-up expenditures over a period of not less than 60 months. In general, start-up expenditures are amounts incurred in connection with investigating the creation or acquisition of an active trade or business or with creating an active trade or business. 26 U.S.C. 195(c)(1)(A). Petitioner focuses on the provision that an expenditure is eligible for amortization only if it "would be allowable as a deduction" if it were "paid or incurred in connection with the operation of an existing active trade or business." 26 U.S.C. 195(c)(1)(B). Rejection of an all-encompassing "separate asset" test does not, as petitioner contends (Br. 33), "nullify Section 195." Section 195 merely recognizes that expenditures incurred in carrying on or expanding an existing business generally are deductible under Section 162(a), while expenditures incurred in creating a new business and expenditures incurred by a going concern in entering a new line of business are capital expenditures. See H.R. Rep. No. 1278, 96th Cong., 2d Sess. 11 (1980):

> In the case of an existing business, eligible startup expenditures do not include deductible ordinary and necessary business expenses paid or incurred in connection with an expansion of the business. As under present law, these expenses will continue to be currently deductible. The determinaiton of whether there is an expansion of an existing business or a creation or acquisition of a new trade or business is to be based on the facts and circumstances of each case as under present law.

its identity and its privilege of doing business as a corporation and is entitled to a deduction for the amounts incurred in creating those attributes.[22] The same rule applies to expenses of a reorganization or other change in the structure of a corporation, which may be deducted as a loss upon dissolution. See *McCrory Corp.* v. *United States*, 651 F.2d at 833.

Not all situations in which a corporation ceases to exist, however, result in a complete termination of corporate life. When a corporation merges into an acquiring corporation, "the attributes of corporate life [of the acquired corporation] are transferred to the surviving corporation and are there continued and preserved." *Vulcan Materials Co.* v. *United States*, 446 F.2d 690, 694 (5th Cir. 1971), cert. denied, 404 U.S. 942 (1971). In such situations, the capitalized organization expenses of the acquired corporation are not deductible upon the merger. 446 F.2d at 694-695; *Canal-Randolph Corp.* v. *United States*, 568 F.2d 28, 31-32 (7th Cir. 1977); *Citizens Trust Co.* v. *Commissioner*, 20 B.T.A. 392 (1930). The correct timing for the *future* deduction of the specific expenditures that petitioner has incurred thus depends on future events that are not presented in this case.

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[22] At a corporation's complete liquidation, realized gains and losses are recognized under Section 336(a) of the Code. 26 U.S.C. 336(a). At that time, the loss associated with the liquidation of the corporate structure may be set off against gain recognized for other corporate assets. The expenses incurred by petitioner for its reorganization would be allowed as a deduction against the income that results from gains (or other income) recognized at its liquidation.

E. The Expenditures Incurred By Petitioner To Facilitate Its Acquisition And Reorganization Are Capital Expenses

1. The distinction between capital expenditures and currently deductible expenses is, as the Court recognized in *Lincoln Savings*, "often difficult." 403 U.S. at 353 (quoting *Commissioner* v. *Tellier*, 383 U.S. at 689).[23] With respect to expenditures that produce future benefits, difficult cases may arise where the expense is recurring in nature, the benefits are short-lived, or the expense produces both current and future benefits. Unlike those more difficult cases, the analysis required in the present case is not complex because the expenditures were incurred in a transaction that produced significant permanent benefits for petitioner.

The Tax Court found 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 the production of income." Pet. App. 30a. The court noted that "petitioner's directors determined that it would be in petitioner's long-term interest to shift ownership of the corporate stock to Unilever." *Id.* at 27a. The transaction provided at least two inherently permanent benefits to petitioner: the "availability of the Unilever group's enormous resources," and "the opportunity for 'synergy' " created by petitioner's affiliation with Unilever. *Id.* at 28a. The court of appeals upheld the Tax Court's findings (*id.* at 12a-

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[23] Indeed, the Court long ago determined that, given the myriad circumstances in which the capital-versus-ordinary controversy arises, "[t]o attempt to harmonize [all of such cases] would be a futile task." *Welch* v. *Helvering*, 290 U.S. at 116.

14a) and petitioner does not directly challenge them here.[24] There is, thus, no basis to disturb the findings "concurred in by the two lower courts" (*Rogers* v. *Lodge*, 458 U.S. 613, 623 (1982)) that the expenditures in this case produced permanent benefits to petitioner. See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985). Since the expenditures provided permanent benefits to petitioner that will help generate income over an indeterminable future period, deduction of the expenses in the current period would quite obviously not yield a clear reflection of petitioner's income. See 1 B. Bittker & L. Lokken, *supra*, ¶ 20.4.1, at 20-69.

The complex transaction involved in this case effected a change in petitioner's "corporate structure for the benefit of future operations," and the associated expenses therefore "are not ordinary and necessary business expenses." *General Bancshares Corp.*

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[24] In the court of appeals, petitioner attacked the Tax Court findings that the expenditures resulted in future benefits, but petitioner did not contend that the expenditures resulted in a current, short-term benefit or were in any way related to the production of current income. Rather, petitioner's argument was that "there is no evidence of any benefit to [petitioner], either immediate or long-term" (Appellant's Br. 37). Petitioner now contends that the expenditures produced a current benefit because they "protected [the] members [of petitioner's board of directors] from personal liability for failure" to "carry out [their] fiduciary duty" (Br. 40). There can be no serious doubt that, as the Tax Court found (Pet. App. 30a), "the dominant aspect of the transaction was the transfer of petitioner's stock for the benefit of petitioner and its shareholders." The Tax Court aptly observed (*ibid.*): "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."

v. *Commissioner*, 326 F.2d at 715. The corporate merger that occurred is a form of reorganization specifically recognized by Section 368(a)(1)(A) of the Internal Revenue Code. The merger of NSC Merger, Inc. into petitioner may have been a procedural device to assure elimination of recalcitrant stockholders, but the merger brought with it cash adequate to cancel some five million shares of petitioner's stock at $73.50 per share. The cancellation of those shares, along with the 1,313,383 acquired by Holding on the Section 351 exchange, can hardly be thought to have left petitioner's corporate structure unaltered. These changes, coupled with the reduction of petitioner's authorized shares from 8,000,000 shares of common stock (with a par value of $.50 per share) to 1,000 shares (with a par value of $1.00 per share) (J.A. 13, 16), substantially altered petitioner's structure.

Petitioner's transformation from a publicly held, free-standing corporation to a corporation with but one stockholder effected a radical change in the corporate enterprise. Now that petitioner has only one shareholder, it no longer need be concerned with shareholder relations. See Pet. App. 4a (petitioner's management "viewed the transaction as 'swapping approximately 3500 shareholders for one'"); J.A. 223. Petitioner will not be involved in any proxy fights brought by dissatisfied shareholders seeking to change corporate policy or oust the board of directors. Petitioner will not need to worry about state law rules mandating fair treatment of shareholders. Petitioner will not be involved in any shareholder's derivative suits. Petitioner can avoid the expense of annual filing of Forms 10-K with the Securities and Exchange Commission and of soliciting proxies for voting on the board of directors and other matters. Petitioner acknowledges that "[e]very corporation, particularly a publicly held corporation whose shares are traded on a securities exchange, is required to incur a substantial amount of expenses that are directly related to its stockholders" because of the corporation's obligations "to provide information about its business activities and financial results to its stockholders and the public" and "to permit stockholders to select the corporation's directors and to vote on major corporate transactions" (Br. 24). Petitioner will no longer incur these "substantial" expenses.

The benefits that petitioner now receives will last "for the indefinite future." *General Bancshares Corp.* v. *Commissioner*, 326 F. 2d at 715. They constitute a permanent betterment of petitioner's corporate enterprise, unless Unilever hereafter decides to make some other change in petitioner's corporate structure. Since the expenditures at issue effected a "restructuring of the enterprise" and "resulted in a benefit to the taxpayer which could be expected to produce returns for many years in the future" (*E.I. du Pont de Nemours Co.* v. *United States*, 432 F. 2d at 1059), the expenditures were undoubtedly capital in nature.[25]

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[25] A transaction that alters a publicly-held corporation to a private corporation quite obviously effects a significant change in the taxpayer's structure. Even a closely-held corporation undergoes a meaningful change in its structure if it becomes a one-shareholder corporation, since it will no longer be subject to disagreements (or deadlocks) among its shareholders.

Unilever acquired all of petitioner's stock in order to acquire petitioner's manufacturing business.[26] Unilever could have acquired petitioner's business by acquiring all of petitioner's assets. The costs incurred by petitioner in that transaction would not have been deductible. See *Odorono Co.* v. *Commissioner*, 26 B.T.A. at 1357-1358. Unilever could have acquired petitioner's business by acquiring petitioner's stock and merging petitioner into one of the corporations in the Unilever group. The costs incurred by petitioner in that transaction similarly would not have been deductible. See *Motion Picture Capital Corp.* v. *Commissioner*, 80 F. 2d at 873-874 (expenses incurred by a corporation to facilitate its acquisition and reorganization were "not necessary in the ordinary course of its [business]"). Unilever did not, however, use either of those methods to carry out the acquisiiton: it chose instead to follow a more complex, multi-stage procedure. The end result of the acquisition process, and the resulting tax consequences for the expenses incurred by the acquired corporation in facilitating the transaction, should be the same in all three situations. See B. Bittker & J. Eustice, *supra*, ¶ 5.06 at 5-36:

> The *acquired* corporation's reorganization expenses in an acquisitive reorganization transaction likewise are generally not deductible currently.

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[26] Any costs incurred by Unilever in the acquisition of petitioner's stock (such as legal and investment banking fees) are also capital expenditures (*Woodward* v. *Commissioner*, 397 U.S. at 575), as are any costs petitioners' shareholders might have incurred in disposing of their stock (*Third Nat'l Bank* v. *United States*, 427 F.2d 343, 344 (6th Cir. 1970)).

2. Petitioner contends (Br. 24-25) that its expenditures in this case are similar to the expenses in proxy contests that have been held deductible under Section 162(a). See *Central Foundry Co.* v. *Commissioner*, 49 T.C. 234 (1967); *Locke Mfg. Cos.* v. *United States*, 237 F. Supp. 80 (D. Conn. 1964); Rev. Rul. 67-1, 1967-1 C.B. 28. Proxy contest expenses incurred by a corporation "in order to defend the policies of its directors from attack by those who would oppose them" are deductible (*Locke*, 237 F. Supp. at 86-87), as are proxy contest expenses incurred by insurgent shareholders to protect the corporation from "alleged poor judgment in management" (*Central Foundry Co.* v. *Commissioner*, 49 T.C. at 251). Such proxy contest expenses are deductible under the rationale that expenses incurred to prevent harm to an ongoing business are currently deductible. See *Commissioner* v. *Tellier*, 383 U.S. at 689-690 (attorney's fees incurred by taxpayer to defend himself from criminal charges arising out of his business were deductible under Section 162(a)); *Commissioner* v. *Heininger*, 320 U.S. 467, 470-472 (1943) (attorney's fees incurred by taxpayer to defend his business from threatened destruction were deductible); *Welch* v. *Helvering*, 290 U.S. at 114 (expenses of a "defense against attack" on a business would be deductible). The primary purpose of such expenses is to prevent immediate damage to the business; any future benefit is incidental. In the present case, by contrast, the future benefits stemming from Unilever's acquisition of petitioner's business operations were the primary focus of the transaction.

Petitioner also contends that its expenditures are currently deductible because they are "stockholder relations expenses" (Br. 24). But labeling an expense as a "stockholder relations expense" does not make it deductible. The cost of listing a stock on an exchange is a non-deductible capital expenditure because "the rights and benefits thereby acquired continued indefinitely." *Dome Mines, Ltd.* v. *Commissioner*, 20 B.T.A. 377, 378 (1930). The annually recurring cost of maintaining the listing, however, is currently deductible because that cost, even if capital in nature, "is one made for a capital item which is exhausted within one year." *Chesapeake Corp.* v. *Commissioner*, 17 T.C. 668, 675 (1951); see also *Affiliated Capital Corp.* v. *Commissioner*, 88 T.C. 1157, 1169-1170 (1987). The question whether a "stockholder relations expense" is a capital expenditure or currently deductible thus depends on the duration of the benefit produced by the expense. Although "corporate housekeeping expenses" such as "annual reports, shareholder relations, proxy solicitation costs, and the like" are deductible under Section 162(a) (B. Bittker & J. Eustice, *supra*, ¶ 5.04, at 5-21 n.56), the expenditures at issue here were not recurring in nature but were made in connection with a nonrecurring transaction that produced permanent benefits. The expenditures are therefore "capital in nature" (*Lincoln Savings*, 403 U.S. at 354) and are not currently deductible under Section 162(a).

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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