Petitioner's Reply Brief

No. 90-1278

In the Supreme Court of the United States

OCTOBER TERM, 1991

INDOPCO, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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

REPLY BRIEF FOR PETITIONER

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The issue before this Court is the standard for determining whether an expenditure is currently deductible as an ordinary expense under Section 162(a) of the Code or should be capitalized. Indeed, the Commissioner urged that certiorari be granted because the "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 Respondent on petition for certiorari at 16. The Commissioner, however, now seeks to avoid defining an "appropriate test" and instead asserts that "[t]here is no readily available formula for . . . every context", that "the courts have employed a variety of general standards" and that the analysis should "properly focus[] 'on whether income will be better reflected by deducting or by capitalizing the amount in question' ". Br. 13. That indeterminacy is not the law, nor should it be.

As petitioner[1] has shown in its opening brief (at 29-36), Section 162(a) and several other Code provisions form part of a coherent tax accounting system that is designed clearly to reflect taxable income by matching the taxpayer's revenues in each taxable period with the expenses of producing them. The Commissioner, although recognizing this general principle (Br. 11), simply ignores the interrelationship among these provisions and their demonstration of Congress' intent to rest the distinction between ordinary expenses and capital expenditures on the existence of "property" or an "asset". This Court's decision in *Lincoln Savings* requiring the creation or

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[1] The information regarding the parties to this proceeding set forth at page ii of petitioner's opening brief is currently accurate, except that the following are no longer non-wholly owned subsidiaries of petitioner: Aromaticos Petroquimicos, S. de R.L.; Lorenz-National Industrial Ltda.; and Norda S. de R.L.

enhancement of an asset implements that statutory scheme. *See* Point I, *infra*.

In contrast, the Commissioner's approach is unprincipled; it would require taxpayers, the Internal Revenue Service and the courts to determine whether expenditures should be deducted or capitalized on the basis of their individual perceptions of what will clearly reflect income in the factual circumstances of each particular case, thereby undermining the important goals of predictability of tax results and uniform treatment of similarly situated taxpayers. *See* Point II, *infra*.

Moreover, the Commissioner's application of so-called "particularized principles" to this case conflicts not only with *Lincoln Savings* and other decisions of this Court, but also with the facts of this case as found by the Tax Court. *See* Point III, *infra*.

Argument

I. THIS COURT IN *LINCOLN SAVINGS* ENUNCIATED A TEST THAT IMPLEMENTS THE STATUTORY SCHEME FOR DISTINGUISHING BETWEEN ORDINARY EXPENSES AND CAPITAL EXPENDITURES.

The ultimate goal of the Internal Revenue Code's tax accounting system, including the "ordinary" requirement of Section 162(a), is to achieve a clear reflection of taxable income. The Commissioner agrees. Br. 11. Taxable income is clearly reflected when the taxpayer's revenues in each taxable period are matched with the expenses of producing them. The Commissioner agrees. Br. 11. The statutory scheme achieves this matching with respect to capitalized expenditures by providing for their recovery through depreciation or amortization and through a deduction of any undepreciated or unamortized costs from the proceeds realized upon a sale or other disposition. The

Commissioner does not dispute this, but fails to address the significance of these elements of the statutory scheme.

These matching provisions all require an item of "property" or "asset" to which a capitalized expenditure has been assigned as "basis". Thus, for example, Section 167 allows depreciation deductions for "property used in the trade or business". App. 1a. Similarly, Treas. Reg. § 1.167(a)-3 (1956) allows amortization of an "intangible asset". App. 6a-7a. Likewise, in determining the amount of allowable depreciation, a depreciation rate is applied to the "basis" of property, which is its cost. *E.g.*, Treas. Reg. § 1.167(a)-11(c)(1)(i)(*d*)(1971); Section 1012 (App. 5a, 7a). And Section 1001(a) provides that gain or loss from a sale or other disposition of "property" is computed by reference to the "adjusted basis" of the property (*i.e.*, its cost less depreciation or amortization). App. 5a.

Since Section 162(a) and these other matching provisions have the same basic purpose, they should be construed in a consistent manner. The specific reference to "property" or "asset" in each instance manifests Congress' intent to draw the line between an ordinary expense and a capital expenditure precisely where this Court in *Lincoln Savings* held that it must be drawn—where a separate and distinct asset is created or enhanced. The Commissioner offers no response to this analysis of the statutory scheme.

Moreover, the *Lincoln Savings* test furthers both aspects of the clear reflection of income principle: first, it denies a current deduction for an expenditure that creates or enhances an asset with a value lasting beyond the taxable year; and, second, it permits recovery of the capitalized cost of such an asset as its value is used up (either over a period of years if its useful life is ascertainable or when the asset is sold or otherwise disposed of). In contrast, any approach that requires capitalization of expenditures without any property or asset to which those expenditures can be assigned as basis would effectively negate the second aspect of the clear reflection of income principle. Since the matching provisions could not operate in such a case, this approach would necessarily deny any recovery of the capitalized costs, as the Commissioner says (Br. 37-38), until the taxpayer ceases to exist (and not even then if the taxpayer merges into another corporation). Thus, the denial of cost recovery would extend far beyond the revenue-producing life of the capitalized expenditures, and would in practical effect amount to a complete denial. This approach, we submit, would defeat the congressional goal of clearly reflecting income.[2]

The Commissioner, however, argues that in *Lincoln Savings* this Court "did not hold that a capital expenditure occurs *only* when a separate and distinct asset is

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[2] The Commissioner also misapprehends the significance of Section 195, which likewise reflects this congressional goal. Contrary to the Commissioner's assertion that Section 195 recognizes that expenditures to create a new business are "capital expenditures" (Br. 37, n.21), Section 195 was enacted in response to a line of cases holding that "[e]xpenses prior to the establishment of a business . . . are not deductible currently since they are not incurred in carrying on a trade or business or while engaging in a profit-seeking activity". S. Rep. No. 96-1036, 96th Cong., 2d Sess. 10 (1980). This denial of cost recovery was inconsistent with the statutory goal of taxing net, and not gross, income, and Congress decided to permit amortization of such expenses over five years. In doing so, Congress limited the expenses eligible for amortization to those that would have been deductible had they been incurred by an existing business—*i.e.*, that would *not* have had to be capitalized. *Id.* at 12 ("startup expenditures do not include amounts paid or incurred for the acquisition of . . . property which may be depreciated or amortized based on its useful life"). The court of appeals' future benefit test would require capitalization and thus deny Section 195 amortization of all start-up expenditures, since the attainment of a future benefit is the sole purpose of such expenditures. Thus, adoption of the future benefit test would nullify Section 195 and thwart the intent of Congress to permit cost recovery in such situations. The Commissioner's approach suffers from the same basic flaw.

involved." Br. 21-22. This argument is wrong; it ignores the salient facts of the case, the arguments of the parties and the process of reasoning followed by this Court in reaching its decision.

The insurance premiums in question in *Lincoln Savings* clearly created a significant long-term benefit for the taxpayer, and not just "some" future benefit, as they were " 'in the nature of a prepayment with respect to future premiums,' " 403 U.S. at 348 (quoting 12 U.S.C. § 1727(d)). The taxpayer devoted an entire section of its brief to its contention that "The Possibility of a Future Benefit Does Not Convert an Ordinary and Necessary Business Expense Into a Capital Expenditure". Brief for Respondent in *Lincoln Savings* at 18-29. This Court did not reject that argument. It held that what was "controlling" was that the premiums served to create or enhance a separate and distinct asset (*id.* at 354), and it undertook a careful analysis showing that the premiums had created a "distinct and recognized property interest" (*id.* at 355).[3] In making this analysis, this Court considered at least five factors: whether the interest acquired by the taxpayer's payment of the premiums was transferable, whether it was redeemable for cash; whether it could be used to satisfy other obligations of the taxpayer; whether it was separately accounted for by the grantor of the interest (FSLIC) and by the taxpayer; and whether it earned income for the taxpayer on a periodic basis. *Id.* at 355-56. All of this would have been pointless if the insurance premiums had been capitalizable even without an asset.

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[3] Contrary to the Commissioner's suggestion (Br. 23), petitioner does not contend that this Court established a "new" test for determining whether expenditures are capital in nature. Rather, in succinct language, this Court distilled the essence of the capital expenditure test that had long been followed by most courts. *See* petitioner's opening brief (at 15 & n.8).

Until the decision by the court below, the courts of appeals had for twenty years consistently construed this Court's opinion in *Lincoln Savings* as mandating the allowance of a current deduction for costs that do not create or enhance an asset and therefore cannot be recovered under the statutory scheme.[4] And the Commissioner—albeit somewhat inconsistently—has similarly interpreted *Lincoln Savings*.[5] Indeed, the Treasury

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[4] Although the Commissioner now contends that only two Circuits (the Second and Fourth) have followed the *Lincoln Savings* test, he admitted in the court of appeals that four Circuits (the Second, Fourth, Ninth and Tenth) followed it. Brief for Appellee at 30. In addition, it cannot be denied that, despite the obvious future benefit to be gained from establishing new bank branches, the Fifth Circuit saw the question before it as "whether [that] . . . creates a separate and distinct additional asset", *Central Tex. Sav. & Loan Ass'n v. United States*, 731 F.2d 1181, 1184 (5th Cir. 1984), and the Eighth Circuit expressly relied on *Lincoln Savings* in allowing a deduction for expenses incurred in obtaining credit information on "prospective" credit card customers, *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979). Moreover, contrary to the Commissioner's assertion (Br. 28), the Eleventh Circuit in *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983), did not criticize the decisions in *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775 (2d Cir. 1973), and *NCNB Corp. v. United States*, 684 F.2d 285 (4th Cir. 1982), for following *Lincoln Savings*. It simply said that, although the question was not before it (since the taxpayer there had acquired stock of subsidiaries), it would probably view the "investigation . . . of specific potential branch locations [as] creat[ing] an asset". 688 F.2d at 1380 n.7. Furthermore, we fail to see why the dissenting opinion in *NCNB Corp.* undercuts the Fourth Circuit's en banc decision in that case, as the Commissioner seems to suggest (Br. 28).

[5] Contrary to the Commissioner's argument (Br. 29), he clearly interpreted *Lincoln Savings* as requiring a separate and distinct asset, and not just a future benefit, in Rev. Rul. 83-66, 1983-1 C.B. 43. In that ruling, there was "an expectancy that a refund [of insurance premiums] may be forthcoming in a future tax year" (like the possibility of future assistance found by the courts below in this case), and the Commissioner expressly held that such an expectancy "does not create an asset in the hands of the taxpayer paying the premium". 1983-1 C.B. at 44-45. Moreover, the technical advice and general counsel memoranda in which the Commissioner interpreted *Lincoln*

Department specifically stated to Congress, in connection with the enactment of Section 195 after this Court's decision in *Lincoln Savings*, that costs incurred in an "existing trade or business are currently deductible if . . . the costs do not create a separate asset". *Hearings on H.R. 5729 Before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee*, 96th Cong., 2d Sess. 11 (1979) (statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury for Tax Policy).

Contrary to the Commissioner's argument (Br. 25-26), the *Lincoln Savings* test does not require a *sub silentio* overruling of *Welch v. Helvering*, 290 U.S. 111 (1933). The decision in *Welch* rested on a finding either that the expenditures in question were "extraordinary" rather than "ordinary" (290 U.S. at 114), or that they enhanced the taxpayer's "reputation and good will" (clearly a separate asset for tax purposes), as the Commissioner had claimed (290 U.S. at 113, 115). It is thus consistent with *Lincoln Savings*. Nor do this Court's decisions in *United States v. Mississippi Chemical Corp.*, 405 U.S. 298 (1972), and *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974), "demonstrate that *Lincoln Savings* did not establish an exclusive 'separate and distinct asset' test", as the Commissioner argues (Br. 26). In both of those cases, a separate and distinct asset was undeniably present: stock of a Bank for Cooperatives in the former and electrical transmission and distribution facilities and transportation equipment used in their construction in the latter. The only question presented in *Mississippi Chemical* was whether the payments for the stock represented, as the

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Savings in this way (*see* petitioner's opening brief at 27-29) are relevant here for the same reason that similar rulings were considered by this Court in *Rowan Cos., Inc. v. United States*, 452 U.S. 247, 261 n.17 (1981): they are "evidence" of the Commissioner's interpretation of a statutory term in light of relevant authority.

taxpayer contended, "a charge for borrowing money [deductible under Section 163, not 162(a)] since the stock ha[d] no value". 405 U.S. at 309. This Court rejected that contention because it found that "the *stock* . . . [was] indeed valuable".[6] *Id.* (emphasis added). The only question presented in *Idaho Power* was whether depreciation on the transportation equipment should be allowed under Section 167 over the life of the transportation equipment or should be capitalized as part of the construction cost of the facilities and depreciated over the longer life of those facilities. 418 U.S. at 10. This Court chose the latter alternative. *Id.* at 13-19. Thus, the question whether an expenditure can be capitalized in the absence of an asset was not involved in either case.

II. THE COMMISSIONER'S UNPRINCIPLED APPROACH WOULD UNDERMINE PREDICTABLE AND EVENHANDED ADMINISTRATION OF THE TAX LAW.

What test for capitalization does the Commissioner now espouse? The answer to this question is not readily apparent.

The Commissioner states that the "hallmark of a capital expense is that it creates 'value in more than one taxable year' " (Br. 9 (quoting *Mississippi Chemical*, 405 U.S. at 310)), but, on the other hand, that "[t]here is no readily available formula for . . . every context", that "the courts have employed a variety of general standards" and

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[6] The Commissioner, in quoting two passages from this Court's opinion in *Mississippi Chemical* (Br. 9, 27), truncates each quotation and substitutes his own term "expense". These two passages actually read as follows: "*the security is of* value in more than one taxable year", 405 U.S. at 310 (omitted words emphasized); and "*this stock was endowed with a* long-term value", *id.* at 312 (omitted words emphasized). Thus, this Court did not find, as the Commissioner claims, that the "expense" gave rise to a long-term value; rather, it held that the stock—clearly a separate asset—had a long-term value.

that "the analysis properly focuses 'on whether income will be better reflected by deducting or by capitalizing the amount in question'" (Br. 13 (quoting 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 20.4.1, at 20-69 (2d ed. 1989))). The Commissioner identifies two "general standards" that he says have been employed by the courts: whether the expense is "recurring" or "nonrecurring", and whether the "purpose" or "result" of the expense is a future benefit to the taxpayer. Br. 13-14 (quoting *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 217 (7th Cir. 1982); *E. I. du Pont de Nemours & Co. v. United States*, 432 F.2d 1052, 1059 (3d Cir. 1970); *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 715 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964)). It appears that, in essence, the Commissioner does not endorse any general formulation and, instead, advocates using whatever "particularized principles" (Br. 20) seem appropriate in each individual case. The choice of principles apparently would depend upon what the taxpayer, the Internal Revenue Service or a court concludes would produce a "clear reflection of income".

This approach, we submit, amounts to a complete rejection of any capitalization test. It would, instead, require taxpayers to deduct or capitalize expenditures on the basis of their individual perceptions of what will clearly reflect income in the factual circumstances of each particular case, and would require the Internal Revenue Service and the courts to review those individual determinations from the same perspective. This approach, even more than the court of appeals' future benefit test, would in large measure frustrate the important objectives of predictability of tax results and uniform treatment of similarly situated taxpayers and would burden the Internal Revenue Service and the courts with a case-by-case resolution of controversies. It would mark a return to the "state of hopeless confusion" existing before *Lincoln Savings*, when, as the Court of Appeals for the Second Circuit stated, determinations were made by "administrative fiat" for which it was impossible to find any common rationale. *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 785 (2d Cir. 1973).

Petitioner's opening brief discussed (at 37-40) the difficulty of applying the court of appeals' future benefit formulation to many common expenditures, as well as those involved in this case.[7] The Commissioner not only fails to respond to this showing, but would multiply these difficulties by, in effect, doing away with any controlling test in favor of greater indeterminacy. Under the Commissioner's approach, taxpayers would continually confront essentially unanswerable questions in deciding how to treat expenses incurred for advertising and promoting their products and services, developing new ways of marketing their products and services, recruiting, training and devising compensation plans for employees, securing supplies of raw materials, improving relationships with customers, suppliers, creditors and the community, and engaging in many other normal business activities, all of which can produce significant amounts of income in both the current and future years. Moreover, the Commissioner's approach might well reopen questions decided by the courts of appeals after *Lincoln Savings*. *See* petitioner's opening brief (at 25-27). Would it clearly reflect income to disallow any deductions for the branch opening, credit card and other expenses involved in those cases until the taxpayers ceased to exist?[8]

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[7] The Commissioner does not mention in his argument, and does not specifically attempt to support, the court of appeals' formulation that any expenditure producing a "not insignificant future benefit that is more than merely incidental" (J.A. 266) must be capitalized.

[8] The Commissioner's assertion (Br. 34) that the separate and distinct asset test simply shifts the inquiry to a different set of words,

The Commissioner's unprincipled approach should be rejected because it would undermine predictable and evenhanded administration of the tax law.

III. THE COMMISSIONER'S APPLICATION OF SO-CALLED "PARTICULARIZED PRINCIPLES" TO THIS CASE IS ERRONEOUS.

The Commissioner's position, stated in the last two sentences of his argument, is that petitioner's expenditures are "capital in nature" because they "were not recurring in nature but were made in connection with a nonrecurring transaction that produced permanent benefits." Br. 45. This position is wrong for at least four reasons.

First, as shown in Point I, *supra*, the Commissioner's argument wrongly advocates a regime that would capitalize expenditures without regard to whether an asset has been created or enhanced.

Second, this Court has specifically held that the nonrecurring nature of an expenditure is irrelevant, provided

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leaving the analysis the same, is wrong. This can be seen most clearly in the instant case, where the court of appeals had no difficulty in concluding that no asset had been created or enhanced, but found that, without that test, determining the appropriate treatment of petitioner's expenses represented "a particularly difficult inquiry" (J.A. 265). Moreover, the inquiry undertaken by this Court in *Lincoln Savings* did not involve just a subjective prediction about the future effect of an expenditure on the taxpayer's business, but rather a determination, based on existing facts, as to whether the expenditure resulted in a "distinct and recognized property interest" (403 U.S. at 355-56). Although this Court did not attempt to define the precise scope of that concept for this purpose, it clearly indicated that the concept of property generally recognized in nontax areas of the law is to be the basic guideline, and, as described *supra*, p. 5, it enumerated several facets of that concept found in the facts before it. Each of the cases criticized by the Commissioner as taking "an extremely broad view of what constitutes an asset" (Br. 33-34) in fact involved generally recognized property rights of this sort.

that the expenditure is not uncommon in the taxpayer's business. *See Commissioner v. Tellier*, 383 U.S. 687 (1966) (expenses incurred to defend the taxpayer against criminal charges arising out of the conduct of his business); *Commissioner v. Heininger*, 320 U.S. 467 (1943) (expenses incurred to set aside an order depriving the taxpayer's mail order business of access to the mails). In allowing the deduction in *Tellier*, this Court held that the expenses were "ordinary business expenses, even though a 'lawsuit affecting the safety of a business may happen once in a lifetime' ". 383 U.S. at 690 (quoting *Welch v. Helvering*, 290 U.S. at 114). And in allowing the deduction in *Heininger*, this Court noted that the taxpayer's business was "threatened with complete destruction" (320 U.S. at 472), which was obviously not a recurring phenomenon for the taxpayer.[9]

The expenditures at issue here clearly meet this standard. Although Unilever's proposal to acquire petitioner's stock may not have been a recurring event for petitioner, such proposals are quite common in the corporate business world, as is the incurring of expenditures to respond to such proposals.

Third, the Commissioner errs in focusing on the benefits allegedly resulting from Unilever's acquisition

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[9] The Commissioner's reliance on the nonrecurring nature of the transaction appears to be based solely on a statement in *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d at 217, that the "distinction between recurring and nonrecurring business expenses provides a very crude but perhaps serviceable demarcation between those capital expenditures that can feasibly be capitalized and those that cannot be". Br. 13-14. The payment in question in that case, however, "was unambiguously identified with a specific capital asset". 685 F.2d at 216. The court cited no authority for its statement, and the Commissioner cites no other authority holding that the recurring or nonrecurring nature of an expense for a particular taxpayer is a test for determining whether it should be capitalized. Indeed, contrary to the Commissioner's statement regarding repairs to tangible property (Br. 14 n.6), those authorities do not mention any such test.

rather than on the benefits resulting from the expenditures themselves. This focus is inconsistent with this Court's decision in *Woodward v. Commissioner*, 397 U.S. 572 (1970). In that case, the question presented was whether professional fees incurred in connection with litigation brought to appraise the value of stock were currently deductible or had to be capitalized. This Court held that the answer to that question depended upon the "origin of the claim litigated". *Id.* at 577. Since the taxpayer incurring the fees was acquiring the stock being appraised, this Court further held that the origin of the claim litigated was "in the process of acquisition itself" (namely, the acquisition of the stock) and required the fees to be capitalized. *Id.*

Here, the taxpayer neither acquired nor disposed of any stock or other property.[10] Petitioner sought to assist its board of directors in fulfilling its fiduciary duties to the company's stockholders. J.A. 255. The Commissioner concedes this. Br. 3-4. Moreover, when petitioner engaged Morgan Stanley and incurred the expenses in question, petitioner did not know whether Morgan Stanley would find the proposed transaction to be "fair and equitable" to petitioner's stockholders, whether the board would recommend it to the stockholders (with or without such a finding) or whether the stockholders would approve it—in sum, petitioner did not know whether any acquisition would ever take place. Thus, the origin of petitioner's expenditures was its board's fiduciary duties to the company's stockholders, and not Unilever's subsequent acquisition of petitioner's stock from the stockholders. Like other stockholder relations expenses discussed in petitioner's opening brief (at 24-25), petitioner's expenditures arose out of its status as a publicly held corporation

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[10] For this reason, the cases cited by the Commissioner (Br. 15-16) relating to a *taxpayer's* purchase or sale of capital assets are irrelevant.

and were part of its ordinary and necessary expenses of doing business as such.[11]

Fourth, the Commissioner's argument that there was a permanent benefit to petitioner is based on a specious analogy to certain "corporate structure" cases. There was no change in petitioner's corporate structure of the type involved in those cases.[12]

As the foundation for this corporate structure argument, the Commissioner claims that the merger of NSC Merger, Inc. into petitioner was a tax-free merger under

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[11] The Commissioner claims that in the court of appeals petitioner did not contend that the expenses produced a current benefit to the company but argued, rather, that " 'there is no evidence of any benefit to [petitioner], either immediate or long-term' ". Br. 40 n.24. The Commissioner misquotes what petitioner said. Petitioner's argument in the court of appeals (as it was in the Tax Court) was that "there is no evidence of any benefit to National, either immediate or long-term, *from the affiliation* [with Unilever]". Brief for Petitioner-Appellant at 37 (omitted words emphasized). Petitioner has always maintained that it received a current benefit from the expenses (as described in the text above), but no significant benefit from its affiliation with Unilever. *See, e.g.*, petitioner's opening brief in this Court (at 39-40); its opening brief in the court of appeals (at 32-37); and its reply brief in that court (at 17-18).

[12] It is unclear whether this argument represents an attempt to claim that petitioner's expenditures enhanced "an intangible asset which we may call its altered corporate structure", *Mills Estate, Inc. v. Commissioner*, 206 F.2d 244, 246 (2d Cir. 1953), or an attempt to establish an "absolute rule", as the court of appeals termed it (J.A. 269), that the acquisition of a corporation's stock by a single stockholder necessarily creates a permanent benefit to the corporation requiring capitalization of its expenditures. As we show in the text, there was no change in petitioner's corporate structure of the type involved in the cases on which the Commissioner relies. Moreover, if the Commissioner is advancing an "absolute rule" of permanent benefit, such a rule, like the future benefit test itself, conflicts with *Lincoln Savings*, since it would require capitalizing expenditures without identifying any asset whose costs could be recovered, and also with *Woodward v. Commissioner*, 379 U.S. 572, since it focuses on the transaction and not on the board's fiduciary duties to stockholders.

Section 368(a)(1)(A) of the Internal Revenue Code, and that this merger brought with it cash used to cancel some five million shares of petitioner's stock and was accompanied by a reduction in the number of shares of petitioner's authorized common stock to 1,000. Br. 41. This simply misstates the facts of this case as found by the Tax Court.

In advance of Unilever's acquisition, petitioner obtained a letter ruling from the Commissioner concerning the proper tax treatment of the transaction. The Commissioner ruled that "the formation of Holding's subsidiary, NSC Merger, Inc., and the merger of that subsidiary into petitioner (a reverse subsidiary cash merger) would be disregarded for Federal tax purposes. The transaction would be a taxable sale to those shareholders who received cash . . . ."[13] J.A. 241. In support of this conclusion, the Commissioner cited a prior published ruling, Rev. Rul. 73-427, 1973-2 C.B. 301, 302, which had specifically held that a similar transaction "does not qualify as a reorganization under section 368(a)(1)(A)".[14] Record on Appeal to the Third Circuit at 567-68.

Consistent with the Commissioner's ruling, the Tax Court concluded that the merger of NSC Merger, Inc. into petitioner "was incidental to the transaction" and "will not

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[13] Thus, the Commissioner's repeated characterization of the transaction as a "reorganization" of petitioner (Br. 8, 39, 41, 43) is not in accord with this letter ruling, from which the Commissioner has not previously attempted to depart (J.A. 255 n.2).

[14] The letter ruling's conclusion that the formation of NSC Merger, Inc. and its immediate merger into petitioner should be disregarded, and the transaction should be treated as a direct sale by the stockholders to Holding, is mandated by the tax law's well-known "step transaction" doctrine—*i.e.*, "a series of formally separate steps may be amalgamated and treated as a single transaction if they are in substance integrated, interdependent, and focused toward a particular end result'. B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 14.51, at 14-175 (5th ed. 1987).

cause the expenditures to be characterized as capital expenditures". J.A. 246. The court of appeals likewise dismissed the merger, noting that the "government concedes that this merger was 'an incidental aspect of the transaction that should be disregarded' ". J.A. 255 n.2, quoting the Commissioner's Brief for Appellee at 18 n.7. Moreover, the Tax Court concluded that the amendment of petitioner's charter to eliminate its authorized but unissued preferred stock and reduce the number of its authorized shares of common stock to 1,000 "was done merely for purposes of administrative convenience and simplicity" and was "not relevant to the deductibility issue". J.A. 246. The Commissioner did not even mention this charter amendment in his brief in the court of appeals, and that court accepted the Tax Court's finding of administrative convenience in its statement of facts (J.A. 256) and made no reference to the charter amendment thereafter.

As is mandated by well-settled tax principles, this case must be judged by this Court on the basis of the substance of the transaction at issue—a direct acquisition by Holding of petitioner's stock from its stockholders. So viewed, the question is whether the capital structure cases cited by the Commissioner (Br. 17 n.9) are applicable. We submit that they are not.

In each of the cited cases in which expenditures were capitalized, the sole purpose and intended effect of the expenditures was to enhance the taxpayer's capital structure in one of the following ways: a change in the par value of stock, an increase in authorized stock or an extension of the maturity of debt obligations;[15] an issuance

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[15] *Bush Terminal Building Co. v. Commissioner*, 7 T.C. 793 (1946); *Borg & Beck Co. v. Commissioner*, 24 B.T.A. 995 (1931); *Holeproof Hosiery Co. v. Commissioner*, 11 B.T.A. 547 (1928).

of stock for cash or other assets;[16] a distribution of stock or warrants as a dividend or as a split-off of a subsidiary;[17] or a redemption of stock or warrants.[18] In contrast, Holding's acquisition of petitioner's capital stock from the stockholders changed the identity, and reduced the number, of the holders of such stock, but did not materially alter its characteristics. Nor did the transaction involve any issuance of petitioner's stock for cash or other assets or any dividend distribution with respect to, or redemption of, its stock. Thus, petitioner's capital structure was not enhanced by its expenditures. All these cases are therefore irrelevant.[19]

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[16] *McCrory Corp. v. United States*, 651 F.2d 828 (2d Cir. 1981) (issuance of stock for assets in a statutory merger).

[17] *El Paso Co. v. United States*, 694 F.2d 703 (Fed. Cir. 1982); *Bilar Tool & Die Corp. v. Commissioner*, 530 F.2d 708 (6th Cir. 1976); *E. I. du Pont de Nemours & Co. v. United States*, 432 F.2d 1052 (3d Cir. 1970); *General Bancshares Corp. v. Commissioner* 326 F.2d 712 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964); *Missouri-Kansas Pipe Line Co. v. Commissioner*, 148 F.2d 460 (3d Cir. 1945).

[18] *Jim Walter Corp. v. United States*, 498 F.2d 631 (5th Cir. 1974); *Mills Estate, Inc. v. Commissioner*, 206 F.2d 244 (2d Cir. 1953).

[19] In addition to the capital structure cases discussed above, the Commissioner cites a variety of other cases in arguing that an expenditure can be capitalized even without an asset. Br. 31-32. All but one of these cases were decided prior to this Court's decision in *Lincoln Savings* and thus cannot necessarily be regarded as valid precedent. Moreover, out of the seven cited cases, two clearly did involve a separate asset of the taxpayer, *Fall River Gas Appliance Co. v. Commissioner*, 349 F.2d 515 (1st Cir. 1965) (expenses incurred in installing leased gas appliances were capitalized as part of the cost of the leases (clearly a separate asset) and were allowed to be amortized over 12 years); *Colony Coal & Coke Corp. v. Commissioner*, 52 F.2d 923 (4th Cir. 1931) (costs of building a railroad spur were capitalized as part of the taxpayer's basis for its coal reserves (which were to be transported on the spur), and were thus recoverable through depletion of the coal (clearly a separate asset)); one case disallowed the deduction because the expense involved was not regarded as "normal, usual, or customary", *Consumers Water Co. v. United States*, 369 F. Supp. 939, 944 (D. Me. 1974) (deduction for SEC stock registration expenses

The Commissioner also argues (Br. 43) that petitioner's expenses should be capitalized because Unilever could have acquired petitioner's assets instead of its stock and, in that case, petitioner's expenses would have been required to be capitalized under *Odorono Co. v. Commissioner*, 26 B.T.A. 1355 (1932). This argument is wrong because an asset acquisition would have been partially taxable to petitioner (and would be fully taxable to petitioner under current law), *compare* Sections 337, 1245 and 1250 of the 1954 Code *with* Sections 336 and 337 of the 1986 Code,[20] and in computing its taxable gain or loss on the sale, petitioner would have been able to recover its selling expenses (including those at issue here) by deducting them from the sale price. *See, e.g., Odorono Co. v. Commissioner*, 26 B.T.A. at 1358-59 ("costs incident to . . . [a] sale of property . . . are deducted from the sale price, thereby, in taxable transactions, either reducing the

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denied because they were not " 'normal, usual, or customary' in the life of the taxpayer or 'of common or frequent occurrence' in the taxpayer's type of business", quoting *Deputy v. du Pont*, 308 U.S. 488, 495 (1940)); and two other cases disallowing educational expenses rested on the grounds that such expenses were personal rather than business in nature or were not incurred in carrying on a current trade or business, *see Weiszmann v. Commissioner*, 52 T.C. 1106, 1111 (1969), *aff'd per curiam*, 443 F.2d 29 (9th Cir. 1971) ("By attending law school, the petitioner acquired a legal education, which will be of inestimable personal value to him."); *Osborn v. Commissioner*, 3 T.C. 603, 605 (1944) ("Here the taxpayer is not incurring the expenses in the course of a business of selling the books, or of building up a business of selling the books for profit, but in the course of preparing books to demonstrate his scholastic attainments, which were to be the subject of his future exploitation."); *see also Denman v. Commissioner*, 48 T.C. 439, 446 (1967), *acq.*, 1968-1 C.B. 2 (educational expenses "are not made any less personal or transformed into business expenditures through the mechanics of capitalizing them").

[20] Since the price paid by Holding consisted 79% of cash and 21% of preferred stock, none of the tax-free reorganization provisions of the Code would have been applicable because of an insufficient continuing equity interest by petitioner's stockholders in Holding. *See, e.g.*, Rev. Proc. 66-34, 1966-2 C.B. 1232, 1233, at Sec. 3.02.

amount of the gain or increasing the amount of the loss"), and the authorities cited in petitioner's opening brief (at 23 n.17).[21] Since petitioner could have recovered its expenses against the sale price in an asset acquisition, the Commissioner's argument that the "resulting tax consequences . . . should be the same" (Br. 43) supports the allowance of a deduction for petitioner's expenses here.

The Commissioner further argues (Br. 43) that petitioner's expenses would have had to have been capitalized if Unilever had acquired petitioner's stock and then merged petitioner into one of the corporations in the Unilever group. Again, the Commissioner confuses the issue without advancing the analysis. If the subsequent merger were respected as a separate transaction, the issue would be the same as is now before this Court; the subsequent merger would have no impact on the tax treatment of the expenses associated with the prior and independent stock acquisition. If, on the other hand, the stock acquisition and the merger were combined into a single asset acquisition under the step-transaction doctrine (*see* note 14, *supra*), the expenses at issue would be recovered against the sale price, as described in the preceding paragraph. The case cited by the Commissioner in this connection, *Motion Picture Capital Corp. v. Commissioner*, 80 F.2d 872 (2d Cir. 1936), did not involve a stock acquisition followed by a merger of the newly acquired subsidiary into a corporation in the acquiring group, but only a merger of one corporation into another unrelated corporation—*i.e.*, an asset acquisition.[22]

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[21] In *Odorono*, the court assumed that the asset transaction in question was nontaxable (26 B.T.A. at 1358), so that the amount of the corporation's gain was irrelevant.

[22] After making these arguments, the Commissioner quotes a statement from B. Bittker & J. Eustice, *supra*, ¶ 5.06, at 5-36, that the "*acquired* corporation's reorganization expenses . . . likewise are generally not deductible currently". Br. 43; *see also* Br. 19. The only

Conclusion

For the foregoing reasons and the reasons given in petitioner's opening brief, the judgment of the court of appeals should be reversed, the deficiency in petitioner's federal income tax determined by the Commissioner should be set aside and the refund of tax claimed by petitioner should be allowed.

Respectfully submitted,

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cases cited in the treatise (at n.109) for that statement, however, are the Tax Court's decision in the instant case and *Motion Picture Capital Corp. v. Commissioner*, 80 F.2d 872, which as indicated above involved an acquisition of assets by merger and not a stock acquisition. As the Tax Court said, the treatment of the acquired corporation's expenses in a stock acquisition is a matter "of first impression" (J.A. 243); there is no finally decided authority for the statement quoted by the Commissioner.