Petitioner's Brief

No. 90–1278

In the Supreme Court of the United States

OCTOBER TERM, 1990

INDOPCO, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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

BRIEF FOR PETITIONER

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June 27, 1991

QUESTION PRESENTED FOR REVIEW

Twenty years ago, this Court, in *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345 (1971) (hereinafter referred to as "*Lincoln Savings*"), resolved a fundamental issue of federal income tax law, namely, what test should be applied to determine whether an expenditure is capital in nature and hence not currently deductible as a business expense under Section 162(a) of the Internal Revenue Code. As the Commissioner says, this issue "arises in virtually every area of business activity". (Brief for Respondent on petition for certiorari at 16)

In this case, the issue arises in the context of an unsolicited offer by a third party to purchase stock from petitioner's stockholders. The expenses in question were made to assist petitioner's board of directors in carrying out its fiduciary duty to the company's stockholders in connection with that offer. Petitioner itself did not sell (or buy) any stock or assets.

The question presented for review is whether the Court of Appeals for the Third Circuit (a) erred in refusing to follow the test enunciated in *Lincoln Savings* and followed by the courts of appeals for six other circuits, which requires an amount to be capitalized only where it creates or enhances a "separate and distinct additional asset", and (b) thus erroneously decided that petitioner's expenses were nondeductible capital expenditures even though, as the Court of Appeals determined, petitioner acquired "neither a tangible asset nor a readily identifiable intangible asset" as a result of those expenses.

PARTIES TO THE PROCEEDING

All parties to this proceeding are shown in the caption of the case. Until December 27, 1989, petitioner was named National Starch and Chemical Corporation, and it was so named in the captions of this case in the courts below. Petitioner is wholly owned by Unilever United States, Inc., a Delaware corporation, which in turn is presently owned 75 percent by Unilever N.V., a publicly held Netherlands corporation, and 25 percent by Unilever PLC, a publicly held United Kingdom corporation. Petitioner's non-wholly owned subsidiaries are the following:

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

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Opinions Below

The opinion of the court of appeals (J.A. 253-73)[1] is reported at 918 F.2d 426. The findings of fact and opinion of the Tax Court (J.A. 237-52) are reported at 93 T.C. 67.

Jurisdiction

The judgment of the court of appeals was entered on November 13, 1990. The petition for certiorari was filed on February 11, 1991, and certiorari was granted

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[1] References to "J.A." are to the separately bound joint appendix.

on May 13, 1991. The jurisdiction of this Court rests on 28 U.S.C. § 1254(1).

Statutory Provisions and Regulations Involved

The relevant portions of Sections 162, 167, 168, 195, 263, 351, 446, 461, 1001 and 1012 of the Internal Revenue Code of 1954, as amended (26 U.S.C.; hereinafter referred to as the "Code"), and of Sections 1.162-5(a), 1.162-20(a)(2), 1.167(a)-3, 1.167(a)-11(c)(1)(i)(*d*), 1.263(a), 1.461-1(a) and 1.1012-1(a) of the Treasury Regulations on Income Tax (26 C.F.R.), are set forth in the appendix, *infra*.

Statement of the Case

1. *Material Facts.* Petitioner (formerly named National Starch and Chemical Corporation and hereinafter referred to as "National Starch") is a Delaware corporation engaged in the manufacture and sale, primarily for industrial use, of adhesives, starches and specialty chemical products. In 1977, its stock was publicly held (by approximately 3,700 stockholders of record) and was traded on the New York Stock Exchange. In October 1977, representatives of the Unilever Group initiated discussions with National Starch regarding an acquisition of its stock from its stockholders. (J.A. 237-38)

The Unilever Group is a worldwide group of companies engaged principally in the production and sale of food, household and personal products, such as soup, tea, detergents and toilet preparations.[2] (J.A.

[2] The companies in the Unilever Group are owned, directly or indirectly, by two parent corporations—Unilever N.V., a publicly held Netherlands corporation, and Unilever PLC, a publicly held United Kingdom corporation. (J.A. 238)

13-14, 238) It had decided to acquire another business in the United States and, after examining many companies, had identified National Starch. Unilever was "very much impressed" with National Starch's management, believing that it "had demonstrated enormous strength and versatility", while Unilever did not have any "people who underst[oo]d the starch or adhesives and or other specialty chemicals" that National Starch manufactured. (J.A. 159, 168) Since Unilever wanted to retain National Starch's management, it ruled out the possibility of making a hostile bid for the company. (J.A. 168) In addition, Unilever did not believe that there would be any synergy with National Starch "in the sense that what [Unilever] could put to the business would necessarily enhance the business or vice versa". (J.A. 160) This lack of synergy and lack of overlap between the respective businesses of National Starch and the Unilever Group alleviated concern on Unilever's part that the U.S. antitrust laws might interfere with the acquisition. (J.A. 160)

On November 7, 1977, National Starch's board of directors was informed of Unilever's interest in acquiring National Starch's stock. At that meeting, the company's counsel advised the board that it had a fiduciary duty under Delaware law to ensure that any such transaction would be fair to the stockholders. Counsel further advised that an independent investment banking firm should be retained to assist the board in valuing the company, to render an opinion on the fairness of the transaction to the stockholders and to be available in the event of a hostile takeover attempt. Counsel also advised that failure to retain an investment banking firm might be evidence that the board had not properly carried out its fiduciary duty. (J.A. 239-40)

The board followed this advice, and National Starch engaged the investment banking firm of Morgan Stanley & Co. Incorporated ("Morgan Stanley"). (J.A. 240) Morgan Stanley undertook a thorough review of National Starch's business operations and historical financial results, as well as its prospects for the future, and summarized its findings in a written report. (J.A. 20) A number of those findings highlight the strong research and development capabilities of National Starch, which "put it in the vanguard in the specialty starch, adhesives and resins areas". (J.A. 66) Morgan Stanley discussed its report with National Starch's board on several occasions and, in a written opinion, concluded that Unilever's offer was "fair and equitable" to the National Starch stockholders "from a financial point of view". (J.A. 81-84, 241)

Based on Morgan Stanley's advice and its own evaluation of Unilever's offer, the board concluded that it would be in the best interest of the National Starch stockholders to accept Unilever's offer. It then convened a special meeting of the stockholders to consider the offer, and, in a letter distributed with the proxy statement for the meeting (which included the Morgan Stanley fairness opinion and other pertinent information), recommended that the transaction be approved. (J.A. 85-87, 241) The stockholders approved the transaction by a virtually unanimous vote. (J.A. 27)

On August 15, 1978, the transaction was consummated. A newly formed subsidiary of the Unilever Group named National Starch and Chemical Holding Corporation ("Holding") acquired all the National Starch stock from its stockholders. Approximately

79 percent of the stock was acquired in a so-called "reverse cash merger" in which a newly formed, transitory subsidiary of Holding was merged into National Starch pursuant to a merger agreement providing for the payment to the National Starch stockholders of $73.50 in cash for each National Starch share held by them. The receipt of this cash was taxable to the stockholders. The other 21 percent of the National Starch stock was acquired from the stockholders for Holding preferred stock in a nontaxable exchange under Section 351 of the Code.[3] (J.A. 241-42)

According to the Commissioner's letter ruling issued to National Starch prior to the transaction, the reverse cash merger of the transitory subsidiary of Holding into National Starch was to be completely disregarded for federal income tax purposes, and the transaction was to be treated as a direct acquisition of National Starch stock by Holding. (J.A. 15, 241) This ruling followed well-established precedent (*e.g.*, Rev. Rul. 73-427, 1973-2 C.B. 301), and the Commissioner has not attempted to depart from it in this proceeding. (J.A. 255, n.7)

National Starch itself was unchanged by Holding's acquisition of its stock from its stockholders. National Starch did not sell or otherwise dispose of any assets in the transaction, nor did it purchase or otherwise acquire any assets or stock of another corporation. All that happened was that its stockholders transferred their stock to Holding, mostly for cash and partly for Holding preferred stock. (J.A. 15-16, 242) Moreover, while the ownership of its stock was changed, National

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[3] This Code provision relates to transfers of property to newly formed corporations (in this case, Holding), not to mergers or other reorganization transactions between corporations.

Starch's capitalization (*i.e.*, its outstanding equity and debt securities) was not altered in any material respect.[4] In essence, the transaction amounted simply to "swapping approximately 3500 shareholders for one". (J.A. 223)

After the transaction, National Starch's management (its directors and officers) remained in place, its key employees entered into employment contracts with the company and its business operations were continued in the same way as before. (J.A. 242) As Unilever originally intended, National Starch operated under a "treaty of autonomy". (J.A. 222-23) Moreover, Unilever did not provide National Starch with any significant technological or financial assistance or any significant legal, administrative or accounting services. (J.A. 242) Furthermore, the Unilever Group was not a major customer of National Starch prior to the transaction (J.A. 79-80), and the Group did not materially increase its purchases of National Starch products thereafter. (J.A. 242)

On its federal income tax return for the period ended August 15, 1978, National Starch deducted Morgan Stanley's fee and out-of-pocket expenses

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[4] Since all the National Starch stock was then held by a single stockholder, the company's certificate of incorporation was amended, for purposes of administrative convenience and simplicity, to eliminate its previously authorized but unissued shares of preferred stock and to reduce the number of its authorized shares of common stock from 8 million to 1,000. The Tax Court held that this incidental amendment was not relevant to the deductibility of the expenses at issue (J.A. 246), and the court of appeals affirmed that holding (J.A. 256).

(totaling $2,225,586), but not its counsel's fee and out-of-pocket expenses (totaling $505,069)[5] or the other expenses that it had incurred in connection with the stockholders' meeting, such as accounting and printing charges and SEC filing fees (totaling $150,962). (J.A. 242-43) The deduction of the investment banking fee was disallowed by the Commissioner on the ground that it constituted a capital expenditure by National Starch rather than an ordinary business expense deductible under Section 162(a) of the Code. (J.A. 37) The Commissioner's disallowance resulted in a deficiency in National Starch's federal income tax of $1,068,281. (J.A. 34) National Starch contested the deficiency in the Tax Court and claimed a refund of tax (limited to $257,444 because of the statute of limitations) on the ground that it was also entitled to deductions for its legal fees and other expenses. (J.A. 4, 243, 257, n.3)

2. *The Decisions Below.* The Tax Court found that the Morgan Stanley fee and the legal fee and other expenses were reasonable in amount and were customarily incurred in connection with similar transactions. (J.A. 242-43) Nevertheless, the Tax Court upheld the Commissioner's disallowance and denied the claimed refund, and the court of appeals affirmed, on the ground that the fees and expenses in question were nondeductible capital expenditures because they were incident to a transaction that conferred on National Starch, in the words of the court of appeals, "a

[5] The legal services rendered included advice to National Starch's board of directors regarding its fiduciary responsibilities to the company's stockholders, preparation of the request for a tax ruling, participation in negotiations with Unilever representatives and preparation of documents (such as the proxy statement for the stockholders' meeting). (J.A. 243)

not insignificant future benefit that [was] more than merely incidental".[6] (J.A. 247, 266)

Such a future benefit, the court of appeals said, had two aspects: "the availability of Unilever's enormous resources" to the company, and "the opportunity for synergy created by Unilever's affiliation with National Starch". (J.A. 266-67) In so stating, the court of appeals upheld, as not clearly erroneous, the Tax Court's finding of a future benefit, which was based solely on the following: (i) the Tax Court's view that Delaware law required National Starch's board of directors to determine whether the transaction would be in the best interest of the company as well as its stockholders; (ii) a statement in a so-called "Progress Report" for 1978 (which was issued by National Starch after its acquisition by Unilever) to the effect that the company would benefit from the availability of Unilever's resources; and (iii) a statement in Morgan Stanley's report to the National Starch board that "[m]anagement also feels that some synergy may exist with the Unilever organization".[7] (J.A. 78, 248)

The court of appeals (as well as the Tax Court) rejected National Starch's argument that, under this Court's decision in *Lincoln Savings*, a taxpayer's payments are not capitalizable unless they create or en-

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[6] Except for the issue of capitalization, none of the requirements for deductibility of expenses under Section 162(a) of the Code is in dispute. (J.A. 259)

[7] The court of appeals also said that the Unilever transaction provided National Starch with an opportunity to avoid the effect of the "estates problems" of the company's two largest stockholders (who were then 81 and 79 years of age, respectively) that were "'overhanging the market'". (J.A. 270, quoting from the record) The Tax Court made no finding that any such "overhang" existed.

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hance a "separate and distinct asset". In support of this argument, National Starch had cited this Court's decision and decisions in six other circuits that had followed the "separate and distinct asset" test. (J.A. 260, 263-64)

The court of appeals acknowledged that National Starch's expenses "resulted in neither a tangible asset nor a readily identifiable intangible asset" (J.A. 265) and that "[s]ome Courts of Appeals have indeed construed *Lincoln Savings* to have created a new standard such as that proffered by National Starch" (J.A. 263), but it refused to follow the *Lincoln Savings* test. Instead, it attempted to distinguish *Lincoln Savings* on the ground that since a separate and distinct asset had been found to exist in that case, "the absence of such an asset is not addressed in the opinion". (J.A. 262) The court of appeals further acknowledged that, having rejected the *Lincoln Savings* test, "the appropriate treatment of National Starch's payments [represented] a particularly difficult inquiry". (J.A. 265) Nevertheless, it held that National Starch's expenses were capitalizable because, in the court of appeals' view, they had conferred on the company "a not insignificant future benefit that [was] more than merely incidental". (J.A. 266) The court of appeals admitted that its decision denied any deduction to National Starch for the expenses until its business is sold, since they "are not susceptible to depreciation or amortization". (J.A. 272)

Summary of Argument

I.

Section 162(a) of the 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." (App. 1a) Capital expenditures may not be deducted under this Section either because they are not "ordinary" (*see Commissioner v. Tellier*, 383 U.S. 687, 689-90 (1966)), or because they are not "expenses" (*see Lincoln Savings*, 403 U.S. at 352-54). The phrase "ordinary expenses", standing alone, provides little guidance as to the precise scope of the capitalization requirement.

Before *Lincoln Savings*, the law was very confused, particularly with respect to the capitalization of costs relating to intangibles. *See Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 783-85 (2d Cir. 1973). Under the prevailing approach, a payment was considered to be capital in nature "where it result[ed] in the taxpayer's acquisition or retention of a capital asset, or in the improvement or development of a capital asset". *Louisiana Land & Exploration Co. v. Commissioner*, 7 T.C. 507, 515 (1946), *aff'd*, 161 F.2d 842 (5th Cir. 1947). Under another approach later articulated by some courts, a capital expenditure was defined as one intended "to produce a positive business benefit whose effects will be reaped in seasons beyond a single year". *Darlington-Hartsville Coca-Cola Bottling Co. v. United States*, 393 F.2d 494, 496 (4th Cir.), *cert. denied*, 393 U.S. 962 (1968).

The expenditures in question in *Lincoln Savings* clearly "produce[d] a positive business benefit whose effects [would] be reaped in seasons beyond a single year". This Court, however, did not view that fact as determinative; it noted that "many expenses concededly deductible have prospective effect beyond the taxable year". *Lincoln Savings*, 403 U.S. at 354. This Court therefore rejected a future benefit test, stating:

"the presence of an ensuing benefit that may have some future aspect is not controlling". *Id.* It held, instead, that: "What is important and controlling . . . is that the . . . payment serves to create or enhance for [the taxpayer] a separate and distinct additional asset". *Id.* It then made a detailed inquiry into the question whether the amounts at issue resulted in the taxpayer's acquisition of a "distinct and recognized property interest", and, after concluding that they did, required the amounts to be capitalized. *Id.* at 355-56.

The "separate and distinct asset" test enunciated in *Lincoln Savings* is consistent with this Court's earlier decisions in *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970); *Woodward v. Commissioner*, 397 U.S. 572 (1970); *Deputy v. du Pont*, 308 U.S. 488 (1940); and *Welch v. Helvering*, 290 U.S. 111 (1933). In addition, the test was applied by this Court one year later in *United States v. Mississippi Chemical Corp.*, 405 U.S. 298 (1978).

II.

Since the *Lincoln Savings* decision in 1971, the courts of appeals for six circuits—the second, fourth, fifth, eighth, ninth and tenth—have followed the "separate and distinct asset" test. In every instance where the court of appeals found that a separate and distinct asset had not been created or enhanced, the amount was allowed as an ordinary business expense deduction; conversely, in each instance where a separate and distinct asset was found to have been created, the amount was required to be capitalized. Thus, those courts of appeals, unlike the Court of Appeals for the Third Circuit in this case, recognized that in *Lincoln Savings* this Court had indeed "addressed" the issue of the appropriate test for capitalization.

In addition, the Commissioner has repeatedly expressed the same interpretation of *Lincoln Savings* as the six circuits. For example, in a published revenue ruling issued in 1983, the Commissioner ruled, citing *Lincoln Savings*, that certain insurance premiums were deductible despite the "expectancy that a refund may be forthcoming in a future tax year", because such an expectancy *"does not create an asset in the nands of the taxpayer"*. Rev. Rul. 83-66, 1983-1 C.B. 43, 44-45 (emphasis added).

III.

This Court's "separate and distinct asset" test faithfully implements congressional intent, as reflected in the language of the statutory and regulatory provisions that govern various interrelated aspects of the federal income tax accounting treatment of taxpayers' costs. The purpose of those provisions and the primary purpose of the capitalization limitation in Section 162(a) are the same, namely, to reflect properly the net income of taxpayers subject to tax in a given period. *See, e.g., Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974); *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983). Section 162(a) and those provisions should therefore be construed in a consistent manner. Since those provisions, in describing amounts that are required to be capitalized and are allowed to be depreciated or recovered upon sale, specifically refer to payments for "property" or an "asset", it is clear that Congress intended to draw the line between a currently deductible ordinary expense and a nondeductible capital expenditure where, as this Court held in *Lincoln Savings*, a separate and distinct asset is created or enhanced.

Moreover, by requiring the identification of a specific asset to which capitalized costs are to be assigned, the *Lincoln Savings* test serves the clear reflection of income principle that underlies the statutory scheme—it permits such costs to be depreciated or amortized over the useful life of the asset and to be recovered upon its sale or other disposition. In contrast, the court of appeals' future benefit approach does not give taxpayers any means of recovering their capitalized costs. Where there is a future benefit but no asset to which capitalized costs can be assigned, the taxpayer will not be allowed any depreciation or amortization deductions or any deductible loss prior to the sale or abandonment of its entire business. Thus, the future benefit approach, by thwarting any recovery of capitalized costs during the period in which the taxpayer is operating its business and earning the income generated by those costs, defeats a clear reflection of income.

IV.

Many kinds of payments, such as those for legal defenses, advertising and employment-related education, have long been recognized as deductible expenses despite their obvious significant future benefits to taxpayers. Adoption of the court of appeals' future benefit test would disrupt this well-settled law and reintroduce the "hopeless confusion" decried by the Court of Appeals for the Second Circuit in *Briarcliff Candy*, 475 F.2d at 785.

Furthermore, as the court of appeals admitted (J.A. 265), its future benefit test is exceedingly difficult to apply. The test requires making a prediction as to whether: (i) intangible factors (such as an "opportunity for synergy") will provide a "not insignificant future benefit" for the taxpayer's business operations; and (ii) this future benefit will be "more than merely incidental" to the current benefits derived from the payments. Making such a prediction is an inherently subjective exercise. Numerous controversies between taxpayers and the Commissioner concerning the application of such a test would be bound to arise. And, in many instances, the courts would be called upon to make the difficult factual judgments required to resolve such controversies.

In contrast to the court of appeals' approach, the *Lincoln Savings* test permits taxpayers to determine whether their payments must be capitalized on the basis of existing facts—whether the payments in fact resulted in a "distinct and recognized property interest" (403 U.S. at 355)—and not on the basis of a subjective prediction about the future.

Argument

I. IN *LINCOLN SAVINGS* THIS COURT ESTABLISHED, AS THE TEST FOR CAPITALIZING EXPENDITURES, THAT THEY MUST CREATE OR ENHANCE A "SEPARATE AND DISTINCT ASSET".

Before *Lincoln Savings*, the law regarding the appropriate test to be applied in distinguishing between deductible ordinary expenses and nondeductible capital expenditures was "in a state of hopeless confusion", particularly in "the realm of intangibles";

"[m]any decisions in this area rest[ed] upon administrative fiat, fortified by the requirement that the taxpayer show clear error". *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 785 (2d Cir. 1973). Two tests for making this distinction had been articulated by the courts. The traditional and more widely applied test turned on whether the payment in question "result[ed] in the taxpayer's acquisition or retention of a capital asset, or in the improvement or development of a capital asset", *Louisiana Land and Exploration Co.*, 7 T.C. at 507, 515 (1946), *aff'd*, 161 F.2d 842 (5th Cir. 1947).[8] The other approach, later articulated by some courts, looked to whether the payment was intended "to produce a positive business benefit whose effects will be reaped in seasons beyond a single year", *Darlington-Hartsville Coca-Cola Bottling Co. v. United States*, 393 F.2d 494, 496 (4th Cir.), *cert. denied*, 393 U.S. 962 (1968).[9] In *Lincoln Savings*, this Court cleared up this confusion.

Lincoln Savings involved the deductibility of premiums paid by a savings and loan association to the Federal Savings and Loan Insurance Corporation

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[8] *See also, e.g., Van Iderstine Co. v. Commissioner*, 261 F.2d 211, 213 (2d Cir. 1958) ("an expectation or hope that . . . [the taxpayer] would be preferred over other possible purchasers . . . cannot be considered as the . . . [acquisition] of an 'intangible capital asset'"); *Snow v. Commissioner*, 31 T.C. 585, 593 (1958) ("we recognize that the benefit derived . . . was not fully realized or exhausted within the taxable year. However, petitioners have not acquired any specific asset . . . .").

[9] *See also, e.g., United States v. Akin*, 248 F.2d 742, 744 (10th Cir. 1957), *cert. denied*, 355 U.S. 956 (1958) ("an expenditure should be treated as one in the nature of a capital outlay if it brings about the acquisition of an asset having a period of useful life in excess of one year *or if it secures a like advantage to the taxpayer which has a life of more than one year*") (emphasis added).

("FSLIC") that were "'in the nature of a prepayment with respect to future premiums'" for insurance coverage of the association's deposit accounts. 403 U.S. at 348 (quoting 12 U.S.C. § 1727(d)). These premiums were paid by the association in addition to those required for current insurance coverage, and thus the benefit that they provided was primarily (or even solely) a future benefit. This Court, however, held that this circumstance, standing alone, provided an insufficient basis for capitalization. It flatly rejected a future benefit test, stating: "the presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year". *Id.* at 354. And it then held: "What is important and controlling is that the . . . payment serves to create or enhance for [the taxpayer] what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a) . . . ." *Id.*

A review of *Lincoln Savings* and the arguments of the parties confirms both aspects of this Court's holding: future benefit alone is insufficient for capitalization; rather, capitalization requires the creation or enhancement of an asset producing a future benefit.

The Commissioner argued in *Lincoln Savings* that the "essence of an ordinary business expense is that the benefit from the expense is derived and exhausted within the taxable year" (citing, *inter alia*, *Darlington-Hartsville Coca-Cola Bottling Co.*, 393 F.2d at 496), and that the benefit of the association's insurance premiums was "not exhausted within the taxable year of payment, but extends far into the future". The

Commissioner further argued that the insurance premiums were "nondeductible capital outlays" because they "result[ed] in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year" (citing, *inter alia*, Treas. Reg. §§ 1.461-1(a)(1) and (2) (1957) (App. 9a-10a)). (Brief for Petitioner in *Lincoln Savings* at 12-13.) The association responded by arguing, as stated in the heading of one section of its brief: "The Possibility of a Future Benefit Does Not Convert an Ordinary and Necessary Business Expense Into a Capital Expenditure". In that section, the association pointed out that "many expenses are deductible though they produce benefits in future years", and it gave a number of examples of such expenses.[10] (Brief for Respondent in *Lincoln Savings* at 18-27)

In enunciating the separate and distinct asset test and rejecting a future benefit approach, this Court explicitly referred to the association's argument indicated above. 403 U.S. at 354. It then undertook a

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[10] These examples included the legal expenses for defenses against criminal and fraud charges held to be deductible by this Court in *Commissioner v. Tellier*, 383 U.S. 687 (1966), and in *Commissioner v. Heininger*, 320 U.S. 467 (1943); the employment-related education expenses allowed as a deduction by Treas. Reg. § 1.162-5(a) (1958) (App. 6a); and the advertising expenses allowed as a deduction in *E. H. Sheldon & Co. v. Commissioner*, 214 F.2d 655 (6th Cir. 1954), and other cases. (Brief for Respondent in *Lincoln Savings* at 18-20, 25-26) In *Tellier* the legal expenses saved the taxpayer from incarceration and in *Heininger* they averted a threatened destruction of the taxpayer's business, thus producing an obvious long-term benefit to the taxpayers in both cases. Nevertheless, as this Court stated in *Tellier*, the "legal expenses . . . were not capital expenditures. They were incurred in [the taxpayer's] defense against charges of past criminal conduct, *not in the acquisition of a capital asset*". 383 U.S. at 690 (emphasis added).

detailed inquiry into the question whether the additional premiums gave the association a "distinct and recognized property interest", *id.* at 355-56, an inquiry that would have been totally unnecessary if a significant future benefit had been all that was considered necessary for capitalization. After concluding that the premiums did result in such a property interest, this Court held that they were capital expenditures.[11] *Id.* at 356.

The court of appeals was manifestly wrong in asserting (J.A. 262) that, if this Court in *Lincoln Savings* made the creation or enhancement of an asset a prerequisite for capitalization, it implicitly overruled its prior decisions in *Welch v. Helvering*, 290 U.S. 111 (1933), and *Deputy v. du Pont*, 308 U.S. 488 (1940). The "separate and distinct asset" test is entirely consistent with those decisions. In each of those cases this Court denied the deduction, not because the expenditure was capital in nature, but because it was found not to be normal, usual or customary—*i.e.*, it was not "ordinary" in the secondary meaning of that term as used in Section 162(a) of the Code. Thus, the payment of another person's debts in *Welch* was considered to be "in a high degree extraordinary". 290

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

U.S. at 114.[12] Similarly, the payment of carrying charges on short sales to benefit a stockholder's company in *du Pont* was not considered "normal, usual, or customary" for a person who was not "an active trader in securities". 308 U.S. at 495.

Also plainly wrong is the court of appeals' assertion (J.A. 262-63) that this Court in *United States v. Mississippi Chemical Corp.*, 405 U.S. 298 (1972), one year after *Lincoln Savings*, ignored the separate and distinct asset test. In *Mississippi Chemical*, the taxpayer was required to purchase stock in a Bank for Cooperatives in order to continue its membership in the Bank and thereby be entitled to borrow money from the Bank. The taxpayer claimed that the stock had no value and therefore the amount paid for it was in substance interest on the taxpayer's loans from the Bank. The government contended that the stock did have value and, in a supplemental brief filed shortly after the *Lincoln Savings* decision was handed down, argued that since the payments for the stock "result[ed] in the creation of an asset having a useful life extending substantially beyond the close of the taxable year", "*Lincoln* requires a decision for the government". (Supplemental Brief for Petitioner in *Mississippi Chemical* at 1-2)

This Court rejected the taxpayer's claim, finding that the stock was valuable because, among other things, it provided the taxpayer with "an opportunity

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12 To the extent that this Court's decision in *Welch* may have rested on a conclusion that the expenses were capital in nature, it was based on an acceptance of the Commissioner's contention that they were "an outlay for the development of reputation and good will," 290 U.S. at 113, which has always been considered a separate and distinct asset for tax purposes. *See, e.g.*, Treas. Reg. § 1.263(a)-2(h)(1958) (App. 9a).

for more patronage and surplus dividends, an ultimate right of redemption, and an *asset* that may be used as a set-off in case of a default on the loan". 405 U.S. at 309 (emphasis added). This Court then concluded that, since the stock was "of value in more than one taxable year, it is a *capital asset* within the meaning of § 1221 of the Internal Revenue Code, and its cost is nondeductible. Cf. *Commissioner v. Lincoln Savings & Loan Assn.*, 403 U.S. 345 (1971) . . . ." *Id.* at 310 (emphasis added). This Court's decision in *Mississippi Chemical* thus represents an endorsement, not a repudiation, of the *Lincoln Savings* test.

Similarly, *Lincoln Savings* is entirely consistent with this Court's earlier decisions in *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970), and *Woodward v. Commissioner*, 397 U.S. 572 (1970). In each of those cases the taxpayer was a corporation that had acquired another corporation's stock, which obviously constituted a separate and distinct asset in the hands of the acquiring corporation. The expenditures at issue were appraisal fees incurred in acquiring the stock, and this Court held that those fees had to be capitalized.

The taxpayers in those two cases were in the same position as Holding, the acquiring corporation in this case, which is clearly required to capitalize *its* costs incurred in purchasing National Starch's stock (just as the sellers of that stock—the National Starch stockholders—must offset their expenses against the proceeds of the sale to determine the amount realized by them).[13] But the fact that a purchaser of a corporation's stock must capitalize its acquisition costs has no bearing on the treatment of the costs of the

[13] *See infra* note 17 and accompanying text.

corporation whose stock is acquired. That corporation's expenses are deductible under *Lincoln Savings*, because, unlike the stock purchaser, that corporation does not acquire or enhance any asset in the transaction.

The court of appeals was also wrong in asserting that certain cases "requiring capitalization of expenses for restructuring" a corporation support its decision. (J.A. 270-71) The "restructuring" involved in those cases (and in other similar cases) was either (i) a change in the capitalization of the taxpayer corporation (*i.e.*, a change in its outstanding equity or debt securities effected by an issuance of new securities, a distribution of a stock dividend, a redemption of stock or an exchange of securities); (ii) a "spin-off" of a newly formed subsidiary by the taxpayer corporation to its stockholders; or (iii) an acquisition by the taxpayer corporation of the assets or stock of another corporation.

Those cases are not directly relevant here, because National Starch did not undergo any restructuring— National Starch did not materially change its capitalization; did not spin off a subsidiary; did not acquire another corporation's assets or stock; and did not sell or dispose of its own assets, by merger or otherwise. However, there is no special rule of capitalization in the Code for corporate restructuring; the normal rules apply. Thus, the reasoning of the courts in the restructuring cases is fully consistent with the *Lincoln Savings* test and mandates the allowance of a deduction for National Starch's expenses.

The costs incurred to change a corporation's capitalization are held to be nondeductible because they are made for the purpose of enhancing an "intangible asset" of the corporation—its capital structure.[14] Similarly, the costs of a spin-off are nondeductible capital expenditures when the "dominant aspect" of the transaction is deemed to be a change in the distributing corporation's capitalization; however, they are deductible where the dominant aspect is deemed to be a partial liquidation of such corporation.[15] In *Gravois Planing Mill*, a spin-off case, then Judge

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[14] *See, e.g., McCrory Corp. v. United States*, 651 F.2d 828, 836 (2d Cir. 1981) (issuance of stock in a merger); *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 716 (8th Cir.) (Blackmun, J.), *cert. denied*, 379 U.S. 832 (1964) (stock dividend); *Mills Estate, Inc. v. Commissioner*, 206 F.2d 244, 246 (2d Cir. 1953) (stock redemption); *Skaggs Cos. v. Commissioner*, 59 T.C. 201, 206 (1972) (conversion of preferred stock into common stock). In addition, stock issuance expenses are viewed as expenses of raising capital and, like selling expenses generally (*see infra* note 17 and accompanying text), are treated as a reduction of the capital raised. *See, e.g., Baltimore & Ohio R. Co. v. Commissioner*, 78 F.2d 460, 463 (4th Cir. 1935). Payments made to change a corporation's capitalization are also held to be nondeductible because they would not have been deductible if those changes had been included in the corporation's original capitalization. *See, e.g., Mills Estate*, 206 F.2d at 246.

[15] *See, e.g., El Paso Co. v. United States*, 694 F.2d 703, 710 (Fed. Cir. 1982) (expenses of a spin-off held to be deductible because it was considered a "significant contraction of [the] corporate enterprise"); *United States v. General Bancshares Corp.*, 388 F.2d 184, 191-92 (8th Cir. 1968) (expenses of a spin-off held to be deductible because the parent company "acquired no additional rights, nor was anything added to its corporate structure. It acquired no tangible or intangible assets nor did it improve any remaining asset"); *E.I. du Pont de Nemours & Co. v. United States*, 432 F.2d 1052 (3d Cir. 1970) (expenses of transferring assets to a new second-tier subsidiary held to be nondeductible capital expenditures because they related primarily to the creation of the new subsidiary); *Gravois Planing Mill Co. v. Commissioner*, 299 F.2d 199, 210 (8th Cir. 1962) (Blackmun, J.) (expenses of a spin-off held to be deductible because its "dominant aspect" was a partial liquidation); *Missouri-Kansas Pipe Line Co. v. Commissioner*, 148

Blackmun said that the "theory usually expressed to support [the nondeductibility of expenditures relating to a corporate recapitalization] is that [such] expenditures . . . have to do with a continuing capital asset", whereas "expenditures of liquidation do not concern the creation or continuance of a capital asset". 299 F.2d at 206. As discussed *supra* at p. 20, the costs incurred by a corporation in acquiring another corporation's assets or stock are held to be nondeductible capital expenditures because they represent part of the acquiring corporation's cost (in addition to its purchase price) for the assets or stock.[16] Conversely, the costs incurred by the corporation selling its assets are deducted from the selling price of the assets in determining the amount realized by it from the sale (and thus its gain or loss thereon).[17]

F.2d 460 (3d Cir. 1945) (expenses of a parent company's distribution of warrants to buy a subsidiary's stock held to be nondeductible capital expenditures because the distribution was considered to be equivalent to a recapitalization of the parent company).

[16] *See, e.g., United States v. Hilton Hotels Corp.* 397 U.S. 580 (1970); *Woodward v. Commissioner*, 397 U.S. 572 (1970).

[17] *See, e.g., United States v. General Bancshares Corp.*, 388 F.2d at 187 ("selling expenses incurred in the sale of a capital asset are treated as capital in nature and chargeable only against the capital proceeds", citing cases); *Odorono Co. v. Commissioner*, 26 B.T.A. 1355, 1358-59 (1932) ("costs incident to . . . [a] sale of property . . . are deducted from the sale price, thereby, in taxable transactions, either reducing the amount of the gain or increasing the amount of the loss", citing cases); Rev. Rul. 77-204, 1977-1 C.B. 40, 41 ("expenses of a sale must be offset against the proceeds of the sale in determining gain or loss on the transaction"); 1 Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts* ¶ 43.1, at 43-2 (2d ed. 1989) ("expenses [incurred in selling property] reduce the amount realized"). In *Motion Picture Capital Corp. v. Commissioner*, 32 B.T.A. 339 (1935), *aff'd*, 80 F.2d 872 (2d Cir. 1936), the taxpayer corporation sold its assets to another corporation by merging into that other corporation. Relying on

In contrast to costs connected with the raising of capital, expenses incurred by a corporation in facilitating a market for its stock are generally deductible. *See Affiliated Capital Corp. v. Commissioner*, 88 T.C. 1157, 1169-70 (1987). Other stockholder relations expenses receive the same treatment. Every 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 but do not directly further the corporation's business operations. Many of these expenses arise because of the corporation's legal obligation to provide information about its business activities and financial results to its stockholders and the public. Other such expenses arise because of the corporation's obligation to permit stockholders to select the corporation's directors and to vote on major corporate transactions. Some of these expenses are incurred periodically and others are not. In either case, there can be no doubt that they are deductible under Section 162(a). *See Welch*, 290 U.S. at 114; *Central Foundry Co. v. Commissioner*, 49 T.C. 234 (1967), *acq.*, 1968-2 C.B. 2 (a corporation's payment of expenses incurred by insurgent stockholders in a proxy contest to unseat incumbent management is deductible, despite the fact that the purpose of the contest was to change the corporation's policies for its future benefit); *Locke Mfg. Cos. v. United States*, 237 F. Supp. 80 (D. Conn. 1964), followed by the Commissioner in Rev. Rul. 67-1, 1967-1 C.B. 28 (a corporation's

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Odorono, the Board of Tax Appeals held that the merged corporation's expenses were not deductible as ordinary business expenses, 32 B.T.A. at 342, and the court of appeals affirmed, saying that such expenses "were made necessary by [the merged corporation's] decision to carry on its business no longer." 80 F.2d at 874.

payment of expenses incurred by incumbent management in a proxy contest is similarly deductible).

The fees and expenses at issue here are in the same category. They arose from National Starch's legal obligations to its stockholders, including its board's obligation to make an informed judgment about Unilever's proposal, to communicate its views to the company's stockholders and to give them an opportunity to accept or reject the proposal. Thus, they were part of National Starch's ordinary and necessary expenses of doing business as a corporation. As such, they are deductible under Section 162(a).

II. FOR TWENTY YEARS THE COURTS OF APPEALS HAVE CONSISTENTLY INTERPRETED *LINCOLN SAVINGS* AS REJECTING A FUTURE BENEFIT TEST, AND THE COMMISSIONER HAS FREQUENTLY SO INTERPRETED IT.

The courts of appeals for six other circuits have previously followed the *Lincoln Savings* separate and distinct asset test. Thus, the Second Circuit has held that the *Lincoln Savings* decision "directs the inquiry . . . to the question whether or not [the taxpayer] . . . 'created or enhanced for [itself] what [was] essentially a separate and distinct additional asset.'" *Briarcliff Candy*, 475 F.2d at 782. The Fourth Circuit has held that, in light of the "unmistakable language in *Lincoln Savings & Loan* that 'the presence of any ensuing benefit . . . is not controlling'", "costs incurred in expanding a business are not considered capital costs unless they meet the *Lincoln Savings & Loan* 'separate and distinct additional asset' test. And this test holds whether or not the expenditures have benefits beyond the current taxation period." *NCNB*

Corp. v. United States, 684 F.2d 285, 289, 291 (4th Cir. 1982).[18] The Fifth Circuit has described *Lincoln Savings* as "stat[ing] the test for distinguishing an ordinary expense from a capital expenditure" and framed the issue before it as "whether the establishment of a new branch office creates a separate and distinct additional asset". *Central Tex. Sav. & Loan Ass'n v. United States*, 731 F.2d 1181, 1184 (5th Cir. 1984).[19] The Eighth Circuit has cited *Lincoln Savings* for the proposition that "the fact that there may be some ensuing benefit and future effect from the expenditure beyond the taxable year when paid is not controlling". *Iowa-Des Moines Nat'l Bank v. Commissioner*, 592 F.2d 433, 436 (8th Cir. 1979). The Tenth Circuit has held that expenditures were deductible where, unlike the *Lincoln Savings* expenditures, they "did not create a property interest" and "produced nothing corporeal or salable". *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185, 1192 (10th Cir. 1974). And the Ninth Circuit has "adopt[ed] the decision of the Tenth Circuit in *Colorado Springs National Bank, supra*, as the law of . . . [the ninth]

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[18] *See also Jack's Cookie Co. v. United States*, 597 F.2d 395, 405 (4th Cir), *cert. denied*, 466 U.S. 899 (1979) (holding payments into a rental reserve fund to be capital expenditures because such fund "was essentially a 'separate and distinct asset'" which "had an ascertainable and real value to the taxpayer"); *First Nat'l Bank of S.C. v. United States*, 558 F.2d 721, 723 (4th Cir. 1977) (holding a membership fee paid by a bank to join a credit card system to be deductible because "[m]embership . . . is not a separate and distinct additional asset").

[19] *See also Campbell Taggart, Inc. v. United States*, 744 F.2d 442, 455 (5th Cir. 1984) (holding an expense to be deductible because, unlike the premiums involved in *Lincoln Savings*, it was "not linked to a specific asset").

circuit". *First Sec. Bank of Idaho v. Commissioner*, 592 F.2d 1050, 1052 (9th Cir. 1979).

Since the payments in question in each of the foregoing cases had been made with the expectation that they would improve the future profitability of the taxpayer's business, and thus had conferred on the taxpayer a "not insignificant future benefit", deductibility turned on whether a separate and distinct asset had been created. In seven of the cases, no such asset was found to exist and the claimed deductions were allowed: *Briarcliff Candy*, (payments to develop a suburban retail distribution network for the taxpayer's candy products); *NCNB* (payments to establish bank branches in new locations); *Iowa-Des Moines*, *Colorado Springs*, *First Sec. Bank* and *First Nat'l Bank* (payments to participate in new credit card systems); *Campbell Taggart* (payments to protect existing goodwill). In the other two cases, payments to establish bank branches (*Central Texas*) and payments into a reserve fund (*Jack's Cookie*) were required to be capitalized because the courts concluded that a property right had been created that amounted to a separate and distinct asset within the meaning of *Lincoln Savings*.

These consistent decisions over the course of twenty years have obviously influenced the expectations of taxpayers in the myriad of instances in which the capitalization issue can arise.

Moreover, the Commissioner himself has frequently held that this Court's decision in *Lincoln Savings* mandates, as a prerequisite for capitalization, that the payments in question create a separate and distinct asset and not just a future benefit. Thus, in Rev. Rul. 83-66, 1983-1 C.B. 43, he ruled, citing

Lincoln Savings, that certain insurance premiums were deductible despite the "expectancy that a refund may be forthcoming in a future tax year", because such an expectancy "*does not create an asset in the hands of the taxpayer*". 1983-1 C.B. at 44-45 (emphasis added). And in numerous memoranda issued in connection with audits of the tax returns of particular taxpayers, the Commissioner has held that a "mere showing that a future benefit has been established is not determinative. *There must be an asset or a property interest that relates to the expenditure*". Tech. Adv. Mem. 82-02-010 (Sept. 28, 1981) (emphasis added). *See* Gen. Couns. Mem. 35,681 (Feb. 19, 1974) (allowing the claimed deduction because the "mere expectation . . . [that] the servicing rights [will produce future income] does not satisfy the definition of a capital asset as that term is commonly understood"); Tech. Adv. Mem. 80-41-001 (Oct. 24, 1979) (allowing the claimed deduction because "four Circuit Courts and the Tax Court have adopted the view that in determining whether a cost should be capitalized under section 263 of the Code, one must look to whether the expenditure created or enhanced what is essentially a separate and distinct asset having an economically useful life beyond the taxable year of acquisition"); Tech. Adv. Mem. 84-23-005 (Feb. 8, 1984) (allowing a deduction for amounts incurred in hiring and training a new work force to operate new restaurants because "no separate asset . . . [was] created)"; Gen. Couns. Mem. 39,669 (Oct. 9, 1987) (allowing a deduction for amounts incurred to establish the taxpayer's right to receive social security benefits in the future because the benefit did not "rise[] to the level of the type of asset or property interest for which capitalization of related expenses would be required under section 263").[20]

III. THIS COURT'S *LINCOLN SAVINGS* TEST FAITHFULLY IMPLEMENTS CONGRESSIONAL INTENT, WHEREAS THE FUTURE BENEFIT TEST DOES NOT.

Section 162(a) and a number of other Code provisions represent interrelated parts of an integrated tax accounting system that is designed to reflect properly the taxpayer's net income subject to tax in a given taxable period by matching its revenues in that period with the expenses of producing them.[21] Such other Code provisions, *inter alia*, deny a current deduction for capital expenditures, as specifically described (Section 263); allow depreciation and amortization of capitalized costs (Sections 167 and 168); require taxable income to be computed under a method of accounting that clearly reflects income and allow deductions only in accordance with such a method (Sections 446 and 461); and provide for the recovery of capitalized (and undepreciated) costs upon a disposition of property (Sections 1001 and 1012).

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[20] The Commissioner has not been consistent in his interpretation of *Lincoln Savings*. *See, e.g.*, Tech. Adv. Mem. 86-11-005 (Nov. 26, 1985) and Gen. Couns. Mem. 39,483 (Mar. 5, 1986), in which he held that either the creation of a separate asset or a future benefit was sufficient to require capitalization.

[21] "Tax accounting is based on the principles of clear reflection of income and of cost recovery. Income is reflected clearly when the taxpayer matches revenue earned in the taxable year with expenses properly allocable to the production of that income." Gregorcich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill*, 28 Tax Lawyer 251, 252 (1975).

This Court and other courts have interpreted these provisions with Congress' clear reflection of income purpose in mind. For example, in *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974), this Court held: "[Section 263] serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing". Similarly, in *Ellis Banking Corp. v. Commissioner*, 688 F.2 1376, 1379 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983), the court of appeals described the functions of Sections 162(a) and 263 as follows:

> "The function of these rules is to achieve an accurate measure of net income for the year by matching outlays with the revenues attributable to them and recognizing both during the same taxable year. When an outlay is connected to the acquisition of an asset with an extended life, it would understate current net income to deduct the outlay immediately. To the purchaser, such outlays are part of the cost of acquisition of the asset, and the asset will contribute to revenues over an extended period. Consequently, the outlays are properly matched with revenues that are recognized later and, to obtain an accurate measure of net income, the taxpayer should deduct the outlays over the period when the revenues are produced."

Furthermore, both the court of appeals in this case (J.A. 258-59) and the Fifth Circuit in *Central Texas*, 731 F.2d at 1184, recognized the interrelation of these provisions, stating that Section 162(a) "must be interpreted in tandem with section 263". Likewise, the Commissioner recognized the interrelation of

Sections 162(a) and 263 in several rulings cited above (*supra* p. 28). In addition, the Tax Court in *Fort Howard Paper Co. v. Commissioner*, 49 T.C. 275, 283 (1967), recognized that "sections 263 and 446 [the method of accounting provision] are inextricably intertwined."

The operation of each of these provisions depends on the existence of "property" or an "asset". Thus:

—Section 263(a), which like Section 162(a) denies a deduction for capital expenditures, describes such expenditures as amounts paid for "permanent improvements or betterments made to increase the value of any *property or estate*." (App. 4a, emphasis added) The Treasury Regulations under Section 263 also refer to "property or estate" and give a number of examples of capital expenditures, all of which relate to specific items of property (including intangible property as well as tangible property).[22] Treas. Reg. §§ 1.263(a)-1 and 2 (1958) (App. 7a-9a).

—Sections 167(a) and 168(a), which prescribe the methods to be used in depreciating tangible assets and amortizing intangible assets whose costs have been capitalized under the rules of Sections 162(a) and 263(a), both refer to "property". This term is construed by Treas. Reg. § 1.167(a)-3 (1956) to include amortization of an intangible asset." (App. 6a-7a) In determining the amount of allowable depreciation or

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[22] Although, as this Court stated in *Lincoln Savings*, Section 263 does not represent "a complete list of nondeductible expenditures", 403 U.S. at 358, the terminology that Section 263 uses to describe the end result of the listed expenditures is instructive.

amortization, a rate is applied to the "basis" of depreciable or amortizable property. *See, e.g.*, Treas. Reg. § 1.167(a)-11(c)(i)(1)(*d*) (1971) (App. 7a).

—The Treasury Regulations under Section 461 of the Code, which implement the requirement of Section 446(b) that any method of tax accounting must clearly reflect income, disallow a deduction to both cash and accrual basis taxpayers for expenditures that create an "*asset* having a useful life which extends substantially beyond the close of the taxable year".[23] Treas. Reg. §§ 1.461-1(a)(1) and (2) (1957) (emphasis added) (App. 9a-10a).

—Section 1012 provides that the "basis" of "property" is its cost, 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 all these provisions have the same basic purpose of properly measuring a taxpayer's net income subject to tax in a given period, they should be construed in a consistent manner. The specific reference to "property" and "asset" in each instance manifests Congress' intent to draw the line between a currently

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[23] The Commissioner has determined that a deduction should not be disallowed on a "clear reflection of income" ground unless the expenditure serves to create or enhance an asset. Gen. Couns. Mem. 39,669 (Oct. 9, 1987) (legal expenses that clearly produced future benefits "would not result in a distortion of taxpayer's income under Sections 446(b) and 461 because such fees did not create an asset within the meaning of Treas. Reg. § 1.461-1(a)").

deductible ordinary expense and a nondeductible (but generally depreciable or amortizable) capital expenditure precisely where this Court held that it must be drawn—where a separate and distinct asset is created or enhanced.

That Congress views the separate and distinct asset test as demarcating the line between a deductible ordinary expense and a nondeductible capital expenditure is also confirmed by its enactment of Section 195 of the Code in 1980. That provision permits five-year amortization of expenditures incurred in starting up a new business, but only if they would be deductible under Section 162(a) if they were incurred in carrying on an existing business. (App. 2a-3a) Since the avowed purpose of start-up expenditures is to derive a future benefit (*i.e.*, from the future operation of the business being started up), no expenditures would ever qualify for Section 195 amortization if future benefit alone were sufficient to preclude a deduction under Section 162(a). Thus, revival of a future benefit test would nullify Section 195—a consequence that Congress could not have intended.[24] Partly for this reason, the Fourth Circuit in *NCNB*, sitting en banc, rejected the future benefit test. It said that "[a]n interpretation by us to the contrary would render § 195 meaningless for it would

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[24] In fact, it is clear from the hearings on proposed Section 195 that the premise underlying its enactment was that the costs of starting up "new operations [that] are part of [an] existing trade or business are currently deductible if . . . *the costs do not create a separate asset*". *Amortization of Start-up Expenditures: 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) (emphasis added).

obliterate the reference point in the statute". 684 F.2d at 291.

Moreover, by requiring a separate and distinct asset, the *Lincoln Savings* test not only conforms to the language of the relevant statutory and regulatory provisions, it also serves the congressional purpose underlying those provisions. It permits capitalized costs to be recognized as the tax basis of the specific asset in question, and thereby allows such basis to be depreciated or amortized over the useful life of the asset under the methods prescribed by Sections 167 and 168, or, as provided in Section 1001(a), to be deducted from any amount realized when the specific asset (as opposed to the taxpayer's entire business) is sold or otherwise disposed of. Only in this way can the taxpayer's costs and revenues be accurately matched and its net income be accurately calculated.

In contrast, a future benefit test provides no apparent means of allowing the taxpayer to recover its costs. As described above, Sections 167 and 168 allow depreciation or amortization only with respect to the basis of property, and Section 1001(a) computes gain or loss on a disposition of property by reference to its adjusted basis. Where no item of property, or asset, is created or enhanced, no depreciation or amortization of capitalized costs can be taken, and no recovery of costs can be allowed before a disposition of the taxpayer's entire business.[25] Some courts have

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[25] Since the court of appeals held that National Starch derived a future benefit from Unilever's ownership of its stock, National Starch might arguably incur a deductible loss (equal to its capitalized expenses) if Unilever disposed of the National Starch stock prior to any disposition by National Starch of its entire business. However, to allow a deductible loss to one

rejected the future benefit test partly for this reason. For example, in *Colorado Springs*, the Tenth Circuit said that "the government's theoretical approach . . . permits a distortion of taxpayer's financial situation" because, under that approach, expenditures of only "temporal value . . . may be neither expensed nor amortized." 505 F.2d at 1192. Similarly, in *First Nat'l Bank of S.C. v. United States*, 413 F. Supp. 1107, 1111 (D.S.C. 1976), *aff'd*, 558 F.2d 721 (4th Cir. 1977), the district court emphasized that under the future benefit test, a "taxpayer has no salable asset from which it could ever recoup the assessments which the government says it must capitalize but would be unable to depreciate or amortize".

The court of appeals in this case sought to justify the lack of cost recovery under its future benefit approach by noting that costs relating to the capitalization of a corporation and to the acquisition of goodwill are also nondepreciable. (J.A. 272) The denial of recovery for such costs, however, represents a narrow departure from the fundamental statutory goal of clearly reflecting the net income of taxpayers. Indeed, there has been continuing criticism over the years of the tax law's failure to provide some method of recovering the cost of purchased goodwill, such as by providing an amortization period fixed by statute. *See, e.g.*, Gregorcich, *supra* note 21, at 281-82; Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill*, 81 Harv. L. Rev. 859, 872-73 (1968). Thus, the treatment of such costs should be viewed as *sui generis*, and the scope of the

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taxpayer upon a disposition of its stock by another taxpayer, an event solely within that other taxpayer's control, would represent a radical departure from well-settled tax concepts.

exception should be narrowly confined lest it swallow up the general principle of clearly reflecting income.

The Commissioner suggests that the lack of cost recovery might be cured, in this case, by adding National Starch's expenses to Holding's basis for its acquired National Starch stock. (Brief for Respondent on petition for certiorari at 11, n.5) Under this suggestion, when Holding disposed of the stock, it would be able to reduce its gain or increase its loss by the increased basis, while National Starch, which paid the expenses, would never receive any recovery of them for tax purposes. This result would be flatly contradictory to the clear reflection of income principle. Moreover, the Commissioner's suggestion bears no relationship to any concept of tax basis presently reflected in the Code, since basis is the amount paid by the taxpayer for his property, not expenses incurred by another person. *See*, *e.g.*, Treas. Reg. § 1.1012-1(a) (1957) (App. 10a).

The Commissioner further suggests that, alternatively, National Starch's costs "could be regarded . . . as vanishing 'into thin air'," and also that "[t]hese potential issues are not presented in this case". (Brief for Respondent on petition for certiorari at 11, n.5) In making these statements, the Commissioner once again fails to recognize that any sensible and workable rule of capitalization under Section 162(a) must be consonant with the fundamental objective of clearly reflecting income by matching revenues and expenses in the appropriate taxable periods and therefore must harmonize with the other statutory and regulatory provisions implementing that same objective.

IV. THE COURT OF APPEALS' TEST FAILS TO PROVIDE ANY PRINCIPLED BASIS FOR DISTINGUISHING BETWEEN ADMITTEDLY DEDUCTIBLE EXPENSES THAT GENERATE SIGNIFICANT FUTURE BENEFITS AND EXPENDITURES THAT MUST BE CAPITALIZED.

Many expenditures that are concededly deductible provide significant future benefits to taxpayers. For example, if an individual taxpayer undertakes an educational program that "improves skills required by the individual in his employment or other trade or business," the expenses of that program—which obviously will benefit the taxpayer in the future—are deductible. *See* Treas. Reg. § 1.162-5(a) (1958) (App. 6a). Similarly, if a taxpayer defends himself against charges of criminal conduct in his business, a conviction of which will result in his imprisonment and, accordingly, cessation of his business activities, the expenses of his defense are deductible. *See Tellier*, 383 U.S. 687. Likewise, if a taxpayer seeks to set aside an order depriving him of access to the mails because of alleged fraud, which would result in the destruction of his mail order business, the expenses of his suit are deductible. *See Heininger*, 320 U.S. 467. And if a taxpayer engages in a program of advertising its products that will have "resulting benefits over future years," the cost of the advertising program is deductible. *See E. H. Sheldon*, 214 F.2d at 656, and cases cited therein. *See also* Treas. Reg. § 1.162-20(a)(2) (1965) ("Expenditures for institutional or 'good will' advertising which keeps the taxpayer's name before the public are generally deductible as ordinary and necessary business expenses *provided the expenditures are related to the patronage the taxpayer might reasonably expect in the future.*") (App. 6a, emphasis added)

There is no principled basis for allowing those types of expenses as deductions and yet requiring the expenses at issue here to be capitalized. All these deductible expenses are, or can be, "once in a lifetime" expenses for a particular taxpayer, and they all can produce, or are intended to produce, significant future benefits.[26] It is apparent, therefore, that to deny a deduction for National Starch's expenses solely because of a perceived future benefit cannot be reconciled with the allowance of those other deductions.

The court of appeals seems to have recognized that many deductible expenses produce future benefits for the taxpayers who incur them, but it would restrict deductibility to those expenses producing a "merely incidental" future benefit. Any expenses generating a future benefit that is "more than merely incidental", and, in addition, is "not insignificant", would have to be capitalized.

Applying the court of appeals' twofold test will require, as in this case, a prediction about the degree to which intangible factors (such as "opportunity for synergy") will favorably impact on the future operation of a business. It will also require an assessment of the relative importance of that future impact as compared to the benefits currently derived by the taxpayer from the expenditures in question. Making such a prediction and assessment is an inherently subjective exercise, and it can be expected that different taxpayers, acting reasonably and in good faith, will draw different

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[26] Indeed, the future benefit aspect of those admittedly deductible expenses is much more definite and concrete than the future benefit to National Starch found by the courts below in this case.

conclusions on virtually identical facts. Moreover, it can be expected that different Internal Revenue Service auditors will draw different conclusions in similar situations, thereby engendering uncertainty, thwarting the goal of consistent treatment of taxpayers and inviting resort to the courts on a case-by-case basis. The courts in such cases will be required to review the facts in detail and make difficult factual judgments, and there will inevitably be inconsistent results in the resolution of such controversies.

The subjective nature of the court of appeals' approach, and the extraordinary difficulty of applying it in practice, are exemplified by the facts of this case. The "not insignificant" future benefit attributed to National Starch was entirely speculative. The company obviously had no control over the Unilever Group and could not compel Unilever to provide additional capital or other resources or to buy more of National Starch's products. At most, National Starch had a mere hope or expectancy of future assistance, which, as the courts below admitted (J.A. 242, 256), remained unfulfilled in the nine years from its acquisition to the time of trial.[27]

In addition, the court of appeals concluded that this unfulfilled hope or expectancy was "more than merely incidental" to the benefits that National Starch actually did receive in the current taxable year from the services rendered to it. These current benefits are

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[27] One of Unilever's officers who participated in the acquisition of National Starch's stock testified at the trial regarding the lack of synergy between National Starch and the Unilever Group. (J.A. 159-60) The court of appeals said that this "self-interested testimony may be discounted" (J.A. 268), even though it was borne out by the actual facts after the acquisition. The Tax Court did not specifically address this testimony.

undeniable. When National Starch was confronted with Unilever's unsolicited offer, the company naturally consulted its counsel, who advised that an investment banking firm should be retained to assist the board. As a practical matter, National Starch had no choice but to retain such a firm, and its services enabled the board to carry out its fiduciary duty in a prudent manner and protected its members from personal liability for failure to do so. (J.A. 240) There does not seem to be any principled basis on which it can be determined that the speculative future benefits identified by the courts below were more than merely incidental to these current benefits.[28]

In contrast to the court of appeals' approach, the *Lincoln Savings* test permits taxpayers to determine whether their expenditures must be capitalized on the basis of existing facts—whether the expenditures actually resulted in a "distinct and recognized property interest"—and not on the basis of a subjective prediction about the future and an assessment of the relative weight to be accorded speculative future benefits as

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[28] It would also be particularly difficult to apply the court of appeals' test to advertising and promotional expenses, which represent a substantial portion of the total expenses of many businesses, and which are commonly recognized as providing significant future benefits as well as current benefits. *See, e.g.*, *E. H. Sheldon*, 214 F.2d at 659 ("The effect of advertising, by its nature, is usually not limited to the year in which it is done, but has a useful life somewhat indefinite in the future"). Similarly, the costs of recruiting and training employees (*see Queen City Printing Co. v. Commissioner*, 6 B.T.A. 521 (1927), *acq.*, VI-2 C.B.6) and maintaining relationships with creditors and suppliers (*see Van Iderstine*, 261 F.2d 211) provide substantial future benefits to employers. What would be the basis on which it could be determined that the future benefits of such expenses were not "more than merely incidental" to their current benefits?

compared to actual current benefits. In making this determination, taxpayers are able to consider whether their rights have the characteristics normally associated with a property interest, including those identified by this Court in *Lincoln Savings*—such as whether the rights are transferable, can be sold or otherwise disposed of for consideration, can earn income and are legally protectible against appropriation by others. *See* 403 U.S. at 355-56. The *Lincoln Savings* test thus promotes an objective inquiry into matters that are more readily ascertainable by taxpayers and the Internal Revenue Service, thereby fostering more certain and uniform administration of the tax laws and reducing the need for case-by-case adjudication.

Conclusion

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

Respectfully submitted,

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June 27, 1991

APPENDIX

STATUTORY PROVISIONS AND REGULATIONS INVOLVED

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

SEC. 162. TRADE OR BUSINESS EXPENSES.

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

SEC. 167. DEPRECIATION.

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

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

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

SEC. 168. ACCELERATED COST RECOVERY SYSTEM.

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

(1) the applicable depreciation method,

(2) the applicable recovery period, and

(3) the applicable convention.

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

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

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

(1) paid or incurred in connection with—

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

(B) creating an active trade or business, and

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

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

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

(b) ELECTION TO AMORTIZE.—

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

(2) DISPOSITION BEFORE CLOSE OF AMORTIZATION PERIOD.—In any case in which a trade or business is completely disposed of by the taxpayer before the end of the period to which paragraph (1) applies, any deferred expenses attributable to such trade or business which were not allowed as a deduction by reason of this section may be deducted to the extent allowable under section 165.

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

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

(A) paid or incurred in connection with—

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

(ii) creating an active trade or business, or

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

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

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

SEC. 263. CAPITAL EXPENDITURES.

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

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

SEC. 351. TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR.

(a) GENERAL RULE.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

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

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

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

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

SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) COMPUTATION OF GAIN OR LOSS.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

SEC. 1012. BASIS OF PROPERTY—COST.

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses). * * *

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

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

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

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

§ 1.162-20. Expenditures attributable to lobbying, political campaigns, attempts to influence legislation, etc., and certain advertising.—(a) *In general*— * * *

(2) *Institutional or "good will" advertising.* Expenditures for institutional or "good will" advertising which keeps the taxpayer's name before the public are generally deductible as ordinary and necessary business expenses provided the expenditures are related to the patronage the taxpayer might reasonably expect in the future. * * *

§ 1.167(a)-3. Intangibles.—If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to good will. * * *

§ 1.167(a)-11. Depreciation based on class lives and asset depreciation ranges for property placed in service after December 31, 1970.— * * *

(b) *Manner of determining allowance*—(1) *In general*—(i) *Computation of allowance.* * * *

(*d*) The annual allowance for depreciation of a vintage account using a declining balance method is determined by applying a uniform rate to the excess of the unadjusted basis of the vintage account over the depreciation reserve established for that account. The rate under the declining balance method may not exceed twice the straight line rate based upon the asset depreciation period for the vintage account.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(2) *Taxpayer using an accrual method.* Under an accrual method of accounting, an expense is deductible for the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. However, any expenditure which results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. * * *

§ **1.1012-1. Basis of property.**—(a) *General rule.* In general, the basis of property is the cost thereof. The cost is the amount paid for such property in cash or other property. * * *