OFFICIAL TRANSCRIPT

ORIGINAL

PROCEEDINGS BEFORE

THE SUPREME COURT

OF THE

UNITED STATES

CAPTION: INDOPCO, INC., Petitioner V. COMMISSIONER OF INTERNAL REVENUE

CASE NO: 90-1278

PLACE: Washington, D.C.

DATE: November 12, 1991

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IN THE SUPREME COURT OF THE UNITED STATES

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INDOPCO, INC., :

Petitioner :

v. : No. 90-1278

COMMISSIONER OF INTERNAL :

REVENUE :

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Washington, D.C.

Tuesday, November 12, 1991

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 10:03 a.m.

APPEARANCES:

RICHARD J. HIEGEL, ESQ., New York, New York, on behalf of the Petitioner.

KENT L. JONES, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C.

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P R O C E E D I N G S

(10:03 a.m.)

CHIEF JUSTICE REHNQUIST: We'll hear argument first this morning in 90-1278, Indopco v. the Commissioner of Internal Revenue. Mr. Hiegel, is it?

MR. HIEGEL: Yes, Your Honor.

CHIEF JUSTICE REHNQUIST: Mr. Hiegel, you may proceed whenever you're ready.

ORAL ARGUMENT OF RICHARD J. HIEGEL

ON BEHALF OF THE PETITIONER

MR. HIEGEL: Mr. Chief Justice, and may it please the Court:

The issue in this case is what test should be applied to determine whether an expenditure is capital in nature and therefore not currently deductible as an ordinary business expense under section 162(a) of the Internal Revenue Code.

This is a fundamental issue arising, as the Commissioner says, in virtually every area of business activity. We contend that the separate and distinct asset test enunciated by this Court in the Lincoln Savings case is controlling, and should have been applied to determine that petitioner's payments are currently deductible.

The Commissioner, on the other hand, would not have any general test and would instead make a

case-by-case determination of the test to be applied. In this case, he would employ a nonrecurring future benefit test to find that petitioner's payments were capital expenditures, not deductible either currently or at any time before petitioner's final liquidation.

The issue arises in the context of an unsolicited offer by Unilever, a large, multinational group of companies, to buy petitioner's stock, which was publicly held. On advice of counsel, petitioner engaged an investment banking firm to value the company so that its board of directors could make recommendations to the stockholders concerning the offer. Under Delaware law, it was required to advise the stockholders, and it had to do this whether or not the stockholders ultimately approved the transaction. The board's recommendation turned out to be favorable, the stockholders voted to approve the offer, and they closed in August 1978.

Petitioner itself did not buy or sell any stock or other assets. Only stockholders transferred their stock to Unilever Corporation. This transfer was accomplished in part by a merger of a transitory subsidiary into petitioner. Before the transaction, the Commissioner ruled that this merger should be disregarded and the transaction should be treated as a direct purchase and sale between the stockholders and the Unilever

Corporation.

After the stock purchase, petitioner carried on its business essentially in the same way as before, without any significant technological or other assistance from Unilever. The investment banking and legal fees and other expenses incurred by petitioner were reasonable in amount and customarily incurred in transactions of this kind.

QUESTION: Were the investment banking fees contingent on successful completion of the transaction?

MR. HIEGEL: There was a partial contingency, Your Honor. There was a $500,000 amount that was to be paid regardless of the completion of the transaction and an additional $1,700,000 in the event it was completed.

The tax court and the court of appeals held that these payments were nondeductible capital expenditures because they were incident to a transaction that, in their view, conferred a long-term benefit on petitioner.

QUESTION: Counsel, in the return as filed, only some of the fees and expenses were asserted.

MR. HIEGEL: That's correct, Your Honor.

QUESTION: Why weren't all of them?

MR. HIEGEL: I -- the record does not show why, Your Honor. The legal fees were not deducted immediately. I've been told that it was a mistake, but there is no

evidence in the record to tell us --

QUESTION: Does that indicate --

MR. HIEGEL: Why that happened.

QUESTION: Does that indicate the taxpayer felt they were not deductible?

MR. HIEGEL: As I say, I've been told that it was a mistake, and I do not -- I do not know any more than that.

QUESTION: You said these expenses were ordinarily incurred in a transaction like this.

MR. HIEGEL: Yes, Your Honor.

QUESTION: Do you think they would have been generally across the country, or is it -- was it just because of the requirements of Delaware law?

MR. HIEGEL: Well, in many -- most corporations today, I think, are incorporated in Delaware, or States that have similar laws, and I do not think that there would be any difference in particular jurisdictions.

QUESTION: Actually, what -- do you think -- do you think ordinarily if somebody who wants to acquire a corporation makes an offer to its stockholder -- to the -- to target stockholders that the corporation goes through this?

MR. HIEGEL: Yes, ordinarily they do, Your Honor.

QUESTION: And you think whether or not the law requires it?

MR. HIEGEL: I think it's just basic -- part of the basic fiduciary responsibility of the board of directors to the shareholders, particularly in a public company, to make a determination as to whether the offer is a reasonable offer and represents a fair price to the stockholders. That, I think, is quite common and ordinary, and in fact there's a case in the Delaware -- again in the Delaware courts that imposed liability on a board if it -- because it did not seek expert advice in this situation.

The long-term benefit that --

QUESTION: Counsel, may I ask, now, what about the expenses of organizing a corporation to get started in business?

MR. HIEGEL: Those expenses are capitalizable, Your Honor.

QUESTION: Well, a special statute was passed, was it, to --

MR. HIEGEL: A special statute --

QUESTION: To allow --

MR. HIEGEL: -- was passed to allow 5-year amortization.

QUESTION: -- some deduction, and before the

passage of that statute, how were those expenses treated?

MR. HIEGEL: They were capitalized and no deduction was allowed until final liquidation.

QUESTION: And no amortization?

MR. HIEGEL: And no amortization, because --

QUESTION: How about the expense --

MR. HIEGEL: Excuse me --

QUESTION: Yes.

MR. HIEGEL: Sorry, Your Honor. I would say, no amortization in the case where the charter was perpetual. Where the charter of the corporation had a limited period, then amortization was allowed over that period.

QUESTION: I see; and how about expenses of restructuring a corporation, a corporate reorganization?

MR. HIEGEL: Well, that depends, Your Honor, on what you mean by restructuring. The term corporate restructuring, or capital structure changes, has been used a great deal in this cases, and it really is -- the cases look at it in two ways, and involve several different types of situations.

The first situation is the organizational expenses, and then there's stock issuance expenses, and changes to the characteristics of the stock such as changing its par value, increasing the authorized shares. Stock issuance expenses are looked at in two ways. One,

the courts say the expenses of doing that is an offset to the amount of capital that is raised by issuing the stock, therefore there's no deduction because you're just raising that much less capital.

Other cases look at those -- those situations and say, there's a creation of a capital asset, an intangible capital asset, and it's not deductible for that reason.

QUESTION: So your answer is that there is a split of authority?

MR. HIEGEL: In -- there is a split of theory on which those cases are based. In each -- in each case, there's no deduction allowed at the outset. In the case where it's held to be a capital -- intangible capital asset, there is a deduction allowed at the end of the corporation's life under section 165 of the code or its predecessor, and in the case where it's treated as an offset to the amount of capital raised, there would be no -- logically no deduction allowed in that case.

QUESTION: What about expenses incurred in connection with a hostile takeover?

MR. HIEGEL: Well, the -- there have been no cases dealing with hostile takeovers. The Internal Revenue Service, in certain private rulings, has changed its position with respect to hostile takeovers.

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Originally, they said that they were deductible, and then they changed their view and said that they were not deductible, and then again changed their -- their view. The most recent view expressed by the Service has just been about 2 weeks ago, in which they said they -- those expenses can be capitalizable if the transaction results in a future benefit to the corporation.

In other words, if the hostile -- if the hostile takeover succeeds, and the company is actually taken over, those expenses can be capitalized.

QUESTION: And if it is not, if it does not occur?

MR. HIEGEL: If it does not occur, then there's no transaction to which that you -- no benefit, no transaction occurs, and the expense is a -- is a deductible loss.

Originally the theory of --

QUESTION: It is a deductible loss in the year incurred?

MR. HIEGEL: If the transaction does not incur -- does not occur. That might not necessarily be the same year. If they're capitalized initially, Your Honor, and the -- and the period of time over which it takes to see whether the --

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QUESTION: Here's the hostile takeover and it -- and it comes and goes and is unsuccessful in one year, and the company spends a lot of money opposing it --

MR. HIEGEL: That would be deductible.

QUESTION: As an -- as an ordinary and necessary business expense?

MR. HIEGEL: Yes, Your Honor.

QUESTION: Is that clear? Does the Internal Revenue Service agree with that, or do you know?

MR. HIEGEL: I believe so, yes. There are cases that so hold, unless it's successful. Yes -- I think the question was whether -- if it were unsuccessful, Your Honor.

QUESTION: Mr. Hiegel, could I go back to Justice Kennedy's question? Is it not true -- you said $500,000 was payable in all events. That's only if the negotiations reached a certain stage in their proxy solicitations, isn't that true? As I read --

MR. HIEGEL: That's correct. That's correct, Your Honor.

QUESTION: In other words, if they had rendered a negative opinion and the negotiations had fallen apart almost immediately, you would have only paid about $100,000?

MR. HIEGEL: You're -- you're right. I think it

was $200,000, but --

QUESTION: Well --

MR. HIEGEL: It was a lesser figure, that's correct.

QUESTION: If the -- if the transaction didn't occur, there would have been a deduction?

MR. HIEGEL: Yes. I see no reason why not, Your Honor.

MR. HIEGEL: At any rate, to get back to the last statement of the facts, the benefit that the courts below, the reason why they capitalized the expenditures in question, was because of the possibility that petitioner's new parent might at some point in the future provide technological or other assistance to petitioner in its business operations.

We believe that the separate and distinct asset test, rather than the future benefit test as followed by the courts below, is controlling for two reasons. First, the separate and distinct asset test is the only test for capitalization that is consistent with the tax accounting system set up by Congress in the code, and second, the future benefit approach has three critical flaws.

First, it is not -- it is inconsistent with our tax accounting system; secondly, it fails to provide any principle or basis for distinguishing between admittedly

deductible expenses and expenditures that have to be capitalized; and thirdly, it will generate unending controversy because of its inherently subjective and speculative nature.

Before addressing these points, I would like to mention that the Commissioner would not necessarily apply a future benefit test in every case, and indeed he does not support the formulation of the future benefit test that the court below indicated. However, we believe that his position is even more at odds with the statute and would further undermine predictable and evenhanded administration of the tax law.

Let me now address those points in turn. In Lincoln Savings, this Court held that the presence of an ensuing benefit having some future aspect was not controlling as to the capital nature of an expenditure. What was important and controlling, it held, was that the payment served to create or enhance a separate and distinct asset. It also --

QUESTION: You -- you don't claim, do you, that Lincoln requires your result in this case?

MR. HIEGEL: We believe that if you look at the facts of the case and follow the process of reasoning of the Court, that it would require the result in this case. That position has been taken by the courts of appeals in

cases following Lincoln Savings, the Treasury Department believed it, and it was a premise on which Congress enacted section 195 of the code. However, if all of those cases and the Treasury Department and the Congress were wrong about that, and what -- what the Court meant to do was only to say that it found an asset in that particular case --

QUESTION: Sufficient condition, not necessary condition.

MR. HIEGEL: That's correct. It -- certainly it's a possibility, but it does not mean that that is not the correct test. Certainly the Court did not reject in that case separate and distinct asset as a general test, and we think that it should adopt that test as a general test for the reason I'm about to state, and the reason is that, as I said, that this is the only test that's consistent with the tax accounting system in the code.

As the cases in this Court -- this Court and other courts, and as the Commissioner agrees, the goal of the system is not simply to disallow a current deduction and thereby tax gross income. Rather, the intention is to spread out the effect of a capital expenditure over its revenue-producing life.

The system does this by providing for the recovery of these capitalized costs through depreciation

or amortization, or by deduction from the proceeds realized upon a sale, or upon another dispcsition, such as by abandonment.

In each and every case, the code sections that perform this function require that there be a property or an asset with a basis, or else they just don't apply. For example, section 167 allows depreciation for, quote, property used in the trade of business, and determines the amount of depreciation by reference to the basis of the property, which is its cost.

The regulations under section 167 allow amortization of an intangible asset. Section 1001 computes gain or loss by reference -- on a sale by reference to the adjusted basis of the property.

Since costs are capitalized under the Lincoln Savings test only where there's an asset or an item of property, then the taxpayer has the means of recovering his cost through those statutory provisions, and therefore the test is entirely consistent with the statutory scheme.

QUESTION: But Mr. Hiegel, you've -- you've said that -- why, you said that these costs in other instances, for example, where they are the costs of restructuring a corporation, are ultimately recoverable when the corporation is dissolved. That's the point at which that asset, if you want to consider it an asset, is finally

disposed of, when the whole corporation is dissolved. Why doesn't that solve your incompatibility problem?

MR. HIEGEL: Well, in the first place, Your Honor, on the facts of this case we don't have a corporate restructuring. We do not have the kind of --

QUESTION: No, I understand, but you're making a theoretical argument --

MR. HIEGEL: That's correct.

QUESTION: That unless you use a separate asset theory you can never recover this money, but you can, when the corporation is dissolved, as you do with respect to restructuring expenses.

MR. HIEGEL: I think restructuring, Your Honor, is an example that -- an exception, really, that proves the rule. It's the one case -- it's really the one case where there isn't an asset that can be depreciated or amortized or where the cost can be recovered on sale or abandonment.

QUESTION: Well, that must be wrong --

MR. HIEGEL: It's the -- it's --

QUESTION: That must be wrong, too, then?

MR. HIEGEL: Well, as I said before -- as I said before, there are two ways of looking at those cases, Your Honor. One is that the amounts expended to raise capital are simply an offset to the amount of capital raised,

therefore it -- it really doesn't matter whether it's considered an asset or not. You just have less capital. You don't have a deductible expense or an intangible asset, either.

But if you look at them as an intangible asset, then it just -- it just happens to be the one case where there is no recovery until final liquidation. That does not mean that that's a good system, and in fact as I said in response to Justice O'Connor's question, Congress enacted section 248 of the code because it was not satisfied with a situation where organizational expenses -- expenses had to be capitalized and there was no recovery of those costs. After all, we have a net income tax system, not a gross income tax system.

The objective is not to tax gross income, it's to recover costs in a rational way during the period that they are producing revenue over the -- over the life of those expenditures. Capital structure is just one case where there is no definite life, and as I said before also, if there were a definite life, it is amortizable, so you do have a means of recovery in that case. It's only where the charter is perpetual, which happens to be the case with most corporations, but that's just the facts of life. There is that one situation.

That does not mean, I think, that we should

adopt a rule that in the generality of cases every time that you capitalize an expense without an asset to which it can be assigned as a basis, you have no recovery whatsoever. You have no way of recovering that cost under the Internal Revenue Code.

QUESTION: Do we have to accept the finding of fact of the district -- of the tax court that there was a long-term future benefit?

MR. HIEGEL: That there was a -- I think what the finding was, Your Honor, was that there was a possibility of a future benefit. I think you do have to accept that. We are not arguing that that is not a correct finding, but that is not relevant to the ultimate result in this case, in our view, because that is not the appropriate test.

Future benefit is not the appropriate test, it's the separate and distinct asset test that is the appropriate test, and there was a finding by the courts below, and a statement to that effect by the court of appeals in particular, that there was no asset found, there was no asset in this case, and I don't see how there could be an asset in this case.

What the Court -- what this Court did in Lincoln Savings, when it talked about a separate and distinct asset, was to look at -- it said it was a recognized -- a

distinct and recognized property interest. In other words, it read the words asset and property in the code in their normal meaning, which is, of course, the paramount rule of statutory construction, as this Court has said many times, and it looked at the characteristics that a property interest would normally have; transferability, the ability to earn income, to be used to satisfy other obligations or to be exchanged for cash, the fact that it was accounted for as an asset for accounting purposes, and presumably could not be misappropriated by anyone else in that case.

QUESTION: I -- I must say I'm having trouble with your argument that if it's not a separate and distinct asset then it must follow that it's an ordinary and necessary business expense. It just doesn't seem to me that the -- that the conclusion follows, and that is your argument, I take it?

MR. HIEGEL: It is my argument that if there are other requirements in section 162(a), it has to be paid or incurred in carrying on a trade or business, necessary in the sense of being appropriate and helpful, so that the only word that's in issue is the question of whether it's -- it's an ordinary expense.

That word apparently has two meanings, according to the decisions of this Court. One is that it's usual

and customary, and the other is that it's not a capital expenditure, and yes, if it is not a capital expenditure, and if it meets the other requirements of section 162(a), then it should be allowed as a deduction. If it is not allowed as a deduction, it will never be recovered.

As I said before, the Government -- and let me just address that point for a second. The Government in its brief says that we would get this deduction on -- we would get a deduction on final liquidation. That assertion rests on the cases that deal with capital structure, where they held that it was an intangible asset and the asset was lost on liquidation, but the section under which that was allowed as a deduction was the predecessor of section 165, and section 165 now, and did then, requires that in order to have a deductible loss, it's limited to the basis of property.

So if you don't have property, if you don't have an asset, there is no deduction under those cases, and therefore there's no deduction under the Commissioner's position here, ever. If we don't have a change in capital structure, then there -- there is -- no asset, even arguably is no asset to which this cost can be assigned, and we never get a deduction, and that would be true even if it were known at the outset that the life of this benefit -- let's assume that there was a future benefit,

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an even more concrete one than was found by the courts below, but it would only last for 10 years.

Let's assume that Unilever had to dispose of the stock of the company in 10 years, for whatever reason, so we knew it would only last for 10 years. You would think that under a rational net income tax system you'd be able to write off that cost over that 10-year period when you were realizing the benefit, or at least that you'd get a loss at the end of that period, a deductible loss under 165.

The answer is, you would not get a loss. There is no provision in the code that would give you either the write-off over the 10-year period, or the loss, because there is no asset. Each of those provisions depends on there being property or an asset with basis.

QUESTION: Mr. Hiegel, can I ask you a question? I haven't really thought this through, but I'd like you -- like you to comment on it.

It seems to me that arguably the investment banker here was really representing the selling shareholders, and that in one sense you could have set up a transaction in which the costs of the -- of this $2 million could have been, in effect, charged to the shareholders in some way and treated as a cost of sale and therefore be recoverable as part of the -- you know, the

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deduccion, reduce the amount of the capital gain that they'd have. Is that conceivable, or is that -- it seems to me there's a little bit of uncertainty as suggests who was being represented by the investment bankers, the stockholders of the corporation. That's what's running through my mind.

MR. HIEGEL: I think it's theoretically possible that could be the situation. The facts in this case, however, show that it was not the situation. The investment banking firm was hired by the board to enable it to decide whether Unilever's offer was a fair price.

QUESTION: But most of the fee went for consummating the sale rather than for giving the advice. Only about $100,000 was for the advice, as I understand it, which was noncontingent. The rest is a contingent fee on completing the transaction.

MR. HIEGEL: I -- I don't -- well, the fact that it was contingent on completing the transaction I don't think indicates necessarily that they were acting for the stockholders, Your Honor. It's just that their liability, because they --

QUESTION: But the decision as to whether or not to go forward with the transaction was governed by the advice they got, which was available for $100,000, $150,000.

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MR. HIEGEL: That's correct, but once -- once if --

QUESTION: That is clearly a corporate function there, but when you go beyond that, aren't they in a sense representing sellers rather than the ongoing corporation?

MR. HIEGEL: I don't -- I don't see on the facts of this case, Your Honor, what they did to help the sellers. They did not negotiate this transaction. In fact, when Unilever originally made their offer of $65 to $70, they reported back to the board that they thought that was a fair price, and it was the board that didn't think that it was a fair price, and asked them to go back and tell them we want $80 a share, and it ended up at $73.50 a share. So they really didn't act on behalf of the corporation -- on behalf of the shareholders at all.

QUESTION: Well, that shows they had an interest in having the sale go through, I guess.

MR. HIEGEL: They had an interest in having the sale because their liability was greater. If their -- if their opinion was in the proxy statement and was published to the stockholders, then they would have much greater liability because of giving that opinion than just advising the board. They were then -- they were then answerable to this whole group of public stockholders if their opinion was negligent or didn't take into account

the proper factors, and that's why, typically, the court -- the fees are much higher.

If the Court please, I would like to reserve my remaining time for rebuttal.

CHIEF JUSTICE REHNQUIST: Very well, Mr. Hiegel. Mr. Jones, we'll hear from you.

ORAL ARGUMENT OF KENT L. JONES

ON BEHALF OF THE RESPONDENT

MR. JONES: Mr. Chief Justice, and may it please the Court:

This is a case where starting at the beginning really will help us get to the end, so before I discuss Lincoln Savings and the reorganization expense cases I'd like to spend a few minutes talking about the fundamental analytical issue that's present in every capital expense case.

The distinction between capital and ordinary expenses is rooted in the simple fact that the Federal income tax is assessed and collected on an annual basis. In order to reflect taxable income for each separate year, it's necessary to match the income derived from each year's activities with the expenses incurred to produce that year's income.

The problem that is addressed in capital expense cases arises when an expense incurred in one year assists

in producing income in more than a single year. For example, 2 years of prepaid rent, if it's deducted entirely in the current year it would understate present income and overstate income in the following year, so the function of capitalization is to achieve, as Judge Wisdom said in the Ellis Banking case, an accurate measure of net income by properly matching expenses with the income that it benefits.

While capitalization is conceptually necessary for all expenses that create a material future benefit, the goal of achieving an accurate measure of net income is a pragmatic one. Expenses of advertising and maintenance create both present and future benefits, but capitalization is not required as a practical matter even though some future benefit results, because the current benefit predominates and the expense is a regularly recurring one, so you achieve essentially the same statement of income whether you deduct the entire expense in the current year or whether you amortize a portion that relates to the future benefit each year. Since the current deduction for those kinds of recurring expenses would not materially misstate income, they are allowed.

QUESTION: What about a hostile takeover, and expenses incurred in connection with that?

MR. JONES: Well, the ordinary way to analyze

that, if you're the acquiring party, and you seek a hostile takeover that doesn't succeed, your expenses are deemed to be capital, but they're deducted as a loss in the year that they're incurred -- I'm sorry, in the year that the transaction falls apart, and that responds to petitioner's suggestion that you have to have --

QUESTION: (inaudible)

MR. JONES: Well, not because an asset has been --

QUESTION: Under the Government's theory.

MR. JONES: Under the Government's theory, they are an expense that was incurred to create an asset that was designed to have a future benefit, but when the asset loses its value by the failure to conclude the transaction, at that point in time we recognize the loss that has occurred and allow it to be deducted under 165, not under 162.

QUESTION: What about expenses of reorganization or merger?

MR. JONES: Well, that -- that, of course, is broadly speaking what this case is about. Reorganization expenses, when incurred by a corporation to achieve future benefits, which is the ordinary situation, are capitalized under the structure of the business, and as counsel has said, they remain in the capital structure until the

ultimate termination of the enterprise.

They have no determinable useful life. There's no basis to amortize or depreciate, so they remain in the current structure until an event of recognition occurs, and the recognition event for those kinds of expenditures is when the -- is when the asset is destroyed by the termination of the enterprise.

QUESTION: But the initial corporate expenses are treated differently to set up the corporation initially?

MR. JONES: Well, prior to 1954, they were treated the same. In 1954, Congress enacted section 248 that allows organizational expenses to be amortized. When Congress did that, the legislative history at page A64 of House Report 1337 shows that Congress knew that reorganizational expenses were also capital in nature, but expressly determined that only the organizational expenses and not reorganizational expenses should be amortized. That was a legislative determination made by Congress.

Functionally, it would be appropriate to capitalize them both until the end of the enterprise, because the benefit isn't exhaustive. The benefit of organization or reorganization isn't exhausted in 60 months. Congress provided the privilege of a deduction for organizational --

QUESTION: But what do you think the test is, Mr. Jones, for knowing what must be capitalized and what isn't? What is the taxpayer to apply as the test in preparing a return?

MR. JONES: The test is a functional one of properly matching expenses with the years they benefit income, but it's a pragmatic test at the same time. It's not pushed to extremes. We allow -- by regulation and rules we allow advertising expenses to be deducted currently, even though to some extent --

QUESTION: Well, is it possible to articulate the test in any -- at any level of generality, and isn't the tax law an area where it's desirable to have some kind of clear standard?

MR. JONES: It is -- it is possible to, as I've already tried to do, articulate the functional test. Given the functional test, it is possible, and the courts have articulated categorical rules, but the rules are subject to exceptions. It is, for example, a categorical rule that courts have consistently held that reorganizational expenses should be capitalized. It is a categorical rule that advertising expenses, on the other hand, may be deducted currently, but we nonetheless recognize exceptions.

For example, advertising that was designed

solely to promote a product not yet in production would be capital in character, and they would be required to be capitalized and either amortized -- and amortized over some appropriate period.

This Court's --

QUESTION: Mr. Jones, what happens -- what happens in this case if Unilever later disposes of this company, so that the value that you think has been acquired in this transaction, the value of the association with Unilever, disappears. Can they take the deduction then?

MR. JONES: Well, I'm not dodging the question, I'll try to answer it, but I think it should be emphasized that that isn't presented here, and the reason that should be emphasized is because it depends -- it depends on future events exactly how that transaction should be characterized.

What courts have done in those situations -- the McCrory case, the Vulcan Materials case -- they have said that even though you dispose of the asset -- for example, sell the assets that you acquired -- you nonetheless retain in your corporation, the merged corporation, the capital costs of the acquisition, because you obtain the benefit of the joining of the corporate forces even if you dispose of some of the assets later on.

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So I think it's a factual inquiry, and different facts could give different results, but the ordinary -- the categorical rule on that situation is well-established.

QUESTION: Well, if Unilever disposed of this company, they would be selling the stock, I suppose.

MR. JONES: If Unilever --

QUESTION: And I thought the question was -- was whether this is deductible by the subsidiary.

MR. JONES: I think you're absolutely right, and I was trying to answer a different question.

QUESTION: Yes, you were answering a different question.

MR. JONES: Right. You're absolutely right. If Unilever simply sold the stock, then the basis -- the basis that we're talking about, the capitalized expenses we're talking about, are in National Starch --

QUESTION: Yes, but -- yes, but you say that -- you say that what they have acquired, that the long-term asset they've acquired is the asset of the close association with Unilever, which gives them all sorts of -- all sorts of benefits. That's how --

MR. JONES: It does.

QUESTION: -- you describe it in your brief, so I'm saying, what happens when Unilever says, get out, you

know, we're selling it to somebody else?

MR. JONES: There are three types of benefits that are -- that are acquired by Indopco in this reorganization. They acquired access to capital possessed by Unilever. That's a --

QUESTION: Right.

MR. JONES: -- characteristic function of reorganization.

QUESTION: Right, and that would disappear when -- when Unilever disposed --

MR. JONES: But they would enjoy the benefit of it during some period of time, and since there is no way, a priori, to determine when that benefit is exhausted -- I mean, they could have received the benefit by expansion. The ordinary way that you benefit from access to capital is by expansion. Theoretically they could expand. They could become three times as big, and then they're sold. They've already received and they possess the benefit of that access to capital, so there would be no recognition event that has occurred to provide for that to be deducted.

The second benefit that they got from the reorganization was the synergy between working with -- combining their assets and abilities with Unilever's business needs. There again, that synergy can

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create benefits for them that would exist even after the entities had separated.

For example, the trial testimony in the tax court from the Indopco officers describes new ventures that they've begun to supply specialized raw materials for Unilever. That kind of expansion of the corporation is the sort of thing that was made possible by this reorganization. It is a long-term benefit which is received by the corporation. It does not terminate predictably, and that's really all we have to talk about at that point, is can we predict now when it will terminate? No, we can't.

Your question about whether, if it was sold later on how we would treat it, is quite honestly a difficult question that would depend upon a different factual record and that would require a very -- a difficult analysis. I can't categorically dispose of the possibility that it would be a recognition event as you suggested, but I can categorically say it might not be, and that's -- that's really --

QUESTION: May I vary Justice Scalia's question? You haven't gotten to your third benefit. I would guess some -- maybe you ought to tell us, what is --

MR. JONES: Well, the third --

QUESTION: You said, access to wealth and

synergy. What -- what --

MR. JONES: The third benefit was -- was a permanent one. It resolved the persistent problem that they had of retiring the shares of a major shareholder in a way that did not interrupt their ongoing business, and if I might say before --

QUESTION: Well, let me give you my other question --

MR. JONES: Okay.

QUESTION: -- because you may want to cover it at the same time. Supposing none of these three features had been present. Supposing they sold to a totally unrelated company that was no larger in wealth than the existing shareholders. As I read the Government's brief, you'd take the same position in that case?

MR. JONES: Yes, we would, and that gets --

QUESTION: So we really shouldn't rely on these factors?

MR. JONES: Well, I think you should rely on them. I think they're important, but there are two separate tests that courts have looked at in the reorganization expense area.

The first, the older test, is the Motion Picture Capital Corporation test, where the court -- the Second Circuit emphasized that reorganization expenses don't

provide any current benefit to the corporation. They do not assist in the production of current income, they do not -- they are not incurred in the ordinary course of producing income, certainly none of the expenses incurred by Indopco have anything to do with generating income for the corporation in 1978, the year they were incurred.

It is the second test, as exemplified by Justice Blackmun's opinion in General Bancshares for the Eighth Circuit, where the court stressed that reorganization expenses do provide a long-term benefit for the corporation and are not devoted to current income production or other immediate needs of the corporation, so those -- this is an area where pragmatic balancing of objectives is the functional necessity of -- of the study.

When the future benefit is predominant and the current benefit is nonexistent, clearly that is an appropriate occasion for capitalization. I'm not -- I'm not saying --

QUESTION: What's the answer when there's no benefit -- when there's no benefit?

MR. JONES: Well --

QUESTION: Justice Stevens' question -- no discernible benefit.

MR. JONES: If there's no discernible benefit from an expense to the business, period, then the question

may -- I have to ask, I would have to ask in what context that is made.

If you're talking about in a reorganizational context, then the answer is that it is not deductible because it has nothing to do with generating income in the year that it's made. It is an expense incurred to achieve something that will last into the future, a reorganizing of the corporation, and that kind of organizational or reorganizational expense is the most characteristic type of capital expenditure.

Well, this Court has struggled for over 60 years and has itself held that there is no verbal formula that supplies a ready touchstone.

QUESTION: Assume --

QUESTION: What about the situation where a company unsuccessfully opposes a hostile takeover, claiming that this couldn't possibly benefit this company, all it could do is benefit the -- these raiders, and that they spent a lot of money and they -- and it's -- and they get taken over anyway? What about those expenses?

MR. JONES: We recognize two possible outcomes in that situation.

QUESTION: Because that may be a case where there's no benefit.

MR. JONES: There may be no benefit, there may

be no appropriate deduction, but there may also be a future benefit. I mean, when a -- it is common in these commercial situations, when someone proposes a takeover, for them to be resisted, and whether the degree of resistance is called hostile or not hostile is a --

QUESTION: Yes.

MR. JONES: -- is a difficult --

QUESTION: But in any event, you say that in this example there would be no current deduction?

MR. JONES: In -- in the --

QUESTION: In the example I just --

MR. JONES: Opposing, hostile --

QUESTION: The unsuccessful opposition to a hostile takeover.

MR. JONES: That is correct. There may be --

QUESTION: No current -- no current deduction.

MR. JONES: There may be a capital -- it may properly be capitalized --

QUESTION: It may be, but not currently.

MR. JONES: But there's no current deduction, because it doesn't benefit current income, but in -- sorry.

QUESTION: By the compulsory -- by the compulsory nature of this expense, let's assume -- and you might quarrel with it on the facts, but let's assume that

the company, the petitioner is correct, that they were required as a matter of corporate policy, as a matter of fiduciary responsibility, to incur these expenses, it seems to me that the compulsory aspect of the case somehow weighs in favor of the taxpayer, although I can't quite fit it into a formulation as to why that should be.

MR. JONES: Well, the -- I think the answer to that was -- is in the Woodward v. Commissioner case, where the court emphasized that you look to the origin of the expense, not its classification as a fiduciary expense, or whatever.

As the tax court said in this case, it would let the tail wag the dog to say that these expenses were incurred out of fiduciary duty. In fact, they were incurred to facilitate the reorganization. The origin of the expense was the reorganization, not the fiduciary duty. That argument would be like saying that attorney's fees incurred in registering stock are simply designed to satisfy legal requirements of the SEC, and so they're current. That's not the way the court has looked at it. They've looked at what is the function of --

QUESTION: Yes, but when you register stock, you have the option to engage in the transaction or not. Here, at least at the outset, they had -- they had no option but to incur the expense, or to make the payment.

MR. JONES: I'm not sure that I would agree that they had no option but to incur a $2 million expense. I think that --

QUESTION: Well, let's assume that there was a finding to that effect.

MR. JONES: Well, even if they had no option, if the result of the -- that's like saying that you have no option but to pay other expenses that are capital in nature, and there are examples of that.

If the reason that the expense has to be incurred is to facilitate a reorganization, as it was here, then whether it's an optional expenditure -- you have to have legal title opinions, you have to do other things to reorganize a company, but that doesn't mean it's not a capital expenditure.

QUESTION: And what -- what happens -- can you give other instances of expenditures that you don't know whether they're capital or current expenditures until you wait and see whether the -- whether the thing is successful or not? I mean, I find that very strange, you know.

MR. JONES: I'm not --

QUESTION: The client comes to me and says, do I deduct this this year, or not, and you say well, you know, have to wait and see. If it's a successful takeover, no;

if it is unsuccessful, it's an ordinary expense.

MR. JONES: Well, it's -- it's like any other loss, Justice Scalia. You don't know when it's going to happen, but when it happens it's then deductible.

QUESTION: Oh, I see, you're allowing it to be deducted as a loss when it happens, not as a -- I've got you.

MR. JONES: I'd like to discuss the suggestion of petitioner that in Lincoln Savings the Court adopted the separate and distinct asset test as a panacea for all capitalization questions.

In a literal sense, the fact that an expense creates an asset that is separate and distinct is neither necessary nor sufficient for capitalization. Prepaid rent expense for 6 months is a distinct capital asset, but it's fully deductible if it's fully consumed in the current year. A ballpoint pen is an asset, and it may well provide benefits beyond a single year, but it's fully deductible as a regularly recurring ordinary business expense.

Goodwill purchased in connection with the business is defined by regulations as a capital asset, but in no real sense is it a separate and distinct asset, because it only exists in combination with the other assets of the corporation. It has no independent value.

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There is a semantic circularity in this problem. From an accounting standpoint, any capitalized expense would be called an asset. To say that an expense that creates an asset should be capitalized is a chicken-and-egg kind of problem.

In Lincoln Savings, the Court therefore emphasized that the asset created by the premium expenses that were involved in that case provided value to the corporation that was more permanent than temporary. The premium expense was capital in nature because it provides a benefit, quote, not only in the current year, but in the future, and as Justice Blackmun concluded in the General Bancshares case in the Eighth Circuit, whether an expense is characterized as an asset or not is not itself critical.

If the expense affords meaningful long-term benefits for the corporation, it is capital in nature because the contribution it makes to the corporation is not fully consumed and therefore not properly matched against income in the current period.

QUESTION: Do you think that General Bancshares and Lincoln Savings are in tension?

MR. JONES: Are -- are what?

QUESTION: Are in tension, there's any inconsistency?

MR. JONES: I don't think there's any logical tension whatever between them. I think that the Court in both cases addressed the issues that were necessary to decide the case. There was a -- it is a characteristic result in capital expense cases for courts to focus upon the existence of assets, for exactly the reason that petitioners would focus on that.

There are -- when especially a tangible asset is seen to exist, a financial asset is seen to exist, it is easier to focus on the capital character of that, but in the General Bancshares the Court emphasized that whether there's a tangible or intangible asset, what is relevant is that the expense provides long-term benefits for the corporation, that it would mismatch income to deduct all of that expense in the current period.

QUESTION: I think the -- the older case was cited in Lincoln Savings, anyway, for what that's worth.

MR. JONES: Well, I think it was -- well, since you wrote both, you could best explain, but I believe it was --

(Laughter.)

MR. JONES: I believe that rather than being in tension, these cases are perfectly consistent.

QUESTION: Maybe I've been around too long, you see. Meet myself coming back on these cases.

(Laughter.)

MR. JONES: Well, at least in our view, Your Honor, you were right both times, and we think if you put those two together the Government's right in this case.

QUESTION: Mr. Jones, let me -- let me ask you about the situation again in which the company is now owned by one large corporation, the stock is acquired by another one. There is no conceivable benefit to the company at all, it is solely a benefit to the stockholders, the company is not acquiring any new connections, or any access to capital that it didn't have. On what possible theory can you say that this has to be treated as a capital expenditure?

MR. JONES: Well, I think I said that in the no possible benefit situation it was not a current expense. I don't think I went on to say that it's therefore a capital expense.

QUESTION: I see.

MR. JONES: And if I may answer --

QUESTION: All right.

MR. JONES: I can explain that.

QUESTION: All right.

MR. JONES: In the tax court we argued that this expense was either a capital expense or a dividend, constructive dividend to the shareholders. It would be a

constructive dividend to the shareholders if it was primarily for the shareholders' benefit and not for the benefit of the corporation. It would be a --

QUESTION: Even -- even if the corporation was obliged in law to make these expenditures?

MR. JONES: If the obligation was one they owed to the shareholders, which is, I believe, the situation you have in mind here, yes, that would not change the case.

Our position was that if it benefits the corporation, then it's capital. If it benefited the shareholders, it was a constructive dividend. The court of appeals didn't address that, the tax court didn't address it, we're not asking this court to address it, but we do think that the findings of the tax court support capitalization and do not support dividend treatment.

The findings of the tax court were that this created several long-term benefits for the corporation. We think that's sufficient in this case to remove the issue of constructive dividend treatment.

We also agree with petitioner it would be very hard to sell to the shareholders that they -- they received any benefit from this $2.25 million fee, because all that Morgan Stanley recommended was a purchase -- was that the sale go forward at $70. It was management that

insisted upon and obtained a higher price.

I wanted to return, if I could, to the third benefit that Indopco received from its reorganization, because it is in its own sense extremely important. By retiring the shares of the major stockholder, Indopco removed what they called the overhang on the market, of the existence of that position.

The only way this overhang could be removed was through a reorganization that changed the common stock of the Greenwalls to fixed value preferred stock, and the fixed value preferred stock was secured by a $100 million capital infusion from Unilever to Holding. That's described at page 76 in the joint appendix. It is described in somewhat murky detail in the exchange agreement, which is at page 500 of the court of appeals' record.

That substantial capital infusion solved a long-term problem for the corporation. There was an additional $2 million capital infusion from Unilever to Holding to Starch, or Indopco, which was used for the purpose of retiring the employee's rights in the stock. They didn't hold stock, they held rights to stock. That $2 million retired those rights, which is clearly a long-term benefit for the corporation. Now, that's described at page 564 in the court of appeals' record.

These long-term benefits for the corporation bring this case squarely within the rule described by Bittker and Eustice that the reorganizational expenses of an acquired corporation are not deductible currently but should be capitalized.

Unless there are further questions, I have completed.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Jones. Mr. Hiegel, you have 5 minutes remaining.

REBUTTAL ARGUMENT OF RICHARD J. HIEGEL

ON BEHALF OF THE PETITIONER

MR. HIEGEL: I'd like to return to a point that Mr. Jones -- an answer to Justice Scalia's question concerning hostile takeovers. You asked him, Justice Scalia, what would happen, what kind of deduction would be allowed if there were a hostile takeover that turned out to be unsuccessful, and counsel answered that there would be a, sort of a suspension of the costs, and then when it turned out -- it proved out that the transaction was unsuccessful, the takeover was unsuccessful, the company had successfully resisted it, that there would be a loss, a deductible loss.

Now, the only provision in the code that allows a deductible loss is section 165, and the amount of the deduction that is allowed by that section is limited to

the basis of the property. It says, for the purposes of subsection (a), which is the subsection that allows the loss, the basis for determining the amount of the deduction for any loss shall be the adjusted basis for determining the loss from the sale or other disposition of property.

So there's no loss unless you have property with a basis. Now, where is the property in the case of the hostile takeover? There is no property. The company itself has no property. The company that's trying to do the takeover is trying to acquire stock --

QUESTION: You would allow that loss if they allowed it, I suppose.

MR. HIEGEL: No, we would not, Your Honor, but I think it illuminates the flaw in their theory. Their theory is, any time you have a future benefit you have to capitalize it.

QUESTION: Well, you may have trouble identifying the property, but you wouldn't have any trouble at all in finding out what it cost.

MR. HIEGEL: That's correct, whatever it is, whatever it is, Your Honor.

QUESTION: Well, but do you claim it's an ordinary and necessary business expense under 162?

MR. HIEGEL: Yes. Yes, we do, Your Honor, and

that's -- and that's what we claim with respect to these expenses. These expenses did not produce any property, and I disagree with counsel's answer to the question about current benefit. There was no -- these expenses did not produce revenue, but they did help the board discharge its fiduciary obligations.

Now, a lot of expenses a corporation incurs that don't produce any benefit, particularly a publicly-held company -- you have to send reports to the SEC, you have to send reports to stockholders, you have to comply with safety regulations, you have environmental laws, things that would actually hinder your revenue-producing capacity. Nevertheless, there's no question that these are deductible.

These are things that a company has to do in order to carry on business as a company, and just because they don't produce a current income doesn't mean they're not deductible as ordinary and necessary business expenses under 162(a), and I think you have to look at the origin of these costs.

Counsel mentioned the Woodward case. The Woodward case held that the costs were capitalizable because they adhered in the process of acquisition. The taxpayer before the court in that case was the -- was the company that was making the acquisition. This company

here is the target. It is not making any acquisition. The origin of its expenses was the fiduciary duty that the board had to the stockholders, not any process of acquisition by the company itself.

The other point that -- that I think reveals a flaw in the Government's position about future benefit, it just doesn't account for a whole host of expenses that everyone would agree are deductible. Advertising the courts recognize, and there can be no doubt that advertising has a future benefit. Strategic planning, companies have whole departments devoted to strategic planning for the future -- nothing but the future.

Those deductions are -- those expenses are clearly deductible. Companies could not carry on business without doing things that -- that affect their future revenue, and for long periods of time in the future, and yet they -- they are deductible. There's no question.

QUESTION: Well -- well, isn't there a separate section for research and development?

MR. HIEGEL: Research and development is a separate section, that's correct, because there you would have an asset. You are, in research and development --

QUESTION: Well, you might or might not, depending on how the research comes out.

MR. HIEGEL: That's -- that's correct. That's

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correct. That is a special section in the code designed to encourage research and development. It is -- it does not -- it does not indicate any question of principle of capitalization. It is acknowledged to be a special benefit, like depletion allowance, for example, that -- to give benefits to the oil, to encourage the oil and gas exploration.

QUESTION: Well, I'm not sure how to distinguish that between your strategic planning, from your strategic planning example.

MR. HIEGEL: My strategic planning -- it is deductible without regard to any special section of the code, without regard to any such section as section 174, because there is no asset created.

CHIEF JUSTICE REHNQUIST: Thank you, Mr. Hiegel.

MR. HIEGEL: Thank you, Your Honor.

CHIEF JUSTICE REHNQUIST: The case is submitted.

(Whereupon, at 10:59 a.m., the case in the above-entitled matter was submitted.)

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BY alan friedman

(REPORTER)