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CAPITALIZING THE TARGET'S TRANSACTION COSTS IN HOSTILE TAKEOVERS

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Abstract: In *A.E. Staley Manufacturing Co. v. Commissioner*, the Court of Appeals for the Seventh Circuit held that costs a corporation incurred to resist a hostile takeover were analogous to costs incurred to defend a business against attack and thus qualified as ordinary and necessary business expenses deductible under Internal Revenue Code section 162. Alternatively, the court held that those costs associated with abandoned capital transactions qualified for loss deductions under section 165. This Note argues that although the court reached approximately the right result in this case, its primary reliance on a defense of business rationale for deductibility under section 162 was erroneous and misguided. The Note further argues that the distinction between hostile and friendly acquisitions is irrelevant to the uniform and objective application of the Tax Code, and that the successful consummation of any acquisition, regardless of how it is subjectively characterized, always constitutes a corporate restructuring necessitating the capitalization of proximately related costs under I.R.C. § 263. Finally, this Note concludes that although the court failed to fully address its proper application, the authorization of a loss deduction under section 165 focuses upon more salient facts than the distinction between friendly and hostile acquisitions and should be the primary avenue for any deductions in such transactions. By more accurately accounting for the real economics of the so-called hostile takeover, this proposed approach better protects the Tax Code's underlying goal of matching income and expenses.

After a brief respite from the breathtaking pace of merger and acquisition (M&A) deals in the 1980s, deal making has again accelerated in recent years, with the latest wave of transactions proving bigger and more complex than anything that came before.[1] This complexity provides a fertile breeding ground for some of the most exorbitant fees in the legal and banking communities. In reference to one recent transaction, the largest takeover in U.S. history, commentators estimated that the legal and banking fees could reach $500 million.[2] Even in smaller M&A deals, transaction fees can be substantial. Accordingly, corporate taxpayers have genuine concerns about the proper tax treatment of such large costs and, specifically, whether they will be deductible in the current tax year or must be capitalized and amortized over the estimated life of the investment.

1. *See* Stephen Lipin, *Murphy's Law Doesn't Apply: The Conditions Are Perfect for Continued Growth in Mergers*, Wall St. J., Jan. 2, 1998, at R6.

2. *See* Patrick McGeehan, *GTE's Bold Bid Could Generate Whopping Fees*, Wall St. J., Oct. 17, 1997, at C1. This figure represents an aggregate of all of the then current and potential future expenses contemplated by all of the players involved in the 1997 MCI-WorldCom deal.

Although the costs incurred by one corporation seeking to acquire control of another corporation are easily characterized as capital expenditures,[3] the status of such fees when incurred by the target of a merger or acquisition has proved more difficult to determine. The U.S. Supreme Court seemingly resolved the issue in *INDOPCO, Inc. v. Commissioner*,[4] holding unanimously that legal, banking, and other fees incurred by the target corporation of a friendly merger do not qualify for deduction as ordinary and necessary business expenses under Internal Revenue Code section 162[5] and therefore must be capitalized under section 263.[6] The Court reasoned that because the target taxpayer would likely realize benefits beyond the year in which the expenditure was incurred, such expenses were capital in nature and currently non-deductible.[7]

Despite *INDOPCO*, the Internal Revenue Service (IRS) and numerous corporate taxpayers continue to disagree over the proper tax treatment of expenditures made by the targets of so-called "hostile" takeovers. The IRS has long argued that the hostile-versus-friendly distinction is irrelevant in determining the tax treatment of corporations involved in such transactions.[8] According to the IRS analysis, if an acquisition occurs, long-term future benefits accrue to the target, necessitating the capitalization of expenses leading to that result.[9] Conversely, corporate taxpayers argue that the hostile or friendly nature of a transaction determines the treatment of related expenditures, so that costs the target corporation incurred to defeat the hostile takeover are directly analogous to expenses made to defend a business from attack, expenses thought to be currently deductible.[10]

In *A.E. Staley Manufacturing Co. v. Commissioner*,[11] the Seventh Circuit adopted the taxpayer's position and held that the taxpayer could deduct legal, banking, and printing costs incurred to defend against a

3. United States v. Hilton Hotels Corp., 397 U.S. 580 (1970); *see infra* Part I.B.

4. 503 U.S. 79 (1992).

5. *Id.* at 88 (citing I.R.C. § 162 (1988)).

6. I.R.C. § 263 (1994).

7. *INDOPCO*, 503 U.S. at 88.

8. *See, e.g.*, Tech. Adv. Mem. 91-44-042 (July 1, 1991).

9. *See* A.E. Staley Mfg. Co. v. Commissioner, 105 T.C. 166, 187 (1995), *rev'd*, 119 F.3d 482 (7th Cir. 1997).

10. *See id.*

11. 119 F.3d 482 (7th Cir. 1997).

hostile takeover as ordinary and necessary business expenses under section 162.[12] The court further held that many of the target's costs associated with abandoned transactions qualified as loss deductions under section 165.[13]

This Note argues that the Seventh Circuit decided *Staley* incorrectly. First, the court placed undue emphasis on the hostile nature of the acquisition, erroneously likening the transaction to an actual threat to or attack on the corporation, and injected a subjective factor into an area of the law that relies on strict neutrality and objectivity. Second, although section 165 is an appropriate means by which taxpayers might seek the deduction of some legal and banking fees, the court in *Staley* treated this section almost as an afterthought and failed to explain how taxpayers should address their burden of proving such deductions.

Part I of this Note presents a brief summary of the relevant statutes and cases culminating in the U.S. Supreme Court's decision in *INDOPCO*. Part II describes the facts, procedural history, and reasoning of the Seventh Circuit's *Staley* decision. Part III argues that the Seventh Circuit erred by applying a defense of business rationale for deductibility to a hostile takeover, incorrectly differentiated friendly from hostile takeovers in the tax context, and failed to address loss deductions under section 165 correctly. Part IV concludes that the consummation of any capital transaction compels the capitalization of related costs, but that the taxpayer may still be able to deduct some costs under section 165 by proving the costs were associated with abandoned transactions and did not facilitate any transaction actually consummated.

I. DEDUCTIBILITY VERSUS CAPITALIZATION

Tax law has long recognized the principle of matching income and expenses, specifically the rule requiring expenses to be allocated among the years benefited by the expense.[14] If, however, an expenditure results in the creation of an asset or the acquisition of property having a useful life that extends beyond the close of the taxable year, that expenditure is generally not deductible for the taxable year in which it was made and

12. *Id.* at 491.

13. *Id.*

14. *See* Boris I. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 105.2.5, at 105–45 (1st ed. 1981). For a more general discussion, see Marvin A. Chirelstein, *Federal Income Taxation* ¶ 12.01 (8th ed. 1997).

instead will have to be capitalized over the life of the investment.[15] Because of both the time value of money and the fact that an immediate deduction can reduce taxable income for the current tax year, taxpayers generally consider immediate deductions more valuable than deductions taken gradually over a number of years. Thus, for over sixty years, courts have struggled with the difficulty of distinguishing deductible expenses from those the taxpayer must capitalize.[16]

A. *The Statutory Framework: Sections 162, 263, and 165*

Section 162(a) of the Internal Revenue Code authorizes the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."[17] The U.S. Supreme Court has held that the term "necessary" does not mean indispensable, but, rather, embodies only the minimal requirement that the expense be appropriate and helpful for the development of the taxpayer's business.[18] Accordingly, the classification of an expense is frequently determined by the "ordinary" requirement.[19] The Court has defined ordinary expenses as those that arise from transactions of common or frequent occurrence in the type of business involved.[20] However, these expenses do not have to be made frequently in the sense that the same taxpayer will have to make them often; instead, they must be typical for members of the taxpayer's class of business.[21]

Capital investment expenditures fall under section 263(a), which disallows deductions for "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate," or "[a]ny amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made."[22] The cost of acquiring property that has a useful life

15. *Id.*; *see also* Chirelstein, *supra* note 14, ¶ 6.02.

16. *See* Peter L. Faber, INDOPCO: *The Still Unsolved Riddle*, 47 Tax Law. 607 (1994).

17. I.R.C. § 162(a) (1994).

18. Commissioner v. Tellier, 383 U.S. 687, 689 (1966) (citations omitted).

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

20. *See* Deputy v. Du Pont, 308 U.S. 488, 495 (1940).

21. *See* Welch v. Helvering, 290 U.S. 111, 114 (1933).

22. I.R.C. § 263(a)(1)–(2) (1994).

extending substantially beyond the close of the taxable year must be capitalized rather than deducted as a current expense.[23] Capitalization, in effect, prevents taxpayers from applying in the current tax year for deductions more properly attributable to later tax years when the capital assets will continue to produce income.[24]

The treatment of an outlay concededly connected with the taxpayer's business thus boils down to the timing of the deduction and whether it can be deducted at once to reduce the taxable income of the current year or must be deducted over a period of years that relates to the asset's useful life.[25] Capitalization applies not only to tangible property, such as buildings and equipment, but also to intangible assets from which the taxpayer expects to realize economic benefits in future years.[26] A taxpayer may amortize capital expenses associated with intangible assets by deductions taken gradually over the useful life of the asset. Intangible assets whose useful lives cannot be determined have a standard amortization period of fifteen years.[27]

Additionally, section 165(a) provides: "There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise."[28] The courts and the IRS generally recognize that expenses incurred in the development of plans involving the organization or reorganization of corporations become deductible as a loss in the year the plans are abandoned.[29] A taxpayer may deduct expenditures related to an abandoned project in the year of abandonment because at that point it becomes clear that the expenditures will not produce any future benefit.[30]

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23. *See* Chirelstein, *supra* note 14, ¶ 6.02.

24. *See* Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1973).

25. *See* Chirelstein, *supra* note 14, ¶ 6.02.

26. *Id.*

27. *See* I.R.C. § 197 (1994); *see also* Chirelstein, *supra* note 14, ¶ 6.10. The addition of § 197 by the 1993 Act put an end to numerous controversies between taxpayers and the IRS over the treatment of purchased intangibles. At present, the cost of most intangibles acquired in connection with the purchase of a business may be amortized on a straight-line basis over a 15-year period. The 15-year term, though completely arbitrary, has the benefit of simplicity and ease of application.

28. I.R.C. § 165 (1994).

29. *See, e.g.*, A.E. Staley Mfg. Co. v. Commissioner, 105 T.C. 166, 200 (1995) (citations omitted), *rev'd*, 119 F.3d 482 (7th Cir. 1997).

30. *Id.*

B. *Deductibility and Capitalization in the Context of Mergers and Acquisitions*

It is well established that in applying the statutory standards to M&As, acquirers must capitalize their acquisition costs. In *United States v. Hilton Hotels Corp.*,[31] the U.S. Supreme Court held that litigation expenses the acquirer incurred in connection with its valuation of the target's stock for a hotel merger were capital expenditures rather than business deductions.[32] In *Ellis Banking Corp. v. Commissioner*,[33] the Eleventh Circuit similarly held that accounting fees the taxpayer incurred to investigate the financial condition of a target in connection with the taxpayer's acquisition of the target's stock must also be capitalized.[34] The court reasoned that, to the purchaser, the outlays form part of the cost of the acquisition of an asset that will contribute to revenues over an extended future period, and that taxpayers should deduct such outlays over the period of revenue production.[35] Although certain specific expenses the acquirer may have become obligated to pay as a result of the merger may be deductible,[36] the general rule requires corporations to capitalize expenses incurred in the acquisition of another corporation.

Prior to *INDOPCO, Inc. v. Commissioner*,[37] the U.S. Supreme Court had not directly addressed whether expenses incurred by the target of an acquisition should be deducted immediately or capitalized. In *INDOPCO*, the Court held that legal and banking fees incurred by the target of a friendly takeover did not qualify for deduction as ordinary and necessary business expenses under section 162(a), but instead had to be capitalized under section 263(a).[38] In reaching this conclusion, the Court divided its analysis into three parts: (1) reexamination of the relationship

31. 397 U.S. 580 (1970).

32. *Id.* at 583.

33. 688 F.2d 1376 (11th Cir. 1982).

34. *Id.* at 1379.

35. *Id.*

36. *See* Rev. Rul. 67-408, 1967-2 C.B. 84 (ruling that acquirer's severance payments to target's employees who were terminated due to merger constituted ordinary and necessary business expenses deductible under I.R.C. § 162).

37. 503 U.S. 79 (1992).

38. *Id.* at 88. Though the Court described the transaction in *INDOPCO* as a "friendly" takeover, nowhere in the opinion did the Court indicate that the "friendly" aspect of the transaction was significant to or dispositive of the holding. Neither did the Court indicate that the outcome would differ if the takeover were considered "hostile."

between deductions and capital expenditures;[39] (2) rejection of the separate and distinct asset test presented by the taxpayer;[40] and (3) discussion of the reasons why the taxpayer's transaction costs were not deductible.[41]

The Court began by reiterating the old and familiar rule that an income tax deduction is a matter of legislative grace and the taxpayer bears the burden of clearly showing a right to the claimed deduction.[42] The Court emphasized that deductions must be strictly construed and allowed only when a clear provision permits them.[43] Amid this recapitulation of settled tax concepts, the Court inserted its own significant addition to the subject, stating that deductions are "exceptions to the norm of capitalization," and that, because deductions are specifically enumerated in the Tax Code, they are subject to disallowance in favor of capitalization.[44] In short, the Court made it very clear that the Tax Code must be applied with a strong presumption in favor of capitalization unless the taxpayer shows evidence supporting a deduction.

The taxpayer in *INDOPCO* relied on the U.S. Supreme Court's separate and distinct asset test from *Commissioner v. Lincoln Savings & Loan Ass'n*,[45] arguing that *Lincoln Savings* indicated deductibility was the rule rather than the exception,[46] and that the Tax Code required capitalization only if the expense resulted in the "creation or enhancement of an asset."[47] Having already established that capitalization is the norm and deductibility the exception, the Court disposed of this interpretation of *Lincoln Savings* by stating that the separate and distinct asset test was not the sole test for capitalization, and

39. *Id.* at 84.

40. *Id.* at 86–87.

41. *Id.* at 88–89.

42. *Id.* at 84.

43. *Id.*

44. *Id.*

45. 403 U.S. 345 (1971). In *Lincoln Savings*, the Court was asked to decide whether certain premiums, required by federal statute to be paid by a savings and loan association to the Federal Savings and Loan Insurance Corporation (FSLIC), were ordinary and necessary business expenses under § 162(a). *Id.* at 345–46. The Court held that the premiums served to create or enhance for Lincoln "a separate and distinct additional asset" with the inevitable consequence that the payment was capital in nature and thus not a deductible expense under § 162(a). *Id.* at 354.

46. *INDOPCO*, 503 U.S. at 86.

47. *Id.*

that the creation of a separate and distinct asset, though perhaps sufficient, is not a necessary condition to classification as a capital expenditure.[48]

Having established that capitalization could be required for other reasons, the Court approached the issue of characterizing expenditures that result in future benefits to the taxpayer. The Court emphasized the taxpayer's realization of future benefits, stating that the presence of a future benefit, or some future aspect, is "undeniably important" in determining the appropriate tax treatment of the expenditure.[49] In applying this principle, the Court identified two future benefits extending beyond the tax year in question that would accrue to the taxpayer from the merger: the synergy achieved through the merger of two complimentary corporations and the stability of changing from a publicly held corporation at the mercy of the marketplace into a wholly-owned subsidiary.[50] Finally, the Court reiterated the more general rule that expenses incurred to change the corporate structure for the benefit of future operations are not ordinary and necessary business expenses and should always be capitalized.[51]

INDOPCO marked a further clarification of the proper tax treatment of expenditures related to M&A transactions. Before *INDOPCO*, the transaction costs incurred by acquirers in both hostile and friendly acquisitions were always capitalized. After *INDOPCO*, the transaction costs of target corporations in friendly acquisitions also had to be capitalized. The tax treatment of fees incurred by the targets of hostile takeovers, however, was not explicitly addressed by an appellate court until the Seventh Circuit's 1997 decision in *A.E. Staley Manufacturing Co. v. Commissioner*.[52]

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48. *Id.* at 87.

49. *Id.* Unfortunately, the "undeniably important" language is undeniably fuzzy. Although the Court had little trouble applying it to the facts in *INDOPCO*, some commentators have criticized the opinion for not establishing a clearer rule and not indicating the applicable scope of the decision beyond the world of M&A deals. *See* Faber, *supra* note 16, at 623–24.

50. *INDOPCO*, 503 U.S. at 88–89.

51. *Id.* at 89.

52. 119 F.3d 482 (7th Cir. 1997).

II. *A.E. STALEY MANUFACTURING CO. V. COMMISSIONER*

In 1988, A.E. Staley Manufacturing Co. (Staley)[53] became the target of a successful hostile takeover bid by Tate & Lyle. Staley sought to deduct as ordinary and necessary business expenses all the costs it incurred resisting the tender offer. The Tax Court held that Staley's expenditures were capital in nature and denied the deduction.[54] The Seventh Circuit reversed, holding that the bulk of the fees were incurred in defending the taxpayer's business from attack and were thus deductible under section 162.[55] Alternatively, the court held that most of the fees were also associated with plans for abandoned capital transactions and thus deductible as losses under section 165.[56]

A. Facts

In 1986, because of both the threat of a hostile tender offer made by an investment banker for Staley and the general M&A climate at the time, the Staley board of directors began to fear the possibility of other hostile takeover attempts.[57] In response, the board hired a law firm to develop various anti-takeover devices and retained investment banking firms to advise it in the case of future hostile takeover attempts.[58] The investment bankers advised the board to find "white knight" investors to acquire enough stock in Staley to block further hostile takeover attempts.[59] Accordingly, Staley negotiated with Tate & Lyle about the possibility of the firm acquiring a twenty percent interest in Staley.[60] By August 1987, Tate & Lyle had already acquired four percent.[61] However,

53. In 1984, Staley began to acquire several additional corporations, and to this end the board formed SCI to act as the parent company for Staley and its various acquisitions. Even though the courts refer to the target company as SCI, for simplicity this Note will refer to SCI and its family of holdings as Staley. *See* A.E. Staley Mfg. Co. v. Commissioner, 105 T.C. 166, 168–69 (1995), *rev'd*, 119 F.3d 482.

54. *Id.* at 200–01.

55. *Staley*, 119 F.3d at 491.

56. *Id.* at 490.

57. *Staley*, 105 T.C. at 170. In 1986, Staley believed that it had become the potential target of a leveraged buy-out by the venture capital firm of Drexel Burnham Lambert, Inc. *Id.*

58. *Id.*

59. *Id.* at 171.

60. *Id.* The CEOs of both corporations also "casually discussed" the possibility of a merger though no substantive merger discussions actually occurred. *Id.*

61. *Id.*

Tate & Lyle refused to sign a standstill agreement limiting the amount of stock it would purchase, and it soon became apparent that Tate & Lyle was not the "white" knight the board had originally envisioned.[62]

In April 1988, Tate & Lyle made a tender offer directly to Staley's public shareholders.[63] Staley's board considered the tender offer hostile because Tate & Lyle made it directly to the shareholders without the board's knowledge, endorsement, or encouragement.[64] Nevertheless, the board understood that it had a duty to evaluate the merits of the tender offer.[65] It subsequently hired investment bankers to evaluate the tender offer and explore ways of resisting the takeover by finding alternatives more appealing to the shareholders.[66] Over the next month, the Staley board and the investment bankers actively sought alternatives to the merger with Tate & Lyle that would be acceptable to the shareholders.[67]

Meanwhile, after repeatedly increasing the amount of its bid, Tate & Lyle eventually submitted a purchase price that Staley's investment bankers considered fair and acceptable.[68] Although the investment bankers continued to seek alternatives, Staley's attorneys had already entered into negotiations with Tate & Lyle on May 10, 1988. On May 13, at a meeting of the Staley board, the directors agreed that no realistic alternatives remained that would better meet the interests of the shareholders, and that Tate & Lyle's offer price of $36.50 per common share appeared fair and reasonable. The Staley board then recommended that the shareholders accept the offer and Tate & Lyle proceeded to acquire all of the stock.[69] During the course of negotiations, Staley paid substantial fees for legal, investment banking, and printing services, which it sought to deduct as ordinary and necessary business expenses.[70]

62. *Id.* at 171–72.

63. *Id.* at 172.

64. *Id.* at 173.

65. *Id.* at 174.

66. *Id.*

67. *Id.* at 175. The investment bankers investigated Staley's various options, such as the sale of the corporation as a whole; the sale of a division; a recapitalization; a leveraged buy-out; placement of blocks of stock; a spin-off; a public offering; and commencing an offer for Tate & Lyle (the "pac-man" defense). Note that the costs associated with any of these options would have to be capitalized if the resulting transaction were successfully consummated. *Id.*; *see infra* Part IV.A.

68. *Staley*, 105 T.C. at 178.

69. *Id.*

70. *Id.* at 180. The Tax Court wrote:

B. *Procedural History*

The IRS disallowed the deductions and determined a deficiency, after which the taxpayer petitioned the Tax Court to set aside the deficiency.[71] In an en banc decision, the Tax Court held that none of the fees incurred to defend against the takeover qualified for deduction under either section 162 or 165.[72] It reasoned that for tax purposes, no distinction exists between hostile and friendly takeovers; accordingly, *INDOPCO, Inc. v. Commissioner* should apply equally to hostile takeovers.[73] In response to the taxpayer's assertion that the Staley board incurred the expenses because it believed them necessary to defend the company from attack, the Tax Court stated that because the relevant Tax Code provisions sought to match expense with income, the board's subjective reasons for making the expenditures were irrelevant to the analysis.[74] The Tax Court further stated that under the well-established "origin of claim" test,[75] the objective nature of the transaction out of which the expenditure in controversy arises determines the proper tax treatment regardless of the subjective motives of the taxpayer.[76] The Tax Court determined that, objectively, the expenditures were made in

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> [Staley] paid $23,052,914 to law firms, investment bankers, and other vendors for services in connection with [its] response to the Tate & Lyle tender offer, all of which it deducted on its short-year return for the period ended May 31, 1988. This amount included $6,238,109 that was paid to First Boston; $6,272,593 that was paid to Merrill Lynch; and $165,318 that was paid to Charles P. Young, a printing company . . . .

Id.

71. *Id.* at 167.

72. *Id.* at 181. The case provided the Tax Court with its first opportunity to apply the broad principles established by the U.S. Supreme Court in *INDOPCO* to the target corporation in a hostile takeover situation. Eleven judges joined the majority opinion, one concurred in the result only, four joined the concurring opinion, and five dissented. *Id.* at 201 (Foley, J., concurring in result only), 201 (Beghe, J., concurring), 210 (Cohen, J., dissenting), and 218 (Laro, J., dissenting).

73. *Id.* at 197–98.

74. *Id.* at 194.

75. *Id.* at 195. The Tax Court wrote:

> In the companion cases of *Woodward v. Commissioner*, 397 U.S. 572 (1970), and *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970), the U.S. Supreme Court held that fees incurred to value stock held by dissident minority shareholders were capital expenditures, rather than expenses deductible under sections 162(a) or 212. In so holding, the U.S. Supreme Court rejected a subjective 'primary purpose' test in favor of the objective 'origin of the claim' test set forth in *United States v. Gilmore*, 372 U.S. 39 (1963).

Id.

76. *Id.*

connection with a change in ownership, and this change in ownership necessarily resulted in "indefinite and extended future consequences" to the taxpayer.[77] In short, the Tax Court held that corporate taxpayers may not deduct expenditures made incident to a recapitalization or other reorganization even if undertaken to protect the corporation against the threat of acquisition.[78]

Finally, the Tax Court dismissed the taxpayer's contention that the fees qualified for a loss deduction under section 165 as costs related to plans and defenses eventually abandoned in the face of the inevitability of the takeover.[79] The Tax Court held that the taxpayer failed to prove any allocation of the fees to separate and distinct proposals that it subsequently abandoned, and that the bulk of the fees were tied to a completed stock sale rather than an abandoned recapitalization.[80]

C. *The Seventh Circuit's Analysis*

In *A.E. Staley Manufacturing Co. v. Commissioner*,[81] the Seventh Circuit reversed the Tax Court, holding that Staley could deduct the bulk of the costs incurred to defend against the hostile takeover under section 162, as ordinary and necessary business expenses, and alternatively, under section 165, as costs associated with abandoned capital transactions.[82] The court began by noting the U.S. Supreme Court's language in *INDOPCO* placing the burden of showing a right to a business deduction on the taxpayer and mandating that deductions are a matter of legislative grace, exceptions to the norm of capitalization, and should be strictly construed.[83] However, the court then stated that the burden on the taxpayer, though "a real one," is not insurmountable.[84]

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77. *Id.* at 197.

78. *Id.* at 197–98.

79. *Id.* at 200.

80. *Id.* Four judges, although agreeing with the majority opinion, wrote separately to propose a "shareholder benefit" or "constructive dividend" theory by which courts could reach the same result without having to search for ever-illusive future benefits. *Id.* at 203. For a brief discussion of this theory, see Calvin H. Johnson, *Snarling for the Cameras: Hostility and Takeover Expense Deductions*, Tax Notes, Aug. 4, 1997, at 689, 689.

81. 119 F.3d 482 (7th Cir. 1997).

82. *See id.* at 491.

83. *Id.* at 486 (quoting INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992)).

84. *Id.*

In finding that the fees incurred by Staley qualified for deduction, the Seventh Circuit reasoned that the majority of the fees related directly to defending the business from an attack because of Staley's struggle against a threat to its business operations and policies.[85] Likening the hostile takeover to a threat to or attack upon the corporation, the court applied the rationale that a taxpayer may deduct expenses incurred in defending a business and its policies from attack as ordinary and necessary business expenses under section 162.[86]

The court laid the foundation of its business defense rationale with a brief discussion of three separate U.S. Supreme Court decisions. In *Commissioner v. Heininger*,[87] the U.S. Supreme Court held deductible the taxpayer's legal fees incurred in litigating against an order by the Postmaster General depriving the taxpayer's mail order business of use of the mails.[88] The Court reasoned that the Postmaster General's legal action threatened to destroy the taxpayer's business. Thus, the taxpayer's cost to employ an attorney to aid in the defense of his business was both ordinary and necessary, and therefore deductible under the Tax Code.[89] In *Commissioner v. Tellier*,[90] the U.S. Supreme Court reaffirmed this principle, holding that under section 162(a) the taxpayer could deduct costs incurred to defend against criminal charges originating from his business activities.[91] Finally, the Seventh Circuit referred to the famous opinion in *Welch v. Helvering*,[92] in which Justice Cardozo wrote that a taxpayer may deduct attorney fees paid to defend against legal action as ordinary and necessary expenses, even though such an attack "may happen once in a lifetime."[93]

The court also discussed some lower court decisions that had applied the rationale to what the court characterized as similar contexts. In *Locke Manufacturing Cos. v. United States*,[94] a district court judge held that a

85. *Id.* at 490.

86. *Id.* at 491–92.

87. 320 U.S. 467 (1943).

88. *Id.* at 471.

89. *Id.* at 471–72.

90. 383 U.S. 687 (1966).

91. *Id.* at 690.

92. 290 U.S. 111 (1933) (holding that payments made by taxpayer to creditors of bankrupt corporation to strengthen his own standing and credit were not deductible as ordinary and necessary business expenses).

93. *Id.* at 114.

94. 237 F. Supp. 80 (D. Conn. 1964).

company could deduct its proxy contest expenses in successfully resisting a stockholder's challenge, including legal fees, proxy solicitor's fees, and public relations fees.[95] The *Staley* court quoted language from that opinion indicating that "it was ordinary for a company to spend money 'to defend the policies of its directors from attack by those who would oppose them.'"[96] The *Staley* court also noted that the IRS now considers *Locke*'s holding as established law.[97] Finally, the court cited one of its earlier decisions holding that a taxpayer may deduct payments made to protect an established business.[98] The court stated that *INDOPCO* never addressed this line of authority because there the U.S. Supreme Court was dealing with the capitalization of expenses associated with a friendly merger.[99]

Having established the rule that expenses incurred to defend a business from attack are deductible, the Seventh Circuit stated that the key determination was whether Staley's expenses were "more properly viewed as costs associated with defending a business or costs associated with facilitating a capital transaction."[100] In reaching its answer, the Seventh Circuit considered the hostile nature of the takeover the crucial and determining factual element, stating that "[t]he totality of the Tax Court's factual findings makes clear that [Staley] was defending against an unwanted acquisition in an effort to maintain and protect an established business."[101] The court therefore held that the costs were defensive and hence deductible.[102] However, the court did find that a few

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95. *Id.* at 89.

96. A.E. Staley Mfg. Co. v. Commissioner, 119 F.3d 482, 488 (7th Cir. 1997) (quoting *Locke*, 237 F. Supp. at 86–87).

97. *Id.*; *see also* Central Foundry Co. v. Commissioner, 49 T.C. 234, 248 (1967) (holding that proxy fight expenses incurred by prevailing stockholders/incoming managers and paid by company were deductible).

98. *Staley*, 119 F.3d at 488 (citing Allen v. Commissioner, 283 F.2d 785, 790–91 (7th Cir. 1960)). In *Allen*, the court was asked to decide, inter alia, the tax treatment of the taxpayer's $10,000 payment to creditors, which he was not obligated to make, but which he made only to protect his business reputation and credit standing. *Allen*, 283 F.2d at 790. The *Allen* court distinguished the case from *Welch v. Helvering*, 290 U.S. 111 (1933), stating that the payments in *Welch* were made to establish good will or business standing and thus were not deductible, but that the taxpayer in *Allen* sought to protect his existing business reputation and credit, making the $10,000 deductible an ordinary and necessary business expense. *Allen*, 283 F.2d at 791.

99. *Staley*, 119 F.3d at 488.

100. *Id.* at 489. In essence, the Seventh Circuit, like the Tax Court, was applying the "origin of the claim" test to the expenditures; *see supra* note 75 and accompanying text.

101. *Staley*, 119 F.3d at 490.

102. *Id.* at 491.

of the services performed by the investment bankers helped to facilitate the eventual merger and should be capitalized.[103] Thus, the Seventh Circuit required the Tax Court on remand to reevaluate all of the expenses to identify those actually deductible and those that should be capitalized for facilitating the completed transaction.[104]

As an additional basis for deductibility, the Seventh Circuit found that many of the taxpayer's costs also qualified for loss deduction treatment under section 165(a), citing to other courts that had generally held that taxpayers may take loss deductions for costs associated with abandoned capital transactions.[105] Thus, a taxpayer may deduct the cost for various plans designed by the investment bankers involving capital transactions, especially when formulated as alternatives to or defenses against a hostile takeover, if they are eventually abandoned or never used.[106] Staley solicited and considered plans for numerous types of capital transactions as alternatives to the takeover, but abandoned them all when the merger eventually occurred.[107] The court held that Staley could therefore deduct the fees paid to investment bankers in connection with these abandoned transactions as abandonment losses under section 165(a).[108]

III. ANALYSIS OF THE SEVENTH CIRCUIT'S OPINION

As a matter of law and policy, the Seventh Circuit erred in *A.E. Staley Manufacturing Co. v. Commissioner*[109] in permitting the taxpayer to deduct costs associated with the acquisition as ordinary and necessary expenses incurred to defend a business. In applying a defense of business rationale for deduction in the context of a hostile takeover, the Seventh Circuit over-emphasized the alleged "hostility" of what was essentially a capital transaction and ignored the U.S. Supreme Court's emphasis on future benefits in *INDOPCO, Inc. v. Commissioner*.[110] All the cases the court relied upon in support of the defense of business rationale are

103. *Id.* The court specifically mentioned the investment bankers' work of evaluating the true value of the company's stock and the performance of "some facilitative function near the end of the process." *Id.*

104. *Id.* at 492–93.

105. *Id.* at 490.

106. *Id.*

107. *Id.*

108. *Id.* at 490–91.

109. 119 F.3d 482.

110. 503 U.S. 79 (1992).

distinguishable from *Staley* as well as other M&A transactions generally.[111] In addition, the court placed undue importance on subjective language commonly employed in the context of hostile takeovers to reach the conclusion that the corporate enterprise faced a threat or attack. For purposes of taxation, no sound basis exists for distinguishing between hostile and friendly takeovers, and the costs associated with such transactions should be capitalized under *INDOPCO*.

Drawing a distinction between friendly and hostile takeovers when determining the appropriate tax treatment of the transaction costs undercuts important policy goals. M&A deals are highly complex transactions, and their subjective nature often changes repeatedly over the meandering course of the deal. Because they frequently involve a bewildering mixture of hostile and friendly attributes, attempting to distinguish defensive and facilitative expenditures based upon the hostile-friendly distinction creates enormous practical difficulties for courts, taxpayers, and the IRS.

Finally, although the Seventh Circuit correctly allowed a deduction for expenditures related to abandoned transactions under section 165, it erred in failing to emphasize that such loss deductions include a very limited category of expenditures, and that the burden of seeking and proving such loss deductions rests with the taxpayer. By simply remanding the task of cost allocation to the Tax Court without any guidance as to how future taxpayers should be required to seek section 165 loss deductions, the court missed an opportunity to establish a clear and workable standard for taking such deductions.

A. *A Defense of Business Rationale Should Not Apply to Hostile Takeovers*

In *Staley*, the Seventh Circuit stated the law correctly regarding the deductibility of expenses incurred to defend a business,[112] but erred in applying the rationale in the context of a hostile takeover. A hostile takeover bid is not an attack or threat of the type envisioned by the defense of business rationale. The cases cited by the Seventh Circuit in support of its theory all involved costs incurred to defend against actions—usually legal actions—with the potential to significantly hinder

111. *See infra* Part III.A.

112. *See supra* Part II.C.

or destroy the ability of the business to operate.[113] By contrast, the investment banking and printing costs Staley incurred went toward efforts to find alternatives to Tate & Lyle's tender offer, all of which involved various forms of corporate reorganization or recapitalization.[114] These alternatives are more properly viewed as attempts to compete for the continuing support and investment of the shareholders in the face of ever-improving terms and conditions offered by outside bidders. The Seventh Circuit likened the "hostility" of the hostile takeover to a lawsuit brought against a corporation or some other action taken by an independent party to prevent the corporation from operating.[115] However, management of the target usually labels the takeover "hostile" not because the takeover attacks the corporation or threatens its ability to continue as a profit-generating entity, but because management either does not welcome the change or finds the price offered by the acquirer unsatisfactory.[116]

1. The Cases Cited by the Seventh Circuit Are Distinguishable from Staley

All the cases the Seventh Circuit presented to buttress its application of the defense of business rationale are legally and factually distinguishable from *Staley*. The *Heininger*, *Tellier*, and *Welch* cases, which together provide the basis for the court's theory, all involved expenses incurred by taxpayers to defend against legal action directed at the activities of or related to the taxpayer's business.[117] Taken together, these cases stand for the simple proposition that expenses incurred to defend one's business against legal action are both ordinary and necessary, and thus deductible under section 162. Nothing in these cases suggests that the rationale should extend to any and all perceived threats to the taxpayer.

Before the *Staley* decision, some tax experts theorized that the expenses a corporation paid to resist a hostile tender offer might be deductible because of their similarity to the deductible cost of defending

113. *See supra* Part II.C.

114. *See supra* note 67.

115. *See supra* Part II.C.

116. *See* A.E. Staley Mfg. Co. v. Commissioner, 105 T.C. 166, 174–75 (1995), *rev'd*, 119 F.3d 482 (7th Cir. 1997).

117. *See supra* Part II.C.

a proxy fight.[118] They suggested that the taxpayers in both situations incurred the costs primarily to protect the business rather than to acquire property, and that both situations involved questions of corporate policy.[119] The Seventh Circuit in *Staley* adopted precisely this view in drawing a parallel between the deductibility of management's proxy contest expenses in *Locke Manufacturing Cos. v. United States*,[120] and the costs the Staley board incurred in resisting the Tate & Lyle takeover.[121] However, a proxy contest usually involves a dispute within the corporation between management and a *portion* of the shareholders—a dissident group—for control of the board and over the policies of the corporation,[122] not for control of shares in the corporation. The board in *Locke* argued, and the court agreed, that the taxpayer incurred the fees for the benefit of all the shareholders in the good faith belief that the best interests of the corporation and all the shareholders collectively required resisting the dissident shareholders.[123] Thus, the board and the IRS viewed the proxy fight as an attack upon the stated policies of the corporation and the interests of the shareholders collectively.[124]

In contrast, a tender offer—whether hostile or friendly, solicited or unsolicited—is in essence an offer by an outside party to purchase the shares of the corporation from the shareholders on the open market, and nothing more. Whether or not the stated intentions of the acquirer contradict the policies of the target's board, the transaction in its purest form involves simply the buying and selling of shares in a publicly traded corporation. In short, management of the target in a hostile takeover does not defend the collective interests of the shareholders as in a proxy fight; it competes with the outside buyer on the open market for the continuing support and investment of the target's shareholders.

In *Staley*, Tate & Lyle did not attack, seek damages against, or attempt to prevent Staley from operating as a profitable business. On the contrary, Tate & Lyle appreciated Staley's considerable worth and saw

118. *See* Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 5.04[4], at 5-26 (6th ed. 1994).

119. *Id.*

120. 237 F. Supp. 80 (D. Conn. 1964).

121. *See* A.E. Staley Mfg. Co. v. Commissioner, 119 F.3d 482, 488 (7th Cir. 1997).

122. *See* Black's Law Dictionary 512 (Pocket ed. 1996).

123. *See Locke*, 237 F. Supp. at 85.

124. *See supra* note 97 and accompanying text.

the corporation as such a good investment that it decided to buy it in its entirety.[125] Staley's board labeled the bid hostile because Tate & Lyle made the bid without management's knowledge.[126] The word "hostile" in the M&A context simply describes the manner in which one corporation makes a tender offer to another.[127] In the end, the intrinsic fairness and reasonableness of Tate & Lyle's final tender offer, not a court of law, compelled the Staley board to recommend that the shareholders accept it.[128]

None of the other cases the Seventh Circuit cited support the deductibility of expenses related to M&A transactions.[129] In *NCNB Corp. v. United States*,[130] the Fourth Circuit characterized various expenditures in connection with the taxpayer's establishment of a statewide network of branch banks as current expenses rather than capital costs.[131] Not only was the case factually unrelated to M&A deals, but the Fourth Circuit based its decision on the now defunct "separate and distinct asset test" and the circuit court's assertion that the presence of future benefits does not control the tax treatment of expenditures.[132] Such a holding can no longer stand in light of the U.S. Supreme Court's subsequent decision in *INDOPCO*, and its explicit mandate that future benefits are undeniably important in classifying expenditures.[133] Additionally, the *NCNB* decision's language relating to the "protection" of existing investments and businesses relied on another case of questionable precedential value following *INDOPCO*'s rejection of the separate and distinct asset test.[134] In short, the deductible protective

125. *See* A.E. Staley Mfg. Co. v. Commissioner, 105 T.C. 166, 179 (1995), *rev'd*, 119 F.3d 482.

126. *Id.* at 173.

127. *See* Lee A. Sheppard, *Will There Ever Be Another Friendly Takeover?*, Tax Notes, July 28, 1997, at 461, 461 ("The reality of being a publicly traded corporation is that there is really no such thing as a hostile takeover. There are only offers that managers and boards believe are insufficient.... 'Hostile' is a construct; what is really going on is no more hostile than professional wrestling.").

128. *See Staley*, 105 T.C. at 179.

129. *See Staley*, 119 F.3d at 488 n.2.

130. 684 F.2d 285 (4th Cir. 1982) (en banc).

131. *Id.* at 294.

132. *Id.* at 290–93.

133. *See supra* Part I.B.

134. *See* Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 785–86 (2d Cir. 1973) (holding that under separate and distinct asset test taxpayer's expenditures would be capitalized only if they served to create or enhance separate and distinct additional asset).

expenses in *NCNB Corp.* that the Seventh Circuit referred to would likely require capitalization today under *INDOPCO*.[135]

In *Fishing Tackle Products Co. v. Commissioner*,[136] the Tax Court allowed a current deduction for payments by a parent corporation to its subsidiary to reimburse the subsidiary for net operating losses sustained in supplying the parent because the court considered the payments essential to the survival of the taxpayer's business.[137] In *Lutz v. Commissioner*,[138] the Fifth Circuit held that the taxpayer could deduct costs incurred to keep its business license, an item essential to the continued operation and existence of the business.[139] The costs at issue in both cases are entirely unrelated to M&A transaction costs, and, after 1993, the costs in *Lutz* would no longer qualify for deduction in any case.[140] None of the above cases apply to costs related to the buying and selling of a corporation's shares and are thus readily distinguishable from the market-driven circumstances surrounding the merger or acquisition of a publicly traded corporation.

2. *Semantics Unduly Influenced the Seventh Circuit's Reasoning*

The language employed by participants and observers to describe various M&A deals has clouded the taxation issue. In placing undue emphasis on subjective language, the Seventh Circuit fell victim to the misleading influence of the M&A lexicon. Evocative and warlike terminology has been universally adopted to describe the action and actors in such transactions.[141] Some commentators characterize a certain

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135. *See NCNB Corp.*, 684 F.2d at 290.

136. 27 T.C. 638 (1957).

137. *Id.* at 644. The court also allowed a current deduction for rental payments paid by the subsidiary for a factory site, but disallowed deductions for fees incurred to increase the corporation's authorized capital. *Id.* at 645.

138. 282 F.2d 614 (5th Cir. 1960).

139. *Id.* at 615–16.

140. *See* I.R.C. § 197(a), (d)(1)(D) (1994). Under I.R.C. § 197, costs related to obtaining or keeping a business license, which is considered a business intangible, are no longer deductible and must be amortized over a 15-year period.

141. Journalists, judges, attorneys, executives, and bankers regularly describe hostile takeovers in such terms. *See, e.g*, James F. Hogg, *Hostile Takeovers and Other War Games*, in James F. Hogg et al., *The Predator and the Predatee: Thoughtful Perspectives on Hostile Takeovers* 2–3 (1988) ("In some cases, the attacks have been fatal—the company sold, broken up and the business dissipated. In others, the company has been damaged and seriously weakened by the attack, but not overcome."). For other examples, see Bryan Burrough & John Helyar, *The Barbarians at the Gate* (1990) [hereinafter Burrough & Helyar, *Barbarians at the Gate*] (comprising best known treatment in

transaction as a "hostile takeover," an "attack" on the present management, or a "threat" by a "corporate raider" to "dismember" the "target" company, while others describe the same transaction as an "unsolicited bid" for a publicly traded corporation undervalued by the market because "entrenched" management is leading the corporation in the wrong "strategic" direction.[142] To those favoring the unsolicited bid, the acquirer is simply a purchaser who understands the potential value of the target but who disagrees with the target's management and therefore presents its offer directly to the shareholders of the target. Those who oppose the same acquisition view the unsolicited tender offer as tantamount to an attack on the corporation, its policies, and management. The M&A vocabulary provides a convenient, illustrative way for participants and observers to understand, describe, and pass judgment on these transactions as they unfold. Such language should not, however, influence the appropriate tax treatment of corporations involved in what remain, simply, capital transactions.

The Seventh Circuit's ready adoption of a defense of business rationale highlights the court's unquestioning acceptance of the language employed and the resulting impression that the Staley board was compelled to react to a genuine attack. The court believed that the Staley board had little choice but to hire investment bankers to defend the corporation from a threat. However, the voluntary or compulsory nature of an expense should not impact how courts characterize the expense.[143] Although commonly referred to as "defensive strategies" by courts and

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popular press of what until recently was largest takeover in U.S. history: "battle" for control of RJR Nabisco in 1988), and Bryan Burrough & John Helyar, *You Call This a Takeover?*, Wall St. J., Nov. 12, 1997, at A22 (chastising civility of 1997 MCI-WorldCom deal and lamenting passing of epic takeover battles of 1980s). Burrough and Helyar write:

> A takeover has name-calling and mudslinging and lawsuits and press leaks. A takeover has short men who threaten each others' kneecaps....
>
> ...
>
> Are there no barbarians left?... Give us a doomed antihero like T. Boone Pickens who mounts Quixotic charges against Gulf Oil. Give us a scoundrel like Carl Icahn who hounds the wounded and tortures the meek. Give us an all-powerful supervillain at Drexel Burnham Lambert who lurks behind an X-shaped desk, orchestrating sinister deals aimed at wreaking havoc on the Fortune 500.

Id.

142. *See supra* note 141.

143. *See* Faber, *supra* note 16, at 614 ("While we may sympathize with a taxpayer who incurs expenses to remedy a defect that was beyond its control... this should not be relevant in determining how to allocate the taxpayer's income among different fiscal periods.").

practitioners alike, much of the investment bankers' work, apart from formulating alternative capital transactions, involve estimating the true value of a corporation's shares above the listed market price and subsequently advertising that value to the media, the marketplace, and other potential suitors. Having already internalized the combative language and its subjective treatment of the transaction, the Seventh Circuit readily accepted the taxpayer's characterization of these expenses as being purely defensive. Adopting this jargon led the court to jump to the erroneous conclusion that the defense of business cases parallel M&A transactions.

B. *Hostile and Friendly Acquisitions Should Not Be Distinguished for Tax Purposes*

Treating hostile and friendly acquisitions differently for tax purposes draws a distinction that objectively does not exist. Recent empirical tests analyzing the accounting and stock performance data of 2048 tender offers between 1975 and 1994 demonstrate that in pure economic terms hostile takeovers are indistinguishable from friendly takeovers.[144] Furthermore, most of the hostile aspects of a takeover arguably reflect "strategic choices" implemented by both the acquirer and the target to "maximize their respective gains from [the] transaction."[145] Shareholders in publicly traded corporations may freely sell their shares to anyone willing to buy them. They may sell their shares individually, in blocks, or, as in the *Staley* case, they may collectively agree at the recommendation of the target's board of directors to sell all the common stock in the corporation to a single buyer. In short, publicly traded corporations are for sale every day the securities markets are open.[146] The alleged hostility or friendliness does not alter the fundamental nature of the transaction as a taxable event.

Problems arise when attempting to characterize a particular transaction as hostile, friendly, or something in between. Most M&A deals in fact contain both hostile and friendly elements.[147] The Seventh Circuit's decision ignores the difficulty of assessing the true nature of

144. Robert Comment & G. William Schwert, *Hostility in Takeovers: In the Eyes of the Beholder?* 2–3 (visited Feb. 2, 1998) <http://papers.ssrn.com/paper.qry?abstract_id=48304>.

145. *Id.* at 36.

146. Sheppard, *supra* note 127, at 461.

147. *See* Comment & Schwert, *supra* note 144, at 1.

these highly complex transactions at each stage of their development. The deduction issues in this area have become quite confused because of the variety of ways in which an initially hostile takeover attempt can play out.[148] Mergers may begin friendly and turn hostile, or may begin hostile and turn friendly.[149] Other factors may complicate attempted mergers, such as the intrusion of competing third offers, auctions, and other mutations of the original deal masking the true nature of the transaction and the subjective motives and goals of the taxpayer. Even in a "classic" hostile takeover such as the *Staley* case, Tate & Lyle, the object of the hostility, began its relationship with Staley's board in the role of a "white knight," or friendly investor.[150] It was Staley that originally invited Tate & Lyle to acquire twenty percent of its stock, and the factual record in the case shows that the CEOs of the two corporations had even discussed the possibility of merging the two companies.[151] Although Staley sought out Tate & Lyle as a friendly investor primarily as a defensive measure against future hostile takeover attempts, their discussions indicate that both corporations appreciated their shared strategic interests. If the two corporations had continued in a "friendly" manner to commence a capital restructuring through either a merger or Tate & Lyle's investment in a part of Staley's shares as originally planned, all of Staley's associated costs would have to be capitalized under *INDOPCO*. The deal turned hostile only when Tate & Lyle changed its mind and decided to purchase much more than just twenty percent of Staley's stock. The fundamental nature of this transaction, however, did not differ from the capital options the parties previously discussed.

Frequently, management of the target of a hostile takeover will suddenly decide that the price offered by the acquirer—often as a result

148. *See supra* note 118.

149. *See generally* Victory Mkts., Inc. v. Commissioner, 99 T.C. 648 (1992). As in the *Staley* case, the taxpayer incurred costs for investment banking services after receiving an offer to be acquired by another corporation. *Id.* at 652–53. Initially, the transaction appeared to be a hostile takeover because the directors of the company rejected the tender offer as inadequate and adopted a "poison pill" plan to deter the takeover. *Id.* at 654. However, the directors later accepted a subsequent higher offer without activating the "poison pill" plan. *Id.* at 655. The taxpayer attempted to characterize the takeover as hostile to argue that *INDOPCO* should not apply. *Id.* at 661–62. The Tax Court held, however, that the transaction was in fact a friendly rather than a hostile takeover, mandating the capitalization of the taxpayer's expenditures under *INDOPCO. Id.* at 665.

150. *See* A.E. Staley Mfg. Co. v. Commissioner, 119 F.3d 482, 484 (7th Cir. 1997).

151. *Id.*

of negotiations—meets its needs after all.[152] In such cases, hostility may simply illustrate situations where the process of fierce negotiations, which in a friendly deal would proceed entirely behind closed doors, is instead disclosed to the public well before the parties have reached agreement on a list of outstanding issues.[153] One commentator describing the eventual consummation of the Staley deal wrote that "[t]he Tate & Lyle offer became too sweet, however, and the Staley directors ultimately capitulated."[154] Staley's management did not face a binding court order the effect of which would harm or destroy the future of its business. Their "capitulation" resulted from the undeniable value of Tate & Lyle's final offer price obtained through open negotiations. Tate & Lyle had simply presented the Staley shareholders with an offer too sweet to refuse and more closely in line with their fiscal interests than anything the Staley board could offer.

In short, ascertaining the true thoughts and motives of the parties involved in a friendly or hostile takeover is often impossible. In a legal battle in tort or contract between two corporations, reaching a resolution or judgment often necessitates just such an inquiry into the parties' motives and intentions. The determination of the proper tax treatment of a corporation's expenditures, however, should not involve such considerations. The Tax Code seeks to match outlays with revenues[155] and does not investigate the taxpayer's reasons for incurring the costs.[156] When matching expenses with the income that they generate, the objective benefit produced by the item should control, not the taxpayer's purpose in incurring it.[157] Thus, expenditures associated with the realization of a future benefit or some future aspect generally must be capitalized.[158]

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152. *See supra* note 149; *see also* Christina Binkley & Greg Hitt, *ITT, Hilton Enter Talks on Hostile Bid*, Wall St. J., Nov. 5, 1997, at A3. Binkley and Hitt write: "After 10 months of refusing to talk with Hilton Hotels Corp., ITT Corp. entered into discussions with Hilton on its sweetened $9.3 billion hostile bid.... The ITT spokesman said the talks were prompted by Hilton's recently raised bid. '*They finally put a respectable offer on the table*,' he said." *Id.* (emphasis added). Thus, even in one of the most bitterly contested takeover battles of the 1990s, the crux of the "hostility" inevitably boiled down to price.

153. *See* Comment & Schwert, *supra* note 144, at 1–2.

154. William L. Raby, *'Friendly' Is Not the Issue with Takeovers*, Tax Notes, Sept. 25, 1995, at 1613, 1614.

155. *See Staley*, 119 F.3d at 489.

156. *See supra* note 75 and accompanying text.

157. Faber, *supra* note 16, at 615.

158. *See* INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87 (1992).

Making such subjective criteria the crucial determining factor also creates the potential for widespread abuse. The Seventh Circuit is effectively encouraging corporate taxpayers to push the limits of credulity and attempt to attribute as many expenses as possible to defensive measures devoid of any future benefit.[159] If, for example, a court applied the principle established by the Seventh Circuit in *Staley* to the factual scenario in *INDOPCO*, the taxpayer in that case could avoid having to capitalize most of its expenses by characterizing the transaction as hostile until immediately preceding the final merger.

Finally, under established tax expenditure analysis principles, allowing a deduction indicates Congress's willingness to permit or often encourage the activity that qualifies for the deduction.[160] In effect, allowing taxpayers like Staley to deduct currently the costs of "defensive" activities amounts to a governmental subsidy to parties resisting tender offers. However, no compelling government interest supports encouraging and helping corporate boards of directors to resist tender offers. With capitalization as the norm, deductions must be handled judiciously. Allowing, as the Seventh Circuit did, for the deduction of such fees as a business expense serves both to encourage and to subsidize such activities. It may be perfectly legal, appropriate, and even justifiable for management to resist a tender offer, but this does not mean that the activity merits special tax treatment by the federal government.[161]

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159. *See* Johnson, *supra* note 80, at 689. ("To separate out a hostile part of the haggling over stock price in a single unitary takeover . . . is a rule just inviting abuse. In future cases, the parties will be acting like professional wrestlers, snarling for the cameras, just to get some extra tax deductions.").

160. *See generally* Stanley S. Surrey, *Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 Harv. L. Rev. 705 (1970).

161. It is also important to note that the party seeking the deductions for costs incurred to resist the acquisition is in fact the new owner of the corporation, originally the acquirer. While this taxpayer awaits approval of its claimed deductions, Staley's original management is long gone and the shareholders are no longer shareholders in Staley. While this taxpayer is capitalizing its acquisition costs, it should not simultaneously be allowed to deduct costs related to the same transaction simply because they were incurred by the former management of the target.

C. *The Seventh Circuit Erred in Failing to State that the Taxpayer Bears the Burden of Seeking and Proving Loss Deductions Under Section 165*

Many of the costs incurred by the Staley board went toward formulating plans for alternative capital transactions, which were subsequently abandoned in favor of the deal with Tate & Lyle. Many of these costs arguably qualify for a loss deduction under section 165, and the taxpayer should have been permitted to demonstrate as much. The taxpayer did argue before the Tax Court that both courts and the IRS already recognize that when a taxpayer abandons a plan for reorganization or a public offering, the taxpayer may deduct the expenditures related to the proposed plan as a loss in the year it abandons the plan.[162] The taxpayer may deduct the loss in the year of abandonment because at that point the expenditures clearly will not produce any future benefit.[163]

The Tax Court agreed with this interpretation of the law, but held that the taxpayer nevertheless had not proven any allocation of the fees paid to the investment bankers to any separate and distinct proposals that it had subsequently abandoned.[164] Based on its analysis of the fee arrangement between Staley and the bankers, the Tax Court characterized all of the services performed by the bankers as integral components of a unitary transaction, a single stock sale.[165] Under this view, all of the fees were sufficiently related to a single capital transaction to require that they all be capitalized.

The Seventh Circuit agreed that the fee arrangement was a relevant consideration,[166] but proceeded to emphasize that the costs could and should in fact be allocated between those incurred to facilitate the eventual deal, and those directed toward failed defensive plans abandoned upon consummation of the merger.[167] The Seventh Circuit then instructed the Tax Court on remand to allocate a sum of the fees for capitalization to the facilitative activities of the investment bankers and

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162. *See supra* note 29 and accompanying text.

163. *See supra* note 30 and accompanying text.

164. *See* A.E. Staley Mfg. Co. v. Commissioner, 105 T.C. 166, 200 (1995), *rev'd*, 119 F.3d 482 (7th Cir. 1997).

165. *Id.*

166. *See Staley*, 119 F.3d at 491.

167. *Id.*

printer,[168] while acknowledging that making such an allocation would not be a simple task.[169]

The Seventh Circuit, like the Tax Court, was correct that the taxpayer has a right to seek loss deductions under section 165, but the circuit court nevertheless erred in failing to establish that the burden of proof for such deductions rests with the taxpayer. Having invested so much effort in its erroneous application of the defense of business rationale, the court seemingly dealt with the application of loss deductions under section 165 as an afterthought. In its cursory treatment of the loss deduction issue, the court missed an opportunity to establish a clear precedent as to how taxpayers should apply for and prove the right to such loss deductions.

IV. PROPOSED APPROACH

Courts should adopt a bright-line rule that when management of the target reaches an agreement with the acquirer and recommends the tender offer to its shareholders, the cost of all services that proximately contribute to the consummation of the transaction must be capitalized. Courts should not consider the hostile versus friendly distinction in determining the tax treatment of costs associated with any successfully consummated merger, acquisition, or alternative capital transaction. However, taxpayers should continue to have an opportunity to seek limited loss deductions under section 165. Because both the Tax Court and the Seventh Circuit correctly recognized the difficulty of distinguishing defensive from facilitative costs, taxpayers and courts should instead differentiate between "facilitative" costs (incurred to effect the eventual transaction), and "non-facilitative" costs (unrelated to the transaction actually consummated). Allowing loss deductions for non-facilitative costs under section 165, but also enforcing strict criteria as to how taxpayers identify which fees are thus deductible, protects both the Tax Code's integrity and *INDOPCO*'s mandate in properly attributing capital expenditures to capital transactions while offering taxpayers a more equitable and reasonable result.

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168. *Id.* at 492–93.

169. *Id.* at 493.

A. INDOPCO *Controls: Consummation of the Transaction Should Generally Result in Capitalization*

INDOPCO, Inc. v. Commissioner[170] compels courts to assume that a taxpayer may not deduct costs incurred in the course of a corporate restructuring for the benefit of future operations.[171] Under *INDOPCO*, courts presume that M&As, common forms of corporate restructuring, result in significant future benefits to the newly formed entity. Consequently, the target of such a merger or acquisition generally should be required to capitalize expenses related to the transaction regardless of how the transaction originated or proceeded.

Although the U.S. Supreme Court specifically addressed a friendly merger in *INDOPCO*, for purposes of neutral and objective tax treatment the principles advocated in that case should apply equally to all M&As. The allegedly hostile or friendly nature of a takeover should have no bearing on the proper capitalization of identifiable capital expenditures. Both types of acquisitions result in the profound restructuring of existing corporate entities; in both cases, the *acquirer* must always capitalize expenses related to the transaction, because the Tax Code presumes that the newly-formed corporate entity will realize significant future benefits as a result of the restructuring. This presumption holds true even if the new corporate entity does not in fact attain any future benefits. For the same reason, the target in both types of acquisitions should also capitalize expenses associated with the transaction.

The Seventh Circuit acknowledged *INDOPCO*'s relevance at the beginning of its discussion.[172] It also noted that if a taxpayer were unable to meet its burden of showing a right to a business deduction, then it would have to capitalize its expenditures under section 263.[173] Because the Staley transaction involved a corporate restructuring that necessarily presumed the presence of future benefits, the Seventh Circuit correctly stated that Staley had the burden to prove the absence of any future benefits and corresponding right to deduct the related costs.[174] Under the Seventh Circuit's own reasoning, if Staley failed to meet its burden of proof, it would have to capitalize the expenditures. In short, without the

170. 503 U.S. 79 (1992).

171. *Id.* at 89.

172. *See Staley*, 119 F.3d at 486.

173. *Id.*

174. *Id.*

defense of business rationale for deduction, the Seventh Circuit would have been compelled to require Staley to capitalize all of the costs associated with the acquisition.

Management of the target corporations in *INDOPCO* and *Staley* have one crucial element in common: both ultimately agreed to the acquisition of their businesses.[175] In both cases, the target boards eventually recommended the transaction to their respective shareholders as in the best interests of the shareholders and the corporation. As a result, the acquisition succeeded in both cases. Regardless of how the deals originated or played out, they resulted in a significant corporate restructuring in each case, necessitating the capitalization of all expenses related to the transaction.

As previously discussed in this Note, participants and observers use the terms "hostile" and "friendly" as subjective labels to describe the origin and nature of M&A transactions.[176] When irrelevant references to the presence or absence of hostility are removed, the acquisition essentially becomes just another capital transaction. As Judge Halpern of the Tax Court stated:

> Neither the investment bankers' fees nor the printing fees related to current income production or the needs of the immediate present. Those fees were incurred in connection with a change in ownership with indefinite and extended future consequences to [Staley]. They are properly matched against revenues of a taxable period (perhaps an indefinite taxable period) longer than the taxable year during which such fees were incurred.[177]

If courts assume that the acquirer realizes future benefits from its acquisition and must capitalize its expenses, then under the same logic, the target must also capitalize its costs associated with the transaction.

If the target does not successfully consummate the proposed merger or acquisition, the tax consequences will depend upon what alternative transaction the target actually adopts. If the target avoids the original tender offer by successfully merging with a white knight, the fees incurred to facilitate the white knight transaction must be capitalized.[178]

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175. *See INDOPCO*, 503 U.S. at 81–82; *Staley*, 119 F.3d at 485.

176. *See supra* Part III.A.

177. A.E. Staley Mfg. Co. v. Commissioner, 105 T.C. 166, 197–98 (1995), *rev'd*, 119 F.3d 482.

178. *See* Tech. Adv. Mem. 90-43-003 (July 9, 1990). This result should hold true even though at least one court did allow a loss deduction under § 165 for fees incurred to facilitate a white knight

The fees associated with any other corporate restructuring or recapitalization will similarly require capital treatment under *INDOPCO*. In short, section 162 has no application to any of the costs surrounding such transactions unless it can be absolutely shown that no future benefit will result, a standard that in practice should be nearly impossible for the taxpayer to meet. In the future, taxpayers, the IRS, and the courts can avoid this troubling conundrum entirely by shifting the focus of the analysis to deductibility under section 165.

B. Deductibility Should Be Determined Under Section 165 Alone

Not only is the application of deductibility under section 165 for all M&A deals one that both the Tax Court and the Seventh Circuit can agree upon, but it also addresses more appropriately the nature of M&A transactions as a whole. Forcing future taxpayers to frame their arguments in terms of facilitative and non-facilitative costs instead of hostile or defensive costs isolates the problem while avoiding messy subjective inquiries into the parties' actual intent and true motives. Reinforcing the general rule of capitalization while allowing for the possibility of limited deductions under section 165 promotes the faithful application of fundamental tax principles and encourages taxpayers to structure their fee arrangements based upon an objective assessment of the various fees involved.

The probable reason for both the Tax Court and Seventh Circuit's inability to reach this more logical and expedient conclusion stems from the traditional approach to the capitalization-deduction debate as an all-or-nothing matter. Following Justice Cardozo's oft-quoted opinion in *Welch v. Helvering*,[179] litigants have fought in each subsequent case over whose "answer to the riddle" was more convincing.[180] The prevailing

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merger, because in that case the proposed white knight merger was abandoned in the face of the successful consummation of the original hostile takeover. *See In re* Federated Dep't Stores, Inc., 171 B.R. 603, 610 (S.D. Ohio 1994).

179. 290 U.S. 111 (1933).

180. *Id.* at 114–15. In numerous subsequent deduction-capitalization disputes, parties inevitably invoke Justice Cardozo's statement on the difficulty of making the distinction:

> Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

Id.

party either won postponement of all of the tax effects to later years or had all of the tax effects recognized in the current tax year. This all-or-nothing approach has come to define the time-worn process of determining whether costs are more properly viewed as outlays or expenses.

Loss deductions under section 165, however, should be viewed separately from this debate. Whereas many of the results in past cases dealing with the choice between deductibility and capitalization rest upon troubling distinctions and policy exceptions,[181] loss deductions under section 165 are generally easier to determine and rarely involve the puzzling dilemma of deciding whether or not a future benefit exists. Loss deductions inherently avoid all-or-nothing inquiries and allow the taxpayer to allocate costs and demonstrate that each claimed deduction stems from an outlay that does not produce anything of value beyond the current tax year.

In practice, taxpayers should be required to first itemize their facilitative costs and designate them for capital treatment, and then identify the non-facilitative costs and explain precisely how they were incurred for services related exclusively to abandoned or never implemented plans for alternative capital transactions. For example, if the target of a hostile takeover pays investment bankers to investigate and plan a self-tender whereby the target would attempt to buy back its own stock in the face of the takeover, the tax consequences would depend entirely on whether or not the plans formulated were implemented. If the self-tender succeeds, then the bankers' fees would require capitalization and the taxpayer would be obligated to designate these fees as capital outlays on its tax form for the year. If the planned self-tender failed, however, and the target was eventually acquired by the hostile bidder, the time and effort spent on the self-tender option will have resulted in nothing. The costs incurred clearly will not result in any future benefit or consequence to the entity extending beyond the current tax year and should logically qualify for a loss deduction in the current year.

Staley hired the investment bankers to investigate the feasibility of and formulate plans for a host of alternative capital transactions. The investment bankers also spent considerable time evaluating the true value

181. *See* Chirelstein, *supra* note 14, ¶ 6.02, at 120. For example, the IRS generally considers advertising and related outlays deductible currently even though such expenditures often contribute to future revenue beyond the current tax year. *Id.*

of Staley's shares, promoting this value to the market place, pitching alternative bidders and potential white knights, and generally advising Staley's board on how to deal with Tate & Lyle. Such services can and should have been broken down and the costs allocated between those that proximately facilitated any subsequent capital transactions and those that did not ultimately facilitate anything lasting beyond the current tax year. The courts should ensure that taxpayers do so in all future capital transactions.

V. CONCLUSION

In *A.E. Staley Manufacturing Co. v. Commissioner*,[182] the Seventh Circuit acknowledged the relevance and importance of the U.S. Supreme Court's decision in *INDOPCO, Inc. v. Commissioner*[183] but failed to apply it properly. The court fell into the word trap of M&A jargon, basing its extension of the business defense rationale of deductibility on the subjective perceptions of some of the participants and observers of the deal. Corporate executives from Tokyo to New York will continue to read up on new age translations of Sun Tzu's *The Art of War*[184] to improve their acumen in fighting off the "barbarians at the gate."[185] Observers and commentators will persist in their attempts to spice up the business section of the newspaper with colorful and evocative terminology. But for purposes of the Tax Code, "hostile" takeovers do not inherently constitute threats or attacks; they involve simply the buying and selling of shares in publicly traded corporations. Accordingly, the defense of business rationale should not apply to the determination of the proper tax treatment of costs related to such transactions. Instead, such costs should generally be capitalized with the limited exception that taxpayers be allowed the opportunity to prove a right to certain loss deductions for costs properly attributable to abandoned transactions.

182. 119 F.3d 482 (7th Cir. 1997).

183. 503 U.S. 79 (1992).

184. Sun Tzu, *The Art of War* (Samuel B. Griffith trans., Oxford Univ. Press 1971). This 2400-year-old Chinese classic on military tactics and strategies was written during the Warring States Period in China (453–221 B.C.). Numerous competing English translations of the book have been hot sellers in corporate America since the early 1980s. The book is especially popular with corporate managers and executives searching for all forms of enlightenment on how to meet the challenges of a rough-and-tumble corporate world.

185. *See* Burrough & Helyar, *Barbarians at the Gate*, *supra* note 141.