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TAX TREATMENT OF TAKEOVER COSTS: SUPREME COURT RESPONDS TO CONTROVERSY!

by

RAY A. KNIGHT & LEE G. KNIGHT*

Recent developments in the tax treatment of takeover costs have caused consternation among corporate taxpayers. According to the IRS, expenses incurred in "friendly" mergers or acquisitions are not deductible, but are treated as capital expenditures, or as constructive dividends to the shareholders of the acquirer. On the other hand, expenditures incurred in the defense of "hostile" takeovers are deductible. Because there is a difference in the tax treatment of these costs, the lack of clear, concise criteria that can be used to differentiate a hostile takeover from a friendly takeover is a significant tax issue. Taxpayers argue that the criteria used by the IRS to differentiate the two are extremely subjective and result in inconsistent rulings. The IRS's position with respect to hostile takeover costs is set forth in Letter Rulings 89-27-005, 89-45-003, and 90-43-003. Further, in National Starch and Chemical, deductions of takeover costs in a friendly acquisition were denied by the Tax Court and Third Circuit Court of Appeals. The Supreme Court granted certiorari in Indopco, Inc. v. Commissioner\(^1\) (formerly known as National Starch and Chemical Corporation v. Commissioner) to decide whether friendly takeover costs incurred are deductible as "ordinary and necessary" business expenses under Section 162(a). This article reviews the position of the IRS along with the reasoning of the courts — including the Supreme Court's 1992 Indopco, Inc. decision — concerning the tax treatment of costs incurred in a takeover.

CLIMATE FOR TAKEOVER COSTS BEFORE INDOPCO

Normal Business Expenses

To qualify as deductible expenses, expenditures must be: (1) ordinary and necessary, and (2) incurred in the carrying on of a trade or business. Thus, in order for takeover expenses to qualify as an allowable deduction under I.R.C. § 162(a), the item must (1) be paid or incurred during the taxable year; (2) be

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incurred in the carrying on of a trade or business; (3) be necessary; (4) be ordinary; and (5) be a current-period cost rather than a capital expenditure. 2

A "necessary" expenditure is one that is appropriate and helpful to the development of the business. 3 In Commissioner v. Tellier, 4 the Supreme Court held that costs incurred to resist a hostile takeover that was not in the best interest of the corporation and its shareholders were necessary because the costs represented the directors' fulfillment of their fiduciary duties to act in the best interests of the shareholders. In short, a necessary expense is a cost that is essential to the continuing operations of the business. An ordinary expense need not be recurring or routine. Rather, it should be a commonly accepted means of defense against a hostile takeover. 5 In Northwest Industries v. B.F. Goodrich Co., 6 the court held that hostile takeover defense costs were not capital expenditures because management was acting in the best interest of the corporation and its shareholders. A current-period cost is one that is incurred during the current period and only benefits the operations of the current period. Conversely, a capital expenditure is incurred during the current period but benefits the operations of future periods as well as the current one. Ultimately, it may be expensed when the business is disposed of or when the plan for the merger or acquisition is abandoned. 7

If the cost does not qualify as a deductible expense, it is either classified as a capital expenditure or as a constructive dividend. These two classifications relate to costs incurred in a friendly merger or acquisition. Any expenditure related to a change in capital structure is classified as a capital expenditure. According to § 263(a), no deduction is allowed for a capital structure expenditure because it constitutes a permanent improvement made to increase the value of the business. 8 An expenditure incurred by a closely held corporation is considered a constructive dividend if the IRS can show that the transactions related to the costs were of personal interest or of advantage to the shareholders rather than for the benefit of business activity. In American Properties v. Commissioner, 9 the Tax Court held that because payments made by a corporation on behalf of its shareholders were made in furtherance of a private hobby, they constituted a constructive dividend.

5 Priv. Ltr. Rul. 89-27-005 (March 27, 1989).
Deduction of Costs in Hostile Takeovers

In Letter Ruling 89-27-005, the IRS held that costs incurred in fending off a hostile takeover attempt are deductible as ordinary and necessary business expenses. In so holding, the IRS rejected the district director's arguments that such costs should be capitalized or treated as constructive dividends to the target's shareholders.

In Letter Ruling 89-27-005, Y commenced a hostile takeover of X. X's board of directors decided to resist the hostile takeover because it did not believe that Y's acquisition of majority control of X would be in the best interests of all of X's shareholders. X's board of directors was concerned that Y's large debt and intercompany transaction practices would damage X's growth and financial stability. Accordingly, X's board concluded that Y's takeover of X would be detrimental to X's future business operations and to its minority shareholders.

X hired Z to defend against Y's hostile takeover. Z searched for possible white knights and agreed to provide a fairness opinion letter to X's board. Z found its white knight, W, which agreed to acquire all of X's stock in a taxable stock purchase. X's board unanimously recommended acceptance of W's offer to X shareholders. After X agreed to the acquisition by W, X and Y agreed in a mutual release that Y would abandon its takeover attempt and would sell its shares to W at the same price that W was offering to X's shareholders. X agreed to reimburse Y for Y's expenses in seeking regulatory approval of its takeover of X. X's board approved the settlement to avoid a proxy fight.

The IRS viewed X's anti-takeover costs as subject to three possible tax treatments: (1) ordinary and necessary expenses deductible under I.R.C. § 162(a), (2) capital expenditures, in whole or in part under § 263, or (3) constructive distributions to X's shareholders. The IRS acknowledged that the costs were incurred by X's directors in carrying out their fiduciary duties, and that the directors' concerns were reasonable in light of Y's debt position, the failure of Y's offer to cover all of X's shares, and the incompatibility of X's business with Y's business. Thus, the IRS deemed anti-takeover costs to be ordinary and necessary because X's directors had a fiduciary responsibility to oppose tender offers that were detrimental to the company or its shareholders. The costs were "ordinary" because they "were expended by X as the common and accepted means of defense against attack from Y." They were "necessary" because "they were, in X's judgment, appropriate and helpful to the corporation and its shareholders due to the perceived harm which would result to the continued successful operation of X if the tender offer of Y was allowed to be consummated." There was no indication that the costs were excessive or unreasonable in light of prevailing business norms.

Rather, the IRS concluded that they had been incurred to protect minority shareholders and the future profitability of X. Management was acting in the best interests of X and its shareholders.

**Significance of Letter Ruling 89-27-005**

On audit, the district director determined that, under an origin of the claim analysis, the costs that X incurred in resisting the hostile tender offer should be capitalized because the costs related to a change in X's capital structure and represented the acquisition costs of the acquiring corporation. The National Office of the IRS disagreed, however, concluding that the costs had not been incurred in connection with an alteration or change in X's capital structure, but resulted from the efforts of the board of directors to inform themselves about the takeover attempt and protect the interests of the shareholders.

At the time of its release, Letter Ruling 89-27-005 was of interest because it was thought to be at odds with a related ruling in Letter Ruling 87-41-009\(^1\) in which the IRS barred a current deduction for the cost of investment banking services and attorney's fees incurred in connection with the redemption of stock held by a hostile shareholder group. In Letter Ruling 87-41-009, the IRS flatly rejected the taxpayer's claim that because the costs were incurred in the exercise of the directors' fiduciary obligations under state law, they were ordinary and necessary. The IRS concluded that the directors' state law obligations were irrelevant because the costs related to the acquisition of a capital asset and corresponded to an alteration of the corporation's capital structure. On the other hand, in Letter Ruling 89-27-005, the IRS found that the costs were ordinary, in that they represented a common and accepted means of defending against a hostile suitor, and necessary in that they were appropriate and helpful in avoiding the hostile takeover. The IRS expressly rejected the idea that the costs were related to changes in X corporation's capital structure.

**Denial of Costs Incurred in Friendly Takeover**

Although the IRS agreed to the deductibility of costs incurred in fighting a hostile takeover, in *National Starch and Chemical Corporation*\(^2\) costs incurred in a friendly takeover were treated differently. There, the Tax Court upheld an IRS determination that investment banking expenditures made by the acquired corporation were not deductible as ordinary and necessary expenses. Instead, the costs had to be capitalized as part of the cost of the recapitalization pursuant to the acquisition.

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\(^{1}\) Priv. Ltr. Rul. 87-41-009 (June 12, 1987).

National Starch was a widely held corporation whose stock was traded on the New York Stock Exchange. National Starch's largest shareholder, Mr. and Mrs. Greenwall, owned approximately 14.5 percent of the company's outstanding common shares. Mr. Greenwall was also chairman of the executive committee of National Starch's board of directors.

The Unilever group expressed an interest in acquiring National Starch. Mr. Greenwall stated that for estate tax planning reasons he would only transfer his stock in a tax-free exchange that would be available to the other shareholders. Unilever, Mr. Greenwall, and National Starch agreed to a plan under which Unilever U.S. would create a subsidiary, Holding, and a transitory subsidiary of Holding, NSC Merger. Holding would exchange one share of its non-voting preferred stock for each share of National Starch common stock it received. Any stock not transferred to Holding would be converted into cash in a merger of NSC Merger into National Starch.

When the National Starch board of directors was informed of the proposed acquisition, it retained an outside independent investment banking firm, Morgan Stanley, to value the National Starch stock, issue a fairness opinion, and assist with respect to any hostile takeover attempt. After some negotiation, the parties agreed to a price, with Morgan Stanley providing a favorable fairness opinion with respect to the price. The parties agreed that the acquisition was to be subject to a favorable ruling on the transfer from the IRS. The IRS ruled that the stock-for-stock exchanges would be tax-deferred exchanges under I.R.C. § 351 and that the stock-for-cash exchanges would be treated as taxable sales.

Twenty-one percent of the National Starch shareholders opted for the nontaxable exchange, and the remaining seventy-nine percent chose to receive cash. After the merger was completed, National Starch's certificate of incorporation was amended to eliminate its previously authorized preferred shares and to reduce its number of authorized shares to 1,000 common shares.

The Tax Court noted several justifications that the parties had given for the acquisition. Morgan Stanley had concluded that National Starch's affiliation with Unilever would create the opportunity for synergy. National Starch's annual report had stated that the company would benefit from the Unilever group's enormous resources. The court noted, however, that in reality National Starch's operations showed little change as a result of the acquisition. The Unilever group made no material changes in National Starch's operations, provided it with no significant services, and declined to engage in intercompany transactions.

National Starch's transaction costs included approximately $2.2 million in fees from Morgan Stanley, $500,000 in legal fees, and $150,962 in other costs. In its tax return for the 1978 tax year, National Starch deducted the Morgan Stanley
fee as an ordinary and necessary business expense under § 162(a). It did not
deduct the other fees. The IRS challenged the deduction of the investment banking
fees, asserting that they were either a capital expenditure or a constructive
distribution to National Starch's shareholders.

In this case of first impression concerning the deductibility of costs incurred
in a friendly takeover, the Tax Court upheld the IRS's denial of the deduction. The
court stated the five requirements of a § 162(a) expense: The expenditure must be:
(1) necessary; (2) incurred in connection with carrying on a trade or business; (3)
ordinary; (4) a current-period cost, not a capital expenditure; and (5) paid or
incurred during the taxable year. The court found that only the last requirement
was clearly satisfied. Having determined that the fees constituted a capital
expenditure, the court never addressed the first three requirements.

In its analysis, the court gave its own reasons for holding that the
expenditures were capital in nature. The court determined that National Starch's
board approved the transaction because it would be in National Starch's long-term
interest to shift ownership of the corporate stock to Unilever. The court based its
conclusion on three grounds. First, the directors' fiduciary duties required them to
approve the takeover only if it was in the best interests of National Starch and its
shareholders. Second, National Starch's annual report and Morgan Stanley's study
both stated that the corporation would benefit from inclusion in the Unilever group.
Third, the resources of the Unilever group provided both an immediate and a long-
term benefit to National Starch in the form of broadened opportunities.

Accordingly, because the expenditures incurred were incident to a shift in
ownership, they had to be capitalized under § 263.

IRS Redefines Its Inconsistent Position

The Tax Court's decision in National Starch provided the impetus for the
IRS to change its position in a private letter ruling that was issued after the
National Starch decision. In Letter Ruling 89-45-003,13 the IRS again addressed
the issue of whether costs are deductible when incurred by a corporation to resist a
takeover that, in the judgment of the board of directors, is not in the best interest of
the corporation or its shareholders. The IRS stated that the Tax Court's reasoning
in National Starch applies with equal force to a hostile takeover that is successfully
resisted by locating a white knight. The IRS found that there is "no less a long-
term benefit to the target of the hostile takeover as in the National Starch case."
Therefore, because the IRS found that Letter Ruling 89-27-005 was inconsistent
with the Tax Court's decision in National Starch, it revoked Letter Ruling 89-27-
005.

This is not the first time that the IRS has had trouble with the deductibility of takeover costs. In Letter Ruling 85-16-002,\textsuperscript{14} citing \textit{United States v. Gilmore}\textsuperscript{15} and \textit{Northwest Industries v. B.F. Goodrich Co.},\textsuperscript{16} the IRS applied the "origin of the claim" doctrine in determining that the costs incurred by a corporation to oppose a stock tender offer "were clearly incurred in carrying on a trade or business." The IRS also stated, citing \textit{Welch v. Helvering},\textsuperscript{17} \textit{Commissioner v. Heininger},\textsuperscript{18} and \textit{Commissioner v. Tellier},\textsuperscript{19} that the costs were ordinary and necessary costs. As a result, the IRS allowed a deduction for costs incurred by the taxpayer in opposing a stock tender offer. In General Counsel Memorandum 39,352, upon reviewing the facts of Letter Ruling 85-16-002, the IRS chief counsel also agreed that costs incurred in opposing a stock tender offer are deductible under I.R.C § 162.\textsuperscript{20}

In Letter Ruling 86-26-001,\textsuperscript{21} the IRS withdrew Letter Ruling 85-16-002, stating that it was reconsidering the area in connection with other costs incurred to resist a hostile takeover — namely, "greenmail" payments. The IRS defined "greenmail" as payments made by a target to a raider as well as payments made as a result of a "stand-still" agreement under which the raider agrees to refrain, for a specified time, from further attempts to acquire the target's stock.

In withdrawing Letter Ruling 85-16-002, the IRS also stated some general rules regarding the corporation's repurchase of its own shares. Apparently, the IRS considered the amounts expended by a corporation in repurchasing its stock to be similar to amounts expended in fighting off a takeover. In Letter Ruling 88-16-005, however, the IRS stated that "after careful and extensive reconsideration," it was reinstating Letter Ruling 85-16-002.\textsuperscript{22}

\textbf{Reason for Supreme Court}

\textit{To Grant Certiorari and Review Issue}

In a November 1990 ruling, the Court of Appeals for the Third Circuit affirmed the Tax Court's decision in \textit{National Starch}. The decision, which dismayed takeover specialists, accountants and lawyers, had important implications affecting the complex issue of what costs companies may deduct in takeover battles. Accountants feel that it is difficult to draw the line between the

\textsuperscript{17} Welch v. Helvering, 290 U.S. 111 (1933).
\textsuperscript{18} Commissioner v. Heininger, 320 U.S. 467 (1943).
\textsuperscript{22} Priv. Ltr. Rul. 88-16-005 (Feb. 13, 1987).
costs of fighting a hostile bid and those of arranging for a friendly bidder to come to the rescue.

In July 1990, in Private Letter Ruling 90-43-003, the IRS told an insurance company — presumably Western States Life Insurance Company of Fargo, North Dakota — that the company could deduct as ordinary business expenses all of its costs related to fighting an unfriendly takeover bid. But the IRS also said that the company could not deduct as current expenses the costs of arranging a friendly merger.

Was this a distinction without a substantive difference? On the surface, it would appear to make little sense to distinguish between hostile and friendly takeovers in determining the deductibility of costs. Nevertheless, the position forced tax practitioners to advise corporate taxpayers to wait for an unfriendly suitor to make its move before seeking a white knight. Following this strategy, the taxpayer was able to deduct the majority of its takeover-defense costs; only the costs associated with seeking the white knight were not tax deductible.

SUPREME COURT SETTLES CONTROVERSY OVER FRIENDLY TAKEOVER COSTS

The Supreme Court granted certiorari in *Indopco, Inc. v. Commissioner* (formerly known as *National Starch and Chemical Corporation v. Commissioner* in the Tax Court and Third Circuit) to decide whether certain professional expenses incurred by a target corporation in the course of a friendly takeover are deductible by that corporation as "ordinary and necessary" business expenses under I.R.C. § 162(a). Most of the facts were stipulated. According to the facts, a "reverse subsidiary cash merger" was devised to satisfy the concerns of the major stockholders. Morgan Stanley charged National Starch a fee of $2,200,000, along with $7586 for out-of-pocket expenses and $18,000 for legal fees, for evaluating its shares, rendering a fairness opinion, and generally assisting in the event of a hostile tender offer. In addition, National Starch's counsel charged National Starch $490,000, along with $15,069 for out-of-pocket expenses. Other miscellaneous expenses of $150,962 were incurred — including accounting, printing, proxy solicitation, and SEC fees in connection with the transaction. After the IRS disallowed the deductions and issued a notice of deficiency, National Starch sought review by the Tax Court asserting the right to deduct both the investment banking fees and expenses and the legal and miscellaneous expenses incurred. The reasonableness or propriety of the expenses was never an issue.

In ruling that the expenditures were capital in nature and therefore not deductible under § 162(a), the Tax Court based its decision primarily on the long-term benefits accruing to National Starch from the Unilever Acquisition. The Third Circuit affirmed the Tax Court's decision by finding that "both Unilever's enormous resources and the possibility of synergy arising from the transaction served the long-term betterment of National Starch." National Starch argued that because the disputed expenses did not "create or enhance... a separate and distinct additional asset," they could not be capitalized, and therefore were deductible under § 162(a). The Supreme Court granted certiorari to resolve a perceived conflict on the issue among the courts of appeals.

**Deductions Versus Capital Expenditures**

The familiar rule is that "an income tax deduction is a matter of legislative grace and the burden of clearly showing the right to the claimed deduction is on the taxpayer." The Court found that deductions are specifically enumerated in the Internal Revenue Code and are exceptions to the norm of capitalization.

Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a "complete list of nondeductible expenditures," Lincoln Savings, 403 U.S., at 358, Section 263 serves as a general means of distinguishing capital expenditures from current expenses. See Commissioner v. Idaho Power Co., 418 U.S., at 16. For these reasons, deductions are strictly construed and allowed only "as there is a clear provision therefor." New Colonial Ice Co. v. Helvering, 292 U.S., at 440; Deputy v. DuPont, 308 U.S., at 493.

**Test for Current Expenses**

Relying on *Lincoln Savings & Loan*, National Starch went away from the "ordinary" and "necessary" tests of I.R.C § 162 to an exclusive test for identifying capital expenditures — a test in which "creation or enhancement of an asset" is a prerequisite to capitalization, and deductibility under § 162 is the rule rather than the exception. The Court held that this interpretation of *Lincoln Savings & Loan* missed the mark.

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28 Indopco, Inc., 112 S. Ct. at 1043.
29 Id.
Lincoln Savings stands for the simple proposition that a taxpayer's expenditure that "serves to create or enhance... a separate and distinct" asset should be capitalized under Section 263. It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized under Section 263. We had no occasion in Lincoln Savings to consider the tax treatment of expenditures that, unlike the additional premiums at issue there, did not create or enhance a specific asset, and thus the case cannot be read to preclude capitalization in other circumstances. In short, Lincoln Savings holds that the creation of a separate and distinct asset well may be a sufficient but not a necessary condition to classification as a capital expenditure.\(^3\)

**Inquiry into Future Benefits**

A taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is as an immediate deduction or as a capital expenditure.\(^3\) "The text of the Code's capitalization provision, Section 263(a)(1), which refers to 'permanent improvements or betterments,' itself envisions an inquiry into the duration and extent of the benefits realized by the taxpayer."\(^3\)

In searching the records and findings of the lower courts, the Court found enough significant benefits to conclude that National Starch had failed to prove that the costs were deductible as "ordinary and necessary" business expenses:

1. The company would benefit greatly from the availability of Unilever's enormous resources, especially in the area of basic technology ("Progress Report").
2. National Starch management felt that some synergy may exist with the Unilever organization given (1) the nature of the Unilever chemical, paper, plastics, and packaging operations... and (2) the strong consumer products orientation of Unilever.
3. National Starch received benefits from its transformation from a publicly held, freestanding corporation into a wholly owned subsidiary of Unilever — i.e., swapping approximately 3,500 shareholders for one.
  a. National Starch was no longer subject to substantial shareholder-relations expenses which a publicly traded corporation incurs,
including reporting and disclosure obligations, proxy battles, and derivative suits.

b. The acquisition also allowed National Starch, in the interests of administrative convenience and simplicity, to eliminate previously authorized but unissued shares of preferred stock and to reduce the total number of authorized shares of common stock from 8,000,000 to 1,000.

The Court found that expenses incurred for the purpose of changing the corporate structure for the benefit of future operations are not treated as ordinary and necessary business expenses. Courts more frequently have characterized an expenditure as capital in nature because "the purpose for which the expenditure is made has to do with the corporation's operations and betterment, sometimes with a continuing capital asset, for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year." In ruling that the expenses were capital expenditures, the Court held the fact that the expenditures do not create or enhance a separate and distinct additional asset is not controlling.

**Impact of Indopco**

The unanimous decision in *Indopco* may have broad ramifications beyond the takeover context. The IRS may interpret the decision as justification for its recent tightening of the standard a company must meet to deduct the cost of fending off a hostile takeover. The combination of the Supreme Court decision and more aggressive enforcement by the IRS could produce huge tax bills for dozens of companies involved in transactions dating well back into the 1980's. The Justice Department told the Court in its arguments that more than $500 million in potential tax liability was at stake in pending disputes over the deductibility of merger and acquisition fees.

The *Indopco* decision could embolden the IRS to deny deductions for expenditures on such things as factory repairs, employee training, environmental cleanups and advertising. Corporate taxpayers should be concerned about the decision's broad language and the heavy burden it places on taxpayers to prove deductibility. The Court's ruling does not explicitly apply to other takeover related fees — such as points on bank loans—the deductibility of which is governed by separate rules. However, the decision could cause the IRS to get tougher on the deduction of bank fees as well.

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34 *See, e.g.,* General Bancshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir.), *cert. denied,* 379 U.S. 832 (1964); Farmers Union Corp. v. Commissioner, 300 F.2d 197 (9th Cir.), *cert. denied,* 317 U.S. 861 (1962); Boris Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders,* 5-33 to 5-36 (5th ed. 1987).

35 *General Bancshares Corp.*, 326 F.2d at 715. *See also* Mills Estate, Inc. v. Commissioner, 206 F.2d 244, 246 (2d Cir. 1953).
CONCLUSION

As has been shown, until recently, the deductibility of takeover costs was not settled. Taxpayers were faced with criteria and reasoning of the IRS that were of questionable logic. Understanding the IRS's previous positions and inconsistencies as well as its current position may help tax professionals understand the Supreme Court's decision.