A.E. STALEY MANUFACTURING CO. V. COMMISSIONER: LIFE AFTER INDOPCO: TAX TREATMENT OF A TARGET CORPORATION'S UNSUCCESSFUL HOSTILE TENDER OFFER DEFENSE FEES

"Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles 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."1

I. INTRODUCTION

Over the last few years, companies have increasingly focused on corporate re-engineering and industry consolidation to strengthen their competitive positions. One result of this focus has been an increase in corporate merger and acquisition activity.2

When a target corporation first confronts a takeover attempt, the corporation will typically retain the services of an investment banker.3 Investment banking fees and other takeover-related professional costs can amount to millions of dollars.4 As a result, one important issue for target corporations incurring takeover-related professional fees concerns the proper tax treatment of those fees.5

In 1992, the Supreme Court first considered the tax treatment of investment banking and other professional fees incurred by a target corporation during a friendly takeover in INDOPCO, Inc. v. Commissioner.6 The Court held that the fees

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1 Welch v. Helvering, 290 U.S. 111, 114-15 (1933) (Justice Cardozo writing about the difficulty of distinguishing between ordinary business expenses and capital expenditures for income tax purposes).
3 Id. at 1-2. ("Regardless of whether a takeover attempt is 'friendly' or 'hostile,' the directors will be compelled to take several takeover-related actions.").
5 Persellin, supra note 2, at 2.
were properly capitalized due to the significant benefits received by the target corporation which extended beyond the current tax year. After the INDOPCO decision, taxpayers and tax practitioners alike speculated as to the scope of its holding.

One specific concern was whether the INDOPCO decision represented a per se rule that takeover-related expenses must always be capitalized. The recent Seventh Circuit decision of *A.E. Staley Manufacturing Co. v. Commissioner* appears to have answered this question in the negative. In *Staley*, the Court of Appeals held that the majority of investment banker fees paid in an unsuccessful attempt to defeat a hostile tender offer were deductible as "ordinary and necessary" business expenses. Alternatively, those expenses allocable to the company's unsuccessful efforts to engage in alternate transactions were deductible as "abandoned transac-

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7 Id. at 88.

8 John Paul LeBlanc, *The Supreme Court Attempts to "Iron Out" the Wrinkles in National Starch*, 54 LA. L. REV. 437, 437 (1993) ("INDOPCO has resulted in confusion for taxpayers and tax attorneys, who are unsure what test applies to determine the deductibility of expenditures."); see also Sarah R. Lyke, Note, *INDOPCO, Inc. v. Commissioner: National Starch Decision Adds Wrinkles to Capital Expenditure Issue*, 88 NW. U. L. REV. 1239, 1270 (1994) (writing that "the decision's broad language leaves open the question of whether capitalization is always required whenever an expenditure produces a significant long-term benefit"); Richard M. Lipton et al., *Supreme Court Approves Focus on Long-Term Benefit in Takeover Controversy*, 76 J. TAX'N 324, 329 (1992) ("[I]t is unclear what the impact of INDOPCO will be outside of the takeover arena. It is possible that the IRS will use the case to justify capitalization of any expenditure that results in a long-term benefit to the taxpayer, even if such expenditure provides short-term benefits as well.").


10 119 F.3d 482 (7th Cir. 1997).

11 *Staley* is not the first court to consider fees incurred by a target corporation in a hostile context. In *Victory Markets, Inc. v. Commissioner*, 99 T.C. 648, 661 (1992), the taxpayer attempted to distinguish INDOPCO by arguing that the takeover of the company's stock was hostile. The Tax Court, however, never addressed the hostile issue because it found sufficient evidence of long-term benefits under INDOPCO to require capitalization. Id. at 662-65. Cf. United States v. Federated Dep't Stores, Inc. (*In re Federated Dep't Stores*), 171 B.R. 603, 610-13 (Bankr. S.D. Ohio 1994) (holding that break-up fees paid to failed white knight merger transactions in response to a hostile tender offer were properly deductible as "ordinary and necessary" business expenses due to no anticipated future benefits; the expenses were also deductible as "abandoned transactions"); see also infra note 40 (defining white knight).

12 *Staley*, 119 F.3d at 491.
tions." However, fees paid by Staley to evaluate its stock required capitalization because they facilitated the completed merger.

The *Staley* decision is unlikely to be the final word on the tax treatment of a target corporation's hostile defense fees. This Note will explore the impact of the *Staley* decision from both a historical and prospective viewpoint. First, this Note will set out the statutory background and major tests developed by the courts over time to determine the appropriate tax treatment of expenses. In the discussion of the major tests, this Note will review the test employed in *INDOPCO* and the Supreme Court's reasoning in that decision. It will then address the *Staley* opinion and its underlying rationale. This Note will explore the tests employed by the *Staley* court, critically analyze the court's approach and its reasoning, and assess some of the practical ramifications of the decision. Finally, it will suggest a simpler and perhaps more satisfactory approach than that utilized by the *Staley* court.

II. BACKGROUND

A. Ordinary Business Expenses vs. Capital Expenditures

One of the most difficult areas in tax law involves distinguishing between expenses which can be deducted from taxable income when incurred and those which must be capitalized over a period of years. This distinction is one of great

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13 *Id.*
14 *Id.*
15 See infra PART II.
16 See infra PART II(C).
17 See infra PART III.
18 See infra PART IV(A).
19 See infra PART IV(B).
20 See infra PART IV(C).
21 See infra PART IV(D).
22 Peter L. Faber, *INDOPCO: The Still Unsolved Riddle*, 47 TAX LAW. 607, 607 (1994). Not all expenditures made by a taxpayer in a given tax period give rise to a deduction in that same tax period. Melissa D. Ingalls, *INDOPCO, Inc. v. Commissioner: Determining the Taxable Nature of a Target Corporation's Takeover Expenses*, 43 DEPAUL L. REV. 1165, 1169 (1994). In general, an expenditure which produces a benefit greater than one year must be capitalized. *Id.* Likewise, an expenditure to acquire an asset with a useful life lasting longer than one year must also be capitalized. *Id.* A capital expenditure is an expenditure for the “acquisition of property or a permanent improvement in the property’s value.” *Id.* If the expenditure is for a tangible asset, such as furniture, fixtures, and equipment, capitalization is accomplished by depreciating the cost of the asset over its determinable
importance, since the time value of money renders current deductions significantly more valuable to the taxpayer than future deductions.23

Historically, the applicable Internal Revenue Code provisions alone have not provided a satisfactory framework for determining the appropriate tax treatment of expenses. As a result, judicial interpretation has played an important role in two primary areas: (1) interpretation of Internal Revenue Code provisions,24 and (2) development of various tests by the Supreme Court and circuit courts to assist them further in determining the proper tax treatment of expenses.25 Unfortunately, even judicial interpretation has not produced a clear, consistent road map for courts to follow.26

useful life. Id. Similarly, if the expenditure is for an intangible asset, capitalization is accomplished by amortizing the cost of the asset over its useful life. Id. The useful life must be ascertainable with reasonable accuracy. Id. Certain intangible assets, such as goodwill, have useful lives which cannot be determined with reasonable accuracy. Id. at 1170. If the useful life cannot be determined with reasonable accuracy, no depreciation or amortization is allowed over the life of the asset. Id. Therefore, there is little or no tax value to the taxpayer; the taxpayer cannot recover the cost of the asset until dissolution of the corporation. Id.

23 Lyke, supra note 8, at 1239-40. The distinction is particularly important in the context of a target corporation's professional fees. Ingalls, supra note 22, at 1170-71. If takeover-related fees are determined to be capital expenditures, an intangible asset is created. Id. at 1170. In all likelihood, the fees will not have a reasonably determinable useful life. Id. Consequently, no tax deduction for amortization or depreciation will be allowed; the only available tax deduction for the corporation would be upon dissolution of the enterprise. Id. at 1170-71. Such a tax deduction is of minimal value to the taxpayer because it does not allow the taxpayer to recover the cost of the fees over time. Id. This is particularly true when compared to the attractive tax benefit received if the expenses are deductible against income in the current tax period. Id. at 1171.

24 Applicable Internal Revenue Code provisions in this Note include Sections 162(a) and 165(a). See infra notes 29 & 37 and accompanying text.

25 Ingalls, supra note 22, at 1171, 1173.

26 Id. at 1173. Although the application of various judicially-developed tests has resulted in no clear consensus as to the appropriate test to apply with takeover-related expenses, courts appear to agree that income tax deductions are a "matter of legislative grace," and the taxpayer bears the burden of "clearly showing the right to the claimed deduction." Id. Each determination is largely fact-specific. Id.; see also Interstate Transit Lines v. Commissioner, 319 U.S. 590, 593 (1943); Deputy v. Du Pont, 308 U.S. 488, 493 (1940); New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440 (1934).
B. Statutory Provisions

In theory, the Internal Revenue Code attempts to match the revenues received in a taxable period with the expenses incurred to generate those revenues. The desired result is a more accurate calculation of net income for tax purposes.

1. Ordinary Business Expenses

There are five requirements to qualify for an allowable deduction under Section 162(a) of the Internal Revenue Code: "[A]n item must (1) be 'paid or incurred during the taxable year,' (2) be for 'carrying on any trade or business,' (3) be an 'expense,' (4) be a 'necessary expense,' and (5) be an 'ordinary' expense." Interpretations of "ordinary" and "necessary" have historically been common sources of controversy. To be classified as an "ordinary" expense, an expense need not occur on a regular basis; an "ordinary" expense may occur only once in a

27 INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992). By distinguishing between expenditures which are ordinary business expenses and those which are capital expenditures, Congress has attempted to develop a consistent and accurate method of matching the timing of expenditures with the revenues from which the expenditures arise. Bryan Mattingly, Note, INDOPCO, Inc. v. Commissioner: Will the IRS Use a Nebulous Supreme Court Decision to Capitalize on Unsuspecting Taxpayers?, 81 KY. L.J. 801, 805-06 (1993). The underlying rationale for distinguishing between the two categories of expenditures is to reduce the taxpayer's ability to manipulate taxable income. Id. at 805. For example, if both types of expenditures were currently deductible, a taxpayer could dramatically reduce a particular period's taxable income by purchasing a costly asset in that period. Id. at 806.

28 INDOPCO, 503 U.S. at 84.

29 I.R.C. § 162(a) (West 1997) provides:

In general.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

(2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and

(3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.


taxpayer’s lifetime provided the expense is customary within the taxpayer’s business community.32 “Necessary” connotes only a minimum threshold that the expense was at least “appropriate and helpful” for the development of the taxpayer’s business.33

2. Capital Expenditures

Section 263(a)(1)34 of the Internal Revenue Code allows no current deductions for “any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.”35 Capital expenditures must be amortized or depreciated over the life of the relevant asset.36

3. Abandoned Transactions

An alternative to deductibility under Section 162(a) in certain circumstances is Section 165(a).37 This Code provision permits a current deduction for “any loss sustained during the taxable year and not compensated by insurance or otherwise.”38 Generally, expenses incurred in the development of plans involving the organization or reorganization of corporations become deductible when the plans are abandoned.39 In the hostile takeover context, a 1994 United States District Court decision held that break-up fees incurred as a result of failed white knight40 mergers in response to a hostile tender offer were properly deductible as “abandoned

32 Welch v. Helvering, 290 U.S. 111, 114 (1933) ("The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part.").
33 Id. at 113; see also Commissioner v. Heininger, 320 U.S. 467, 471 (1943). Because “appropriate” and “helpful” are broad and subjective terms, virtually any expense in a taxpayer’s business will meet the “necessary” prong of the five-part test. Ingalls, supra note 22, at 1172.
35 Id.
36 INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 83-84 (1992); see also Ingalls, supra note 22.
37 I.R.C. § 165(a) (West 1997).
38 Id.
39 El Paso Co. v. United States, 694 F.2d 703, 712 (Fed. Cir. 1982) (holding here, however, that expenses incurred to create an entity to serve as a vehicle for divestiture were not deductible as abandoned plans because the entity was eventually used for the very purpose for which it was created).
40 A white knight is “a potential acquirer usually sought out by the target of an unfriendly takeover to rescue it from the unwanted bidder’s takeover.” BLACK’S LAW DICTIONARY 1596 (6th ed. 1990).
transactions” as well as “ordinary and necessary” business expenses.41

C. Tests for Deductibility

While the various judicially-created tests to determine tax deductibility have not provided a bright-line standard, most of the tests share one thread of consistency: the focus of the inquiry is on the presence and duration of an expenditure’s benefits.42 The tests pertinent to the Staley decision are set out below.43

1. Business Attack Defense

Expenses incurred by a taxpayer while defending its business and corporate

41 United States v. Federated Dep’t Stores, Inc. (In re Federated Dep’t Stores), 171 B.R. 603, 611-13 (Bankr. S.D. Ohio 1994) (rejecting the IRS’s argument that there was only one transaction (a successful merger) and finding instead two mutually exclusive capital transactions (a successful merger with the hostile acquirer and a failed merger with the white knights) such that the breakup fees related to the failed merger with the white knights and were, therefore, deductible)).

42 Ingalls, supra note 22, at 1174 (stating that a corporate expenditure is a capital expenditure if it betters the corporation for (1) the duration of its existence, (2) the indefinite future, or (3) longer than the current tax year).

43 Two other important judicially-created tests are the “primary purpose” test and the “origin of the claim” test. The “primary purpose” test looks to the taxpayer’s purpose or motive in incurring an expense to determine if the taxpayer anticipated a long-term benefit which must be capitalized; this test was first articulated in the 1946 case of Rassenfoss v. Commissioner, 158 F.2d 764, 767 (7th Cir. 1946). The subjective nature of the “primary purpose” test has been criticized often; in 1963, the United States Supreme Court adopted a standard for tax deductibility based upon the “origin of the claim.” United States v. Gilmore, 372 U.S. 39, 49 (1963). Rather than focus on the taxpayer’s motive for incurring an expense, this test purportedly established an objective standard by focusing on the nature of the claim which gave rise to the expense; that is, the “origin and character of the claim with respect to which an expense was incurred . . . .” Id. In Gilmore, the court held that legal fees incurred by a taxpayer in a divorce action to defend his business assets from his wife’s community property claims had their “origins” in the marital relationship and not in the taxpayer’s business; therefore, the expenses were personal expenses and not deductible. Id. at 51-52. For an in-depth treatment of some of the shortfalls of the “origin of the claim” test, see Timothy A. Rodgers, Note, The Transaction Approach to the Origin of the Claim Doctrine: A Proposed Cure for Chronic Inconsistency, 55 BROOK. L. REV. 905, 905-09 (1989) (stating that one of the reasons for chronic inconsistency of the test is that the “origin” and “character” language requires a court to apply the test to two entirely different elements).
policies from attack are deductible as "ordinary and necessary" expenses.\(^{44}\) This principle has been applied by different courts within the federal judiciary; the most common applications have been in the context of litigation expenses and proxy fight expenses.\(^{45}\) The business attack defense has been recognized for over fifty years, and has not been abrogated by any subsequently developed judicial tests.\(^{46}\)

2. "Separate and Distinct Asset" Test

In 1971, the Supreme Court enunciated a test in *Commissioner v. Lincoln Savings and Loan Ass'n.*\(^{47}\) that signaled a departure from the traditional benefits inquiry. In *Lincoln,* financial institutions were required to make premium payments to a Federal Savings and Loan Insurance Corporation Secondary Reserve.\(^{48}\) The Court held that the payments to the Secondary Reserve created a "separate and distinct asset"; therefore, the payments were capital in nature and not deductible as an ordinary business expense.\(^{49}\) The Court also noted that possibility of a future benefit does not mandate treatment as a capital expenditure, because many currently deductible expenses have "prospective effect" beyond the taxable year.\(^{50}\)

The decision resulted in great confusion. Based on *Lincoln,* several courts concluded that presence of future benefits was no longer relevant, and that the sole

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44 A.E. Staley Manufacturing Co. v. Commissioner, 119 F.3d 482, 487 (7th Cir. 1997); *see also* Persellin, *supra* note 2, at 27 (stating that costs directly related to defending corporate policies "do not give rise to any long-term benefit or other capital asset and therefore should be deductible").

45 *Staley,* 119 F.3d at 488; *see, e.g.,* Commissioner v. Heininger, 320 U.S. 467, 469-75 (1943) (holding that legal expenses incurred by a dentist with a mail order business to enjoin enforcement of a mail fraud order were deductible considering that the enforcement of the order posed a threat to the dentist's continued existence of his lawful business); Locke Manufacturing Cos. v. United States, 237 F.Supp. 80, 82-84 (D. Conn. 1964) (holding that proxy contest expenses incurred by a corporate taxpayer to successfully resist a stockholder's challenge of corporate policy were deductible as ordinary and necessary expenses).

46 *Staley,* 119 F.3d at 487-88 ("We begin our pragmatic assessment with the well-worn notion that expenses incurred in defending a business and its policies from attack are necessary and ordinary--and deductible--business expenses."). The *Staley* court further said, "The foregoing line of authority was neither abrogated nor indeed even addressed by *INDOPCO* . . ." *Id.* at 488.

47 403 U.S. 345 (1971).

48 *Id.* at 348. Each institution had a pro rata share of the Secondary Reserve which was available in the event of a loss by the Federal Savings and Loan Insurance Corporation. *Id.* at 350.

49 *Id.*

50 *Id.*
inquiry should be whether the expense created a “separate and distinct asset.”

3. Long-term Benefits

The Supreme Court granted certiorari in *INDOPCO* to settle a “perceived conflict” among the Courts of Appeals as to whether the *Lincoln* test was the exclusive test for determining an expenditure’s tax deductibility. The *INDOPCO* decision unequivocally renewed focus on future or long-term benefits as a means of distinguishing an ordinary business expense from a capital expenditure.

In *INDOPCO*, Unilever United States, Inc. (“Unilever”) expressed an interest in acquiring *INDOPCO*’s predecessor, National Starch and Chemical Corporation (“National Starch”) through a friendly acquisition. National Starch engaged investment banker Morgan Stanley to evaluate its shares, render a fairness opinion, and otherwise generally assist the company. The Supreme Court held that investment banking and other professional fees incurred in the friendly takeover were capital expenditures based on the significant long-term benefits to National Starch. The Court rejected the taxpayer’s argument that since the expense did not create a “separate and distinct asset”, no capitalization was required. The Court clarified *Lincoln* by stating that while creation of a “separate and distinct asset” may be a sufficient condition for classification as a capital expenditure, it is not a necessary condition. Instead, the Court focused on future benefits.

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51 Faber, *supra* note 22, at 610-11 (noting that in *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 782 (2nd Cir. 1973), the court relied on *Lincoln* in holding that expenses incurred in expanding a company’s business were deductible because no separate asset was created; likewise, the court in *NCNB Corp. v. United States*, 684 F.2d 285, 291 (4th Cir. 1982) held that bank expenses to establish a branch banking system were deductible because they, too, did not create a separate asset).


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

54 Id. at 80.

55 Id. at 81.

56 Id. at 88.

57 Id. at 86-87.

58 Id. at 87.

59 Id. at 88. The Court found evidence of three long-term benefits to National Starch. *Id.* First, National Starch’s “Progress Report” remarked favorably on the benefits to National Starch from Unilever’s abundant resources. *Id.* Second, Morgan Stanley’s fairness opinion noted the “synergy” the resulting merger would produce. *Id.* Finally, National Starch benefited by changing from a publicly held corporation to a wholly owned subsidiary.
"mere presence of an incidental future benefit . . . may not warrant capitalization, 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 immediate deduction or capitalization."

III. STATEMENT OF THE CASE

A. Statement of Facts

The primary business of A.E. Staley Manufacturing Co. ("AES") was the production of high fructose corn syrup for the food and beverage industry. Because AES believed this product had a mature market, the company made a long-term strategic decision in 1984 to diversify into the food service business. Consistent with this strategy, AES acquired other companies.

An investment banker threatened to acquire Staley Continental Inc. and Subsidiaries ("SCI") in 1986, and SCI began to fear a hostile takeover. SCI hired two investment bankers, First Boston Corporation ("First Boston") and Merrill Lynch Capital Markets ("Merrill Lynch"), to advise and assist the company in the event of another hostile takeover attempt.

Shortly thereafter, Merrill Lynch recommended various anti-takeover defense strategies to SCI. One of Merrill Lynch’s suggestions was for SCI to identify through reduction of shareholder relations expenses. Id.

A.E. Staley Manufacturing Company and Subsidiaries ("Staley") was an affiliated group of corporations formerly named Staley Continental Inc. and Subsidiaries ("SCI"). A.E. Staley Manufacturing Co. v. Commissioner, 119 F.3d 482, 483 (7th Cir. 1997). AES was the predecessor of both Staley and SCI. Id.

One of the companies AES acquired was CFS Continental ("CFS"), a leading food service supplier. Id. SCI was formed as the parent company to AES and CFS. Id.

SCI also agreed to hire the investment bankers if an offer were made. Id.
friendly white knight investors who could acquire enough SCI stock to block future takeover attempts.

In response to this suggestion, SCI identified Tate & Lyle PLC ("T & L") as a possible white knight. The top executives at both companies discussed the possibility of T & L acquiring up to a 20 percent interest in SCI. In April 1987, T & L began buying SCI stock on the open market; after acquiring 4 percent of SCI's stock, T & L refused to sign a "standstill agreement." Instead, T & L filed a Hart-Scott-Rodino notification to acquire up to 25% of SCI's stock.

On April 8, 1988, T & L made a public tender offer directly to SCI shareholders to purchase their stock for $32 per share. SCI and the investment bankers considered T & L's tender offer to be hostile because it was made without their consent or knowledge. Cognizant of their fiduciary duty to evaluate the merits of the tender offer, SCI's board of directors hired First Boston and Merrill Lynch to advise and assist them in evaluating T & L's offer. SCI agreed to an investment banking fee structure which provided for $1 million in fixed compensation with

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68 See supra note 40 (defining white knight).
69 Staley, 119 F.3d at 484.
70 Id. Tate & Lyle PLC was a publicly held United Kingdom corporation which was the largest sugar refiner and distributor in the world. A.E. Staley Manufacturing Co. v. Commissioner, 105 T.C. 166, 169 (1995), rev'd, 119 F.3d 492 (7th Cir. 1997).
71 Staley, 119 F.3d at 484.
72 Id. The standstill agreement would have limited the amount of stock T & L could purchase. Id.
73 A Hart-Scott-Rodino notification is a premerger notification. The notification is part of the Hart-Scott-Rodino Antitrust Improvement Act, a procedural statute that strengthens the Department of Justice's antitrust enforcement powers. BLACK'S LAW DICTIONARY 718 (6th ed. 1990).
74 Staley, 119 F.3d at 484.
75 Id. On the same day, T & L also sued SCI to enjoin the use of their anti-takeover devices and the application of various states' anti-takeover statutes. Id. These challenges were ultimately unsuccessful. Staley, 105 T.C. at 177. In addition, T & L's Chairman and Chief Executive Officer sent a letter to his SCI counterpart stating that if his bid were successful, he intended to disband SCI's diversification strategy and return the company to its core business of corn syrup. Staley, 119 F.3d at 484.
76 Staley, 119 F.3d at 484. The SCI defense team also concluded that the tender offer was not in SCI's best interests due to T & L's lack of capital, marketing, and research and development. Id.
77 Id.
additional compensation contingent on an acquisition or recapitalization of SCI.\textsuperscript{78}

SCI and the investment bankers began considering various alternatives to the tender offer including recapitalization, a leveraged buy-out,\textsuperscript{79} and a sale to a white knight.\textsuperscript{80} The investment bankers’ evaluation of SCI stock revealed that $32 per share was below the company’s true value.\textsuperscript{81}

On April 20, SCI’s board voted unanimously to reject T & L’s tender offer.\textsuperscript{82} Without any further solicitation from SCI, T & L raised its offering price to $35 per share on April 29, and the board again rejected the tender offer.\textsuperscript{83} On May 13, T & L increased its offering price to $36.50 per share.\textsuperscript{84} The investment bankers advised SCI that the offer was fair and that they had been unsuccessful in finding any other suitable alternatives.\textsuperscript{85} SCI’s board recommended that shareholders accept the offer, and T & L subsequently acquired SCI.\textsuperscript{86} SCI paid $6,238,109 to First Boston and $6,272,593 to Merrill Lynch for services related to SCI’s response to T & L’s tender offers.\textsuperscript{87}

\textbf{B. Procedural History}

SCI deducted the investment banking fees on its federal income tax return as

\textsuperscript{78} \textit{Id.} The investment banking fee arrangements provided the following: (1) $500,000 in cash; (2) an additional fee of 0.40% of the value of the transaction if T & L or another company acquired at least 50 percent of SCI’s stock; (3) an additional fee of 0.40% of the recapitalization if SCI effected a recapitalization; and (4) additional quarterly fees of $500,000 for four quarters if no fees were paid under (2) or (3). \textit{Id.}

\textsuperscript{79} A leveraged buy-out is a method of purchasing the outstanding stock of a publicly held corporation by management or outside investors with financing obtained primarily from borrowed funds from investment banks or brokers; the capital is usually secured by the target company’s assets with repayment generated from the company’s current and future operations. \textit{BLACK’S LAW DICTIONARY} 906 (6th ed. 1990).

\textsuperscript{80} \textit{Staley}, 119 F.3d at 484.

\textsuperscript{81} \textit{Id.} at 485.

\textsuperscript{82} \textit{Id.}


\textsuperscript{84} \textit{Staley}, 119 F.3d at 485.

\textsuperscript{85} \textit{Id.}

\textsuperscript{86} \textit{Id.} After the sale, T & L replaced SCI’s management, terminated 104 executives, fired the clerical staff, moved the executive offices, and sold CFS. \textit{Staley}, 105 T.C. at 179.

\textsuperscript{87} \textit{Staley}, 119 F.3d at 485.
The Commissioner disallowed the claimed deduction and issued a notice of deficiency. SCI challenged the disallowance by filing a petition in the United States Tax Court.

1. United States Tax Court Proceedings

The full Tax Court, with five judges dissenting, held that the investment banking fees were not deductible under Section 162(a) as ordinary business expenses or under Section 165(a) as "abandoned transactions." The court rejected the taxpayer's argument that the hostile nature of the acquisition distinguished Staley from INDOPCO. Instead, the Tax Court began with the proposition that since the purpose of the relevant Tax Code provisions is to match expense with income, the "taxpayer's subjective reasons for making the expenditure are irrelevant." The court relied on INDOPCO and the "origin of the claim" test, finding that the transaction which gave rise to the claim was a change in corporate structure and ownership. The change had long-term consequences to SCI, and therefore, the expenses required capitalization.

The majority rejected deductibility as an "abandoned transaction" because it held that the taxpayer must be able to allocate the abandonment fees to separate and

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88 *Id.* at 483. $165,318 of printing costs were also deducted, $50,000 of which was disallowed. It was not clear from the record why a portion of the fees was allowed. *Id.* at 485.

89 *Id.*

90 *Id.*

91 The Tax Court also disallowed the printing costs of $50,000. *Staley*, 105 T.C. at 200.

92 *Id.* at 201-02.

93 *Id.* at 194.

94 *Staley*, 119 F.3d at 485. The Tax Court rejected the "primary purpose" test. *Staley*, 105 T.C. at 195. For a discussion of the "primary purpose" test, see *supra* note 43.

95 *Staley*, 105 T.C. at 195. The Tax Court interpreted INDOPCO as requiring capitalization whenever there was a change in corporate ownership which had long-term consequences. *Id.* at 200. The INDOPCO Court, however, did not use the "origin of the claim" test in reaching its decision. Ingalls, *supra* note 22, at 1200. For a discussion of the "origin of the claim" test, see *supra* note 43.

96 Like INDOPCO, the Tax Court also found shareholder-related benefits to SCI by changing from a publicly held corporation to a wholly owned subsidiary. *Staley*, 105 T.C. at 197-98.

97 *Id.* Judge Beghe wrote a concurring opinion to advance another theory for fee nondeductibility. *Id.* at 202-03 (Beghe, J., concurring). In his view, the investment bankers' fee provided a benefit to SCI shareholders by helping them obtain a higher price for their shares than T & L's initial offer. *Id.*
distinct proposals. In this case, the bulk of the investment banking fees were contingent on a completed stock sale and not an abandoned transaction.

Trial Judge Cohen dissented and distinguished this case from INDOPOCO. In contrast to INDOPOCO, there was no evidence in Staley that SCI anticipated any benefits from a merger with T & L. Therefore, "the purpose of the expenditures was not to facilitate a change in corporate structure, but to prevent such a change."

In a second dissent joined by two other judges, Judge Laro stressed a long-term benefits inquiry. He, too, found no long-term benefits to SCI. He concluded that the appropriate "legal analysis would address the issue as to whether or not the takeover was hostile or friendly for the purpose of seeing whether there were any long-term benefits in connection with the transaction."

2. United States Court of Appeals, Seventh Circuit Proceedings

The Court of Appeals held that all investment banking fees in Staley were deductible with the exception of fees that facilitated the T & L acquisition. Accordingly, the court reversed the Tax Court decision and remanded the case back to the Tax Court for proper fee allocation.

The court’s discussion began with the “well worn” notion that expenses incurred in defending a business and its policies from attack are “ordinary and necessary”

98 Id. at 200.
99 Id.
100 Id. at 210 (Cohen, J., dissenting). Four other judges joined Judge Cohen’s dissent. Id. at 217.
101 Id. at 215 (“The only benefits to the future operations of petitioner discussed in the majority opinion are those perceived by the offeror, Tate & Lyle, and not by the management that incurred the expenses.”).
102 Staley, 119 F.3d at 486. Judge Cohen read the majority’s rule as a stringent one requiring capitalization of any expenses related to a change in corporate ownership. Staley, 105 T.C. at 217 (Cohen, J., dissenting).
103 Staley, 105 T.C. at 218-20 (Laro, J., dissenting).
104 Id. at 219.
105 Id. Judge Laro also wrote that while the majority considered the purpose of the expenditures irrelevant, INDOPOCO, by contrast, emphasized the purpose. Id. at 220.
106 Staley, 119 F.3d at 492.
107 Id. at 492-93.
business expenses. The Court of Appeals interpreted *INDOPCO* as "merely reaffirming settled law that costs incurred to facilitate a capital transaction are capital costs."

The court determined that the totality of the Tax Court’s factual findings made it clear that SCI incurred the majority of the investment banking fees while defending their business from an unwanted acquisition. Therefore, these expenses were deductible under Section 162(a) as "ordinary and necessary" business expenses.

The court then looked at the nature of the services performed by the investment bankers. The court found that the main efforts of the investment bankers were directed towards defeating a hostile tender offer by exploring alternative capital transactions. None of these efforts facilitated the T & L acquisition. Because the efforts failed, SCI did not obtain long-term benefits like the *INDOPCO* taxpayer. The court held, therefore, that the costs properly allocable to the unsuccessful efforts of the investment bankers to engage in alternate transactions were also deductible under Section 165(a) as "abandoned transactions."

The court concluded its analysis by determining that a few facilitative tasks performed by the investment bankers required capitalization. In particular, the court found that the fees attributable to the evaluation of SCI stock required capitalization, because the evaluation was eventually used to determine that T & L’s

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108 *Id.* at 487. The court noted that the *INDOPCO* decision did not abrogate, or even address, this longstanding rule. *Id.* at 488.
109 *Id.*. The court then framed the *Staley* issue in the following terms: Are the investment banking costs more properly viewed as costs associated with defending a business or as costs associated with facilitating a capital transaction? *Id.* at 489.
110 *Id.* at 490. The factual findings included SCI’s consideration of the offer as hostile because it was made without their consent or knowledge, the board’s initial reaction that the T & L offer was inadequate and T & L lacked marketing, capital, and research and development, T & L’s attack on SCI’s diversification policy, and T & L’s post merger actions of selling CFS, replacing management, firing executives and clerical staff, and closing the company’s headquarters. *Id.* at 489-90.
111 *Id.* at 491.
112 *Id.* at 490.
113 *Id.*
114 *Id.*
115 *Id.* at 492.
116 *Id.* at 491.
117 *Id.* at 490.
final offer was fair.\textsuperscript{118}

In making its fee allocation, the investment banking fee arrangement was viewed as one relevant consideration.\textsuperscript{119} In the court's view, however, the primary purpose of the fee arrangement was for the investment bankers to get paid regardless of the outcome.\textsuperscript{120} In that event, "the substance of the transaction, not its form, is controlling."\textsuperscript{121}

IV. ANALYSIS

A. The Staley Two-Test Approach

The court's approach to the issues presented in Staley was primarily a detailed, mechanical approach. This approach was dictated, in part, by the court's use of two different tests for tax deductibility. On one hand, the court used the business attack defense.\textsuperscript{122} At the same time, the court also purported to use INDOPCO's long-term benefits test which effectively analyzes an expense to determine if it facilitated a capital transaction "for the benefit of future operations."\textsuperscript{123} The court then analyzed the specific functions performed by the investment bankers and classified each task as either a business defense expense, a "capital facilitative" expense, or alternatively, as part of an "abandoned transaction."\textsuperscript{124}

1. Business Attack Defense

The court's application of the business attack defense on the facts of Staley was straightforward. The Staley court determined that most of the investment banking fees incurred by SCI were related to the defense of its business and corporate policy;\textsuperscript{125} therefore, those fees were deductible as "ordinary and necessary" business expenses.\textsuperscript{126}

\textsuperscript{118} Id. The court also identified a few hours of facilitative work performed by the investment bankers at the time of the merger. Id. at 492.

\textsuperscript{119} Id. at 491. The investment banking fee arrangement provided for $1 million fixed fee with the remainder of the compensation contingent on an acquisition or recapitalization of SCI. See supra note 78.

\textsuperscript{120} Staley, 119 F.3d at 491.

\textsuperscript{121} Id.

\textsuperscript{122} Id. at 487.

\textsuperscript{123} Id. at 488-89.

\textsuperscript{124} Id. at 489.

\textsuperscript{125} See supra note 110 and accompanying text.

\textsuperscript{126} Staley, 119 F.3d at 491.
2. Long-term Benefits

While the INDOPCO Court required fee capitalization because of evidence of future benefits, the Staley court required fee capitalization because the fees facilitated a completed capital transaction - in this case, T & L's acquisition of Staley. The Staley court did not specifically discuss any future benefits the taxpayer might have anticipated in requiring the capitalization of these fees.

Interestingly enough, the Staley court did find long-term benefits analysis relevant when analyzing costs properly deductible as "abandoned transactions." After reviewing the various alternative transactions contemplated by SCI and the investment bankers, the court concluded, "These efforts failed; the investment bankers' services in this regard bore no fruit. As a result, unlike the taxpayer in INDOPCO, SCI did not obtain a long-term benefit as a result of making these expenditures."

B. Critical Analysis

1. Overall Approach

The result in Staley is largely a satisfactory one, but the court's approach evidenced a hesitation to "go all the way." Perhaps that is why the court chose to employ two tests. The court could have found that all the fees were deductible by applying either a pure business attack defense test or a pure long-term benefits test. Even when the court purported to apply INDOPCO, it applied the long-term benefits test inconsistently. On one hand, the court ignored future benefits when it determined that "capital facilitative" expenses required capitalization; yet, the

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128 Staley, 119 F.3d at 491 (finding that the investment bankers' evaluation of SCI stock facilitated the merger because it was used to determine that T & L's final offer was fair).
129 The Tax Court found benefits to SCI from changing from a publicly held corporation to a wholly owned subsidiary in the form of relief from shareholder-related expenses, but the Court of Appeals did not discuss any benefits. A.E. Staley Manufacturing Co., v. Commissioner, 105 T.C. 166, 197 (1995), rev'd, 119 F.3d 492 (7th Cir. 1997).
130 Staley, 119 F.3d at 491-92.
131 Id. at 492 (finding that the costs which could be allocated to efforts to engage in alternate transactions were deductible as "abandoned transactions").
132 See Staley, 105 T.C. at 218-19 (Laro, J., dissenting). Judge Laro writes: "Having found facts to conclude that the takeover is hostile, one should strongly suspect that there are no long-term benefits anticipated by the target in connection with the transaction." Id at 219.
court then stressed a lack of future benefits as its rationale for allowing deductibility as an “abandoned transaction.”

2. “Capital Facilitative” Expenses

The Staley court’s reasoning that the investment bankers’ evaluation of SCI’s stock facilitated the completed acquisition and therefore required capitalization because it validated the fairness of T & L’s offer is unconvincing. Investment bankers routinely perform stock evaluations when they begin an engagement. Arguably, the major reason SCI’s investment bankers performed a stock evaluation was to consider alternatives to T & L’s hostile takeover attempt. Even when T & L raised its tender offer price, it was without solicitation from SCI. If there were any connection between the evaluation of SCI’s stock and the “fairness” of the ultimate hostile acquisition by T & L, the relationship is too tenuous to require capitalization.

Had the Staley court focused more on the presence of long-term benefits like the INDOPCO court, this task most likely would have been an “incidental future benefit” not requiring capitalization. Alternatively, the stock evaluation fee was just another cost of defending SCI’s business or part of the cost of an “abandoned transaction.” In any case, it should have been deductible.

133 Staley, 119 F.3d at 490-92.
134 Id. at 491.
135 Persellin, supra note 2, at 2 (“For instance, an investment banker often is retained to value the corporation’s stock and issue a ‘fairness’ opinion.”).
136 Staley, 119 F.3d at 485. Presumably, evaluation of SCI’s stock was contained in the “selling book for prospective buyers that contained information about SCI.” Id. In addition, T & L most likely had its own investment bankers to advise it on tender offer strategy. Staley, 105 T.C. at 217 (Cohen, J., dissenting) (“Tate & Lyle certainly had its own reasons for desiring the purchase and was independently evaluating the acquisition in relying on its own advisers.”).
137 Staley, 105 T.C. at 176.
138 Id. at 217 (Cohen, J., dissenting). Judge Cohen makes a similar argument when she disagrees with the assertion that investment banking fees paid by SCI increased the price of SCI’s stock. Id. She says, “This analysis confuses the simple sequence of events with the purpose for which the expenditure was incurred, or the cause and effect relationship between an expenditure and a change in the price of the stock.” Id.
139 INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 87 (1992) (stating that “[a]lthough the mere presence of an incidental future benefit--‘some future aspect’--may not warrant capitalization, 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 immediate deduction or capitalization”).
3. The Investment Banking Fee Arrangement

When the Staley court analyzed the investment banking fee arrangement, it abandoned its systematic, technical approach and virtually ignored the specifics of the fee arrangement.\(^{140}\) The court considered the fee arrangement just one relevant consideration,\(^{141}\) but it never addressed the fact that the majority of the fee was pegged to a completed transaction.\(^{142}\) In light of the court’s emphasis on capitalization of “capital facilitative” expenses, the court’s treatment of the fee arrangement is surprising; the court might have found that the majority of the fee arrangement actually facilitated a completed capital transaction.\(^{143}\)

C. Practical Considerations

The Staley court’s use of two different tests to determine tax deductibility of a target corporation’s hostile defense fees is likely to add a new layer of confusion in the courts.\(^{144}\) While the tests themselves are not new, this may be the first time a court has used two tests simultaneously. In addition, the court’s inconsistent application of the INDOPCO test makes it uncertain whether the emphasis should be on “capital facilitative,” long-term benefits, or both.\(^{145}\)

Although the Staley court largely ignored the particulars of the investment banking fee arrangement, the opinion suggested that “[b]usinesses in the future

\(^{140}\) Staley, 119 F.3d at 491 (recognizing that the fee arrangement was simply a way to be paid regardless of whether or not the investment bankers were successful in their efforts to defeat T & L’s hostile tender offer).

\(^{141}\) Id.

\(^{142}\) Staley, 105 T.C. at 200 (“Of the approximately $12.5 million in fees paid, [only] $1 million was fixed compensation, payable in any event.”).

\(^{143}\) See Lipton, supra note 9, at 26 (stating that “the fundamental flaw in the taxpayer’s position in Staley is that SCI agreed to pay the investment bankers’ fee primarily as a result of the completion of an acquisition”). For an example of a court that based its decision on the specifics of a fee arrangement, see Honodel v. Commissioner, 76 T.C. 351, 366-67 (1981) (holding that with a two-tier fee schedule consisting of a monthly retainer fee and an investment fee, the monthly retainer fee was deductible but the investment fees were not since they were a cost of acquiring an interest in a limited partnership project).

\(^{144}\) Confusion for taxpayers is nothing new. See LeBlanc, supra note 8, at 465 (“INDOPCO has certainly created confusion for taxpayers, because now they are unsure as to the appropriate test to apply in determining the deductibility of expenditures . . . “).

\(^{145}\) The uncertainty already existed prior to Staley. See Faber, supra note 22, at 622 (noting that the significance of future benefits after INDOPCO is unclear; the Court did not attempt to define “future” benefits, nor did it say what other factors could outweigh the presence of a future benefit).
would do well to structure their agreements in a fashion more amenable to the requirements of the Tax Code as we have delineated today." At a minimum, some careful attention to tax considerations when drafting investment banking fee arrangements may help a target corporation defend its tax position.

Target corporations should also maintain a detailed analysis of takeover-related expenditures. If the costs and their purposes are clearly identified, it may help a target corporation meet its burden of proof at trial.

D. A Simpler Approach

A simpler approach to the problem of determining tax deductibility for takeover-related expenses is to use just one test - the long-term benefits test. This test has

146 Staley, 119 F.3d at 493.
147 Lipton, supra note 9, at 26 (suggesting that with a fixed fee arrangement, SCI would have had a stronger argument that the fees were incurred purely for defensive purposes). The author suggests a fixed investment bankers' fee in advance, regardless of the outcome of the takeover. Id. If the investment bankers insist on a contingent fee, then a "failure fee" could be payable if the hostile takeover succeeds, while a larger "success fee" might be pegged to a friendly acquisition. Id.
148 Coenen, supra note 4, at 614.
149 Id.; see also James David Ruffner, II, Comment, Corporate Reorganization Expenses: An Overview of the Denial of Current Federal Tax Deductibility and Resulting Capitalization, 19 U. DAYTON L. REV. 197, 225 (1993) (stressing proper tax planning by documenting the nature of expenditures and requesting itemized bills for professional services). Proper tax planning is particularly important when there are multiple overtures from potential suitors; proper delineation of expenditures "may present opportunities for maximizing deductions to the extent that nonrepetitive expenditures, such as those for the initial valuation of stock, relate to abandoned overtures." Id.
150 But see Lyke, supra note 8, at 1257-58 (stating that a pure long-term benefits test should not apply to hostile takeover costs because the board's fiduciary duty to incur only those expenditures which are in the best interests of the corporation would preclude deductibility). However, Lyke writes that hostile defense costs should be currently deductible as either business attack defense costs or "abandoned transactions." Id. at 1258; see also Brett M. Alexander, Comment, An Analysis of INDOPCO, Inc. v. Commissioner, 54 OHIO ST. L.J. 1505, 1516 (1993) (proposing a distortion of income test instead of a long-term benefits test as the critical factor in determining tax deductibility). Based upon administrative and practical considerations, this test would permit current deductibility for some expenditures that provide benefits beyond the tax year. Id. at 1519; cf. Faber, supra note 22, at 634 ("The issue should be viewed as one of accounting. If a taxpayer's treatment of an item clearly reflects income, that treatment should be respected without regard to whether it creates a separate asset or produces a future benefit."); Friedman, supra note 52, at 1257 (suggesting that Congress should establish a pre-determined amortization period for
many advantages.

1. Consistency With Section 263(a)(1)

The current confusion over multiple tests and friendly vs. hostile takeover-related expenses overshadows the underlying purposes of the Tax Code. A return to basics reveals that the ultimate goal of capitalizing expenditures is to match expenses with the revenues in the taxable periods in which they belong.\(^\text{151}\) Indeed, the language of Section 263(a)(1) itself focuses the taxpayer's attention on "permanent improvement or betterment made to increase the value of any property."\(^\text{152}\) Therefore, an inquiry into the long-term benefits of an expense is consistent both with the principle of matching expenses and revenues as well as the language of the Code itself.\(^\text{153}\)

2. One Test

In many cases, the long-term benefits test will reach the same result as the application of other tests.\(^\text{154}\) The distinctions between hostile and friendly takeover-related expenses will be relevant only in the context of determining the presence of takeover-related expenses). "The courts would be freed from having to determine, on an individual basis, whether an acquisition is friendly or hostile and whether a long-term benefit exists."\(^\text{Id.}\)

\(^\text{151}\) INDOPOCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992). Proper matching results in a more accurate calculation of net income for tax purposes.\(^\text{Id.}\)

\(^\text{152}\) Patrick Crawford, Note, INDOPOCO v. Commissioner: Form Over Substance in the Judicial Regulation of the Market for Corporate Control, 12 VA. TAX REV. 121, 129 (1992) ("Finally, the Code's language itself focuses the inquiry upon the duration of the benefit."). The author suggests that the "future benefits" language used by the INDOPOCO Court is broader than the Code's language.\(^\text{Id.}\) at 133. He states that a narrow interpretation should be given to the Court's language because "[p]reventing harm and maintaining the status quo are, in one sense, continuing benefits, but they are not necessarily an improvement or betterment."\(^\text{Id.}\) at 133-34. Thus, a narrow interpretation would allow deductibility of a target corporation's hostile defense fees.\(^\text{Id.}\) at 134.

\(^\text{153}\) Ruffner, II, supra note 149, at 201 (concluding that INDOPOCO's long-term benefits test successfully matches income with expenses but also makes merger and acquisition tax planning more difficult).

\(^\text{154}\) For example, hostile takeover-related expenses incurred by a taxpayer in defending his business and its corporate policies are deductible under the business attack defense as "ordinary and necessary" expenses. A.E. Staley Manufacturing Co. v. Commissioner, 119 F.3d 482, 487 (7th Cir. 1997). The expenses would also be deductible under a long-term benefits analysis. See supra note 132 and accompanying text.
long-term benefits. 155

3. Caveats

The biggest challenge for users of the long-term benefits test will be appropriate determination of long-term benefits. 156 Because every expense arguably has some "long-term benefits," 157 courts will have to adopt a practical approach consistent with the Tax Code and common sense. 158 The purpose of expenditures will undoubtedly continue to play an important role in tax deductibility, particularly in the assessment of "incidental future benefits" which may not require capitalization. 159

V. CONCLUSION

While the Staley decision produced a largely satisfactory result, the court’s two-test approach for determining the tax deductibility of unsuccessful hostile defense fees is likely to add even more confusion to an already confused area. A simpler approach would be to determine tax deductibility of takeover-related expenses based on a long-term benefits analysis. This test is consistent with the goals of the applicable Tax Code provisions and entails only a single inquiry. However, until the courts develop a uniform approach for determining "long-term benefits," tax deductibility of a target corporation’s takeover-related fees will continue to be decided on a case by case basis, and any "attempt to harmonize them [will] be a futile task." 160

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155 A.E. Staley Manufacturing Co. v. Commissioner, 105 T.C.166, 219 (1995) (Laro, J., dissenting), rev’d, 119 F.3d 492 (7th Cir. 1997). This Note essentially adopts the position of Judge Laro by suggesting that the distinction between a hostile or friendly takeover is only relevant in determining whether there are any long-term benefits. Id. While hindsight provides an advantage in determining whether an expenditure provided future benefits, the focus of the inquiry should be on the taxpayer’s expectations at the time the expense was incurred.

156 For some of the difficulties in applying the long-term benefits test (future benefits), see supra note 60 and accompanying text.


158 Staley, 119 F.3d at 487 (commenting on the difficulty of determining tax deductibility that “[b]ecause of this difficulty, distinguishing between ordinary and capital costs often requires a rather pragmatic approach”).
