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Wells Fargo & Co. And Subsidiaries v. Commissioner: Rethinking the Deductibility of Certain Pre-Merger Expenditures

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Wells Fargo & Co. and Subsidiaries v. Commissioner: Rethinking the Deductibility of Certain Pre-Merger Expenditures*

I. INTRODUCTION

According to the *Mergers and Acquisitions Journal*, mergers and acquisitions activity has been smashing records over the past few years.[1] In fact, in 1998, for the first time in American history, over 10,000 transactions were completed.[2] A record breaking $1.394 trillion in transactions was completed in 1999.[3] This trend has continued. In the first two quarters of 2000 alone there were nearly $1 trillion in deals.[4] Mega-mergers such as Chevron/Texaco, Time Warner/AOL, and J.P. Morgan/Chase Manhattan are announced on what seems to be a regular basis. Indeed, there has been continual growth in the mergers and acquisitions arena.

In each transaction, significant pre-merger costs are incurred.[5] Such costs may include due diligence costs, legal fees, accounting fees, and investment banking fees. These expenditures account for millions, if not billions, of dollars in expenses on an annual basis. As such, the tax characterization of these expenditures, i.e., whether they are capital expenses or ordinary business expenses, has significant ramifications on the tax liability of the taxpayer and, consequently, on the revenue collected by Internal Revenue Service ("IRS").

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1. *See* Martin Sikora, *M&A Almanac—1999 M&A Profile*, MERGERS & ACQUISITIONS J., Feb. 1, 2000.

2. *See id.* The statistics were supplied by the Mergers & Corporate Transactions Database of Thomson Financial Securities Data Co.

> The . . . information [was] based on all completed mergers, acquisitions, and divestitures priced at $5 million and over, as well as purchases of partial interest that involved at least a 40% stake in the target company or an investment of at least $100 million. Except where noted, the data only cover transactions in which American companies were on both sides of the deal or were on at least one side as buyer or seller.

Id.

3. *See id.*

4. *See M&A Scoreboard 2nd Q 2000*, MERGERS & ACQUISITIONS J., Sept 1, 2000.

5. Although different in nature and form, for purposes of this Note, the terms "merger" and "acquisition" are used interchangeably. Additionally, the Note uses terms such as "deal" and "transaction" to signify the event that has occurred or will occur to which the expenditures at issue are related.

The question of what expenditures may be deducted and what must be capitalized has long been controversial.[6] This basic tax question has been around since the enactment of the income tax. More recently, it was the question at issue in *Wells Fargo & Co. and Subsidiaries v. Commissioner* (“*Wells Fargo*”).[7]

In *Wells Fargo*, the Eighth Circuit Court of Appeals reversed in part the Tax Court’s holding that pre-closing investigatory/legal fees and officers’ salaries attributable to the merger must be capitalized. In doing so, the court explained that the Tax Court had misinterpreted the Supreme Court’s opinion in *INDOPCO Inc. v. Commissioner*.[8]

This Note seeks to explain the basic law with respect to the tax consequences of the pre-merger expenditures at issue. In particular, the Note seeks to explain why the Eighth Circuit was correct in its interpretation and application of *INDOPCO* as it relates to the specific expenditures at issue in *Wells Fargo*—namely, investigatory/legal fees and officers’ salaries attributable to the merger. Part II outlines the relevant sections of the Internal Revenue Code and briefly summarizes the historical case law. Part III explains the history of the *Wells Fargo* case, including the facts, the Tax Court’s opinion, and the Eighth Circuit’s opinion. Part IV analyzes the deductibility of the legal fees and officers’ salaries at issue in the case. Part V summarizes the Note and concludes that the Eighth Circuit properly allowed the expenses to be currently deductible.

II. RELEVANT CODE SECTIONS AND CASE LAW

A. *Applicable Code Sections*

Section 162(a) of the Internal Revenue Code (I.R.C.) allows for a deduction for all “ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .”[9] This includes “salaries or other compensation for personal services actually rendered.”[10]

Section 263 prohibits deductions for amounts “paid out for new buildings or for permanent improvements or betterments made to in-

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6. *See* Ellen Macneil, et. al., *Tax Accounting Issues in Mergers and Acquisitions*, *in* 2 TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCING, REORGANIZATIONS & RESTRUCTURINGS 923, 954 (PLI Tax Law & Estate Planning Course Handbook Series No. J-404, 1997) [hereinafter Macneil].

7. 224 F.3d 874 (8th Cir. 2000).

8. *See generally* INDOPCO Inc. v. Comm’r, 503 U.S. 79 (1992).

9. I.R.C. § 162(a) (1994). All Code sections refer to the Internal Revenue Code of 1986, as amended, and the regulations thereunder, unless otherwise noted.

10. I.R.C. § 162(a)(1) (1994).

crease the value of any property or estate."[11] These items must be capitalized.[12] Treasury Regulation 1.263(a)–2(a) provides that capital expenditures include "[t]he cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year."[13]

B. Historical Case Law

Prior to *INDOPCO*, the case law concerning outlays in relation to the expansion of a business was somewhat in disarray.[14] Nonetheless, the courts generally had ruled that costs incurred in expanding an existing business were deductible.[15] In determining what constituted the expansion of an existing trade or business, the courts generally focused on whether the taxpayer obtained a "separate and distinct additional asset."[16] Many courts concluded that if a business expenditure could not be reasonably allocated to a specific asset, then it should not be capitalized but immediately deducted as an expense.[17]

Briarcliff Candy Corp. v. Commissioner[18] was the principal case permitting businesses to deduct expansion costs. In *Briarcliff Candy*, a candy manufacturer that had historically sold its products to stores downtown sought to expand by selling to suburban retailers. Consequently, Briarcliff Candy incurred significant promotional costs and costs in negotiating franchise contracts with the suburban retailers. The Second Circuit Court of Appeals found that these expenditures did not create any separate and distinct asset and thus were currently deductible.[19] The court

11. I.R.C. § 263 (1994).

12. Treas. Regs. § 1.263(a)-2 (1994). This regulation lists examples of capital expenditures and explains that section 263 disallows deductions for the cost of acquiring property "having a useful life substantially beyond the taxable year." *Id.* at §1.263(a)-2(a) (1994). Thus, any item falling within the interpretation of section 263 is characterized as a capital expenditure and must be capitalized rather than deducted as a current expense. This does not mean that the expenditure will never be recovered. Expenditures for most assets are amortized over the useful life of the asset. Nonetheless, some assets, like merger-related costs, start-up costs and land are assumed to have a perpetual or indefinite useful life, thus the expenditure is not recovered until the property is sold or the business is terminated.

13. Treas. Regs. § 1.263(a)-2(a) (1994).

14. *See* NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982) (finding that expenses incurred by expanding bank were deductible because no new asset was created); Briarcliff Candy Corp. v. Comm'r, 475 F.2d 775 (2d Cir. 1973) (finding that expenses were currently deductible because there was no separate and distinct asset); *but see* Central Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181 (5th Cir. 1984); Bilar Tool & Dye v. Comm'r, 530 F.2d 708 (6th Cir. 1976).

15. *See* Javaras & Maynes, 534 T.M. Start-up Expenditures (BNA Tax Mgmt. Portfolios 1997) [hereinafter Javaras & Maynes].

16. *Id.* § IV at A–19.

17. *See supra* note 14.

18. 475 F.2d 775 (2d Cir. 1973).

19. *See Briarcliff Candy*, 475 F.2d at 782.

derived the "separate and distinct additional asset" test from the Supreme Court's decision in *Commissioner v. Lincoln Savings & Loan Ass'n.*[20]

In *INDOPCO*, the Supreme Court held that expenditures incurred in evaluating a friendly takeover had to be capitalized.[21] In so doing, it seemed to reject key precedents like *Briarcliff Candy*. The Supreme Court found the expenditures had to be capitalized because of the factual finding that the acquisition produced a long-term benefit. The Court did not rely on the "separate and distinct asset" test.[22]

III. THE HISTORY OF *WELLS FARGO*

A. *General Facts of* Wells Fargo

Norwest,[23] Bettendorf Bank,[24] and Davenport[25] were the parties to the original transaction. In short, the transaction consisted of the consolidation of Davenport and Bettendorf to form New Davenport with New Davenport being a subsidiary of Norwest.

In 1989, due to new interstate banking legislation adopted in Iowa, Davenport's management believed that larger outside banks would enter the Quad Cities area,[26] and Davenport would be unable to compete.[27] Shortly thereafter, Norwest discussed with Davenport the possibility of joining the businesses. These merger discussions intensified in early 1991, at which time Davenport retained the law firm of Lane & Waterman ("L & W") to represent and assist them. L & W researched whether Davenport would strategically fit with Norwest and whether the reorganization would benefit the community.[28]

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20. 403 U.S. 345 (1971).

21. *See INDOPCO*, 503 U.S. at 79.

22. *Id.*

23. Norwest, incorporated in 1929, is a bank holding company that is the parent corporation of an affiliated group of corporations including 79 commercial banks in 12 states and other financial services corporations. *See Wells Fargo*, 224 F.3d at 876. The facts outlined in this section are those facts adopted in *Wells Fargo*.

24. Bettendorf Bank, National Association ("Bettendorf"), is a member of the Norwest consolidated group. *See id.* at 876.

25. Davenport, incorporated in 1932, is an Iowa State Bank with a main office in Davenport and four branches, three in Davenport, and one in Donahue, Iowa. Davenport originally provided banking services in the four-city area that consists of Davenport, Bettendorf, Rock Island, IL, and Moline, IL ("Quad Cities Area"). *See id.* at 876-77.

26. *See id.*

27. *See id.* at 877. Davenport's management was particularly concerned with its size. Davenport was larger than the small community banks but smaller than the large regional banks. *Id.*

28. *See id.*

On June 10, 1991, Davenport's board met to consider the merger of Davenport into Norwest.[29] The board authorized executive officers to negotiate with Norwest and appointed a special committee to perform an independent due diligence review, obtain professional advice, and report as to the fairness of the proposed transaction.[30]

On July 22, 1991, Davenport's board met to discuss the transaction consisting of the consolidation of Davenport and Bettendorf to form New Davenport, which would be a wholly owned subsidiary of Norwest.[31] After the special committee recommended that the transaction be approved and J.P. Morgan opined that it was fair, Davenport's board approved the transaction. Similarly, Bettendorf's board approved the transaction.

On the same day, the parties agreed to the transaction subject to certain approvals.[32] Immediately after the agreement, Norwest, with the assistance of Davenport employees and L & W, began performing a due diligence review on Davenport. L & W acted as the primary contact between Norwest and Davenport.[33]

At a special shareholder's meeting, on November 26, 1991, Davenport's shareholders approved the transaction.[34] A few weeks later, Bettendorf's shareholders approved the transaction.[35] The consolidation of Davenport and Bettendorf became effective on January 19, 1992, and at 12:01 a.m. the transaction became effective.[36] The board and management of Davenport believed that the transaction would provide significant long-term benefits for Davenport and its shareholders.[37]

For 1991, Davenport alleged that $111,270 of the legal expenses should be deductible. Of the $111,270, $83,450 was paid for services rendered in investigating the products, services, and reputation of Norwest and determining whether the Norwest and Bettendorf consolidation would fit well into the business community.[38] The $83,450 was for services rendered prior to July 21, 1991, and none of it was for services relating to negotiating price, working on the fairness opinion, advising

29. *See id.*

30. *See id.*

31. New Davenport would be a national bank that would be wholly owned by Norwest. *See id.*

32. *See id.* In particular, the parties agreed to the transaction subject to regulatory approvals, approval of Davenport's and Bettendorf's shareholders, and a positive tax opinion.

33. *See id.*

34. *See id.* at 878.

35. *See id.*

36. *See id.* at 878-79.

37. *See id.* at 878. The merger would enable the bank to offer a wider array of products and services. *See id.*

38. *See id.*

Davenport's board with respect to its fiduciary duties, or satisfying securities law requirements.[39]

Additionally, Davenport deducted $150,000 on its federal income tax return for 1999 for the officers' salaries attributable to the services performed in the transaction.[40] None of the officers were specifically hired to facilitate the merger. The officers carried on the normal day-to-day activities of Davenport, and the merger did not affect the officers' salaries.[41]

B. The Tax Court's Decision in Norwest

Wells Fargo began in the Tax Court as *Norwest Corp. and Subsidiaries v. Commissioner.*[42] In *Norwest*, the Tax Court followed its previous position and held that Davenport, the target company, was not entitled to deduct pre-transaction investigatory and due diligence costs incurred by the target company.[43] In addition, the Tax Court held that the salaries of Davenport's officers were not deductible to the extent that the salaries were attributable to the officers' work on the transaction.[44]

In rejecting Norwest's arguments that the fees and costs should be immediately deducted because they were ordinary and necessary expenses and that *INDOPCO* was not controlling because it did not overrule the line of cases allowing such costs to be deducted,[45] the Tax Court explained that it interpreted *INDOPCO* to have displaced the body of law in *Briarcliff Candy* and its progeny. The court opined that, although a separate and distinct asset may not have been created, an expense is still not "ordinary" if it "generates a significant long-term benefit that extends beyond the end of the taxable year."[46]

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39. *See id.*

40. *See id.* at 880.

41. *See id.*

42. 112 T.C. 89 (1999). This was the Tax Court case for the *Wells Fargo* case discussed in this Note. Norwest was litigating as a successor in interest to Davenport Bank. By the time of the appeal, Wells Fargo had merged with Norwest, thus accounting for the various changes in the party names.

43. *See id.* at 90; *see also* Mark J. Silverman & Andrew J. Weinstein, *Tax Treatment of Reorganization Costs*, *in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCING, REORGANIZATIONS & RESTRUCTURINGS, 1131, 1147 (PLI Tax Law and Estate Planning Course Handbook Series No. J0-002R, 2000) [hereinafter Silverman & Weinstein"]; Gary L. Maydew, *To Deduct or Capitalize: Courts and IRS Interpret INDOPCO*, 63 PRAC. TAX STRATEGIES 145, 147 (Sept. 1999) [hereinafter Maydew].

44. *See Norwest*, 112 T.C. at 90.

45. *See Briarcliff Candy*, 475 F.2d at 775; *NCNB*, 684 F.2d at 285. These cases allowed for the deduction of investigatory and due diligence costs incurred incident to the business expansion.

46. *Norwest*, 112 T.C. at 97 (citing *INDOPCO*, 503 U.S. at 79).

The Tax Court went on to explain that in two prior cases it had required the capitalization of acquisition-related expenditures.[47] The court held that in both cases, as in *INDOPCO*, the expenses (investigatory costs, due diligence costs, and professional services fees) had to be capitalized because the expenditures were incurred incident to a friendly takeover from which significant long-term benefits would be derived.[48] Norwest argued that its case was distinguishable from those cases because its costs were not a direct cost of the corporate acquisition but were incurred before and incidental to the acquisition. The Tax Court was unpersuaded by Norwest's argument and responded that they were "preparatory expenses" and that, according to *INDOPCO*, "the costs must be capitalized because they are connected to an event (namely, the merger) that produced a significant long-term benefit."[49]

The Tax Court did not explain why the officers' salaries were to be capitalized. It merely stated in its general findings that "all costs were sufficiently related to an event that produced a significant long-term benefit."[50] The court disallowed the deductions for these salaries.

C. Wells Fargo & Company and Subsidiaries v. Commissioner

1. General background of Wells Fargo

After the transaction at issue, Norwest was acquired by Wells Fargo. The case went directly to the Court of Appeals for the Eighth Circuit[51] from the Tax Court.[52] The Court of Appeals, reversing in part the Tax Court, concluded that the Tax Court had misread *INDOPCO* and that the $150,000 of officers' salaries in dispute and $83,450 of legal fees, which were incurred prior to Davenport's final decision, were fully deductible.[53]

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47. *See Norwest*, 112 T.C. at 99-100 (discussing Victory Mkts., Inc. & Subs. v. Commiss'r, 99 T.C. 648 (1992) and A.E. Staley Mtg. Co. & Subs. v. Comm'r, 105 T.C. 166 (1995), *rev'd and remanded*, 119 F.3d 482 (7th Cir. 1997)).

48. *See id.* There has been some distinction between friendly takeovers and hostile takeovers. Although it is not the topic of this Note, it is important to understand the current distinctions. Many have argued and some courts have agreed that in a hostile takeover, it is "necessary" and "ordinary" to defend in order to maintain the ongoing company, so expenses related to successfully defeating a hostile takeover should be immediately deducted. Nonetheless, it is clear that fees incurred in an unsuccessful merger, even if friendly, are currently deductible. *See* Silverman & Weinstein, *supra* note 43, at 1131.

49. *Norwest*, 112. T.C. at 100.

50. *Id.* at 102.

51. The Eighth Circuit Court of Appeals is referred to in the Note as the "Eighth Circuit" or the "Court of Appeals."

52. *See Wells Fargo*, 224 F.3d at 876.

53. *See id.* at 889.

2. The Eighth Circuit's analysis of the case

The Court of Appeals began its analysis by explaining the basic foundation and distinction between capitalization and deductibility of expenses.[54] It then outlined the Supreme Court's precedent and explained how and why the Tax Court had erred.

a. The Supreme Court's precedent. The Court of Appeals explained how and why the Tax Court erred in its interpretation and application of *INDOPCO* by likening the alleged error in logical reasoning made by the Tax Court to similar logical fallacies among the circuit courts of appeal in interpreting *Lincoln Savings*,[55] and the Supreme Court's attempt to clarify *Lincoln Savings* in its holding in *INDOPCO*.

The issue in *Lincoln Savings* was whether the Savings and Loan association could deduct an "additional premium."[56] In finding that the additional premium must be capitalized, the Supreme Court stated that the presence of a "future benefit" is not controlling and that it was important and controlling that "a separate and distinct asset" had been created.[57] The Eighth Circuit explained that at least five circuit courts of appeal erroneously interpreted this language to mean that the Supreme Court had adopted a new "separate and distinct additional asset" test that allowed necessary business expenditures to be fully deductible unless the expenditure "created or enhanced a separate and distinct additional asset."[58]

The Eighth Circuit illustrated the fallacy through the use of basic logical symbols, equations, and diagrams in relation to *Lincoln Savings*.[59]

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54. It began by explaining that under the I.R.C., section 162 allows deductions for "all the ordinary and necessary expenses." However, section 263 does not allow deductions for capital expenditures—"an amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." The Court then explained that the dispute is centered around "whether the expenses in this case can properly be characterized as 'ordinary.'" *See id.* If the expense is "ordinary," then it may be fully deducted. On the other hand, if it is not ordinary, it is a capital expense and must be depreciated over the life of the underlying asset, or where no specific asset or useful life exists, the expense is deducted upon dissolution of the enterprise. *See id.* (citing *INDOPCO*, 503 U.S. at 83-84).

55. *See id.*

56. *See id.* at 881; *see also* Commissioner v. Lincoln Sav. & Loan Ass'n., 403 U.S. 345, 345 (1971). In *Lincoln Savings*, the Savings and Loan companies were initially required to pay only one premium to the Federal Savings and Loan Insurance Corporation, but beginning 1962, the companies were required to pay an "additional premium" that funded the Secondary Reserve. Lincoln Savings had a property interest in the Secondary Reserve. *Id.* at 354.

57. *Lincoln Savings*, 403 U.S. at 354.

58. *Wells Fargo*, 224 F.3d at 881. *See, e.g.*, *Briarcliff Candy*, 475 F.2d at 775; *NCNB*, 684 F.2d at 285; *Central Tex. Sav. & Loan*, 731 F.2d at 1181; Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185 (10th Cir. 1974); First Sec. Bank of Idaho v. Comm'r, 592 F.2d 1050 (9th Cir. 1979).

59. *Wells Fargo*, 224 F.3d at 881. The court used the following symbols for its equations:

A = physical capital ASSET created or enhanced;

NOT A = NO physical capital ASSET created or enhanced;

In *Lincoln Savings*, the Supreme Court held that if an expenditure creates or enhances a separate and distinct asset, then it must be capitalized.[60] In terms of the logical equation, this holding would read as "if A then C."[61] The Eighth Circuit explained that the logical error occurred when the circuit courts read "if A then C" as if it read "only if A then C."[62] In addition, *Lincoln Savings* held that "the presence of an ensuing benefit that may have some future aspect is not controlling; many expenses concededly deductible have prospective effect beyond the taxable year."[63] The Eighth Circuit explained that this was misinterpreted to mean that the future benefit was irrelevant when determining if an expenditure must be capitalized—a holding in error with what *Lincoln Savings* actually held.[64]

b. The court's analysis of INDOPCO. After years of confusion among the circuit courts, as illustrated above, the Supreme Court issued *INDOPCO*[65] to clarify the holding in *Lincoln Savings*. Writing for the Court in *INDOPCO*, Justice Blackmun clarified:

> *Lincoln Savings* stands for the simple proposition that a taxpayer's expenditure that serves to create or enhance . . . a separate and distinct as-

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B= BENEFIT beyond the taxable year;
NOT B = NO benefit beyond the taxable year;
R= the expense is directly Related to B;
NOT R= the expense is only indirectly Related to B;
C= CAPITALIZE;
NOT C= do NOT Capitalize (this can be equal to a deduction).

Id. See also WADDELL, WARD JR., STRUCTURE OF LAWS: AS REPRESENTED BY SYMBOLIC METHODS 1 (1961).

60. *See Lincoln Savings*, 403 U.S. at 354.

61. *Wells Fargo*, 224 F.3d at 882. *See* note 59 and accompanying text for explanations of the symbols.

62. *See id.* The court further explained variations of the mistake in logic:

> Clearly, the two statements are different and yield different results. Another way to misstate the holding of *Lincoln Savings* is to say "if NOT A then NOT C, but this too is not interchangeable with the actual holding, "if A then C." An equally poor reading of the term "if A then C," would be "if C then A" Unless two terms are proven to be reflexive of one another, they can not be haphazardly interchanged. And yet these are the very mistakes in logic that some Circuits were laboring under while misinterpreting *Lincoln Savings*. By establishing a "new test" which would not require capitalization unless a new asset was created, those courts were reading Lincoln Savings to hold one of the following: 1) "if C then A", 2) "only if A then C or 3) "if NOT A then NOT C," none of which is equivalent to the true holding, "if A then C."

Id.

63. *Lincoln Savings*, 403 U.S. at 354.

64. *Wells Fargo*, 224 F.3d 882. In the logic terms outlined, the court re-wrote the statement in *Lincoln Savings* to read: "B not = C." (B does not equal C). The court then explained: "This simply is not true. When determining whether a necessary business expenditure must be capitalized or deducted, it is of critical importance to determine whether the expenditure resulted in a long term benefit." *Id.* (citing *INDOPCO*, 503 U.S. at 87-88).

65. *INDOPCO*, 503 U.S. at 79.

> set should be capitalized under § 263. It by no means follows, however, that only expenditures that create or enhance separated and distinct assets are to be capitalized under § 263.
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> 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.[66]

According to the Eighth Circuit, *INDOPCO* clarifies that if an expenditure creates a separate and distinct asset then it must be capitalized and no further analysis need be done (if A then C); but if the expenditure does not create a new capital asset, further inquiry must be performed.[67]

The Eighth Circuit went on to explain that according to *INDOPCO*, even when a particular expenditure does not create a new asset (NOT A), there are situations where the expense must still be capitalized (C). However, there are also occasions when such expenditures may be deducted. Hence, the court concluded, "if NOT A then (C or D)."[68] It then explained that determining whether to capitalize (C) or deduct (D) depends in part on the long-term benefit of the asset. "If there is not a long term benefit (B) associated with the expenditure, then the appropriate tax treatment is current deduction."[69] On the other hand, the court stated that there is not an easy answer if the expenditure does not create a new asset, but does provide a long-term benefit.[70]

c. The Tax Court's illogical reading of INDOPCO. The Court of Appeals explained that the Tax Court's first mistake was its failure to separate the officers' salaries from the investigatory/legal expenses and perform independent analyses to determine their deductibility. Second, the Eighth Circuit, through the use of logical equations, illustrated how the Tax Court erroneously interpreted *INDOPCO* to require capitalization of the expenses simply because the expenditures were incidentally connected with a future benefit.[71] In particular, the Tax Court held: "In accordance with INDOPCO [sic], [all] the costs must be capitalized because they are connected to an event (namely, the transaction) that

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66. *See id.* at 86-87. As the Eighth Circuit explained, "*INDOPCO* clearly and unequivocally demonstrates that statements such as "only if A then C," and "if NOT A then NOT C" are false statements." *Wells Fargo*, 224 F.3d at 883.

67. *See Wells Fargo*, 224 F.3d at 883.

68. *Id.* at 884.

69. *Id.* The court further explained that this is because the Code seeks to match expenses with the revenues of the taxable period to which they are associated.

70. *See id.* The court supports this by quoting *INDOPCO* where Justice Blackmun explained: "The Court has recognized, however, that the 'decisive distinctions' between current expenses and capital expenditures 'are those of degree and not of kind,' and that because each case 'turns on its special facts,' the cases sometimes appear difficult to harmonize." *Id.* (internal citations omitted).

71. *See id.* at 886.

produced a significant long-term benefit."[72] The Eighth Circuit concluded:

> This is a misinterpretation of *INDOPCO*. The Tax Court is saying that C must result because of the presence of B. This is equivalent to "if B then C," which we have previously proven to be a false statement. Herein lies the mistake of the Tax Court. Just as the Court in *Lincoln Savings* did not create a new test for determining whether current deduction or capitalization is the proper tax consequence of an expenditure, it also did not create a new test in the *INDOPCO* case. Therefore, it is not proper to decide that a cost must be capitalized solely because the fact finder determines that the cost is "incidentally connected" with a long term benefit.[73]

d. The court found Davenport's officers' salaries were a fully deductible expense. The court rejected the Tax Court's holding that the officers' salaries must be capitalized. Instead, it found that the salaries were directly related to the employment relationship but only indirectly related to the acquisition, and, therefore, the salary expenses were deductible.[74] The Eighth Circuit, applying the "origin of the claim doctrine" and somewhat persuaded by many private letter rulings of the IRS, agreed that the expenses in *INDOPCO* were directly related to the transaction that produced the long-term benefit and so needed to be capitalized.[75] However, the court distinguished those expenses from the officers' salaries by explaining that the salary expenditures at issue were only indirectly related to the long-term benefit (the acquisition); consequently, the salaries could be deducted.[76]

e. A portion of Davenport's legal/investigatory expenses were deductible. The court allowed $83,450 of the $111,270 of legal fees in dispute to be deducted. The Commissioner apparently changed his position with respect to the expenditures that it determined were attributable to the "investigatory stage" of the transaction and agreed with the taxpayer

72. *Id.* at 885 (quoting *Norwest*, 112 T.C. at 100).

73. *Id.* (internal footnotes omitted). The court went on to explain that this is supported by both *Lincoln Savings* and *INDOPCO*. *See Lincoln Savings & Loan.*, 403 U.S. at 354 (stating that "many expenses concededly deductible have prospective effect beyond the taxable year"); *INDOPCO*, 503 U.S. at 87 (noting that "the mere presence of an incidental future benefit—'some future aspect'—may not warrant capitalization").

74. *See Wells Fargo*, 224 F.3d at 888.

75. *See id.*

76. *See id.* at 887-88. *See* Woodward v. Comm'r, 397 U.S. 572 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970); Deputy v. du Pont, 308 U.S. 488 (1940); TAM 95-40-003 (June 30, 1995); PLR 93-26-001 (Mar. 18, 1993); TAM 95-27-005 (Mar. 15, 1995); TAM 97-21-002 (Jan. 24, 1997); TAM 97-31-001 (Jan. 31, 1997).

that such expenses should be deducted, not capitalized. The Commissioner attributed $83,450 of the expenses to the "investigatory stage."[77]

IV. ANALYSIS

The question of whether to capitalize or deduct acquisition-related expenses has long been a controversial one. Some courts have made distinctions between friendly takeovers and other takeovers, such as hostile or abandoned takeovers.[78] Although this area of tax law may be unclear, it is clear that the courts have raised the bar, making it more difficult for a taxpayer to deduct a pre-acquisition expenses.[79] In *INDOPCO*, the Supreme Court asserted that capitalization is the norm and deductions are the exception, and that creation of a separate and distinct asset never was necessary to require capitalization.[80] While the IRS has been somewhat moderate in its position with respect to pre-merger expenses, the Tax Court has been aggressive in interpreting *INDOPCO* as unfavorable to taxpayers.[81] *Wells Fargo* is an example of the Tax Court taking an aggressive position in applying its interpretation of *INDOPCO*.[82] On appeal, the Eighth Circuit ruled that the Tax Court was too aggressive in its interpretation and held that certain pre-transaction investigatory costs were currently deductible.[83]

After the Supreme Court's decision in *INDOPCO*, many authors have commented that it has become very difficult for companies to deduct acquisition-related expenditures.[84] Indeed, one author even suggested that "[a]fter the [*INDOPCO*] decision, there seems to be very little to discuss regarding the deductibility of takeover costs incurred where a

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77. *Id.*

78. *See* Silverman & Weinstein, *supra* note 43, at 1139. This Note focuses on the limited scope of the holding in *Wells Fargo*. For other types of transactions, *see* MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND BUYOUTS (2000) [hereinafter GINSBURG & LEVIN].

79. *See* Maydew, *supra* note 43.

80. *See INDOPCO*, 503 U.S. at 84.

81. *See* Maydew, *supra* note 43, at 152.

82. *See id.*

83. *See Wells Fargo*, 224 F.3d at 874.

84. *See* Maydew, *supra* note 43, at 146. Gary Maydew of Iowa State University explained:

> The Court obviously did not want the tax definition of a capital asset narrowed to the extent that taxpayers could expense all expenditures that did not create separate and identifiable assets.
>
> . . . . .
>
> The application of INDOPCO by the lower courts has made it very difficult for companies to deduct acquisition costs incurred in a friendly takeover. The Tax Court, in particular, has relied on INDOPCO to eliminate the deductibility of these acquisition costs.

Id. See also Macneil, *supra* note 6, at 975.

board willingly approves a takeover."[85] The IRS and the Tax Court have been very aggressive in not allowing deductions.[86]

In one of its more recent attempts to require capitalization, the Tax Court held in *Norwest* that the portion of regular and ordinary salaries of a bank's officers (salaries that were payable regardless of the merger and not affected by the merger) attributable to the time spent analyzing a potential merger were not currently deductible as an operating expense, but had to be capitalized.[87] The Tax Court's holding in *Norwest* has been criticized by some authors as "wrong."[88] Moreover, others have suggested that the *INDOPCO* decision is being "asserted out of context by overly aggressive revenue agents."[89] The Eighth Circuit agreed and in *Wells Fargo* reversed the Tax Court finding that the officers' salaries and part of the investigatory/legal fees were currently deductible.[90]

This portion of the Note explores the tax consequences of the merger-related expenses incurred in the *Wells Fargo* case, namely, pre-merger investigatory and legal fees and officers' salaries attributable to the merger. This Note does not seek to establish a new test, or recommend a new test that would miraculously and easily resolve all controversy.[91] The Note will, however, seek to analyze and explain that the court of appeals in *Wells Fargo* correctly concluded that the expenditures at issue were deductible because: (1) case law supports the holding; (2) it is consistent with the legislative history of section 195 of the I.R.C.; (3) the IRS's own positions support it; and (4) public policy requires it.

As the Eighth Circuit explained, the two expenditures at issue are inherently different and, because of the positions taken by the parties, will be analyzed separately.[92]

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85. Macneil, *supra* note 6, at 975.

86. *See* Silverman & Weinstein, *supra* note 43.

87. *See Norwest*, 112 T.C. 89, No. 9; *see also* Curtis Elliott & Christopher E. Hannum, *The Chaos of* INDOPCO *and Value Creation: Long-term Business Expansion or Recovery?*, 90 J. TAX'N 338 (June 1999) [hereinafter Elliott & Hannum].

88. *See* GINSBURG & LEVIN, *supra* note 78, at 4-16 ("We believe *Norwest* was wrongly decided to the extent that it concluded none of the investigatory expenses were deductible business expansion costs.").

89. Elliott & Hannum, *supra* note 87, at 339.

90. *See Wells Fargo*, 224 F.3d at 889.

91. One author, after explaining that most of the time either parties just "admit" to future benefit or the courts simply "equate" benefit without really evaluating the value:

> The controversy created by INDOPCO will not be put to rest until legislation clarifies this issue or the Supreme Court undertakes a renewed examination of the area. Until either of these events occur, taxpayers will continue to find what otherwise would be considered traditional ongoing expenses to be in jeopardy unless they support deductibility through sufficient preparation and logical strategies.

Elliott & Hannum, *supra* note 87, at 357.

92. As the court in *Wells Fargo* explained, the Tax Court erred "when it failed to perform an independent analysis to determine the fate of Davenport's officers' salaries, and another for the in-

A. *Investigatory Expenditures Incurred Before the "Final Decision" Are Deductible*

The controversy over what pre-merger legal and investigatory costs in a friendly merger may be deducted has largely been resolved and therefore will not be discussed in detail in this Note. Originally, the Commissioner had argued that all such expenditures must be capitalized. However, after *Norwest*, the Commissioner changed his position regarding investigatory/legal expenditures.[93] On appeal, the Commissioner conceded that he had been wrong and that the Tax Court had erred in requiring capitalization of all the costs.[94] In fact, the Commissioner agreed that legal expenses "attributable to the investigatory stage of the transaction" may be deducted.[95] Thus, the only material issue remaining was the question of how to define what constituted "investigatory costs."[96] According to I.R.C. section 195's legislative history, investigatory expenses are those incurred prior to the "final decision to acquire or to enter" a particular business.[97] The IRS determined that deductible investigatory costs are those "which are related to the questions 'whether to acquire a business' and 'which business to acquire.'"[98] Once the "final decision" is made to acquire a particular business, further investigatory costs "be-

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vestigatory costs associated with the acquisition." *Wells Fargo*, 224 F.3d at 885.

93. *See id.* at 888.

94. *See id.* Because the IRS is the body enforcing the tax laws, as a practical matter, the position taken by the Commissioner can generally be relied upon as the governing law.

95. *Id.* (internal quotations omitted).

96. *Id.*

97. S. REP. NO. 96-1036, at 11 (1980).

98. *Wells Fargo*, 224 F.3d at 889. Levin explained:

> The meaning of "final decision" is not entirely clear. One rational approach would be that P has made a final decision to acquire T only when it has signed a binding agreement to acquire T and no longer has a discretionary right to withdraw from the transaction, e.g., a general due diligence out (as opposed to a right to withdraw only for T's breach of a specific representation or warranty, e.g., a material adverse change out). Under this approach, if P signed a binding contract to acquire T, which gave P a general due diligence out, a final decision would be made at the earlier of expiration of the due diligence out or closing of the acquisition.
>
> At the other end of the spectrum, P could be viewed as having made a final decision to acquire T when it entered into a non-binding letter of intent to acquire T or perhaps even earlier when P made an offer to acquire T.
>
> In Rev. Rul. 99-23, IRS opted for the latter approach, stating:
>
> The "final decision" referred to in the legislative history of section 195 is the point at which a taxpayer makes its decision *whether to acquire a business*, and *which business to acquire*, rather than the point at which a taxpayer and seller are legally obligated to complete the transaction . . . Accordingly, expenditures incurred in the course of a general search for, or an investigation of, an active trade or business, i.e., expenditures paid or incurred in order to determine whether to enter a new business and which new business to enter . . . , are investigatory costs that are start-up expenditures under section 195 . . . .

GINSBURG & LEVIN, *supra* note 78, at 4-12.

come expenses attributable to facilitating consummation of the acquisition" and as such are not deductible.[99] The Eighth Circuit correctly concluded that there is no "bright line rule" for determining when the "final decision" occurred, but that it must instead be determined on a case-by-case basis.[100]

The frustrating result emerging from the holding in *Wells Fargo* is that it does not give much guidance as to when the "final decision" occurs. Obviously, having a bright line rule would make it easier to determine when the "final decision" occurred. However, having a case-by-case rule has various benefits. Each transaction and negotiation is different and thus the "final decisions" are likely to occur at different stages of the transaction depending on the parties. The case-by-case rule gives the court the flexibility to more closely determine when the final decision actually occurred. Along the same lines, establishing a bright line rule could lead to wide spread taxpayer abuse. For example, if the "final decision" were to be established as occurring when the board formally approved the transaction or when the letter of intent was signed, then companies could incur substantial investigatory expenses and simply delay performing the event that would trigger the "final decision." Consequently, companies could shift costs "attributable to facilitating consummation of the acquisition," which generally must be capitalized, into pre-"final decision" costs that could be deductible. This would violate the underlying principle that only costs related to the questions of "whether to acquire a business" and "which business to acquire" are properly deductible.[101] Moreover, under a bright line rule, companies may be able to avoid the "final decision" altogether. For example, if the signing of a letter of intent constituted the "final decision," companies could simply not sign a letter of intent. Thus, the case-by-case approach is appropriate.

B. The Court Correctly Concluded that the Officers' Salaries Were Deductible

This Note concludes that case law, the legislative history of section 195, the IRS's own positions, and public policy support the Eighth Circuit's ruling that the officers' salaries were deductible.

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99. *Wells Fargo*, 224 F.3d at 889.

100. *Id.* ("Our determination on this point is not to be construed as a 'bright line rule' for determining when a 'final decision' has been made. The facts and circumstances of each case must be evaluated independently to make a proper finding on that issue.").

101. *See id.*

1. Case law supports deducting the officers' salaries

Traditionally, the courts have allowed officers' salaries, similar to those in this case, to be currently deducted.[102] However, the Tax Court clearly took the position that acquisition-related expenses in a friendly transaction must be capitalized. The Tax Court committed three fatal flaws in reaching this conclusion. First, in its apparent decision to expand the scope of *INDOPCO*, the court failed to separately analyze the distinct and unique expenditures at issue. Secondly, the court further erred by confusing the argument that the salaries were only indirectly related to the merger with being one of timing. Thirdly, it misinterpreted *INDOPCO* as requiring all pre-acquisition expenses to be capitalized.[103]

The two expenditures at issue—legal/investigatory fees and officers' salaries—are very different in nature and thus needed to be analyzed separately. Although some of the legal/investigatory fees may have been incurred prior to the "final decision," the fees were clearly related to the transaction. Had there never been merger talks, the fees would not have arisen. On the other hand, the officers' salaries had always existed. The merger in no way affected the salaries the officers received. Even if there were no merger talks, the officers would have received the same compensation. By failing to separate the two expenditures, the Tax Court set itself up for failure.

The salaries at issue here were only indirectly related to the merger and thus are distinguishable from the other costs. The Tax Court clearly recognized that *INDOPCO* dealt with costs that were "directly" related to the corporate acquisition while the costs in the case at bar were only "incidentally" or "indirectly" related to the corporate acquisition.[104] Nonetheless, the Tax Court refused to distinguish between direct and indirect costs and consequently did not allow the taxpayer to deduct the indirectly related officers' salaries. In reaching this conclusion, the Tax Court wrongly equated the fact that the salaries were only indirect costs with that of timing. The Tax Court never analyzed or explained why officer salaries were required to be capitalized when those salaries had always been paid and would be paid regardless of the merger and had no association with the merger other than some unexplained allocation of time that the officers spent on pre-merger issues. The Tax Court simply concluded that it believed that any pre-transaction costs that provided "long-term benefit" must be capitalized regardless of whether "management

102. *See, e.g.*, *id.* at 874; Dixie Frosted Foods, Inc. v. Comm'r, 6 T.C.M. (CCH) 586 (1947); Fort Howard Paper Co. v. Comm'r, 49 T.C. 275 (1967).

103. *See Norwest*, 112 T.C. at 100.

104. *See id.*

[had] formally decided to enter into the transaction."[105] In addition, the court arbitrarily concluded that the costs were "sufficiently related" to the transaction that produced long-term benefit.[106] Moreover, the Tax Court continued analyzing the issue of timing when timing had nothing to do with the officers' salaries.

The Tax Court argued that the officers' salaries at bar are similar to *Acer Realty Co. v. Commissioner*, in which the salaries were determined to be capital expenditures.[107] However, the salaries in *Acer Realty* were "unusual, nonrecurrent services."[108] In the case at hand, the officers had always received salaries, and they were not increased or altered as a result of the transaction.[109] In *Acer Realty*, the company was in the leasing business, and the officers had not received salaries prior to the particular building transaction for which they were paid.[110] The salaries were directly related to the transaction for services typically performed by a general contractor and not by a leasing business.[111] Thus, the court found that the salaries in *Acer Realty* were not ordinary expenditures for the leasing business and must be capitalized.[112]

The Tax Court concluded that *INDOPCO* required the capitalization of the officers' salaries. However, a closer analysis of *INDOPCO* supports the Eighth Circuit's opinion in *Wells Fargo*. In *INDOPCO*, the Supreme Court held that in investment banking, legal and other expenses incurred in a friendly takeover were not ordinary and necessary expenses but instead must be capitalized.[113] In particular, the Court articulated four principles as the foundation for requiring the expenditures to be capitalized: (1) the clear reflection of income; (2) the principle that capitalization is the norm; (3) the "separate and distinct" asset test; and (4) the "future benefits" test.[114]

The Supreme Court began its analysis by explaining that the issue was one of clear reflection of income. Referring to sections 162, 263, and 167 of the I.R.C., the Court explained: "Through provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting

105. *Id.* at 100-01.

106. *Id.* at 102.

107. *See* Acer Realty Co. v. Comm'r, 132 F.2d 512 (8th Cir. 1942).

108. *Wells Fargo*, 224 F.3d at 887 (quoting *Acer Realty*, 132 F.2d at 513).

109. *See id.* at 888.

110. *See Acer Realty*, 132 F.2d at 514.

111. *See id.*

112. *See id.*

113. *See INDOPCO*, 503 U.S. at 79.

114. *See id.* at 83-88; *see also* GINSBURG & LEVIN, *supra* note 78, at 957-59. The third principle, "separate and distinct" asset test is not applicable here because there was not separate asset.

in a more accurate calculation of net income for tax purposes."[115] This statement supports the finding in *INDOPCO* that the investment banker fees and legal fees incurred as a direct result of obtaining professional opinions regarding the takeover would be attributable to future tax periods. However, it is not so clear that expenses like those at issue here (officers' salaries that have always been paid and would have been paid regardless of the merger) would be attributable to future tax periods. Indeed, it would appear that the opposite was true—that the salaries were attributable to the current tax period and thus would warrant current deduction. The officers' salaries had always been paid and were not determined or affected by the merger. Had there been no merger talks, the salaries still would have been paid and would have been currently deductible as an ordinary expense.

In *INDOPCO*, the Court required investment banking fees and legal expenses that were a direct result of a friendly merger to be capitalized. These expenses are markedly different from those in the case at hand. The expenses in *INDOPCO* were incurred as a direct consequence of the merger. Had the merger talks never been undertaken, these costs would not have been incurred. Consequently, they were directly related to the merger and thus clearly attributable to any future benefits that the merger would bring. However, this link cannot be made for the officers' salaries in the *Wells Fargo* case at hand.

The second principle outlined in *INDOPCO* is that capitalization is the norm. The Supreme Court explained:

> The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a 'complete list of nondeductible expenditures,' . . . section 263 serves as a general means of distinguishing capital expenditures from current expenses.[116]

Although at first this may appear to be a powerful blow to the deduction-seeking taxpayer, it is important to note that the Court was not establishing a new rule but merely seeking to explain the established law. The Court obviously explained that the bar was high, but it did not state anything new. Even the Commissioner stated that *INDOPCO* did not change any governing principles.[117]

115. *INDOPCO*, 503 U.S. at 83-84.

116. *Id.* at 84.

117. *See* Rev. Rul. 94-12.

Finally, the Supreme Court attempted to clarify *Lincoln Savings* and explained 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 the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."[118]

The Tax Court interpreted this as meaning that any expenditure that creates a "future benefit" must be capitalized. But as the Eighth Circuit explained, that is simply not what *INDOPCO* held.[119] The Supreme Court did not expressly or exclusively adopt either the "separate and distinct asset" test or the "significant future benefit" test. *INDOPCO* merely pronounced a "facts-and-circumstances" standard.[120] The Tax Court failed to analyze the facts and circumstances and instead jumped to the conclusion that all the expenditures even indirectly relating to the merger must be capitalized because a merger would provide a significant future benefit.[121] The Court of Appeals, on the other hand, correctly analyzed the separate expenditures and, based on the facts and circumstances, determined that the officers' salaries were deductible.

2. The legislative history of Code section 195 supports the holding in Wells Fargo

The Eighth Circuit's opinion is consistent with the legislative intent of section 195. Section 195 allows a taxpayer to amortize any "start-up expenditures."[122] Section 195(c)(1) defines "start-up expenditures" to mean any amount

> (A) paid or incurred in connection with investigating the creation or acquisition of an active trade or business . . . and (B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)), would be allowable as a deduction for the taxable year in which paid or incurred.[123]

Consequently, when the parties are not in the same business, a portion of the investigatory costs should qualify for elective amortization. When the parties are in the same business, the expenses should be immediately deductible. However, if *Norwest* is correct, it would require that any expenses that produce a significant future benefit be capitalized.

118. *INDOPCO*, 503 U.S. at 87.

119. *See Wells Fargo*, 224 F.3d at 889; *see supra* notes 59-73 and accompanying text.

120. *See* Javaras & Maynes, *supra* note 15 § IV at A-25.

121. *See Norwest*, 112 T.C. at 89.

122. I.R.C. § 195 (1994). *See generally* Javaras & Maynes, *supra* note 15.

123. I.R.C. § 195(c) (1994).

Thus, no deduction would be allowed if the parties were in the same business. Similarly, no amortization would be allowed when the parties were not in the same business because it would not pass the second prong, i.e. that the expenditure would have been deductible if incurred in connection with an existing business.[124]

In *Norwest*, the Tax Court held that section 195 was not contrary to its conclusion. In particular, the court "held that section 195 does not require 'that every expenditure incurred in any business expansion is to be currently deductible.'"[125] However, what the Tax Court did not consider was that, although section 195 does not require all business expansion costs to be deductible, it clearly does not require that all costs be capitalized.

The legislative history to section 195 states: "In the case of an existing business, eligible start-up expenditures do not include deductible ordinary and necessary business expenses paid or incurred in connection with an expansion of the business. As under present law, these expenses will continue to be currently deductible."[126] If business expansion costs are not deductible, then the expenses described in section 195(c)(1)(A) could never satisfy the requirements in section 195(c)(1)(B), and no expenditure incurred for expanding an existing trade or business would qualify as a "start-up expenditure," a proposition that is clearly contrary to the intent of Congress that the expenses described in section 195(c)(1)(A) be eligible for amortization under section 195.[127]

The opinion in *Norwest* was inconsistent with the legislative intent in section 195, and the Court of Appeals correctly reversed the Tax Court.

3. Wells Fargo *is consistent with the IRS's prior positions*

The Service has stated that the decision of *INDOPCO* "did not change the fundamental legal principles for determining whether a particular expenditure may be deducted or must be capitalized."[128] However, the IRS seems to be arguing a new position with respect to the deductibility of salaries.

The IRS has long held the position that the portion of salaries allocable to an acquisition must be capitalized. But that has only been for those who spend a "substantial amount of their time on mergers and ac-

124. *See* GINSBURG & LEVIN *supra* note 78, at 4-11.

125. *Norwest*, 112 T.C. at 102 (quoting FMR Corp. & Subs. v. Comm'r, 110 T.C. 402, 429 (1998)).

126. S. REP. NO. 96-1036, at 12 (1980).

127. *See* GINSBURG & LEVIN *supra* note 78, at 4-15 to 4-16.

128. Notice 96-7, 1996-6 I.R.B. 22.

quisitions."[129] In Rev. Rul. 73-580, the IRS stated that "compensation paid for services performed by . . . employees relating to the acquisition of other corporations . . . is not distinguishable from fees paid for similar services performed by outsiders."[130] The expenses at issue in Rev Rul. 73-580 were payments to employees in the company's legal department, accounting department, and internal audit staff who spent a substantial amount of their time on mergers and acquisitions—costs directly related to and incurred solely as a result of the merger.

However, the Tax Court went well beyond Rev. Rul. 73-580 in requiring capitalization of salaries which were only "incidentally" related to the acquisition. Moreover, the payments in the case at bar were to officers and were the ordinary and regular salaries that they had always received.

The IRS might argue that Rev. Rul. 73-580 specifically included executives' salaries in its holding. In Rev. Rul. 73-580, the IRS explained that payments to a corporation's president were required to be capitalized. However, these payments are distinguishable because they were not in the form of salaries but were essentially a payment in stock "as a commission for consummating the contract of a reorganization."[131] The stock paid to the president was entirely dependent and directly related to the consummation of the transaction. The president's regular salary was not required to be capitalized. In the *Wells Fargo* case, the salaries were not bonuses for undertaking or completing the merger, but instead were regular salaries that were in no way dependent upon the consummation of a transaction. These salaries were similar to the president's regular salary that was not required to be capitalized.

Rev. Rul. 99-23 made clear that investigatory costs incurred in the general search for a new business are eligible for amortization under section 195. Furthermore, it distinguished costs incurred when expanding an existing business and concluded that "a taxpayer incurring costs to investigate the expansion of an existing business generally could deduct those costs under § 162, assuming that other requirements of that section were met." This is consistent with the legislative history of section 195.[132] The position of the IRS and the Tax Court that the investigatory costs are not deductible is inconsistent with section 195, its legislative history, and Rev. Ruls. 73-580 and 99-23.

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129. Rev. Rul. 73-580, 1973-2 C.B. 86. *See also* GINSBURG & LEVIN *supra* note 78, at 4-19.

130. Rev. Rul. 73-580, 1973-2 C.B. 86.

131. *Id.*

132. *See supra* notes 122-27 and accompanying text.

4. *Public policy supports the* Wells Fargo *decision*

A fundamental problem with the Tax Court's ruling that "indirect" costs of a merger be capitalized is that, if the rationale is carried to its logical extreme, it would result in the capitalization of any cost that in any way could be indirectly allocated to a business expansion because the expansion itself is arbitrarily deemed to have a significant benefit. This could lead to a requirement that overhead costs that have always been ordinary and necessary expenses, and that would be incurred regardless of the merger, similar to the officers' salaries, be capitalized to a certain extent because the costs are somehow indirectly related to the merger (perhaps there were meetings in the offices, or the officers used corporate supplies while evaluating the transaction). At some point the rationale becomes absurd, and capitalizing the officers' salaries in this case reaches that point. Nearly everything officers do provides a future benefit. But it would be inequitable for their ordinary salaries to be capitalized.

More disturbing is the fact that if these expenses are required to be capitalized, not only will they not be currently deducted, but for practical matters they may never be deducted. The expenditures are not tied to an asset or something that can be depreciated. Instead, they relate to a transaction that has no defined useful life. Consequently, the expenses cannot be deducted until the business is disposed of or sold. In essence, the Tax Court's holding simply evaporated an ordinary and necessary expense.

V. CONCLUSION

The Eighth Circuit correctly concluded that the investigatory/legal fees and the officers' salaries were currently deductible. The investigatory and legal fees at issue were incurred prior to the "final decision" and thus were properly deducted. The officers' salaries were ordinary expenses only indirectly related to the transaction. After an analysis of the case law, the legislative history of section 195, the IRS's positions, and public policy, it is reasonable to conclude that the Eighth Circuit properly allowed the salaries to be currently deducted.

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