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WHOA! EIGHTH CIRCUIT REIGNS IN INDOPCO FOR WELLS FARGO

by Robert W. Wood • San Francisco

It is not too often that tax cases make the *Wall Street Journal* (especially the front page), and indeed, not too frequent that the tax bar seems to universally cheer a particular tax decision (tax lawyers being a contrary lot). But that seems to be what just happened in *Wells Fargo & Co. et al v. Commissioner*, No. 99-3307, Tax Analysts Doc. No. 2000-22578, 2000 TNT 169-18 (8th Cir., Aug. 29, 2000). The Eighth Circuit reversed (in part) a Tax Court decision to hold that officers' salaries of an acquired subsidiary paid during the year of the acquisition, as well as certain legal and investigatory expenses incurred before the acquisition, are all deductible under Section 162. The IRS truly got run over by the stagecoach in this one. Most M&A lawyers are cheering as the Wells Fargo wagon, (or is that stagecoach) trundles by.

The facts arose out of Norwest exploring a merger with Davenport Bank and Trust Co. Davenport retained advisors to help evaluate the transaction, but some of its own officers performed services relating to the consolidation of Davenport with Norwest's Bettendorf Bank. Davenport shareholders approved the

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deal in late 1991, and the Norwest Bettendorf shareholders approved it several weeks later (also in 1991). The transaction became effective in mid-January 1992.

Davenport deducted its salaries paid to officers on its 1991 return, but the IRS determined that the portion of those salaries attributable to "merger related services" (what's that anyway?) had to be capitalized.

Tax Court Supports Salary *INDOPCO*-ization

Most of us remember the Tax Court decision in *Norwest,* which was fairly widely publicized. See *Norwest Corp, et al v. Commissioner,* 112 T.C. (No. 9, March 8, 1999). For prior coverage of this decision the M&A see Muntean and Wood, "Tax Court Bloats *INDOPCO* in *Norwest v. Commissioner,* Vol. 7, No. 10, *M&A Tax Report* (May 1999), p. 1.

The Tax Court found that Davenport could not deduct the portion of the salaries they paid officers in 1999 (the year of the acquisition) because the salaries were attributable to services performed in the deal. The Tax Court thus agreed with the IRS, citing— you guessed it— *INDOPCO Inc. v. Commissioner,* 503 U.S. 79 (1992). Predictably, Norwest said these were deductible salaries, because they were for investigating the expansion of an existing business.

Eighth Circuit Rides Shotgun

The Eighth Circuit reversed, holding that the Tax Court erred by interpreting *INDOPCO* to find that salaries of officers of a subsidiary during the year of an acquisition are not currently deductible. In fact, the court said that the Tax Court (and other circuit courts!) have mistakenly interpreted *INDOPCO,* which in the Eighth Circuit's view should be interpreted as follows: If an expenditure creates or enhances a separate and distinct asset, then it is a capital item which (by its very nature) provides long term benefits and must be capitalized. The court noted that these "when to capitalize or deduct" situations also may involve an expenditure that does not create separate and distinct assets.

The *INDOPCO* court, at least according to the Eighth Circuit, shows that courts must look to the presence of a long term benefit associated with the expenditure. If there is no long term benefit, then the appropriate tax treatment is a current deduction. Where the expenditure does not create a separate and distinct asset, but *does* provide a long term benefit, the courts must look to the facts of the case to unscramble what should be deductible.

New Standard?

These couple of simple rules may sound somewhat mushy, but bear in mind that there has been a remarkable tendency on the part of the Service (and the courts) to find that virtually anything has benefits extending beyond the tax year. This "count the benefits" mantra has caused a considerable number of conclusory assumptions that expenditures should be capitalized.

In *Wells Fargo,* the Eighth Circuit determined that the Tax Court made its first mistake by lumping together the officers' salaries and the investigatory costs associated with the acquisition. The salaries, said the Eighth Circuit, were incidental to the future benefit, and were not common and frequently occurring expenses. Noting that the costs considered in *INDOPCO* were directly related to the acquisition, the court found the Wells Fargo salaries were at best "indirectly" related to the acquisition.

Curiously, the court noted a number of the IRS' own Technical Advice Memoranda that have found compensation payments to employees to be deductible in the context of acquisitions. (Still, the Eighth Circuit was quick to note that Tech Advice Memos may tech-

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nically not be cited as precedent.) The Eighth Circuit held that the salaries were indirectly related to the capital transaction, and therefore were deductible. The legal expenses were also questioned, although the IRS had by then agreed that $83,450 of Davenport's legal expenses related to the acquisition were deductible, being attributable to the investigatory stage of the transaction. The court agreed with the IRS (and the Tax Court) that the remaining $27,820 of legal fees were capital expenditures.

Investigatory expenses incurred *after* a final determination concerning an acquisition are capital, and the Eighth Circuit did not disagree with this result. Still, the Eighth Circuit had to determine *when* the final decision regarding the acquisition was made. According to the Eighth Circuit, it was made no later than July 22, 1991: expenses related to the acquisition incurred after that date had to be capitalized.

Bifurcation in Time and Task

The *Wells Fargo* case has been widely watched and does not disappoint with its criticism of a broad application of the "future incidental benefit" inquiry. Since the Tax Court has generally been supportive of the IRS on its INDOPCO capitalization crusade, the *Wells Fargo* case with its sharp rebuke of INDOPCO theory is especially helpful. When you add to this the Third Circuit's holding in *PNC Bancorp, et al v. Commissioner*, 212 F.3d 822 (3rd Cir. 2000), *reversing* 110 T.C. 349, covered elsewhere in this issue, the climate is truly heartwarming.

If we turn back the clock to the Supreme Court's decision in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), most will remember that the initial reaction to this Supreme Court shocker was bifurcation, bifurcation, bifurcation. If one could divide up investment banking fees, legal costs, etc, between those attributable to the deal, and those not, some hope for deductions remained. There were more aggressive allocations and less aggressive ones, but the general theory seemed to be working.

The court cases were somewhat less charitable. That is why it is especially interesting that in *Wells Fargo*, the Eighth Circuit found that the Tax Court had simply refused to attach any significance to the fact that the costs in question were incurred *before* Davenport's management team had formally approved the transaction. The Tax Court had explained that Davenport could not deduct any of the disputed costs because all costs "were sufficiently related to an event that produced a significant long term benefit."

The Eighth Circuit, on the other hand, found that this made no sense at all. After all, one could truly go overboard with the question of exactly what is related to the acquisition. Virtually everything might be. The salaries, according to the Eighth Circuit's analysis were only in indirect relationship to the deal, even though the deal clearly provided long term benefits. In addition to INDOPCO, the court analyzed the decisions in *Briarcliff Candy v. Commissioner*, 475 F.2d 775 (2nd Cir. 1973), and *Commissioner v. Lincoln Savings and Loan Association*, 403 U.S. 345 (1971).

The initial reaction to this Supreme Court shocker was bifurcation, bifurcation, bifurcation.

In the salaries area, the court relied on it's own decision in *Acer Realty Co. v. Commissioner*, 132 F.2d 512 (8th Cir. 1942). The salaries were clearly and directly related to a particular project in that case, so capitalization made sense. But in the case of the Davenport officers, the court found that the officers had *always* received salaries (a nice touch!). They were going to be paid the same amount even before the acquisition was a possibility. As the Eighth Circuit noted, there were no increases in salaries attributable to the proposed merger, and the salaries would have been paid regardless of whether the merger had taken place. (Another nice point!).

Consequently, the court found that the salary expenses originated from the employment relationship between the bank and its officers. Only *indirectly*, said the court, was the payment of the salaries something that provided Davenport with a long-term benefit.

More Bifurcation

In an implicit underscoring of the customary view that expenses should be bifurcated, the Eighth Circuit considered the legal and investigatory expenses, first looking at those that were attributable to the investigatory stage of the transaction which the IRS had already conceded could be deducted. The only disagreement in the Eighth Circuit, the court explained, was whether the remaining $27,820 in fees were capital or ordinary. The question was whether any expenses that post-dated the final decision to acquire the business ought to be capitalized. The parties agreed that this was the standard

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to apply. The parties disagreed, though, on just when the "final decision" was made.

Revenue Ruling 93-23, 1999-20 IRB 3, suggests that the IRS notes differences between investigatory expenses and those that must be capitalized. That ruling determined that investigatory expenses are deductible. There is no substitute for a facts and circumstances analysis, though. Here, the Eighth Circuit found that the final decision regarding the acquisition took place on July 22, 1991. It was on that date that Norwest and Davenport entered into an agreement. Perhaps readers may assume that a bright line test applies here not! The court cautioned that this determination should not be construed as a bright-line rule for determining when a "final decision" has been made. The facts and circumstances of each case, at least according to the Eighth Circuit, need to be evaluated independently to make a proper finding.

> **Planning Note:** At least a few *M&A Tax Report* readers may note that this "final decision" (smacking almost of Regis Philbin's "Is that your final answer?") may be somewhat malleable. After all, the point at which a decision is truly taken may not always be precise. Especially if a buyer *knows* that this final decision will operate as a cutoff of deductible items, perhaps there are cases where the decision can remain open for just a little while longer before it is taken.

It will not escape most readers that a kind of "but for" analysis was applied by the court about the salaries: they were going to be paid in any event, just like every year. That kind of practical "we would have paid it anyway" analysis will do much to help taxpayers seeking deductions. By its very nature, the Eighth Circuit view puts a real limit on the concept of future benefits, something which tax lawyers have been struggling with since INDOPCO was decided in 1992.

Before the *Wells Fargo* decision, some particularly worrisome readers might have been concerned that they were receiving a long term benefit from reading *The M&A Tax Report*, and might have scratched their head to figure out the term over which to capitalize their subscription. Any such silly notions should be dispelled by *Wells Fargo*, even if that case does (at least technically) only deal with the question of salaries.

Toehold or More?

Hopefully, the Eighth Circuit's decision in *Wells Fargo* will be expanded to cover other expenses incurred in connection with acquisitions. Equally hopefully, it will be expanded in effect beyond the Eighth Circuit and become the law of the land. Of course, not everyone hopes that cases such as *Wells Fargo* are universally received. There are those — such as Tax Analysts peripatetic naysayer Lee Sheppard — who argue that capitalization is the norm, that INDOPCO changed nothing (the vast majority of expenses always having been required to be recapitalized, etc.). For example, see Sheppard, "What Part of 'Capitalize' Don't You Understand?" Tax Notes, Sept. 18, 2000, p. 1435.

Ms. Sheppard, postal-like in her zeal, argues that the mantra that should prevail in the United States is: "when in doubt, capitalize." *Id.* at p. 1438. She notes ruefully that a veritable army of tax practitioners benefit from making the question "to capitalize or deduct" seem a lot more complicated than it really is. She argues — and certainly the government has reason to support her — that virtually everything has to be capitalized. Not to unduly focus on this "capitalize everything" view, but it may be particularly shocking to note that some (Ms. Sheppard and others) even take issue with the very facts of the cases.

For example, Sheppard notes that the Seventh Circuit held in *A.E. Staley Manufacturing Co. and Subsidiaries v. Commissioner*, 119 F.3d 482 (7th Cir. 1997), that the expenses of a hostile takeover were immediately deductible. Sheppard then adds her own comment, "as if there were any such thing as a hostile takeover." Id. at p. 1439. Just how does one respond to an argument, when the very question of whether a takeover is hostile or friendly apparently cannot even be addressed? Go figure. It Makes me, well, downright hostile, and I do think there is such a thing as hostile, Ms. Sheppard not withstanding.

Conclusion

Ultimately, no debate on an issue of this magnitude can easily be resolved. especially given the fervor with which some address the topic. Almost rising to the level of the abortion debate (at least in the limited and reserved sphere of the tax community), the *INDOPCO* debate will go on and on, and on, Energizer Bunny like in its persistance. And, amidst the debate there will be some voices (like Ms. Sheppard's tireless one) arguing that more IRS resources ought to be devoted to tax accounting problems "that affect every taxpayer of every size every year." *Id.* at p. 1441.

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Maybe the IRS started the ball rolling with Revenue Ruling 94-12, 1994-1 C.B. 36, in which the IRS stated that *INDOPCO* did not change the law regarding capitalization. Maybe so, but many of us act — with some justification — as though items that used to be routinely treated as ordinary and necessary (on both sides of the aisle) now seem subject to capitalization. The *Wells Fargo* decision takes a fairly healthy step (one small step for mankind?) in the right direction..