National Starch & Chemical Corp. v. Commissioner, T.C. Memo. 1991-471

Expenditures incurred by a target corporation in a friendly takeover, aimed at shifting corporate ownership for long-term benefit, are considered capital expenditures and are not currently deductible as ordinary business expenses under Section 162(a) of the Internal Revenue Code.

Summary

National Starch & Chemical Corp. (National Starch) sought to deduct expenses incurred during its acquisition by Unilever in a friendly takeover. The Tax Court addressed whether these expenses, primarily legal and investment banking fees, were deductible as ordinary and necessary business expenses under Section 162(a) or if they should be capitalized. The court held that the expenses were capital in nature because they were incurred to facilitate a shift in corporate ownership that was intended to produce long-term benefits for National Starch, despite not creating a separate and distinct asset. Therefore, the expenses were not deductible.

Facts

National Starch, a publicly traded company, was acquired by Unilever through a friendly takeover. Unilever initiated the acquisition, and National Starch's board, after advice from investment bankers Morgan Stanley and legal counsel Debevoise, Plimpton, approved the deal. The acquisition was structured as a reverse subsidiary cash merger, allowing some shareholders to exchange stock for Unilever preferred stock in a tax-free transaction, while others received cash. National Starch incurred expenses for investment banking fees to Morgan Stanley ($2,200,000), legal fees to Debevoise, Plimpton ($490,000), and other related expenses ($150,962). National Starch deducted the Morgan Stanley fee but not the Debevoise, Plimpton fee or other expenses on its tax return, which the IRS disallowed.

Procedural History

The Commissioner of Internal Revenue determined a deficiency in National Starch's federal income tax. National Starch contested this deficiency in Tax Court, arguing for the deductibility of the Morgan Stanley fee and claiming overpayment due to the non-deduction of the Debevoise, Plimpton fee and other expenses. The Tax Court heard the case to determine the deductibility of these takeover-related expenses.

Issue(s)

1. Whether expenditures incurred by National Starch incident to a friendly takeover by Unilever are deductible as ordinary and necessary business expenses under Section 162(a) of the Internal Revenue Code.

Holding

1. No. The expenditures incurred by National Starch incident to the friendly takeover are not deductible as ordinary and necessary business expenses because they are capital expenditures.

Court's Reasoning

The Tax Court reasoned that while Section 162(a) allows deductions for ordinary and necessary business expenses, capital expenditures are not deductible. The court emphasized that the distinction between a deductible current expense and a non-deductible capital expenditure is crucial. Referencing prior case law, the court stated that expenditures related to corporate reorganizations, mergers, and recapitalizations are generally considered capital in nature. Although the transaction was not a reorganization in the technical sense of Section 368, the court focused on the long-term benefit to National Starch from the shift in ownership to Unilever. The court stated, *"The expenditures in issue were incurred incident to that shift in ownership and, accordingly, lead to a benefit 'which could be expected to produce returns for many years in the future.' E.I. duPont de Nemours & Co. v. United States, 432 F.2d 1052, 1059 (3d Cir. 1970). An expenditure which results in such a benefit is capital in nature."* The court rejected National Starch's argument that because no separate and distinct asset was created, the expenses should be deductible. The court clarified that the creation of a separate asset is not the sole determinant of a capital expenditure; the long-term benefit to the corporation is a primary factor. The court concluded that the dominant aspect of the transaction was the transfer of stock for the long-term benefit of National Starch and its shareholders, making the expenses capital expenditures.

Practical Implications

National Starch establishes a significant precedent regarding the deductibility of expenses in corporate takeovers. It clarifies that even in friendly takeovers, expenses incurred by the target corporation to facilitate a change in corporate ownership are likely to be treated as capital expenditures, not currently deductible business expenses, if the purpose is to secure long-term benefits. This case highlights that the long-term benefit doctrine can apply even when no tangible asset is created. Legal professionals advising corporations involved in mergers and acquisitions must consider that fees for investment bankers, lawyers, and other advisors related to facilitating the transaction are generally not deductible in the year incurred but must be capitalized. This ruling has been consistently followed and applied in subsequent cases dealing with deductibility of costs associated with corporate acquisitions and restructurings, reinforcing the principle that expenses related to significant corporate changes with long-term implications are capital in nature.

