To What Extent Can Treasury Abandon or Overrule INDOPCO?

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The extent to which Treasury can abandon or overrule the Supreme Court is the subject of significant controversy between the IRS and taxpayers. This article focuses on the subject in the context of INDOPCO.

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Introduction

In Santa Fe Pacific Gold,1 the Tax Court held that a payment made by a target corporation to terminate a merger agreement (a termination fee) after receiving a superior offer from another suitor was currently deductible under both section 162 and section 165. In its ruling, the court examined both the anticipated benefits and the actual benefits resulting from the second transaction. The court rejected the IRS’s position that payment of the termination fee produced the type of benefit requiring capitalization as contemplated by the Supreme Court in INDOPCO.2 Of significance here, the Tax Court’s decision conflicts with a portion of the final regulations effective for years after Santa Fe Pacific Gold (the INDOPCO regulations), which created an irrefutable presumption of future benefits. Recently issued temporary regulations providing that a basis overstatement can give rise to an omission from gross income for limitations purposes (the basis overstatement regulations) have suggested considering post-transaction events in determining whether a particular cost can be immediately deducted or must be capitalized. As to the second question, strong arguments exist that Treasury exceeds its regulatory authority when it promulgates rules inconsistent with Supreme Court precedent.

Statutory Framework

Section 162(a) allows a deduction for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.” In contrast, section 263(a)(1) provides generally that a deduction is not allowed for amounts “paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.” These general rules are long-standing, originating in the first income tax acts during the Civil War era and remaining largely unchanged over the past 150 years. The legislative history on the general rules is sparse, indicating only that Congress was concerned with distinguishing between amounts expended to keep property in its present condition and amounts expended to improve its condition.3

The capitalization rules of section 263 trump the deductibility rules of section 162. Neither section distinguishes between anticipated versus actual benefits related to a payment. Further, neither section contains an express grant of authority for Treasury to promulgate regulations interpreting the statute.

The statutes and the interpretations given by courts before INDOPCO were not particularly helpful in many cases.4 Following the Supreme Court’s 1971 opinion in Lincoln Savings,5 taxpayers successfully argued in two

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1Santa Fe Pacific Gold Co. v. Commissioner, 132 T.C. No. 12 (2009), Doc 2009-9470, 2009 TNT 79-23. The opinion, written by Judge Goeke, constitutes the opinion of the entire Tax Court and is binding precedent on the court.


3Section 117 of the Internal Revenue Act of 1864, 13 Stat. 223, 282, permitted a deduction for “the amount paid out for usual and ordinary repairs” but not for “any amount paid out for new buildings, permanent improvements, or betterments made to increase the value of any property or estate.” The current “ordinary and necessary expenses” language in section 162 first surfaced in the 1909 act. J.S. Seidman, Seidman’s Legislative History of Federal Income Tax Laws, 1938-1861, pp. 1011-1012.


5Commissioner v. Lincoln Savings & Loan Ass’n, 403 U.S. 345 (1971).
circuits; the decision meant a current deduction had to be allowed in the absence of a separate and distinct asset to which the cost could be capitalized. The Supreme Court rejected this reasoning in INDOPCO, explaining that its decision in Lincoln Savings stood for the simple proposition that when an expenditure serves to create or enhance a separate and distinct asset, the expenditure should be capitalized under section 263. However, the Court’s statement in Lincoln Savings that “the presence of an ensuing benefit that may have some future aspect is not controlling” did not mean that the creation or enhancement of a separate and distinct asset was a prerequisite to capitalization.

The Supreme Court, acknowledging that “each case ‘turns on its special facts,’” clarified that “although the mere presence of an incidental 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 the determination of whether to immediately deduct or capitalize. Relying on the “permanent improvements or betterments” language in section 263(a)(1), the Court emphasized that the analysis “envisions an inquiry into the duration and extent of the benefits realized by the taxpayer.” Thus, the future benefits test was born, seemingly agreeing with the analysis in Santa Fe Pacific Gold, because a court cannot determine if there is a realized benefit unless it examines the future.

The reaction to INDOPCO has been mixed. Both taxpayers and the IRS have struggled to distinguish between future benefits that are “incidental” versus those that are “significant.” The IRS has been characterized as “aggressive” in not allowing deductions, and courts have struggled to reach a uniform understanding and interpretation of the future benefits test, as reflected by several disagreements among the Tax Court and the appellate courts.

Treasury’s Response to INDOPCO

Ten years after INDOPCO, Treasury issued proposed regulations designed to provide bright-line rules on whether specified costs must be capitalized or can be immediately deducted. In doing so, it criticized the Supreme Court’s future benefits analysis as not providing “the certainty and clarity necessary for compliance with, and sound administration of, the law.” Although Treasury indicated that it was seeking to retain a future benefits analysis in many of the categories covered by the regulations, some of the rules were more policy based and aimed at establishing bright-line distinctions while irrefutably assuming significant future benefits.

After receiving comments on the proposed regs, Treasury promulgated the INDOPCO rules, effective for amounts paid or incurred after December 31, 2003. Termination fees are dealt with under a broad section requiring the capitalization of amounts paid to “facilitate” an “acquisition or a trade or business, a change to the capital structure of a business entity, and certain other transactions.” Termination fees generally fall under this rule — “an amount paid to terminate (or facilitate the termination of) an agreement . . . constitutes an amount paid to facilitate a second transaction.”

In Example 13, a target corporation (Y) is the subject of a hostile takeover attempt by another party (Z) and, in defense of the takeover, incurs legal fees defending against the takeover and locating a white knight (W). Y and W enter into a letter of intent with a $10 million termination fee provision. Z thereafter increases its offer, and Y decides to accept the increased offer instead of merging with W. Under the example, the $10 million termination fee that Y must pay to W is capitalized as facilitating the merger agreement with Z. The rationale is

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6See Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775 (2d Cir. 1973); NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982).
7INDOPCO, 503 U.S. at 86.
8Id. at 86-88.
9Id. at 88 (emphasis added).
10Although the Supreme Court referenced appellate cases analyzing the “purpose for which the expenditure” was made, it long ago rejected a “primary purpose” test for determining whether costs are currently deductible or must be capitalized. See Woodward v. Commissioner, 397 U.S. 572 (1972).
12See, e.g., PNC Bancorp Inc. v. Commissioner, 212 F.3d 822, 825 (3d Cir. 2000), Doc 2000-14529, 2000 TNT 100-4. (“INDOPCO ushered in the era of generally more aggressive IRS pursuit of capitalization.”)
13Id. (reversing Tax Court and holding that the costs were “ordinary and necessary” business expenses geared toward income production and other current needs, not to “the corporation’s operations and betterment into the indefinite future”); Wells Fargo, 224 F.3d 874 (reversing Tax Court and holding that the proper inquiry under INDOPCO is whether the costs were directly related — and therefore had to be capitalized

(Footnote continued in next column.)
that, because $W$ could not merge with both $W$ and $Z$, the termination fee facilitates the transaction with $Z$.19

This portion of the INDOPOCO regulations makes no reference to a future benefits analysis, either anticipated or actual, in determining whether to capitalize or deduct termination fees. Moreover, it creates a bright-line rule that obviates the need to examine the special facts of each case.

**Santa Fe Pacific Gold**

In *Santa Fe Pacific Gold* the Tax Court addressed a situation similar to that contained in Example 13 of the INDOPOCO regulations. Although the court issued its opinion six years after the INDOPOCO regulations were published, it did not apply them because the year at issue was 1999. As explained below, had the year at issue postdated the effective date of the INDOPOCO regulations, the result likely would have been different, assuming the regulations are valid and afforded deference.

In *Santa Fe Pacific Gold* the taxpayer was approached by a larger mining company about a business combination. The taxpayer initially rejected the offer, expressing its belief that a combination with the acquiring company would not be beneficial. When the larger company did not relent, the taxpayer sought a white knight to pursue a different business combination involving a merger of equals. The taxpayer and the white knight entered into a merger agreement that, among other provisions, obligated the taxpayer to pay a $65 million termination fee if it received a superior offer from a third party and later terminated the agreement. On learning of the merger agreement, the larger mining company initiated a hostile takeover of the taxpayer. The taxpayer determined that its fiduciary duties under Delaware law required it to obtain the highest value for its shareholders, and it ultimately decided that the larger company’s offer was superior in value and that it had to accept and terminate the existing merger agreement. After consummating the transaction, the larger mining company, as the taxpayer had originally feared, aggressively cut duplicative costs by eliminating the taxpayer’s staff or putting them under control of the larger company and by closing all of its offices. The taxpayer deducted the termination fee in the year paid, and the IRS challenged on the grounds that the fee resulted in future benefits to the taxpayer in the form of the consummated capital transaction.

The Tax Court sided with the taxpayer and allowed a deduction for the termination fee because it found that the payment did not lead to significant long-term benefits for the taxpayer.20 The court focused on the hostile nature of the transaction and found that any synergies from the merger benefited only the larger mining company, not the taxpayer, and that the taxpayer did not pay the termination fee in hopes of some future benefit. Consistent with INDOPOCO’s requirement that the taxpayer obtain a realization of benefits, the court also looked at what actually occurred after the merger, finding that the taxpayer did not reap the type of future benefits that require capitalization, such as operating in an improved manner, gaining access to wider services, and operating more competitively after the merger. The court cautioned that not every benefit received after payment of a fee should be treated as caused by or related to that fee, and that all facts and circumstances must be considered. The court also emphasized the purpose of the termination fee and the effect of state law fiduciary duties, concluding that the purpose of the fee was to compensate the unsuccessful bidder and that the taxpayer’s board essentially had no choice but to accept the larger mining company’s offer.21 The court determined that payment of the termination fee did not lead to significant benefits for the taxpayer extending beyond the year at issue.

The court’s approach of looking at the actual future benefits is consistent with its approach in *Victory Markets*,22 the Tax Court’s first post-INDOPCO opinion. In requiring that costs related to a merger agreement be capitalized, the court stated that “while as a general rule we do not consider after-the-fact occurrences, these factors in this case corroborate that the board’s representations to its shareholders were substantially realized.”23 In the only other termination fee case resulting in a published opinion, the District Court for the Southern District of Ohio similarly tested its conclusion that the deduction was appropriate by looking at actual future benefits: “While the benefit of hindsight should not be used to determine the classification of an expenditure, it

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19Examples 13 and 14 in the INDOPOCO regulations treat parties differently depending on whether they occupy the position of the target corporation or the acquiring corporation. An acquiring corporation can deduct a termination fee made for the express purpose of abandoning one transaction to enter into a second transaction as long as the acquirer could have acquired both targets, while a target company with the same or even greater resources would have to capitalize its termination fee under the same circumstances merely because of its position as a target instead of an acquirer. No rationale is provided for treating taxpayers differently depending on their status as a target or as an acquirer.

20The Tax Court also allowed a deduction under section 165 as a cost of an abandoned transaction. The court’s opinion is consistent with *United States v. Federated Department Stores*, 171 B.R. 603 (S.D. Ohio 1994), aff’d 135 Bankr. 950 (Bankr. S.D. Ohio 1992), which also permitted a target corporation to deduct a termination fee under sections 162 and 165 under similar circumstances. See also *B.J. Servs. Co. Canada v. The Queen*, 2003 TCC 900 (similar conclusion by the Supreme Court of Canada). The Tax Court’s allowance of a loss deduction under section 165 raises the separate question of whether the INDOPOCO regulations are even relevant in situations when a termination fee provision is triggered for calling off a merger agreement because, in those situations, the transaction in which the termination fee originates is always being abandoned.

21In *Cox Enterprises v. Commissioner*, T.C. Memo. 2009-134, Doc 2009-13101, 2009-1 TNT 109-16, the Tax Court, relying on *Santa Fe Pacific Gold*, indicated that the appropriate analysis is whether the future benefits go to the taxpayer rather than the taxpayer’s shareholders in the case of a corporation. This issue was also present in *A.E. Staley Mfg. Co. v. Commissioner*, 119 F.3d 482 (7th Cir. 1997), Doc 97-19670, 97 TCT 129-9 in both the Tax Court and the Seventh Circuit, although it was not definitively resolved in those opinions.


23Id. at 664.
is useful to assess the validity of the Debtor’s apprehension.”24 Thus, while the focus has traditionally been on anticipated future benefits, looking at actual future benefits (that is, realized benefits) reflects a real-world approach that may be significant because there is often a large disparity between anticipated benefits and actual benefits from a merger transaction. It remains to be seen whether future courts will consistently use hindsight as a tool in a future benefits analysis.25

Can Treasury Abandon or Overrule INDOPCO?

The result in Santa Fe Pacific Gold cannot be reconciled with the treatment of termination fees under the INDOPCO regulations.26 The INDOPCO regulations require that termination fees paid by a target corporation be capitalized if the target later enters into a second merger transaction, as long as the two transactions are mutually exclusive. The regulations, contrary to Santa Fe Pacific Gold, A.E. Staley, and Federated Department Stores, do not distinguish between termination fees related to hostile or friendly takeovers, nor do they acknowledge that state fiduciary laws may require the board of a target corporation to accept an offer that may be detrimental to that corporation’s continued existence. In essence, no attempt is made in the regulations to incorporate INDOPCO’s future benefits analysis. Thus, the reasoning that won the day for the taxpayer in Santa Fe Pacific Gold is rendered moot.27

Santa Fe Pacific Gold therefore raises the question to what extent INDOPCO and its future benefits analysis survive in light of the INDOPCO regulations. While there is authority for the proposition that the IRS may, under some circumstances, promulgate regulations that change the result in previous cases,28 the extent to which it may engage in this practice has not been definitively estab-

lished. Indeed, this issue is the subject of significant controversy under the basis overstatement regulations that overrule several recent decisions, as well as the Supreme Court’s 1958 decision in Colony,29 rejecting the Service’s position on whether a basis overstatement can give rise to an omission from gross income, thereby triggering the extended six-year limitations period under section 6501(e)(1)(A).30

In Chevron31 the Supreme Court set forth a two-prong test for judging whether an agency’s interpretation of the law is entitled to deference from the courts.32 Under the first prong of Chevron, if the “intent of Congress is clear,” the matter is over; both courts and agencies “must give effect to” the “unambiguously expressed intent of Congress.”33 The courts, not agencies, are the final authority on issues of statutory construction, and administrative constructions contrary to clear congressional intent must be rejected. Thus, the intent of Congress, as determined by a court using traditional tools of statutory construction, “is the law and must be given effect.”34 Under the second prong of Chevron, if the intent of Congress is not clear, courts must determine whether the regulation is a reasonable construction of the statute. If so, the agency interpretation is given controlling weight.

Although the Supreme Court has characterized the principle of section 162(a) as “clear”35 and its provisions as “plain,”36 it has also recognized “that the ‘decisive distinctions’ between current expenses and capital expenditures ‘are those of degree and not kind,’” and that because each case ‘turns on its special facts,’ the cases sometimes appear difficult to harmonize.”37 Given the struggles by the courts, taxpayers, and the IRS over the years in applying the general rules of sections 162 and

24Federated Department Stores, 171 B.R. at 610.
26Commentators have noted that other portions of the INDOPCO regulations are also inconsistent with INDOPCO. See Gregg D. Polsky, “Can Treasury Overrule the Supreme Court?” 84 B.U.L. Rev. 185, 244 (2004); Calvin H. Johnson, “Destroying Tax Base: The Proposed INDOPCO Capitalization Regulations?” Tax Notes, June 2, 2003, p. 1381, Doc 2003-13382, or 2003 TNT 106-32.
27Moreover, the requirement in the INDOPCO regulations that the two transactions be mutually exclusive — that is, the taxpayer must capitalize if it could not have entered into both transactions — arguably conflicts with long-standing case law allowing immediate deductions under analogous circumstances. See, e.g., Staley, supra note 21; Iychuk v. Commissioner, 116 T.C. 374 (2001); United States v. Federated Dept. Stores, Inc., 171 B.R. 603 (S.D. Ohio 1994); Sibley, Lindsay & Curr Co. v. Commissioner, 15 T.C. 106 (1950); Portland Furniture Mfg. Co. v. Commissioner, 30 B.T.A. 878 (1934); but see United Dairy Farmers Inc. v. United States, 267 F.3d 510 (6th Cir. 2001), Doc 2001-25388, 2001 TNT 193-5.

32Chevron deference does not apply to all agency rules. In United States v. Mead Corp., 533 U.S. 218 (2001), the Supreme Court instructed courts to engage in a “Chevron step zero” inquiry to determine whether Chevron applies in the first instance, or whether the less deferential standard set forth in Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944), applies. Cass R. Sunstein, “Chevron Step Zero,” 92 Va. L. Rev. 187, 191 (2006). Given that the INDOPCO regulations were issued after a lengthy notice-and-comment process and were plainly intended to be binding and carry the force of law, they would likely be judged under the Chevron framework.
33Chevron, 467 U.S. at 842-843.
34Id. at 843 n.9.
35Deputy v. du Pont, 308 U.S. 488, 496 (1940).
37INDOPCO, 503 U.S. at 86 (quoting Welch v. Helvering, 290 U.S. 111 (1933), and Deputy v. du Pont, 308 U.S. 488 (1940)).
supports the position that a regulation inconsistent with doctrine of stare decisis, and we assess an agency's later statute's meaning, we adhere to our ruling under the Court has repeatedly held: ''Once we have determined a tal agency to overrule existing precedent, Supreme Court's 2005 opinion in ing the validity of those regulations, is that the Supreme (Scalia, J., concurring).

Yates, M.D., P. C. Profit Sharing Plan v. Hendon (Brand X) held that the statute unambiguously forecloses the agency's interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction.42 [Emphasis added.]

However, the Supreme Court did not purport to overrule its earlier decisions in Neal, Lechmere, and Maislin; instead, it characterized those opinions as allowing a court's prior interpretation of a statute to override an agency's interpretation only if the court held that statute unambiguous.43

The scope of the Supreme Court's opinion in Brand X is unclear. In a concurring opinion, Justice Stevens clarified that the rationale of Brand X would not necessarily apply to a Supreme Court decision removing any preexisiting ambiguity.44 In his dissent, Justice Scalia argued not only that judicial decisions should not be subject to reversal by executive officers, but that an agency's overruling of a Supreme Court decision is "probably unconstitutional."45

The Supreme Court recently declined to provide Chevron deference to a regulation that was inconsistent with Supreme Court precedent, despite a finding that there was ambiguity in the statutory language at issue.46 The Court explained that "the presence of some uncertainty or otherwise, as long as the statutory language at issue is ambiguous and the Service's interpretation is reasonable."47 In Brand X the Supreme Court upheld the validity of a regulation that construed a statute inconsistently with a prior judicial interpretation by the Ninth Circuit. The Court stated:

A court's prior judicial construction of a statute trumps an agency construction otherwise entitled to Chevron deference only if the prior court decision holds that its construction follows from the unambiguous terms of the statute and thus leaves no room for agency discretion. . . . Only a judicial precedent holding that the statute unambiguously forecloses the agency's interpretation, and therefore contains no gap for the agency to fill, displaces a conflicting agency construction.42 [Emphasis added.]

Even assuming that the INDOPCO regulations pass Chevron's two-prong test, the validity of Treasury's regulatory construction of the tax treatment of termination fees is not necessarily established. Long-standing authority indicates that only the Supreme Court or Congress, not a governmental agency, has the power to overrule Supreme Court precedent.38 For example, the Supreme Court has repeatedly held: "Once we have determined a statute's meaning, we adhere to our ruling under the doctrine of stare decisis, and we assess an agency's later interpretation of the statute against the settled law."39 The Supreme Court also opined over 200 years ago that "it is emphatically the province and duty of the judicial department to say what the law is."40 This authority supports the position that a regulation inconsistent with Supreme Court precedent is invalid.

Examining the Uncertainty Created by Brand X

The IRS's position, as contained in the recently issued basis overstatement regulations and court filings defending the validity of those regulations, is that the Supreme Court's 2005 opinion in Brand X authorizes a governmental agency to overrule existing precedent, Supreme Court

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38For a thorough pre-Brand X discussion on this point, see Polsky, supra note 26.


does not expand *Chevron* deference to cover” a regulatory construction contrary to Supreme Court jurisprudence and normal principles of construction.47 Four justices dissented on this point, arguing that the finding of ambiguity meant that *Brand X* provided the framework for deciding the case, and that the agency’s construction should be upheld because it was reasonable.48 The Ninth Circuit recently engaged in a detailed analysis of *Brand X*, explaining that the Supreme Court did not suggest “that an agency may resurrect a statutory interpretation that a circuit court has foreclosed by rejecting it as unreasonable at *Chevron’s* second step.”49 It remains to be seen whether other courts that are reluctant to apply *Brand X* broadly will engage in a narrower *Chevron* step two analysis to avoid overruling Supreme Court or appellate court precedent.

Also, it is worth noting that *Brand X* arguably overstates step one of *Chevron* by referring to the “unambiguous terms of the statute” instead of the “unambiguously expressed intent of Congress.”50 Although the Supreme Court has not been entirely consistent on this point since *Chevron*, it has used statutory tools of construction in step one, such as dictionary definitions, legislative purpose, and legislative history to determine whether the intent of Congress is clear (that is, unambiguous).51

**Conclusion**

Whether *Brand X* authorizes Treasury to overrule or disregard Supreme Court or other judicial precedent is the subject of significant dispute.52 Not surprisingly, the government is seeking a broad application of *Brand X* which would allow it to abandon or overrule such Supreme Court decisions as *INDOPCO* and *Colony*. This is clearly a controversial issue. Until the Supreme Court revisits the issue, there will continue to be much uncertainty.

The stakes are high — for example, termination fee provisions are found in most merger agreements, are generally calculated as a percentage of transaction value (historically 3 percent), and have exceeded $1 billion in some cases. There are many pending cases tied in part to the validity of the basis adjustment regulations. Taxpayers and their attorneys will need to explore all options when dealing with administrative guidance that may conflict with existing judicial precedent.

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47See supra note 30. Moreover, the Tax Court’s general position is that the validity of tax regulations issued under section 7805(a) is judged under the standard enunciated by the Supreme Court in *Nat’l Muffler Dealers Ass’n v. United States*, 440 U.S. 472 (1979). *Swallows Holding*, 126 T.C. at 129. The Tax Court raised but did not answer the issue of whether, because it generally reviews regulations under *Nat’l Muffler*, the Supreme Court’s opinion in *Brand X* even applies to tax regulations. Id. at 143-144.

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