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Wells Fargo v. Commissioner: Deductibility of Corporate Officer Salaries During Merger and the Need for Rules Over Standards

Brodie H. Smith

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**WELLS FARGO V. COMMISSIONER:**
**DEDUCTIBILITY OF CORPORATE OFFICER SALARIES DURING MERGER AND THE NEED FOR RULES OVER STANDARDS**

I. INTRODUCTION

The last ten years have seen an incredible expansion of corporate merger activity, with mergers increasing in both quantity and size.\(^1\) The ongoing $113 billion merger of Time Warner and America Online is the largest in U.S. history.\(^2\) The telecommunications industry has seen a consolidation of its major players into a handful of enormous corporations,\(^3\) and the trend has not been limited to the “new economy.” United and American Airlines are both presently seeking approval for acquisitions of smaller airlines,\(^4\) while the banking industry has been similarly restless.\(^5\) These mergers call down an avalanche of difficult tax issues, one of which is the deductibility of corporate officer salaries during the transition period.

The Internal Revenue Code allows businesses to deduct “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.”\(^6\) However, when an

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expenditure has the effect of creating a new asset, or improving an old asset, the expenditure must be capitalized—deducted incrementally over the life of the asset or benefit.

During normal tax years, officer salaries are deductible as ordinary and necessary business expenses. Some interesting deductibility questions arise when companies merge. It is not obvious whether merger activities should be considered ordinary business operation for purposes of § 162. During a merger, the corporate officers of both parties often cease their day-to-day operations, and take up merger-related work.

On August 28, 2000, the Eighth Circuit Court of Appeals, in a case called *Wells Fargo v. Commissioner*, created a new test for deductibility of officer salaries during merger. The “direct/indirect” test was established as a distinct offshoot of the “origin of the claim doctrine.” The test proves clumsy and unwieldy in the officer salary context, and its implications outside of this narrow context become much more problematic.

The interpretation problems with the direct/indirect test recall the ubiquitous rules-versus-standards debate. The issue of officer salaries during merger will recur under substantially similar fact patterns and is a perfect candidate for a rules application. Furthermore, the *Wells Fargo* court should have expressly limited the test to officer salary issues, because, applied to capitalization and deduction issues generally, the test proves completely inconsistent with §§ 162 and 263.

Part II of this Note outlines the Tax Code sections governing capitalization and deduction, and the economic policies behind them. It traces the judicial development of capitalization and deduction in its modern formulation, from the 1971 Supreme Court case of *Commissioner v. Lincoln Savings* to the subject case. Part III reviews the facts of the recent *Wells Fargo* case, and the conflicting decisions

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9. 224 F.3d 874 (8th Cir. 2000).
10. See id. at 886-88.
reached in the Tax Court and Eighth Circuit Court of Appeals. Part IV of this Note will explore the practical mistakes of the Wells Fargo court’s direct/indirect standard for officer salary deductibility. It will suggest an alternative to the direct/indirect test; a rule which preserves the policy behind the test, but eliminates most of its ambiguities. This Note frames the analysis of its proposed test within the rules-versus-standards debate, and concludes that a judicial rule in this context would reduce system abuses and litigation expenses for taxpayers and the Internal Revenue Service ("IRS" or "Service"). Finally this Note will briefly explore the probable effects of Wells Fargo on capitalization and deduction issues generally.

II. BACKGROUND

A. Capital Versus Ordinary Expenses

As a basic policy matter, the federal government only taxes a business’s net income. The IRS’s method for arriving at net profit is to begin with the assumption that all monies taken in by a business are nondeductible. The Internal Revenue Code then provides a handful of classifications within which businesses may claim deductions; usually expenses necessary to earning revenue. However, not all deductions are taxed within the same timeframe. Some can be deducted, in full, during the tax year in which they were incurred. Others must be capitalized—deducted in yearly increments for as long as the expense produces benefit to the business.

The rationale for capitalization becomes evident when a corporation purchases a major asset, or pays out an unusually large expense. For instance, imagine a small delivery business with a gross income of $100,000 per year. The firm wishes to purchase two additional delivery vans. If the firm were allowed to deduct the entire

12. See JOSEPH BANKMAN ET AL., FEDERAL INCOME TAX: EXAMPLES AND EXPLANATIONS 248 (2d ed. 1998). The apparent rationale behind this policy is to foster a healthy business environment by taxing only that which is truly profit.

13. A related assumption is that expenses are not deductible unless specifically provided for in the Internal Revenue Code or regulations. See RAY M. SOMMERFELD ET AL., AN INTRODUCTION TO TAXATION 6-1 (1980).

cost of the vans in the year in which it was incurred, and after deducting its normal operational expenses, the firm would likely not have any taxable income for that year, even though it grossed $100,000. Because of the time value of money, such a tax scheme would be preferable to the firm, and indeed, to most businesses. The federal government would be allowing the firm to avoid all income tax payments that year. Meanwhile, the firm would be making revenue aided by the new vans.

Capitalization rectifies this potential discrepancy. It is rooted in the overarching concept of matching: making sure that deductions match contemporaneously with corresponding costs of doing business. Businesses clearly prefer current deduction while the government tends toward capitalization. They both, of course, want their money sooner rather than later.

B. The Statutory Framework

The basic statutory scheme for business expenditures begins with two statutes and flows outward. One statute describes capital expenses and another defines deductible business costs. A host of other laws interpret the two categories.

1. The controlling pair

Sections 162 and 263 of the Internal Revenue Code are the bookends of corporate expense deduction. These two statutes are both mutually exclusive and mandatory; a business wanting to claim tax exemption for an expense must do so under one of these two rules, and never both.

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15. Such expenses include everything from employee salaries and rent to paper clips and manila folders.
17. See, e.g., I.R.C. § 167 (West 2000) (determining the life of an asset for purposes of deduction or capitalization); I.R.C. § 261 (West 2000) (outlining the "general rule for disallowance of deductions").
Section 162 provides that a business may deduct any expense it incurs in the process of making money.\textsuperscript{19} Although the statute contains a number of requirements, case law tends to focus only on the words “ordinary” and “necessary.”\textsuperscript{20} Conversely, § 263 provides: “No deduction shall be allowed for (1) [a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.”\textsuperscript{21} Courts have given this rule a life of its own. It has come to apply to much more than just “new buildings” or improvements upon an “estate.” It applies to expenses ranging from physical assets to intangible benefits; machinery to reputation. Whether such judicial activism was proper or warranted is the subject of another discussion, but for present purposes, it is enough to recognize that broad interpretations of § 263 have given rise to dozens of capitalization issues, one of which will be discussed below.

2. Peripheral statutes

Various tax statutes supplement §§ 162 and 263, aiding in determinations of which of the two apply to a given expense. For instance, § 161 ensures that once it has been determined that § 263 applies to a given expense, capitalization will always trump ordinary deduction.\textsuperscript{22} Therefore, the choice set out in the preceding subsection, between capitalization and deduction, can be simplified. As long as the expense is a business expense, the question becomes: Does § 263 apply? Or, in other words, does the expense in question require capitalization?

Another statute relevant to the discussion infra, § 165(a), states that a company may deduct “any loss sustained during the taxable year and not compensated by insurance or otherwise.”\textsuperscript{23} Among other things, courts have determined this section to include attempts to guard against a hostile takeover, whether successful or not.\textsuperscript{24}

\textsuperscript{19} See I.R.C. § 162 (West 2000).
\textsuperscript{20} See, e.g., Welch v. Helvering, 290 U.S. 111, 113-16 (1933) (focusing on the meaning of the word “ordinary”).
\textsuperscript{21} I.R.C. § 263(a)(1) (West 2000).
\textsuperscript{22} See I.R.C. § 161 (West 2000).
\textsuperscript{23} I.R.C. § 165(a) (West 2000).
\textsuperscript{24} See United States v. Federated Dep’t Stores, Inc. (In re Federated Dep’t Stores), 171 B.R. 603, 608 (Bankr. S.D. Ohio 1994).
More generally, the statute allows deductions for any business-related plans that are later abandoned.25

C. The Judicial Framework

1. Commissioner v. Lincoln Savings & Loan Ass'n

The 1971 Supreme Court case of Commissioner v. Lincoln Savings & Loan Ass'n26 was the first of two modern benchmark cases on capitalization versus current deduction. In that case, the IRS challenged Lincoln Savings when it attempted to deduct an “additional [insurance] premium” the bank paid to the Federal Savings and Loan Insurance Corporation.27 In the years prior to this litigation, Lincoln Savings had properly deducted its insurance premiums as normal business expenditures.28 So it was perhaps a logical step in reasoning when, in 1962, the bank was required to pay a second premium, that the second premium would also be deductible. Lincoln Savings relied on the fact that the second premium was also mandatory, like the first, in characterizing it as a necessary business expense.29 The Supreme Court, however, saw the issue differently. It reasoned that since Lincoln Savings actually held a pro rata share in the Secondary Reserve to which it paid its additional premium, the bank had a property interest in the Secondary Reserve.30 In other words, the additional premium created an asset. The Court explained, in often quoted language:

[T]he 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 . . . . What is important and controlling, we feel, is that the [additional premium] payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset . . . .31

25. This rule is referred to as “abandoned transaction” deductions.
27. See id. at 348-49.
28. See id. at 352.
29. See id. at 354.
30. See id. at 355.
31. Id. at 354.
Little did the 1971 Court realize that its "separate and distinct asset" language would become a widely disputed and greatly misunderstood piece of stare decisis in the world of tax law. Notwithstanding its holding, requiring capitalization, *Lincoln Savings* actually created a more deduction-friendly climate. By changing the capitalization trigger from benefits to assets, capitalization became more difficult to find. Current deduction became easier. After all, a future benefit can be interpreted from just about any expense, while asset creation proves the rarer occurrence.

2. The varied interpretations of *Lincoln Savings*

In one of the first cases to interpret *Lincoln Savings*, *Briarcliff Candy Corp. v. Commissioner*, the Second Circuit faced the question of whether costs incurred in the process of convincing retailers to carry a corporation's candy were deductible. The Tax Court had determined that the expenses must be capitalized because they created benefits that extended well beyond the current tax year. But the Second Circuit reversed, citing *Lincoln Savings* as the basis for its holding that future benefits should be completely ignored. The court further explained that since it could not characterize the expenses as creating a separate and distinct asset, the expenses were deductible. Essentially, the court said that the addition of wholesale customers was not tangible enough to be properly considered an asset.

In the two decades that followed *Briarcliff*, the circuit courts usually adhered to this reading of *Lincoln Savings*. For instance, in *Colorado Springs National Bank v. United States*, the plaintiff bank attempted to deduct all costs associated with overhauling its credit card system. The court asserted that the costs in question went

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32. 475 F.2d 775 (2d Cir. 1973).
33. See *Briarcliff Candy Corp. v. Comm'r*, 31 T.C.M. 171 (CCH) (1972).
34. See *Briarcliff*, 475 F.2d at 782-83.
35. See id. at 782.
36. See id. at 782-83.
37. See, e.g., infra notes 38-43.
38. 505 F.2d 1185 (10th Cir. 1974).
39. See id. at 1186. When Colorado Springs bought the right to use Master Charge (the Master Card credit system), it had to both supplement and alter its existing credit system to accommodate the high-technology Master Charge
toward modernizing an old business rather than creating a new business altogether. In this way, explained the Tenth Circuit, the expenses were deductible because they did not create a separate and distinct asset. Prior to Lincoln Savings, the credit card system overhaul probably would have been a capital expense because, of course, it would provide benefits extending far beyond the year of the expense.

In the most surprising interpretation of Lincoln Savings, NCNB Corp. v. United States, the Fourth Circuit determined that consulting and application costs associated with establishing new bank branches were currently deductible. The court reasoned that the process of opening new branches was actually an ordinary business practice for NCNB. It managed to characterize the new branches, not as separate and distinct assets, but as vital extensions of the existing organization. NCNB Corp. stands out as the most egregious of the broad circuit court interpretations of Lincoln Savings.

Such creative interpretations of Lincoln Savings were not the only problem. Other circuit courts found ways to interpret the seemingly deduction-friendly language from that case in favor of capitalization. For instance, the Fifth Circuit, in Central Texas Savings & Loan Ass'n v. United States, held that research and attorney's fees for establishing new bank branches were capital. At times, even the Supreme Court itself conveniently shelved its "separate and distinct asset" test.

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40. See id. at 1190.
41. See id. at 1190-91.
42. 684 F.2d 285 (4th Cir. 1982).
43. See id. at 292. Cf. Cent. Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1185-86 (5th Cir. 1984) (holding that research and attorneys' fees for establishing new bank branches are capital expenses).
44. See NCNB, 684 F.2d at 292.
45. See id.
46. 731 F.2d 1181 (5th Cir. 1984).
3. *INDOPCO, Inc. v. Commissioner*\(^4^8\)

In 1992, the Supreme Court found a case that allowed it to clarify the rule of law as set forth in *Lincoln Savings*. *INDOPCO Inc. v. Commissioner*, ended an era of deduction-friendly corporate accounting and became the new benchmark case. It also brought forth what would become a more common and often complex subissue of capitalization: merger and acquisition costs.

The merger costs at issue in *INDOPCO* came about when Unilever United States Inc. ("Unilever") approached one of its suppliers, National Starch and Chemical Corp. ("National Starch") about a friendly takeover.\(^4^9\) The National Starch board of directors hired the investment banking firm of Morgan Stanley & Co. to determine the value of National Starch’s shares and perform the obligatory fairness opinion.\(^5^0\)

Based upon Morgan Stanley’s valuation of their stock, National Starch negotiated for the sale of its stock to Unilever at a price well above what Unilever had originally asked.\(^5^1\) When the deal was complete, Morgan Stanley sent a bill to National Starch for over $2.2 million.\(^5^2\) National Starch proceeded to deduct this entire bill in the single tax year of 1978.\(^5^3\) As might be expected, the IRS disagreed with National Starch’s classification of the investment banking valuation fees as ordinary and necessary expenses under § 162(a).\(^5^4\) National Starch took its case to the Tax Court.\(^5^5\)

After losing in both the Tax Court and the Third Circuit Court of Appeals, National Starch petitioned for certiorari. The Supreme Court granted certiorari with the intention of settling the “perceived

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\(^{49}\) See id. at 80. Unilever was a holding company, with Thomas J. Lipton, Inc. as one of its major subsidiaries. See id. at 80 n.1. National Starch was a Delaware corporation that produced adhesives, starch, and various chemicals. See id. at 80.

\(^{50}\) See id. at 81.

\(^{51}\) See id. Unilever began negotiations with a target price of between $65 and $70 per share. The deal closed at $73.50 per share, which Morgan Stanley agreed was a fair price. See id.

\(^{52}\) See id. at 82. National Starch also had over $500,000 in merger-related legal costs which they did not attempt to deduct. See id.

\(^{53}\) See id. at 81-82.

\(^{54}\) See id. at 82.

\(^{55}\) See id. at 82-83.
conflict" among the courts of appeal regarding the *Lincoln Savings* rule of law. The Supreme Court held that the investment banking fees incurred in a friendly takeover were capital because they would lead directly to long-term benefits for National Starch. In reaching this decision, the Court stressed that although a "separate and distinct" asset will usually be sufficient to require capitalization, it is not necessary. The result: Focus was back on future benefits and away from asset creation.

III. STATEMENT OF THE CASE

A. *The Facts of Wells Fargo & Co. v. Commissioner*  

The petitioner in the original Tax Court action was the Norwest Corporation, a holding company for a large group of finance corporations. Norwest consisted of seventy-nine banks in twelve states, as well as various other financial institutions. The payments that Norwest sought to deduct were incurred by a corporation that it eventually acquired as an affiliate, DBTC ("Davenport").

Davenport, a small regional bank with four branches, served customers in and around the Quad Cities area on the border of Iowa and Illinois. Its stock was traded in modest volume on the

56. Id. at 83.
57. See id. at 88. National Starch tried to downplay the beneficial effects of the merger, calling them "merely incidental," but the Supreme Court pointed to the corporation's own reports touting the benefits of the merger. Id.
58. Id. at 87.
59. Although the creation of assets still required capitalization after *INDOPCO*, the issue received less attention because it was, by then, well settled.
60. 224 F.3d 874 (8th Cir. 2000).
62. See id. Norwest files consolidated federal income tax returns for all its affiliates, which explains why Norwest, rather than New Davenport, appears as the petitioner in this case. See id.
63. See id. The Tax Court opinion refers to this target corporation only as DBTC. See id. at 90. In adopting the Tax Court's factual findings into its opinion, the court of appeals changed all references to DBTC to "Davenport." *Wells Fargo*, 224 F.3d at 876. This Note adopts the circuit court's renaming of DBTC.
64. See Norwest, 112 T.C. at 90-91.
Davenport over-the-counter market. As noted by both the Tax Court and the appeals court in this case, approximately one-third of the bank's 1.2 million shares were held by the founder and his children. These shareholders also served as the corporate officers of Davenport.

When, in 1989, the Iowa legislature allowed banks from bordering states to acquire in-state banks for the first time, Davenport management became concerned that their bank might be left behind in the inevitable reorganization of the Iowa banking industry. Accordingly, when Norwest approached the bank about "joining their businesses," Davenport expressed immediate interest. The board of directors of Davenport authorized its executive officers John K. Figge, James K. Figge, and Thomas K. Figge to obtain outside legal counsel and other professional services to facilitate the merger. The board also appointed its own ad hoc committee of outside directors, responsible for obtaining professional advice on the impending transaction.

The executive officers proceeded to hire the law firm of Lane & Waterman to assist in legal and nonlegal research on the probable

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65. See id. at 91.
66. See id.; Wells Fargo, 224 F.3d at 876 (adopting figures used in the Tax Court proceeding).
67. See Wells Fargo, 224 F.3d at 878.
68. See Norwest, 112 T.C. at 91. The Iowa legislation did not directly allow the merger at issue here since Davenport eventually merged with another Iowa bank, but its perceived effects caused Davenport to entertain Norwest's offer. Davenport feared that, as a result of the legislation, national banks would move into the Quad City market, squeezing Davenport out of the market. See id.
69. Id. at 91. The proposed transaction would have Davenport merge with one of Norwest's affiliated banks—Bettendorf Bank, National Association ("Bettendorf"). The two banks would be consolidated into a national bank called New Davenport. See id. at 93. Bettendorf was a national banking association under charter of the office of the Comptroller of Currency. See id. at 92. The merger would be simplified by the fact that Bettendorf operated exclusively in the same Quad City area as Davenport. See id. at 90-91.
70. See id. at 92. The founder, V.O. Figge, objected to the merger and was not involved in the initial stages of the deal. He later agreed that the merger would benefit both Davenport and its customers. See id. at 92-93.
71. See id. at 92. The committee was also commissioned to perform a due diligence review, and to report to the board on the fairness of the potential deal. See id.
effects of a merger with Norwest. Davenport also enlisted the investment banking services of J.P. Morgan & Co., to perform the customary fairness opinion for the sake of Davenport’s stockholders. Finally, Davenport hired KPMG Peat Marwick to determine if the merger would be considered a reorganization under federal income tax laws, and whether it would qualify for a “desired method of accounting.”

1. The transaction and related expenses

The result of these negotiations was that, in January of 1992, Davenport merged with a Norwest affiliate bank to form a national bank, called New Davenport, owned by Norwest. After the merger, New Davenport operated out of the same offices and four branches that Davenport had previously occupied. It also used the three locations of the former Norwest affiliate bank with which it merged. New Davenport offered expanded products and services, and its board and management overtly expected that “significant long-term benefits” would soon follow.

The participation of the Figge family, as Davenport’s executive officers and major shareholders, was a necessary element in concluding the deal. For instance, Norwest established a voting agreement with John Figge, James Figge, Thomas Figge, and a few other shareholders, whose combined holdings were 24.5% of Davenport’s stock. These shareholders agreed to vote their shares in favor of

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72. See id. Lane & Waterman helped determine whether Davenport would “strategically fit with Norwest and its affiliates, and whether [the deal] would be good for the community.” Id.

73. See id. at 92. Note that a “fairness opinion” was one of the services, along with a valuation of shares, that J.P. Morgan & Co., Inc., performed for National Starch in INDOPCO. See INDOPCO, Inc. v. Comm’r, 503 U.S. 79, 81 (1992).

74. Northwest, 112 T.C. at 92. Again, the facts mirror those in INDOPCO, where the merger was dependant on the initial determination that it would qualify as a tax free reorganization under I.R.C. § 351. See id.; INDOPCO, Inc. v. Comm’r, 503 U.S. 79, 80-81 (1992).

75. See Norwest, 112 T.C. at 92, 94. The Davenport affiliate referred to was Bettendorf (BBNA).

76. See id. at 95.

77. See id.

78. Id.

79. See id. at 93.
transaction and otherwise render assistance in pushing the merger to completion. These same members of the Figge family, with the addition of V.O. Figge, Davenport's founder, contracted with Norwest to ensure that they would be employed as officers of the new Davenport. Nonetheless, Davenport's officers were paid the same salaries during the period in which they helped facilitate the merger as in previous years.

2. Davenport's 1991 federal income tax return

Davenport properly capitalized under § 263 all fees paid to J.P. Morgan and KPMG Peat Marwick—undoubtedly because Davenport's accountants were aware of the INDOPCO rule of law and the unmistakable similarities between the fees at issue in that case and the fees in the instant case. But, Davenport proceeded to deduct the full bill of $474,018 for the legal services of Lane & Waterman. The IRS took exception to this deduction and issued a deficiency notice. Davenport conceded that they erred in deducting the entire bill, and alleged that the proper deduction should have been for only those investigatory services rendered prior to the decision to merge, or $111,270.

Davenport also deducted its officers' salaries for the 1991 tax year. A total of $150,000 worth of the salaries could be attributed to work performed in the transaction. The IRS again responded by

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80. See id.
81. See id. John, James, and Thomas Figge were to be made senior vice-presidents of the new bank, and the other members of the board were assured positions on the board of directors. See id.
82. See id. at 96.
83. See id.
84. See INDOPCO, Inc. v. Comm'r, 503 U.S. 79 (1992); Norwest Corp. v. Comm'r, 112 T.C. 89 (1999). Petitioners in both cases are smaller firms being absorbed into larger corporations. The fees in the cases covered investment banking fairness opinions and due diligence, and both transactions hinged on whether or not the transaction would qualify as a tax-free reorganization under I.R.C. § 351.
85. See Northwest, 112 T.C. at 95.
86. The existence of the deficiency notice is inferred from the venue of the original action.
87. See Northwest, 112 T.C. at 95.
88. See id. at 96.
demanding that the $150,000 be capitalized under § 263. The case was brought before the Tax Court.

B. The United States Tax Court Decision

The Tax Court chose not to address the deductibility of the investment banking fees.\(^9\) Perhaps not wishing to issue an advisory opinion, the court noted that petitioners had conceded to capitalization of these expenses.\(^9\) However, the court went on to introduce the issues of the officers' salaries and legal fees\(^9\)—issues the court lumped together and dispensed as essentially identical.

The court held that none of the expenses Davenport claimed as deductions were actually deductible under § 162(a).\(^9\) It framed the current state of case law in this way: *INDOPCO* demands that an expense is capital if it creates a long-term benefit, but an expense is also capital if it creates a separate and distinct asset.\(^9\) In other words, *INDOPCO* had not overturned any part of the *Lincoln Savings* holding, it had simply added a new requirement on top of the existing ones from *Lincoln Savings*.\(^9\)

Following a review of the holdings in *INDOPCO*, *Victory Markets v. Commissioner*,\(^9\) and *A.E. Staley Manufacturing v. Commissioner*,\(^9\) the Tax Court labored to analogize the cases with the facts of the present case. Ultimately, it concluded:

The disputed expenses are mostly preparatory expenses that enabled [Davenport] to achieve the long-term benefit that it desired from the transaction, and the fact that the costs were

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89. See id.
90. See id.
91. See id.
92. See id. at 97.
93. See id.
94. It seems that this interpretation of *INDOPCO* is the strictest of all interpretations in favor of capitalization. By preserving the old barrier and creating a new one, both of which are mandatory, the Tax Court would leave a very narrow, if not nonexistent margin, for deductible expenses related to corporate consolidations.
95. 99 T.C. 648 (1992) (holding that *INDOPCO* prohibits current deductions of expenses for professional services incurred incident to a takeover that was not hostile).
96. 105 T.C. 166 (1995) (holding that investment banking fees related to a takeover are capital in nature).
incurred before [Davenport's] management formally decided to enter into the transaction does not change the fact that all these costs [must be capitalized because they were] sufficiently related to the transaction. In accordance with INDOPCO, the costs must be capitalized . . . . 97

The court held that Davenport "may not deduct any of the disputed costs because all costs . . . produced a significant long-term benefit."98 No indication was given as to what "significant" might mean in this context. Not satisfied with the Tax Court's standard for the requisite relationship between the expense and benefit, Davenport appealed to the Eighth Circuit.

C. The Eighth Circuit Reverses in Part

Justice Hand began his analysis with a breakdown of INDOPCO and Lincoln Savings, recognizing that there are only four possible combinations of asset creation and future benefit.99 The court said that three of the four possible combinations produce absolute results.100 The presence of a separate asset will require capitalization, whether or not there is a future benefit. And, of course, no asset and no benefit will never warrant capitalization. However, Justice Hand noted that, unfortunately, the expenditures at issue in the instant case fall into a nebulous, fourth category: no separate asset, but long-term benefits.101 The Tax Court, he said, erred when it jumped to the conclusion that the presence of a future benefit always requires capitalization.102 The Tax Court should have performed an "independent

97. Norwest, 112 T.C. at 100 (emphasis added).
98. Id. at 102. Although the Tax Court must have assumed that the figures for "disputed costs" were apparent from the rest of the opinion, the Eighth Circuit clarified them as: "$150,000 worth of salaries paid to Davenport's corporate officers [and] . . . $111,270 of fees and disbursement paid to Davenport's attorneys." Wells Fargo & Co. v. Comm'r, 224 F.3d 874, 876 (2000). Without this clarification, one might wonder whether the Tax Court considered, for instance, all officer salaries from 1991 to be "disputed costs."
99. See Wells Fargo, 224 F.3d at 879-85. The "four combinations" were not labeled as such, but the suggestion is there. At the risk of stating the obvious, they are: (1) asset and benefit, (2) asset and no benefit, (3) benefit and no asset, and (4) no asset and no benefit.
100. See id.
101. See id. at 885.
102. See id. at 886.
and appropriate legal analysis to determine whether each of the expenditures at issue were ‘ordinary.’” At this point the Court lamented that “[t]here is no easy answer for this question.”

The court went on to address the issue of officer salaries. Following a brief historical argument in favor of deduction for all officer salaries, the court introduced the “origin of the claim doctrine.” Justice Hand argued that, although this doctrine was originally used to differentiate between personal and business expenses, it should apply to officer salary capitalization issues as well. If the expense is directly related to the transaction that provides a benefit, it should be capitalized. But if it is only indirectly related, then it may be currently deducted. Applying the newly coined test, the court concluded that Davenport’s officer salaries were only indirectly related because they arose from a preexisting employment relationship. The salaries were held fully deductible.

The remaining question was what to do with a disputed $27,820 of legal bills. The circuit court preferred a temporal test, where the defining moment was the final decision to go ahead with the transaction. Under that test, costs preceding the final decision were termed “investigatory costs” and held currently deductible. Any bills for work done after the decision were deemed too closely related to a future benefit. On this issue, the Tax Court was upheld.

103. Id. (emphasis added).
104. Id. at 884.
105. See id. at 886.
106. Id.
107. See id. at 886-87.
108. See id. at 887.
109. See id. at 888.
110. See id.
111. See id.
112. See id. at 888-89.
113. See id. at 889.
114. See id.
115. See id. Justice Bright wrote a brief concurring opinion emphasizing the importance of extensive fact-finding at the Tax Court level, especially with regard to the direct or indirect relationship between the officers’ work and the transaction. See id. at 889-90.
IV. ANALYSIS

A. The Direct/Indirect Test for Officer Salaries

On the issue of deductibility of officer salaries during merger, the Eighth Circuit created the direct/indirect test. The test raises a couple of concerns. The first is that, in merger cases, it offers no answer to the question of what kinds of future benefits lead to capitalization in the absence of asset creation. The second is that the Wells Fargo opinion suggests applicability of the direct/indirect test outside of the merger context. In general deductibility cases, the language of the test is so vague as to render it impossible to apply with consistency.

1. Why the test fails

The issue of future benefits actually embodies two subissues: (1) what kinds of future benefits require capitalization, and (2) what relationship must exist between the expense and the future benefit to warrant capitalization? The capitalization cases since INDOPCO, and indeed INDOPCO itself, tend to focus on one or the other of these issues, never seeming to realize both subissues in any given case. The direct/indirect test addresses only this second question. It speaks to the relationship of a portion of officer salary to the “transaction which provides a long term benefit.” However, the very nature of this two-pronged issue demands that one subissue be resolved before the other. Without first determining what kinds of future benefits must result from the merger, the relationship issue is meaningless.

The problem becomes evident when the direct/indirect test is applied. The test was never actually applied in the Wells Fargo opinion because there were no specific costs on record upon which to apply the test. Justice Bright was correct, in concurrence, to regret

116. Id. at 886.
117. The court said, “Upon consideration of the facts and circumstances of this case, we determine that Davenport’s salary expenses are directly related to (and arise out of) the employment relationship, and are only indirectly related to the acquisition itself.” Id. at 888 (Bright, J., concurring). But the stipulated facts adopted from the Tax Court do not contain any “facts and circumstances” pertaining to the nature of work to which the officer salaries were attributable.
that the Tax Court record lacked specific facts as to what "officers' time [was] devoted to the acquisition as compared to time spent on regular work during a particular and relevant time period." Without such facts, the court was not able to apply the test. But instead of remanding for further factual determinations, the court chose to render a decision.119

In the absence of actual facts from the case, one can only try to apply the direct/indirect test to a hypothetical quantity of work hours. Take, for instance, a meeting between Davenport officers and Norwest officers discussing the impending due diligence review by Norwest. Applying the direct/indirect test to this meeting, some significant crossover appears between "work directly related to the employment relationship" and "work directly related to the capital transaction." For instance, during this meeting, the Davenport officers' fiduciary duty to the shareholders comes directly from the employment relationship. As full-time employees, rather than independent contractors, the officers' very presence at the meeting also stems directly from the employment relationship. Yet the meeting would not have taken place but for the impending transaction, and thus, one could argue, it is directly related to the transaction. Of course, the final decision to merge has not yet been made, so the meeting may not be directly related to the transaction in that sense. The argument could continue in this fashion, but the point is that the direct/indirect test hales its own interpretive mess. It requires a preliminary determination of whether corporate officer salaries, the "expense" in question, should be considered (1) compensation for acting...
as a fiduciary, (2) the terms of an employment contract, or (3) a variable depending on the demands of the job.

The direct/indirect test is a semantics nightmare because it demands such difficult preliminary determinations. Ultimately, the test laid out by the Eighth Circuit adds another layer of jargon to an already complicated issue and its growing body of precedent. This particular issue, more than most in tax law, calls for application of rules over standards. This assertion will be discussed more thoroughly infra.

2. The test should have been limited to officer salary issues

Another concern is that the court failed to limit the direct/indirect test to issues of officer salaries. On the one hand, the court's own use of the test implies that it should be limited to determining the tax status of officer salaries. After all, the court employed the test only in the subsection of the opinion that addressed officer salaries, and then abandoned the test as it moved to the issue of attorney's fees. However, when the court introduced the test, it explained: "Although the 'origin of the claim doctrine' was originally used to distinguish personal expenses from business expenses, it has been extended to distinguish capital business expenses from ordinary expenses." This is basically an invitation to future courts and litigants to apply the test to issues of capital expenditures generally.

The court also explained how the direct/indirect test is derived from the holding of INDOPCO. The problem is, INDOPCO did not involve questions of officer salaries. Taking the direct/indirect test outside the context of officer salaries creates the impetus for future litigants and lower courts to expand the test beyond its use in this case. At least when the direct/indirect test was applied to officer salaries, it tended to preserve the outcome determinations of the controlling statutes. When allowed outside this context, the test completely falls apart.

124. See Wells Fargo, 224 F.3d at 886-89.
125. Id. at 886.
126. "The INDOPCO case addressed costs which were directly related to the acquisition, while the instant case involves costs which were only indirectly related to the acquisition." Id. at 886.
If the direct/indirect test is applied to other typical capitalization issues, it no longer follows the outline of § 263. For instance, what happens when courts employ this test in deciding the tax status of advertisement consulting expenses, which are generally accepted as deductible? The payment of advertising fees essentially is the transaction that provides the long-term benefit. This test would demand capitalization for a historically deductible expense. It would require overturning a long and well-established line of precedent.

The direct/indirect test would also seem to require capitalization of loan origination expenses (LOEs) since they, too, directly relate to the "transaction" which provides the long-term benefit. LOEs are, in fact, the cost of the loan transaction itself. It is hard to imagine how they could be more "directly" related to the transaction. Yet LOEs are one of the most ordinary and necessary services a bank performs. The examples of divergence between the direct/indirect test and longstanding principles in the law of capitalization and deduction could continue ad nauseam.

3. A better approach

The tax classification of officer salaries during times of reorganization has been and will be a recurring issue, and those instances of recurrence will have little, usually negligible, factual variations.

127. See, e.g., Treas. Reg. § 1.162-1(a); Colonial Ice Cream, Co. v. Comm'r, 7 B.T.A. 154, 156-57 (1927).
128. Wells Fargo, 224 F.3d at 886.
129. See id. at 886-89.
130. See generally Roger T. Weitkamp, Taxation of Loan Origination Expenditures: Lenders May No Longer Bank on Deductibility, 16 GA. ST. U. L. REV. 477 (1999) (outlining how the IRS is systematically attacking the traditionally deductible status of LOEs); Alan B. Rosenthal, Comment, Deductibility of Loan Origination Costs, 43 BUFF. L. REV. 263 (1995) (arguing that the future of LOEs will move away from deduction toward capitalization).
131. Such examples would include repairs, start-up costs, and hazardous waste removal; each of which has its own body of law that is either inconsistent with, or difficult to apply to the terms of the direct/indirect test. See, e.g., Treas. Reg. § 1.162-4 (1995) (repair costs); Treas. Reg. § 1.263(a)-2(a) (1995) (repair costs); I.R.C. § 195(a)-(c) (1995) (start-up costs); Midland Empire Packing Co. v. Comm'r, 14 T.C. 635 (1950) (hazardous waste removal).
132. Despite the likelihood of recurrence, the issue is narrow by definition,
For that reason, the issue demands a rule-like judicial test. Such a test would prove more efficient—both judicially and administratively—while preserving the benefits of a more discretionary standard.

A preferable test would ask, simply, whether the corporate officers were paid higher salaries during the period of acquisition. A negative answer would create the judicial presumption that the salaries were ordinary, and thus, deductible. If the matter went to court, the burden would be on the IRS to overcome the presumption by proving that a specific portion of the officer salaries for the year of reorganization can be attributed to work facilitating merger. On the other hand, an affirmative answer would create the presumption that the difference between the new salaries and the salaries of the last full fiscal year before merger efforts began, is capital. The corporation would then have the burden of proving that the increased salary was attributable to something other than merger-related work. For continuing reference, this test will be called the “relative salaries” test.

Consider what this test does for efficiency. On the broadest level of this argument lies the ideal behind stare decisis. As more and more cases arise, the courts decide how each set of unique factual circumstances fares against the backdrop of the statute or common law rule. Theoretically, there should come a day when all possible fact patterns have been exhausted, and the outcome of a given case is totally predetermined. The test suggested here carves out two possible factual situations—(1) where the salaries are the same as in previous years, and (2) where the salaries are different—and provides outcomes for each. Tax practitioners, accountants, and the IRS would now have something solid upon which to make decisions in this area. The test in Wells Fargo, by contrast, adds more complexity to the linguistic backdrop against which fact patterns must be having three qualifiers: merger, officer, and salaries. These ensure little factual variation from instance to instance compared to, for example, personal versus business expenditures.

133. A necessary precursor to this question is whether the fees in dispute were paid to officers of the corporation claiming deduction, or to independently contracted professional services. If the fees were paid to independent contractors, then there is no need for this proposed test. In those cases, one should defer to the court’s analysis for legal fees in the instant case.
Notice, also, that the relative salaries test eliminates the two major problems with the direct/indirect test discussed in the previous subsections. First, no initial interpretation is needed because the test speaks in terms of relative dollar amounts. Second, the vocabulary of the test itself ensures that courts cannot apply it to general capitalization and deduction issues. The test contains the word “salary,” making it irrelevant to issues of LOEs, advertising expenses, and other deduction issues.

Essentially, the argument unfolding here falls within the rules-versus-standard debate. It advocates a rulelike approach to deductibility of officer salaries during merger. The relative salaries test occupies a place somewhere near the rule’s end of the rule/standard continuum—at least compared to the Wells Fargo test. By one popular definition of “rule,” the relative salaries test is a rule because it is given substance ex ante. That is, the test’s outcome depends upon a predetermined value, albeit a relative value. However, to the extent that the test creates a rebuttable presumption, it retains qualities of a standard. Compare this to the direct/indirect test, which can only be given content ex post. Each new application of the direct/indirect test requires new determinations of the meaning of the words direct and indirect with respect to the specific expense and transaction.

One of the cornerstones of the rule-versus-standards debate is the notion that rules are more costly for the government to formulate, while standards are more costly for the taxpayer to understand. This author would suggest that when the court, as opposed to the

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135. Professor Kaplow explains that rules and standards are not “pure types” and that most laws retain qualities of both. See Kaplow, supra note 136, at 561-62.

136. See id.

137. See, e.g., id.
legislature, creates rules, the cost of formulation all but disappears. The court need not determine the range of probable fact patterns in a given area of law. It need only work with one fact pattern at a time, which has been carefully packaged and delivered. On the other hand, a standard like the direct/indirect test will increase costs to taxpayers and the IRS. Taxpayers, naturally, will interpret the test as favorable to deduction while the IRS will interpret it as favorable to capitalization. The result, of course, will be increased litigation and expense.

The relative salaries test would also avoid a common criticism of rules, that they are over- and underinclusive,\textsuperscript{138} because the test’s initial determination merely creates a rebuttable presumption. Admittedly, there will be instances where corporate officer salaries remain equal from merger years to previous years, even though the officers have dedicated substantial, compensated time to merger efforts. In these cases, the test would seem underinclusive—allowing for current deduction when capitalization is proper. Conversely, the test would become overinclusive where an inflation in the corporation’s officer salaries happens to coincide with a merger. But again, the relative salaries test creates a rebuttable presumption to cover these instances. In the overinclusive scenario, an innocent corporation should find little trouble overcoming the presumption, with its inherent knowledge of its own compensation scheme and schedule of raises. In the underinclusive scenario, the IRS would encounter a similarly light burden by virtue of the fact that major corporate reorganizations tend to leave major paper trails.

The courts should consider that tax law is an area of law examined closely by many nonlawyer professionals. Accountants and IRS agents are not accustomed to the idiosyncrasies of legal theory; to balancing tests and terms of art. They “crunch numbers” and they expect no less of the judicial system which so often affects the formulas they use. The test advocated here offers yes and no answers, and specifies who and what must be shown when the parties do not agree with those answers. This helps potential parties make better-educated decisions about the likely outcome of challenging a claim or ruling. The parties would have a better idea of what the court will

\textsuperscript{138} See id. at 586-95.
presume, and exactly what evidence will be required if they expect to overcome the presumption. Potential litigants would not have to gamble on how the next court might interpret the nebulous words of the last.

B. Wells Fargo’s Effect on Capitalization Cases Generally

1. Defining future benefits?

Since *INDOPCO*, there have been few, if any, judicially constructed parameters on the “future benefits” language from that case. Wells Fargo, coupled with the recent *PNC Bancorp* case, mark the only significant circuit court attempts at setting those parameters. The decision in this case was heavily anticipated for its interpretation of *INDOPCO*. But if *Wells Fargo* is to be interpreted as an effort to further define the future benefits test of *INDOPCO*, it cannot be seen as a very effective one.

The circuit court plainly leads up to the expectation that it will discuss exactly what kinds of future benefits do, in fact, warrant capitalization. But when it comes to doing an actual analysis based on the facts of the case, the court diverts its attention to the question of how “directly” related the expense must be to the benefit. Whereas past merger cases have often played with the notion that not all mergers produce benefit, the *Wells Fargo* court either chose to overlook the issue, or did not realize it existed. The court


140. See *PNC Bancorp*, 212 F.3d at 822 (3d Cir. 2000).

141. At the end of the “Issues of Law” section of the opinion, Justice Hand explained that where there is no separate and distinct asset, but an anticipated future benefit, “there is no easy answer.” *Wells Fargo & Co.* v. Comm’r, 224 F.3d 874, 885 (2000). The expectation is that the subsequent section will attempt an answer.

142. See 224 F.3d at 886-90; *supra* notes 66-94 and accompanying text.

143. Justice Blackmun wrote in *INDOPCO*, “Although petitioner attempts to dismiss the benefits that accrued to National Starch from the Unilever acquisition as ‘entirely speculative’ or ‘merely incidental,’ the Tax Court’s and the Court of Appeals’ findings that the transaction produced significant benefits to National Starch that extended beyond the tax year in question are amply supported by the record.” *INDOPCO*, Inc. v. Comm’r, 503 U.S. 79, 88 (1992)
seemed to take for granted that corporate mergers always produce benefits for the parties involved. Whether they do or not should be a question which turns on the unique facts of each case. So, it seems that while the Eighth Circuit was attempting to curtail IRS encroachment into traditionally deductible areas, the court may have overlooked half of the issue.

To be fair, determining whether a merger has resulted in benefits cannot practically be done within the same tax year that the merger occurs. Without the benefit of a crystal ball, the court can only assume one way or the other. And given that the court must make an assumption, the more rational assumption is that the merger would result in benefit to the corporation. For one, corporations do not normally merge without good reason to believe that the merger will improve the bottom line. And in this particular case, the board of directors of Davenport actually issued a statement to the stockholders, saying that it believed the merger would result in benefits to the bank. To that extent, it would have been logical for the court to assume that the merger would produce future benefits.

The problem, however, is that the court should have made its assumption explicit, and limited such an assumption to friendly merger cases. Instead, Wells Fargo practically begs Service agents to misread its holding. For instance, in the context of capitalization and deduction cases generally, Wells Fargo seems to unwittingly support a presumption of future benefits sufficient for capitalization in any case where the question arises. It tacitly bypassed the issue of what kinds of future benefits suffice, but in doing so, resolves the issue in favor of capitalization. Otherwise, the court would never have had to address the relatedness of the benefit to the expense.

In the narrower context of mergers and acquisitions, A.E. Staley made it clear that the Service wants to capitalize acquisition-related expenses, regardless of whether the acquisition was friendly or hostile. Considering that the difference between a friendly and hostile takeover is usually in future benefits to the acquired company, Wells Fargo implicitly supports the Service's position that future benefits sufficient for capitalization should be presumed in any corporate merger.

(citation omitted).

144. See Wells Fargo, 224 F.3d at 878.
As an addition to the body of precedent, *Wells Fargo* will place more focus on the relationship between the expense and benefit, while allowing that any *potential* future benefit is the equivalent of an asset under § 263. This result is far from desirable. Common sense dictates that not every business expense creates a future benefit. To ignore this aspect of the issue is to turn away from the overarching principle of matching.

2. The favorable view of *Wells Fargo*

Finally, this Note arrives at an opportunity to explore a positive aspect of *Wells Fargo*. Despite a problematic test on the question of deductibility of officer salaries during merger, the end result of the test as applied in this case is favorable. It seems to set an appropriate standard for the requisite relatedness of the future benefit to the expense, despite the problems with the formulation of that standard.

The Tax Court had agreed with the Service agents’ view that an expense need only be “incidentally connected” to a future benefit.¹⁴⁵ Regardless of the problems with the direct/indirect test, it makes clear that the Eighth Circuit categorically rejects the “incidentally connected” theory.¹⁴⁶ Rightly so, because *any* expense can be characterized as incidentally connected with a future benefit. Considering that the “future benefits” language of *INDOPCO* has yet to be narrowed in any notable way, it was almost imperative that the “incidentally connected” test—another test extremely favorable to capitalization—be wiped out. Had the circuit court not drawn the proverbial line where it did, one might wonder what business expenses, at all, would remain to currently deduct. As discussed in the previous subsection of this Note, the means by which the court curtailed the Tax Court’s language leaves something to be desired in the realm of clarity and practical application, but the fact that it actually did was crucial.

V. CONCLUSION

When courts attempt to sort through the vague standards of *INDOPCO*, and the equally vague statutes, they should rule with a

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¹⁴⁵ Id. at 885.
¹⁴⁶ See id.
mind toward practicality. Tax law often lends itself nicely to rules creation; with fact patterns that are likely to recur in substantially similar forms. The Eighth Circuit in this case should have taken the opportunity to taper the language of \textit{INDOPCO} and relevant statutes. Instead, the court unwisely broadened that language with a superfluous test. Perhaps this is good for the business of tax practitioners who will earn more fees trying to sort through the latest judicial exercise in semantics—but that, of course, is not the goal. The goal should be eliminating abuses, rather than encouraging those who will be tempted to interpret broad language in their favor. The goal should be working toward an established statutory interpretation where tax practitioners, accountants, and Service agents can determine, at first glance, the tax status of a given business expense.

This Note does not advocate going back to pre-\textit{INDOPCO} times, when deductibility was a somewhat reliable conclusion for the expenses discussed herein. Indeed, the ubiquitous principle of matching seems to demand more capitalization than was the standard before \textit{INDOPCO}. However, in authoring a new era of statutory interpretation, as the courts must do to clean up the \textit{INDOPCO} standard, the desirable outcome will place narrower rules upon the existing standards.

\textit{Brodie H. Smith}\footnote{J.D. candidate, May 2002. I would like to thank Professor Katherine Pratt for her generous advice at critical points in the writing of this Note. I dedicate this Note to Thomas H. Smith, my father and mentor.}