Santa Fe Pacific Gold Company v. Comm'r

132 T.C. 240 (2009)

[Santa Fe Pacific Gold Co. ("Santa Fe", sometimes "South)) entered a merger agreement with Homestake, a similarly sized mining company, to avoid a hostile takeover by Newmont (sometimes "North"), a larger company. The agreement included a termination fee clause requiring the payment of $65 million in case of a breach. When Newmont made an offer that Homestake could not match, it became obvious that Santa Fe could not resist a takeover, and it breached the merger agreement with Homestake. Santa Fe claimed a $65 million deduction for the termination fee it paid to Homestake. The deduction was disallowed by the IRS, which argued that the fee was a capital expense.]

Deductibility vs. Capitalization

For Federal income tax purposes the principal difference between classifying a payment as a deductible expense or a capital expenditure concerns the timing of the taxpayer's recovery of the cost. As the Supreme Court observed in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 83-84 (1992):

> The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery: While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise. * * * Through provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. * * *

Section 162(a) allows as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business". To qualify for a deduction, "an item must (1) be 'paid or incurred during the taxable year,' (2) be for 'carrying on any trade or business,' (3) be an 'expense,' (4) be a 'necessary' expense, and (5) be an 'ordinary' expense." *Commissioner v. Lincoln Sav. & Loan Association*, 403 U.S. 345, 352 (1971). Section 165(a) allows as a deduction "any loss sustained during the taxable year and not compensated for by insurance or otherwise."

An expense may be ordinary even if it rarely occurs or occurs only once within the lifetime of the taxpayer. *Welch v. Helvering*. Although the transaction may be unique to the individual taxpayer, the question is whether the transaction is ordinary in the "life of the group, the community, of which * * * [the taxpayer] is a part." *Id*. An expense is necessary if it meets "the minimal requirement that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business.'" *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966) (quoting *Welch v. Helvering*). A deduction is generally allowed for expenses incurred in defending a business and its policies from attack. *INDOPCO, Inc. v. Commissioner*; *Commissioner v. Tellier*; *Commissioner v. Heininger*, 320 U.S. 467 (1943); see also *Locke Manufacturing Cos. v. United States*, 237 F. Supp. 80 (D. Conn. 1964) (permitting corporation to deduct expenses incurred in successful defense to proxy fight). The underlying reasoning in this line of cases is that the expenses were incurred to protect corporate policy and structure, not to acquire a new asset. See, e.g., *United States v. Federated Dept. Stores, Inc.*, 171 Bankr. 603, 610 (S.D. Ohio 1994), *affg. In re Federated Dept. Stores, Inc.*, 135 Bankr. 950 (Bankr. S.D. Ohio 1992).

Section 263(a)(1) generally provides that a deduction is not allowed for "Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

The determination of whether an expenditure is deductible under section 162(a) or must be capitalized under section 263(a)(1) is a factual determination. When an expense creates a separate and distinct asset, it usually must be capitalized. See, e.g., *Commissioner v. Lincoln Sav. & Loan Association*. When an expense does not create such an asset, the most critical factors to consider in passing on the question of deductibility are the period over which the taxpayer will derive a benefit from the expense and the significance of that benefit. See *INDOPCO, Inc. v. Commissioner*, *United States v. Miss. Chem. Corp.*, 405 U.S. 298, 310 (1972); *FMR Corp. & Subs. v. Commissioner*, 110 T.C. 402, 417 (1998); *Conn. Mut. Life Ins. Co. v. Commissioner*, 106 T.C. 445, 453 (1996). Expenses must generally be capitalized when they either: (1) Create or enhance a separate and distinct asset, or (2) otherwise generate significant benefits for the taxpayer extending beyond the end of the taxable year. *Metrocorp, Inc. v. Commissioner*, 116 T.C. 211, 222 (2001). Under the required test, capitalization is not always required when an incidental future benefit is generated by an expense. *INDOPCO, Inc. v. Commissioner*. "Whether a benefit is significant to the taxpayer who incurs the underlying expense rests on the duration and extent of the benefit, and a future benefit that flows incidentally from an expense may not be significant." *Metrocorp, Inc. v. Commissioner*.

Origin of the Claim Doctrine

The issue of whether expenses are deductible or must be capitalized may be resolved by the origin of the claim test. *Woodward v. Commissioner*, 397 U.S. 572 (1970); *United States v. Gilmore*, 372 U.S. 39 (1963). Under this test, the substance of the underlying claim or transaction out of which the expenditure in controversy arose governs whether the item is a deductible expense or a capital expenditure, regardless of the motives of the payor or the consequences that may result from the failure to defeat the claim. The origin of the claim test does not involve a "mechanical search for the first in the chain of events" but requires consideration of the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the amounts claimed as deductions were expended, and all other facts relating to the litigation. *Boagni v. Commissioner*, 59 T.C. 708, 713 (1973). The Supreme Court, in adopting the origin of the claim test, chose in favor of

> the view that the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was "business" or "personal" and hence whether it is deductible or not under § 23(a)(2). * * *

United States v. Gilmore.

The origin of the claim doctrine can help determine whether the termination fee should be deducted or capitalized by determining whether it is more closely tied to the Santa Fe-Homestake deal or the Santa Fe-Newmont deal.

Analysis

As discussed above, we must determine whether payment of the termination fee "[generated] significant benefits for * * * [Santa Fe] extending beyond the end of the taxable year." *Metrocorp. Inc. v. Commissioner*, 116 T.C. at 222. As we stated in *Metrocorp:* "Expenses must generally be capitalized when they either: (1) Create or enhance a separate and distinct asset or (2) otherwise generate significant benefits for the taxpayer extending beyond the end of the taxable year." Id. at 221-222. However, we must take care not to interpret every benefit received after payment of the termination fee as being caused by or related to the termination fee.

We note at the outset that this was clearly a hostile takeover of Santa Fe by Newmont. The management, board of directors, and investment bankers of Santa Fe considered Newmont hostile. Although initial contacts between the two entities were informal, Newmont went directly to Santa Fe's shareholders once it learned that Santa Fe and Homestake had entered into an agreement. The presentations Goldman Sachs made to Newmont executives clearly foresaw a hostile takeover. Mr. Cambre's letters to the Newmont board anticipated a fight and warned the board that this would lead to higher costs.

Executives of Santa Fe, Newmont, and Homestake all testified credibly that this was a hostile takeover. Further, we find credible petitioner's expert Mr. Matthews's conclusion that this was a hostile takeover. Respondent's expert's contention that this was a friendly transaction is at odds with the record as a whole and is not credible.

Although the merger was described in terms of "shared synergies", the only synergy found in the transaction benefited Newmont. By acquiring Santa Fe, Newmont was able to obtain Santa Fe's land while disregarding most of Santa Fe's annual expenses. The record makes clear that Newmont was primarily interested in obtaining Santa Fe's land position, and the only way for Newmont to acquire Santa Fe's land was to purchase the entire company. Because Newmont was primarily interested in Santa Fe's land, it quickly terminated Santa Fe's employees and discarded the business plans of Santa Fe's management. Although Santa Fe the entity continued to exist on paper, it was nothing more than a shell owning valuable land.

Santa Fe did not reap the types of benefits present in *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992). After the merger was completed, Newmont shut down Santa Fe's headquarters and let go most of its management. The Supreme Court's decision in *INDOPCO, Inc.* to require capitalization of the fees at issue therein relied on findings of this Court and the Court of Appeals for the Second Circuit that the expenditures at issue benefited the operations of the taxpayer incurring the fees. Santa Fe's operations did not benefit from payment of the termination fee.

Santa Fe's executives testified credibly that Santa Fe did not have as a strategic goal a business merger with any other mining company. Newmont was a hostile acquirer. In attempting to avoid Newmont's overtures, Santa Fe sought a white knight: Homestake. Santa Fe was defending against an unwanted acquisition in an effort to maintain and protect its growing business. The termination fee was contracted for in an attempt to salvage its business plan and employees through a white knight combination. See *United States v. Federated Dept. Stores, Inc.*, 171 Bankr. at 610.

The termination fee was intended to protect the Santa Fe-Homestake agreement, to deter competing bids, and to reimburse Homestake for its time and effort in the event that the deal was terminated. Although Santa Fe had structural defenses in place, its major defensive strategy was to engage in a capital transaction with a third party that would prevent Newmont's acquisition. This attempt failed. The record does not support a finding, and we do not find, that paying the termination fee produced any long-term benefit. See id. Respondent argues that *Federated Dept. Stores* is distinguishable on the facts because Santa Fe allegedly did not engage in defensive measures; however, the District Court in Federated Dept. Stores stated that the targets "engaged in defensive measures — the white knight proposals with DeBartolo and Macy respectively." Id. The white knight transactions in *Federated Dept. Stores* were in fact viewed by the court as defensive measures meant to prevent the respective takeovers. The Santa Fe-Homestake agreement was a defensive measure meant to prevent Newmont's takeover of Santa Fe. The termination fee was a part of the Santa Fe-Homestake agreement and served as a defense against Newmont. Any benefit as a result of incurring the termination fee died along with the Santa Fe-Homestake agreement. Had Santa Fe's shareholders rejected the Santa Fe-Newmont agreement, or had some exigent circumstance arisen that required termination of the Santa Fe-Newmont agreement, Santa Fe would not have recovered the $65 million.

Although the fact that National Starch became a subsidiary as a result of its merger was viewed as a benefit supporting capitalization in *INDOPCO, Inc.*, we do not find Santa Fe's becoming a subsidiary to be a significant benefit. In *INDOPCO, Inc.*, National Starch's management viewed becoming a subsidiary as a positive aspect of the acquisition because it relieved National Starch of its shareholder responsibilities. The Supreme Court relied on this change of ownership in support of its decision to require capitalization precisely because the change in ownership structure served to benefit National Starch's operations. In the instant case, Santa Fe did not become a subsidiary which functioned much as Santa Fe had before the merger. Santa Fe no longer functioned as an autonomous business after the merger. Santa Fe viewed Homestake as a potential white knight to avoid just this result. Santa Fe management sought an agreement with Homestake to avoid being absorbed by Newmont, but the results of the Newmont merger confirm the accuracy of their concerns that Santa Fe would lose its operating identity in a merger with Newmont.

As stated above, the record does not support a finding that Santa Fe had as an overarching goal a business combination. The fact that the Santa Fe board had hired investment advisers and knew the state of the industry before initiating contact with Newmont does not mean that Santa Fe had decided on a corporate restructuring. Santa Fe executives testified credibly that Santa Fe's first contact with Newmont was meant to be preventative and meant to enable Santa Fe to remain in control of any investigation and agreement. The Santa Fe-Newmont agreement was not a modified form of the Santa Fe-Homestake agreement. Payment of the termination fee and subsequent signing of the Santa Fe-Newmont agreement was not, in substance, a continuation of the Santa Fe-Homestake agreement in some modified form. The two transactions were separate: (1) A white knight transaction; and (2) a hostile takeover. See *United States v. Federated Dept. Stores Inc.*

Santa Fe viewed Newmont's overtures as hostile; and in an attempt to defeat Newmont's takeover, Santa Fe sought out Homestake as a white knight. Because Newmont's offer was higher than Homestake's, the Santa Fe board believed that in order to fulfill its fiduciary duties the board had to terminate its agreement with Homestake and accept Newmont's higher offer. The facts do not support respondent's contention that the termination fee was paid to restructure Santa Fe in hopes of some future benefit. See id. The termination fee was paid to Homestake to compensate it for whatever expenses it incurred. See id. As the District Court concluded in Federated Department Stores: "in the instant case, the white knight mergers were abandoned. Any effect that this merger had on the later merger with Campeau is irrelevant." Id. at 611-612.