

Bond Case Briefs

Municipal Finance Law Since 1971

IRS LTR: Lawsuit Settlement Liabilities Were Deductible Business Expenses.

The IRS ruled that liabilities, including legal fees and other expenses, incurred by a corporation to settle a lawsuit stemming from alleged securities law violations are deductible as ordinary and necessary business expenses under section 162 because the acts that gave rise to the litigation were performed in the ordinary conduct of business.

Third Party Communication: None
Date of Communication: Not Applicable
Person To Contact: * * *
Telephone Number: * * *

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TY: * * *

LEGEND:

Taxpayer = * * *
Target = * * *
Date 1 = * * *
Year 1 = * * *
Date 2 = * * *
Date 3 = * * *
Year 2 = * * *
Year 3 = * * *
Amount 1 = * * *

Dear * * *: This is in response to your request for a ruling that the liabilities incurred to settle a lawsuit, including legal fees and other expenses attributable to the lawsuit, are deductible as ordinary and necessary business expenses under section 162 of the Internal Revenue Code. We conclude that Taxpayer's payment of these liabilities is deductible as ordinary and necessary business expenses under section 162.

FACTS

On Date 1, ***, Taxpayer and Target, publicly traded corporations, entered into a merger agreement under which Taxpayer agreed to acquire Target in a stock-for-stock transaction. The merger closed on Date 2, ***. In ***, litigation was filed against Taxpayer, Target, and other defendants for alleged securities law violations relating to Target's and Taxpayer's alleged misrepresentations and omissions made prior to Date 2, ***, in disclosures required by federal securities laws, e.g., ***. The alleged misrepresentations and omissions related to undisclosed *** incurred by Target and *** in ***. The plaintiffs also alleged that Taxpayer's board of directors was aware of material facts regarding the ***. ***. The plaintiffs' claims were based on Taxpayer stock other than stock acquired in the merger. All plaintiffs were holders of Taxpayer securities at some time during the period beginning *** after Taxpayer and Target entered into the merger agreement and ending *** after the merger closed. The eventual settlement was paid not only to plaintiffs who held Taxpayer securities at the time of the merger, but also to plaintiffs who acquired Taxpayer securities after the merger. None of the settlement was allocated to stock acquired from the exchange of Target stock in the merger.

The plaintiffs claimed that the alleged misrepresentations and omissions were material facts affecting the post-merger price of Taxpayer stock. The plaintiffs did not question the validity of the merger, request rescission of the merger, or seek to adjust the consideration in the merger. Thus, their claimed damages were measured by drops in Taxpayer's stock price after *** disclosures that occurred after Date 2, ***.

In ***, Taxpayer paid Amount 1 to the plaintiffs to settle all of the plaintiffs' claims.

LAW & ANALYSIS

Under section 162(a) of the Internal Revenue Code, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. In order to be deductible under section 162, an expenditure must be (i) paid or incurred during the taxable year; (ii) sustained in carrying on a trade or business; (iii) an expense; (iv) a necessary expense; and (v) an ordinary expense. Commissioner v. Lincoln Savings and Loan Association, 403 U.S. 345, 352 (1971).

Section 263(a) prohibits a deduction for capital expenditures. Under section 263(a), an expense must be capitalized if incurred for new buildings, permanent improvements, or betterments made to increase the value of any property or estate. Treasury Regulation section 1.263(a)-4(c)(1) provides, in part, that a taxpayer must capitalize an amount paid to another party to acquire any intangible from that party in a purchase or similar transaction. For these purposes, an intangible includes an ownership interest in a corporation, partnership, trust, estate, limited liability company or other entity. Treas. Reg. § 1.263(a)-4(c)(1)(i). In addition, a taxpayer must capitalize amounts paid to facilitate (i.e., investigate or otherwise pursue) the acquisition of an intangible. See Treas. Reg. § 1.263(a)-4(b)(1)(iv); Treas. Reg. § 1.263(a)-4(e)(1)(i).

Under § 1.263(a)-5, a taxpayer must capitalize an amount paid to facilitate a business acquisition or reorganization transaction described in § 1.263(a)-5(a), which includes a merger. In general, an amount is paid to facilitate a transaction described in § 1.263(a)-5(a) if the amount is paid in the process of investigating or otherwise pursuing the transaction. Facilitative costs are generally for services provided to the taxpayer in the process of an acquisition or reorganization. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. See § 1.263(a)-5(b)(1).

Generally, amounts paid in settlement of lawsuits are currently deductible if the acts which gave rise to the litigation were performed in the ordinary conduct of the taxpayer's

business. See, e.g., Federation Bank & Trust Co. v. Commissioner, 27 T.C. 960 (1957) (allowing petitioner to deduct amounts paid in settlement of legal proceedings charging petitioner with mismanagement in the liquidation of assets). Similarly, amounts paid for legal expenses in connection with litigation are allowed as deductible business expenses where such litigation is directly connected to, or proximately results from, the conduct of a taxpayer's business. See, e.g., Howard v. Commissioner, 22 B.T.A. 375 (1931) (legal fees incurred by taxpayer to settle a shareholder's claim of misrepresentation in the conduct of business are deductible business expenses).

If litigation arises from a capital transaction, the settlement costs and legal fees associated with such litigation are characterized as acquisition costs and must be capitalized under section 263(a). See Woodward v. Commissioner, 397 U.S. 572, 575 (1970) (holding litigation costs incurred by corporation in appraisal proceedings mandated by state law to determine the value of dissenter's shares were part of the cost of acquiring those shares).

However, business expenses are not converted into capital expenditures solely because they have some connection to a capital transaction. In determining whether litigation costs are deductible expenses or capital expenditures, the courts and the Service have looked to the "origin of the claim" to which the settlement or other litigation costs relate. See Woodward, 397 U.S. at 577; United States v. Gilmore, 372 U.S. 39, 47 (1963). Under the origin of the claim test, the character of a particular expenditure is determined by the transaction or activity from which the taxable event proximately resulted. Gilmore, 372 U.S. at 47. The purpose, consequence, or result of the expenditure is irrelevant in determining the origin of the claim, and therefore, the character of the litigation cost for tax purposes. McKeague v. Commissioner, 12 Cl. Ct. 671, (1987), aff'd without opinion, 852 F.2d 1294 (Fed. Cir. 1988).

In the present case, the issue is whether Taxpayer's payment to settle its lawsuit, as well as legal and other expenses attributable to its lawsuit, may be deducted under section 162 as an ordinary and necessary business expense or must be capitalized under section 263(a). Under the origin of the claim test, the inquiry is whether the claims in the litigation had their origin in the conduct of the taxpayer's ordinary and necessary business activities or whether the claims were rooted in a capital transaction.

Here, while the facts of the case involve a capital transaction, the plaintiffs' claims were that the alleged misrepresentations and omissions harmed the value of their investment in post-merger Taxpayer. The plaintiffs did not challenge the validity of the merger or the price of the merger. Further, none of the plaintiffs' claims were based upon Taxpayer stock received in exchange for shares of Target, and some of the plaintiffs acquired shares on the open market after the merger. The origin of the claim here is in the manner and extent to which Taxpayer's board of directors provided information to shareholders in securities filings concerning Target's * * *. Thus, the amounts paid to settle the claims did not facilitate the transaction within the meaning of § 1.263(a)-5. Further, the amounts are not otherwise part of the price paid for Target.

RULING

We conclude that Taxpayer's payment of liabilities incurred to settle the securities lawsuit, including any legal fees and other expenses attributable to the lawsuit and settlement thereof, are deductible as ordinary and necessary business expenses under section 162. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides

that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The ruling contained in this letter is based upon information and representations submitted by Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

- Sincerely,
- Robert M. Casey
- Senior Technician Reviewer,
- Branch 3
- (Income Tax & Accounting)

Citations: LTR 201412002