Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:FS:HAR:TL-N-3273-01
CJSantaniello

date: AUG

to: Richard A. Bowers, Acting Team Manager, LMSB, Group 1655
Attn: Revenue Agent Steven Chomyn

from: Associate Area Counsel, Area 1, (LM:FS:HAR)

ubject: **Large Case Advisory Opinion -** [redacted]

THIS DOCUMENT INCLUDES CONFIDENTIAL INFORMATION SUBJECT TO THE ATTORNEY-CLIENT AND DELIBERATIVE PROCESS PRIVILEGES AND SHOULD NOT BE DISCLOSED TO ANYONE OUTSIDE THE SERVICE, INCLUDING THE SUBJECT TAXPAYER. THIS DOCUMENT ALSO CONTAINS TAX RETURN INFORMATION SUBJECT TO THE PROVISIONS OF I.R.C. § 6103 AND ITS USE WITHIN THE SERVICE SHOULD BE LIMITED TO THOSE WITH A NEED TO REVIEW IT.

This memorandum responds to your request for assistance dated May 11, 2001. This memorandum should not be cited as precedent.

In your memorandum, you request our legal advice regarding whether the taxpayer is entitled to currently deduct a portion of the $[redacted] paid by the taxpayer in [redacted] to defend and ultimately settle a class action lawsuit brought by those who purchased its stock in the initial public offering of such stock. For the reasons set forth below, we conclude that the taxpayer must capitalize the entire $[redacted] as there is no distinction between the loss attributable to the shares purchased on the date of the public offering and those purchased in the open market from the underwriters, as recovery was available to both groups under the Securities Act of 1933 based on the false and misleading information appearing in the registration statement.

Issue

Whether the taxpayer is entitled to currently deduct a portion of the $[redacted] paid to defend and ultimately settle a class action lawsuit brought by those who purchased its stock in reliance on information appearing in the Registration Statement filed in connection with a [redacted] Initial Public Offering of such stock. **U.I.L. Nos. 162.25-04; 162.25-08.**

Facts

[redacted] (the taxpayer) is a provider of [redacted]. After filing a Registration Statement and a Prospectus, the taxpayer made an Initial Public Offering (IPO) of [redacted] shares of its common stock at $[redacted] per share, beginning on [redacted]. This was a "firm commitment" underwriting, i.e., one in which the taxpayer sold all of the shares issued in the IPO to the underwriters, who, in turn, sold all of the shares directly to the investing public.

On [redacted], the taxpayer announced lower revenues for its [redacted] quarter ending [redacted] than it had experienced in the [redacted] quarter. The [redacted], the taxpayer's common stock traded at $[redacted] per share. Thereafter, in [redacted], at the end of the fiscal year, the taxpayer announced an increase in its bad debt allowance from approximately $[redacted] at the time of the IPO to approximately $[redacted].

On [redacted], several individuals who purchased the taxpayer's common stock from [redacted] through [redacted] brought suit against the taxpayer under the Securities Act of 1933. Other defendants named in the suit include the two underwriters and certain officers and members of the taxpayer's board of directors. In the consolidated complaint, the plaintiffs asserted three bases for relief, all of which rested in plaintiffs' allegations that the prospectus filed with the Securities Exchange Committee in connection with the [redacted] IPO contained materially false statements and omissions. In [redacted], the district court denied the defendants' motion to dismiss under Fed. R. Civ. P. 12(b)(6) (failure to state a claim for relief).

Thereafter, the plaintiffs moved to certify their lawsuit as a class action Fed. R. Civ. P. 23(a). The defendants opposed the motion on a number of grounds, including, among others, that the plaintiffs' proposed class was impermissibly broad because it included people who purchased shares in the aftermarket rather than in the IPO. On [redacted], the district court granted the plaintiffs' motion over the defendants' objection. [redacted]. The class certified by the court consists of all purchasers of the taxpayer's common stock from [redacted] through [redacted], and included a subclass consisting of those who purchased stock from the two underwriters from [redacted] to [redacted]. Id. at [redacted].

On [redacted], the parties agreed to settle the above suit in a settlement agreement filed with the court. Per the agreement, the parties agreed that each plaintiff's loss was to be measured by the difference between the purchase price and the greater of (1) the sales price, if sold before [redacted], or (2) $[redacted], the closing price of the taxpayer's stock on [redacted]. The agreement further provides that the agreement should not be construed as an admission of wrongdoing by the defendants, and that the defendants chose to settle the litigation to avoid further expense and inconvenience from protracted litigation.

Pursuant to the settlement agreement, the taxpayer placed cash of $[redacted] and its common stock valued at $[redacted] into a separate settlement fund. The fund, which was administered by [redacted], was a "qualified settlement fund" within the meaning of Treas. Reg. § 1.468B-1.

Total litigation costs reflected on the taxpayer's books are $[redacted], representing the $[redacted] placed in the settlement fund ($[redacted] + $[redacted]) and attorneys fees (presumably) of $[redacted]. Disbursements from the fund were subsequently made to shareholders who submitted proofs of claims to the claims administrator. A report from the claims administrator dated [redacted] provides that [redacted] claims were filed, totaling $[redacted]. The total value of the claims related to the IPO shares was $[redacted].

On its [redacted] Form 1120, the taxpayer deducted only a portion ($[redacted]) of the $[redacted]. According to the taxpayer, this amount represents the portion of the settlement costs attributable to the return of capital relating to the shares acquired on [redacted], computed as follows:

Total shareholder loss	$[redacted]
Loss attributable to IPO shares	$ [redacted]
$[redacted] / $[redacted] =	[redacted]%
Return of capital ([redacted]% x $[redacted])	$ [redacted]
Ordinary loss ($[redacted] - $[redacted])	$ [redacted]

The remaining $[redacted], which was capitalized by the taxpayer, represents the portion of the $[redacted] attributable the return of capital relating to the shares purchased after [redacted]. In

its memorandum dated [redacted], [redacted] relies heavily on Rev. Rul. 80-119 and PLR 9621037 to support the tax treatment of the allocated settlement payment.

The examiner proposes to disallow the claimed expense on the ground that, because the entire $[redacted] relates to the IPO, no portion of those costs is currently deductible. To date, the taxpayer has not responded in writing or otherwise to the examiner's position.

Discussion

The taxpayer is not entitled to currently deduct $[redacted] paid to defend and ultimately settle a class action lawsuit brought by those who purchased its stock in reliance on information appearing in the Registration Statement filed in connection with a [redacted] Initial Public Offering of such stock.

Section 162[1] allows as a deduction all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Regulations provide, in part, that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. Treas. Reg. § 1.162-1. It is well settled that amounts expended to avoid or settle liability claims are deductible under section 162 as ordinary and necessary expenses if they are directly connected with or proximately related to the taxpayer's business. Kornhauser v. United States, 276 U.S. 145 (1928); Ditmars v. Commissioner, 302 F.2d 481, 485 (2d Cir. 1962) (the conduct of almost any trade or business will give rise to claims and thus expenditures to defend, settle, or satisfy judgments from such claims are ordinary and necessary business expenses under section 162); Old Town Corp. v. Commissioner, 37 T.C. 845 (1962), acq. 1962-2 C.B. 5.

Treas. Reg. § 1.162-1 contains a reference to sections 261 through 276, pertaining to items that are not deductible. Listed among these sections referring to nondeductible items is section 263, providing that deductions shall not be allowed for capital expenditures.[2]

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[1] All statutory section references are to the Internal Revenue Code in effect during the years in question.

[2] Section 263 enumerates specific expenditures that are not deductible, but this list does not comprise the universe of all nondeductible expenditures. "It is clear from the very

Under Treas. Reg. § 1.263(a), the cost of acquiring a capital asset is considered a capital expenditure. See also Treas. Reg. § 1.461-1(a)(1) (any expenditure which results in the creation of an asset having a useful life which extends beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which it occurred). Generally, an expense that "is of value in more than one taxable year" is a nondeductible capital expense. United States v. Mississippi Chemical Corp., 405 U.S. 298, 310 (1972). Thus, "the text of the Code's capitalization provision, § 263(a)(1), which refers to 'permanent improvements or betterments,' itself envisions an inquiry into the duration and extent of the benefits realized by the taxpayer." INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 88 (1992). A capital expenditure includes the "cost of acquisition...[of] property having a useful life substantially beyond the taxable year." Treas. Reg. § 1.263(a)-2(a). This concept extends to classifying as assets against the sale price (i.e., capital expenditures) costs associated with buying and selling securities in situations where the taxpayer is not a dealer in securities. Spreckels v. Commissioner, 315 U.S. 626, 630 (1942). Similarly, costs associated with a public offering of stock have been held to be nondeductible capital expenditures. Davis v. Commissioner, 4 T.C. 329 (1944), aff'd, 151 F.2d 441 (8th Cir. 1945), cert. denied, 327 U.S. 783 (1946).

In INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992), the Supreme Court held that costs incurred to facilitate a friendly acquisition are capital expenditures and, therefore, not currently deductible under section 162. In that case, the Court reaffirmed settled law that costs incurred to facilitate a capital transaction are capital costs. A.E. Staley Mfg. Co. and Subsidiaries v. Commissioner, 119 F.3d 482, 488-89 (7th Cir. 1997). See e.g., Ellis Banking Corp. v. Commissioner, 688 F.2d 1376 (11th Cir. 1982), cert. denied, 463 U.S. 1207 (1983) (involving expenditures made in investigating financial condition of target corporation); Mills Estate, Inc. v. Commissioner, 206 F.2d 244 (2d Cir. 1953) (involving costs associated with corporate reorganization); Davis v. Commissioner, 151 F.2d 441 (8th Cir.), cert. denied, 327 U.S. 783 91945) (costs associated with public offering of stock must be capitalized); Rev. Rul. 79-2, 1979-1 C.B. 98 (costs associated with

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language of §§ 162 and 263 that the two sections together are not all inclusive, and that § 263 does not provide a complete list of nondeductible expenses." Commissioner v. Lincoln Savings and Loan Ass'n, 403 U.S. 345, 358 (1971).

public offering of stock must be capitalized). The fact that expenses do not create or enhance a separate and distinct asset is not controlling. INDOPCO, 503 U.S. at 86-87.

When determining whether or not legal costs are deductible as an ordinary and necessary trade or business expense under section 162, the appropriate criterion is 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..." United States v. Gilmore, 372 U.S. 39, 49 (1963). In that case, the Supreme Court was asked to determine whether litigation expenses in a hotly contested divorce proceeding were deductible business expenses or nondeductible personal expenses. Believing that his loss in the divorce proceeding would threaten his controlling stock interest in an automobile dealership and jeopardize the renewal of his General Motors franchise, the taxpayer in Gilmore deducted $40,000 of his legal expenses as an ordinary and necessary business expense.

The Commissioner denied the deduction, but the Claims Court held that 80 percent of the expenses were deductible as defending community property claims against the taxpayer's stockholdings. The Supreme Court reversed, holding that the Claims Court had applied the wrong test in determining whether the taxpayer's legal expenses were personal expenses or ordinary and necessary business expenses. The Court stated the proper test as follows:

> [T]he 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 [section 212].

Gilmore, 372 U.S. at 49. See also Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970); Anchor Coupling Company v. United States, 427 F.2d 429, 433 (7th Cir. 1970); Rev. Rul. 80-211, 1980-2 C.B. 57; Rev. Rul. 78-210, 1978-1 C.B. 39.

In Anchor Coupling, the taxpayer entered into negotiations with an unrelated third party for the sale of its assets. During negotiations, the third party submitted a proposed agreement which gave it a sixty-day option to purchase the assets. In its written reply, the taxpayer stated, in substance, that it would sell its assets to the third party as proposed, provided it received suitable assurance that its lower level executives would be retained by the third party. When it became apparent that the

third party would not consent to retain the taxpayer's executives, the taxpayer decided to terminate the negotiations and to resist, if necessary, the third party's efforts to acquire its assets.

The third party eventually commenced a lawsuit, alleging breach of contract, for which it sought specific performance. Following five years of litigation, the parties agreed to settle their dispute. Under the agreement, the taxpayer agreed to pay the third party $600,000 in return for its release of any and all claims arising out of any alleged contract.

On its Form 1120 for the year of payment, the taxpayer deducted the entire $600,000 as an ordinary and necessary business expense. The Commissioner disallowed the deduction on the ground that the payment was a nondeductible capital expenditure. The district court, finding that the pending litigation with the third party had "an adverse effect upon [the taxpayer's] day-to-day operations," held that the payment was deductible under section 162. In holding that the settlement payment was an ordinary and necessary business expense, the court relied primarily on two factors; (1) the effect of the third-party's claim and litigation of the taxpayer's operations and the possible consequences of not settling the claim; and (2) the taxpayer's primary motivation in making the settlement was to avoid the adverse consequences of the litigation on its business operations.

Relying primarily on the Supreme Court's rejection of the primary purpose test in Gilmore, the Seventh Circuit reversed. As the court stated:

> we hold that the origin and character of the claim with respect to which a settlement is made, rather than its potential consequences on the business operations of a taxpayer is the controlling test of whether a settlement payment constitutes a deductible expense or a nondeductible capital outlay.

Anchor Coupling, 427 F.2d at 433. From this, it concluded that the origin and nature of the third party's claim, which was liquidated by the taxpayer's settlement payment, directly concerned the taxpayer's capital assets. Id. The alleged contract between the taxpayer and the third party created a claim on the taxpayer's assets, against which the taxpayer protected itself through the settlement.

In Rev. Rul. 80-119, 1980-1 C.B. 41, taxpayer A, a shareholder and director of X corporation, purchased additional shares of X stock from B, an unrelated individual. Subsequent to the purchase, the management and controlling shareholders of X organized Y as a holding company. Immediately thereafter, Y acquired X as a controlled subsidiary with the controlling X shareholders exchanging their stock for stock of Y. Following the corporate acquisition, an offer to the remaining X shareholders to exchange their stock for shares of Y, and a public offering by Y of its stock, B filed a complaint in federal district court against A for securities fraud. In the complaint, B alleged that when A purchased B's stock in X, A concealed the pending organization of Y, the planned exchange of stock by the controlling shareholders, the planned offer to the remaining shareholders to exchange their stock, and the planned public offering by Y. A and B eventually entered into a settlement agreement, under which B received a cash payment from A in return for B's release of all claims against A.

Applying the Gilmore origin-of-the-claim test, the Service concluded in Rev. Rul. 80-119 that the entire amount of the settlement payment was a capital expenditure because all the claims it settled arose from the acquisition of a capital asset. Although the settlement may have had positive effects on the taxpayer's operations and overall profitability, the Service rejected these facts as determinative of the issue. According to the Service, because the claim originated in the stock purchase transaction, no portion of the settlement payment was deductable under section 162(a).

In PLR 9442021 (October 21, 1994), various lawsuits were brought against the taxpayer, an accrual basis corporation. These suits were eventually consolidated into a class action brought by and on behalf of purchasers of the taxpayer's common stock during a specified period. The class action named the taxpayer and several of its present and former officers and directors as defendants. Plaintiffs in the class action allege that the defendants violated federal securities laws and state common law by artificially inflating the price of taxpayer's common stock and the price of its call options through alleged misrepresentations and nondisclosures regarding taxpayer's actual and prospective financial condition. Subsequently, the taxpayer and the other defendants entered into a settlement agreement to create a class settlement fund of $[redacted], of which taxpayer was responsible for $[redacted]. The taxpayer did not make any public stock offerings during the period at issue in the class action suit.

The Service concluded in PLR 9442021 that the amounts paid by the taxpayer as legal fees and in settlement of the class action suit are deductible under section 162. According to the ruling, the settlement originates in the dispute as to whether the information it disseminated regarding the corporation's financial and business status was appropriate, adequate, or accurate. As such, the expense arose from the business activities of the taxpayer. The settlement payment is an ordinary expense because the settlement of such suits is an ordinary and necessary expense of carrying on a trade or business. The Service further concluded that the legal fees paid in connection with the suit and settlement are costs that originated in these same claims and, therefore, are also ordinary and necessary expenses of carrying on a trade or business. However, the ruling expressly states that the taxpayer's misrepresentations and nondisclosures were not related to a public offering of stock, strongly suggesting that Service's conclusion would have been different had that been the case. The Service reached a similar conclusion in PLR 9550011 (September 13, 1995) (also finding that there was no connection between the taxpayer's alleged actions and the issuance of any stock by the taxpayer).

In the present case, the taxpayer, which is not a dealer in securities, undertook an IPO of its shares. The facts demonstrate that the taxpayer's alleged misrepresentations and failures to disclose material adverse information were related to the IPO, rather than the normal reporting activities of the taxpayer's business activities. Further, the costs in question were incurred by the taxpayer in the course of defending and settling the lawsuit alleging its misrepresentations and failures to disclose information. Consequently, the settled claims originated in the sale of securities, which is considered to constitute the acquisition or disposition of a capital asset. Therefore, under the origin of the claim test, the costs incurred by the taxpayer to settle the lawsuit are not deductible under section 162, but must instead be capitalized in the manner of expenses of issuing stock. Although these expenses may have averted detrimental consequences to the taxpayer's future business operations, under the origin-of-the-claim test, they were made in satisfaction of claims that all had their origin the IPO.

As noted above, the taxpayer did not deduct the entire $[redacted]. Instead, it allocated the total payments to two separate classes of claimants - those who purchased stock on [redacted] and those who purchased stock in the aftermarket from the underwriters. The $[redacted] relates to the former.

In our opinion, the taxpayer's allocation is without support. Under section 11 of the Securities Act of 1933, purchasers have standing to sue even though they did not acquire the stock in the IPO, provided the stock can be traced back to the offering containing the allegedly defective registration statement. Additionally, the Securities Act extends to aftermarket trading of a publically offered security, provided that aftermarket trading occurs by means of a prospectus or oral statement. Consequently, because all claims against the taxpayer in this case were based on false and misleading statements made in connection with the IPO, the entire claim originated in connection with the IPO.

We are simultaneously submitting this memorandum to the National Office for post-review and any guidance they may deem appropriate. Consequently, you should not take any action based on the advice contained herein during the 10-day review period. We will inform you of any modification or suggestions, and, if necessary, we will send you a supplemental memorandum incorporating any such recommendation.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

Since there is no further action required by this office, we will close our file in this matter ten days from the issuance of this memorandum or upon our receipt of written advice from the National Office, whichever occurs later.

Please call Carmino J. Santaniello at (860) 290-4075 if you have any questions or require further assistance.

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By: _____
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