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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR BRADFORD A. JOHNSON
ASSOCIATE AREA COUNSEL (LMSB) CC:LM:FSH:HAR

FROM: Associate Chief Counsel (Income Tax and Accounting) CC:ITA

SUBJECT: Deductibility of Legal Fees Incurred Defending Class Action Suit

This Field Service Advice responds to your memorandum dated January 2, 2001. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Purchaser =
Parent =
Subsidiary =
Z =
Plaintiff =

Court =
Defendant =

IPO Amount =
IPO Price =
Price =
Y =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =
Year 1 =
Year 2 =
Legal Costs =

ISSUE

Whether Taxpayer is entitled to a current deduction for costs incurred to defend and ultimately settle a class action lawsuit by purchasers of Subsidiary's stock in the initial public offering (IPO) of that stock.

CONCLUSIONS

The origin of the class action lawsuit was representations allegedly made by Subsidiary in conjunction with an initial public offering of Subsidiary's stock. Consequently, Taxpayer's expending funds to defend against the suit was the consequence of the sale of stock, not the day-to-day operation of Taxpayer's business. Accordingly, Taxpayer is not entitled to deduct these costs currently, but is instead required to capitalize them.

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FACTS

During the taxable years at issue, Parent was the parent company of a consolidated group. As a holding company, Parent had no operations; its sole assets consisted of shares of its subsidiaries. Among them was Subsidiary, the actions of which formed the gravamen of the legal proceedings in question. Parent and Subsidiary are collectively named "Taxpayer" in this advice. Taxpayer is a large international Z company engaged in manufacturing and marketing a variety of products.

On Date 1, Taxpayer undertook an initial public offering (IPO) of IPO Amount, consisting of Y shares at IPO Price. The principal purpose of the IPO was a recapitalization to reduce Taxpayer's debt and to facilitate its plans for growth.

In a press release issued on Date 2, Taxpayer announced that its expected fourth quarter earnings for Year 1 would be even lower than analysts' already reduced earnings projections. The announcement, forecasting the second earnings decline since the IPO, caused an immediate drop in Taxpayer's stock price, which closed at Price on Date 3.

On Date 4, Plaintiff filed a class-action lawsuit in Court against Defendant and others involved in the IPO on behalf of all purchasers of Taxpayer's stock during the period beginning with the IPO and extending through Date 3. Plaintiff alleged that Defendant misrepresented or failed to disclose material adverse information regarding both the projected demand for Taxpayer's products and the price and availability of raw materials used in manufacturing. Plaintiff asserted that Defendant's alleged misrepresentations and failures to disclose constituted violations of federal and state law. Plaintiff further alleged that as a consequence of Defendant's conduct, members of the class were induced to purchase Taxpayer's stock at artificially inflated prices.

On Date 5, the parties reached a settlement whereby, inter alia, Defendant agreed to establish a settlement fund in cash for payment of distributions to class members and Plaintiff's counsel and for payment of all costs of administration of claims and requests for exclusion. Additionally, Defendant agreed to pay all costs connected with the notice of settlement to class members.

As a result of the settlement, Taxpayer in Year 2 paid Legal Costs to defend and settle the class action suit. On its Form 1120 for that year, Taxpayer claimed a deduction for the entire amount of Legal Costs. The Service proposes to disallow this claimed deduction on the ground that the costs incurred must be capitalized because the origin of the claims was the IPO.

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LAW AND ANALYSIS

The Internal Revenue Code permits a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. I.R.C. 162(a). Regulations provide, in part, that business expenses deductible from gross income include ordinary and necessary expenditures directly connected with, or pertaining to, a taxpayer's trade or business. Treas. Reg. § 1.162-1. Generally, expenditures 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, 151-153 (1928); Old Town Corporation v. Commissioner, 37 T.C. 845 (1962), acq., 1962-2 C.B. 5.

Treasury Regulation § 1.162-1 contains also a reference to I.R.C. §§ 261-276, pertaining to items that are expressly not deductible. Listed among these sections referring to nondeductible items is I.R.C. § 263, providing that deductions shall not be allowed for capital expenditures¹. 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 offsets 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).

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). Applying this test, the Supreme Court held that litigation costs arising out of the acquisition or disposition of a capital asset are

¹Section 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 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 Assn., 403 U.S. 345, 358 (1971).

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capital expenses, whether or not the taxpayer incurred them in defending or perfecting title to the property. Woodward v. Commissioner, 397 U.S. 572 (1970); see also Anchor Coupling Co. v. United States, 427 F.2d 429 (7th Cir. 1970) (costs of defending against a lawsuit seeking specific performance of an asset-purchase agreement were nondeductible capital expenditures because their origin was protection of taxpayer's capital assets).

The Service has applied these principles in Rev. Rul. 79-2, 1979-1 C.B. 98. In that situation, the corpus of a decedent's testamentary trust contained shares of stock of a privately held corporation in which the decedent had invested. The trustees of the trust met with the other shareholders of the corporation and decided to make a public offering of a portion of the corporation's stock. Although the corporation was not to participate in the public offering, the registration statement was to be filed in the corporation's name.

During the ensuing months, the parties to the offering paid legal, accounting, registration, and printing fees preparatory to the public offering. However, a market downturn caused the parties to postpone the offering. The shareholders ultimately abandoned the offering. At the end of the taxable year in question and thereafter, the product of the expenses associated with the abortive public offering was totally without residual value.

The Service held that the costs of the abandoned public offering were deductible as losses under I.R.C. § 165, not as ordinary and necessary business expenses under section 162. The Service reasoned that under Davis, the costs of preparing the public offering are considered costs incurred to sell the offered stock. Further, under Woodward, costs incurred in acquiring or disposing of a capital asset are considered to be capital expenditures. Therefore, the Service reasoned that the costs in question were not deductible under section 162. Rather, the trust and the other shareholders were required to capitalize them as an intangible asset, separate from the stock, to offset the contemplated sale of the stock under Treas. Reg. § 1.263(a)-2(e). When the public offering was abandoned, the intangible asset became worthless, and the trust and shareholders were entitled to deduct them under section 165.

In Rev. Rul. 80-119, 1980-1 C.B. 41, a shareholder and director ("Director") of Corporation purchased additional shares of Corporation's stock from an unrelated individual ("Individual"). Subsequently, management and controlling shareholders of Corporation organized Holding Company, and Holding Company acquired Corporation as a controlled subsidiary with the controlling shareholders of Corporation exchanging their stock for stock of Holding Company. Following the acquisition, an offer to the remaining shareholders of Corporation to exchange their shares for shares of Holding Company, and a public offering of Holding Company's stock, Individual filed a lawsuit against Director, alleging inter alia that Director had concealed at the time of purchase of Corporation's stock the pending organization of Holding Company, the planned

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exchange of stock by Corporation's controlling shareholders, the planned offer to the remaining shareholders of Corporation, and the planned Holding Company public offering. After negotiations, the parties settled the lawsuit out of court.

The service applied the origin of the claim test to each of the claims at issue in the lawsuit to determine if the claim was deductible from originating in the course of conduct of a trade or business, or if it originated in a transaction giving rise to a nondeductible expenditure, such as the acquisition of a capital asset. The Service found that each of the settled claims originated in the stock purchase transaction. Accordingly, the Service held that the entire amount of the settlement was a capital expenditure because the settled claims arose from the acquisition of a capital asset.

In the present case, Taxpayer, which is not a dealer in securities, undertook an IPO of its shares. All representations of fact available to us indicate that Taxpayer's alleged misrepresentations and failures to disclose material adverse information were related to the IPO, rather than the normal reporting activities of Taxpayer's business operations. Further, the costs in question were incurred by Taxpayer in the course of defending and settling the lawsuit alleging Taxpayer's misrepresentations and failures to disclose information. Accordingly, we conclude that 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 Taxpayer to settle the lawsuit are not deductible under I.R.C. § 162, but must instead be capitalized in the manner of expenses of issuing its stock.

Please call if you have any further questions.

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