INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

March 05, 2004

Number: **200427023**
Release Date: 7/2/04
Third Party Contact: None
Index (UIL) No.: 61.02-06, 61.28-03, 1016.00-00
CASE-MIS No.: TAM-102647-04, CC:ITA:BR4

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference:

LEGEND:

Date 1 =
XCorp =

Holding =

Sub =
Date 3 =
$*a* =
$*b* =
$*c* =
dd =
$*e* =
ff =
Year 0 =

$*g* =
hh =
Sub 2 =

$*i* =
jj =
kk =
$*l* =
$*m* =
Date 2 =
Buyer 2 =

$*n* =

Date 4	=	Date 6	=
P District	=	Date 7	=
State Q	=	Date 8	=
Date 5	=	Date 9	=

rr =

Year 1	=	$*t-*	=
Year 2	=	$*u*	=
Year 3	=	$*v*	=
Year 4	=	$*w*	=
Year 5	=	$*x*	=
Year 6	=	$*y*	=
Year 7	=	$*z*	=
$*t*	=	*a* percent	=
$*t+*	=	*b* percent	=

ISSUE:

Are amounts received pursuant to a settlement with Buyer 2 ordinary income, as originally reported on Taxpayer's consolidated tax returns, or are they treated as nontaxable reductions to Taxpayer's basis in the shares of Holding.

CONCLUSION:

The amounts received pursuant to a settlement with Buyer 2 are ordinary income, as originally reported on Taxpayer's consolidated tax returns.

FACTS:

The Sale

On Date 1, Taxpayer entered into an agreement with XCorp to purchase all of the stock of Holding, the holding company for Sub. Taxpayer agreed to pay $*a* for the stock, consisting of: (i) $*b* in cash; (ii) $*c* in Taxpayer common stock; and (iii) warrants to purchase *dd* shares of Taxpayer common stock at an exercise price of $*e* per share for a term of *ff* years after the closing date of the sale transaction. The sale closed on Date 3.

On its tax return for Year 0, Taxpayer treated the acquisition of the stock of Holding as a taxable stock acquisition. Taxpayer made no election under § 338 of the Internal Revenue Code to treat the stock acquisition as an asset acquisition. Accordingly, the purchase price for the stock was reflected as Taxpayer's basis in the Holding stock. In addition, the stock purchase agreement allocated $*g* to certain covenants not to compete contained in the agreement. The amount allocable to XCorp's covenant not to compete for administration services was capitalized and amortized by Taxpayer over *hh* years.

Sub had four principal business lines: mutual fund administration; institutional trust and custody services; institutional asset management; and private client services. Sub's mutual fund business, , included the provision of administration and custody services to mutual funds.[1] This business was operated through a subsidiary known as Sub 2. A significant part of the value of the Holding stock acquired by Taxpayer was attributable to the continuing stream of revenue generated by Sub 2 through the provision of administrative and custody services to mutual funds. Most of Sub 2's business consisted of providing such services to mutual funds created, advised, or sponsored by XCorp. Sub 2's compensation for providing administration and custody services to mutual funds (including the XCorp-sponsored funds) was based on the amount of assets in the mutual funds serviced. As of mid-Year 0, Sub 2 administered approximately $*i* in assets in the XCorp mutual funds.

A mutual fund is a type of investment company, typically organized as a corporation, which is required to have an independent board of directors and a separate investment advisor. The board of directors of the mutual fund has the exclusive authority to make decisions respecting the fund, including the retention of an investment advisor, fund administrator, and custodian. While the independent directors of each XCorp mutual fund determined which firm to retain to provide administrative and custodial services, as the funds' sponsor XCorp had been recommending Sub 2 to provide those services. Sub 2 had satisfactorily performed such services to the funds on a regular basis for years. All of the administrative and custody services provided by Sub 2 to the XCorp mutual funds were provided pursuant to contracts with each fund.

Since the sale of Sub 2 meant that it was no longer an affiliate of XCorp, Taxpayer sought and received contractual protection against the risk or possibility of XCorp, or any of its affiliates, either ceasing to recommend Sub 2 as the provider of administrative or custodial services to the mutual funds sponsored by XCorp, or offering such services to the funds in competition with Taxpayer and Sub 2. To this end, the stock purchase agreement executed

[1] "Administration services" include the maintenance of books and records and the preparation and filing of financial statements, regulatory reports and tax returns. They may also include performing legal and compliance services and providing corporate secretary and treasury functions. "Custody services" generally involve the determination and collection of income on securities, safekeeping of securities, and other similar activities.

by XCorp and Taxpayer had certain restrictive and affirmative covenants designed to ensure that the relationships between Sub 2, XCorp, and the XCorp mutual funds continued as if no sale had occurred. The stock purchase agreement (and a subsequent letter agreement modifying and supplementing the terms of this agreement) provided, among other things, that:

> (a) for a period of *jj* years, neither XCorp nor any of its affiliates would compete with Sub 2 in the provision of administrative and custody services to existing and any new XCorp mutual funds (created during the *jj*-year period);
>
> (b) for a period of *jj* years, XCorp and its affiliates would recommend to the board of directors of all existing and any new XCorp mutual funds that Sub 2 provide administration and custody services to the funds;
>
> (c) XCorp would use all reasonable efforts to maintain in effect all material contractual and business relationships between XCorp's affiliates and Sub 2;
>
> (d) for a period of *jj* years XCorp would recommend Taxpayer's nominee for election to the board of directors of each XCorp mutual fund; and
>
> (e) for a period of *kk* years neither XCorp nor any of its affiliates would solicit for employment any employee of Sub 2.

The stock purchase agreement also provided for indemnification and remedies. XCorp expressly acknowledged that money damages would be an inadequate remedy in the event of any breach of its covenants in the agreement. Accordingly, without prejudice to the rights of Taxpayer to seek indemnification or other remedies, XCorp agreed that it and its affiliates would not contest injunctive or other equitable relief in any proceeding that Taxpayer might bring to enforce any covenant.

As far as indemnification, XCorp was required to indemnify Taxpayer for any losses incurred by Taxpayer arising from:

> (a) any inaccuracy in a representation or warranty made by XCorp;
>
> (b) any claim arising out of any action or omission to act occurring prior to the closing date; or
>
> (c) any litigation pending against XCorp or any of its subsidiaries on the closing date.

Other than for certain specified claims, Taxpayer was not entitled to indemnification for any breach by XCorp except to the extent the indemnification would exceed $*l* , with the total indemnification capped at $*m*. Any claim for indemnification by Taxpayer and Sub 2 required written notice and commencement within 24 months after the closing date. According to the stock purchase agreement, any indemnification payments were to be treated for tax purposes as adjustments to the purchase price of the Holding stock acquired by Taxpayer.

On Date 2, after Taxpayer signed the stock purchase agreement, but before the Date 3 closing, XCorp and Buyer 2 entered into a contract for the sale/purchase of XCorp's mutual fund advisory business, for approximately $*n*. The assets purchased included the remaining parts of XCorp's business involving the creation and management of mutual funds that were the subject of the restrictive and affirmative covenants in the stock purchase agreement between Taxpayer and XCorp. As part of the purchase, Buyer 2 expressly assumed XCorp's obligations to Taxpayer under the stock purchase agreement. Taxpayer asserts that representatives of Buyer 2 (and the respective parent companies of both Buyer 2 and XCorp) repeatedly assured Taxpayer that Buyer 2 was fully bound by the restrictive and affirmative covenants of the agreement between XCorp and Taxpayer and that Buyer 2 would live up to the terms of that agreement.

However, shortly after the latter sale closed, Buyer 2 allegedly engaged in a multi-step scheme to shift assets away from the XCorp funds administered by Sub 2.

<u>Litigation</u>

On Date 4, Taxpayer filed a complaint in the United States District Court for the P District of State Q against Buyer 2. In the complaint, Taxpayer asserted that Buyer 2 breached XCorp's obligations under the stock purchase agreement that had been assumed by Buyer 2. The particular conduct cited by Taxpayer included instances in which Buyer 2 created new mutual funds that were virtual clones of and deceptively similar to existing XCorp funds, initiated mergers of XCorp funds into Buyer 2 funds serviced by Buyer 2 instead of Sub 2, and designed a plan to mislead or induce investors to invest in Buyer 2 funds to the exclusion of XCorp funds.

Taxpayer complained that the effect of Buyer 2's conduct was that the revenues flowing to Sub 2 for the provision of administrative and custodial services to mutual funds would not remain as they were. Rather, the revenues would be dramatically reduced as assets were siphoned into mutual funds sponsored and administered by Buyer2. Taxpayer alleged that if the District Court failed to intervene, the defendants' conduct would cause irreparable injury by depriving Taxpayer of its entitlement to the substantial economic benefit associated with owning a business that should be free from competition from XCorp or Buyer 2. It also alleged its entitlement to be recommended as the provider of the services in question.

According to the complaint, Buyer 2's conduct jeopardized the viability of Sub 2's business and caused collateral consequences to other parts of the business holdings of Holding (including Sub and Sub 2).

In count one of the complaint, Taxpayer alleged that the defendants were liable for breach of contract under the terms of the XCorp/Taxpayer stock purchase agreement. Additional theories of liability advanced by Taxpayer in subsequent counts included tortious interference with contractual relations, unfair competition, and breach of covenant of fair dealing. With respect to the relief requested, Taxpayer first prayed for injunctive relief, as contemplated by the stock purchase agreement, requiring Buyer 2 to refrain from the allegedly improper conduct. In particular, Taxpayer sought to extend XCorp's obligations to refrain from competition and to recommend Sub (through Sub 2) as a provider of administrative and custodial services. Taxpayer also sought compensatory and punitive damages.

Settlement of Litigation

The parties subsequently settled the litigation. As of Date 5, Taxpayer, Buyer 2, and Sub 2 signed a settlement agreement, which provided that Buyer 2 was to make payments to Sub 2 with respect to certain "covered funds." The agreement provided that Buyer 2 would seek to act as administrator and servicer for all covered funds. In so doing Buyer 2 would negotiate in good faith with the board of directors of each covered fund to obtain appointment of Sub 2 as sub-administrator and sub-servicer. The covered funds included all mutual funds sponsored by Buyer 2 or its subsidiaries, including mutual funds for which Buyer 2 was primarily responsible for recommending or selecting advisers and sub-advisers. Except for administration services that Buyer 2 determined to undertake to provide as administrator, Sub 2 agreed to provide as sub-administrator substantially the same level and quality of administration services to the covered funds as it was currently providing as administrator. The term of the settlement agreement ran to Date 9.

The amount to be paid Sub 2 depended upon the category of the covered fund involved. Covered funds were segregated into the following three categories:

(a) money market mutual funds formerly advised by XCorp (Category 1 Funds);

(b) non-money funds formerly advised by XCorp (Category 2 Funds); and

(c) funds organized by Buyer 2 after Date 2, when it agreed to acquire XCorp's brokerage business (Category 3 Funds).

For each category, Sub 2 was to receive amounts representing a percentage of the average daily net assets, plus a fractional part of the administrative fee received by Buyer 2. For example, from Category 1 Funds, Sub 2 was entitled to *rr*.

If either Buyer 2 or Sub 2 was retained by a covered fund to perform administration services and the other was not, the retained party was required to pay the other party an ongoing fee to be mutually agreed upon by the parties to make the non-retained party "whole." If Sub 2 was the non-retained party, Sub 2 would continue receiving the fee otherwise payable as described in the settlement agreement, reduced by 3 basis points (except for one fund, Buyer 2 XCorp Fund, where the reduction was only 2 basis points). Buyer 2 also could choose not to utilize the services of Sub 2 as a sub-administrator with regard to one or more covered funds. In such event, provided Sub 2 was "ready, willing and able to provide such services," Buyer 2 again was required to make Sub 2 "whole" by paying Sub 2 the fee otherwise payable as described in the settlement agreement, reduced according to the same terms described above.

In addition to the foregoing terms, the settlement agreement also called for general releases from liability. For its part, Taxpayer released Buyer 2 from all claims that it had under the stock purchase agreement with respect to administrative services, but not custody services. In addition, Taxpayer agreed to file a stipulation of dismissal of the case.

On Date 6, the parties entered into a letter agreement modifying the prior settlement agreement. The parties agreed that no later than Date 7, Buyer 2 would provide the administration services currently provided by Sub 2 to the covered funds. The parties also agreed that Sub 2 would have no obligation to provide administration services to any covered fund after Date 8. Sub 2, which no longer had to be "ready, willing and able" to render administrative services, continued to receive fees based on the terms of the original settlement agreement until *a* percent or more of the total number of covered funds had been converted to Buyer 2 for administration services. Thereafter, Sub 2 was entitled to a modified sum, through Date 9, with respect to the covered funds and certain other funds, equal to *b* percent of the average daily net assets in such funds. For Year 1 through Date 9, Sub 2 received the following payments from Buyer 2 under the terms of the settlement agreement, as modified:

YEAR	AMOUNT
1	$*t*[2]

[2] Sub 2 received a total of $*t+* from Buyer2 for Year 1. A portion of the payments received prior to October Year 1 was for services rendered. Due to a lack of records, Sub 2 was unable to specifically determine how much was received for actual services performed. From October Year 1 to December Year 1, Sub 2 received payments pursuant to the settlement, totaling $*t-*, for which no services were rendered. Sub2's claim of $*t* as a purchase price adjustment for Year 1 is based upon prorating the payments received from October through December over the entire year.

2	$*u*
3	$*v*
4	$*w*
5	$*x*
6	$*y*
7	$*z*

For the above taxable years, Taxpayer reported the foregoing amounts received by Sub 2 as ordinary income on its consolidated tax returns. Subsequently, Taxpayer filed Forms 1120X for tax Years 1-4 and informal refund claims for tax Years 5-7 on audit. The refund claims are all based on the theoretical applicability of the “relation back” doctrine of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), and its progeny.

LAW AND ANALYSIS:

Under § 61 of the Internal Revenue Code, gross income means all income from whatever source derived. The Supreme Court of the United States has long held that the definition of gross income sweeps broadly and reflects Congress' intent to exert the full measure of its taxing power. *Helvering v. Clifford*, 309 U.S. 331, 334 (1940). Congress intended to bring within the definition of income "any accession to wealth." *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955); *United States v. Burke*, 504 U.S. 229, 233 (1992); *Commissioner v. Schleier*, 515 U.S. 323, 327 (1995). Accordingly, any receipt of funds by a taxpayer is presumed to be gross income unless the taxpayer can demonstrate that the accession fits into one of the exclusions provided by other sections of the Code. *Glenshaw Glass Co.*, 348 U.S. at 430-31. However, a receipt constituting a refund or return of basis is not generally classed as income within the meaning of § 61 because it is not an “accession to wealth.”

Taxpayer argues that the settlement payments should be treated as a non-taxable adjustment to basis in its Holding stock, under the principle of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), because the payments relate back to the purchase of the stock. Taxpayer points to the fact that the settlement resolved the suit that Taxpayer had filed against Buyer 2 for breach of XCorp’s covenants under the stock purchase agreement that Buyer 2 had expressly assumed

.

Further, the settlement provided that Sub 2 was to continue to be paid by Buyer 2, albeit on a somewhat reduced scale, even if Sub 2 furnished no administrative services to the covered funds. Also, as subsequently modified, the settlement called for continued payments to Sub 2 even though Sub 2 was no longer required to render services to the covered funds or even be prepared to render such services. Taxpayer, therefore, contends that at most, Sub 2 should only be required to report as ordinary income the value of the administrative services that it actually performed for the covered funds, while the remainder should be treated as reductions to its Holding stock basis. As a secondary position, Taxpayer contends that the "origin of the claim" doctrine set forth in *United States v. Gilmore*, 372 U.S. 39 (1963) provides the same result as *Arrowsmith* in this case.

Applicability of *Arrowsmith*

In *Arrowsmith*, two individual shareholders liquidated their corporation and divided the proceeds equally. The shareholders reported the resulting gain as capital gain. Four years later, a judgment was rendered against the liquidated corporation and one of the shareholders. The shareholders each paid one-half of the judgment as transferees of the assets of the old corporation and deducted their payments as ordinary loss. The Commissioner determined that the loss claimed by the stockholders was part of the corporate liquidation and classified the loss as capital. The Supreme Court agreed with the Commissioner, stating that "their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceeding." *Arrowsmith,* 344 U.S. at 8. The Court considered the judgment as simply the last event in the liquidation begun four years earlier. The stockholders, in effect, were required to return a portion of the assets received in the liquidation. The Court held that since the original distribution of assets was a capital transaction, the return of assets resulted in a capital loss.

The Supreme Court applied *Arrowsmith* subsequently in *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969). In that case the taxpayer had overcharged customers for natural gas over a period of several years. During this same period, the taxpayer was allowed a 27 ½ percent depletion allowance as a direct offset to income from those same receipts. The court determined that the taxpayer was not entitled to deduct the full amount of the overcharge refunded. An offset was required by the same percentage as was allowed for depletion in prior years. In explaining its decision, the court stated:

> The rationale for the *Arrowsmith* rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if the repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income. The Court in *Arrowsmith* was unwilling to infer that Congress intended such a result…. We cannot believe that Congress intended to give taxpayers a deduction for refunding money that was not taxed when received.

Skelly Oil Co., 394 U.S. at 685.[3]

[3] In the present case, there is no windfall to correct. Taxpayer is not attempting to offset ordinary income by paying back proceeds previously taxed as capital gains as in *Arrowsmith* or not taxed at all as in *Skelly Oil Co.* Similarly, the government is not attempting to tax as ordinary income proceeds from a capital transaction. The cost basis will remain intact. Taxpayer may always recover the basis whenever it sells its stock in Holding.

Courts generally cite *Arrowsmith* for the principle that two transactions, one occurring subsequent to the other, and each integrally related, should be treated as parts of the same transaction, so that the subsequent event should relate back and be given the same effect and treatment as the prior. This relation-back doctrine is premised on the idea that the tax consequences should be the same as if the prior and the subsequent transactions had occurred at the same time. *Seagate Technology, Inc. v. Commissioner*, T.C.M. 2000-361. The *Arrowsmith* doctrine is commonly employed to distinguish between capital and ordinary treatment. It is authority for barring taxpayers from receiving a double benefit of enjoying preferential capital gain treatment on liquidating distributions and thereafter offsetting ordinary income by the amount refunded. The courts have expanded the scope of *Arrowsmith* beyond corporate liquidations to cover a myriad of factual settings, not always in the government's favor.

The United States Tax Court applied the *Arrowsmith* doctrine in *Wener v. Commissioner*, 24 T.C. 529 (1955), *aff'd*, 242 F.2d 938 (9th Cir. 1957) to a renegotiation of a prior sale. In *Wener*, the taxpayers were partners in a partnership and conveyed their partnership interests to other partners, receiving a cash down payment and an agreement to receive the remainder of the purchase price over three installments. In the year following the sale, due to a pressing need for funds, the taxpayers negotiated a settlement of the remaining installment obligations. The taxpayers settled for an immediate cash payment that was less than the amount remaining under the installment agreement, and they treated the difference as an ordinary loss. The court rejected the taxpayer's argument that the sale and the settlement were two separate transactions.

> [P]rior to the dates the remainder of the purchase price was to become due, there was a renegotiation, adjustment, or revamping of the sale itself both as to price and the terms of payment.... [T]here was ... a renegotiation and revision of the unexecuted provisions of the sales contract itself and the substitution of new provisions therefor.

Wener, 24 T.C. at 532-3.

Courts also use *Arrowsmith* to determine the capital or ordinary character of damages paid by a party to a sale transaction in settlement of a claim relating to the sale. For example, in *Kimbell v. United States*, 490 F.2d 203 (5th Cir. 1974), the taxpayer sold his interest in two oil and gas leases and reported a long-term capital gain. It was later discovered that the wells were illegally slanted and production was stopped. A bank that held a security interest in the leases from the buyer threatened to sue the taxpayer. Subsequently, the taxpayer settled the claim based upon fraud and deducted the payment as a § 162 expense. The court concluded that *Arrowsmith* was controlling and characterized the settlement proceeds as an adjustment of the sales price of the oil and gas leases. The court in *Kimbell* also relied on the origin of the claim doctrine.

Similarly, in *Bresler v. Commissioner*, 65 T.C. 182 (1975), the taxpayer settled an antitrust action in 1967. Part of the settlement was to compensate the taxpayer for a loss incurred in 1964 when it was forced to sell § 1231 property at an ordinary loss.[4] The Court found that *Arrowsmith* required that the settlement proceeds allocable to the earlier loss must be treated in the same manner as if it had been received in the year of the sale. The Court reasoned:

> Since the gain, if received in 1964, would have resulted in an increase in ordinary income, it is not transformed into capital gain by a mere delay in receipt. The subsequent gain is part and parcel of the original loss transaction and cannot be segregated for tax purposes. The gain in 1967 is merely an adjustment of the prior sale price; it is not a new and independent sale or exchange of section 1231 property.... The receipt of the payment in 1967 was merely the completion of the prior transaction.

Bresler, at 187.

In *Federal Bulk Carriers, Inc. v. Commissioner*, 66 T.C. 283 (1976), *aff'd on other grounds*, 558 F.2d 128 (2d Cir. 1977), a taxpayer sold the stock of a corporation. The principal asset of the corporation was a tanker. As part of the stock sale, the taxpayer entered into an indemnity agreement with the buyer that guaranteed a specified projected level of earnings for the tanker. The guarantee was, in turn, secured by setting aside a portion of the proceeds from the sale of the stock. When the earnings of the tanker later failed to reach the projected level, the taxpayer was called to make good under the guaranty. The court, citing *Arrowsmith*, found that the guarantee payments were so intimately tied to the stock sale that their character must be ascertained by reference to that sale. Accordingly, the guarantee payments were treated as adjustments to the purchase price of the stock.

In *Freedom Newspapers, Inc. v. Commissioner*, T.C.M. 1977-429, a broker was engaged by a newspaper owner to sell a group of newspaper properties. The broker offered to sell four of the properties to the taxpayer. While the taxpayer was willing to buy three of the properties it was reluctant to purchase the fourth, the Jackson County Floridan. The broker was to receive his commission from the owner only if all four newspapers were sold. The taxpayer eventually agreed to buy the four newspapers at the asking price as long as the broker agreed to resell the Floridan within 1 year for a stated price. If the sale did not occur, the broker agreed to pay the taxpayer $100,000, which sum was placed in escrow during the 1-year period. The broker was not successful in selling the paper and subsequently

[4] The taxpayer conceded that a portion of the settlement represented lost profits to be reported as ordinary income. Although the taxpayer also alleged that a part of the settlement was for loss of goodwill or going concern value of the business, the taxpayer failed to produce any evidence to establish the amount of the damages properly allocable to such claim.

paid the $100,000. The court found that even though the taxpayer had contracted with two different parties, the two agreements were, nevertheless, each part of the original sale transaction. Under *Arrowsmith*, the court concluded that the $100,000 was an adjustment to the purchase price and not ordinary income to the taxpayer. In substance, the broker agreed to a reduction of his commission on the sale. This had the effect of reducing the taxpayer's cost and hence its basis in the Floridan.

Courts in numerous other cases have also applied *Arrowsmith* to payments made to indemnify a party pursuant to the terms of a prior sale transaction. *See, e.g., Smith v. Commissioner*, 67 T.C. 570 (1976) (settlement payment of suit for selling unregistered stock in violation of the Securities Act of 1933 "integrally related" to the prior sale); *Estate of Shannonhouse v. Commissioner*, 21 T.C. 422 (1953) (amount paid by a transferor for a release of claim under a covenant of title in a warranty deed for an encroachment on adjoining property treated as an "outgrowth of the sale of the property" on which the taxpayer had reported a capital gain); *Nelson v. Commissioner*, T.C.M. 1971-327, *aff'd per curiam*, 472 F.2d 1224 (9th Cir. 1973) (characterizing indemnity paid to buyer of stock of a finance company pursuant to a warranty that all of the company's loans were validly made and that there were no defenses against them).

The present case, however, is distinguishable from the line of cases following *Arrowsmith*. Here, Taxpayer's purchase of the Holding stock from XCorp and the subsequent settlement payments were not so integrally related that the tax character of such payments should be fixed by reference to the stock purchase transaction. Unlike *Arrowsmith*, at the time of closing there were no inchoate liabilities lurking to denigrate the value of the acquired stock. Neither does Taxpayer claim that the stock was less worth at closing than what was paid. Unlike *Wener*, the settlement cannot be looked upon as an adjustment, renegotiation, or revision of the terms or effect of Taxpayer's earlier acquisition of the Holding stock. The stock sale was fully executed and completed as to all parties prior to the time any claim arose. The purchase price for the stock, which was fixed and non-contingent, was fully paid at closing. No aspect of the transaction relating to the consideration for the stock was open or pending when the settlement was reached.

In contrast to the indemnity cases cited above, including *Federal Bulk Carriers*, *Freedom Newspapers*, *Estate of Shannonhouse* and *Nelson*, the settlement payments here did not represent indemnity or warranty payments tied to the terms of the prior transaction. Article VIII of the Stock Purchase Agreement provided in section 8.2 that Taxpayer could seek indemnification against XCorp or Buyer 2 for any losses incurred arising from "(i) any inaccuracy in a representation or warranty made by Seller . . .; or (ii) any claim . . . arising out of any action or omission to act . . . occurring prior to the Closing Date . . .; or (iii) any litigation pending against the Company or any Company subsidiary on the Closing Date...." None of the foregoing clauses obligating XCorp to indemnify Taxpayer applied to Buyer 2's alleged misconduct, which occurred after closing. Taxpayer admitted as much in its response to an inquiry as to why the $*m* cap on indemnification (also contained in section 8.2 of the stock purchase agreement) did not limit the settlement amount. Instead of exercising any right to seek indemnification, which was deemed an inadequate remedy, Taxpayer sought injunctive and equitable relief to compel the defendants to comply with the affirmative and restrictive covenants included in the stock purchase agreement. Taxpayer also asserted that the payments at issue were made under the terms of the settlement agreements (one dated Date 5 and the other, modifying the first, dated Date 6), and not under the indemnification provisions of the stock purchase agreement.[5]

There is also a fundamental flaw in Taxpayer's theory that connects indemnity for post-sale misconduct of a party other than the seller with Taxpayer's basis in the acquired stock. Notwithstanding the fact that Buyer 2 agreed to uphold the restrictive covenants when it acquired the remaining mutual fund businesses of XCorp, it was never in the position of the seller and did not have any part of the sales price available to refund to Taxpayer. Evidently, XCorp, as seller, kept all of the sales proceeds. Also, the amounts paid in settlement bore no relationship in amount to the price originally paid by Taxpayer. Rather, the settlement payments were determined yearly, and were based upon a percentage of the total cash invested in certain "covered" mutual funds. Rather than a modification of the terms of the original sales contract, the settlement appears structured to preserve for Taxpayer at least part of the benefit of its bargain with XCorp, i.e., the potential to earn taxable ordinary income.

The present case does not involve a subsequent transaction that is so integrally related to a previous one such that the two should be considered part and parcel of the same transaction in order to prevent a double tax benefit as in *Arrowsmith* and *Skelly Oil Co.* Neither does this case involve subsequent adjustment or revision of the terms or effect of the original transaction as in *Wener.* Applying all factors and considerations noted above leads to the conclusion that *Arrowsmith* is not a sound basis for treating the settlement payments as non-taxable return of capital expended by Taxpayer to acquire the stock of Holding.

Applicability of Origin-of-the-Claim Doctrine

---

[5] Thus, Taxpayer's reliance on section 8.6 of the stock purchase agreement, calling for the parties for tax purposes to treat all payments made "pursuant to this Article VIII" as adjustments to the purchase price, is misplaced. Even if Section 8.6 were relevant, however, we doubt that a provision characterizing a payment as either ordinary or capital, in a contract to which the government was not a party, can effectively commit the government to such characterization or override substantive tax law. Taxpayer's reliance on the fact of the existence or restrictive noncompete covenants in its original sales contract as a basis for applying *Arrowsmith* is also misplaced. For example, *Seagate Technology,* T.C.M. 2000-361, demonstrates that subsequent events, even if contemplated in the original sales agreement, do not necessarily require application of relation-back principles.

While the relation-back doctrine of *Arrowsmith* is inapplicable under these facts, this case is well-suited for analysis under the similar origin-of-the-claim test, first articulated in *United States v. Gilmore*, 372 U.S. 39 (1963). The Court in *Gilmore* held that under the origin-of-the-claim test, the legal expenses involved in the taxpayers' divorce suit (though ostensibly to protect business assets) were personal in nature and therefore, not deductible. The test focuses on the origin and nature of the claim, rather than upon the potential consequences to the taxpayer. *Gilmore* at 48-49. It looks to the nexus between the origin of the litigation and the basis with which the settlement was reached and not the taxpayer's subjective motives. *Newark Morning Ledger Co. v. United States*, 539 F.2d 929, 935 (3rd Cir. 1976).

In the years since *Gilmore*, courts have applied the origin-of-the-claim test to many fact situations, not just in matters relating to the classification and treatment of legal fees. *See, e.g., McDonald v. Commissioner,* 592 F.2d 635 (2d Cir. 1978) (settlement expenses in will contest based on personal right under will, not deductible as business expenses); *Brown v. United States*, 526 F.2d 135 (6th Cir. 1975) (valuation costs originated in negotiations to sell stock, not deductible); *Kimbell v. United States*, 490 F.2d 203 (5th Cir. 1974), c*ert. denied*, 419 U.S. 833 (1974) (payment in satisfaction of liability arising from fraudulent sale of capital asset, not deductible); *Clark Oil and Refining Corp. v. United* States, 473 F.2d 1217 (7th Cir. 1973) (amount paid to landowner to settle nuisance action not deductible, as origin of dispute was an attempt to acquire the property); *Anchor Coupling Co. v. United States*, 427 F.2d 429 (7th Cir. 1970), *cert. denied*, 401 U.S. 908 (1971) (settlement payment in suit based on breach of contract to sell corporation was a nondeductible capital expenditure).

One case with a fact pattern similar to Taxpayer's is *Keller Street Development Co. v. Commissioner*, T.C.M. 1978-350, *aff'd*, 688 F.2d 675 (9th Cir. 1982). In that case, the Tax Court refused to relate back a settlement to an original sale transaction, indicating that for *Arrowsmith* to apply the settlement payment must be nothing more than an additional portion of the purchase price paid several years later. The court applied the origin-of-the-claim test to treat amounts received in settlement of a shareholders' derivative suit as ordinary income, stating that "the origin-of-the-claim test demands an analysis of the underlying claim, *Arrowsmith* notwithstanding."

In determining the origin and character of the claim, courts have employed several criteria. As explained by the court in *Boagni v. Commissioner*, 59 T.C. 708, 713:

> [T]he "origin of the claim" rule does not contemplate a mechanical search for the first in the chain of events which led to the litigation but, rather, requires an examination of all the facts. The inquiry is directed to the ascertainment of the "kind of transaction" out of which the litigation arose. Consideration must be given to the issues involved, the nature and objectives of the litigation, the defenses asserted, ... the background of the litigation, and all facts pertaining to the controversy. *[Citations omitted.]*

The court in *Alexander v. IRS*, 72 F3d 938 (1st Cir. 1995), was consistent with these principles when it held for the government that a settlement received by the taxpayer under an employment contract was ordinary income. The court stated that the test is not whether the action was one in tort or contract. Rather, the question to be asked is "[i]n lieu of what were the damages awarded." *Id. at* 942, *quoting Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir.), *cert. denied*, 323 U.S. 779 (1944). The basic function of the origin-of-the-claim test is to treat an amount received in satisfaction of a claim as a substitute for the item of loss and tax it in the same manner as if the loss had not occurred. The tax classification of settlement amounts is determined by reference to the nature of the claim settled. *Canal-Randolph Corp. v. United States*, 568 F.2d 28, 33 (7th Cir. 1977). If a settlement recovery represents damages for lost profits or earnings, it is taxable as ordinary income. Conversely, if it represents a replacement of capital destroyed or injured, the money received, to the extent it does not exceed the basis, is a return of capital and not taxable. *Fono v. Commissioner*, 79 T.C. 680 (1982) *aff'd in unpublished opinion*, 749 F.2d 37 (9th Cir. 1984); *Sager Glove Corp. v. Commissioner*, 36 T.C. 1173, 1180 (1961) *aff'd*, 311 F.2d 210 (7th Cir. 1962), *cert. denied*, 373 U.S. 910 (1963); *State Fish Corporation v. Commissioner*, 48 T.C. 465 (1967) (involving a suit for breach of a covenant not to compete).[6]

Applying the origin-of-the-claim test to the facts in our case leads to the conclusion that the settlement proceeds received by Sub 2 constitute ordinary income. The mere fact the purchase of the Holding stock was first in the chain of events that led to Taxpayer's litigation is not controlling for determining the origin of the claim settled. *Boagni v. Commissioner*, 59 T.C. at 713. The affirmative and restrictive covenants at issue were geared to preserving Sub 2's future flow of revenue from contracts to provide administrative services to mutual funds sponsored by XCorp and later acquired by Buyer 2. Taxpayer filed its suit in equity to protect Sub 2's contractual rights to provide these services, which are compensatory in nature. The future fees generated by these service contracts would have been taxed as ordinary income to Sub 2 had the fees been received in the ordinary course of business. Accordingly, the settlement payments, which are a substitute for such income, should be impressed with the same ordinary income character. *See Taracido v. Commissioner*, 72 T.C. 1014 (1979) (settlement amount for corporate right to present and future commission income is ordinary income); *Canal-Randolph Corp. v. United States*, 568 F.2d at 33 (yardage fees to be paid whether or not animals passed through taxpayer's stockyard under terms of settlement are taxed as ordinary income); *Bisbee-Baldwin Corp. v. Tomlinson*, 320 F.2d 929 (5th Cir. 1963) (termination fees for mortgage servicing contracts are ordinary income).

---

[6] In *State Fish Corporation* the restrictive covenant was held to be protective of goodwill, which was a capital item. Payments in satisfaction of such obligations under the covenant were deemed to be capital as well. In the present case, however, both the restrictive covenants and the settlement were aimed at protecting the stream of ordinary income to be derived by Sub 2 in its business unimpeded by XCorp or any successor.

In the suit filed by Taxpayer against Buyer 2 on Date 4, the complaint allegations center on how defendants' conduct has or will negatively impact Sub 2's anticipated future revenue on which the parties had based the purchase price of Holding stock. However, the acquisition of the stock itself was not the basis of the lawsuit.

In the same complaint, Taxpayer alleged that Sub 2 is a "provider of high quality custody and administration services" to mutual funds and, generally, the "compensation for these services is a function of the amount of money invested in the funds serviced." Taxpayer further alleged that a significant part of the value of the business it purchased stemmed from "the continuing stream of revenue attributable to the provision of high quality custody and administrative services to mutual funds." This caused Taxpayer to seek firm contractual protection from XCorp in the stock purchase agreement against "diminution in value of the revenue" flowing to Sub 2 through the continued provision of custodial and administrative services. The complaint then describes how Buyer 2 acted in violation of the various affirmative and restrictive covenants in the stock purchase agreement that they had expressly assumed. The complained of conduct, including the creation of clones of mutual funds serviced by Sub 2, planned mergers of XCorp funds into Buyer 2 funds not serviced by Sub 2, and inducement of investors to invest in Buyer 2 funds to the exclusion of XCorp funds, fundamentally impacted Sub 2's future service income.

Taxpayer further complained that because of the various arrangements put in place by the defendants, the "revenues flowing" to Sub 2 for the provision of custodial and administrative services "are not going to remain as they were."

The references in the complaint to Sub 2's revenue stream run to the heart of the matter at issue and were not made to establish the extent of damages to Sub 2's business or its goodwill. The complaint did not even attempt to measure such damage. The relief sought was primarily injunctive in nature. The complaint was filed to force the defendants to act in conformity with the covenants contained in the stock purchase agreement, to maintain Sub 2's business relationships with the XCorp mutual funds and preserve its anticipated revenue flow.

Notwithstanding the claim that injunctive relief was said to be the only effective remedy, the parties reached a monetary settlement. The settlement amounts represent a percentage of the daily net assets in the covered mutual funds. In this regard the settlement amounts closely resemble the type of the fees that Sub 2 could have earned under the service contracts had Buyer 2 adhered to contractual commitments. Apparently, the character and structure of the settlement was designed to compensate Taxpayer for loss of ordinary income caused by affirmative acts of Buyer 2 soon after both sales by XCorp were closed and final.

Although Sub 2 was no longer required to perform any services to be entitled to payments after Date 6 under the terms of the modified settlement, the payments received in settlement, before and after Date 6, were effectively in lieu of what fees Sub 2 would have earned under its service contracts. Therefore, the settlement payments are taxable as ordinary income, consistent with how Taxpayer originally reported the payments on its consolidated returns.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.