INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

May 21, 2004

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CASE-MIS No.: TAM-111159-04, CC:ITA:1

Director, Field Operations,

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No
Years Involved:
Date of Conference: none held

LEGEND:

Taxpayer =
Old Taxpayer =
State A =
State B =
State C =
State D =
Merger A =
Merger B =
Merger C =
Company A =
Company B =

Company C =

City =
Payment A =
Payment B =

Payment C	=	
Foundation A1	=	
Foundation A2	=	
Foundation A3	=	
Foundation B1	=	
Foundation B2	=	
Foundation C1	=	
Foundation C2	=	
Year 1	=	
Year 2	=	
Year 3	=	
Year 4	=	
Year 5	=	
Year 6	=	
Year 7	=	
Year 8	=	
Year 9	=	
Year 10	=	
Year 11	=	
Year 12	=	
Year 13	=	
Month 1	=	
Month 2	=	
Month 3	=	
Month 4	=	
Month 5	=	
Month 6	=	
Date 1	=	
Date 2	=	
Date 3	=	
Date 4	=	
Date 5	=	
Date 6	=	
Date 7	=	
Date 8	=	
Date 9	=	
Date 10	=	
Date 11	=	
d	=	
e	=	
f	=	
g	=	
h	=	
i	=	

<u>j</u>	=
<u>k</u>	=
<u>l</u>	=
<u>m</u>	=
<u>n</u>	=
<u>o</u>	=
<u>p</u>	=
$<u>q</u>	=
<u>r</u>	=
<u>s</u>	=
<u>t</u>	=
$<u>u</u>	=
$<u>v</u>	=
$<u>w</u>	=

ISSUE:

Whether Taxpayer may deduct Payments A, B, and C, made by Taxpayer in Year 1 to settle certain lawsuits, as ordinary and necessary business expenses under § 162 of the Internal Revenue Code.

CONCLUSION:

Taxpayer may not deduct Payments A, B, and C under § 162.

FACTS:

<u>Taxpayer History</u>

Taxpayer was formed in Year 2 under the name of <u>d</u>, commonly known as <u>e</u>. In Year 3, <u>f</u>, also known as <u>g</u>, was incorporated as a State D mutual insurance company. In Year 4 these two companies merged and became Old Taxpayer. In Year 5, Old Taxpayer changed its name to Taxpayer. Taxpayer's primary line of business is providing <u>h</u> and Taxpayer is now the exclusive <u>i</u> licensee in <u>j</u> states. Taxpayer was mutually held by its policyholders until Year 6 at which time it demutualized. Taxpayer is now publicly held and trades its stock on the New York Stock Exchange.

<u>The Mergers</u>

Many changes occurred in the <u>h</u> industry during the 1980s and 1990s, and Taxpayer grew its business by merging with existing <u>k</u> organizations operating in State A, State B, State C, and <u>l</u> other states. Prior to the mergers in States A, B, and C, Taxpayer and Companies A, B, and C were all organized as mutual insurance companies. The assets of the organizations were combined in each merger through the operation of the various state statutes. In Year 7, Company B, a State B domiciled mutual insurance company, was merged into Taxpayer. In Year 8, Company C, a State C domiciled mutual insurance company, was merged into Taxpayer. In Year 9, Company A, a State A domiciled mutual insurance company, was merged into Taxpayer.

Subsequent to the three mergers, the ns of States A, B, and C filed lawsuits alleging, in general, that the assets of the three acquired entities were impressed with a charitable trust.[1] During Year 1, Taxpayer settled the lawsuits by making Payment A, Payment B, and Payment C. Payments A, B, and C were made after all the mergers were complete. Taxpayer deducted Payments A, B, and C on its consolidated Form 1120 PC filed for Year 1.

Merger A

Prior to Year 10, Company A was a consolidated hospital and medical service corporation. Company A's certificate of incorporation provided that it was non-profit, shall not have or issue stock or pay dividends, shall be exclusively operated for the promotion of social welfare, and that no part of the earnings or assets shall inure to the benefit of or be distributed to its members. The certificate further stated that Company A's primary purpose was to provide hospital, medical, and other health care benefits. Company A was an independent licensee of i and was exempt from state taxes. Until Year 11, Company A had federal tax exempt status as a social welfare organization under § 501(c)(4).

In Year 10, the State A general assembly enacted legislation allowing a consolidated hospital and medical service corporation to convert to a mutual insurance company. The law provided that the amended and restated certificate of incorporation could not state that the company was non-profit. In Month 1, Year 10, Company A received approval and converted to a mutual insurance company. Its certificate of incorporation stated that it was to be operated exclusively for the promotion of the social welfare of State A residents. In Month 1, Year 9, Taxpayer received approval from the State A m to merge with Company A. In the merger, the assets of the organizations were combined through the operation of the various state statutes.

After the merger, the State A n's office, the State A o, and p filed separate lawsuits against Taxpayer to protect policyholder rights and preserve charitable assets acquired by Taxpayer prior to the merger. In the fall of Year 9, o and p filed lawsuits appealing the m's order approving the merger.[2] For various reasons, o withdrew the appeal in Month 6, Year 12. However, the p litigation remained active. On Date 1, the court ruled in favor of Taxpayer and upheld the merger. On Date 11, o filed a revised complaint

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[1] Additional lawsuits were filed by other parties in State A and in State B. These lawsuits are discussed in more detail in the Merger A and Merger B sections of this technical advice memorandum.

[2] Previous to this lawsuit, p had brought a lawsuit to block a policyholder vote on the merger. The plaintiffs alleged that Company A had accumulated assets and surplus as a result of special statutory treatment and tax exemptions; therefore, the assets must be dedicated to a charitable purpose or, alternatively, belonged to voting members and policyholders. This lawsuit was ultimately settled as part of the State A settlement agreement.

against Taxpayer and various officers and directors, alleging breach of fiduciary duty, unjust enrichment, and violation of the State A unfair trade practices law. The o sought creation of a trust comprised of the $q surplus of the Taxpayer as of Date 2, the effective date of the merger. This lawsuit was ultimately settled as part of the State A settlement agreement.

On Date 3, the State A n filed a complaint against Taxpayer setting forth numerous allegations relating to Taxpayer's obligation to preserve charitable assets. The n's theories were *cy pres*, *ultra vires* conduct, breach of fiduciary duty, conversion, unjust enrichment, constructive trust, and negligent misrepresentation. The n asserted that Company A had accumulated substantial revenue, reserves, and surpluses as a result of tax exemptions, hospital discounts, and other benefits because of its charitable status and operation as a non-profit corporation pre-merger. The n alleged that all of the accumulated assets were subject to a constructive trust. The n requested that the court enter an order of *cy* pres requiring Taxpayer to convey the trust assets to a charitable organization, enjoin Taxpayer from distributing or disposing of the assets to private persons or organizations, impose a constructive trust on the assets accumulated before the merger, and award various damages.

On Date 4, Taxpayer reached a settlement of all of the lawsuits with the n, the o, and p releasing Taxpayer from—

The State A settlement agreement states that Taxpayer specifically denies that any part of the property or assets held by it or held or derived from its predecessors is or was impressed with a charitable trust and denies that it or its predecessors is or was, in whole or in part, a charity. The agreement further states that the settlement was made as a compromise of a disputed claim to avoid litigation and business interruption, and to protect Taxpayer's goodwill and business reputation.

Under the State A settlement, Taxpayer agreed to make Payment A, which was substantially less than the $q originally demanded by the n and the o. Two charitable foundations were formed to ultimately receive the Payment. Foundation A1 was formed to act as a holding company of which Foundation A2 is a subsidiary. Foundation A2 was formed to serve the health needs of the citizens of State A, including the indigent, uninsured, and under-insured. The Payment initially was paid to Foundation A3 until the new foundations obtained tax exempt status under § 501(c)(3). Ultimately, the settlement proceeds were transferred to Foundation A2. Taxpayer deducted Payment A on its Year 1 consolidated income tax return.

Merger B

Prior to Year 13, Company B was a medical service plan corporation. Company B was the k organization in State B and paid no State B income tax. For years prior to Year 12, Company B was exempt from federal income tax under § 501(c)(4). In Year 13, the State B general assembly enacted legislation allowing medical-surgical, dental, and health service corporations to convert to mutual insurance companies. The State B m approved the conversion and Company B became a mutual insurance company in Year 13.

In Year 7, Company B was merged into Old Taxpayer. As part of the merger, all the assets of Company B became the property of Taxpayer. In Year 5, the State B m requested that the State B n's office seek an audit of the Year 7 merger. On Date 5, Taxpayer filed a lawsuit against the m and n, alleging that the merger investigation exceeded their scope of authority. This lawsuit was eventually settled as part of the State B settlement agreement. The m also filed a lawsuit against Taxpayer, alleging that, during the merger, Company B and Taxpayer provided false and misleading information to the m, failed to appropriately implement the merger plan, failed to issue guaranty policies, and violated certain State B statutes. The court was requested to declare that the merger was harmful and that Company B and Taxpayer materially misrepresented the facts during the merger, order an appraisal and accounting to determine damages to policyholders, and issue monetary fines. This lawsuit was ultimately settled as part of the State B settlement agreement.

On Date 6, the State B n filed a lawsuit against Taxpayer and Company B alleging misrepresentation during the merger process, nondisclosure of a fiduciary relationship with respect to charitable assets, and seeking the return of charitable assets. The n's theories were failure of Taxpayer to hold assets in charitable trust, constructive trust based on unjust enrichment resulting from charitable status and non-profit operations, and unfair, false, misleading, and deceptive practices. The n alleged the corporate history of Taxpayer's predecessors revealed they were non-profit organizations operated for a charitable or social welfare purposes, received interest-free loans, and enjoyed certain tax exemptions. The remainder of the allegations were duplicative of those asserted in the lawsuit filed by the m. The n requested that the court declare that Taxpayer held charitable assets and was unjustly enriched, that Taxpayer be enjoined from encumbering the assets, and that a constructive trust be imposed on the fair market value of Company B at the time of the merger (approximately $w). In Month 3, Year 12, Taxpayer filed a motion for summary judgment, which asked the trial court to dismiss the charitable trust claims without a trial. The n opposed the motion. In Month 4, Year 1, the trial court held a hearing on Taxpayer's motion for summary judgment on the charitable trust claims, and on Date 7, the court denied Taxpayer's summary judgment motion. The trial court's decision meant that the case would proceed to trial, and that the n would have the opportunity to prove that Company B held charitable assets and to determine the value of those assets.

Prior to trial, on Date 8, the m, the n, and Taxpayer announced a settlement of the lawsuit. The State B settlement agreement releases Taxpayer from –

The State B settlement agreement states that Taxpayer specifically denies that any part of the property or assets held by it or held or derived from its predecessors is or was impressed with a charitable trust and denies that it or its predecessors is or was, in whole or in part, a charity. The agreement further states that the settlement was made as a compromise of a disputed claim to avoid litigation and business interruption, and to protect Taxpayer's goodwill and business reputation.

Under the settlement, Taxpayer agreed to make Payment B, which was substantially less than the n's initial claim of $w. Payment B was to be held in an account designated as Foundation B1. State B then established Foundation B2 as a § 501(c)(3) organization, the purpose of which was to address the unmet health care needs of State B residents. Payment B ultimately was transferred to Foundation B2. Taxpayer deducted Payment B on its Year 1 consolidated income tax return.

Merger C

In Month 5, Year 8, Company C, a State C mutual insurance company, merged with Taxpayer. Company C was organized as the consequence of the consolidation of r, a State C domiciled mutual insurance company, and s, a non-profit corporation licensed to operate as a t. Under State C law, a t was a charitable and benevolent institution exempt from state income tax. In Year 10, r and s consolidated to form Company C. In Year 8, Company C merged with Taxpayer. Effective Date 9, State C law changed and ts became subject to the provisions of State B law that govern mutual insurance companies. In Month 1, Year 5, the State C n announced the initiation of an investigation to determine whether there were charitable assets involved in the merger that should have been protected and preserved.

On Date 10, the State C n filed a complaint against Taxpayer to enforce the performance of a charitable trust. The complaint alleged that Taxpayer's predecessors manifested an intention to create a charitable trust, that Taxpayer held charitable assets pursuant to a charitable trust, and that Taxpayer, as possessor or the charitable assets, was under a fiduciary duty to hold and ultimately apply the charitable assets in its possession to proper charitable purposes under which the assets were accumulated. On the same day the n filed suit against Taxpayer, Taxpayer filed an answer denying that ts had a charitable purpose or status or that it held assets subject to a charitable trust.

Later on Date 10, the n and Taxpayer announced and filed a settlement of the lawsuit, releasing Taxpayer from any claim –

The State C settlement agreement states that Taxpayer specifically denies that any part of the property or assets held by it or held or derived from its predecessors is or was impressed with a charitable trust and denies that it or its predecessors is or was, in whole or in part, a charity. The agreement further states that the settlement was made as a compromise of a disputed claim to avoid litigation and business interruption, and to protect Taxpayer's goodwill and business reputation.

Under the terms of the State C settlement, Taxpayer and State C agreed that a fair and reasonable settlement of the disputed claim was $u.[3] Taxpayer received a $v credit for previous contributions and investments by Taxpayer and its predecessors to Foundation C1. The remaining amount, Payment C, was paid in Year 1 to Foundation C2 for the purpose of providing grants for the health care of indigent State C citizens, with an emphasis on preventive healthcare. Taxpayer deducted Payment C on its Year 1 consolidated income tax return.

LAW AND ANALYSIS:

Section 162 allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. *See also* §1.162-1(a) of the Income Tax Regulations. Taxpayer asserts that Payments A, B, and C are deductible under § 162. In contrast, the field argues that the payments were made to satisfy Taxpayer's charitable trust obligation and are not deductible under § 162.

Under the charitable trust doctrine, the n of each state has authority to impose a constructive trust upon assets impressed with a charitable purpose. In this case, the ns of State A, B, and C, as well as other interested parties in States A and B, asserted in their lawsuits that Taxpayer and its predecessors owned assets impressed with a charitable purpose. The lawsuits further alleged that the charitable assets were subject to a constructive trust and must be conveyed to a charitable organization. Payments A, B, and C were made to settle these charitable trust lawsuits.

Taxpayer argues that Payments A, B, and C are deductible under § 162 because the lawsuits had their origin in Taxpayer's corporate history and status, as well as in the ordinary course of Taxpayer's business. However, it is clear from the complaints and the settlement documents that the origin of the lawsuits was the alleged status of Taxpayer and its predecessors as charitable organizations. If Payments A, B, and C represent the transfer of assets held by Taxpayer in trust for charitable purposes, the Payments do not constitute ordinary and necessary business expenses of Taxpayer.

Taxpayer argues that the Payments did not represent the transfer of charitable trust assets. Taxpayer notes that, in each settlement agreement, Taxpayer specifically denied that any part of the property or assets held by it, or held or derived from its predecessors, is or was impressed with a charitable trust. Taxpayer further denied in each settlement agreement that it or its predecessors is or was, in whole or in part, a charity. Taxpayer also emphasizes that the Payments (at least in States A and B) were considerably less than the amounts initially demanded by the n and other plaintiffs and, thus, could not represent the transfer of charitable trust assets.

[3] Letters submitted with the technical advice request indicate that the $u amount was approximately derived from an appraisal of the fair market value of s, Taxpayer's non-profit predecessor, as of October 1, 1987 (the date s became a mutual insurance company), with an annual accretion rate of 5% to bring the value forward to Year 1.

Despite Taxpayer’s arguments to the contrary, Taxpayer’s denial of the claims and ultimate settlement for lesser amounts does not change the essential nature of the claims themselves. The various claims against Taxpayer had their common origin in the allegation that Taxpayer owed a charitable trust obligation because of its historical status, through its predecessors, as a charitable organization. The fact that Taxpayer contested its obligation, and ultimately paid less because of the contest, does not change the character of the Payments. Had Taxpayer not contested the claim and instead paid the full amount initially demanded, that full payment also would have been nondeductible.

Taxpayer emphasizes that each settlement agreement states that the settlement was made as a compromise of a disputed claim to avoid litigation and business interruption, and to protect Taxpayer’s goodwill and business reputation. We do not disagree with Taxpayer’s stated purpose for settling the various claims. However, a taxpayer’s motive in settling a claim and the possible consequences of not settling are irrelevant in determining whether a settlement payment is deductible. *See, e.g.*, *Woodward v. Commissioner*, 397 U.S. 572, 578 (1970); *Anchor Coupling Co. v. United States*, 427 F.2d 429, 431 (7th Cir. 1970). In this case, the origin of the claims against Taxpayer was its alleged historical status as a charity and its concomitant charitable trust obligation. Further, although the Payments were made in settlement of the lawsuits, the Payments were not made to the plaintiffs. Instead, Taxpayer was required to distribute the Payments to various charitable organizations. This fact reinforces that Payments A, B, and C were made to settle claims based on Taxpayer’s alleged charitable trust obligation. Thus, the Payments were not made in the ordinary course of Taxpayer’s business and cannot be deducted as ordinary and necessary business expenses under § 162.

CAVEAT:

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.