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In Re:

LEGEND

Taxpayer	=
Corp X	=
a	=
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date 1	=
date 2	=
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x	=
date 3	=
date 4	=
date 5	=
date 6	=
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Court A	=
Case A	=
date 8	=
date 9	=
date 10	=
date 11	=
date 12	=
Complaint	=
Firm 1	=
Firm 2	=
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Dear :

This letter responds to your request of April 4, 2005, supplemented by letters dated September 14, 2005, and October 18, 2005, in which you requested a ruling on behalf of the above-referenced Taxpayer. Specifically, you have requested a ruling that amounts incurred to settle a class action lawsuit, as well as attorney fees and other fees attributable to the lawsuit, may be deducted as ordinary and necessary business expenses under § 162 of the Internal Revenue Code.

FACTS

Taxpayer is engaged in the business of a. Corp X was engaged in the business of providing b. After extensive due diligence, on date 1, Taxpayer and Corp X announced that they had signed a definitive merger agreement pursuant to which Taxpayer would acquire Corp X. The transaction closed on date 2. On that date, a specially created single purpose merger subsidiary of Taxpayer merged with and into Corp X, with Corp X surviving as a wholly owned subsidiary of Taxpayer. In the merger, the former Corp X shareholders received w shares of Taxpayer's stock in exchange for each share of Corp X stock. Approximately x years later, Corp X was converted into a single member limited liability company that was wholly owned by Taxpayer. Taxpayer then treated, and continues to treat, this entity as a division of Taxpayer for U.S. federal income tax purposes.

Following the merger, Taxpayer's financial statements were consolidated with those of Corp X. On date 3, Taxpayer issued a press release in which it announced its preliminary earnings for the quarter and fiscal year ending date 4, the first post-merger financial accounting period. Shortly thereafter, however, Taxpayer discovered that Corp X may have improperly recognized revenue, and, on date 5, Taxpayer issued an additional press release. In this press release, Taxpayer stated that certain transactions for the fiscal year ending date 4 were improperly recorded and had been reversed. Taxpayer also indicated that an audit was ongoing and that additional problems might be found. On that date, the price of Taxpayer's stock dropped. On date 6, Taxpayer issued a press release describing the conclusions of its internal investigation of Corp X, and restated its financial results by revising revenues downwards for y fiscal years, beginning with the fiscal year ending date 7.

According to the date 6 press release and Taxpayer's related SEC filings, the restatement was necessitated by several accounting improprieties allegedly perpetrated by Corp X management over a period of years. These accounting improprieties included the improper booking of revenues before the conditions required for revenue recognition were satisfied, the improper booking of revenues that were contingent on future events, the premature booking of revenue with respect to backdated contracts, and other miscellaneous revenue adjustments relating to the timing of recognition of certain items, expense underaccruals, and the reversal of certain excess accruals. The result of these improprieties was publication by Corp X of false financial statements for the y fiscal years ending date 4.

Following the date 5 press release, numerous class action lawsuits were filed against Taxpayer and Corp X under the federal securities laws. The majority of these lawsuits were consolidated into a single case in Court A under the caption, Case A. In general, the plaintiffs alleged that the public dissemination of inflated financial results by Corp X management during the period from date 8, the first date that Corp X published allegedly fraudulent financial results, through the day before date 5, the date that Taxpayer issued the first press release disclosing certain accounting improprieties, had the effect of artificially inflating the value of Corp X's securities from date 8 and Taxpayer's securities from date 1. The prayer for relief sought compensatory damages on behalf of all class members, costs, and expenses, and such other relief that Court A may require.

In the Complaint, the plaintiffs made claims against both Taxpayer and Corp X under various sections of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §§ 78j(b), 78n, 78t(a) (2006), and the rules promulgated thereunder, 17 C.F.R. §§ 240.10b-5, 240.14a-9 (2006). With regard to Corp X, the Complaint alleged that Corp X and certain of its officers violated Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b) (2006), and Rule 10b-5, 17 C.F.R. § 240.10-5b (2006), (collectively "the Section 10(b) claims") by participating in a scheme to intentionally defraud investors and the public markets through conduct designed to inflate Corp X's financial results and conceal its true financial condition. According to the Complaint, this scheme was accomplished by a variety of devices to create revenue and earnings, including the use of the accounting improprieties discussed above. Moreover, the complaint alleged that the scheme enabled Corp X to publish false financial results, with such information appearing in year-end and quarterly financial statements, 10K and 10Q filings, registration statements, press releases, the Taxpayer/Corp X joint proxy statements, and annual and quarterly reports. Finally, the complaint alleged that the publication of these fraudulent results allowed Corp X to use its stock as currency to acquire other companies at artificially low prices and accomplish the merger with Taxpayer. These claims against Corp X were brought on behalf of persons who purchased or otherwise acquired Corp X securities from date 8, the first date that Corp X published all allegedly fraudulent financial results, through date 2, the merger date. These claimants included not only those persons who acquired Corp X stock on the open market, but also those persons who acquired Corp X stock in exchange for the stock of various target corporations that were acquired by Corp X between the specified dates. These Section 10(b) claims against Corp X were also made on behalf of persons who purchased Taxpayer's securities from date 1, the merger announcement date, through the day before date 5, the date that Taxpayer issued the first press release disclosing the accounting improprieties.

With regard to Taxpayer, the Complaint alleged that Taxpayer and certain of its officers had also violated Section 10(b) of the Exchange Act and Rule 10b-5, promulgated thereunder, by knowingly making untrue and misleading statements about Corp X's financial condition and operating results. These statements were claimed to have appeared in information published after the merger, including press releases and Taxpayer's Form 10-Q. In addition, Taxpayer was alleged to be jointly and severally liable with Corp X, as a "control person" with respect to Corp X, for Corp X's alleged violations of Section 10(b) after the merger under Section 20(a) of the Exchange Act, 15 U.S.C. § 78t(a) (2006) (the "Section 20(a) claim"). The Section 10(b) and Section 20(a) claims against Taxpayer were brought on behalf of persons who purchased Taxpayer's securities on the open market after the merger through the day before the date 5 press release.[1]

In addition, the plaintiffs alleged that Taxpayer violated Section 14(a) of the Exchange Act, 15 U.S.C. § 78(n) (2006) and Rule 14a-9, 17 C.F.R. § 240.14a-9 (2006), promulgated thereunder, (hereinafter "the Section 14(a) claim") because the Taxpayer/Corp X joint proxy statement contained false and misleading statements regarding Corp X's financial results.[2] The Section 14(a) claim against Taxpayer was brought on behalf of persons who held Taxpayer's common stock on date 9, the date that the joint proxy statement was issued, continuously through date 2, the date that the shareholders voted to approve the merger. The factual allegations underlying the Section 14(a) claim were that Taxpayer had engaged Firm 1 to perform accounting due diligence on Corp X, and had engaged Firm 2 to render a fairness opinion for the benefit of Taxpayer's shareholders; that in its evaluation, Firm 1 discovered certain accounting errors, (i.e., failures to comply with GAAP),[3] which were communicated to Taxpayer's management; and that Taxpayer instructed Firm 2 not to consider these accounting

[1] The Complaint also alleged that Taxpayer violated Section 10(b) of the Exchange Act and Rule 10b-5, promulgated thereunder, with regard to its conduct and statements prior to the merger. However, in an order dated, date 11, Court A dismissed these claims, indicating that it found no strong inference of scienter and suggesting that Taxpayer itself was a victim of Corp X's fraud. Accordingly, this claim is not addressed in this ruling letter.

[2] According to Taxpayer's submission, the joint proxy statement consisted of a consolidation of Taxpayer's and Corp X's historical financial statements and other previously released information, all of which was previously available to the public. In an earlier complaint, the plaintiffs also asserted an identical Section 14(a) claim directly against Corp X. However, the court dismissed the Section 14(a) claim against Corp X, holding it was filed after the expiration of the applicable statute of limitations.

[3] These accounting errors were different from the accounting improprieties that resulted in the date 6 press release, describing the alleged large-scale fraud at Corp X, and the ensuing restatement of financial results for y fiscal years. These smaller errors were corrected in earnings releases dated, date 10 and date 3, prior to the announcement of the larger accounting improprieties, and their correction created no adverse market reaction.

errors in issuing a fairness opinion on the potential merger. The plaintiffs contended that Taxpayer knew, or should have known, that the accounting errors observed by Firm 1 were relevant in that they put Corp X's management's integrity into question and pointed to the possibility of a larger scale fraud perpetrated by Corp X over a period of years. Thus, they alleged that Taxpayer and its management acted negligently in failing to make adjustments and disclosures in the Joint Proxy Statement in recognition of these accounting errors.

On date 12, Taxpayer and the plaintiffs entered into a Stipulation and Agreement of Settlement ("Settlement Agreement") between Lead Plaintiff, Taxpayer and Corp X, pursuant to which the parties agreed to settle the litigation in exchange for the payment of z by Taxpayer. While the defendants, including Taxpayer and Corp X, continued to deny the claims, they decided to settle and terminate the claims to avoid the substantial uncertainties, expense, inconvenience, and the distraction of continued defense of the litigation. The settlement was intended by the parties to fully and finally compromise, resolve, discharge, and settle the released claims against Taxpayer, Corp X, their officers, directors, and employees.[4]

Under the settlement agreement, Taxpayer agreed to contribute the settlement amount to an escrow account to be established on behalf of the plaintiffs, and ultimately distributed to the plaintiffs pursuant to a plan of allocation drafted by the plaintiffs and approved by the court. Pursuant to the plan of allocation, the damages per share determined with respect to claimants that held Taxpayer's stock on the date of the issuance of the joint proxy statement were calculated in the same manner as the damages per share with respect to claimants that purchased Taxpayer's stock on the open market after the merger announcement, and with respect to claimants that acquired Corp X stock during the same timeframe (whether on the open market or through an exchange of shares in an acquisition), except that in the case of the Corp X shareholders, an adjustment was made to account for the exchange ratio in the merger with Taxpayer.[5]

In addition to the settlement amount, Taxpayer incurred legal and administrative fees in connection with the litigation. These include amounts incurred for attorneys, expert witnesses, court reporters, document management support, reporter transcripts, document copying, accounting advisors/consultation, damages consultants, insurance

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[4] Taxpayer represented that, during the class period, Taxpayer and Corp X had by-laws providing for mandatory indemnification with respect to amounts incurred by any person in settlement of any lawsuit to which that person was made a party by reason of being an employee or director of the corporation.

[5] The same methodology would be applied regardless of whether the claim was brought against Taxpayer under Section 14(a) of the Exchange Act or against Taxpayer or Corp X under Section 10(b) of the Exchange Act.

coverage attorneys, investigative expenses, trial graphic support, jury focus groups, general trial support, and audit committee investigative expenses.

LAW AND ANALYSIS

Section 162 provides, in part, that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business.

Section 263 prohibits a deduction for capital expenditures. Specifically, § 263(a)(1) disallows a deduction for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. Section 1.263(a)-4(c)(1) of the Income Tax Regulations provides, in part, that a taxpayer must capitalize an amount paid to another party to acquire any intangible from that party in a purchase or similar transaction. For these purposes, an intangible includes an ownership interest in a corporation, partnership, trust, estate, limited liability company or other entity. § 1.263(a)-4(c)(1)(i). In addition, a taxpayer must capitalize amounts paid to facilitate (i.e., investigate or otherwise pursue) the acquisition of an intangible. See § 1.263(a)-4(b)(1)(iv); § 1.263-4(e)(1)(i); Cf. § 1.263(a)-5 (costs to facilitate an acquisition of a trade or business, a change in capital structure, and certain other transactions).

Generally, amounts paid in settlement of lawsuits are currently deductible if the acts which gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business. See, e.g., Federation Bank & Trust Co. v. Commissioner, 27 T.C. 960 (1957) (allowing petitioner to deduct amounts paid in settlement of legal proceedings charging petitioner with mismanagement in the liquidation of assets); Rev. Rul. 80-211, 1980-2 C.B. 57 (allowing corporation to deduct amounts paid as punitive damages that arose from a civil lawsuit against the corporation for breach of contract and fraud in connection with the ordinary conduct of its business activities); Rev. Rul. 79-208, 1979-2 C.B. 79 (permitting taxpayer to deduct payments to settle lawsuit and obtain a release from claims under a franchise agreement). Similarly, amounts paid for legal expenses in connection with litigation are allowed as business expenses where such litigation is directly connected to, or proximately results from, the conduct of a taxpayer's business. See, e.g., Kornhauser v. United States, 276 U.S. 145 (1928) (holding that taxpayer may currently deduct amounts paid in defense of a suit against it by its former law partner); Howard v. Commissioner, 22 B.T.A. 375 (1931) (deciding that legal fees incurred by taxpayer to settle a shareholder's claim of misrepresentation in the conduct of business are deductible as business expenses).

However, if the litigation arises from a capital transaction, then the settlement costs and legal fees associated with such litigation are characterized as acquisition costs and must be capitalized under § 263(a). See Woodward v. Commissioner, 397

U.S. 572, 575 (1970) (holding litigation costs incurred by corporation in appraisal proceedings mandated by state law to determine the value of dissenter's shares were part of the cost of acquiring those shares); United States v. Hilton Hotels Corp., 397 U.S. 580, 583 (1970); (similarly, deciding that litigation costs incurred in appraisal action to determine fair purchase price were costs to acquire property); Berry Petroleum Co. v. Commissioner, 143 F.3d 442 (9th Cir. 1998)(concluding that legal expenses to defend class action lawsuit alleging breach of fiduciary duty in accomplishing merger were non-deductible acquisition costs); Clark Oil and Refining Corp. v. United States, 473 F.2d 1217 (7th Cir. 1972) (deciding that amounts paid in settlement of nuisance action that was brought to establish price of property were capital expenditures).

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

The courts have indicated, and the Service has acknowledged, that the origin of the claim doctrine "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." Boagni v. Commissioner, 59 T.C. 708, 713 (1973) (citing Gilmore, 372 U.S. at 47-48) acq., 1973-2 C.B. 1; Rev. Rul. 80-119, 1980-1 C.B. 40. This examination must include consideration of the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertaining to the controversy. Morgan's Estate v. Commissioner, 332 F.2d 144, 151 (5th Cir. 1964). Furthermore, where the litigation costs are incurred in conjunction with multiple claims, each claim must be analyzed to determine its nature and origin. Boagni, 50 T.C. at 714; Rev. Rul. 80-119. If certain claims originate in ordinary business transactions, and others originate in capital transactions, the litigation costs may be allocated among the various claims. See, e.g., Eisler v. Commissioner, 59 T.C. 634 (1973) (allocating settlement amount between negligence claim, which was deductible, and release of stock claim, which related to sale of capital asset).

In the present case, the issue involves whether Taxpayer's payment to settle its class action lawsuit, as well as its attorney and other administrative fees, may be deducted by Taxpayer under § 162 as ordinary and necessary business expenses or must be capitalized under § 263(a) as costs incurred in connection with the acquisition of assets. Under the origin of the claim test, the inquiry in this case involves examining the particular claims in the class action litigation and determining whether each claim had its origin in the conduct of Taxpayer's and Corp X's ordinary and necessary business activities or whether any of the claims were rooted in the merger of Taxpayer and Corp X or in any other corporate acquisitions made by Corp X during the class period. Taxpayer argues that the costs of settling all the claims made against it and Corp X in the litigation were attributable to the alleged fraud occurring during the defendants' ordinary course business activities, and did not originate in the merger of Taxpayer and Corp X or any other capital acquisition.

Several courts have addressed the origin of the claim doctrine in contexts similar to Taxpayer's situation. In Missouri Pacific Corp. v. United States, 5 Cl. Ct. 296 (1984), the taxpayer made a public offer to acquire shares of a target corporation's stock in exchange for its own common stock. The exchange offer was contained in a prospectus and letter to target's shareholders. The prospectus was then incorporated into a registration statement filed with the SEC. Following the consummation of the exchange, the target's former shareholders filed a class action lawsuit against the taxpayer and the former target alleging that the prospectus and letter contained false representations that overstated the value of taxpayer's shares and understated the value of the target's shares. Specifically, the claims alleged that the prospectus did not properly reflect target's net income, earnings, dividends available, and falsely gave the impression that all target's officers considered the offer to be favorable. In addition, the prospectus understated taxpayer's expenses and failed to reveal the business's lack of growth potential. Pursuant to a settlement, the taxpayer paid damages to shareholders who participated in the exchange offer in an amount that compensated for the true value of the stocks exchanged on the exchange date.

The taxpayer claimed that the settlement costs were deductible as ordinary and necessary business expenses because the complaints were the product of an ongoing dispute between target's shareholders and the taxpayer, as controlling shareholder of target, for withholding dividends, issuing fraudulent and incomplete financial statements, and artificially depressing its stock price. The Claims Court disagreed with the taxpayer, and determined that the settlement payments constituted an adjustment to the amount paid for the target stock. Moreover, the court analyzed the settlement payment under the origin of the claim test and determined that the claims originated in the taxpayer's purchase of the target stock. The Claims Court noted, first, that the district court had dismissed the class action claim dealing with the ongoing dispute between taxpayer and target shareholders as inappropriate to state a basis for a class action. Then, the court looked to the district court order approving the settlement, which specifically stated that the action resulted from a public offer made by the taxpayer to acquire target's stock. Lastly, the court noted that the settlement payment was made only to the shareholders that exchanged their stock for taxpayer's stock, and not to the target shareholders in general. Based on these facts, the court concluded that the predominant nature of the proceedings involved the adequacy of the consideration paid for the target's stock in the exchange offer, and thus, was grounded in a capital transaction.

Similarly, in Berry Petroleum Corp. v. Commissioner, 104 T.C. 584 (1995), aff'd, 142 F3d 442, 1998 WL 196716 (9th Cir. 1998) (unpublished disposition), the petitioner purchased a controlling portion of target corporation shares from another corporation. Subsequently, the petitioner and target effected a freeze-out, exchange of stock merger, whereby the petitioner acquired the remaining shares of the target from the public shareholders. Later, the target's former minority shareholders filed a class action lawsuit against petitioner. The claimants included a selling class, those former shareholders who sold their target stock on the open market following the petitioner's acquisition of control of target but before the merger, and a merger class, those shareholders who exchanged their target stock for taxpayer's stock in the freeze-out merger. The classes sued for "breach of fiduciary duty – merger fraud," which according to the complaint "had its origins in the freezeout merger" and was the result of fraud perpetrated in the prospectus by misrepresenting and concealing the actual values of the target and certain of its properties. Id. at 600. More specifically, the complaint alleged that the petitioner had material information and took actions with respect to target and its assets, which it failed to disclose to the minority shareholders, and that in SEC filings made prior to the merger, the petitioner belittled the value of target and its properties, causing an improper evaluation of the exchange ratio. Eventually, the petitioner and the classes entered a stipulation of settlement, under which the petitioner agreed to pay the former minority shareholders $ 5 million. The petitioner then deducted the legal expenses and other costs attributable to its defense of the class action as ordinary and necessary business expenses. The Service challenged the deduction on the grounds that the legal expenses constituted capital expenditures under § 263, and the courts agreed.

Using the origin of the claim test, the Tax Court concluded that the litigation originated in the taxpayer's acquisition of the target stock, which culminated in the merger. The court noted that the class action complaint specifically stated that the breach of fiduciary duty had its origins in the merger and that the factual allegations and legal arguments made by both parties in the litigation focused on the merger and the establishment of a fair exchange ratio. The Court of Appeals for the Ninth Circuit affirmed the Tax Court in an unpublished decision, determining that there was no difference between the claims of the selling class or the merging class, and that the origin of the claim for both classes "was fraud in the representations made to accomplish the merger at a good price, not merely fraud in the operation of the companies, which was incidental to the merger and related to it only in a "but for" sense." Berry Petroleum, 142 F3d 442, 1998 WL 196716, at *2.

Claims Against Corp X:

Because the litigation at issue in Taxpayer's ruling request involves several different claims, each claim must be analyzed in order to determine its origin, and accordingly, the character of the settlement payments and litigation costs relating to the claim. See Rev. Rul. 80-119, 1980-1 C.B. 40. As discussed above, part of the litigation at issue involves Section 10(b) claims filed against Corp X. Under these claims, the Complaint alleges that Corp X and certain of its officers engaged in a scheme to intentionally defraud investors and the public markets through conduct that was designed to inflate Corp X's financial results and to conceal its actual financial status. This conduct included the use of improper accounting devices in the reporting of business transactions, which had the effect of creating revenue and earnings. According to the Complaint, these devices enabled Corp X to publish false financial statements and other public reports and regulatory filings, which then allowed Corp X to acquire other corporations at artificially low prices and to eventually accomplish the merger with Taxpayer. The class members making these claims include persons who purchased or otherwise acquired (e.g., through exchange of shares) Corp X securities from the first date that Corp X allegedly published allegedly fraudulent financial results through the date of the merger with Taxpayer. These class members also include persons who purchased Taxpayer's securities on the open market from the merger announcement date until the day before the press release announcing the possible fraud.

Under these circumstances, we believe that the origin of these claims was in the ordinary conduct of Corp X's trade or business. Specifically, based on our review of the various litigation documents, we believe that these claims had their basis in the accounting improprieties allegedly perpetrated by Corp X and its officers over a period of years, and the publication, over these years, of the allegedly fraudulent financial results that incorporated these improprieties. Generally, the preparation and publication of financial statements is a common and routine activity in the carrying on of a trade or business. Thus, the plaintiffs' claims accusing Corp X and its officers of using improper accounting devices in the reporting of its business transactions and of including this allegedly fraudulent information in Corp X's financial statements and other filings have their origin in the ongoing operation and conduct of Corp X's business. Both the courts and the Service have allowed taxpayers to deduct the costs of settling and defending claims arising out of fraudulent misrepresentations made in the conduct of their trade or business. See James E. Caldwell & Co. v. Commissioner, 234 F.2d 660 (6th Cir. 1956); Ostrom v. Commissioner, 77 T.C. 608 (1981); Howard v. Commissioner, 22 B.T.A. 375 (1931); Rev. Rul. 80-211, 1980-2 C.B. 57. Since the Section 10(b) claims against Corp X arose in the ordinary conduct of the Corp X's business, the costs of litigating and settling these claims constitute ordinary and necessary business expenses under § 162.

Furthermore, the Section 10(b) claims against Corp X did not arise out of any capital transactions. Although Corp X's alleged accounting improprieties and resulting publication of fraudulent financial results may have affected the value (or perception of the value) of Corp X's stock in various corporate acquisitions made by Corp X during years in which the fraud occurred and may have affected the price paid for Corp X stock in the merger with Taxpayer, these consequences are not probative of the origin of the claims. Most importantly, as discussed above, the pleadings make clear that the Section 10(b) claims against Corp X have their basis in the accounting improprieties allegedly perpetrated by Corp X and its officers in the ordinary conduct of Corp X's business over a period of years. The Complaint provides no indication that these accounting improprieties stemmed from any conduct by Corp X in the course of any acquisition transaction or in the merger with Taxpayer. Further, the Section 10(b) claims against Corp X would exist regardless of whether Corp X engaged in any acquisition or merger transactions. While some of the claimants acquired their Corp X securities in corporate acquisition transactions, the parties making these claims also include parties that purchased their securities on the open market, unrelated to any particular acquisitive transaction. In either case, the Section 10(b) claims against Corp X are identical. In all of these cases, the claims originated from Corp X's use of allegedly improper and fraudulent accounting practices in reporting its business transactions. While this conduct had the ultimate effect of artificially inflating the value of Corp X's stock, this inflation was a result of the accounting improprieties. The fact that certain claimants acquired their shares in or after an acquisition transaction would not recharacterize the origin of their claims.

In addition, this situation is distinguishable from Missouri Pacific, 5 Cl. Ct. at 296, and Berry Petroleum, 104 T.C. at 584, discussed above. In these cases, the courts determined that the claims at issue originated in the taxpayers' acquisitions of targets' stock, rather then in their ordinary business operations. In Missouri Pacific, the alleged misrepresentations were made solely in the preparation of information for taxpayer's public offer and involved only those parties that participated in the exchange offer. See Missouri Pacific, 5 Cl. Ct. at 310-12. In Berry Petroleum, the complaint specifically alleged that the taxpayer's breach of fiduciary duty had its origins in the merger. See Berry Petroleum, 104 T.C. at 619. In that case, the allegations focused on the taxpayer's misrepresentations and omissions in the prospectus for the purpose of accomplishing the merger at a good price and in establishing a fair exchange price and ratio. Id. at 620. Further, the litigation documents characterized the Berry litigation as a "'quasi-appraisal' action." Id. To the contrary, in the present case, the Section 10(b) claims against Corp X involve accounting improprieties that occurred independent of and outside the context of any particular acquisitions by Corp X or the merger with Taxpayer. Moreover, these Section 10(b) claims were not limited to parties that purchased or exchanged securities in an acquisition, but were brought by all parties who purchased and acquired securities during the time the alleged accounting improprieties occurred. In addition, unlike Missouri Pacific and Berry Petroleum, the

Complaint and the litigation documents underlying the claims against Corp X do not focus on the facts surrounding the establishment of a fair exchange price for purposes of the acquisitions or merger. Rather, the factual allegations underlying these claims focus on the fraudulent and deceptive accounting practices allegedly perpetrated by Corp X over the course of several years. Thus, the origin of the Section 10(b) claims against Corp X was not in the process of any acquisition or the merger with Taxpayer, but in the ongoing accounting fraud. Accordingly, the settlement and litigation costs allocable to these claims should not be treated as capital expenditures under § 263.

Claims Against Taxpayer:

(1) The Section 10(b) and Section 20(a) Claims:

In addition to the claims asserted against Corp X, the litigation also includes certain claims against Taxpayer. The first set of claims against Taxpayer involves alleged violations of Sections 10(b) and 20(a) of the Exchange Act. These claims were brought on behalf of parties who purchased Taxpayer's securities on the open market after the merger of Corp X and Taxpayer, and alleged that Taxpayer violated these statutes (in its own capacity and as a controlling person with respect to Corp X's violations) by knowingly making untrue and misleading statements about Corp X's financial condition and operating results in documents published after the merger.

These claims were almost identical to the claims brought against Corp X under Section 10(b) of the Exchange Act except they were based on statements published by Taxpayer and Corp X after the merger. In essence, Taxpayer is being held accountable for the long-term accounting fraud allegedly perpetrated by Corp X and its own failure to discover and/or reveal the fraud in financial statements and other documents filed after the merger until date 5. For the same reasons discussed above with regard to the claims against Corp X, we believe that the Section 10(b) and Section 20(a) claims asserted against Taxpayer also had their origin in the ongoing operation and conduct of Taxpayer's trade or business. As with Corp X, the allegations of fraud under these claims originated in Taxpayer's preparation and publication of financial statements and related documents, a routine activity in the conduct of a trade or business. Moreover, these claims do not have their origin in the merger of Taxpayer and Corp X. While the litigation came soon after the merger and the merger itself may have triggered Taxpayer's potential liability by connecting it to Corp X, these facts do not establish that the merger was the origin of the claim. See, e.g., Newark Morning Ledger Co. v. United States, 539 F.2d 929 (3d Cir. 1976) (legal expenses were deductible where government could not show litigation was integral part of the corporate acquisition). As previously noted, these claims were brought by persons that purchased stock after the merger and were based on alleged misrepresentations in statements published after the merger. Thus, these particular claims were not based on Taxpayer's activities in the process of the merger, but rather were based on alleged misrepresentations occurring in the course of its business operations after and outside the context of the merger. Accordingly, the settlement and litigation costs allocable to the Section 10(b) and 20(a) claims against Taxpayer are not treated as capital expenditures under § 263, but may be deducted under § 162.

(2) The Section 14(a) Claim:

An additional claim against Taxpayer involves Taxpayer's alleged violations of Section 14(a) of the Exchange Act and Rule 14a-9, promulgated thereunder. The Section 14(a) claim against Taxpayer was brought on behalf of persons who held Taxpayer's common stock on the date that the joint proxy statement was issued and continued to hold such stock through the date that the shareholders approved the merger. Under this claim, the plaintiffs alleged that Taxpayer knew or should have known that the joint proxy statement issued in the merger of Taxpayer and Corp X contained materially false and misleading statements regarding Corp X's financial results. In addition, the complaint alleged that for purposes of the joint proxy statement, Taxpayer failed to reveal and instructed Firm 2 not to consider certain accounting errors (i.e., failures to comply with GAAP)[6] discovered by Firm 1 during the due diligence process. According to the complaint, the discovery of these accounting errors, and their proper consideration in the joint proxy process, should have caused Taxpayer to question Corp X's management's integrity and would have alerted Taxpayer to the possibility of larger scale fraud perpetrated by Corp X over the several preceding years.

In determining the origin of a claim, the courts have looked beyond the formal characterization of the claim, and instead considered the substance of the entire transaction. See Clark Oil and Refining Corp. v. United States, 473 F.2d 1217, 1220 (7th Cir. 1973) (holding that amounts paid to settle a nuisance action, in substance, had their origin in the acquisition of a capital asset, and thus were considered capital expenditures); American Stores Co. v. Commissioner, 114 T.C. 458, 471 (2000) (holding that legal fees incurred in defending against an anti-trust action had their origin in the taxpayer's acquisition transaction). While on its face the Section 14(a) claim appears to arise in the context of the merger (i.e., in the preparation of the joint proxy), a thorough consideration of the facts in this case suggests that the actual origin of this claim was not the merger itself, but rather, was the ongoing fraud allegedly perpetrated by Corp X during the years prior to the merger. First, although the Section 14(a) claim is based on the inclusion of false and misleading statements in the joint proxy statement, many of these statements did not originate in the merger transaction. According to Taxpayer, the joint proxy statement consisted of a combination of Taxpayer's and Corp X's previously published financial statements and previously

[6] These accounting errors were different from the accounting improprieties that were the main subject of the litigation and that resulted in the date 6 press release and restatement. See supra note 3.

disseminated financial information. As asserted in the Section 14(a) claim and the claims previously discussed, Corp X's historical financial statements incorporated the results of Corp X's ongoing accounting fraud. Thus, in essence, these claims are identical to the claims alleged by the other claimants in the litigation, i.e., that the parties were damaged by the accounting improprieties allegedly perpetrated by Corp X in the reporting of its business transactions and in the publication of fraudulent financial results incorporating these improprieties.[7] As discussed above, we believe these claims originated in the ordinary conduct of Corp X's business, and not in the merger or any other capital transaction.

Second, although the Section 14(a) claim also alleges that Taxpayer made additional misrepresentations in the joint proxy statement by failing to consider and by instructing Firm 2 not to consider certain additional accounting errors discovered by Firm 1 during the due diligence process, this allegation, by itself, does not provide the foundation for the claim. The Complaint suggests, rather, that these accounting errors were significant primarily because of their relationship to the larger fraud perpetrated by Corp X. As noted above, the plaintiff's allege that these accounting errors, although different from the accounting irregularities perpetrated by Corp X in their ongoing fraud, should have caused Taxpayer to question Corp X's management's integrity and alerted Taxpayer to the possibility of larger scale fraud perpetrated by Corp X over the several preceding years. Furthermore, the allegation regarding Taxpayer's failure to reveal or consider the accounting errors, by itself, appears to have only incidental value to the claim. In fact, after the merger and prior to Taxpayer's announcements regarding the finding of Corp X's large-scale accounting fraud, Taxpayer corrected these accounting errors by issuing earnings releases which created no adverse market reaction. Thus, the value of this allegation appears to be in its relationship to the larger accounting fraud, specifically, in connecting Taxpayer, by means of the joint proxy statement, to the ongoing accounting fraud allegedly perpetrated by Corp X over the years prior to the merger.

Third, like the foregoing claims, we believe that the Section 14(a) claim is distinguishable from the situations addressed in Missouri Pacific, 5 Cl. Ct. at 296, and Berry Petroleum, 104 T.C. at 584. As noted above, in both of these cases, the courts denied deductions for amounts to settle claims because the claims arose from corporate acquisitions. Unlike the Section 14(a) claim presently at issue, the allegations in these cases involved misrepresentations and omissions made solely in the context of, and for the purpose of, an acquisition. In both cases, the courts looked to the various litigation documents, which specifically characterized the claims as arising out of the mergers or in the process of the acquisition. See Missouri Pacific, 5 Cl. Ct. at 311 (looking to the language of the complaint and the district court order approving the settlement); Berry

[7] In fact, an identical section 14(a) claim was brought directly against Corp X in an earlier version of the Complaint. However, the court dismissed this claim, holding it was filed after the expiration of the applicable statute of limitations.

Petroleum, 104 T.C. at 619-20 (citing language in the class action complaint and the petitioner's brief). Moreover, in both cases, the courts rejected the taxpayers' contentions that the claims arose from any ongoing disputes or breaches of fiduciary duty in the management of the corporation. See Missouri Pacific, 5 Cl. Ct. at 311 (noting that the ongoing dispute between shareholders and management "could hardly have been a substantial basis for the subsequent settlement of the class action"); Berry Petroleum, 104 T.C. at 617, aff'd, 142 F3d at 442, 1998 WL 196716, at *2 (suggesting that fraud in the operation of the companies was merely incidental to the merger).

In contrast, in the current case, the litigation documents expressly connect the Section 14(a) claim to Corp X's on-going accounting fraud. Specifically, under the Complaint, the claim is based primarily on fraudulent information contained in financial documents published well before the merger and only republished as a consequence of the merger. In addition, the Section 14(a) claim is based, in substantial part, on the inclusion or omission of information in the joint proxy statement that the plaintiff asserts is relevant in its relationship to the possible discovery by Taxpayer of the ongoing accounting fraud at Corp X. In fact, the litigation documents consistently characterize all the financial misrepresentations in the litigation as arising from massive accounting fraud carried out by Corp X, and after the merger, by the combined entity of Taxpayer and Corp X. This identity of claims is consistent with the Taxpayer's draft settlement agreement, which pays out similar damages to all the claimants regardless of whether their claims arise under Section 14(a) or 10(b) of the Exchange Act. Thus, unlike the facts in Missouri Pacific and Berry Petroleum, the Section 14(a) claim in the present case had a direct and substantial relationship to the fraud perpetrated in the operation of Corp X's business. The Section 14(a) claim, with its connection to the joint proxy statement, was merely the mechanism by which certain of Taxpayer's shareholders could show harm by, and receive damages for, Corp X's ongoing accounting fraud. As such, we believe that, in substance, the origin of the Section 14(a) claim was not in the process of the merger, but in the long-term accounting fraud. Accordingly, the settlement and litigation costs allocable to this claim are not treated as acquisition costs under § 263, but may be deducted as ordinary and necessary business expenses under § 162.

CONCLUSION

Thus, for the reasons discussed above, and based solely on the facts and circumstances presented herein, we conclude that amounts incurred by Taxpayer to settle the above-referenced class action lawsuit, as well as legal fees and other administrative fees attributable to the claims discussed above, may be deducted as ordinary and necessary business expenses under § 162.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Further, except as expressed herein, no opinion is expressed or implied regarding the application of any section of the Code, including, but not limited to, § 482. Thus, the conclusion determined herein shall not preclude an adjustment under any other applicable Code provisions, including § 482.

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

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

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the provisions of a power of attorney on file with this office, we are sending copies of this letter ruling to Taxpayer's authorized representatives.

Sincerely yours,

ROBERT M. CASEY
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Income Tax & Accounting)

cc: