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CC:ITA:03
PLR-110963-07
Date: JUNE 27, 2007

In Re:
EIN:

LEGEND

Taxpayer =
a =

b =
Corp a =
Corp b =
Corp c =
Note a =
Note b =
Court A =
Case A =
date 1 =
date 2 =
date 3 =
date 4 =
date 5 =
date 6 =
date a =
date b =
State A =
State B =
z =
Year 1 =

Dear :

This is in reply to your letter dated March 1, 2007, requesting a ruling regarding the federal income tax treatment of amounts paid by Taxpayer to settle a class action lawsuit. You have requested a ruling that amounts paid by Taxpayer to settle 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. Taxpayer's division, Corp a is engaged in the business of b. A significant portion of the claims against Taxpayer in the class action related to alleged omissions and misrepresentations by Taxpayer regarding Corp a in its financial reports, SEC filings, and securities offerings. Additional claims against Taxpayer in the class action related to alleged omissions and misrepresentations by Taxpayer regarding its former subsidiary, Corp b, in financial reports, SEC filings, and securities offerings.

On date a, actions were filed in Court A as securities class actions on behalf of persons and entities who purchased or otherwise acquired Taxpayer's securities. The defendants were Taxpayer, its individual officers and directors, its outside auditor, and certain lenders, underwriters, and financial advisors to Taxpayer with respect to its securities offerings. These actions were consolidated as Case A.

The complaint alleged causes of action against Taxpayer under sections 11 and 12(a)(2) of the Securities Act of 1933, section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, State B securities laws and common law.

The class members are:

1. all purchasers of Taxpayer's common stock from date 1-date 2. (the class period).

2. purchasers of Taxpayer's common stock issued on date 3. (the date 3 stock offering).

3. purchasers of Taxpayer's common stock issued as a result of the date 4 merger of Corp c into Taxpayer. (the Corp c offering).

4. purchasers of Taxpayer's notes issued on date 5 either purchased in the open market or in the date 5 offering. (the Note a offering).

5. purchasers of the Taxpayer's notes issued on date 6, either purchased in the open market or in the date 6 offering. (the Note b offering).

The complaint alleged that plaintiffs purchased or otherwise acquired the above items at prices that were artificially inflated as a result of material omissions and misrepresentations by Taxpayer. The alleged material misrepresentations and omissions by Taxpayer related to:

1. Taxpayer's failure to properly account for its credit exposure to Corp b.

2. Taxpayer's concealment of its manipulation of the profits, assets, and revenues of Corp a.

3. Taxpayer's concealment of various other guarantees, obligations, risks, and improprieties, including its role in the State A energy crisis.

With regard to the allegations of material misrepresentations and omissions by Taxpayer: (i) all of the allegations of material omissions or misrepresentations in the date 3 stock offering were also alleged to have occurred in the financial reports and SEC filings of Taxpayer; (ii) all of the allegations of material omissions or misrepresentations in the Note a offering were also alleged to have occurred in the financial reports and SEC filings of Taxpayer; (iii) all of the allegations of material omissions or misrepresentations in the Corp c offering were also alleged to have occurred in the financial reports and SEC filings of Taxpayer; (iv) all of the allegations of material omissions or misrepresentations in the Note b offering were also alleged to have occurred in the financial reports and SEC filings of Taxpayer; and (v) none of the alleged omissions or misrepresentations in press releases by Taxpayer was alleged to have occurred in connection with the date 3 stock offering, the Corp c offering, the Note a offering, or the Note b offering.

Under the settlement agreement entered into as of date b, Taxpayer agreed to pay $z to an escrow account that will be treated as a qualified settlement fund as defined in Treas. Reg. § 1.468B-1(c). Pursuant to the final judgment entered by Court A, Taxpayer was released from all claims of members of the settlement class upon payment.

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. Treas. Reg. § 1.263(a)-4(c)(1) 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. Treas. Reg. § 1.263(a)-4(c)(1)(i). In addition, a taxpayer must capitalize amounts paid to facilitate the acquisition of an intangible.

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).

If litigation arises from a capital transaction, 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) (litigation costs incurred in appraisal action to determine fair purchase price were costs to acquire property); Clark Oil and Refining Corp. v. United States, 473 F.2d 1217 (7th Cir. 1972) (amounts paid in settlement of nuisance action that was brought to establish price of property were capital expenditures).

Business expenses, though, 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 (1988).

In the present case, the issue involves whether Taxpayer's payment to settle its class action lawsuit may be deducted under § 162 as an ordinary and necessary business expense or must be capitalized under § 263(a) as a cost incurred in connection with the acquisition of assets. Under the origin of the claim test, the inquiry involves examining the particular claims in the class action litigation and determining whether the claims had their origin in the conduct of Taxpayer's ordinary and necessary business activities or whether any of the claims were rooted in a capital transaction.

The substantive allegations against Taxpayer in large measure originate as material misrepresentations or omissions in financial reports and SEC filings. See Exhibit B, Table of Allegations in Complaint, Taxpayer's PLR Submission. The same material omissions and misrepresentations are also alleged in the date 3 stock offering, the Corp c offering, the Note a offering, and the Note b offering.

Specifically with respect to the Corp c offering, for example, the complaint alleges that the registration statement materially misrepresents the true financial condition, business assets, earnings and prospects of Taxpayer as to several of its divisions. The complaint also alleges that the registration statement materially omits to state and materially misrepresents the true financial condition, business, assets, earnings and prospects of Taxpayer because it omits various undisclosed matters (such as, the nature of one of its division's interest rate risk and credit default risk) in existence at the date thereof and which are disclosed in Taxpayer's Year 1 10-K. Furthermore, the complaint alleges that the Taxpayer's financial statements incorporated by reference in the Corp c offering and registration statement were materially misleading because of material omissions and misrepresentations...as well as failure to record a charge against earnings...in respect of the credit exposure of one of its divisions. These same omissions and misrepresentations are alleged in financial reports and SEC filings. We note that the Corp c offering was made as a result of the date 4 merger of Corp c into Taxpayer. See Complaint Case A, .

Taxpayer's position is that the settled claims were based on alleged omissions and misrepresentations in financial reports, SEC filings, press releases, and offering materials in securities offerings. The alleged acts were claimed to have resulted in the inflation of the prices of Taxpayer's securities during the class period, adversely affecting all persons who acquired Taxpayer's securities, either in the open market or in a securities offering. All of the alleged omissions and misrepresentations made in connection with any offering were also alleged to have occurred in financial reports and SEC filings, and none of the alleged press release omissions and misrepresentations were alleged to have occurred in connection with any of the offerings. Accordingly, Taxpayer states that each alleged omission or misrepresentation was alleged to have occurred in connection with Taxpayer's normal business activities of preparing and publishing financial reports, making SEC filings, or issuing press releases related to its business.

In Missouri Pacific Corp. v. United States, 5 Cl. Ct. 296, (1984), the taxpayer made a public offering 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. After the exchange, the target's former shareholders filed a class action lawsuit against the taxpayer and the former target alleging the prospectus and letter contained false representations that overstated the value of taxpayer's shares and understated the value of the target's shares. 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 sought to deduct the settlement costs as business expenses because the complaints were the result of an ongoing dispute between target's shareholders and the taxpayer, but the Claims Court disagreed, stating that the settlement payments constituted an adjustment to the amount paid for the target stock. Under the origin of the claim test, the court determined that the claims originated in the taxpayer's purchase of the target stock. The district court order approving the settlement specifically stated that the action resulted from a public offer made by the taxpayer to acquire target's stock. Thus, 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. See also, Berry Petroleum Co. v. Commissioner, 104 T.C. 584(1995), aff'd, 142 F.3d 442 (9th Cir. 1998). (settlement of litigation originated in acquisition of target stock resulting in merger and that origin of the claim 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.)

Here, the factual circumstances of the litigation leading to the settlement are claims against taxpayer by purchasers of stock or notes pursuant to specific offerings. All of the allegations involve representations which are part of ordinary business activities—i.e., registration statements, financial reports, SEC filings, press releases. Pursuant to the origin of the claim, the transaction or activity from which the taxable event proximately resulted was to settle claims resulting from ordinary business activities. It is irrelevant that the settled claims had some connection to stock and note offerings or that one stock offering was immediately after and a result of a merger. Capital transactions were not the sine qua non of the allegations in the complaint. Rather, the alleged misrepresentations occurred in a number of reports, statements, filings etc. which were produced over a period of time as part of regular business activities. The Complaint does not indicate that the allegations stemmed from any conduct by Taxpayer involving any acquisitive transaction or merger transactions. Rather the claims focus on alleged misrepresentations and omissions occurring over several years while in pursuit of ongoing business activities.

Accordingly, we believe that the origin of these claims was in the ordinary conduct of Taxpayer's business. The misrepresentations and omissions occurred over a number of years in documents prepared as a common and routine activity in carrying on a trade or 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); Rev. Rul. 80-211, 1980-2 C.B. 57. While technically the claims arise in the context of stock and note offerings, the actual origin of the claims was not a capital transaction but rather the ongoing alleged false statements and omissions.

In addition, this situation is distinguishable from Missouri Pacific, supra, and Berry Petroleum, supra. In both cases, the courts determined that the claims originated in the taxpayers' acquisitions of targets' stock, rather than in their ordinary business operations.

CONCLUSION

Thus, for the reasons discussed above, and based solely on the facts and circumstances presented berein, we conclude that amounts incurred by Taxpayer to settle the above-referenced class action lawsuit 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 transaction or item discussed or referenced in this letter.

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

In accordance with a Power of Attorney on file with this office, a copy of this letter is being sent to Authority's authorized representative.

The ruling contained in this letter is based upon information and representations submitted by Authority and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the materials submitted in support of the request for a ruling, it is subject to verification upon examination.

Sincerely yours,

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ROBERT M. CASEY
Senior Technician Reviewer
Office of Associate Chief Counsel
(Income Tax and Accounting)