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TY:

Legend

Taxpayer =
Target =

Parent =
Group W =

Entity X =
Entity Y =
Entity Z =
Date 1 =
Year 1 =
Year 2 =
Year 3 =
Years 4 =
Year 5 =
$A =
$B =
$C =

Dear :

This is in response to a letter dated Date 1, that was submitted by the authorized representative of Taxpayer. In that letter, a ruling was requested that (1) the proceeds received in settlement of the lawsuit described below are ordinary income in Year 5; and (2) the litigation costs and related expenses attributable to the lawsuit are ordinary expenses that are fully deductible in Year 5.

BACKGROUND

Target is a wholly owned subsidiary of Parent. In Year 1, Target and Entity X entered into an agreement to acquire substantially all of the assets of Entity Y in a plan of reorganization. Target, Entity X, and a corporation formed for the purpose of acquiring the Entity Y assets, executed a written agreement with each other and reached an oral agreement in principle with Entity Y. Shortly before the transaction was completed in Year 2, a disagreement arose between Target and Entity X, and Entity X entered into and carried out a separate agreement with Entity Z to acquire the Entity Y assets.

Target brought a lawsuit against Entity X in Year 2, later adding to the complaint as defendants Entity Z and the successor in interest to Entity Y. The second amended complaint in the lawsuit (the complaint that was ultimately settled) asserted two counts for damages for lost profits arising from breach of contract and breach of fiduciary duty. In the first count, Target alleged that the defendants prevented Target from "enjoy[ing] the economic benefits of the acquisition for which the parties contracted." The damages asserted in this count included "lost cash flow and profits resulting from the operation of [Entity Y] following the acquisition of [the Entity Y assets]. [Entity X] knew [Target] intended to continue [Entity Y's] business . . . as an ongoing enterprise which [Target] anticipated would generate significant cash flows. . . . [Target] was damaged by the loss of business opportunity, loss of [an] investment, and loss of cash flow and profits." The second count alleged that Target had been damaged "by the loss of business opportunity (including the unique opportunity to acquire [Entity Y]), loss of investment, and loss of cash flow and profits resulting from [Entity Y's] operations." Finally, the complaint asserted a third count in which Target sought a constructive trust to hold an ownership interest in the successor in interest to Entity Y.

In Year 3, Taxpayer acquired Target by purchasing 100 percent of the stock of Parent from Group W in a taxable sale. At the time of the stock purchase in Year 3, the lawsuit had proceeded to pretrial discovery. In negotiating the purchase price, Taxpayer was unwilling to assign any value to the lawsuit. Although Target had been separating out various assets that Taxpayer did not want to acquire, placing them into two separate entities, it was not practicable for Target to separate out the lawsuit because (1) valuation was too uncertain, and any such valuation would be discoverable in the lawsuit; and (2) Target was the real party in interest to the lawsuit, which had arisen out of Target's business.

The stock purchase agreement entered into by Taxpayer and Group W provided that Target would retain and continue to prosecute the lawsuit. However, because it was Group W rather than Taxpayer or Target that was interested in pursuing the lawsuit, Group W agreed to fund the lawsuit and Taxpayer agreed to allow Group W to control the proceedings. The lawsuit initially was funded with \$A, which had been placed in escrow pursuant to the purchase agreement and which was taken into account in the total amount of consideration paid for the shares. The purchase agreement provided

that Group W would be liable for any expenses in excess of the initial escrow amount if Group W continued to pursue the lawsuit. Accordingly, after the initial escrow amount was exhausted Group W provided additional funding for the lawsuit, ultimately paying $B in litigation costs to law firms and other parties. The $B was paid as the services were performed and expenses were incurred in Years 4.

Under the purchase agreement, Group W was entitled to receive all "Net Recovery Amounts (which shall constitute a part of the Share Purchase Consideration)" derived from the lawsuit. "Net Recovery Amounts" was defined generally as any amount received by Target, Parent or Taxpayer from the lawsuit after the closing date of the purchase agreement, net of any costs, taxes or other liabilities incurred by Target, Parent or Taxpayer in connection with the lawsuit. The agreement further stated that "all Net Recovery Amounts * * * will be treated as a component of the Share Purchase Consideration when received for all tax and tax reporting purposes and the Parties will not take any tax position inconsistent with such treatment."

By the end of Year 3, when Taxpayer acquired Target, the third count in the lawsuit had become moot. Target no longer had the operating infrastructure necessary to manage Entity Y, and neither Target nor Taxpayer had an interest in owning Entity Y or any part thereof.

The lawsuit was settled in Year 5. The settlement agreement released all parties from all claims without any admission of wrongdoing. Pursuant to the settlement agreement, Entity X agreed to pay Target $C.

ISSUE #1

The first ruling requested by Taxpayer is that the proceeds received in settlement of the lawsuit are ordinary income in Year 5.

The character of income received in settlement of a lawsuit generally is determined using the origin-of-the-claim test. The test focuses on the origin and nature of the claim and looks to the nexus between the origin of the litigation and the basis with which the settlement was reached, not to the taxpayer's subjective motives. *United States v. Gilmore*, 372 U.S. 39, 48-49 (1963); *Newark Morning Ledger Co. v. United States*, 539 F.2d 929, 935 (3d Cir. 1976).

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 (1973):

> [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 basic function of the origin-of-the-claim test in characterizing an amount received in satisfaction of a claim is to treat the amount 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). Accordingly, if a settlement recovery represents damages for lost profits or earnings, it is taxable as ordinary income. *Sager Glove Corp v. Commissioner*, 36 T.C. 1173, 1180 (1961), *aff'd*, 311 F.2d 210 (7th Cir. 1962); *Keller Street Development Co. v. Commissioner*, T.C. Memo. 1978-350, *aff'd,* 688 F.2d 675 (9th Cir. 1982)

The facts in this case, as represented by Taxpayer, show that the lawsuit arose from Target's trade or business activities, specifically from its attempt to expand further into an existing line of business through acquisition of the Entity Y assets. Furthermore, Target was—both before and after its acquisition by Taxpayer—the real party in interest to the lawsuit. While Group W was given the right to control the proceedings, Target retained and continued to prosecute the lawsuit.

At the time the lawsuit was settled, three counts had been asserted: Two counts for monetary damages for lost profits (breach of contract and breach of fiduciary duty), and a third count in which Target sought a constructive trust to hold an ownership interest in the successor in interest to Entity Y.

Taking into account Taxpayer's factual representation that at the time of the settlement the third count in the lawsuit was moot, and Target was seeking only a recovery of lost profits, we agree with Taxpayer that the damages received in settlement of the lawsuit are ordinary income to the taxpayer in Year 5, the year of receipt, under the origin-of-the-claim test.

In the event that the Service did not agree with Taxpayer's argument with respect to the second issue, discussed below, Taxpayer presents an alternative argument with respect to both issues. We address only the first premise in this alternative argument; namely, that the receipt of the settlement proceeds by Target relates back to Taxpayer's purchase of Parent stock and, under the *Arrowsmith* doctrine, should be treated as a purchase price reduction resulting in a reduction in Taxpayer's basis in Parent stock.

The *Arrowsmith* doctrine originated with the opinion of the Supreme Court in *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), in which the Court held that taxpayers who were required to pay a liability attributable to capital gain realized on the liquidation of stock in a prior year must treat the payment as a capital loss. The Court stated that the taxpayers' liability as transferees of the corporation had not been based on any ordinary

business transaction of the taxpayers apart from the liquidation proceedings. Under the *Arrowsmith* doctrine, two transactions, one occurring subsequent to the other and each integrally related, are treated as parts of the same transaction, so that the subsequent event relates back to and is given the same character as the prior transaction. 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. Memo. 2000-361.

We disagree with Taxpayer's alternative argument because we conclude that it is inconsistent with the factual representations made by Taxpayer. The settlement proceeds were paid by Entity X to Target in settlement of a claim arising out of Target's business. The proceeds were not paid to Taxpayer (or Target) as additional consideration for Taxpayer's purchase of Parent's stock from Group W. Because the settlement proceeds received by Target were in no manner related to Taxpayer's acquisition of Parent and Target, the *Arrowsmith* doctrine is not applicable with respect to Target's receipt of the proceeds.

The Tax Court addressed a similar argument in the case of *Keller Street Development Co. v. Commissioner*, *supra*, involving a settlement payment received in a shareholders' derivative suit. The suit had arisen in connection with the purchase and sale of corporate assets. The court applied the origin-of-the-claim test and found that the payment was received as a substitute for lost profits, concluding that the payment was ordinary income. The court refused to apply the *Arrowsmith* doctrine in order to relate the settlement payment back to the 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 further stated that "the origin-of-the-claim test demands an analysis of the underlying claim, *Arrowsmith* notwithstanding."

Taxpayer cites *Freedom Newspapers, Inc. v. Commissioner*, T.C. Memo. 1977-429, in support of its argument that *Arrowsmith* should apply in this case. In *Freedom Newspapers*, the taxpayer-corporation acquired four newspapers, one of which the taxpayer initially did not want to purchase. In order to induce the taxpayer to purchase the unwanted newspaper, a third-party broker entered into an agreement with the taxpayer that required the broker to attempt to resell the newspaper for a set price in a set amount of time or, in the event that the broker failed to resell the newspaper, to pay the taxpayer $100,000. The broker was unable to sell the newspaper, resulting in a payment to the taxpayer that was made several years after the purchase. The Tax Court held that that the payment received by the taxpayer was sufficiently related to the original purchase that its characterization must be made in reference to the original transaction. Accordingly, the court held that the $100,000 was a reduction in the purchase price of the newspaper, resulting in a reduction in the taxpayer's basis in the newspaper.

The facts in *Freedom Newspapers* are distinguishable from the case at hand. The payment in *Freedom Newspapers* clearly related back to the original purchase of the underlying asset because the payment was made pursuant to an agreement entered into at the time of the purchase, and the taxpayer would not have purchased the asset in the absence of the agreement. In the present case, the payment originated not from an agreement concerning Taxpayer's purchase of Parent and Target, but rather from the settlement of a lawsuit that arose out of the conduct of Target's trade or business. In fact, the lawsuit arose a number of years prior to the time Taxpayer acquired Parent and Target. There was no connection between the lawsuit and the purchase.

A case with facts more analogous to the present case is *Nahey v. Commissioner*, 111 T.C. 256 (1998), *aff'd*, 196 F.3d 866 (7th Cir. 1999). In *Nahey*, a taxpayer (through two S corporations) purchased the assets of Wehr Corporation, including a pending lawsuit against Xerox Corporation that had arisen from the conduct of Wehr's trade or business. Because the taxpayer considered the lawsuit too speculative to be valued, no portion of the assets' purchase price was assigned to the lawsuit. Six years after the sale, the lawsuit was settled and the taxpayer received a $6 million settlement. The taxpayer argued that the settlement proceeds were capital gain to the taxpayer because the lawsuit was purchased from Wehr in a capital transaction; namely, the purchase of Wehr's assets. The court disagreed and held that the proceeds were ordinary income to the taxpayer. While the court's rationale for the holding centered primarily on the lack of an underlying sale or exchange, the court specifically rejected an argument by the taxpayer that the *Arrowsmith* doctrine required capital gain treatment because the proceeds related to the prior acquisition of assets. The court stated that:

> The acquisition of Wehr's assets was not the basis for the lawsuit against Xerox, and the settlement in favor of the S corporations was not related to the leveraged buy out. The origin of the claim in this case was Xerox's breach of contract, as detailed in the complaint filed by Wehr in the District Court. The treatment of the settlement proceeds as ordinary income or capital gain is not dependent on the fact that the S corporations acquired Wehr's assets in a capital transaction. As such, the *Arrowsmith* doctrine is inapplicable. [Citation and footnote omitted.]

In an accompanying footnote, the court cited *Fahey v. Commissioner*, 16 T.C. 105, 108 (1951), and *Pounds v. United States*, 372 F.2d 342, 349 (5th Cir. 1967), for the proposition that "the mere occurrence of a sale or exchange of the subject asset at some point in time is not sufficient to obtain capital gain treatment on a later disposition. The sale or exchange must be proximate to the event which gave rise to the gain." *Nahey v. Commissioner*, *supra* at 266 n.4.

Taxpayer attempts to distinguish *Nahey* on the following grounds:

> In *Nahey*, the taxpayer purchased a pending lawsuit seeking lost profits as part of an acquisition. Other than being part of one of the assets, the lawsuit was not

> an integral part of the acquisition. It was not a contingent claim that affected the terms of the acquisition. An indemnity agreement did not exist and the outcome of the lawsuit did not affect the final purchase price. Based on these facts, the court held that the settlement amount was ordinary income to the taxpayer. In contrast, as described above, the lawsuit at issue determined the final purchase price and played an integral role in the acquisition. Thus, the settlement proceeds received by [Taxpayer] should be characterized for tax purposes by reference to the acquisition, *i.e.*, a reduction in its purchase price of [Parent] stock.

The facts in the case at hand do not show that the lawsuit significantly determined the final purchase price in Taxpayer's acquisition of Parent and Target. Other than the escrowed funds used to pay the initial $A in litigation expenses, Taxpayer did not place any value or cost on the lawsuit and therefore did not take into account any such value in the amount of consideration paid for the shares at the time the agreement was entered into. The purchase agreement contemplated only that the settlement proceeds paid to Group W, after their receipt by Target, would be additional consideration for Group W's stock. In other words, the purchase agreement contemplated a contingent adjustment to the purchase price in the amount of the payment to Group W if the outcome of the lawsuit showed that the value of Target and its business operations was greater than contemplated at the time the purchase agreement was entered into. While the payment of the proceeds by Target to Group W was a payment of additional consideration based upon the change in the value of Target's business, the payment of the proceeds by Entity X to Target was a payment in settlement of the lawsuit that arose out of Target's business. Similarly to the transfer of the lawsuit as an asset in *Nahey*, the transfer of ownership of Target did not change the nature of the lawsuit itself and did not change the characterization of the settlement proceeds from ordinary income to either capital gain or a purchase price adjustment when the proceeds were received by Target.

ISSUE #2

The second ruling requested by Taxpayer is that the litigation costs and related expenses attributable to the lawsuit are ordinary expenses that are fully deductible in Year 5.

Section 162(a) of the Internal Revenue Code allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 461(a) of the Code provides that the amount of a deduction under § 162(a) shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing a taxpayer's taxable income. Treas. Reg. § 1.461-1(a)(2)(i) provides that under an accrual method of accounting, a liability is incurred, and

generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Treas. Reg. § 1.461-4(d)(2)(i) provides that, where a taxpayer's liability arises out of the providing of services or property to a taxpayer by another person, economic performance generally occurs as the services or property is provided.

Section 118(a) of the Code states that in the case of a corporation, gross income does not include any contribution to the capital of the corporation. Treas. Reg. § 1.118-1 provides, in part, that in the case of a corporation, section 118 provides an exclusion from gross income with respect to any contribution of money or property to the capital of the taxpayer. Thus, if a corporation requires additional funds for conducting its business and obtains such funds through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special account, such amounts do not constitute income, although there is no increase in the outstanding shares of stock of the corporation. In such a case the payments are in the nature of assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company.

The facts of this case are similar to the facts presented in Rev. Rul. 83-73, 1983-1 C.B. 84. That ruling involved the merger of Z corporation with X corporation in 1979. X obtained all the assets and assumed all the liabilities of Z, including a contingent liability to C, an employee of Z. No adjustment was made during the merger to reflect the contingent liability to C. As a condition of the merger, however, A and B, the shareholders of Z, agreed to indemnify X for any after-tax expenses that X might incur as a result of C's contingent claim against Z. Subsequently, during 1981, X settled C's claim for 700x dollars. A and B then reimbursed X in the amount of 500x dollars, which was X's after-tax cost of the settlement. Rev. Rul. 83-73 concluded that X could deduct the payment to C and would not have to report the reimbursement as income. The indemnity payments related back to the initial exchange and were considered an adjustment to that exchange, based upon the *Arrowsmith* doctrine. Because they related back to the initial exchange, the indemnity payments were treated as if they had been contributions to the capital of the transferor, Z, that were made by its shareholders immediately before the merger. *See VCA Corporation v. United States*, 566 F.2d 1192 (Ct. Cl. 1977). Additionally, the ruling concluded that, under § 118 and its regulations, the indemnity payments increase the shareholders' bases in their stock of Z immediately before the merger.

In the present case, as in Rev. Rul. 83-73, there existed a contingent liability the value of which the parties were unable to determine at the time of the sale or exchange. The contemporaneous agreement by the shareholders in the ruling is effectively the same as Group W's contemporaneous agreement to pay Target's liabilities for the litigation

expenses in this case. Both agreements were directly related to, and were adjustments to, the earlier sale or exchange.

Based upon the reasoning outlined in Rev. Rul. 83-73, Group W's payment of litigation expenses on behalf of Target were contributions to the capital of Target (through Parent) made by Group W immediately before the sale. Group W's basis in its Parent stock is increased by the amount of Group W's contributions to capital. Target therefore is entitled to a deduction for the litigation expenses in accordance with the requirements of § 461 and the regulations thereunder.

Taxpayer argues, and we agree, that economic performance occurred with respect to the litigation expenses as the litigation services were provided in Years 4 and Year 5. *See* Treas. Reg. § 1.461-4(d)(2)(i). Taxpayer further argues, however, that not all events occurred to establish the fact of the liability until Year 5, when the settlement proceeds were paid to Group W. Thus, Taxpayer argues that Target may deduct in Year 5 the full $B in litigation expenses paid by Group W in Years 4 and Year 5.

Taxpayer's argument that the liabilities were not fixed until Year 5 is based upon its argument that the litigation expenses were paid using funds loaned by Group W to Target. Because the "repayment" of these funds, in the form of the payment of the settlement proceeds, was highly contingent, the liabilities were not fixed until repayment had in fact occurred. As support for this argument, taxpayer cites several cases, including *Denver & Rio Grande Western R.R. Co. v. United States*, 505 F.2d 1266 (Ct. Cl. 1974) (holding that a taxpayer could not increase its investment credit and deprecation deductions with respect to property purchased using advances that may or may not be repaid); and *Brountas v. Commissioner*, 692 F.2d 152 (1st Cir. 1982) (holding that a partnership could not currently deduct a drilling contract expense to the extent the expense had been paid using proceeds from a non-recourse note).

The common fact in each of the cited cases, and the central assertion in Taxpayer's argument, is that the taxpayer used loan proceeds to make capital investments or pay business expenses. The court in each case denied the taxpayer basis in the underlying assets, or denied deductions for the expenses, on the grounds that the taxpayer had used loaned funds which had a high likelihood of never being repaid. The taxpayer would be entitled to basis in its assets or deductions only at the time repayment was made.

The facts of the present case are distinguishable from these cases. The expenses were paid by Group W, and Group W's payment of these expenses did not take the form of a loan to Target. It is evident from the share purchase agreement that, rather than a loan, Group W was merely paying the expenses of Target pursuant to an agreement in which Group W agreed to indemnify Target for the costs of the lawsuit. Furthermore, the litigation expenses were no longer contingent liabilities as the liabilities were incurred by Target in conducting its business and paid on Target's behalf by Group W.

Target's deduction of the entire $B in liabilities in Year 5 would not be a proper method of accounting under § 461 and Treas. Regs. §§ 1.461-1 and 1.461-4, because the liabilities were properly deductible in Years 4 and Year 5 as the liabilities became fixed and economic performance occurred with respect thereto. We conclude, however, that Target's deduction in Year 5 of that portion of the $B that represents amounts that were fixed, and with respect to which economic performance occurred, in Year 5, would be a proper method of accounting.

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. The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty 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 Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Thomas D. Moffitt
Branch Chief, Branch 2
(Income Tax & Accounting)