Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:
CC:ITA:B03
PLR-108360-10
Date: 7/29/10

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's EIN:

Employee

Wife

State A

Corp B

Business C

Corp D

Location E

Business F

Date a

b

Date c

Date d

Date e

Date f

g

h

Date i

j

k

Dear :

This responds to your letter dated February 15, 2010, requesting a ruling on the federal income tax treatment with respect to the deductibility of amounts paid by the Taxpayer with respect to an employee's lawsuit and settlement, thereof.

Ruling Requested

Taxpayer requests a ruling that it will be entitled to a deduction, under section 162(a) of the Internal Revenue Code, for payments made on behalf of Employee regarding restitution and legal expenses attributable to Employee's lawsuit and settlement.

Applicable Facts

Taxpayer is a domestic subchapter S corporation that was incorporated in State A in Date a. Corp B is the sole owner of all of the stock of Taxpayer. Employee and Wife are joint owners (as tenants by the entirety) of b percent of the stock of Corp B.

Article VIII, section 8.01 of Taxpayer's By-Laws provides an indemnification for its directors, officers, employees or agents who, while serving at the request of the corporation become a party to litigation whether civil, criminal, or administrative.

From c to d, Taxpayer was engaged in providing Business C services to Corp D.

Corp D was in the business of providing investment services to its clients. Specifically, the purpose of Corp D was to invest and reinvest monies for its clients in bank certificates of deposit ("CDs") seeking the best rates of return available at the time in the marketplace. Corp D used a database of information to search banks nationwide for the best terms and rates of return available for CDs, and Corp D invested its clients' monies accordingly.

Taxpayer, through Employee, provided Business C services to Corp D. Employee was responsible for finding the rates for bank CDs, assisting in placing CDs for the customers of Corp D, producing paperwork related to those purchases including trade tickets, trade confirmations, interest credit memos, and other Business C activities for the benefit of its client, Corp D. Taxpayer was compensated a flat fee of approximately $j per year for providing such services to Corp D.

Near the end of Taxpayer's relationship with Corp D, on or about Date e, Employee became aware that Corp D had wrongfully liquidated CDs of clients and had not reinvested the proceeds as it was supposed to do. Rather, Corp D held the investment funds of such clients in Corp D's general account but mailed a statement to Corp D's client that reflected the monies were still invested in a CD, when, in fact, they were not so invested.

Taxpayer, through Employee, subsequently ceased providing services to Corp D. In addition, Employee eventually notified the Office of the United States Attorney for Location E (the "Enforcement Section") of the allegedly fraudulent investment activities of Corp D.

During the Enforcement Section's investigation, it was determined that Corp D had defrauded numerous clients through embezzlement of investment funds by the sole owner of Corp D. It was also determined by these governmental authorities that neither Employee nor Taxpayer participated in the fraudulent scheme.

As a result of the governmental investigation, it was determined that Employee's notification to the Enforcement Section was not timely. It was further determined that Employee should have alerted the authorities about his knowledge regarding the activities of Corp D and its sole owner at an earlier date. Therefore, the Enforcement Section concluded that Employee was guilty of the crime of misprision. Taxpayer represents that misprision means a failure by a person, not an accessory, to timely notify a government authority of the occurrence of an ongoing felony and concealment of such felony. Consequently, Employee agreed to plead guilty to the crime of misprision because Employee had knowledge that Corp D had sent erroneous and false statements to clients and Employee had not timely informed governmental authorities of the crimes being committed by Corp D.

In pleading guilty to the charge of misprision, and at the order of the United States District Court, Location E on Date f, Employee was sentenced to a period in prison. In addition, the Federal Court also determined that Employee should be held jointly and severally liable with Corp D for payments of restitution in the amount of $g, which represents the clients' losses resulting from misprision during a h month period. That amount was paid by Taxpayer on behalf of Employee in Date i.

It is represented that Taxpayer and Corp B have other clients and customers, and are concerned that they maintain their business names and reputations in order to continue their business activities.

Based upon the above, separate civil actions were brought against the Taxpayer, Employee, as well as Corp D and its owner. Taxpayer and Employee were required to hire defense attorneys and incurred legal expenses over $k.

Law

Section 162(a) of the Code provides that there is allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 1.162-1(a) of the Income Tax Regulations provides that deductible business expenses include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business.

Section 263(a) provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

Section 162(f) of the Code provides that no deduction shall be allowed under section 162(a) for any fine or similar penalty paid to a government for the violation of any law.

18 U.S.C § 3663A(c)(1)(A) and (B), provides in part, that this section applies to an offense against property under this title, including any offense committed by fraud or deceit, and in which identifiable victims have suffered a pecuniary loss.

18 U.S.C. §3663(A)(b)(1)(B) provides in part, that the order of restitution under § 3663A shall require the defendant to pay an amount equal to the greater of the value of the property on the date of the damage, loss or destruction, or the value of the property on the date of sentencing, less the value of any part of the property that is returned.

Discussion

To qualify as a deduction allowable under section 162 of the Code, an expenditure must satisfy a five part test: it must (1) be paid or incurred during the taxable year, (2) be for carrying on a trade or business, (3) be an expense, (4) be necessary, and (5) be ordinary. Commissioner v. Lincoln Savings and Loan Association, 403 U.S. 345, 352 (1971)..

Generally, an expense arising from a taxpayer's trade or business is ordinary and necessary, and therefore, is deductible under section 162 of the Code. Ditmars v. Commissioner, 302 F.2d 481, 485 (2nd Cir.1962).

The Supreme Court, in Welch v. Helvering, 290 U.S. 111 (1933), has discussed the meaning of the term "ordinary." The Court stated:

> Ordinary in this context does not mean that the payments must be habitual or nominal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. Nonetheless, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, and the common and accepted means of defense against attack. Welch, 290 U.S. at 114. The Supreme Court in Welch also explained that the term "necessary" under section 162 of the Code imposes only the minimal requirement that the expense be appropriate and helpful for the taxpayer's business.

In Old Town Corporation v. Commissioner, 37 T.C. 845 (1962), acq., 1962-2 C.B. 52, the court held that a payment by a corporation to settle a claim asserted against it in a lawsuit by a former employee constituted an ordinary and necessary business expense. Citing Welch, the court held that the settlement payment was ordinary because it resulted in the protection of the corporate assets that were subject to the lawsuit.

Taxpayers' payment will be deductible under section 162 of the Code as a trade or business expense only if it is not a personal expenditure, a capital expenditure under section 263 of the Code, or subject to 162(f). The controlling test to distinguish business expenses from personal or capital expenditures is the "origin of the claim" test. Anchor Coupling Company v. United States, 427 F.2d 429, 433 (7th Cir.1970), cert. denied, 401 U.S. 908 (1971).

The origin of the claim test was first set forth by the Supreme Court in United States v. Gilmore, 372 U.S. 39 (1963). In Gilmore, the Court held that the controlling test of whether an expense is "business" or "personal" is to consider the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer. See also Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970).

Although these Supreme Court cases considered whether an expense was business or personal, the origin of the claim test has also been applied to distinguishing between business and capital expenditures. For example, in Anchor Coupling, the court held that examination of the origin and character of the claim with respect to which a settlement is made, rather than the estimation of the potential consequences of the claim upon the business operations of the taxpayer, is the controlling test in determining whether a settlement payment constitutes a deductible business expense or a nondeductible capital outlay. Anchor Coupling, 427 F.2d at 431 (citing Gilmore, Woodward, and Hilton Hotels, supra).

The Tax Court has described the origin of the claim rule as follows:

> Quite plainly, the "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 purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertaining to the controversy. Boagni v. Commissioner, 59 T.C. 708, 713 (1973), acq., 1973-2 C.B. 1.

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); Kornhauser v. United States, 276 U.S. 145 (1928) (attorney fees that are directly connected with, or are proximately result from a taxpayer's business, are deductible).

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 section 263(a) of the Code. See Woodward v. Commissioner, 397 U.S. at 575 (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. at 583 (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).

However, 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. at 47. 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).

In the instant case, the payment by Taxpayer of restitution resulted from Employee providing operational services, on behalf of the Taxpayer, to Corp D. It is clear that Employee's delay in reporting Corp D's illegal activities arose from his ordinary business activities, rather than a capital transaction. Under the origin of claim test, the Employee's conduct was within the normal course of business activities he performed for the Taxpayer. As a result, Taxpayer made the restitution payment, on behalf of Employee, under its contractual obligation to indemnify Employee. Therefore, after examining all the facts and circumstances, the payment of restitution was a business expense, and not a personal expense or a capital expenditure.

The next issue to be addressed is whether the restitution payment is deductible under section 162(a) of the Code, or whether the payment is more akin to a fine or similar penalty paid to a government for the violation of any law, and thus, nondeductible under section 162(f). Under Employee's plea agreement with the office of the United States Attorney and 18 U.S.C § 3663A, it is clear Taxpayer's restitution payment was intended to be compensatory in nature. Again, applying the origin of claim test, since the payment is compensatory, as opposed to a fine or penalty within the meaning of section 162(f) of the Code, Taxpayer's restitution payment is not precluded from being deductible under 162(a).

The origin of claim test will also be used in determining whether the legal fees are deductible under section 162(a) of the Code. Since the legal fees were directly connected to Taxpayer's business activities and were for the protection of corporate assets, as opposed to expenditures, such expenses are deductible under section 162(a).

Conclusion and Ruling

Based solely on the facts and representations submitted, we conclude and rule as follows:

Under the origin of the claim test, Taxpayer's payments made on behalf of Employee for restitution and legal expenses attributable to Employee's lawsuit and settlement had its origin in the conduct of Taxpayers' trade or business. An examination of all the facts indicates that both the restitution and legal expenses were ordinary and necessary business expenses, and not personal expenditures, capital expenditures or subject to section 162(f) of the Code, and therefore, such expenses are deductible under section 162(a).

DISCLAIMERS AND LIMITATIONS:

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.

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.

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.

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.

Under the powers of attorney on file in this office, a copy of this ruling is being sent to your authorized representative.

Sincerely,

Christopher F. Kane
Branch Chief, Branch 3
(Income Tax & Accounting)