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LEGEND

Taxpayer =

x =

Date A =

Date B =

Date C

Date D =

Date E =

p =

Year 1=

Dear :

This is in response to your request for a ruling that the amounts incurred to settle a class action suit, including legal fees and other administrative fees attributable to the suit, are deductible as ordinary and necessary business expenses under section 162 of the Internal Revenue Code.

FACTS

The Taxpayer is in business x. In Year 1, various federal securities class action suits were filed against Taxpayer and certain officers of Taxpayer. These actions were consolidated and a consolidated class action complaint (“Complaint”) was filed against the Taxpayer on Date A by the lead plaintiff. The class is defined as all persons or entities who purchased or otherwise acquired Taxpayer’s securities from Date B through Date C and who were damaged thereby. A subclass is defined as consisting of all persons or entities who purchased or otherwise acquired newly issued Taxpayer’s securities pursuant to the Prospectus Supplement dated Date D and who were damaged thereby.

In addition, three federal derivative lawsuits and two state derivative lawsuits were filed against the Taxpayer. The federal income tax consequences of the outcome of the federal and state derivative lawsuits are not addressed in this letter ruling.

The Complaint alleges that the Taxpayer violated various provisions of federal securities laws by the issuance of materially false and misleading statements concerning Taxpayer’s revenues, earnings, profitability, and financial condition in ten SEC filings issued between Date B through Date C. Specifically, the claims were that the defendants (i) deceived the investing public (ii) artificially inflated and maintained the market price of Taxpayer’s securities and (iii) caused the plaintiff and class members to purchase Taxpayer’s securities at artificially inflated prices. The claims were based on fraudulent financial information in various SEC documents concerning Taxpayer’s revenues, earnings, profitability, and financial condition. The Complaint alleged that Taxpayer improperly recognized revenue by recording revenue in quarters it had not been earned in violation of generally accepted accounting principles, and made material errors in its purchase accounting, recording of impairments, recording of accrued expenses, and recording of deferred compensation. These accounting irregularities were designed to create an illusion of linear revenue growth and make it appear as though Taxpayer was capable of delivering steady, reliable growth, while in reality, Taxpayer had uneven ordering patterns and high customer concentration.

The first claim in the Complaint alleged violation of Section 10(b) of the Securities Exchange Act of 1934, by means of issuing materially false and misleading statements, and Section 20(a) of the same Act because Taxpayer’s officers were controlling persons as to Taxpayer. The second and third claims alleged violation of Sections 11, 12(a)(2) and 15 of the Securities Act of 1933 by means of a Prospectus Supplement relating to a public offering of shares of its common stock in which the Taxpayer issued materially false and misleading statements concerning its financial results by incorporating previously filed SEC reports that contained material misrepresentations and or omissions. The Section 10(b) claims against the individual defendants were dismissed.

The Section 11 claim was dismissed as to the individual defendants, but upheld with respect to Taxpayer. The Section 15 claim as to the individual defendants was upheld. The Section 12(a)(2) claim was dismissed by the Court as to both Taxpayer and Taxpayer's officers.

Taxpayer and the individual defendants vigorously contested the claims brought against them in the securities class action lawsuit, and have denied committing any wrongful act or liability. However, in order to eliminate the risks, expense, and length of continued proceedings necessary to defend the lawsuit, the defendants agreed to mediation following which the defendants agreed to settle the case. On Date E, the lead plaintiff and the defendants, including Taxpayer, entered into a stipulation and agreement of settlement, which provided for the Taxpayer to pay \$p in settlement of the securities class action lawsuit. Taxpayer also paid legal fees and other administrative fees attributable to the lawsuit and settlement.

Ruling Requested

Taxpayer requests a ruling that its payment of amounts to settle the securities class action lawsuit, including any legal fees and other administrative fees attributable to the lawsuit and settlement thereof, are deductible as ordinary and necessary business expenses under section 162.

Law and Analysis

Under section 162(a) of the Internal Revenue Code, 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.

In order to be deductible under section 162, an expenditure must be (i) paid or incurred during the taxable year; (ii) sustained in carrying on a trade or business; (iii) an expense; (iv) a necessary expense; and (v) an ordinary expense. Commissioner v. Lincoln Savings and Loan Association, 403 U.S. 345, 352 (1971).

Section 263(a) prohibits a deduction for capital expenditures. Under section 263(a), an expense must be capitalized if incurred for new buildings, permanent improvements, or betterments made to increase the value of any property or estate. Section 1.263(a)-5(a)(8) of the Income Tax Regulations states that a taxpayer must capitalize an amount paid to facilitate a stock issuance.

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 section 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).

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. 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).

In Missouri Pacific Corp. v. United States, 5 Cl. Ct. 296, (1984), the court held that settlement costs were not deductible because the predominant nature of the lawsuit involved the adequacy of the consideration paid for a target corporation's stock in an exchange offer, and thus, the lawsuit was grounded in a capital transaction. In that case, 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. 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.)

In the present case, the issue involves whether Taxpayer's payment to settle its class action lawsuit as well as legal and administrative fees associated with its class action lawsuit may be deducted under section 162 as an ordinary and necessary business expense or must be capitalized under section 263(a). 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. Because the litigation at issue 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.

The first claim alleged violation of Section 10(b) of the Securities and Exchange Act of 1934 pursuant to Rule 10b-5 promulgated under that section and Section 20(a) of the same Act because Taxpayer's officers were controlling persons as to Taxpayer. This claim arose as a result of the publication of allegedly fraudulent financial information in various SEC documents concerning Taxpayer's revenues, earnings, profitability, and financial condition. Specifically the Complaint alleged that Taxpayer improperly recognized revenue by recording revenue in quarters it had not been earned in violation of generally accepted accounting principals, and made material errors in its purchase accounting, recording of impairments, recording of accrued expenses, and recording of deferred compensation. These accounting irregularities were designed to create an illusion of linear revenue growth and make it appear as though Taxpayer was capable of delivering steady, reliable growth, while in reality, Taxpayer had uneven ordering patterns and high customer concentration. Generally, the preparation and publication of financial statements is a common and routine activity in the carrying on of 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); Ostrom v. Commissioner, 77 T.C. 608 (1981); Rev. Rul. 80-211, 1980-2 C.B. 57. Therefore, we believe the origin of this claim was in the ordinary conduct of Taxpayer's trade or business.

The second claim is based on violation of Section 11 and Section 15 of the Securities Act of 1933 against Taxpayer and Taxpayer's officers on behalf of members of the class who acquired Taxpayer's shares pursuant to the Prospectus Supplement dated Date D. Under Section 11 of the Securities Act purchasers of a registered security are allowed to sue when false or misleading information is included in a registration statement. The claim alleges that the Prospectus Supplement contained untrue statements of material fact and/or omitted to state material facts required to be stated therein which were necessary to make the statements therein not misleading, in violation of Section 11 of the Securities Act. The materially false and misleading statements were contained in the Prospectus Supplement by means of incorporating previously filed SEC reports that contained material misrepresentations and/or omissions, in particular certain Form 10-Ks and Form 10 Qs filed during the period between Date B and Date C. The Prospectus Supplement did not make any disclosure of taxpayer's revenue manipulations other than by incorporation of those documents. Under Section 15, derivative liability is imposed upon persons who control those liable under Sections 11 or 12 of the Securities Act of 1933.

While the second claim is brought on behalf of purchasers of stock pursuant to a specific stock offering, the allegations involve representations which are part of ordinary business activities, i.e. the SEC filings in which the fraudulent statements occur. Therefore, 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 a stock offering. Rather, the alleged misrepresentations occurred in a number of filings which were produced over a period of time as part of regular business activities. Accordingly, we believe that the second claim also arose in the ordinary conduct of the taxpayer's business. This is distinguishable from Missouri Pacific, supra, and Berry Petroleum, supra, in which the courts determined that the claims originated in the Taxpayers' acquisitions of targets' stock, rather than in their ordinary business operations.

The third claim alleges violation of Section 12(a) of the Securities Act of 1933 alleging that Taxpayer and its officers offered or sold securities by means of the Prospective Supplement dated Date D which included untrue statements of material fact and/or omitted to state material facts required to be stated therein which were necessary to make the statements therein not misleading. The Section 12(a)(2) claims were dismissed by the court. The materially false and misleading statements were contained in the Prospectus Supplement by means of incorporating previously filed SEC reports that contained material misrepresentations and/or omissions, in particular certain Form 10-Ks and Form 10-Qs filed during the period between Date B and Date C. The third claim, like the second claim, involved representations which are part of ordinary business activities, i.e. the SEC filings in which the fraudulent statements occur. Therefore, 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.

Conclusion

We conclude that Taxpayer's payment of amounts to settle the securities class action lawsuit, including any legal fees and other administrative fees attributable to the lawsuit and settlement thereof, are deductible as ordinary and necessary business expenses under section 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.

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.

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.

Sincerely,

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