OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Richard E. Coss
Assistant to the Branch Chief CC:CORP:3

SUBJECT:

This Field Service Advice responds to your memorandum dated June 5, 2001. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Field Service Advice should not be cited as precedent.

LEGEND

Taxpayer =

Sub =

A =
Year 1 =
Year 2 =

Date 1 =
Date 2 =
Date 3 =
Date 4 =
Date 5 =
Date 6 =

Date 7 =
Date 8 =
a =

b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
Citation 1	=
Citation 2	=

ISSUES:

1. Whether any part of the amount paid by Taxpayer in redemption of its stock can be deducted as an ordinary and necessary business expense under § 162(a)? (Specifically, whether any part of the amount paid by Taxpayer of the judgment against its directors/shareholders can be deducted as an ordinary and necessary business expense under § 162(a)?)

   a. If any part of the amount paid can be deducted as an ordinary and necessary business expense, how should the amount be determined?

2. Whether any part of the amount paid by Taxpayer in redemption of its stock can be deducted as interest under § 163? (Specifically, whether any amount paid by Taxpayer for the interest on the judgment against its directors/shareholders can be deducted as an ordinary and necessary business expense under § 162(a)?)

   a. If any part of the amount paid can be deducted as interest, how should the amount be determined?

3. Whether fees, costs, and other expenditures related to the redemption and bankruptcies can be deducted as ordinary and necessary business expenses under § 162(a)? (Specifically, whether any amount paid by Taxpayer of the legal fees that the directors/shareholders incurred in the initial litigation or the bankruptcy proceedings can be deducted as an ordinary and necessary business expense under § 162(a)?)

CONCLUSIONS:

1. To the extent that payment by Taxpayer of the judgment against the directors/shareholders was for Taxpayer to acquire its own stock, the payment is not a deductible business expense. How much of the payment was to acquire its own stock is a question of fact. Whether the remainder, if any, of the payment was deductible as an ordinary and necessary business expense depends on a factual determination as to whether Taxpayer reasonably believed that it may have been liable to indemnify the directors/shareholders for the judgment.

2. The answer to this issue is the same as the answer to the first issue. If it is determined that a portion of the payment of the judgment amount is a deductible business expense because Taxpayer reasonably believed that it was liable, then a portion of the interest is deductible as a business expense. The interest would be allocated in the same manner and proportion that the judgment amount is allocated.

3. The answer to this issue follows from the answer to the first issue. How much of the legal expenses are deductible as an ordinary and necessary business expense depends on how much of the payment by Taxpayer of the judgment is an ordinary and necessary business expense. How much of the payment for legal expenses that can be allocated to the portion of the judgment that is an ordinary and necessary business expense is a factual question.

FACTS:

Taxpayer is a domestic corporation and the common parent of an affiliated group that files a consolidated federal income tax return with Sub and other corporations. Prior to the redemption (described below), Taxpayer was owned by A, and individual, and A's children. The redemption arose out of litigation between two factions of the family for control of the company. In Year 1, A and certain members of A's family who supported him (the "Plaintiffs") brought suit and sought relief both individually and derivatively on behalf of Taxpayer.[1] The Plaintiffs sued certain other family members and certain other individuals who also served as members of Taxpayer's Board of Directors (collectively, the "Defendants"). Taxpayer was a named defendant for the purpose of enforcing equitable relief. The

[1]The Plaintiffs named in the suit were the family members and certain holding corporations formed for estate planning purposes and through which they asserted to be beneficial owners of Taxpayer stock. They brought suit in their capacity as shareholders.

Plaintiffs asserted multiple causes of action and sought various remedies as follows:

Cause of Action	Remedy Sought
Count One Breach of fiduciary duty by officers, directors and controlling shareholder	Equitable relief in the form of a judgment restraining and enjoining certain actions
Count Two Wrongful exclusion from board of directors	Declaratory judgment establishing the status of certain individual plaintiffs as duly elected members of the board of directors
Count Three Breach of fiduciary duty to Taxpayer (derivative suit)	Damages, imposition of a constructive trust and injunctive relief
Count Four Breach of contract and covenant of good faith and fair dealing	Damages and other relief as is just and equitable "to restore the parties to the status quo"

The case proceeded for many years. The initial focus of the Plaintiffs was to regain control of Taxpayer. However, the causes of action seeking injunctive and declaratory relief were eventually dismissed and Taxpayer was dismissed as a defendant.

In Year 2, the Defendants moved for summary judgment on the remaining causes of action. They argued that the Plaintiffs "failed to present a legally cognizable theory of damages." Plaintiffs asserted a theory which sought damages for the full value of their stock and at the same time allowed them to retain their stock. In response to the motion, the trial court ruled that, prior to submitting the case to the jury, the Plaintiffs would have to elect to either surrender their Taxpayer common stock or dismiss their lawsuit and continue to be shareholders.

At the conclusion of the trial, the Plaintiffs elected to surrender their Taxpayer stock. This development of the case has been summarized as follows:

> The state court, perhaps in an effort to reduce the opportunity for further feuding, ruled during the trial that, if the plaintiffs prevailed and were awarded damages on their worthless stock theory, there would be a "double recovery" inherent in permitting the plaintiffs to collect money damages and to retain their stock. Hence, before allowing the case to go to the jury, the state court made the plaintiffs choose between either: (1) dismissing the case and retaining their stock; or (2) surrendering their stock upon payment of an amount to be determined

by the jury. The plaintiffs chose the latter option, agreed that surrender of stock would be a condition of a money judgment, and presented their case to the jury.

Citation 1.

The jury rendered a verdict and determined that members of the Board of Directors had breached their fiduciary duty to the Plaintiffs and that the breach had virtually eliminated the value of the Plaintiffs' stock. The jury determined that the Year 1 value of the Plaintiffs' stock was $a per share and the Year 2 value was only $b per share. This would have resulted in a "damage" verdict of approximately $c. On remittitur, the award was reduced to $d per share.

On Date 1, the trial court entered its Judgment on Special Verdict and Remittitur. It granted Plaintiffs judgment in the amount of $e (f shares times $d per share) plus interest (10% per annum accruing from Date 2). It further provided that upon payment of the judgment, together with interest and accrued costs, all of the Plaintiffs stock would be transferred to Defendants or their designees. The judgment amounted to a judicially forced sale of the stock at its Year 1 value.

On the same day the judgment was entered, the judgment Defendants commenced Chapter 11 bankruptcy cases. They filed Chapter 11 plans which proposed to pay the judgment in full, but without payment of any interest accruing after the bankruptcy petition date. The plans further proposed that Taxpayer would make the payment and in return receive the Plaintiffs' stock.[2]

The bankruptcy court denied confirmation of the plans because, among other reasons, they provided for transfer of stock without payment of interest accruing after commencement of the bankruptcy cases. The parties then agreed to modified plans which placed the disputed interest in escrow to be resolved through separate litigation. This allowed the modified plans to be confirmed without waiting for a result from appellate courts on whether the bankruptcy court was correct.

In analyzing the interest issue, the bankruptcy and appellate courts struggled with how to characterize the judgment. Typically, money judgments for damages can be satisfied in a Chapter 11 case without payment of postpetition interest; that appears to be one of the objects in commencing the bankruptcy cases. On the other hand, a Chapter 11 debtor can only enforce the rights of an executory contract by fulfilling the obligations associated with it. The bankruptcy court, and the appellate courts which later affirmed it, treated the judgment as a "judicially-ordered right to

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[2] This was described by Taxpayer as an action which it took "pursuant to either its right of first refusal under its bylaws, or in the pursuit of a corporate opportunity."

acquire property for a pre-arranged price" or a "judicially prescribed sale of stock," rather than a money judgment for damages.[3]

Pursuant to the modified plans and escrow arrangement, Taxpayer satisfied the judgment with postpetition interest and received a transfer of Plaintiffs' stock. The payments and transfers occurred between Date 3 and Date 4. Taxpayer also funded all of the fees and costs incurred by the individual Defendants in connection with their bankruptcy cases.

On its returns, Taxpayer treated the payments as a redemption to the extent of $g per share[4] and deducted the balance as an ordinary and necessary business expense. It also deducted all of the interest paid and all of the costs of the Chapter 11 bankruptcy cases. This request for Field Service Advice concerns the treatment of these payments on Taxpayer's consolidated returns for the tax years ended Date 5 and Date 6.

Taxpayer has argued that this case simply presents an allocation issue: how much of the payment should be treated as redemption costs (nondeductible under § 162(k)) and how much should be treated as the payment of ordinary and necessary business expenses (deductible under § 162(a)). It argues that most of the payment is properly deductible as a business expense incurred in performing its obligation under the indemnification agreement to satisfy the money judgment entered against the Defendants.

AREA COUNSEL'S POSITION:

You would like to assert as your primary position that the entire transaction should be treated as a redemption, the expense of which is nondeductible under § 162(k); and, as a secondary position, you would assert that even if an allocation is called for, little or no amount should be allocated to expenses deductible under § 162(a) since the stock had a value at the time of the redemption at least as much as the amount of the judgment.[5]

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[3]Citation 2

[4]Apparently, this was the price used in ESOP purchases in Year 1.

[5]On Date 7, one of the director Defendants sold stock to the Taxpayer at $h per share. On Date 8, Taxpayer sold stock under a public offering at $i per share.

LAW AND ANALYSIS:

I. Section 162(k)(1)

The first question to be decided is, to what extent can Taxpayer deduct costs associated with its redemption of its stock pursuant to a court order? Generally, no deduction shall be allowed under chapter 1 of the Code for any amount paid by a corporation in connection with the reacquisition of its stock or of the stock of any related person. *See* § 162(k)(1).[6]

Section 162(k)(1) states that no deduction is allowed for any amount paid or incurred by a corporation "in connection with" a redemption of its stock. Deductions for legal, accounting, and brokerage fees in connection with a redemption are not permitted.[7] Section 162(k)(2) states that § 162(k)(1) does not apply to deductions allowable under § 163 (relating to interest) or under § 561 (relating to the dividends paid deduction), or redemptions for regulated investment companies. The legislative history states:

> While the phrase "in connection with a redemption" was intended to be construed broadly, Congress did not intend the provision to deny a deduction for otherwise deductible amounts paid in a transaction that has no nexus with the redemption other than being proximate in time or arising out of the same general circumstances. For example, if a corporation redeems a departing employee's stock and makes a payment to the employee in discharge of the corporation's obligations under an employment contract, the payment in discharge of the contractual obligation is not subject to disallowance under this provision.

Staff of the Joint Committee on Taxation, 100 Cong., 1st Sess. (May 4, 1987) at 277.

The courts have long attempted to answer a question relevant to whether an amount paid by a corporation is "in connection with" a redemption. The courts have looked at what the shareholder(s) have received and asked whether money or an item of property distributed to a shareholder is part of the redemption price of the

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[6]The Small Business Job Protection Act of 1996 amended § 162(k) to provide that the rules of § 162(k) apply to any acquisition of its stock by a corporation or by a party that has a relationship to the corporation described in § 465(b)(3)(C) (which applies a more than 10 percent test in certain cases). P.L. 104-188, § 1704(p).

[7] Legal fees for tax advice pursuant to a stock redemption were not deductible prior to the 1986 enactment of § 162(k). Rev. Rul. 67-125, 1967-2 C.B. 31.

stock. The courts have treated this question as a question of fact. Merely because items of property are transferred to a shareholder simultaneously with a redemption of its stock does not mean that the property will be treated as part of the redemption exchange. The courts allocate the payment to the different elements to which the payment relates. The intention of the parties prevail. In the instant case it is the intention of the court in entering its judgment which will prevail. It must be determined how much of the court's judgment was intended to be allocated to the price of the stock redeemed and how much, if any, was intended to be allocated to interest or some other cost.

Wilkin v. Commissioner, T.C. Memo 1969-130, addressed whether the cash surrender value of a life insurance policy on the officer-shareholder's life was intended as part payment for the shareholder's stock. The corporation had assigned the policy to him during the period it was redeeming his stock. The court found, on the facts, that the cash surrender value was not intended as payment for the stock. Whether the distribution was taxable to the shareholder as a dividend or as compensation was not determined by the court.

In Graybar Electric Company, Inc. v. Commissioner, 29 T.C. 818 (1958), aff'd per curium, 267 F. 2d 403 (2nd Cir.), cert. denied, 361 U.S. 822 (1959), a special death benefit was paid by the corporation to a deceased employee's widow. This amount was in addition to the price set in the employee stock purchase plan to reacquire the employee's stock from his estate. The "death benefit" was held part of the price paid for the stock and nondeductible to the corporation. The "special death benefit" was payable over five redemption years and was measured by the dividends paid on a number of shares equal to the number redeemed.

Frequently stock of departing employees is redeemed. When the employee had an employment contract some part of the distribution to the employee may be in settlement of his contract right(s). Courts have had to determine whether part of the property received by the redeeming shareholder should be allocated to the employment contract. In Coca Cola v. Commissioner, 359 F.2d 913 (8th Cir. 1966), aff'g T.C. Memo 1965-285, S. Bleckman and Sons, Inc. v. Commissioner, 229 F.2d. 925 (2nd. Cir. 1956), aff'g per curium, T.C. Memo 1954-152, and Scull v. Commissioner, T.C. Memo 1964-152, the courts refused to allocate any portion of the redemption proceeds to the simultaneous termination of the employment contract. By contrast, in Lewis and Taylor, Inc. v. Commissioner, 447 F.2d 1074 (9th Cir. 1971), the court did allocate the proceeds received by the deceased shareholder-employee's estate between the redemption price of the stock and additional compensation for the decedent's past services. The $17,500 death payment by the corporation to the shareholder's estate was held to be $10,000 for redemption of the stock and $7,500 as additional compensation for decedent's past services. A key finding by the court appears to be that the fair market value of the stock redeemed was only $10,000. The Service had estimated the fair market value

of the stock at $17,500 and argued that the entire payment was attributable to the redemption.

In Royal Arrow Company v. Commissioner, T.C. Memo 1972-58, the corporation agreed to retain the redeemed shareholder as a consultant for 6 years at $25,000 a year. The consulting fee was found to be separate from the redemption price for the stock where the court found that the corporation otherwise paid fair market value for the stock. The court said it was irrelevant that the consulting agreement was the inducement to get the shareholder to redeem his stock.

In Thermoclad Company v. Commissioner, T.C.Memo 1974-289, the redeeming shareholder had been one of two equal owners of the corporation. When a dispute arose, it was agreed that one of the shareholders would be redeemed out at a price of $100,000. A redemption at that price would have put a deficit in the company's capital account, however. It was agreed that the shareholder would have his stock redeemed for $50,000 and he entered into a two year consulting agreement in which he would be paid $30,000 in the first year and $20,000 in the second year. The court found that despite the consulting agreement the shareholder was prohibited from entering the company's premises and that no consulting was ever done under the contract. The court found that the parties never intended any consulting relationship to exist; that they only recast the agreement because of the potential deficit in the company's capital account.

In allocating the property received to the redemption or the other competing elements the price of the stock being redeemed is a key factor. In Lewis and Taylor, Inc. and Royal Arrow Company, money and/or property received was first allocated to the fair market value of the stock received before it was allocated to any other source. Likewise, in this case the amounts paid by Taxpayer first should be allocated to the fair market value of the stock received. It appears that the intention of the court was to facilitate a forced sale of the stock and the judgment was its best effort to enforce a fair price for the stock. The post judgment interest could also be found to be part of the sale price of the stock if that was the court's intention.[8]

II Section 162(a)

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[8] Under the indemnification agreement, Taxpayer is "stepping into the shoes" of the Defendants (director/shareholders) and paying the judgment. If the indemnification agreement is invalid, the Taxpayer’s payment of the Defendant’s expenses may be dividends to the Defendants and thus not deductible by the taxpayer corporation. We will not address the tax effects to the individual Defendants as we understand that their tax years are closed. Lastly, if the indemnification agreement is not a valid exercise of corporate power, Taxpayer's ability to claim a deduction will be limited for additional reasons discussed in Section II, herein.

ISSUE 1:

Taxpayer treated part of the amount that it paid for the judgment against the Defendants as payment for a redemption of Plaintiffs' stock and part of that amount as a business expense that is deductible under § 162(a). The analysis in this Section II concerns the treatment of the amount of the payment (if any) that would not be treated as a payment for the redemption of Plaintiffs' stock, but would be treated as an award of damages paid by Taxpayer in excess of the amount paid to redeem the Plaintiffs' stock.

Section 162(a) 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. Here, Taxpayer was not paying a damages award against itself. Rather, it was paying a damage award against its directors/shareholders (the Defendants). This raises the question of whether such a payment is an ordinary and necessary business expense of Taxpayer.[9]

Section 1.162-1(a) of the Income Tax Regulations provides that business expenses deductible from gross income include the ordinary and necessary expenditure directly connected with or pertaining to the taxpayer's trade or business, except items which are used as a basis for a deduction or a credit under provision of law other than § 162.

Costs of acquiring a capital asset, including costs of litigation, are not deductible. See Woodward v. Commissioner, 49 T.C. 377, 382-83 (1968), aff'd 410 F.2d 313 (8th Cir. 1969), aff'd 397 U.S. 572 (1970). In Woodward, the majority shareholders wanted to renew and extend the existence of a corporation. Under State law they had to buy out the stock of the dissenting shareholder. The court ruled that the expenses of litigation over the value of the dissenter's stock were non-deductible capital expenditures. See Arthur H. DuGrenier, Inc. v. Commissioner, 58 T.C. 931 (1972).

A payment is not deductible as an ordinary and necessary business expense if there was no obligation to make the payment. See Independent Oil Co. v. Commissioner, 4 T.C. Memo 1945-36. A payment of someone else's obligation that the payer is not obligated to pay is not deductible. Wallin v. Commissioner, 32 B.T.A. 697 (1935). In Fortv-Four Cigar Co., 2 B.T.A. 1156 (1925), a corporation could not deduct as business expenses payments that it made to settle disagreements between the president, who was the principal shareholder, and his relatives. The court, in Forty-Four Cigar Co., found that the transactions amounted

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[9]To the extent the payment by Taxpayer is on behalf of the Defendant(s), it would be a dividend to the Defendant(s) and nondeductible by Taxpayer.

to a withdrawal of corporate assets and their use for the personal benefit of the president. A payment of a judgment against an employee is not deductible if the employee was not acting within the scope of his employment. See San-Knit-Ary Textile Mills. Inc. v. Commissioner, 22 B.T.A. 754 (1931) (corporation paid judgment against its president).

Even if a payment of someone else's debt somehow helps the payer's business, such as by improving the payer's reputation and good will, the payment may not be an ordinary business expense that is deductible under § 162. See Welch v. Helvering, 290 U.S. 111 (1933); Sam P. Wallingford Grain Corp. v. Commissioner, 74 F.2d 453 (10th Cir. 1934). Such a payment would instead be a capital outlay. See Welch v. Helvering.

On the other hand, payments to preserve a business's goodwill and protect its reputation may be deductible as an ordinary and necessary business expense under § 162(a). See Rev. Rul. 76-203, 1976-1 C.B. 45; Rev. Rul. 73-226, 1973-1 C.B. 62; Dunn & McCarthv. Inc. v. Commissioner, 139 F.2d 242 (2d Cir. 1943); Marks v. Commissioner, 27 T.C. 464 (1956), acq.,1966-2 C.B. 6; Scruggs-Vandervoort-Barney, Inc. v. Commissioner, 7 T.C. 779 (1946), acq., 1946-2 C.B. 5. A difference between these cases and the cases described in the preceding paragraph is that these cases involve an existing business making the payments to preserve good will, while Welch v. Helvering and Wallingford involve a new business that was started by someone who was affiliated with an earlier business that had unpaid obligations. See Dunn & McCarthv, at 244 ("On the facts the case [(Welch v. Helvering)] is plainly distinguishable from the case at bar. Welch made a capital outlay to acquire good will for a new business. In the present case the payment was an outlay to retain an existing good will, that is, to prevent loss of earnings that might result from destroying such good will by failing to recognize the company's moral obligation.") However, such payments are deductible only to the extent that they are "integral" to the taxpayer's business. See Thompson v. Commissioner, 46 T.C. Memo 1983-1109.

Similarly, in Catholic News Publishing Co. v. Commissioner, 10 T.C. 73 (1948), acq., 1948-1 C. B. 1, a corporation instructed one of its officers to settle a claim by an association against that officer, even though the officer denied any wrongdoing. The corporation did this to prevent damage to its reputation that would materially affect its business. The corporation reimbursed the payment that the officer made to the association. The court held that the payment by the corporation was an ordinary and necessary business expense.

A corporation can deduct under § 162 a payment that it made to indemnify an affiliate, if it reasonably believed that it might be held legally liable to make such a payment. Old Town Corp. v. Commissioner, 37 T.C. 845 (1962), acq., 1962-2 C.B. 5. In Old Town Corp., James H. McGraw, Jr., decided to acquire a majority of the

voting stock of the petitioner. During this period he also had discussions with Charles Roberts about employing Roberts as president of the petitioner if McGraw acquired the majority of the voting stock. After McGraw acquired the stock, Roberts was made the president, but the board removed him as president shortly after that. Roberts sued the petitioner and McGraw for fraud and breach of contract. Roberts sought $500,000 in damages from McGraw and $31,250 in damages from the petitioner. Old Town Corp., at 853. McGraw sent a letter to the petitioner stating:

> It is my view that all my activities with respect to the Roberts matter were for the Corporation and in the corporate interest. Accordingly, this letter will serve to advise you that I reserve the right to claim reimbursement from you for any liability in the * * * [Roberts] action.

Old Town Corp., at 853 (deletion and brackets in original). The petitioner's general counsel sent a memorandum to each director of petitioner, which stated, in part,

> The corporation's general counsel have advised that Mr. McGraw's claim for reimbursement against the corporation should be regarded as having substance. Without attempting at this time to predict the outcome of an assertion of such claim, they advise further that it would not, in their opinion, constitute waste or mismanagement but would be a valid and lawful exercise of their powers for the Board of Directors of the corporation as a matter of business judgment to effect a settlement of the action, including the claims against Mr. McGraw, out of its own funds. They point out that such a settlement would eliminate the risk that the corporation's possible liability to Mr. McGraw on his claim for reimbursement would be measured by the amount of a possible jury verdict against Mr. McGraw greatly exceeding the portion of the settlement amount that could be considered applicable to the settlement of Roberts' claims against Mr. McGraw. They point out further that settlement will save further legal expense and the time and effort of senior officers of the company, avoid public litigation of a personal matter, and avert possible future controversy and incident expense in connection with any claim of Mr. McGraw for reimbursement.

Old Town Corp., at 854. The petitioner paid $80,000 to Roberts to settle his claim and also assumed all of the legal expenses of defending the suit. The petitioner on its tax return claimed a deduction of $117,128.78 for "settlement of litigation plus related expenses." The Service determined that $100,000 of the payment was attributable to the claims against McGraw, and disallowed that portion of the claimed deduction on the ground that the amount did not constitute an ordinary and necessary business expense under § 162(a).

The court in Old Town Corp., at 861, held that the payment was an *ordinary* and *necessary* business expense of the petitioner under § 162(a). The court treated the issue of whether the payment was an ordinary and necessary expense as a question of fact. Old Town Corp., at 857. On the one hand, the court reasoned that "[i]n the usual situation where a taxpayer compromises a legal claim of an adverse party and incurs legal expenses in connection with it, the courts are slow to override petitioner's judgment as to the necessity of incurring the expenses." Old Town Corp., at 857. The court also pointed out that, on the other hand, a payment is not necessary without an obligation or business purpose. Old Town Corp., at 857.

The court in Old Town Corp., at 858-60, used three tests enumerated in Levitt & Sons. Inc. v. Nunan, 142 F.2d 795, 798 (2d Cir. 1944). The first test was whether the petitioner was entirely confident that any suit which McGraw would institute would not succeed. The second test was whether the payments were made for the purpose of avoiding the damages or liability that might have resulted from a suit by McGraw. The third test was whether the belief held by the petitioner concerning the validity of McGraw's claim was justified so far that a reasonable person would have thought that the settlement for McGraw would be necessary. The court "noted that one of the tests of determining necessity is not ...whether petitioner was justified in believing there existed sufficient exposure to liability in order to justify believing that the compromise was necessary." Old Town Corp., at 859. The court stated that it knew "of no requirement that there must be a legal obligation to make an expenditure before it can qualify as a necessary legal expense." Old Town Corp., at 859. The court further stated, "A Taxpayer, acting in good faith with the intention of compromising a potential claim which he reasonably believes has substance, should not be denied a business deduction even if the facts indicate that it was unnecessary to pay the settlement." Old Town Corp., at 860.

As a preliminary matter, the issue of whether Taxpayer can deduct part or all of the damages award as an ordinary and necessary business expense under § 162 depends on whether part or all of the payment for damages by Taxpayer was a payment by Taxpayer to reacquire its own stock. To the extent that it was, the payment would be nondeductible under § 162(k).

Any remaining portion of the payment that is not characterized as being spent for Taxpayer to reacquire its own stock normally would not be deductible by Taxpayer since the payment was made for an obligation of the Defendants (shareholders/directors) and not of Taxpayer.[10] Independent Oil Co. However, if as in Old Town Corp., Taxpayer reasonably believed that it may have been held liable

[10] This would constitute a dividend to the Defendant(s) and would be nondeductible to Taxpayer.

to indemnify the Defendants (shareholders/directors) for the judgment, the payment would have been an ordinary and necessary business expense and thus deductible.

In the present case, Taxpayer argues that it was legally obligated to indemnify the Defendants. Whether Taxpayer reasonably believed that it may have been held legally liable is a factual question, the answer to which depends on interpretation of state corporate law and the facts and circumstances of the case. Also, as in Old Town Corp., the payment may have been an ordinary and necessary business expense of Taxpayer if Taxpayer made a reasonable decision that it would be better for Taxpayer to settle the matter by paying the award instead of going to the effort and expense of litigating the issue of whether it was liable to indemnify the Defendants.

ISSUE 2:

Section 163(a) provides, as a general rule, that there is allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

A Taxpayer may only deduct payments of interest on its own obligations. See Arcade Realty Co. v. Commissioner, 35 T.C. 256, 262 (1960), acq., 1961-2 C.B. 3. The payment of the interest by Taxpayer would not be deductible as an interest expense under § 163 because the interest was not on an obligation that was owed by Taxpayer to the Plaintiffs. Nevertheless, as in our discussion of Issue 1, above, the payment by Taxpayer of the interest on the judgment would be a deductible business expense under § 162(a) if Taxpayer reasonably believed that Taxpayer could be held liable for indemnifying the Defendants.

The interest payment would be allocated between the amount paid by Taxpayer to acquire its own stock, which would be nondeductible because it is associated with the acquisition of a capital asset,[11] and the amount paid for damages, which could be a deductible business expense. The amount of interest would be allocated in the same proportion that the judgment payment would be allocated. This is because interest accrued at the same rate on both the portion of the award that was paid for reacquiring the stock and on the portion of the award that was paid for damages.

ISSUE 3:

The answer to the issue of whether any portion of the Defendants' legal expenses related to the judgment and bankruptcies can be deducted under § 162 follows from the first issue, above. As in Old Town Corp., if Taxpayer reasonably

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[11] To the extent it is a "disguised payment" for the stock itself, it is nondeductible under § 162(k).

believed that it may have been held liable to indemnify the Defendants for the judgment, the reimbursement of the Defendants' legal expenses that relate to this portion of the judgment, as opposed to any amounts that relate to the redemption, would also be an ordinary and necessary business expense of Taxpayer.

Whether the legal expenses must be treated as nondeductible expenses for acquisition of a capital asset or as deductible business expenses depends on the nature of the underlying claim and its resolution in the award and settlement. See Gilmore v. United States, 372 U.S. 39 (1963); Arthur DuGrenier. Inc. v. Commissioner, 58 T.C. 931 (1972).

As discussed above, costs of acquiring a capital asset, including costs of litigation, are not deductible. See Woodward v. Commissioner, 49 T.C. 382 (1968); DuGrenier v. Commissioner, 58 T.C. 931 (1972).

The tax character of legal expenses must be determined pursuant to the same principles that govern the nature of the settlement payment. Eisler v. Commissioner, 59 T.C. 634, 641 (1973), acq., 1973-2 C.B.1; See Arthur DuGrenier, Inc. v. Commissioner, 58 T.C. 931, 938 (1972); United States v. Gilmore, 372 U.S. 39 (1963). Legal expenses can be allocated between expenses paid to acquire a capital asset and legal expenses paid for purposes that are deductible as ordinary and necessary business expenses. See Eisler; Singer v. Commissioner, 34 T.C. Memo 1975-337, aff'd, 560 F.2d 196 (5th Cir. 1977). The allocation of legal expenses does not have to correspond to the allocation of the settlement itself. See Eisler. The allocation is a factual issue. See Eisler, at 642.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

An alternative argument that could be made by Taxpayer is that, as in some of the cases cited above, such as Dunn & McCarthy, the payment may have been an ordinary and necessary business expense if Taxpayer can show that the payment was made to preserve Taxpayer's reputation or good will. In the present case, Taxpayer has not made such an argument nor do the facts, as supplied, reasonably demonstrate that this argument is potentially viable.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges; such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any additional questions, please call CC:CORP:B03 at (202) 622-7790.

Sincerely,

Richard E. Coss
Assistant to the Branch Chief, Branch 3
Office of Associate Chief Counsel (Corporate)