

Stock Offering Lawsuit Settlement Held Deductible

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Many, if not most businesses, seem to assume automatically that any settlement payment they make in any way related to their trade or business will be fully deductible. Litigation, after all, seems to be a cost of doing business these days. Tax specialists know, however, that not *everything* is deductible. Some settlements must be capitalized, and that can be painful.

The most classic category of settlement payment that would be capitalized relates to disputes over title to assets. Yet there are many other types of expenses that must be capitalized as well. Consider stock redemption or stock offering expenses.

Settlement Offering

Recently, in LTR 200911002 (Tax Analysts Doc. 2009-5561, 2009 TNT 48-20, Dec. 2, 2008),

the IRS considered a fact pattern involving a class action settlement arising out of a stock offering. This ruling involved a federal securities law class action filed against the taxpayer company. The complaint alleged that the taxpayer violated various securities laws by issuing false and misleading statements concerning its revenues, earnings, profitability and financial condition.

The claims related to a variety of revenue and earnings projections and statements, and were alleged to have violated Section 10(b) of the Securities Exchange Act of 1934, Section 20(a) of the same act, and Sections 11, 12(a)(2) and 15 of the Securities Act of 1933. Eventually, the taxpayer settled, paying a settlement amount as well as legal and administrative fees.

The taxpayer company requested a ruling that its payments (including legal fees and administrative expenses) were deductible as ordinary and necessary business expenses. The IRS recites the predictable authorities divining the line between deductible business expenses and expenses that must be capitalized. The IRS admonishes that if litigation arises from a capital transaction, the settlement costs and legal fees associated with the litigation are acquisition costs.

That means they must be capitalized under Code Sec. 263(a). [See *F.W. Woodward*, S Ct, 70-1 USTC ¶9348, 397 US 572 (1970) (litigation costs incurred in appraisal proceedings to determine the value of dissenter's shares were part of the cost of acquiring the shares). See also *Hilton Hotels Corp.*, S Ct, 70-1 USTC ¶9349, 397 US 580 (1970). In contrast, amounts paid in settlement of lawsuits are generally deductible if the acts which gave rise to the litigation were performed in the ordinary course of the taxpayer's business. See *Federation Bank & Trust Co.*, 27 TC 960, Dec. 22,290 (1957) (Taxpayer could deduct amounts paid in settlement of legal proceedings charging it with mismanagement in the liquidation of assets).]

In between these extremes, it is necessary to refine the analysis. A business expense is not converted into a capital expenditure solely because it has *some* connection to a capital transaction. Traditionally, to determine whether litigation costs are deductible or capitalizable, one looks to the origin of the claim. [See *D. Gilmore*, S Ct, 63-1 USTC ¶9285, 372 US 39 (1963).] The character of the expenditure is determined by the transaction or activity from which the taxable event proximately resulted.

That is, the purpose, consequence or result of the expenditure is irrelevant. [See *J.P. McKeague*, Cls Ct, 87-2 USTC ¶9401, 12 Cls Ct 671 (1987), *aff'd without opinion*, CA-FC, 852 F2d 1294 (1988).]

In some cases, the analysis will result in the payment not being deductible, when it is too closely aligned with (and emanates from) the capital transaction. Thus, in *Missouri Pacific Corp.*, Cls Ct, 84-1 USTC ¶9474, 5 Cls Ct 296 (1984), a court held that settlement costs were not deductible because the predominant nature of the suit involved the adequacy of

the consideration paid for a target's stock in an exchange offer. After the acquisition, the target's former shareholders had filed a class action against the company, alleging misstatements in the offering materials that understated the value of the target shares.

The taxpayer settled the case and sought to deduct the settlement. The Claims Court ruled that the settlement payment constituted an adjustment to the amount paid for the target stock. Therefore, it could not be deducted. Under the facts in LTR 200911002, the issue was whether the taxpayer's payment to settle the class action (and legal and administrative fees) was ordinary or rather had to be capitalized.

The IRS first noted that the litigation involved several distinct claims, and one must analyze each of them to determine its origin. The first claim related to Section 10(b) of the 1934 Act and the peripatetic rule 10b-5. The claim arose out of the publication of allegedly fraudulent financial information in SEC documents. In particular, accounting irregularities were alleged.

The IRS noted that it was in the preparation and publication of financial statements that the taxpayer company was alleged to have fallen down on its duties. Generally, noted the IRS, the preparation and publication of financial statements is a common and routine activity incident to carrying on any trade or business. As a result, the courts have been inclined to allow payments related to such claims to be deductible as ordinary and necessary business expenses.

The second claim considered in the letter ruling was based on Sections 11 and 15 of the 1933 Act. Section 11 allows claims by purchasers of registered securities, and here focused on untrue statements of material fact. The statements were allegedly untrue by reference to the incorporation of previously filed SEC reports, including forms 10-K and 10-Q. Although this claim was brought on behalf of purchasers of stock pursuant to a specific stock offering, the IRS viewed the allegations as involving representations that were a part of the ordinary business activities of the company (namely, the regular SEC filings). The IRS therefore characterized this claim too as emanating from ordinary business activities.

Indeed, the IRS went so far as to say that it was *irrelevant* that the settled claims had some connection to a stock offering. Instead, the alleged misrepresentations occurred in a number of filings that were produced over a period of time as part of the company's regular business activities. That meant the settlement payment allocable to this claim was also deductible.

Finally, the third claim analyzed by the IRS was brought under Section 12(a) of the 1933 Act. This claim (which was dismissed by the court prior to the settlement) related to allegedly materially false and misleading statements contained in the prospectus supplement. Once again, though, these allegedly misleading statements were made so by reference to prior SEC filings (including Form 10-Q). Although this third complaint was dismissed, the IRS considered this within the ambit of its second analysis. That is, it too was part of the ordinary financial statement reporting incident to the taxpayer's trade or business.

Deduct It

The bottom line of LTR 200911002 was that all payments to settle the securities class action, including legal fees and other administrative fees, were deductible under Section 162. Nevertheless, bear in mind that there is some adverse authority out there. Sometimes, analyzing the origin of the claim test is not all that easy.

For example, consider *Berry Petroleum Co. and Subsidiaries*, 104 TC 584, Dec. 50,649 (1995), *aff'd*, CA-9 (unpublished opinion), 98-1 USTC ¶150,398 (1998). There, the Tax Court and the Ninth Circuit held that settlement costs were not deductible because the claims originated in the taxpayer's purchase of a target corporation's stock. The origin of the claim, held the court, was fraud and the representations made to accomplish the merger at a good price.

Nevertheless, in LTR 200911002 is a nice victory for taxpayers in an area where the IRS's knee-jerk reaction is often to require capitalization.

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