Deducting Stock Offering Lawsuit Settlements

By Robert W. Wood

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Many businesses seem to automatically assume that any settlement payment they make that is even tangentially related to their trade or business will be fully deductible. Litigation, after all, is a cost of doing business these days. And business expenses are deductible.

Tax specialists know, however, that not everything is deductible, not even every settlement payment. Some settlements must be capitalized, and that can be painful. Also, some settlements by some types of taxpayers are deductible only as miscellaneous itemized deductions. That hurts, too, because the alternative minimum tax and other limitations can whittle those deductions down to nothing.

Some settlements are not deductible at all. These include settlements (and related legal fees) that are entirely personal. Also within the nondeductible category are settlements that are in the nature of fines or penalties paid to governmental entities. In the latter case, however, at least the related counsel fees would be deductible.

All these possibilities involve varying degrees of pain. I want to focus here on the Grand Canyon-sized chasm between deducting and capitalizing a payment. It is a large issue and yet often appears to be misunderstood or overlooked.

Whether to Capitalize or Expense

A neglected but important distinction dominating tax considerations for defendants is the recurrent dichotomy between deductible expenditures and those that must be capitalized. A deductible expenditure is always preferable, generating an immediate tax benefit. Capitalization involves spreading a deduction over multiple tax years, depending on the useful life of the asset in question.

Fortunately, when business defendants pay a settlement or judgment, they generally can deduct it as an ordinary and necessary business expense under section 162.[1] However, this is not always the case, and capitalization can be a painful surprise. It can be difficult to discern when you must capitalize a payment.

The general rule is that the origin of the claim controls whether an amount is deductible.[2] Consequently, you need to know something about ''deduct vs. capitalize'' lore, which is a huge subject unto itself. It has generated no end of controversy, including many high-stakes tax disputes, some of which have gone to the Supreme Court.

Preservation Versus Sale

The most classic category of settlement payment that would need to be capitalized concerns disputes over title to assets. Yet there are many other types of expenses that must be capitalized. Those expenses include:

- the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the tax year;
- amounts expended for securing a copyright and plates, which remain the property of the person making the payments;
- the amount expended for architect's services;
- commissions paid in purchasing securities; and
- the cost of goodwill in connection with the acquisition of the assets of a going concern.[3]

Drawing lines can be difficult. For example, consider litigation about commercial real property. It can be debatable whether a payment is to preserve or maintain the property and is deductible, or whether it relates to the property's sale and is capital in nature. Thus, in *Braznell v. Commissioner*,[4] the taxpayer paid a judgment for failure to pay brokerage commissions on negotiations for the sale of real estate. The payment was held to be deductible as an expenditure to preserve the property.[5]

The taxpayer in *Estate of Shannonhouse v. Commissioner*[6] was not so lucky. There, the taxpayer sold property and in the next tax year had to make a settlement payment. The settlement was intended to reimburse the purchasers for the cost of moving a building that had encroached on the adjoining lot of another owner. These amounts were held to be capital losses because they were paid after the property had been sold.

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[1] *See, e.g.*, *Vermont Bank & Trust Co. v. United States*, 296 F. Supp. 682 (D. Vt. 1969); *Rassenfoss v. Commissioner*, 158 F.2d 764 (7th Cir. 1946).

[2] *Anchor Coupling Co., Inc. v. United States*, 427 F.2d 429 (7th Cir. 1970), *cert. denied*, 401 U.S. 908 (1971); *Arthur H. DuGrenier, Inc. v. Commissioner*, 58 T.C. 931 (1972).

[3] *See* reg. section 1.263(a)-2.

[4] 16 T.C. 503 (1951), *acq.*, 1951-2 C.B. 1.

[5] *Swaim v. Commissioner*, 20 T.C. 1022 (1953), *acq.*, 1954-1 C.B. 6.

[6] 21 T.C. 422 (1953).

On the surface, the idea is to examine how strong a connection the suit (and thus the expense) has to ordinary business operations. Compare those connections with the connections to capital items. Bearing that paradigm in mind, how do you suppose stock redemption and stock offering expenses would fare?

That seems simple: They are usually required to be capitalized. The theory is that when a company offers stock and raises money, that is a permanent benefit.[7] Plus, stock redemption expenses are made nondeductible by statute. Section 162(k) expressly provides that no deduction is allowed for any amount paid or incurred by a corporation in connection with the reacquisition of its stock.

Payments for Securities Violations

In this milieu, how do payments to resolve securities law liabilities measure up? The courts have occasionally considered whether payments for violations of the securities laws must be capitalized or may be deducted. One case held that payments made under section 16(b) of the Securities Exchange Act of 1934 must be treated as a capital loss rather than an ordinary deduction.[8]

The theory of the decision was that the origin of the claim was the sale of securities. Again, the sale of securities is classically capital. In another case, payments made under section 10(b) of the Securities Exchange Act of 1934 were also held to be capital items. The taxpayers in *Bradford v. Commissioner*[9] disgorged profits to the Securities and Exchange Commission from their insider trading as broker-dealers. They then sought to deduct those payments.

The taxpayers argued that the origin of the claim was their dealings as broker-dealers and that the settlement payments to the SEC were made to protect their business reputations. The Tax Court demurred, finding that the disgorgement was based solely on the alleged illegal gains realized on the purchase of the stock, and the payments to the SEC had to be capitalized.

This may cause you to believe that capital treatment is the norm. Sure enough, payments for securities violations are most frequently considered capital in nature. However, in LTR 200649011,[10] the IRS ruled that payments for violations of section 10(b) were ordinary and could be deducted. The violations were based on improper accounting, which the IRS found was part of the taxpayer's normal business and not based on a subsequent merger.[11]

Settlement Related to Stock Offering

Stock offerings seem few and far between these days, with a particular dearth of initial public offerings. Still, if a company is sued over the details of a securities offering, will settlement payments be viewed as capital or ordinary? If litigation arises from a capital transaction, the settlement costs and legal fees associated with the litigation are typically acquisition costs.

By contrast, amounts paid in settlement of lawsuits are generally deductible if the acts that gave rise to the litigation were performed in the ordinary course of the taxpayer's business. Between these poles, it is necessary to refine the analysis. But how does one determine if a piece of messy kitchen sink litigation belongs in one camp or the other?

Defining the Origin

A business expense is not converted into a capital expenditure solely because it has *some* connection to a capital transaction. This is a question not so much about nexus as it is about roots. To determine whether litigation costs are deductible or capitalizable, one traditionally looks to the origin of the claim.[12]

The character of an expenditure is determined by the transaction or activity from which the taxable event proximately arises. If that sounds like legal mumbo jumbo, think genesis, not effects. That is, the purpose, consequence, or result of the expenditure, is irrelevant.[13]

In other words, the origin of the claim is not so much about where you are going as about where you've been. Still, it cannot be denied that the latter nexus seems to matter, too. 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. v. United States*,[14] a court held that settlement costs were not deductible. The predominant nature of the suit involved the adequacy of the consideration paid for a target's stock in an exchange offer. That sounds capital. After the acquisition, the target's former shareholders filed a class action against the company.

The suit claimed misstatements in the offering materials undervaluing the target shares. The taxpayer settled the case and sought to deduct the settlement payment. The claims court ruled that the settlement payment constituted an adjustment to the amount paid for the target stock and therefore could not be deducted.

Supreme Origins

In *Woodward v. Commissioner*,[15] the majority shareholders sought to buy out a minority shareholder who dissented from a proposed perpetual extension of the

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[7] *Affiliated Capital Corp. v. Commissioner*, 88 T.C. 1157, 1166 (1987) (citing *Davis v. Commissioner*, 151 F.2d 441, 443 (8th Cir. 1945) *aff'd*, 4 T.C. 329 (1944)).

[8] *Brown v. Commissioner*, 529 F.2d 609 (10th Cir. 1976).

[9] 70 T.C. 584 (1978). *See also Missouri Pacific Corp. v. United States*, 5 Cl. Ct. 296 (1984); *Berry Petroleum v. Commissioner*, 104 T.C. 584 (1995), *Doc 95-5157*, *95 TNT 100-21*, *aff'd*, 142 F.3d 442 (9th Cir. 1998), *Doc 98-14717*, *98 TNT 89-6*; Rev. Rul. 80-119, 1980-1 C.B. 40.

[10] LTR 200649011 (Sept. 6, 2006), *Doc 2006-24611*, *2006 TNT 237-13*.

[11] *See also* LTR 200742004 (June 27, 2007), *Doc 2007-23406*, *2007 TNT 204-20* (holding that amounts incurred by a corporation to settle a securities class action lawsuit originating from claims based on material misrepresentations or omissions in financial reports and SEC filings may be deducted as ordinary and necessary business expenses under section 162).

[12] *See United States v. Gilmore*, 372 U.S. 39 (1963).

[13] *See McKeague v. Commissioner*, 12 Cl. Ct. 671 (1987), *aff'd without opinion*, 852 F.2d 1294 (Fed. Cir. 1988).

[14] 5 Cl. Ct. 296 (1984).

[15] 397 U.S. 572 (1970).

charter. Unable to agree on a price, the majority group brought a state court appraisal action. The Supreme Court held that the appraisal litigation expenses must be capitalized into the cost of acquiring the stock. The appraisal proceeding was merely the substitute provided by state law for the negotiation to fix the purchase price.

Similarly, in *United States v. Hilton Hotels Corp.*,[16] appraisal litigation expenses incurred to buy out the minority shareholders who objected to a proposed corporate merger were held to be capital because the origin of the claim was the acquisition of stock, a capital asset. In *Anchor Coupling Co., Inc. v. United States*,[17] the taxpayer made a settlement payment to a prospective purchaser after one of the taxpayer's main shareholders balked at the sale. The taxpayer sought to deduct the settlement payment.

Based on the Supreme Court's rulings in *Gilmore*,[18] *Woodward*, and *Hilton Hotels Corp.*, the Seventh Circuit in *Anchor Coupling* held that the origin and character of the claim for which the payment was made controlled whether the settlement payment was deductible. The potential consequences the claim or its payment would have on the business operations of the taxpayer did not. The application of the origin of the claim test required the company to capitalize the payment because the potential purchaser's claim was directly related to the taxpayer's capital assets.

New Favorable Ruling

In the recently released LTR 200911002,[19] the IRS considered a fact pattern involving a class action settlement arising out of a stock offering. The complaint alleged that the taxpayer violated various securities laws by issuing false and misleading statements concerning the company's revenues, earnings, profitability, and financial condition.

The claims related to a variety of revenue and earnings projections and statements. The company was alleged to have violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934 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 company requested a ruling that its payments (including the associated legal fees and administrative expenses) were deductible as ordinary and necessary business expenses.

The IRS recited the predictable authorities divining the line between deductible expenses and those that must be capitalized. The IRS then analyzed each claim separately to determine its origin. The first claim related to section 10(b) of the 1934 act and the ubiquitous rule 10b-5. The claim arose out of the publication of allegedly fraudulent financial information in SEC documents.

In particular, the complaint alleged accounting irregularities. Indeed, it was irregularities in the preparation and publication of financial statements that the complaint said were actionable. That was key to the IRS. The IRS added that "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 those claims to be deductible as ordinary and necessary business expenses. These particular financial statements were to be used to support an offering of the company's securities. That is surely a capital transaction, and yet that did not seem to matter to the IRS.

The second claim considered in the letter ruling was based on sections 11 and 15 of the Securities Act of 1933. Section 11 allows claims by purchasers of registered securities, one focus being whether there were any 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 under a specific stock offering, the IRS viewed the allegations as involving representations that were a part of the company's ordinary business activities. This is a key point. After all, the company had to make regular SEC filings as part of its ordinary and ongoing business operations. The IRS therefore characterized this claim too as emanating from ordinary business activities.

Nexus Nixed

In fact, 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 an extended period 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 Securities Act of 1933. The claim related to statements in the prospectus supplement that were alleged to be materially false and misleading. Notably, this claim was dismissed by the court before the settlement. So in some ways it seems downright odd that the IRS chose to even mention it.

After all, if a cause of action is dismissed, how could it be part of the settlement? The courts have tended to treat a dismissed claim as, well, dismissed. If there is no legal claim, then without getting overnuanced, it seems pretty hard to say a payment relates to that legal nullity.

Once again however, the IRS said these allegedly misleading statements were made by reference to prior SEC filings (including Form 10-Q). Although this third claim was dismissed, the IRS considered it within the ambit of its second analysis. The IRS said this (dismissed) claim too was part of the ordinary financial statement reporting incident to the taxpayer's (regular old) trade or business.

Deduct It

The bottom line of LTR 200911002 was that all payments to settle the securities class action, including legal and administrative fees, were ruled to be deductible under section 162. That is great news for companies facing lawsuits over stock offerings. However, bear in mind that there is some adverse authority out there.

[16] 397 U.S. 580 (1970).

[17] 427 F.2d 429 (7th Cir. 1970), *cert. denied*, 401 U.S. 908 (1971).

[18] 372 U.S. 39 (1963).

[19] LTR 200911002 (Dec. 2, 2008), *Doc 2009-5561, 2009 TNT 48-20*.

For example, consider *Berry Petroleum Co. v. Commissioner*.[20] 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.

Unclear Origins

This reflects a fundamental and disturbing truth: Sometimes analyzing the origin of a claim is not all that easy. For example, suppose a taxpayer is getting divorced and as part of that proceeding may lose his business. Does that make the divorce costs deductible? The counsel fees?

The answer is no on both counts, although it took a Supreme Court case to resolve this.[21] The Court determined that even though the *consequence* of the divorce would be serious business repercussions, the *origin* of the dispute was personal. This is a useful paradigm. In large part, consider where you have already been, not where you are going.

Bear in mind this classic divorce fact pattern, which is often looked to as a leading case on the origin of the claim doctrine. How do the facts in LTR 200911002 compare? It seems debatable.

One could look at the origin of the claim question on these facts in several ways. The preparation of financial statements is clearly ordinary and necessary. Every company does it, and every company *must* do it. That means a dispute relating to these ordinary filings, according to the IRS's recent ruling, should be ordinary.

On the other hand, one could easily argue that the nature of the stock offering was the genesis of this dispute. Isn't that obvious? Note that the expense in question was *not* the cost of preparing the financial statements. Those costs had already been deducted.

It was the *settlement* payment that was being examined. What went awry was the stock offering, and that was what triggered the need for a settlement. In fact, one might say the glitches in the financial statements were merely the chariot that took this match to the Coliseum.

Under this analysis, what should be the tax treatment of the settlement payment to make the securities class action go away (along with counsel and administrative fees)? Well, they had their genesis in the stock offering. That was how the offending financial statements were used. They (the financial statements) were what nominally triggered the lawsuit. However, maybe it was the stock offering that triggered the lawsuit. Confused?

Clear as Mud

I've long thought the origin of the claim doctrine sounds more precise than it is. Like one of those movies that tells the same story repetitively from different points of view, it is often possible with a simple set of facts to come out differently in the origin of the claim quicksand.

Plainly, LTR 200911002 is a definitive victory for taxpayers. Not only that, but it is a victory in an area in which the IRS's knee-jerk reaction is often to require capitalization. That is great news, and we should not look a gift horse in the mouth. But the ruling is also one more piece of apocryphal evidence that reaching a conclusion about the origin(s) of a claim can be a critical point, and one about which parties can differ widely.

[20] 104 T.C. 584.
[21] *See Gilmore,* 372 U.S. 39.