



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

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR AREA COUNSEL (COMMUNICATIONS, TECHNOLOGY,
AND MEDIA: OAKLAND)
CC:LM:CTM

FROM: Senior Technical Reviewer
CC:INTL:BR3

SUBJECT:

This Chief Counsel Advice responds to your memorandum dated December 14, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

- Corporation A =
- Corporation B =
- Corporation C =
- x =
- Date 1 =
- Date 2 =
- Date 3 =
- Year 4 =
- Date 5 =
- Date 6 =
- Taxpayer =

- Taxpayer Subsidiary =
- \$k =
- \$m =
- \$n =

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ISSUE

Whether Taxpayer properly allocated, under section 861, damages paid in settlement of a breach of contract award solely to U.S. source income?

CONCLUSION

Taxpayer's characterization and allocation of the breach of contract damages as a loss recognized with respect to stock under Treas. Reg. §1.865-2 is incorrect. The damages do not have a factual relationship to a class of gross income constituting less than all of Taxpayer's gross income. Thus, the deduction must be allocated to all gross income and ratably apportioned among the statutory and residual groupings therein under Treas. Reg. §1.861-8(b)(5) and (c)(3).

FACTS

On Date 1, Corporation A, a large multinational corporation, entered into a merger agreement with Corporation B, another large multinational corporation. In reliance on the merger agreement, Corporation B reacquired x shares of its stock held by another corporation. Subsequently, on Date 2, Corporation A unilaterally cancelled the merger agreement.

On Date 3, Corporation B filed a lawsuit against Corporation A in state court seeking damages for various claims, including breach of contract. Corporation B sought damages equal to the amount it expended to reacquire its shares in anticipation of the merger. In Year 4, Taxpayer Subsidiary (a wholly owned subsidiary of Taxpayer) acquired all of the outstanding stock of Corporation A, after which Corporation A merged with and into Taxpayer Subsidiary. On Date 5, a jury returned a verdict in favor of Corporation B and awarded damages for breach of contract in the amount of \$k. The court also awarded prejudgment interest on the damages totaling \$m (accruing from the date of the breach to the date of the judgment), and postjudgment interest accruing from the date of judgment to the date of payment. On Date 6, Taxpayer Subsidiary and Corporation B's successor¹ entered into a settlement agreement pursuant to which Taxpayer Subsidiary paid Corporation B's successor \$n, which was the amount of the actual damages plus prejudgment and postjudgment interest.

¹ After Corporation B filed the lawsuit, it merged with and into Corporation C. Thereafter, Corporation C acted on behalf of the former Corporation B in the litigation.

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On its consolidated federal tax return for the tax year in which Taxpayer Subsidiary paid the settlement amount, Taxpayer deducted the postjudgment interest component of that payment as interest and apportioned that amount to both foreign and U.S. source income. However, Taxpayer deducted the damages and prejudgment interest portions of the payment and allocated such amounts solely to U.S. source income as a personal property stock loss².

LAW AND ANALYSIS

Taxpayers determine their taxable income attributable to gross income from domestic and foreign sources by deducting the expenses, losses, and other deductions properly allocated or apportioned to that gross income, and a ratable part of any expenses, losses, and other deductions that cannot definitely be allocated to some item or class of gross income. Code sections 861(b), 862(b), and 863. Treasury regulations provide specific guidance regarding the allocation and apportionment of deductions³ to gross income. Treas. Reg. §§1.861-8 through 1.861-17.

Under the general rules of Treas. Reg. §1.861-8(a)(2), an expense must be allocated and apportioned on the basis of the factual relationship of the expense to gross income. The allocation of a deduction is to be made by first determining the activity from which the deduction resulted or to which the deduction was incident, or the property in connection with which the deduction was incurred. The deduction is then allocated to the class of gross income generated by that activity or property. Treas. Reg. §1.861-8(a)(2) and (b)(2). If a deduction does not have a factual relationship to a class of gross income constituting less than all of a taxpayer's gross income, it is allocable to all of that gross income. Treas. Reg. §1.861-8(b)(5).

Another set of rules applies, however, to a deduction attributable to a loss on the sale, exchange, or other disposition of a capital asset or other personal property (including

² The issue of the proper treatment of the prejudgment interest portion of the settlement payment will be addressed separately. Accordingly, this memorandum addresses only the damages portion of the settlement payment.

³ The portion of the settlement payment attributable to damages and postjudgment interest is a deductible business expense under section 162 and not a cost that must be capitalized as part of the cost of the assets acquired. Illinois Tool Works, Inc. v. Commissioner, 117 T.C. 39 (2001). Generally, amounts paid in settlement of lawsuits are currently deductible if the acts that 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).

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stock). Under Treas. Reg. §§1.865-1 and -2, such deductions are allocated to the class of gross income with respect to which gain from the sale of such personal property would give rise in the hands of the seller. Accordingly, under those regulations, consistent with the rule under section 865 of the Code that gain recognized on the disposition of personal property is sourced generally to the residence of the seller, loss from the sale of personal property is also sourced generally to the residence of the seller, which in Taxpayer's case is the United States.

Accordingly, the proper allocation and apportionment of a deduction turns on the nature of the deduction and its factual relationship, if any, to a class of gross income. In Taxpayer's situation, the settlement payment resulted from Corporation A's breach of its contract with Corporation B and the litigation that followed. The settlement payment was in lieu of the judgment amount which was the amount expended by Corporation B to reacquire its shares from one of its shareholders, plus interest. Corporation B reacquired those shares in reliance on the merger agreement, and the damages sought to place the injured party, Corporation B, in the same position as prior to the breach by paying it the exact amount expended on unnecessarily reacquiring the shares plus interest.

Taxpayer did not suffer any loss due to the abandoned merger. Accordingly, the damages settlement amount paid by Taxpayer Subsidiary does not represent a loss with respect to a capital asset, personal property, or any other asset. The only loss suffered was the loss borne by Corporation B when Corporation A unilaterally cancelled the merger agreement; the cost incurred by Corporation B to reacquire its stock was only the measure of the damages. Accordingly, the damage payment is not a loss with respect to stock, but rather represents a reimbursement by Taxpayer Subsidiary to Corporation B to restore it to its position prior to the breach. Therefore, Taxpayer's exclusive allocation of the damages paid pursuant to the settlement agreement to U.S. source income by analogizing it to a stock loss was incorrect. The payment with respect to actual damages is properly treated as a business expense deduction allocable under Treas. Reg. §1.861-8(b)(5).

The damages payment arose from Corporation A's breach of the merger agreement with Corporation B. Taxpayer Subsidiary never owned any of the property from which the damages derived, i.e., the stock or assets of Corporation B. Taxpayer Subsidiary presumably agreed to the settlement conditions and the damages payment in order to avoid the possibility of eventually having to pay an even larger amount as a result of the continuing litigation. In short, the damages payment was made in an attempt to preserve all of Taxpayer Subsidiary's remaining assets and income. Thus, the damages payment is not factually related to a class of gross income constituting less than all of Taxpayer Subsidiary's gross income.

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Accordingly, based on these facts, it is reasonable to allocate the portion of the deduction attributable to the damages payment to all gross income under the general rule of Treas. Reg. §1.861-8(b)(5). Once allocated to all of Taxpayer's gross income, Treas. Reg. §1.861-8(c)(3) provides that the damages payment must be apportioned ratably between the applicable statutory grouping or groupings and the residual grouping or groupings within that class.

Please call (202) 622-3850 if you have any further questions.

ANNE O'CONNELL DEVEREAUX
SENIOR TECHNICAL REVIEWER
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