

Internal Revenue Service

Department of the Treasury
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TY:

Taxpayer:

U. S. City:

Foreign Parent:

Foreign Subsidiary 1:

Foreign Subsidiary 2:

Country:

Fund:

Settlement:

Date 1:

Date 2:

Final Date:

\$x:

\$y:

Year 1:

Year 2:

a%:

b%:

Dear _____ :

This letter responds to a ruling request dated July, 16, 2010, submitted by Taxpayer. Taxpayer requests a determination that certain settlement payments are deductible under § 162 of the Internal Revenue Code.

FACTS:

Taxpayer is an _____ Corporation _____, and engages solely in _____ financial services. Taxpayer, headquartered in U. S. City, does not provide any services to U.S. persons, is a calendar year taxpayer and uses the accrual method of accounting for U.S. tax purposes.

Foreign Parent, headquartered in Country, is a bank. Foreign Parent provides a full range of banking services to a diverse client base. Individual customer services include private banking services for high net worth individuals. Taxpayer is part of Foreign Parent's private banking division, and Taxpayer services high net worth individuals of a specific geographic area. In addition to traditional banking services, Taxpayer also provides asset management and investment advisory services. In connection with its private banking business, Taxpayer made available to some of its clients the opportunity to invest in shares of several investment funds. Taxpayer's clients were thus beneficial owners of shares of these funds,

In Year 1 criminal actions were commenced against Fund's manager for his role in a fraud that resulted in the placement of Fund into bankruptcy. Taxpayer's clients who were invested in Fund consequently suffered losses as a result of the criminally fraudulent activities of Fund's manager.

As a result of these loses, four class action lawsuits were filed in Year 2 naming Taxpayer as a defendant, among others. Damages sought included the principal

invested with Fund, profits that otherwise could have been earned from the funds invested with Fund, and interest thereon.

The claims alleged the following causes of action against the taxpayer: (a) violation of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the SEC; (b) negligent misrepresentation; (c) breach of fiduciary duty; (d) gross negligence; and (e) unjust enrichment.

On Date 1, Foreign Parent announced that it would offer a Settlement to its clients who had invested in Fund and were therefore affected by the fraud. The structure of the settlement was conceived to satisfy Taxpayer's regulatory requirements as well as its clients.

Taxpayer participated in the Settlement via a contribution to Foreign Subsidiary 1. Foreign Subsidiary 1 in turn would issue its own preferred securities directly to Taxpayer's clients who accepted the terms of the Settlement. Foreign Subsidiary 1 is a wholly owned subsidiary of Foreign Parent and is incorporated under the laws of Country. The preferred securities entitle the holder, subject to certain conditions, to a $a\%$ non-cumulative annual cash distribution and have a perpetual term. Annual distributions, as well as liquidation and redemption payments, are guaranteed by Foreign Parent. The preferred securities are redeemable at the option of Foreign Subsidiary 1, in whole but not in part, on any distribution date occurring on or after Final Date. The preferred securities are listed on the _____, but not actively traded.

The Settlement in turn required Taxpayer's clients to transfer legal title to the shares in the Taxpayer funds (including any causes of actions those funds may have against Fund, its manager, and/or any other third party) to Foreign Subsidiary 2, which are held in a Foreign Subsidiary 2 account.

. In addition, Taxpayer's clients were required to forgo any legal actions against the Foreign Parent and related subsidiaries included Taxpayer, for the clients' investments in Fund. At the time of the Settlement, Taxpayer did not obtain compensation from Foreign Subsidiary 2 in connection with Funds' securities because the value thereof was doubtful. Taxpayer represents that it does not stand to obtain any compensation in the future in connection with Fund.

. Taxpayer did not receive any reimbursement from an insurance company, or similar compensation, as a result of the Taxpayer's payment in connection with the Settlement. Approximately *b*% of Taxpayer's clients who invested in the Taxpayer funds that invested through Fund accepted the Settlement and decided to continue doing business with Taxpayer rather than pursue legal action against it.

On Date 2, Year 2 Foreign Subsidiary 1 issued preferred securities directly to Taxpayer's clients who accepted the Settlement. Taxpayer did not hold in its own account or name any of the preferred securities for future settlements. Taxpayer did not hold the preferred securities for any period of time after issuance during which the value of the preferred securities could have fluctuated. Based on the number of Taxpayer's clients who accepted the Settlement, and the principal amount of their investment in the funds, Taxpayer made a cash contribution of \$x to Foreign Subsidiary 1. Taxpayer also represented that the preferred shares are the equivalent of cash. Taxpayer received a capital contribution of approximately \$y from Foreign Parent in connection with Taxpayer's contribution to Foreign Subsidiary 1.

REPRESENTATIONS:

Taxpayer makes the following representations in connection with this ruling request:

- 1) Taxpayer adopted the Settlement for commercial reasons aimed at preventing disruptions to Taxpayer's private banking business and not as a result of a pre-existing contractual obligation or other pre-existing arrangement to do so.
- 2) Taxpayer did not receive payment or reimbursement from an insurance company, or similar compensation, in connection with the payment made by Taxpayer pursuant to the Settlement.

RULINGS REQUESTED:

- 1) Pursuant to the Origin of the Claim Doctrine, the potential liability (if any) released by Taxpayer clients under the Settlement originated from common and routine trade or business activities.
- 2) Taxpayer's Payment under the Settlement is deductible under § 162 as an ordinary and necessary trade or business expense.
- 3) No portion of Taxpayer's Payment will be characterized as a capital expenditure under § 263 or the regulations thereunder.

LEGAL ANALYSIS:

Section 162(a) provides generally that there is allowed as a deduction all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263(a)(1) provides generally that no deduction is allowed for any amount paid out for new buildings or for permanent improvements or betterments. See §§ 1.263(a)-1(a)(1); see also 1.263(a)-2(a), (h); 1.263(a)-4 of the Income Tax Regulations.

Whether expenditures incurred in connection with a settlement are capital in nature depends on the origin of the claim. That analysis requires that prior transactions be examined in order to determine if a cause of action originates from form an ordinary or capital event.

The Origin of the Claim:

The origin of the claim doctrine was established by U.S. v. Gilmore, 372 U.S. 39 (1963). In Gilmore the Court held that “the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences... is the controlling basic test of whether the expense [is] business or personal...”. Id. at 49. A taxpayer’s motive is not determinative when classifying a payment as a capital expenditure.

The class action complaints that were filed naming Taxpayer as a defendant identify the types of claims that Taxpayer’s clients who accepted the Settlement could have raised against Taxpayer. Such claims arise from services ordinarily rendered by Taxpayer in connection with its private banking business. The putative class action complaints alleged; a) violation of § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 of the SEC; (b) negligent misrepresentation; (c) breach of fiduciary duty; (d) gross negligence; and (e) unjust enrichment.

. The complaints allege that Taxpayer was negligent as an investment manager due to its failure to properly manage and monitor its client’s assets, breached its fiduciary duty, and failed to comport with the Securities Settlement Act of 1934. Therefore, the claims against the Taxpayer arose from the conduct of Taxpayer’s private banking business.

Business Deductions under § 162:

Ordinary and Necessary:

In order to be deductible under § 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 Sav. & Loan Ass'n, 403 U.S. 345, 354 (1971)

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).

However, in Donovan v. Commissioner, T.C. Memo 1990-373, the Tax Court disallowed a deduction for payments made by a financial advisor to disgruntled investors who suffered losses on investments made on their behalf. The taxpayer alleged that payments were made to appease investors and prevent them from suing him. The taxpayer wrote checks to the investors but required that the investors endorse the checks to another entity controlled by him, and to assign their rights in the failed investment to the taxpayer. The Tax Court questioned whether the taxpayer could be considered to have made an expenditure given the circular transfer of the funds, but found that even if the expenditure was made taxpayer did not establish that it was necessary reasoning that the investor's reinvestment undermined the taxpayer's assertion as to potential lawsuits.

Taxpayer, as a trusted financial advisor, adopted the Settlement to protect its reputation in the market place and maintain its current level of business. The Settlement was reasonable given the alleged damages sought in the class action lawsuits. Also, the Settlement resulted in a payment of value to Taxpayer's clients. Therefore, the payment for the release of potential liability pursuant to the Settlement was an ordinary and necessary expense of Taxpayer's trade or business.

Paid or Incurred During the Taxable Year:

Section 461(h) and § 1.461-1(a)(2) provide that, an accrual method taxpayer is considered to have incurred a liability in the taxable year in which all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Section 1.461-4 sets forth when economic performance is considered to have taken place and identifies certain liabilities for which payment to the person to whom the liability is owed is economic performance. Section 1.461-4(g)(2) provides that such liabilities include settlement payments that arise from a dispute in which a tort, breach of contract, or violation of law is alleged.

For purposes of the economic performance rules the term payment has the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment. Payment to a particular person is accomplished if a cash basis taxpayer would be treated as having actually or constructively received the amount of the payment as gross income under the principles of § 451. Sections 1.461-4(g)(1)(ii)(A) and 1.461-4(g)(1)(ii)(B). Thus in order to satisfy the economic performance requirement and treat the liability as incurred, Taxpayer's clients must receive payment.

Section 1.461-4(g)(8) Ex. 1, addresses the application of the economic performance rules to a tort liability and explains that if the taxpayer transfers ownership of an annuity contract to the claimant, an amount equal to the fair market value of the annuity on the date of transfer is incurred by the taxpayer in the taxable year of the transfer. In addition, the transfer constitutes a transaction to which § 1001 applies. See also, Rev. Rul. 69-75, 1969-1 C.B. 52.

Taxpayer entered into a Settlement agreement with its clients who accepted the Settlement, during Year 2. Also in Year 2 Taxpayer made a contribution to Foreign Subsidiary 1 and on the same date Foreign Subsidiary 1 issued preferred securities directly to Taxpayer's clients who accepted the Settlement. Taxpayer's liability was fixed by the Settlement agreement, the amount of the liability is determinable with reasonable accuracy, and economic performance occurred upon the issuance of the Foreign Subsidiary 1 preferred securities to Taxpayer's clients to the extent of the fair market value of those shares. Accordingly, Taxpayer's liability under the Settlement was incurred in Year 2.

Section 263(a):

Section 263(a) provides that no deduction shall be allowed for the cost of permanent improvements or betterments made to increase the value of any property, requiring the capitalization of such costs instead.

The Supreme Court has stated that determining whether expenditure is a current expense or a capital expenditure entails a facts and circumstances analysis with material distinctions being of degree and not of kind. In Lincoln Savings, 403 U.S. 345, the Court stated that a "payment that serves to create or enhance ... a separate and distinct additional asset" is a capital expenditure. Accordingly, the capitalization rules were initially understood to require that expenditures be capitalized only if they resulted in separate and distinct assets. However, in INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 86 (1991), the Court clarified Lincoln Savings by stating that the creation of a separate and distinct asset supports, but is not a necessary condition to, capitalizing an expenditure. Id. at 87. In INDOPCO the Court established the future benefit test, whether a significant future benefit exists so as to require capitalization.

Currently, the capitalization of intangibles is generally governed by §§ 1.263(a)-4 and 1.263(a)-5. Section 1.263(a)-4(b)(3)(i) provides that the term separate and distinct intangible asset means a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable State, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business. In addition, for purposes of this section, a fund (or similar account) is treated as a separate and distinct intangible asset of the taxpayer if amounts in the fund (or account) may revert to the taxpayer. The determination of whether a payment creates a separate and distinct intangible asset is made based on all of the facts and circumstances existing during the taxable year in which the payment is made.

Section 1.263(a)-4(d)(2)(i), requires that payments to create a financial interest be capitalized, therefore a payment for preferred stock must be capitalized. However, § 1.263(a)-4(d)(2)(ii), provides that an amount paid to another party is not paid to create, originate, enter into, renew or renegotiate a financial interest with that party if the payment is made with the mere hope or expectation of developing or maintaining a business relationship with that party and is not contingent on the origination, renewal or renegotiation of a financial interest with that party.

Section 1.263(a)-4(d)(6)(i)(B), provides that a taxpayer must capitalize amounts paid to another party to create, originate, enter into, renew or renegotiate with that party an agreement providing the taxpayer the right to provide services.

Section 1.263(a)-4(d)(6)(ii), provides an amount paid to another party is not paid to create, originate, enter into, renew or renegotiate an agreement with that party if the payment is made with the mere hope or expectation of developing or maintaining a business relationship with that party and is not contingent on the origination, renewal or renegotiation of an agreement with that party.

Section 1.263(a)-4(d)(6)(iv) provides that an agreement does not provide the taxpayer a right to provide or receive services if the agreement may be terminated at will by the other party in the first year. An agreement is not terminable at will if the other party to the agreement is economically compelled not to terminate the agreement. All of the facts and circumstances will be considered in determining whether the other party (or parties) to an agreement is economically compelled not to terminate the agreement. An agreement also does not provide the taxpayer the right to provide services if the agreement merely provides that the taxpayer will stand ready to provide services if requested, but places no obligation on another person to request or pay for the taxpayer's services.

Taxpayer's payment of preferred stock to its settling clients for the release of liabilities and to maintain good business relations with its clients does not create a separate and distinct asset, a financial interest, or a significant future benefit.

. Therefore the payment to Taxpayer's clients is not required to be capitalized by § 1.263(a)-4(b)(3)(i), § 1.263(a)-4(d)(2) or § 1.263(a)-4(d)(6).

CONCLUSION:

Based on the representations submitted, we rule that:

- 1) Pursuant to the Origin of the Claim Doctrine, the potential liability (if any) released by Taxpayer's clients under the Settlement originated from common and routine trade or business activities.
- 2) Taxpayer's payment under the Settlement is deductible under § 162 as an ordinary and necessary trade or business expense.
- 3) No portion of Taxpayer's payment will be characterized as a capital expenditure under § 263 or the regulations thereunder.

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. We express no opinion regarding the value of the preferred stock distributed to the settling clients or whether under the terms of Settlement those shares are a cash equivalent. We have however, assumed that the value of the preferred stock distributed to the settling clients is equal to the Taxpayer's contribution to Foreign Subsidiary 1.

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,

SEAN M. DWYER
Assistant to the Branch Chief, Branch 1
(Income Tax & Accounting)