

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to: Nicholas Singer, Attorney
(CC:LB&I, San Francisco)

from: Issac W. Zimbalist,
Senior Technical Reviewer, Branch 5
(Corporate)
John F. Tarrant, Attorney, Branch 3
Corporate

subject:

Legend

Common Parent =

Domestic Sub =

B Members =

Member 1 =

Plaintiff 1 =

Corporation 1 =

State A =

Year 1 =

Year 2 =

Month 1 =

Month 2 =

Date 1 =

Date 2 =

Date 3 =

a =

b =

c =

d =

Designated Litigation =

This memorandum responds to your request for assistance in the above named case. This advice is based on the facts that you have previously sent to us and which are not repeated here. This advice may not be used or cited as precedent.

ISSUES

- (1) Does the lowering of the number of Common Parent Class A shares into which Common Parent Class B shares convert, constitute an actual, constructive or deemed redemption of Class B shares?
- (2) Does the Common Parent consolidated group get an I.R.C. 162 deduction for the litigation expenses paid out of the Escrow Account for the cost of settling the litigation with Plaintiff 1?

Recommendations:

- (1) The lowering of the number of Common Parent Class A shares into which Common Parent Class B shares convert, does not constitute an actual, constructive or deemed redemption of Class B shares.
- (2) The Common Parent group may deduct under section 162 the amounts paid from the Escrow Account for litigation expenses from settling the litigation with Plaintiff 1.

Background:

LB&I has requested that the above issues be addressed in connection with audits of the Common Parent consolidated group for its Date 1 tax year and of at least one B Member, Member 1

FACTS

Prior to the Restructuring in Month 1, Domestic Sub and Corporation 1 were State A non-stock corporations, associations whose ownership is defined by membership interests. Common Parent, a State A stock corporation, was formed to facilitate the reorganization of the membership interests. In Month 1, as part of the Restructuring, Domestic Sub and Corporation 1 became wholly-owned subsidiaries of Common Parent. The owners of the membership interests in Domestic Sub ("B Members") and Corporation 1 received stock in Common Parent. The B Members received Common Parent Class B shares and owners of membership interests in Corporation 1 received Class C shares. The parties to the transaction reported that the transfers of membership interests to Common Parent in exchange for Class B and Class C shares of Common Parent as tax-free exchanges under section 351.

After the Restructuring, Common Parent files a consolidated return for an affiliated group that includes Domestic Sub.

In Month 2, Class A shares of Common Parent were issued to the public in an Initial Public Offering (IPO). Common Parent Class B shares and Class C shares were not publicly traded but were convertible into Class A shares.

On Date 3, Common Parent used \$b of the net proceeds from the IPO to redeem \$c shares of Common Parent Class B shares.

The Litigation:

At the time of the Restructuring, Domestic Sub and its members were named defendants in certain unresolved lawsuits (including one by Plaintiff 1). The potential liability from these lawsuits was unknown at the time. The lawsuits arose from action taken by Domestic Sub and the B Members in the ordinary course of their businesses and were related to their businesses. Beginning in Year 1, Domestic Sub and the B Members began to settle the lawsuits. (The potential liability from the lawsuits is referred to as the "Contingent Liabilities and these lawsuits are referred to as the "Designated Litigation.") As part of the Restructuring, Common Parent became the sole owner of Domestic Sub. The Contingent Liabilities would reduce the value of the Common Parent's shareholders' equity interests. The parties to the Restructuring agreed that only the former members of Domestic Sub should bear the economic effects of the Contingent Liabilities since the other shareholders were not involved in the activities which gave rise to the litigation. Accordingly, the value of the Domestic Sub membership interests contributed for Class B shares in the Restructuring should be reduced by the Contingent Liabilities. However, it was unclear what the amount of that reduction should be and it was impossible to value the Domestic Sub membership interests at the time of the Restructuring because the litigation had not settled.

The Escrow:

To cure the problem of valuing the Contingent Liabilities an escrow account ("Escrow Account") was created to hold only funds designed to pay expenses of the Designated Litigation. Common Parent paid cash derived from operations or the sale of newly issued Class A shares into the Escrow Account. As Common Parent made deposits into the Escrow Account, a ratio reduction formula reduced the number of Common Parent Class A shares into which Common Parent Class B shares would convert. As Class B shareholders would receive fewer Class A shares upon conversion, the value of their Class B shares would drop commensurate with the litigation costs. The ratio reduction was based upon the value of the Class A shares at the time that the cash is placed into the Escrow Account. Since Common Parent Class B shares were issued only to the former members of Domestic Sub, only these entities would bear the economic burden of the ratio reduction. Class B shares will not be convertible into Class A shares until the Designated Litigation is resolved.

In Year 2, Common Parent contributed amounts from its IPO to the Escrow Account and then used those funds to satisfy the settlement liability with Plaintiff 1.

The Common Parent group claimed a deduction of \$a for payments made from the Escrow Account to pay Designated Litigation expenses for its tax year ending on

Date 1.¹ LB&I has asked whether the claimed deduction should be disallowed on the theory that the expenses were expenses of the B Members and not expenses of Common Parent group. LB&I has also asked whether, alternatively, that the Common Parent group should be allowed the deduction but had an offsetting amount of income under § 61 of \$a because the ratio conversion was a deemed redemption of Class B shares and the transfer of cash into the escrow was income to Common Parent.

LAW AND ANALYSIS

Issue 1:

Section 317(b) states that stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock. In this case, Common Parent has not acquired Class B shares from a shareholder for property. No redemption as defined by section 317(b) has occurred. The ratio by which Class B shares are convertible into Class A shares is being adjusted. No Class B shares are being surrendered or acquired.² The value of the Class B shares was unclear at the time of the Restructuring. The adjustment in the conversion ratio is a correction to the ratio so that the ratio represents the true value of the Class B shares in light of the Contingent Liabilities. As the Contingent Liabilities become fixed and certain, the conversion ratio is adjusted accordingly. This results in no deduction or allowable loss to either Common Parent or its Class B shareholders.

Issue 2:

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. This language requires that the expenses directly relate to the business of the taxpayer. See Deputy v. DuPont, 308 U.S. 488, 493-4 (1940); Kornhauser v. United States, 276 U.S. 145, 153 (1928).

Payments made in satisfaction of liabilities arising out of litigation are deductible under section 162 if the acts which give rise to the litigation were performed in the ordinary course of the taxpayer's business and the payments are not otherwise capital expenditures. See Welch v. Helvering, 290 U.S. 111, 114 (1933); Ditmars v. Commissioner, 302 F.2d 481, 485 (2d Cir. 1962). Payments to settle a claim against a corporation in a lawsuit have been held to be ordinary and necessary business expenses, so long as the payments were a reasonable way of protecting the corporation

¹ The B Members sent \$d million cash to Common Parent. to pay for expenses of the Designated Litigation. This payment was not paid into the Escrow Account and no dilution of the B Member Class B shares occurred. Common Parent did not claim a deduction for this \$d million.

² By contrast, on Date 3, as noted above, Common Parent did redeem Class B shares in a transaction where shares were actually surrendered for cash.

or mitigating potential damages. See Old Town Corp. v. Commissioner, 37 T.C. 845 (1962), acq. 1962-2 C.B. 5; see also Rev. Rul. 80-211, 1980-2 C.B. 57

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. See Wallin v. Commissioner, 32 B.T.A. 697 (1935). Expenditures made to protect a taxpayer's business are deductible, even though the transaction giving rise to the expense originated with another taxpayer, if the expenditure did not result in a capital asset. See e.g. Scruggs-Vandervoort-Barney, Inc. v. Commissioner, 7 T.C. 779 (1946), acq. 1946-2 C.B. 5.

Based upon the documents submitted, it appears that Domestic Sub and the B Members were liable for the Contingent Liabilities. Common Parent contributed amounts from its IPO to the Escrow Account and then used those funds to actually pay the settlement amounts to the plaintiffs.

Consequently, the Common Parent group, (i.e., Domestic Sub) may deduct amounts paid in connection with the litigation liability.

Please call (202) 622-7790 if you have any further questions.