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Dear \_\_\_\_\_ :

This is in response to your request for a private letter ruling dated Date 1. You requested a ruling that legal expenditures consisting of compensatory damages, punitive damages and all related legal expenses paid in Year 1, Year 2 and Year 3 that resulted from a lawsuit against you as the managing shareholder of a corporation are deductible under section 162 of the Internal Revenue Code. By letter dated Date 2, you agreed that the ruling would only address the expenditures for the Year 2 and Year 3 tax years.

#### FACTS

Taxpayer is an individual. Taxpayer is a shareholder in several closely held corporations that own and operate A in State. Taxpayer personally or jointly manages the finances of all the closely held corporations that operate A. Taxpayer has been in the business of operating A for B years. Taxpayer was also a shareholder in a corporation that owned C and another that owned an D. In Year 4, Taxpayer, E and F formed a closely held corporation called Corporation, a subchapter S corporation for federal tax purposes, to purchase and operate a A. In Date 3, the Corporation purchased a G located in H, State. Taxpayer contributed \$I for J percent of the stock; E contributed \$K for L percent of the stock and F contributed \$M for N percent of the stock. The shareholders agreed that Taxpayer was to manage the Corporation and receive a management fee of O percent of the net profits. The distribution of the remaining net profits was allocated based on the ownership percentages.

From Date 4 through Date 5, E consistently received monthly distribution checks from Taxpayer. E only received P monthly checks in Year 5 and Q in Year 6. When E inquired after not receiving any distribution checks from Date 6, Taxpayer told E that R. There were several meetings and many letters and e-mails in which E asked Taxpayer

for the Corporation's financial records. E eventually received some of the records, but they did not explain why Corporation was losing money. E filed a lawsuit in Year 6 against Taxpayer asserting causes of action including fraud, breach of fiduciary duty, and breach of contract. The allegations in the complaint included that Taxpayer S. The lawsuit also named as defendants other entities controlled by Taxpayer. The jury found Taxpayer liable for breach of fiduciary duty and fraud. The jury also awarded E punitive damages. The trial court denied the liability claims against the entities named as defendants. The court awarded costs to E and denied costs to Taxpayer. The final judgment against Taxpayer was for \$T, consisting of compensatory and punitive damages and prejudgment interest, plus costs of \$U, and postjudgment interest of V percent per annum. Taxpayer filed an appeal, and the appellate court affirmed the trial court's judgment. In Year 2, Taxpayer paid E amounts ordered by the judgment of the trial court. In addition, Taxpayer paid legal fees in Year 2 and Year 3 to his accounting consultants and expert at trial, as well as to attorneys he retained to defend him in the lawsuit at the trial court and during his appeal.

#### LAW AND ANALYSIS

Section 162(a) of the Internal Revenue Code 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.

Section 1.162-1(a) of the Income Tax Regulations provides that deductible expenses include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business.

Section 263(a) provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Section 1.263(a)-4(c)(1) provides that a taxpayer must capitalize an amount paid to another party to acquire any intangible, including an ownership interest in a corporation, partnership, or other entity, from that party in a purchase or similar transaction.

To qualify as a deduction allowable under section 162, an expenditure must satisfy a five part test: it must (1) be paid or incurred during the taxable year, (2) be for carrying on a trade or business, (3) be an expense, (4) be necessary, and (5) be ordinary. *Commissioner v. Lincoln Savings and Loan Association*, 403 U.S. 345, 352 (1971). Thus, personal expenditures incurred outside of a taxpayer's trade or business are not deductible under section 162. In addition, capital expenditures under section 263 are not deductible.

Even though a particular taxpayer may incur an expense only once in the lifetime of its business, the expense may qualify as ordinary and necessary if it is appropriate and helpful in carrying on that business, is commonly and frequently incurred in the type of business conducted by the taxpayer and is not a capital expenditure. See *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966); *Deputy v. Du Pont*, 308 U.S. 488, 495-96 (1940); *Welch v. Helvering*, 290 U.S. 111, 113-14 (1933).

The Supreme Court in *Welch* discussed the meaning of the term “ordinary.” The Court stated:

Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose whether the amount is large or small, are the common and accepted means of defense against attack.

*Welch*, 290 U.S. at 114. The Supreme Court in *Welch* also explained that the term “necessary” under section 162 imposes the requirement that the expense be appropriate and helpful for the taxpayer’s business. *Id.* at 113.

If litigation arises from a capital transaction, then the costs and legal fees associated with the litigation are characterized as acquisition costs and must be capitalized under section 263(a). See *Woodward v. Commissioner*, 397 U.S. 572, 575 (1970).

A payment will be a deduction under section 162 as a trade or business expense only if it is not a personal expenditure or a capital expenditure. The controlling test to distinguish business expenses from personal or capital expenditures is the “origin of the claim.” *Woodward v. Commissioner*, 397 U.S. at 577-78; *Anchor Coupling Co. v. United States*, 427 F.2d 429, 433 (7th Cir. 1970).

The origin of the claim test was first set forth by the Supreme Court in *United States v. Gilmore*, 372 U.S. 39, 49 (1963). In *Gilmore*, the court held the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was “business” or “personal” and hence whether it is deductible or not. Although the Supreme Court in *Gilmore* considered whether an expense was business or personal, the origin of the claim test has also been applied to distinguish between business and capital expenditures. In *Anchor Coupling*, the court held that the origin and character of the claim with respect to which a settlement is made, rather than its potential consequences on the business operation of the taxpayer, is the controlling test of whether a settlement payment constitutes a deductible expense or a nondeductible capital outlay. *Anchor Coupling*, 427 F.2d at 431-32. See also *Woodward v. Commissioner*, 397 U.S. at 578-79; *United States v. Hilton Hotels Corp.*, 397 U.S. 580, 583-84 (1970).

The Tax Court has described the origin of the claim rule as follows:

Quite plainly, the “origin-of-the-claim” rule does not contemplate a mechanical search for the first in the chain of events which led to the litigation but, rather, requires an examination of all the facts. The inquiry is directed to the ascertainment of the “kind of transaction” out of which the litigation arose. . . . Consideration must be given to the issues involved, the nature and objectives of the litigation, the

defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all the facts pertaining to the controversy.

*Boagni v. Commissioner*, 59 T.C. 708, 713 (1973), *acq.*, 1973-2 C.B. 1. See also *Scallen v. Commissioner*, T.C. Memo. 1987-412, *aff'd*, 877 F.2d 1364 (8<sup>th</sup> Cir. 1989) (applying origin of claim rule, Tax Court held that settlement payments relating to suit against partner for his alleged failure to properly carry out his duties as sole general managing partner in liquidation of partnership were deductible as business expenses).

Courts have held that it is ordinary and necessary to defend claims arising from a taxpayer's trade or business. *Kornhauser v. United States*, 276 U.S. 145 (1928). In *Kornhauser*, amounts petitioner paid in defense of a suit for an accounting brought by a former partner were held deductible as expenses incurred in connection with the conduct of petitioner's partnership business. *Id.* at 153. See also *Great Island Holding Corp. v. Commissioner*, 5 T.C. 150, 163 (1945), *acq.*, 1945 C.B. 7 (settlement payment by majority shareholder, president, and director of corporation relating to settlement of a lawsuit for mismanagement of corporate affairs held deductible as it proximately related to his business activity); Rev. Rul. 78-210, 1978-1 C.B. 39 (amounts paid for judgments and legal fees arising from alleged negligent acts of physician employees were deductible by medical association as section 162 expenses where the contract provided that the association would hold the employees harmless from claims for negligent actions).

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, 973 (1957), *aff'd*, 256 F.2d 764 (2d Cir. 1958), *acq.*, 1969-2 C.B. xxiv (allowing petitioner to deduct amounts paid in settlement of legal proceedings charging petitioner with mismanagement in the liquidation of assets); *Butler v. Commissioner*, 17 T.C. 675, 679-81 (1951), *acq.*, 1952-1 C.B. 1 (settlement payment arising from shareholder suit for damages against principal officer for mismanagement of corporate affairs held deductible as an ordinary and necessary business expense directly connected to and proximately resulting from his business activity); Rev. Rul. 79-208, 1979-2 C.B. 79 (permitting taxpayer to deduct payments to settle lawsuit and obtain a release from breach of contract claims under a franchise agreement).

Similarly, amounts paid for legal expenses in connection with litigation are allowed as business expenses where such litigation is directly connected to, or proximately results from, the conduct of a taxpayer's business. See, e.g., *Howard v. Commissioner*, 22 B.T.A. 375, 378 (1931), *acq.*, 1945 C.B. 4 (holding that legal fees incurred by taxpayer to settle a shareholder's claim of misrepresentation in the conduct of business are deductible as business expenses); *D'Angelo v. Commissioner*, T.C. Memo. 2003-295 (petitioner entitled to a section 162 deduction for legal fees paid in defending suits alleging breach of fiduciary duty, mismanagement, and breach of contract in his capacity as an officer, partner, and shareholder of entities in which he had an ownership interest).

In Rev. Rul. 80-211, 1980-2 C.B. 57, the taxpayer was sued civilly for breach of contract and fraud relating to the ordinary conduct of its trade or business. A judgment was rendered that included punitive damages. The ruling allowed the taxpayer to deduct amounts paid as punitive damages under section 162(a) as an ordinary and necessary business expense because the acts that gave rise to the civil suit were performed in the ordinary course of the taxpayer's business.

In the instant case, Taxpayer's payments to satisfy the final judgment awarded against him, including legal fees and costs, are ordinary and necessary expenditures. Under the origin of the claim test, E's claims against Taxpayer clearly had their origin in the conduct of Taxpayer's trade or business. Taxpayer's activities that gave rise to the lawsuit did not result in the acquisition of a capital asset, did not perfect or defend title to an existing asset and did not create a separate and distinct asset. Taxpayer did not receive a long-term benefit from the payments. An examination of all the facts indicates that the litigation payments were business expenses, and not personal expenditures or capital expenditures.

#### RULING

Thus, based solely on the facts and representations submitted, we conclude that legal expenditures, consisting of compensatory damages, punitive damages and all other amounts ordered by the judgment of the trial court, as well as Taxpayer's legal fees described above, that Taxpayer paid in Year 2 and Year 3 that resulted from a lawsuit by E against Taxpayer as the managing shareholder of Corporation are deductible under section 162(a), provided that Taxpayer has not been reimbursed for any of the payments by insurance or similar compensation.

#### CAVEATS

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. No opinion is expressed as to the federal tax treatment of the transaction under any other provisions of the Internal Revenue Code and the Treasury Regulations that may be applicable or under any other general principles of federal income taxation. This letter ruling is only applicable to matters under our jurisdiction. See Rev. Proc. 2015-1, 2015-1 I.R.B. 1, 18, Section 1. No opinion is expressed as to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by the above ruling.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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 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.

Enclosed is a copy of this letter ruling showing the deletions proposed to be made in the letter when it is disclosed under section 6110.

Pursuant to a power of attorney on file with this office, a copy of this letter ruling is being sent to Taxpayer's authorized representative.

Sincerely,

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NORMA C. ROTUNNO  
Senior Technician Reviewer, Branch 2  
Office of the Associate Chief Counsel  
(Income Tax & Accounting)

cc :

Enc. Copy for section 6110 purposes