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DEPARTMENT OF THE TREASURY
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: **District Counsel,**

ATTN:

FROM: **Deborah A. Butler**
Assistant Chief Counsel (Field Service)

SUBJECT:

This Field Service Advice responds to your memorandum dated May 3, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

<u>LEGEND:</u>
A =
B =
C =
D =
E =
F =
Partnership I =
Partnership II =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Date 1 =
Date 2 =

Date 3 =
Date 4 =
Date 5 =
Date 6 =
Date 7 =
Date 8 =
Date 9 =
S= $
T = $
U = $
V = %
W = $
X = %
Y = $
Z = $
Court G =
F_1 = $
F_2 = $
F_3 = $

ISSUE(S):

Whether legal fees incurred by A are currently deductible pursuant to I.R.C. § 162(a), or capitalizable under section 263(a), in defending a lawsuit alleging the following causes of action:

1. fraud, conspiracy to commit fraud and breach of fiduciary duty surrounding the acquisition of C's partnership interest;
2. breach of contract, conversion, breach of fiduciary duty and dissolution of partnership with respect to A's and other defendants' conduct as partners which allegedly led to a decrease in the value of C's partnership interest.

CONCLUSION:

Legal fees incurred by A to defend the above-stated causes of action should be capitalized.

FACTS:

A, a corporation, is primarily engaged in the business of renting property to automobile dealerships. B is the sole owner of A.

A also served as a partner in several partnerships. One of the partnerships in which A served as a general and limited partner was Partnership I. In addition to A, the other general partners of Partnership I consisted of B, C and D. C and D specialized in real estate development. In year 1, A contributed real property to Partnership I, which C and D developed.

A, B, C and D formed several additional partnerships, such as Partnership II. C served as general managing partner of Partnership II from Date 1 to Date 2. A was a general and limited partner during this time. Other partners included E and F. A and B often loaned money to C and D to enable them to engage in their real estate development activities.

In May 1986, C and D decided to terminate their business relationship due to complaints made by E against C's management of Partnership II. C agreed to resign from all partnerships and other ventures in which he and D had been involved. C requested additional loans from A to assist in the termination of his business activities with D. On or about Date 2, A loaned C and D an additional $T, for which amount they were jointly liable. On Date 3, to aid in terminating all business relationships in which C and D had engaged, C entered into three loan agreements with A and B in which the joint note was canceled, and two separate notes were executed, each making C and D liable for a fifty percent share of the outstanding loan amounts, plus interest. The loan agreements, which were executed on Date 3, provided that C pay back all loan amounts and accrued interest by Date 4. [1] The agreements further provided that as security for the loans, C would pledge his V% partnership interest in Partnership I. The parties agreed that the fair market value of C's partnership interest was $U. [2] In the event of C's non-payment, the agreements stated that a portion of the partnership interest, equivalent to the amount still owed on the due date, would automatically be deemed sold and transferred to A and B. A and B would receive a portion of C's

[1] C and D entered into one loan agreement with A, and two loan agreements with B. The agreements contained substantially similar provisions.

[2] This amount was equivalent to C's total outstanding loan obligations owed to A and B.

partnership interest in proportion to the amount of money loaned by each. [3] C did not pay his portion of the loan and interest by Date 4. Pursuant to the agreement, a proportionate share of C's partnership interest was deemed sold and transferred to A.

More than three years later, C sued A, B, D, E, F, and other parties with whom he conducted business as a real estate developer. The suit was commenced in the Court G in Year 2. The complaint and amended complaint contained a variety of causes of action relating to C's business dealings with these defendants, including the aforementioned loan agreements with A and B. Most of the causes of action in the complaint did not pertain to A, but rather to D and various entities under D's control.

In his amended complaint, C asserted causes of action concerning A in two different areas. The first area related to the provision of the loan agreement between A and C which set forth the fair market value of C's partnership interest in Partnership I. C asserted that the value set forth in the loan agreement was less than half of the actual fair market value of his partnership interest. C accused A, D, and B of breach of fiduciary duty, fraud and conspiracy to commit fraud by allegedly misleading him as to the fair market value of his partnership interest in Partnership I. C accused D and B of representing to him that D would be subject to an agreement with similar terms, (allegedly in order to induce C to sell his Partnership I partnership interest for less than its fair market value). C alleged that even though D failed to pay the loan amounts, his partnership interest was not transferred to either B or A. The relief requested for these causes of action totaled $W.

The second area in the amended complaint concerning A related to its role as a partner in Partnership II. [4] C, who served as a general and limited partner of

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[3] One of the loan agreements between B and C also provided that if C failed to repay the amounts due under all of the agreements, then B would have the option to require C to withdraw as a general partner from Partnership I, and to convert C's general partnership interest to a limited partnership interest. The agreement further provided that if C was forced to convey a portion of his interest in the partnership to B or A as a result of non-payment of the loan, C had the option to sell the remaining partnership interest in Partnership I to B, and, if C did not exercise this option, then B would have the option (for a limited time) to require C to sell B the remainder of his partnership interest.

[4] Counsel did not mention this set of claims in its FSA request. Counsel subsequently indicated to this office in a telephone conversation that he would like the FSA to analyze the tax treatment of the legal expenses stemming from these claims.

Partnership II, alleged that various partners of Partnership II, including A, breached the terms of the partnership agreement by meeting without his knowledge and engaging in various actions which had the effect of reducing a percentage of his Partnership II partnership interest. C also alleged that the general partners met without his knowledge and amended various terms of the agreement. The partnership agreement provided that if the partnership was in need of funds, then the various partners would advance funds at their own election in proportion to their partnership interest. Once the funds were advanced, each partner's percentage interest would be recalculated and increased or decreased accordingly. C alleged that B loaned monies to Partnership II. Thereafter, the general partners met, without C's knowledge or consent, reclassified B's loan as a capital contribution made by A on behalf of B, and reduced C's partnership interest in Partnership II. C alleged that according to the adjustments made to each partner's interest, A converted X% of his partnership interest. Based on these allegations, C asserted causes of action for conversion, breach of contract and breach of fiduciary duty. C requested $Y in damages. C also requested that Partnership II be judicially dissolved, due to the alleged misconduct of its partners, described above.

A and B filed an answer with counterclaims, and an amended answer with counterclaims, on Date 8. They denied all of the allegations contained in the causes of action regarding the loan agreement. They did not address the claims relating to Partnership II, presumably since the court dismissed these claims by order of Date 9. However, A and B asserted counterclaims for malicious prosecution and abuse of process relating to the causes of action asserted in C's complaint regarding Partnership II. In their counterclaims, they asserted that C brought these claims to force them to pay him a large sum of money. They highlighted Court G's order dismissing the Partnership II causes of action as evidence of their lack of merit. The counterclaims sought $S in compensatory damages, as well as a separate award of punitive damages.

Thereafter, A, B and D moved for partial summary judgment against C regarding the fraud, conspiracy to commit fraud, and breach of fiduciary duty claims relating to the acquisition of C's Partnership I interest. The court granted the motion by order of Date 5. The court held that defendants were entitled to judgment as a matter of law on these claims. [5]

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[5] In its order, the court noted that there was no evidence to suggest that B, A or D committed fraud, as the value of the partnership was set with all parties' consent and C, a sophisticated businessman, voluntarily accepted the valuation. As to the breach of fiduciary duty claims, the court pointed out that B and D were not trying to force C out of Partnership I, but instead B was approached by C to sell his partnership interest.

On Date 6, C and the defendants, including A, entered into a settlement agreement. The agreement provided that C's suit, and all appeals related thereto, be dismissed with prejudice. The agreement also contained general releases as to liability for any past, present or future claims brought against all defendants named in C's suit. The agreement required defendants to maintain insurance for C, in relation to Partnership II, until Date 7. It is possible that this settlement provision related to other claims asserted against Partnership II in which A was not named, since the claims pertaining to A, set forth above, were dismissed by the court on Date 9. The agreement also makes no reference to any amount to be given to C in settlement of the causes of action relating to the loan agreement, since the motion for partial summary judgment for these claims was granted. According to the facts in your request, C allegedly received $Z in this out-of-court settlement. The Date 6 agreement does not refer to this amount.

A incurred legal expenses in defending the suit in the following amounts for the following years: $\$F_1$ for Year 3, $\$F_2$ for Year 4, and $\$F_3$ for Year 5. [6] A deducted the legal expenses in each of the respective tax years. The Service denied A's deductions on the basis that the legal fees A expended to acquire a partnership interest are capital expenditures, and not presently deductible. A's representative filed a protest which contended that the legal expenses A incurred originated in A's real estate business dealings with C and D, and thus were deductible as ordinary and necessary business expenses.

LAW AND ANALYSIS

Section 162(a) provides that a taxpayer may deduct all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Treasury Regulation § 1.162-1(a) provides that ordinary and necessary expenditures directly connected with the taxpayer's trade or business are deductible from gross income. Section 263(a) provides that no deduction shall be allowed for capital expenditures. Capital expenditures include the cost of permanent improvements made to increase the value of any property, and expenses which either create or enhance a capital asset. Commissioner v. Idaho Power Co., 418 U.S. 1, 17 (1973). Capital expenditures are added to the basis of a capital asset for which they were incurred, and are recognized either through depreciation or reduction in capital gains at the time the asset is sold. Woodward v. Commissioner, 397 U.S. 572, 574-575 (1970). The deduction of expenses is an

[6] The Service adjusted these amounts downward based on the amount of damages claimed and the number of defendants named in each cause of action.

exception to the general rule that expenses should be capitalized. Idaho Power Co., 418 U.S. at 17.

In determining whether litigation costs are deductible or capitalizable, courts have examined the origin of the claim with respect to which the costs were incurred. U.S. v. Gilmore, 372 U.S. 39, 47-49 (1963). Under the origin of the claim test, the focus of inquiry is the event that led to the tax dispute. Keller Street Development Co. v. Commissioner, 688 F.2d 675, 681 (9th Cir. 1982); McKeague v. United States, 12 Cl. Ct. 671, 675 (1987), aff'd, 852 F.2d 1294 (Fed. Cir. 1988). The purpose of the origin of the claim test is to find the transaction or activity from which a taxable event resulted in order to minimize the number of factual elements to be taken into account, and to limit the category of controlling facts to those which are objective, rather than subjective. Woodward v. Commissioner, 397 U.S. at 577, 578. In creating the origin of the claim test, the Supreme Court rejected a prior test, known as the primary purpose test, which examined the motives and purposes for which the parties instituted a claim. Woodward, 397 U.S. at 576.

The origin of the claim analysis is a factually-based one. Boagni v. Commissioner, 59 T.C. 708, 713 (1973), acq., 1973-2 C.B. 1. Factors which the Tax Court has employed in making this analysis include: the allegations appearing in the complaint, the legal issues involved, the nature and objectives of the litigation, the defenses asserted, the purposes for which the amounts claimed to be deductible were expended, the background of the litigation and all facts pertaining to the controversy. Id. at 713. The transaction from which the claim arose must also be carefully examined. Boagni, 59 T.C. at 713. The taxpayer has the burden of proving that the claimed legal expenses may be deducted as ordinary and necessary business expenses. T.C. Rule 142(a); Welch v. Helvering, 290 U.S.111, 115 (1933).

In order for a legal expense to be presently deductible, the expense must not be based in or originate from the acquisition or disposition of a capital asset. Woodward v. Commissioner, 397 U.S. 572, 575 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580, 583 (1970). Treasury Regulation § 1.263(a) provides that the cost of acquiring a capital asset is a type of capital expense. Expenses incurred in acquiring or protecting an interest in an capital asset are considered to be part of the cost of the asset, and thus are capitalizable. Woodward v. Commissioner, 397 U.S. at 576. Thus, the question of whether litigation expenses are incurred in the purchase or disposition of a capital asset "involves . . . whether the origin of the claim litigated is in the process of acquisition itself." Id.

Under section 162(a), litigation costs are deductible if they arise directly from, or are proximately related to, taxpayer's business activity and if they are ordinary and necessary. Litigation costs must be directly attributable to a trade or business carried on by the taxpayer to be deductible as a business expense. I.R.C.

§ 162(a). "Ordinary" business expenses have been described as those which are normal in relation to the taxpayer's business, and "necessary" has been defined as "appropriate" or "helpful." Deputy v. du Pont, 308 U.S. 488, 495 (1940).

If a suit contains multiple claims, courts have examined each claim using the origin of the claim test to determine whether the claim was based in the taxpayer's trade or business or in a transaction giving rise to a nondeductible expenditure, such as the disposition of a capital asset. See McCay v. Commissioner, 102 T.C. 465, 490 (1994); Rev. Rul. 80-119, 1980-1 C.B. 40. If it is determined that legal expenses were incurred relating to claims based in capital and non-capital transactions, an allocation must be made as to the amount of legal fees to be assigned to each claim. Singer v. Commissioner, T.C. Memo. 1975-63, aff'd, 560 F.2d 196 (5th Cir. 1977) (court apportioned legal expenses between defending the ownership of stock, a capitalizable expense, and conserving the income-producing level of shares, a deductible expense). See generally Kurkjian v. Commissioner, 65 T.C. 862 (1976); Buddy Schoellkopf Products, Inc. v. Commissioner, 65 T.C. 640 (1975), acq. in part, 1981-2 C.B. 3; Boagni v. Commissioner, 59 T.C. 708, 714 (1973); Eisler v. Commissioner, 59 T.C. 634 (1973), acq. 1973-2 C.B. 1.

In the present case, in order to determine whether A's legal expenses constitute ordinary and necessary business expenses or capital expenses, it is necessary to determine whether the claims brought against A by C arose from A's activities in the ordinary course of its business, or from the acquisition or disposition of a capital asset. As there are two sets of claims involving two distinct areas, namely those relating to the acquisition of C's Partnership I interest and those relating to the decrease in C's Partnership II interest, each set of claims will be separately analyzed below.

Claims relating to C's Partnership I interest

One set of claims in C's suit for which A incurred legal expenses consisted of fraud, conspiracy to commit fraud and breach of fiduciary duty. All of these claims had their origin in C's dissatisfaction with the amount designated in the loan agreement as the fair market value of his partnership interest in Partnership I. As noted above, the agreement contained this valuation to inform the parties of the amount for which A could acquire C's partnership interest upon his non-payment of the outstanding loans, and upon either party's exercise of the options to sell and purchase the partnership interest.

The legal expenses which A incurred to defend against C's claims must be capitalized, since they involved a capital asset, the partnership interest, and originated in a capital transaction, A's acquisition of that interest. In general, a partnership interest constitutes a capital asset, and the sale of a partnership interest constitutes a capital transaction. See I.R.C. § 741. See generally Williams v. McGowan, 152 F.2d 570, 571 (2nd Cir. 1945) ("partner's interest in a going firm is to be regarded as a capital asset"); Shapiro v. Commissioner, 125 F.2d 532 (6th Cir. 1942).

As noted above, it is well established that legal fees incurred in connection with the purchase or disposition of a capital asset must be capitalized. A number of courts have held that legal fees arising from claims pertaining to the valuation of a capital asset which is being acquired or sold must be capitalized. In Woodward v. Commissioner, and United States v. Hilton Hotels Corporation, the Supreme Court was faced with the issue of whether expenses incurred in stock appraisal litigation were capital expenses. Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Hilton Hotels Corporation, 397 U.S. 580 (1970). Taxpayers, who were required to purchase stock of shareholders who objected to a proposed corporate transaction, incurred litigation expenses in suits commenced to determine the fair market value of the shares. The Supreme Court concluded that in both cases, where a capital asset is transferred to a new owner in exchange for an agreed upon price, the payment is a capital expense, and the legal fees incurred in determining the value of the asset are also capital expenses, since they are part of the cost of acquiring the asset. Woodward, 397 U.S. at 575; Hilton Hotels Corporation, 397 U.S. at 583. See also Dower v. United States, 668 F.2d 264 (7th Cir. 1980) (legal fees incurred in defending claims pertaining to key employee's stock purchase agreement held to constitute capital expenses); Leigh v. United States, 611 F.Supp. 33 (1985) (N.D. Ill. 1985) (held that legal fees paid in suit for fraud, securities violations and breach of contract surrounding stock sale were capital expenses); Missouri Pacific Corp. v. United States, 5 Cl. Ct. 296 (1984) (expenses from suit commenced by purchasers of stock for misrepresentation of its value held to be capitalizable, as origin of claim was in capital transaction); Bradford v. Commissioner, 70 T.C. 584 (1978) (legal expenses incurred in securities fraud claims held to be capital based on claims' origin in stock purchase).

In McKeague v. United States, petitioner, a corporate officer, entered into a contract with the other officers for a buyout of his shares as the result of a dispute. McKeague v. United States, 11 Cl. Ct. 342, 343 (1986). The parties were unable to reach an agreement regarding the value of petitioner's shares. Id. at 344. Petitioner commenced an action alleging, *inter alia*, that the other officers breached the agreements relating to the acquisition of his shares. Id. The court determined that the legal fees relating to the dispute as to whether the price offered for petitioner's shares was unreasonably low should be capitalized, as they related to an increase in the basis of a capital asset. Id. at 345.

Courts have applied similar reasoning where the valuation of a capital asset has been challenged after its sale or purchase has been completed. In Locke v.

Commissioner, an individual sold shares of stock to petitioner, and, following the purchase, the individual learned that petitioner had shortly thereafter sold the shares to another entity at a substantially higher price. Locke v. Commissioner, 65 T.C. 1004, 1007 (1976), aff'd, 568 F.2d 663 (9th Cir. 1978). Petitioner, who was sued for fraud, incurred legal expenses. Id. The court held that the legal expenses were capital in nature, since the claims that formed the basis for the action originated in allegedly fraudulent representations made to the buyers when they bought the shares. Id. at 1012. Accord Berry Petroleum Company v. Commissioner, 104 T.C. 584 (1995), aff'd, 1998 U.S. App. LEXIS 7936 (9th Cir. 1998) (legal fees from suit by minority shareholders regarding dispute over value of stock sold by majority shareholder held to be capitalizable since claim originated in stock sale).

The origin of the claim test has been applied to legal fees incurred by both sellers and purchasers of capital assets, since it is the kind of transaction out of which the fees arise, rather than the identity of the party who commenced the action, which is relevant. Helgerson v. United States, 426 F.2d 1293, 1297 (8th Cir. 1970) (construing Woodward and Hilton Hotels as favoring a liberal interpretation of an expense "incurred in the disposition of a capital asset"). In Wagner v. Commissioner, after a buyer agreed to purchase stock from petitioner, buyer sued petitioner for securities fraud for allegedly failing to disclose information affecting the stock's value, which led the buyer to purchase the stock at an inflated price. Wagner v. Commissioner, 78 T.C. 910, 913 (1972). Petitioner deducted expenses which it incurred in defending these claims. Id. at 914. The Tax Court determined that petitioner must capitalize its legal expenses, as they originated in the purchaser's suit to modify the terms of the stock sale to reflect the stock's true value, and thus the legal expenses are part of the costs of the stock transaction. Id. at 918, 920.

In Arthur H. DuGrenier, Inc. v. Commissioner, petitioner entered into an agreement with a former shareholder's estate to redeem the decedent's stock. DuGrenier v. Commissioner, 58 T.C. 931, 936 (1972). The estate subsequently sued petitioner for allegedly misrepresenting and concealing information which caused it to receive less than fair market value for the decedent's shares. Id. Petitioner made a payment to the shareholder to settle the action, which it thereafter deducted. Id. Applying the origin of the claim test, the court held that the settlement payment must be capitalized, since the payment originated in the stock purchase. Id. at 938.

As in the above cited precedent, C's claims of fraud, conspiracy to commit fraud and breach of fiduciary duty directly pertained to whether A misrepresented or failed to disclose information regarding the fair market value assigned to the partnership interest for purposes of its acquisition. The agreement allowed C to sell and A to purchase C's partnership interest in Partnership I. The loan agreement provided that if C did not pay the loan or interest, his partnership interest would automatically be deemed sold to A. C executed a “collateral assignment of partnership interest” for this purpose. Since A incurred legal fees based on C’s claims relating to the valuation of a capital asset which A had acquired, such fees should be deemed to constitute fees incurred in connection with the acquisition of a capital asset, and should be capitalized by A.

In its protest, A raises several arguments against the capitalization of legal fees it incurred relating to the fraud, conspiracy to commit fraud and breach of fiduciary duty claims. A primarily argues that the origin of all of the claims in C’s suit involving A was its commercial real estate business activities with C, and disputes between C and D which occurred during the course of those activities, and thus are deductible under section 162 as ordinary and necessary business expenses incurred in its trade or business. A reasons that it would not have been involved in the suit had it not been for its history of business dealings with C and D, and that respondent mischaracterizes the suit by contending that its origin was in the loan agreement.

A’s arguments contain several weaknesses. First, in analyzing the origin of C’s claims, A fails to examine each claim separately to discover if it originated in the conduct of a trade or business as an ordinary and necessary business expense, or if it originated from a transaction giving rise to a capital expense, as set forth in the precedent cited above. A repeatedly refers to the origin of the claims or the origin of the suit, and frequently notes that the Service is incorrect in focusing on the loan agreement, a single aspect of the parties’ business relations. As stated above, C’s claims against A arise from two distinct sets of transactions and events involving different partnerships. [7] The claims relating to each of these transactions must be scrutinized separately in order to discover their true origins. Due to the multiplicity of defendants and transactions addressed in C’s complaints, A’s argument that the entire suit should be considered in analyzing the origin of the claim analysis is inappropriate. The analysis runs counter to the very purpose for which the origin of the claim test was created, namely to narrow the focus of the court to those issues which are most directly related to the claims.

Second, A places the origin of the claims for fraud, conspiracy to commit fraud and breach of fiduciary duty at too remote a point. A argues that it would not have been named in C’s suit but for its commercial real estate dealings with C, and thus the origin of the claims is in C’s business activities with A. The origin of the claim test involves an inquiry into the specific activity or transaction from which a taxable event resulted, and not merely a “but for” causation analysis. A’s test not only

[7] In its protest, A makes no specific reference to the claims C asserted regarding Partnership II, but only refers to the claims surrounding the loan agreement and the transfer of C’s Partnership I interest.

traces the origin of the claim to remote events with only a peripheral connection to the claim, but it also runs counter to the purpose of the origin of the claim test by increasing the number of factual elements to be taken into account, and expanding the category of controlling facts. As the Tax Court stated in Boagni v. Commissioner, the origin of the claim test "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." Boagni v. Commissioner, 59 T.C. 708, 713 (1973). Although A is correct in stating that it would not have been sued by C had theynot met and been engaged in any business dealings, the claims asserted by C did not directly stem from this source, but from C's dissatisfaction with the fair market value placed on his Partnership I interest in the loan agreement between himself and A. A also asserts that the origin of C's claims was in the partners' dissension. This statement is inaccurate, as these claims did not originate in the dissension and dissolution of the parties' business relationships, but in C's dissatisfaction with the value placed on his interest in Partnership I. C agreed to terminate his business relationship with D, and to resign from all partnerships in which they had been involved, including Partnership I.

A also maintains in its protest that C's suit was merely an attempt by C to coerce A into making large payments to him. This argument incorrectly focuses on the subjective motivation or purpose for which the underlying action was commenced or defended. As stated above, the "primary purpose" test was rejected by the Supreme Court due to its subjectivity and arbitrariness.

A cites several cases to support its position that the legal fees relating to the claims stemming from the valuation of C's Partnership I interest are deductible. All of the cases cited are factually distinguishable from the present case. A relies on the Supreme Court's decision in Kornhauser v. United States, in which legal fees incurred by a partnership in a former partner's suit for an accounting for partnership profits were deductible. Kornhauser v. United States, 276 U.S. 145, 151 (1928). The basis of the former partner's claim was that he failed to receive his share of compensation for professional services performed by the partnership while he was still a partner. Id. The court held that the partnership's legal fees incurred in defense of the claim were deductible since they proximately resulted from the partnership's trade or business. Id. at 153. This case is distinguishable from the present case in that the claim in Kornhauser related to the collection of compensation or business earnings, rather than the valuation of a capital asset. In addition, this case pre-dated the "origin of the claim" test, which is the governing analysis with regard to the tax treatment of legal expenditures.

Also cited is Howard v. Commissioner, in which taxpayer, the owner of a corporation, incurred legal fees in a suit by a former shareholder for misrepresentation and conspiracy in the conduct of the corporation's business. Howard v. Commissioner, 22 B.T.A. 375, 377 (1931), acq. 1945 C.B. 4. The court held that the legal fees were deductible since they arose out of the business dealings between the parties, and did not result in the acquisition of a capital asset. Id. at 378. In contrast, the causes of action surrounding the loan agreement in the present case arose from the acquisition of a capital asset, and did not involve allegations of fraud in the conduct of A's real estate business. The fraud claims were instead alleged in connection with the valuation of C's partnership interest set forth in the loan agreement.

A relies heavily on BHA Enterprises v. Commissioner, where the Tax Court allowed a radio broadcasting corporation to deduct legal expenses incurred in connection with litigation commenced by the Federal Communications Commission to revoke its license to operate a radio station. BHA Enterprises v. Commissioner, 74 T.C. 593, 594 (1980), acq. in part, 1982-2 C.B. 1. The court reasoned that even though the broadcast licenses were capital assets, they were essential to the operation of taxpayer's business, and thus the fees taxpayer incurred in defending against the lawsuit were deductible. Id. at 600. The court analogized taxpayer's situation to an example contained in a Revenue Ruling 78-389, which provided that a taxpayer, who had an established business of extracting and supplying sand and stone, incurred legal fees in a suit to challenge a newly enacted local law prohibiting the operation of taxpayer's business in the locality. Id. at 598. See Rev. Rul. 78-389, 1978-2 C.B. 126. The Service declared that in such a situation, taxpayer would be permitted to deduct legal fees on the ground that the suit arose from the taxpayer's business activities, and no capital asset was either acquired or sold. Id. BHA is factually distinguishable from the present case in that a capital asset was not created, enhanced, acquired or sold. The Revenue Ruling can be similarly distinguished. The claim in that example consisted of a challenge to the validity of a statute which prevented taxpayer from conducting its business. In contrast, the claims asserted in C's suit did not affect the A's ability to operate its business, and were directly related to the acquisition of a capital asset.

Also cited by A is NCNB Corporation v. United States, in which taxpayer, who was in the business of operating a network of banks, incurred expenses relating to the opening of a new bank branch. NCNB Corporation v. United States, 684 F.2d 285, 286 (4th Cir. 1982). These expenses included: feasibility and metro studies, which related to finding new sites to open bank branches, as well as for applications to the Comptroller of the Currency, for the purpose of obtaining authorization to open a particular branch. Id. The court held that these expenditures were deductible since they were essential to the successful operation of the business. Id. at 290. The court categorized these costs as relating to the protection of an existing investment, and the continuation of an existing business, both of which are currently deductible, rather than to the creation or enhancement of a capital asset. Id. at 293. The present case does not entail legal expenses stemming from an expense incurred by taxpayer on a regular basis for the purpose of carrying on its business. Thus, the expenses at issue in this case are wholly different from those discussed in NCNB.

Taxpayer also cites Dunlap v. Commissioner, where the Tax Court allowed a corporation to deduct expenses incurred to acquire controlling interests in banks. Dunlap v. Commissioner, 74 T.C. 1377 (1980), rev'd. on other gds., 670 F.2d 785 (8th Cir. 1982). The corporation was a bank holding company. Id. at 1380. It incurred various expenses, such as rent, advertisements, employee benefits and depreciation, related to its acquisition of other companies' stock. Id. The court reasoned that these costs were incidental to the corporation's business of acquiring and holding an interest in banks, and not directly related to the acquisition of the banks. Id. at 1426. In the present case, the legal fees relating to taxpayer's acquisition of C's partnership interest were not expenses incidental to the conduct of its commercial real estate business, but pertained to the acquisition of a partnership interest, a capital transaction.

Claims relating to C's partnership interest in Partnership II

The other set of claims in C's suit pertained to Partnership II, for which A presumably incurred legal expenses in defending causes of action for of breach of contract, conversion, breach of fiduciary duty and partnership dissolution. In relation to these claims, B and A asserted counterclaims alleging malicious prosecution and abuse of process. All of these causes of action had their origin in C's belief that the other partners of Partnership II, including A, had reduced his partnership interest in Partnership II. C's causes of action were asserted in an attempt to protect, defend and restore the portion of his interest in Partnership II, which had allegedly been reduced by the defendants without his knowledge or consent.

The legal expenses which A incurred in defending C's suit, and in pursuing its counterclaims, must be capitalized, since the claims were based in the defense and protection of a capital asset, namely A's partnership interest in Partnership II which C claimed was improperly increased at the expense of C's partnership interest. Legal expenses incurred in asserting or defending claims related to the protection or defense of title to a capital asset must be capitalized. Treas. Reg. § 1.263(a)-2(c). See also Woodward v. Commissioner, 397 U.S. 572, 575 (1970); Reed v. Commissioner, 55 T.C. 32, 39-40 (1970); Lewis v. Commissioner, 27 T.C. 158, 164 (1956), aff'd, 253 F.2d 821 (2nd Cir. 1958); Singer v. Commissioner, 34 T.C.M. at 347. Such expenses are considered to be a part of the cost of the asset, and are thus non-deductible. See Heath v. Commissioner, T.C. Memo. 1983-399, 46 T.C.M. 698, 700; Berger v. Commissioner, No. 54,063 (T.C. Memo. 1954).

This principle is illustrated in several Tax Court decisions. In Lin v. Commissioner, taxpayers commenced an action for dissolution of two corporations. Lin v. Commissioner, T.C. Memo. 1984-581, 49 T.C.M. 1, 2. With regard to the first corporation, taxpayers claimed that they possessed a 50% ownership interest in the corporation, contrary to defendants' contention that defendants owned a majority interest in the corporation. Id. at 2, 3. With regard to the second corporation, taxpayers contested the validity of a deed in which defendants asserted full ownership of a parcel of real property. Id. at 3. The court held that the origin of claims was to protect their ownership interests in stock and real property, and thus taxpayers' legal fees incurred in asserting the claims were capitalizable. Id. at 4. In Reed v. Commissioner, taxpayer incurred legal expenses in her attempt to rescind a partnership agreement which restricted her ability to sell her partnership interest. Reed v. Commissioner, 55 T.C. 32, 38 (1970). The court characterized this restriction as effectively depriving taxpayer of an incident of ownership. Id. at 42. Since the origin of taxpayer's claim constituted an attempt to repeal these restrictions, the court held that the legal fees expended in asserting the claim involved the perfection of title to the partnership interest, and were thus capitalizable. Id. See also Wallace v. Commissioner, 56 T.C. 624, 633 (1971) (legal fees incurred in defending action brought by stockholder to preserve ownership of stock which taxpayer was allegedly holding in trust constituted capitalizable expenses); Duntley v. Commissioner, T.C. Memo. 1987-579, 54 T.C.M. 1138 (legal fees incurred by decedent's husband defense of suit by heirs contesting husband's entitlement to decedent's property held to be capitalizable since rooted in defense and protection of title).

As in the above-cited cases, the claims asserted by C stemmed directly from his desire to defend, protect and restore his Partnership II interest, a capital asset, which had allegedly been reduced by the other partners without his knowledge or consent. Accordingly, we recommend that you take the position that A must capitalize the legal costs incurred in defending these claims, and in asserting its counterclaims.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

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