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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR: Associate Area Counsel (LMSB)

FROM: Associate Chief Counsel
Income Tax & Accounting

SUBJECT: Expenses attributable to prior sale of stock

This Field Service Advice responds to your memorandum dated March 9, 2001.
In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

Corp A =
Corp B =
Corp C =
Corp D =
Corp E =
Corp F =
Period G =
Corp H =
Mr. J =
Mr. K =
$L =
X Business =
Tax Years =

ISSUE

Whether the expenses incurred by a subsidiary to administer certain claims both of and against a former related subsidiary are currently deductible when the underlying claims relate back to the sale of the stock of the former subsidiary.

CONCLUSION

The expenses incurred by a subsidiary to administer certain claims both of and against a former related subsidiary are not currently deductible because they represent the expenses of another taxpayer and because they relate back to the sale of the stock of the former subsidiary.

FACTS

Corp A was and still is engaged in the X Business. Corp A is a wholly owned subsidiary of Corp B. Corp A and Corp B are subsequently referred to as Corps AB. Corp B was formerly the wholly-owned subsidiary of Corp C, which in turn is a wholly-owned subsidiary of Corp D. Corp D changed its name to Corp E, and will subsequently be referred to as such.

The stock of Corp B was sold to Corp F in Period G. Corp F originally intended to acquire the assets of Corp A or Corp B rather than Corp B's stock. However, concerns over the potential interruption of Corp A's X Business, altered Corp F's plans. Corp A was required by most states to become licensed. These state licenses were nontransferable. Therefore, if Corp F merely purchased Corp A's assets, it would have had to apply for new state licenses, and would have had to suspend Corp A's X Business operations until such licenses were granted.

During negotiations for the purchase of Corp B's stock, Corp F and Corp E agreed upon a value for certain outstanding claims pending against Corp A on the purchase date (Preclosing Claims). Some of these Preclosing Claims were in litigation. Corp F and Corp E were also unable to agree upon a value for certain claims made by Corp A against third parties which were also outstanding on the purchase date (Pre-Closing Plaintiff Claims). The Pre-Closing Plaintiff Claims included rights to reimbursement, subrogation rights, and litigation in which Corp A was the plaintiff. We will subsequently refer to the Preclosing Claims and the Preclosing Plaintiff Claims collectively as the Claims. In the Purchase Agreement, Corp E and Corp C essentially agreed to retain the Claims. They agreed also to indemnify and hold harmless Corp F and Corps AB against all losses resulting or arising from certain listed events as well as any other claim or liability against Corps AB arising before the sale.

Under the Purchase Agreement, the aggregate purchase price payable by Corp F to Corp C for all of Corp B's stock was an amount equal to the "Adjusted Shareholders' Equity," defined as the shareholders' equity of Corp B as shown on an "Adjusted Closing Date Balance Sheet" as of the closing date for sale of the stock. The Claims were excluded from this closing date balance sheet through an adjustment mechanism provided in the Purchase Agreement.

Corp E used another of its subsidiaries, Corp H, to administer the Claims. Under an agreement between Corp E and Corp H, Corp H had to consult with Corp E before making significant tactical decisions, and to keep Corp E informed on the progress of the Claims on a monthly basis. Corp E would either reimburse Corp H or pay directly all expenses directly or indirectly related to the Claims including, without limitation, all costs of paying the Claims, all costs of managing the Claims including counsel and expert fees, internal administrative expenses, salaries and other employee benefits, overhead, court costs and other costs. Corp H would engage certain Corp E employees, specifically Mr. J and Mr. K, pursuant to the same terms and conditions due them by Corp E. Corp E would pay Corp H an administrative fee of $L per month for its services in administering the Claims.

To handle the Claims, Corp H rented an office and incurred expenses in relation to that office. Mr. K would meet regularly with Corps AB's management to discuss their liability for claims made after the stock sale that related to events occurring prior to the sale. If the parties were in agreement that Corps AB should pay all or a portion of any claims, Corp E was obligated under the stock sale agreement to indemnity Corps AB for that payment. Often however, Corps AB would want to pay a claim in order to retain a continuing customer in circumstances where Mr. K believed that Corps AB had no liability. In that event, Corps AB were not entitled to an indemnity payment from Corp E. With respect to litigation matters involving Corps AB as either plaintiff or defendant relating to matters that arose prior to the stock sale, Mr. J selected and supervised outside counsel, who were engaged with Corps AB's consent and were technically retained and paid by Corps AB. Within the limitations of the Purchase Agreement, Corp E was obligated to Corps AB for the attorneys fees and any amounts paid to resolve Preclosing Claims. Corps AB and Corp F were in turn obligated to turn over to Corp E any recoveries from Preclosing Plaintiff Claims.

Corp E now agrees that the Claims relate back to the sale of the stock under the rationale of Arrowsmith v. Commissioner, 344 U.S. 6 (1952), and are therefore adjustments to sales price. The expenses at issue here are those incurred by Corp H in administering the Claims (the Corp H expenses). The Corp H expenses include such items as compensation, including the compensation of Mr. J and Mr. K and the administrative expenses of renting and running a office. Corp H was a member of Corp E's affiliated group and filed consolidated returns with Corp E for the Tax Years, which are at issue here.

LAW AND ANALYSIS

I.R.C. § 162(a) generally allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263(a)(1) generally disallows deductions for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. The Supreme Court has determined that section 263 has priority over section 162. Commissioner v. Idaho Power Co., 418 U.S. 1 (1974).

Expenses are expenses of another

Corp E argues that the Corp H expenses are currently deductible as its current business expenses or as the expenses of a former business, relying upon Groetzinger v. Commissioner, 480 U.S. 23 (1987); Kornhauser v. United States, 276 U.S. 145 (1928); Ostrom v. Commissioner, 77 T.C. 608 (1981); and Dowd v. Commissioner, 68 T.C. 294 (1977), nonacq. 1978-2 C.B. 3, among others. However, these expenses do not relate to a current or former business of either Corp E or Corp H, but to the former and current business of Corps AB. The expenses of another are not deductible; specifically, a parent corporation normally may not deduct the expenses of its subsidiary. See Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943); Young & Rubicam, Inc. v. United States, 410 F.2d 1233 (Cl. Ct. 1969); The Austin Co., Inc. v. Commissioner, 71 T.C. 955 (1979), acq. on other issues, 1979-2 C.B. 1; Columbian Rope Co. v. Commissioner, 42 T.C. 800 (1964), acq. on other issues, 1965-2 C.B. 4. That the amounts are paid under a contractual obligation is not determinative. Interstate Transit Lines, 319 U.S. at 594; B. Forman Co. v. Commissioner, 453 F.2d 1144, 1160 (2d Cir.), cert. denied, 407 U.S. 934 (1972).

To be deductible, the amount paid must proximately and directly benefit the parent's own business beyond its role as a shareholder. Austin, 71 T.C. at 967. See Young & Rubicam, 410 F.2d at 1238-39. The test is whether a hardheaded businessman would have incurred the expense for his or her own business. B. Forman, 453 F.2d at 1160; Austin, 71 T.C. at 968; Coulter Electronics, Inc. v. Commissioner, T.C. Memo. 1990-186, aff'd without published opinion, 943 F.2d 1318 (11th Cir. 1991). Benefits derived by a parent corporation as the owner of the subsidiary are considered indirect and incidental benefits which do not justify a current deduction by the parent. Austin, 71 T.C. at 967-68; Columbian Rope, 42 T.C. at 815-26.

The expenses in the present case appear to have been incurred solely in the parent's role of a shareholder. Corp E acknowledges that the Claims relate back to the sale of the stock in Corps AB, which it no longer owns. Thus, we do not see how the Claims can comprise a current or former business of Corp E, because they relate only to Corp E's ownership of Corps AB. Further, Corp E does not have the licenses to run a X Business and has no interest in retaining any of the clients. In conclusion, Corp E "simply cannot claim as its own expense, amounts paid for activities that were concerned with the day-to-day operation of the subsidiary's business." Austin Co., 71 T.C. at 969; citing Young & Rubicam, 410 F.2d at 1239.

Here, Corp H, another Corp E subsidiary, is actually deducting the expenses. However, the analysis when one subsidiary is taking the expenses of another is the same as when a parent is deducting the expenses of a subsidiary. See Bone v. Commissioner, T.C. Memo. 2001-43; A.J. Concrete Pumping, Inc. v. Commissioner, T.C. Memo. 2001-42; Oxford Development v. Commissioner, T.C. Memo. 1964-182. For example, in A.J. Concrete, the Tax Court relied upon Austin to require a subsidiary, which was deducting the expenses of another subsidiary, to demonstrate that the expenses were for its own proximate and direct benefit. Because the subsidiary had no relationship to the other subsidiary beyond common shareholders, the expenses were not deductible. The present case is indistinguishable from these facts in A.J. Concrete.

Character of the expenses relates back to the sale of stock

It is appropriate to consider whether Corp H expenses should be disallowed as current deductions under the principle of Arrowsmith v. Commissioner, 344 U.S. 6 (1952), because they relate back to the sale of its stock. In Arrowsmith, two former shareholders of a liquidated corporation were required as its transferees to pay a judgment against the corporation several years after its liquidation. The gain from the liquidation had been a capital gain to the shareholders. However, they deducted the judgment payment made in the subsequent year as an ordinary loss. The Supreme Court found the loss to be capital rather than ordinary. The Court reasoned that had the judgment payment been required during the tax year of the liquidation there was no question that the payment would have been capital. Arrowsmith, 344 U.S. at 8. The Court held that the payment would still be capital even though the payment was made in a subsequent year and that this classification did not offend the well-established principle that each taxable year is a separate unit for tax purposes. Id. at 8-9.

Although the relation-back principle established in Arrowsmith normally involves a determination of whether an amount is capital or ordinary, if no gain or loss was recognized on the prior transaction, no gain or loss will be allowed on subsequent transactions found to relate back to it. Rev. Rul. 58-374,1958-2 C.B. 396. See Estate of McGlothlin v. United States, 370 F.2d 729 (5th Cir. 1967); Missouri Pacific Corp. v. United States, 5 Cl. Ct. 296 (1984). We assume that if the Corp H expenses relate back to the sale of the stock, they are subject to disallowance under Treas. Reg. § 1.1502-20.

Generally, the relation-back principle established in Arrowsmith is that a subsequent event is so intimately tied to a prior transaction, here a sale of stock, that the character of the subsequent event must be ascertained by reference to the prior one. Federal Bulk Carriers, Inc. v. Commissioner, 66 T.C. 283 (1976), aff'd 558 F.2d 128 (2d Cir. 1977). Seagate Technology, Inc. v. Commissioner, T.C. Memo. 2000-361. The rationale is that the tax consequences should be the same as if the subsequent event had occurred at the time of the prior event. Seagate. However, each taxable year remains a separate accounting period and the events are recognized in the year they normally would be. See Abdalla v. Commissioner, 69 T.C. 697 (1978), aff'd 647 F.2d 487 (5th Cir. 1981), nonacq. 1984-2 C.B. 2. Their character is determined by the earlier event. Thus, a payment is not deductible under section 162 if it is required to be capitalized to the stock sale under Arrowsmith. Mitchell v. Commissioner, T.C. Memo. 1994-237. See Nelson v. Commissioner, T.C. Memo. 1971-327, aff'd per curiam, 472 F.2d 1224 (9th Cir. 1973), rejecting the relevance of Kornhauser to a case governed by Arrowsmith.

Numerous cases have held that expenses incurred by former shareholders of corporations take on the character of the prior transfer of the corporate interest under the rationale of Arrowsmith. See, e.g., Federal Bulk Carriers, supra; Fred H. Lenway & Co. v. Commissioner, 69 T.C. 620 (1978), aff'd without opinion, 620 F.2d 310 (9th Cir. 1980); Smith v. Commissioner, 67 T.C. 570 (1976). Amounts received rather than expended by former shareholders have been likewise characterized by the prior transaction. See Lowe v. Commissioner, 44 T.C. 363 (1965), acq. in result, 1966-2 C.B. 5, holding that there is nothing in Arrowsmith to make it inapplicable to a gain to former shareholders. See also Bressler v. Commissioner, 65 T.C. 182 (1975), acq. 1976-2 C.B. 1. Here, Corp E agrees that the Claims relate back to the sale of stock under Arrowsmith.

However, Corp E continues to contend that the Corp H expenses are current deductions. Corp E argues that existing case law is distinguishable because Arrowsmith is only applicable if the expenses are part of an agreement between the buyer and seller and the expenses involve payments between the buyer and the seller. The present case involves neither circumstance. Corp E's argument ignores that Arrowsmith itself involves a payment to a third party other than the purchaser, that is, payment of a judgment. Admittedly, in Arrowsmith there were no new owners of the stock because the corporation had been liquidated.

However, other cases where there are new owners of the stock and the corporation still exists have treated payments to others by former shareholders as part of a sale of stock. Clay v. Commissioner, T.C. Memo. 1981-375; Nelson v. Commissioner, T.C. Memo. 1971-327, aff'd per curiam, 472 F.2d 1224 (9th Cir. 1973). See Siple v. Commissioner, 54 T.C. 1 (1970). See also Freedom Newspapers v. Commissioner, T.C. Memo. 1977-429, holding that a third party payment to the new owner of a corporation related back to the original sale of stock. In particular, the Corp H expenses are analogous to litigation and legal expenses paid to third parties, which in Clay and Nelson were found to relate back to the sale of stock. In neither Clay nor Nelson were the litigation and legal expenses incurred mentioned in the original agreement for sale of the stock.

In Clay, the taxpayers sold their stock in a Subchapter S corporation, which they properly treated as a capital gain. As part of the contract for sale, the taxpayers agreed to indemnify the buyer for any undisclosed liabilities. Pursuant to the contract, the buyer subsequently filed for arbitration claiming damages from the taxpayers for certain undisclosed liabilities. Both the arbitrator and, subsequently, a court of law found that the taxpayers had to pay damages to the buyer, which the taxpayers paid and deducted. The taxpayers also expended $7,197 in the tax year for their own legal fees and other costs of litigation in connection with the dispute with the buyers.

The court in Clay found that the indemnity damages paid related back to the sale of the stock under Arrowsmith and were therefore adjustments to purchase price. More importantly, the court found that the $7,197 in litigation expenses were therefore also capital. The court reasoned that the character of the underlying claim determined the nature of the litigation expenses. See Woodward v. Commissioner, 397 U.S. 572 (1970); Redwood Empire Savings & Loan Assoc. v. Commissioner, 68 T.C. 960 (1977), aff'd 628 F.2d 516 (9th Cir. 1980).

Similarly, in Nelson, the taxpayer owned all of the stock of Hollywood Finance Company (HFC), which he sold for a capital gain. HFC was in the business of making loans and purchasing installment sales contracts. In the contract for the sale of the stock, the taxpayer warranted that all of HFC's loans were validly made and that there were no defenses against them. He also agreed to reimburse the purchaser for any claims against HFC arising out of transactions before the sale, if the claims had not been reflected on HFC's balance sheet.

Subsequently, the California Commissioner of Corporations threatened to sue HFC for alleged violations of California's Personal Property Broker Law. The new shareholders of the corporation told the taxpayer that defense of the suit would be costly and that numerous loans, including many that the taxpayer had warranted, were in danger of being declared void. The taxpayer decided to settle all of his potential liability to the new shareholders by paying them a total of $20,000.

In the meantime, the taxpayer had formed a new corporation and had applied to the Commissioner of Corporations for a Personal Property Broker's License. His license was ultimately denied because of his involvement with HFC.

The taxpayer incurred expenses of $2000 for legal services. It was stipulated that these services involved "representation of the petitioners' interest before the California Commissioner of Corporations relating to the loans of Hollywood Finance Company that were about to be voided and the negotiation and drafting of the agreement releasing petitioner Mr. Nelson of liability on those loans."

The Tax Court in Nelson found that the $20,000 payment was an outgrowth of the sale of the stock and was a capital expenditure under Arrowsmith. The court also found that the $2000 payment was so closely related to and identified with the $20,000 payment that it must be treated in a like manner. In coming to this conclusion, the court relied upon similar cases holding that legal fees incurred in disputes over prior sales of property relate back to the prior sale. See Rees Blow Pipe Manufacturing Co. v. Commissioner, 41 T.C. 598, 604 (1964), aff'd per curiam, 342 F.2d 990 (9th Cir. 1965); Estate of Shannonhouse v. Commissioner, 21 T.C. 422, 424 n.4 (1953).

The Corp H expenses incurred in the present case are analogous to the litigation and legal expenses incurred in Clay and Nelson. Corp E agrees that the Claims, which are part Purchase Agreement, relate back to the sale under Arrowsmith. Therefore, the expenses incurred to settle the Claims are to be treated in a like manner. See Woodward, supra. See also United States v. Gilmore, 372 U.S. 39 (1963). In such circumstances, it does not matter that the Claims originally arose in Corp A's prior business. See Clay, in which the undisclosed liabilities appear to have arisen in the prior business.

In one sense, the present case is a less compelling case for the taxpayer than Clay and Nelson, in that the Corp H expenses incurred would have been completely foreseeable at the time of the contract for sale and would have been necessary to implement the sale. That is, both parties knew that Corp E would have to incur additional expenses to settle the Claims. Those expenses would have reasonably been considered in valuing the Claims had they been part of the sale price. Again, the Claims were excluded from the sales price because the parties could not agree on their value. The expenses were thus incurred as part of the implementation of the sale of stock and as a condition of the sale. See Siple, 54 T.C. at 9. Although the Corp H expenses are not totally attributable to an actual dispute between the parties to the sale of stock as in Clay and Nelson, at least some of the expenses arose in reconciling conflicting interests between the two sides to the transaction.

In arguing the Corp H expenses are currently deductible, the taxpayer relies upon VCA Corporation v. United States, 566 F.2d 1192 (Ct. Cl. 1977), 40 AFTR 2d 77-5429, which held that the purchaser of stock could take a current deduction for a cost that had been indemnified by the seller. The Service followed VCA in Rev. Rul. 83-73, 1983-1 C.B. 84, which reaches the same conclusion on similar facts. Although VCA as well as Rev. Rul. 83-73 rely extensively on section 381, they also rest the allowance of the deduction on conclusions significant to the present case; notably that the indemnity payment by the seller is a capital contribution which relates back to the sale of stock under the rationale of Arrowsmith. Significantly, in reaching this conclusion, both rely upon Rev. Rul. 58-374, which found the seller had no gain or loss on indemnities paid and received, where there was no gain or loss on the original sale of stock. Capital contributions are not reimbursement and can provide basis for a deduction for the corporation indemnified. See VCA, 40 AFTR 2d at 77-5437.

Thus, the rationale of VCA would lead to conclusion that the Corp H expenses relate back to the sale of the stock and are not deductible. As the seller of the stock, Corp E cannot rely on the holdings of indemnity cases applying to purchasers, because the legal position of the two sides of the transaction are completely different. Compare Rev. Rul. 83-73, focusing on the buyer's side of transaction, with Rev. Rul. 58-374, dealing with the seller's side. See Nahey v. Commissioner, 111 T.C. 256 (1998), aff'd 196 F.3d 866 (7th Cir. 1999), holding that amounts received by a purchaser of stock from a law suit that had existed prior to the purchase does not relate back to or derive its character from the initial stock purchase.

Analogy to Old § 337

Finally, denying the deductibility of the Corp H expenses is supported by analogy to cases decided under (pre-1986) I.R.C. § 337 ("Old § 337"). Old § 337 provided that a corporation that had: (1) adopted a plan of complete liquidation, (2) sold all of its assets within 12 months of the adoption of that plan, and (3) distributed the sales proceeds to its shareholders in complete liquidation, recognized no gain or loss on the sale of its assets.

Two cases in which the application of Old § 337 was at issue, Benedict Oil Company v. United States, 582 F.2d 544 (10th Cir. 1978), and Of Course, Inc. v. Commissioner, 499 F.2d 754 (4th Cir. 1974), are similar to the present case. In these cases, legal fees and other expenses which were related or incidental to the sale were considered capital expenditures affecting basis and thus were not currently deductible. In each, the taxpayer sold all of its assets after adopting a plan of complete liquidation and distributed the proceeds to its shareholders in complete liquidation. Pursuant to Old § 337, neither taxpayer recognized gain on the sale of its assets (although the taxpayer in Benedict Oil reported recapture income from the sale, which was not protected from nonrecognition under Old § 337). Both taxpayers incurred legal fees and other expenses in executing the sale and sought to deduct such expenses.

The Government argued that such expenses were related to or were incidental to the sale of the assets of a business. Thus, such expenses should be considered capital expenditures affecting the basis of those assets. In that case, such expenses would not be currently deductible. In other words, such expenses simply offset the gain realized on the sale of the assets.

On the other hand, the taxpayers argued that these expenses were separate from the sale and, consequently, deductible. It should be noted that these taxpayers derived no tax benefit from the payment of these expenses.

These courts held that the expenses were related to the sale of the assets and thus reduced the amount of gain the taxpayers realized (but did not recognize) on such sale. The courts noted that the fact that the taxpayers received no tax benefit from the payment of these expenses was irrelevant because the taxpayers were not required to recognize the gain on the sale. The courts concluded that symmetry required that if gain was not recognized, the expenses necessary to determine such gain should not be recognized either.

In the present case, the expenses Corp H incurred to resolve the Claims indirectly determined the amount of loss Corp E realized (but did not recognize) on the sale of the stock. That is, if the parties had been able to agree on a value for the Claims, such valuation would have also reflected their estimate of the amount that the holder of the Claims would have expended in order to resolve those Claims. Because Corp E's loss on the sale of the stock was subject to disallowance under Treas. Reg. § 1.1502-20, Corp E would have the same incentive as the taxpayer in the Old § 337 cases cited to argue that such expenses were separate from the sale (no tax benefit). However, for the reasons cited in those cases (and discussed above), we agree that they are related to the sale (and not deductible).

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