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Department of the Treasury

Washington, DC 20224

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Date:
January 16, 200

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Taxpayer	=
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Plaintiffs' Lead Counsel	=
Court 1	=
Court 2	=
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Date 1	=
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This letter is in response to your request for a private letter ruling dated January 18, 2001. The facts are as follows:

Taxpayer is a domestic corporation operating on the accrual method of accounting and using a calendar year to file its federal income tax return. On Date 1, Taxpayer sold x number of shares of its common stock on the NASDAQ National Market System in connection with its initial public offering. Taxpayer initially sold the x number of shares to an underwriting syndicate, A. A in turn then sold shares to "initial purchasers" on Date 1. Public trading of Taxpayer's stock commenced on Date 2.

Commencing on Date 3, Taxpayer's shareholders filed twenty-three class action complaints against Taxpayer and its officers in Court 1. On Date 5, these complaints were consolidated into a single class action lawsuit alleging that Taxpayer violated Sections 10(b) and 20(a) of the Securities Act of 1934 and Rule 10(b)(5) promulgated thereunder by the Securities and Exchange Commission (SEC). The class was defined as "all persons who purchased the common stock of [Taxpayer] on the open market during the period between [Date 2] and [Date 4], inclusive." The complaint stated that Taxpayer, through its officers, decided to prematurely book sales and net income in a manner inconsistent with GAAP, after disappointing first quarter earnings were announced. The complaint alleged that this decision lead to a generation of false and misleading financial statements and press releases concerning the company's revenues, income, and earnings, which in turn inflated Taxpayer's stock price throughout the class period. Taxpayer represents that it did not make any public stock offerings during the class period.

On Date 6, a settlement agreement was filed with Court 1, which provided for the dismissal of all claims against Taxpayer with prejudice in exchange for the settlement consideration consisting of cash and common stock. On Date 7, Court 1 issued its final judgment approving the settlement of the class action lawsuits. On Date 8, the lead plaintiff filed a notice of appeal with Court 2. On Date 10, Court 2 dismissed all parts of the appeal pertaining to Taxpayer, allowing the Court 1's judgment approving the settlement to become final.

The settlement agreement provided that Taxpayer pay the class of plaintiffs $y in cash[1] and z shares of Taxpayer's freely tradeable common stock. Taxpayer was to deposit $y in an interest bearing account within five business days following the grant of

[1] Of the cash settlement, $g was paid by Taxpayer and $h was paid by an insurance company under an insurance policy that Taxpayer had with the company.

the preliminary approval of the settlement by Court 1. In contrast, Taxpayer was not required to transfer any shares of stock until the grant of final approval by the court. Specifically, Taxpayer had five business days after the court's final approval of the settlement in which to transfer shares awarded as attorneys' fees. The agreement then provided that Taxpayer was to deliver the remaining shares after final approval of the settlement within a reasonable time after receiving written instructions of plaintiffs' lead counsel.

The settlement agreement provided procedures for transferring the shares of stock following final approval of the settlement agreement; however, a clause in the agreement indicated that the court may order a transfer of shares as attorneys' fees before final approval. While no court ordered a transfer of shares before the settlement agreement was finalized, or before the appeal was dismissed, Taxpayer transferred a shares to plaintiffs' lead counsel on Date 9 as a courtesy to such counsel, with the stipulations that counsel would not distribute, sell, hypothecate or otherwise dispose of the shares until after the appeal was fully and finally resolved. The transfer dates and number of shares transferred for the remaining shares of stock are as follows:

Date 11	b
Date 12	c
Date 13	d
Total	e[2]

RULINGS REQUESTED

1) Whether the amounts paid by Taxpayer pursuant to the settlement are currently deductible under § 162 of the Internal Revenue Code, and not characterized as capital expenses under § 263(a); and

2) Whether the proper dates to value the z shares of stock are:

Date 10	a
Date 11	b
Date 12	c
Date 13	d

LAW AND ANALYSIS

1) Whether the amounts paid by Taxpayer pursuant to the settlement are

[2] This includes the Date 9 transfer. Taxpayer states that f shares remain unclaimed by plaintiff's counsel.

currently deductible under § 162 of the Internal Revenue Code, and not characterized as capital expenses under § 263(a).

Section 162 of the Code provides in part that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Section 1.162-1 of the Income Tax Regulations further provides in part that business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business.

Section 263(a) of the Code provides in part that no deduction shall be allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. Section 1.263(a)-2 of the regulations provides, in part, that an example of a capital expenditure is the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

In the present case, the issue is whether the settlement payments are currently deductible as ordinary and necessary business expenses under § 162, or whether such payments must be capitalized as a capital expenditure under § 263(a). The fact that, under the settlement agreement, the plaintiff class is defined as all purchasers of Taxpayer's stock on the open market during a period of time beginning close to the date of Taxpayer's initial public offering calls into question whether the litigation, and therefore the settlement payments, arose out of the initial public offering.

In general, expenditures incident to the alteration of the capital structure of a corporation for the benefit of future operations constitute non-deductible capital expenditures under § 263. See INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992) (requiring taxpayer to capitalize legal, investment banking, and other fees incurred in evaluating friendly takeover bid); General Bancshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir. 1964) (requiring that taxpayer capitalize costs of issuing nontaxable stock dividends where they effected a change in the capital structure of the corporation); Rev. Rul. 73-580, 1973-2 C.B. 86 (holding that compensation attributable to services performed in connection with corporate mergers and acquisitions must be capitalized).

Nevertheless, a business expense is not converted into a capital expenditure solely because it is incurred in the context of a corporate reorganization. Rather, the important consideration in determining the nature of an expenditure for federal tax purposes is the origin and character of the claim for which the expenditure is incurred. See Woodward v. Commissioner, 397 U.S. 572, 577(1970); United States v. Gilmore, 372 U.S. 39, 47 (1963). Under the "origin of the claim doctrine," the character of a particular expenditure is determined by the transaction or activity from which the taxable event proximately resulted. Gilmore, 372 U.S. at 47. The purpose, consequence, or result of the expenditure is irrelevant in determining the origin of the claim, and therefore the character of the expenditure. McKeague v. United States, 12 Cl. Ct. 671 (1987) aff'd without opinion, 852 F.2d 1294 (Fed. Cir. 1988). Accordingly, the origin and character of the claim with respect to which a payment is made, rather than its potential consequences on the business operations of a taxpayer, is the controlling test for determining whether a particular payment constitutes a deductible expense or a capital expenditure. Anchor Coupling Co. v. United States, 427 F.2d 429, 433 (7th Cir. 1970).

In the present case, the question is whether the litigation arose out of the initial public offering or out of Taxpayer's routine business activities. From the facts before us, it appears that the proximate cause of the litigation was the dissemination of false and misleading financial statements and press releases. Such dissemination of financial information is a routine business activity. Therefore, the amounts paid by Taxpayer under the settlement are not capitalized under § 263(a).

While the settlement payments did not originate in Taxpayer's initial public offering, they are not automatically deductible under § 162. To qualify as a deduction under § 162, an item must be (1) an "expense," (2) a "necessary" expense , (3) an "ordinary" expense, (4) "paid or incurred during the taxable year," and (5) for "carrying on any trade or business." Commissioner v. Lincoln Savings & Loan Assn., 403 U.S. 345, 352 (1971). Ordinary has the connotation of normal, usual, or customary. Deputy v. du Pont, 308 U.S. 488, 495 (1940). The transaction giving rise to an ordinary expense must be a common or frequent occurrence in the type of business involved. Id. Expenses from a lawsuit affecting the safety of the business, even though happening only once in a company's lifetime, may be deductible, as payments for such a suit are the common and accepted means against attack. Welch v. Helvering, 290 U.S. 111, 114 (1933).

A necessary expense is an expense that is appropriate and helpful to the taxpayer's trade or business. Welch v. Helvering, *supra*, at 113. In determining whether a settlement payment is appropriate and helpful to the taxpayer's trade or business, three factors must be considered: (1) whether taxpayer was entirely confident that any suit would not succeed, (2) whether the payments in question were made for the purpose of avoiding damages or liability which might have resulted from a lawsuit, and (3) whether the belief held by the taxpayer concerning the validity of the plaintiffs' claims was justified in that a reasonable person in the taxpayer's position would have thought the settlement would be necessary. Old Town Corp. v. Commissioner, 37 T.C. 845, 858-859 (1962).

In the present case, the lawsuit concerned the dissemination of financial statements and reports concerning Taxpayer's revenues, income, and earnings, and therefore, is related to Taxpayer's business. Such dissemination of a corporation's financial information is a common, expected occurrence in the business world, and therefore the expense of settling allegations regarding disseminating inaccurate information may be considered ordinary. Furthermore, a payment pursuant to a settlement agreement is a customary means of resolving litigation against a corporate taxpayer.

As to whether the expense is necessary, Taxpayer indicates that it did not have confidence that the lawsuit would succeed, as it indicated in its 10-K Annual Report to the SEC filed on Date 14. The settlement agreement states that Taxpayer's desire to settle was to avoid lengthy and time-consuming litigation, as well as the burden, inconvenience, and expense associated therewith. Finally, it appears from the facts that Taxpayer could reasonably believe that plaintiffs would win their case, and therefore, settlement was necessary to avoid further damage.

2) Whether the proper dates to value the z shares of stock are:

Date 10	**a**
Date 11	**b**
Date 12	**c**
Date 13	**d**

Transfer Occurring on Date 9

Section 468B(g) provides, in part, that nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. Pursuant to the authority granted to the Secretary under § 468B(g), the Secretary has published § 1.468B-1 through § 1.468B-5 of the Income Tax Regulations relating to qualified settlement funds.

Section 1.468B-1(c) of the regulations provides that a fund, account, or trust is a qualified settlement fund if it meets the following three requirements:

(1) It is established pursuant to an order of, or it is approved by, the United States, any state (including the District of Columbia), territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing and is subject to the continued jurisdiction of that governmental authority;

(2) It is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability (i) Under the Comprehensive Environmental Response, Compensation and Liability Act of 1980 . . . as amended, 42 U.S.C. 9601 et seq.; or (ii) Arising out of a tort, breach of contract, or violation of law; or (iii) Designated by the Commissioner in a revenue ruling

or revenue procedure; and

(3) The fund, account, or trust is a trust under applicable state law, or its assets are otherwise segregated from other assets of the transferor (and related persons).

The legislative history of § 468B shows that sub-section (g) of that section was added to the Internal Revenue Code to provide for the current taxation of escrow accounts, settlement funds, and similar funds, reversing Rev. Rul. 71-119, 1971-1 C.B. 163 (a settlement fund is not a trust, and the court administering the fund is not a fiduciary). See H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. (1986), 1986-3 (Vol. 4) C.B. 844-845. The legislative history shows that § 468B(g) was enacted to eliminate the "homeless income" problem that arose when defendants deposited amounts into a settlement fund to pay a claim. The Qualified Settlement Fund (QSF) regulations were published in order to implement the Congressional mandate contained in § 468B(g) by providing for current income taxation of such accounts and funds that might otherwise escape current taxation.

Section 1.468B-2(k)(3) of the regulations provides that "[t]he administrator (which may include a trustee if the qualified settlement fund is a trust) of a qualified settlement fund is, . . . (iii) The escrow agent, custodian, or other person in possession or control of the fund's assets; . . . ."

Section 1.468B-3(c)(1) provides that "economic performance occurs with respect to a [relevant] liability . . . to the extent the transferor makes a transfer to a qualified settlement fund to resolve or satisfy the liability." This section provides a taxpayer with a deduction earlier than the time of distribution to a claimant by allowing economic performance to occur upon the transfer of assets to a qualified settlement fund.

Section 1.468B-3(c)(2)(i) provides that:

> Economic performance does not occur to the extent-- (A) The transferor (or a related person) has a right to a refund or reversion of a transfer if that right is exercisable currently and without the agreement of an unrelated person that is independent or has an adverse interest... ; or
>
> (B) Money or property is transferred under conditions that allow its refund or reversion by reason of the occurrence of an event that is certain to occur, such as the passage of time, or if restrictions on its refund or reversion are illusory.

Taxpayer argues that the a shares of stock transferred by Taxpayer on Date 9 and held in escrow by plaintiffs' lead counsel should be valued on Date 10, the date on which Court 2 dismissed the appeal of Court 1's judgment and finalized the settlement agreement. This raises the question of whether the transfer on Date 9 constituted a transfer to a qualified settlement fund.

In this case, the account in which plaintiffs' lead counsel held the a number of shares transferred on Date 9 ("escrow account"), satisfies the three requirements outlined in the regulations for qualified settlement fund treatment under § 468B. First, the escrow account was established pursuant to a court's order and was subject to the court's continuing jurisdiction. The agreement, as approved by Court 1, provides for the establishment of a "Settlement Fund." The "Settlement Fund" was defined with respect to its assets, and not the location of those assets. The assets described in the "Settlement Fund" included z shares of Taxpayer's freely tradeable common stock. Therefore, the escrow account, containing Taxpayer's freely tradeable common stock and held by plaintiffs' lead counsel (which contained only assets of the "Settlement Fund") was an account established pursuant to a court's order.

The agreement makes clear that any "Settlement Fund" assets would be subject to the court's continuing jurisdiction. The court's order also states that the court retains jurisdiction over all matters relating to the administration of the agreement. Since the assets in the "Settlement Fund" were subject to the court's continuing jurisdiction, and since the escrow account is part of the "Settlement Fund", the escrow account itself is subject to the court's continuing jurisdiction. Thus, the escrow account held by plaintiffs' lead counsel satisfies the first requirement in the qualified settlement fund regulations.

Secondly, the "escrow account" held by plaintiffs' lead counsel was established to resolve or satisfy one or more contested or uncontested claims that arose from a violation of law. The agreement establishes the "Settlement Fund", which includes $y in cash and z shares of stock, for the purpose of resolving or satisfying Taxpayer's liability that arose from its alleged violations of §§ 10(b) and 20(a) of the Securities Act of 1934, and SEC Rule 10b-5. In satisfying this liability, Taxpayer transferred cash and stock, both of which are "Settlement Fund" assets, to separate accounts. Because each of these accounts only held "Settlement Fund" assets and because those assets had to be used to satisfy liability in connection with the underlying allegations, each of these accounts must have been established for the purpose of resolving or satisfying claims arising from Taxpayer's alleged violations of the law. As noted earlier, the cash assets were to be placed into an interest bearing account. The a common shares (part of the "Settlement Fund") were placed into an escrow account held by plaintiffs' lead counsel. It is clear that the agreement allowed for multiple accounts, and that both accounts were established and used, pursuant to the agreement, to satisfy claims arising out of Taxpayer's alleged violations of the law.

Finally, the a shares of Taxpayer's common stock were segregated from its other assets and from the assets of related persons. As described in the facts, the shares were held in an escrow account by plaintiffs' lead counsel, subject to stipulations that counsel would not distribute, sell, hypothecate or otherwise dispose of the shares until the appeal was finally resolved.

Thus, because the circumstances surrounding the transfer of a shares of Taxpayer's freely tradeable common stock on Date 9 satisfied the requirements of § 1.468B-1(c), the escrow account held by plaintiffs' lead counsel was a qualified settlement fund under § 468B.

Because the shares transferred on Date 9 are considered a qualified settlement fund, the regulations under § 468B govern the date on which such shares are valued. Section 1.468B-3(c)(1) provides that economic performance occurred once the Taxpayer transferred the a shares to plaintiffs' lead counsel. Economic performance was not affected, under the regulations, by the fact that the appeal was still pending because the appeal gave the Taxpayer neither a current right of reversion, nor an absolute right to the funds in the future.

With regard to the other transfers of stock on dates 11, 12, and 13, the facts seem to indicate that those shares were given directly to their intended recipients. From the facts given, it does not appear that these assets were segregated from Taxpayer's other assets until the date that they were transferred to the intended recipients. Therefore, it does not appear that these assets were ever placed into an account governed by the qualified settlement fund regulations.

Transfers Occurring on Dates 11, 12, and 13

Section 461(a) of the Code provides in part that the amount of any deduction shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income. Section 1.461-1(a)(2) provides in part that for a taxpayer using the accrual method of accounting, a liability is incurred and taken into account for Federal income tax purposes 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 461(h)(1) provides that in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs. Section 461(h)(2)(D) provides that in the case of any liability of the taxpayer other than a liability arising out of the provision of services or property to the taxpayer, the provision of services or property by the taxpayer, or workers compensation and tort liabilities of the taxpayer, economic performance occurs at the time determined under regulations prescribed by the Secretary. Section 1.461-4(g)(2) provides in part that if the liability of a taxpayer requires a payment or series of payments to another person and arises out of any violation of law, economic performance occurs as payment is made to the person to which the liability is owed. A liability arising out of a violation of law includes a liability arising out of the settlement of a dispute in which a violation of law is alleged. Furthermore, § 1.461-4(g)(1)(A) provides in part that 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. Thus, payment includes furnishing of cash or cash equivalents and the netting or offsetting of accounts.

Because the transfers taking place on Dates 11, 12, and 13 did not fall under the qualified settlement fund rules of § 468B, the stock transferred on those dates is valued according to § 461 and the regulations thereunder. Therefore, valuation is proper on the dates(s) upon which all events have occurred which fixed Taxpayer's liability, the amount of the liability is determinable with reasonable accuracy, and economic performance with respect to the liability has occurred. Under the regulations governing economic performance, liability for a settlement payment arising out of a violation of law is a payment liability, with economic performance occurring when payment is made.

It appears from the facts that all events which fixed Taxpayer's liability under the settlement agreement occurred on Date 10, when Court 2 dismissed all parts of the appeal pertaining to Taxpayer. Furthermore, the settlement payment arose out of violations of the Securities and Exchange Act of 1934, and therefore, economic performance occurred as stock was transferred to the plaintiffs pursuant to the settlement agreement. The price of Taxpayer's stock is readily ascertainable on the dates the shares were transferred, and therefore, the amount of the liability was determinable upon those dates. Thus, the dates of valuation of the final three transfers of Taxpayer's stock are: Date 11, Date 12, and Date 13.

CONCLUSION

1) The amounts paid by Taxpayer pursuant to the settlement are currently deductible under § 162 of the Internal Revenue Code, and not characterized as capital expenses under § 263(a); and

2) The proper dates to value the z shares of stock are:

Date 9	a
Date 11	b
Date 12	c
Date 13	d

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110 of the Internal Revenue Code.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any item discussed or referenced in this letter. This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,
Douglas A. Fahey
Assistant to the Branch Chief, Branch 3
Office of Associate Chief Counsel
(Income Tax & Accounting)