# THE ORIGIN OF THE CLAIM DOCTRINE AND LITIGATION EXPENSES WITH A CONNECTION TO PROPERTY TRANSACTIONS – *WOODWARD* AND *HILTON HOTELS* POST *ASH GROVE CEMENT*

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*The origin of the claim doctrine was first set forth by the Supreme Court in United States v. Gilmore and expanded upon by the Court in Woodward v. Commissioner and its companion case, United States v. Hilton Hotels. Woodward applied the origin of the claim doctrine to require taxpayers, majority shareholders of a company, to capitalize expenses incurred in litigation over the value of the stock it was legally obligated to purchase from a minority shareholder of the company. Since Woodward and Hilton Hotels, the courts have utilized the principle in connection with a wide variety of property transactions. Under the doctrine, taxpayers are required to determine the origin of the claim (or claims) from which the item, such as importantly litigation or settlement expenses, proximately resulted. The purpose of the doctrine is to insure proper matching of the item in question with the related event. The article explores some of the boundaries as to when and how the origin of the claim doctrine is utilized. The principal focus is on expenses incurred in litigation, including settlement related payments, with a connection to property transactions. It provides expanded analysis of the recent decisions of both the district court and Tenth Circuit in Ash Grove Cement Co. v. United States, where the courts correctly concluded that the origin of the claim was not the defense of an obligation to indemnify the taxpayer's board of directors, but the reorganization transactions that triggered the indemnification lawsuit.*

## I. INTRODUCTION

It has been well over a half century since the United States Supreme Court decided the companion cases of *Woodward v. Commissioner*[1] and *United States v. Hilton Hotels Corp.*[2] in which the Court applied the origin of the claim doctrine to characterize costs connected with a lawsuit as either currently deductible or requiring capitalization. In *Woodward*, the Supreme Court determined that the costs associated with litigation must be capitalized if "the origin of the claim litigated is in the process of acquisition itself."[3] The majority shareholders were required under applicable state law to purchase the stock of a dissenting shareholder and since negotiations on the purchase price were fruitless, litigation was required to determine the price. In holding that the majority shareholders could not deduct expenses in connection with such litigation, the Court declared that "[w]here property is acquired by purchase, nothing is more clearly part of the process of acquisition than the establishment of a purchase price. Thus expenses incurred in that litigation were properly treated as part of the cost of the stock that the taxpayers acquired."[4]

The Supreme Court observed in *Woodward* that "[t]he standard here pronounced may, like any standard, present borderline cases, in which it is difficult to determine whether the origin of particular litigation lies in the process of acquisition."[5] This article explores some boundaries as to when and how the origin of the claim doctrine is utilized. The principal focus is on expenses incurred in litigation, including settlement related payments, with a connection to property transactions. The article provides expanded analysis of the recent decisions of both the district court and the Tenth Circuit in *Ash Grove Cement Co. v. United States*.[6] As discussed in more detail below, in *Ash Grove*

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1. Woodward v. Commissioner, 397 U.S. 572 (1970).
2. United States v. Hilton Hotels Corp, 397 U.S. 580 (1970).
3. *Woodward*, 397 U.S. at 577 (1970).
4. *Id.* at 579 (footnote omitted).
5. *Id.* at 578 (footnote omitted).
6. No. 11–2546–CM, 2013 WL 451641 (D. Kan. Feb. 3, 2013), *aff'd*, 562 F. App'x

*Cement* the taxpayer was unsuccessful in its arguments that it should be allowed to expense certain legal fees and settlement payments. The taxpayer asserted that these costs were incurred solely as a result of its indemnification obligation to its directors and as such should be deductible. The courts however required these costs to be capitalized because the obligation proximately resulted from a dispute over the taxpayer's reorganization transactions.

The origin of the claim doctrine as initially framed and applied by the Supreme Court makes conceptual sense, and most of the decisions rendered with respect to litigation expenses with a connection to a property transaction are proper. There are however some questionable decisions and rulings in this area. As discussed below, in certain circumstances, importantly, the determination of the origin of the claim should not serve to conclude the tax analysis of the item in question. Because of the voluminous amount of decisions and rulings even in the limited area focused upon by this article, coverage is far from exhaustive.

## II. WOODWARD AND HILTON HOTELS

In *Woodward*, the taxpayers were majority shareholders of an Iowa publishing corporation. In 1960, the taxpayers had voted their controlling interest in the corporation in favor of a perpetual extension of the charter. Iowa law required that a minority shareholder who had voted against the charter extension have his interest purchased at its "real value" by those voting in favor of the perpetual charter extension, i.e., the taxpayers. The taxpayers' attempt to negotiate the price of the dissenting shareholder's stock were unsuccessful and they subsequently brought an action in the state court to determine the value of the minority shareholder's interest, which was ultimately resolved by the Iowa Supreme Court.

The taxpayers deducted fees paid for attorneys, accountants and appraisers in connection with the appraisal litigation. The taxpayers asserted that they were entitled to deduct these fees since they were "ordinary and necessary expenses paid . . . for the management, conservation of property held for the production of income" under I.R.C. section 212.[7] The Service disallowed the deduction "because the fees represent capital expenditures incurred in connection with the acquisition of capital stock of a

697 (10th Cir. Apr. 22, 2014).

7. *Woodward*, 397 U.S. at 574.

corporation"[8] and this position was sustained by both the Tax Court and the Eighth Circuit.

The taxpayers argued that the Court should follow other courts that utilized a "primary purpose" test developed in the context of cases dealing with costs of defending or perfecting title to property. Under the primary purpose test if the primary or sole purpose of the lawsuit was to perfect or defend title to property the expenditure was required to be capitalized. Under that test taxpayers asserted the litigation expenses incurred should be deductible since the "'primary purpose' . . . [of the] the legal proceedings in which they were incurred did not directly involve the question of title to the minority stock. . .but rather was concerned solely with the value of that stock."[9] In disallowing the deduction, the Court indicated its dissatisfaction with the primary purpose test. The Court stated "[t]hat uncertain and difficult test may be the best that can be devised to determine the tax treatment of costs incurred in litigation that may affect a taxpayer's title to property more or less indirectly, and that thus calls for a judgment whether the taxpayer can fairly be said to be 'defending or perfecting title.'"[10] The Court went on to reject the application of the primary purpose test to the case and instead apply the origin of the claim doctrine. The Court declared that "[s]uch uncertainty is not called for in applying the regulation that makes the 'cost of acquisition' of a capital asset a capital expense. In our view application of the latter regulation to litigation expenses involves the simpler inquiry whether the origin of the claim litigated is in the process of acquisition itself."[11]

The Court noted that the appraisal litigation was just a "substitute" for negotiating a purchase price and that since legal, accounting and appraisal costs incurred in such negotiations would be capitalized the same should be true for costs incurred in legal proceedings aimed at achieving the same objective. The Court stated in this regard that "[a]llowing deduction of expenses incurred in such a proceeding [litigation concerning the shares' value], merely on the grounds that title was not directly put in question in the particular litigation, would be anomalous."[12]

In the companion case to *Woodward, United States v. Hilton Hotels Corp.*, the taxpayer, Hilton Hotels, owned close to 90% of

8. *Id.*
9. *Id.* at 577.
10. *Id.*
11. *Id.*
12. *Id.* at 578.

the Hotel Waldorf-Astoria Corporation and wanted to merge Hilton and Waldorf.[13] In the transaction that was ultimately implemented, Waldorf shareholders were offered 1.25 shares of Hilton stock for each Waldorf share not already owned by Hilton.[14] About 6% of the Waldorf shareholders filed written objections and demanded payment for their stock pursuant to section 91 of the New York Stock Corporation Law.[15] The dissenting shareholders, not satisfied with what Hilton proposed for their shares began appraisal proceedings in the New York courts.[16] In connection with this litigation, the taxpayer incurred expenses including legal fees and other professional fees. The taxpayer deducted its expenses in connection with the appraisal litigation as ordinary and necessary business expenses under I.R.C. section 162.[17] The Service disallowed the deduction and the taxpayer sued for refund in district court.[18]

Taxpayer won both in district court and at the Seventh Circuit and the Supreme Court granted certiorari. In reversing the Seventh Circuit decision, the Court noted that "[t]he chief distinction between this case and *Woodward* is that under New York law title to the dissenters' stock passed to Waldorf as soon as they formally registered their dissent, placing them in the relationship of creditors of the company for the fair value of the stock, whereas under Iowa law passage of title was delayed until after the price was settled in the appraisal proceeding. This is a distinction without a difference."[19] The Court noted that in both cases the expenses were incurred in litigating what the price of the shares should be.[20] The Supreme Court opined that "[t]he whole process of acquisition required both legal operations—fixing the price, and conveying title to the property—and we cannot see why the order in which those operations occurred under applicable state law should make any difference in the characterization of the expenses incurred for the particular federal tax purposes involved here."[21]

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13. *Hilton Hotels Corp*, 397 U.S. at 581.
14. *Id.*
15. *Id.* at 581-82.
16. *Id.* at 582.
17. Hilton also deducted fees paid to a consulting firm which had prepared a merger study including the determination of fair value but later conceded these were a "non-deductible capital outlay." *Hilton Hotels Corp.*, 397 U.S. at 582.
18. *Id.*
19. *Id.* at 583-84 (footnotes omitted).
20. *Id.* at 583-84 (footnotes omitted).
21. *Id.* at 584. The Supreme Court in *Hilton Hotels* also rejected taxpayer's assertion that the appraisal costs cannot be considered a capital expenditure of the taxpayer since Waldorf acquired the shares before the merger. *Id.* The Court stated in

In *Woodward* and *Hilton Hotels* the litigation costs were capitalized since they were matched to the origin of the claim giving rise to the lawsuit, i.e., the acquisition of property, a capital expenditure.[22] Professor John W. Lee observed that *Woodward* and *Hilton* "stand for the proposition that mismatching the character of a claimed ordinary deduction when the related income is tax preferenced by either capital gains treatment or complete nonrecognition distorts the taxpayer's income."[23]

## III. THE ORIGIN OF THE ORIGIN OF THE CLAIM DOCTRINE

The Supreme Court observed in *Woodward* that its application of the origin of the claim doctrine in its ruling "comports with this Court's recent ruling on the characterization of litigation expenses for tax purposes in *United States v. Gilmore*. . . . This Court there held that the expense of defending a divorce suit was a nondeductible personal expense. . . . The Court rejected a test that looked to the consequences of the litigation, and did not even consider the taxpayer's motives or purposes in undertaking defense of the litigation, but rather examined the origin and character of the claim against the taxpayer, and found that the claim arose out of the personal relationship of marriage."[24]

The taxpayer in *Gilmore* was at the time of his divorce proceedings the president and principal managing officer of three General Motors franchised automobile interests in which he owned controlling interests.[25] His "overriding concern in the divorce litigation was to protect these assets against the claims of his wife."[26] His qualms were two-fold. If he lost controlling interests in the dealerships he could have lost his corporate positions which were the source of most of his income.[27] Furthermore, if his wife was successful with respect to her marital infidelity allegation, General Motors might have

this regard that "[t]he debts that Hilton inherited from Waldorf retained their capital or ordinary character through the merger, and so did the expenditure for fixing the amount of those debts." *Id.* at 585.

22. *See Woodward*, 397 U.S. 572; *see also Hilton Hotels Corp*, 397 U.S. 580.

23. John W. Lee, *Transaction Costs Relating to Acquisition or Enhancement of Intangible Property: A Populist, Political, but Practical Perspective*, 22 VA. TAX. REV. 273, 275 (2002) (footnote omitted).

24. *Woodward*, 397 U.S. at 578 (citing United States v. Gilmore, 372 U.S. 39 (1963)).

25. *Gilmore*, 372 U.S. at 41.

26. *Id.*

27. *Id.* at 42.

cancelled his dealer franchises.[28] Taxpayer deducted in total about $40,600 of legal expenses in his 1953 and 1954 tax returns, that were incurred in successfully pursuing his cross-claim for divorce (The California court had denied both his ex-wife's community property and alimony claims.).[29] Taxpayer's position was that these expenses were deductible, pursuant to a predecessor to I.R.C. § 212, since they were "incurred . . . for the . . . conservation . . . of property held for the production of income."[30]

The Service denied taxpayer's deduction on grounds they were "personal" or "family" expenses.[31] The Court of Claims found that 80% of the litigation expense to be "incurred . . . for the . . . conservation . . . of property held for the production of income" and as such allowed the deduction.[32] The Government did not question the Court of Claim's allocation, but instead contended "that the deductibility of these expenses turns . . . not upon the consequences to respondent of a failure to defeat his wife's community property claims but upon the origin and nature of the claims themselves."[33]

Drawing on Supreme Court precedents including *Kornhauser v. United States*,[34] *Lykes v. United States*[35] and *Deputy v. du Pont*,[36] the Supreme Court in *Gilmore* embraced the Government's position.[37] The Court stated that "[t]he principle we derive from these cases is that the characterization, as 'business' or 'personal,' of the litigation costs of resisting a claim depends on whether or not the claim *arises in connection with* the taxpayer's profit-seeking activities. It does not depend on the *consequences* that might result to a taxpayer's income-producing property from a failure to defeat the claim, for, as *Lykes* teaches, that 'would carry us too far' and would not be compatible with the basic lines of expense deductibility drawn by Congress."[38] The Court also observed that adopting taxpayer's position to focus on the consequences of not prevailing in the litigation would lead to

28. *Id.*
29. *Id.* at 40-42.
30. *Id.* at 43 (quoting from I.R.C. § 23(a)(2) (1939)).
31. *Id.* at 42 (quoting from I.R.C. § 24(a)(1) (1939)).
32. *Id.* at 43.
33. *Id.* at 43-44.
34. Kornhauser v. United States, 276 U.S. 145 (1928).
35. Lykes v. United States, 343 U.S. 118 (1952).
36. Deputy v. Du Pont, 308 U.S. 488 (1940).
37. *Gilmore*, 372 U.S. at 46-48.
38. *Id.* at 48 (footnotes omitted; italics are from the opinion).

disparate tax treatment among taxpayers.[39] The Court illustrated this with a hypothetical involving two taxpayers being sued as a result of automobile accidents occurring while driving for pleasure.[40] The Court commented that a test of tax deductibility based on consequences to income producing property, "would turn on the mere circumstance of the character of the assets each happened to possess. . . ."[41]

The rule of the case in *Gilmore* is "that 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. . . ."[42]

As to the origin of the claim doctrine's purpose, Professor Lee commented that "[t]he purpose of the [origin of the claim] doctrine is to prevent a taxpayer from distorting income by mismatching timing and/or character of income and expenses, lest the tax treatment of an expenditure or method of tax accounting for that item violate the clear reflection of income mandate of section 446."[43] Its roots go back even prior to *Gilmore*. In the *Deputy v. du Pont* decision that was cited and quoted in *Gilmore*, the Supreme Court stated "it is the origin of the liability out of which the expense accrues which is material."[44]

While not cited in *Gilmore*, *Woodward*, or *Hilton Hotels*, the leading case *Arrowsmith v. Commissioner* establishes the importance of determining the tax character of a subsequent event from an earlier original transaction tied to it.[45] In *Arrowsmith*, taxpayers had obtained favorable capital gains treatment upon the liquidation of a corporation.[46] In a later year, taxpayers were required to pay a judgment arising from the liquidated corporation and attempted to deduct the expenditure as an ordinary business loss rather than as an unfavorable

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.* at 49. In a companion case to *Gilmore* also involving legal fees of a taxpayer-husband in a divorce proceeding, the Court denied the deduction by finding "no significant distinction in the fact that the legal fees for which deduction is claimed were paid for arranging a transfer of stock interests, leasing real property, and creating a trust rather than for conducting litigation." United States v. Patrick, 372 U.S. 53, 57 (1963).

43. Lee, *supra* note 23, at 312 (citing Fort Howard Paper Co. v. Comm'r, 49 T.C. 275, 283-284(1967) and IRC § 446(b)).

44. *Du Pont*, 308 U.S. at 494.

45. *See* Arrowsmith v. Commissioner, 344 U.S. 6 (1952).

46. *Id.* at 7.

capital loss.[47] The Court adopted the Government's view that the later "payment [should be considered] as part of the original liquidation transaction requiring classification as a capital loss. . . ."[48] The *Arrowsmith* doctrine of tying the tax character of a subsequent event with an earlier transaction is certainly consonant with determining whether or not expenses incurred in litigation are deductible based on the nature of the origin of the claim. As discussed below, some courts have cited both *Woodward* and *Arrowsmith* in analyzing settlement payments with a connection to an earlier property transaction.

The link between *Arrowsmith* and the later origin of the claim Supreme Court cases is illustrated in the Fifth Circuit decision *Estate of Meade v. Commissioner*, although *Arrowsmith* is again not cited.[49] The case also demonstrates the doctrine is all about matching. In *Estate of Meade*, the taxpayers were the shareholders of a company that, like the entity in *Arrowsmith*, was liquidated.[50] One of the assets the taxpayers received in the liquidation was an antitrust claim.[51] The claim had no ascertainable fair market value at the time of liquidation and no value was thus ascribed to it in computing the taxpayer's capital gain from the liquidation.[52] The taxpayers retained counsel in successfully pursuing a settlement of the antitrust claim.[53] While they treated the settlement proceeds as additional capital gain from the liquidation they deducted the legal expense from ordinary income under I.R.C. section 212 as expenses incurred "for the production or collection of income."[54] The court held the taxpayer's position was improper under the origin of the claim doctrine.[55] The Fifth Circuit reasoned that the antitrust claim "had its origin in the process of the disposition of their stock. . . ., the claim was part of the . . . assets received by taxpayers in the liquidation of the corporation, and the taxpayers' disposition of their stock was an open transaction for purposes of the collection of the proceeds of the settlement.[56] Thus, the valuation of the [antitrust] claim . . . was vital to the disposition of taxpayers' stock, and the litigation necessary for this determination was an

47. *Id.*
48. *Id.* at 7-8.
49. *See* Estate of Meade v. Comm'r, 489 F.2d 161 (5th Cir. 1974).
50. *Id.* at 162.
51. *Id.*
52. *Id.* at 163.
53. *Id.*
54. *Id.*
55. *Id.* at 165.
56. *Id.* at 166.

integral part of the overall transaction."[57] The Fifth Circuit recognized that the character of the litigation expense incurred in obtaining the antitrust claim settlement, needed to match taxpayer's treatment of this asset.[58] The court opined that "the expenses incurred in the litigation that led to the settlement are properly treated as part of the cost of the stock that the taxpayers exchanged in the liquidation."[59] This is really no different conceptually from the Court in *Arrowsmith* treating a liability from the liquidation as having the same character as the capital gain from the transaction. It was a proper matching of the two items.

## IV. What does Origin of the Claim Mean?

Determining the origin of the claim or claims in a particular fact pattern can in certain circumstances be problematic. One can't undertake such an analysis without an understanding of what "origin of the claim" exactly means. Some commentators have questioned whether the Supreme Court intended in *Gilmore* that the origin of the claim doctrine incorporate the concept of "proximate cause" from tort law.[60] The Supreme Court itself, however, nine years after *Gilmore* was decided, in a leading case as to whether a worthless obligation was a nonbusiness bad debt, specifically challenged the application of proximate cause to the tax law. In *United States v. Generes*, the Court stated that "[i]n tort law factors of duty, of foreseeability, of secondary cause, and of plural liability are under consideration, and the concept of proximate cause has been developed as an appropriate application and measure of these factors. It has little place in tax law where plural aspects are not usual, where an item either is or is not a deduction, or either is or is not a business bad debt, and where certainty is desirable."[61] While the Court may well have correctly rebuffed the general utilization of proximate cause to the tax laws, perhaps its reasoning is questionable especially if used in conjunction with the origin of the claim doctrine. In any event, as noted below, other courts in analyzing the application of the origin of the claim doctrine have used terms like "proximately resulted" and "proximately related" rather than "proximate

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57. *Id.*
58. *Id.* at 167-68.
59. *Id.* at 166.
60. See, *e.g.*, Timothy A. Rogers, *Note: The Transaction Approach to the Origin of the Claim Doctrine: A Proposed Cure for Chronic Inconsistency*, 55 BROOK. L. REV. 905, 934 (1989).
61. United States v. Generes, 405 U.S. 93, 105 (1972).

cause" to describe the necessary connection between the underlying transaction and the event being analyzed.

Robert W. Wood observes that "[g]enerally, one can ascertain the origin and nature of the claim(s) by examining: (i) the complaint; (ii) the history of the negotiations if the parties have entered into settlement discussions; and (iii) the settlement agreement (if any)."[62] Revenue Ruling 85-98 involved in part the taxation of amounts received in settlement of a libel suit for injury to personal reputation, specifically how much of the payment received should be treated as compensatory versus punitive damages.[63] The Service indicated there that "the best evidence to determine a proper allocation is the taxpayer's complaint."[64] As discussed herein, this however may not always be appropriate in undertaking an origin of the claim analysis.

While there are situations where what is the origin of the claim is self-evident, that is not always the case. There are certainly instances where valid arguments can be made on contrary positions as to what was the origin of the claim. Even in *Gilmore* itself, one could legitimately question the conclusion reached as to the origin of the claim. Professors Marvin Chirelstein and Lawrence Zelenak commented that "[w]hile the outcome in *Gilmore* is generally viewed as satisfactory, the argument from cause-and-effect is, as usual, slightly circular.[65] To be sure, there would have been no litigation without the divorce; but without the property ownership the taxpayer's legal fees would have been appreciably smaller. Just why the divorce rather than the property interest must logically be viewed as *the* 'source' of the added legal expense is not completely obvious."[66] The writers rationalize that "perhaps the result in *Gilmore* can be explained more simply by pointing out that the costs of rearranging titles within a family group . . . have always been regarded as a personal expense of property ownership . . . the Court in *Gilmore* correctly perceived that it had no warrant to differentiate between divorce settlements and other kinds of intra-family property dispositions."[67]

In *Dye v. United States*, the Tenth Circuit characterized the origin of the claim doctrine as one focusing not on proximate

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62. Robert W. Wood, TAX MGM'T, *Tax Aspects of Settlements and Judgments*, section II.

63. Rev. Rul. 85-98, 1985-2 C.B. 51.

64. *Id.*

65. MARVIN A. CHIRELSTEIN & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION - A LAW STUDENT'S GUIDE TO LEADING CASES AND CONCEPTS ¶ 6.01 (12th ed. 2012).

66. *Id.* (Italics are from the original text.)

67. *Id.* at 129.

cause but instead on "the transaction or activity from which the taxable event *proximately resulted*."[68] In *Dye*, the taxpayer settled her action against her stockbroker's former employers for the stockbroker's various improprieties including securities fraud and mismanagement of her investment accounts.[69] In her tax return, the taxpayer treated the settlement proceeds as long-term capital gain and her attorneys' fees as a capital expenditure reducing the taxable proceeds.[70] The Tenth Circuit noted that "the settlement agreements did not allocate the settlement proceeds by individual claim. . . . Thus, the 'origin of the claim' test requires that a court determine how the settlement should be allocated among the various claims actually settled, and the court must then determine whether the damages associated with each settled claim were stated in terms of loss in value to Dye's capital assets."[71] The court went on to find that "[a] reading of the amended complaint reveals that Dye was asserting claims for impairment to her capital, as well as claims whose origin relate to lost income or claims which the law otherwise treats as claims for ordinary income."[72]

The court in *Dye* determined that "the district court erred in treating the legal expenses as a unified whole, rather than attempting to allocate them based on their respective 'origins' in *each* of Dye's legal claims. Where, as here, the litigation involves more than one claim, '[t]he origin [of the claim] test must be applied separately to each part.'"[73] The court acknowledged that how such an allocation should be undertaken can be difficult and that other courts have established different approaches.[74] Without deciding which approach it favored and simply remanding the case back to the district court, the court observed the contrary approaches of the Federal Circuit and the Ninth Circuit.[75]

The Tenth Circuit in *Dye* noted that in *Baylin v. United States*, the Federal Circuit held that "legal expenditures should not necessarily be based on the relative amounts of capital and ordinary income ultimately received. . . . Rather, under the *Baylin* court's approach, legal expenditures should be allocated according to the approximate proportion of the lawyers' efforts

68. Dye v. United States, 121 F.3d 1399, 1404 (10th Cir. 1997) (italics added).
69. *Id.* at 1402.
70. *Id.* at 1402–03.
71. *Id.* at 1404 (citation omitted).
72. *Id.*
73. *Id.* at 1406 (alteration in original; citations omitted).
74. *See id.* at 1410–11.
75. *Id.*

attributable to the pursuit of each claim."[76] In contrast to the Federal Circuit in *Baylin*, the Ninth Circuit in *Leonard v. Commissioner*,[77] "rejected an approach similar to that of the *Baylin* court, 'because it ignores the contingent fee[78] portion of the taxpayers' contract with their lawyers . . . .' Under the *Leonard* court's approach, 'taxpayers are entitled to deduct what they actually paid their lawyers, according to the contingent fee contract, to obtain their share of [each] portion of the [litigation

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76. *Dye*, 121 F.3d at 1410 (citing Baylin v. United States, 43 F.3d 1451, 1454 (Fed. Cir. 1995)).

77. Leonard v. Comm'r, 94 F.3d 523 (9th Cir. 1996).

78. A major controversy that has now been resolved by the Supreme Court was the application of the assignment of income doctrine to contingent fee arrangements. That is under what circumstances if any can a taxpayer exclude from gross income a contingent fee payment made in conjunction with a court decision or settlement. Exclusions are often preferable because of both the fact that the deduction is treated by individual taxpayers as a miscellaneous itemized deduction from adjusted gross income subject to a two percent floor under I.R.C. § 67, and the fact that the deduction may not be allowed because of the application of the alternative minimum tax. S*ee* I.R.C. § 56(b)(1)(A) (2014). In *Commissioner v. Banks*, the Supreme Court held that "as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee." Banks, 543 U.S. 426, 430 (2005). The plaintiffs in *Banks* and a companion case both had received settlements in conjunction with lawsuits against former employers with one of the actions involving alleged employment discrimination. The Supreme Court explained both the assignment of income doctrine and the rationale behind the policy. The Court wrote that "a taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party. . . . The rationale for the so-called anticipatory assignment of income doctrine is the principle that gains should be taxed 'to those who earned them,' . . . a maxim we have called 'the first principle of income taxation,'. . . . The anticipatory assignment doctrine is meant to prevent taxpayers from avoiding taxation through 'arrangements and contracts however skillfully devised to prevent [income] when paid from vesting even for a second in the man who earned it.'" *Id.* at 433-34 (alteration in original; citations omitted). The Court agreed with the Government's argument "that a contingent-fee agreement should be viewed as an assignment to the attorney of a portion of the client's income from any litigation recovery." *Id.* at 434.

I.R.C. § 62(a)(20), added by Pub. L. No. 108-357 § 703(a), (b), 118 Stat. 1418 (2004), softened some of the impact of *Banks* by providing for a deduction *for* adjusted gross income "allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination . . . ." Bittker & Lokken note that "[t]he term 'unlawful discrimination' includes actions that are unlawful under any of several federal laws, including various provisions of the Civil Rights Acts of 1964 and 1991, the Fair Labor Standards Act, the Age Discrimination in Employment Act, the Employee Retirement Income Security Act (ERISA), and the Family and Medical Leave Act. The term also includes actions for which recovery may be had under federal whistleblower protection provisions and federal, state, and local laws (including the common law) 'providing for the enforcement of civil rights' or 'regulating any aspect of the employment relationship.' Fees and costs in connection with actions against the U.S. government under 31 USC §§ 3721 through 3733 and claims against health care plans under 42 USC § 1395y(b)(3)(A) may also be deducted in determining adjusted gross income. A 'judgment or settlement' may be 'by suit or agreement' and may be payable as a 'lump sum' or 'periodic payments.'" BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 2.1.3, n.18.1 (citations omitted) (Boston: Warren, Gorham & Lamont ed., 3d ed. 2014-date).

proceeds].'"[79] The notable point here is that there are situations where there are multiple claims that need to be matched with various origins and courts have used different approaches in apportioning the expenses in such circumstances.

*Dye* is just one example of a case in which there is more than one claim for which an origin needed to be determined.[80] At times it is difficult to discern if more than one claim exists and the form of the complaint may influence the resolution of this matter. Professors Edward Schnee and Nancy Stara comment that "[d]ual origins necessitates [*sic*] that ancillary costs which are related to capital assets be distinguished from other costs which should be considered ordinary business expenses. This distinction can be close. Under the origin of the claim test, an expenditure is characterized by the nature of the underlying claim. Depending on how an underlying claim is structured, it may be viewed as a single transaction or two distinct transactions which provide dual origins."[81]

While *Dye* uses the term "proximately resulted" to connote the connection to the litigation costs in question and the origin of the claim, other courts use similar terms such as "proximately related."[82] For example in *Guill v. Commissioner*, the Tax Court stated that "[o]rdinary and necessary litigation costs are generally deductible under section 162(a) when the matter giving rise to the costs arises from, or is *proximately related* to, a business activity."[83] In *Guill*, the court had to decide whether litigation costs that were attributable to an independent contractor's recovery of punitive damages were deductible in arriving at adjusted taxable income or a miscellaneous itemized deduction subject to a two percent floor under I.R.C. section 67.[84] The taxpayer had served as an agent for an insurance company.[85] In that capacity he was an independent contractor.[86] He was fired, and in breach of contract the insurance company paid him

79. *Dye*, 121 F.3d at 1411 (alterations in original) (citations omitted).

80. Another example of multiple origin of claims is *McKeague v. United States*, 12 Cl. Ct. 671 (1987), wherein the court allocated attorney fees in settlement of a suit by taxpayer, an officer/shareholder in a company, between claims relating to his employment termination and forced buy-out of his stock at an unreasonably low price. Litigation expenses not dealing with his stock sale were treated as ordinary deductions and an amount attributed to taxpayer's stock sale was added to his basis in the shares.

81. Edward J. Schnee & Nancy J. Stara, *The Origin of the Claim Test: A Search for Objectivity,* 13 AKRON TAX J. 97, 124-25 (1997) (footnotes omitted).

82. *E.g.*, Guill v. Comm'r, 112 T.C. 325 (1999).

83. Guill v. Comm'r, 112 T.C. 325, 329 (1999) (italics added).

84. *Id.* at 327-28.

85. *Id.* at 326.

86. *Id.*

less renewal commissions than the amount of which he was entitled.[87] The taxpayer sued the insurance company seeking both actual and punitive damages.[88] The jury awarded him about $51,500 in actual damages and $250,000 in punitive damages.[89] In arriving at his adjusted gross income, he deducted about $148,600 in attorney's fees and a little over $3,000 in court costs as ordinary and necessary business expenses.[90]

The Tax Court in *Guill* held for the taxpayer, finding that the legal fees and courts costs were entirely ordinary and necessary business expenses deductible in arriving at adjusted gross income.[91] The court rejected the Service's attempt to bifurcate the tax treatment of these costs to the type of damages the taxpayer received, i.e., the Service had asserted that costs associated with punitive damages should be treated as an itemized deduction pursuant to I.R.C. section 212.[92] The Tax Court stated "[t]he mere fact that petitioner sought and was paid punitive damages to punish Academy [the insurance company] for its 'extraordinary misconduct, and to serve as a warning [to it and to other persons] not to engage in such conduct in the future' does not change the fact that petitioner's legal costs were all attributable to his business activity."[93]

The attorney's fees and court costs incurred by the taxpayer in *Guill* were all deductible as ordinary and necessary business expenses because the expenses were "attributable to claims which originated in his business activity. . . ."[94] The court also observed that absent an award of actual damages, punitive damages would have not been given, i.e., "punitive damages could not have been made in isolation."[95]

In *Boagni v. Commissioner*, the Tax Court pointed out that "[q]uite 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."[96] The Tax Court in *Boagni* went on to state that

87. *Id.*
88. *Id.*
89. *Id.* at 327.
90. *Id.*
91. *Id.* at 332.
92. *Id.* at 331.
93. *Id.* at 330.
94. *Id.* at 331.
95. *Id.* at 332.
96. *Id.*

"[c]onsideration 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 facts pertaining to the controversy. . . ."[97] This last sentence quoted from *Boagni* was however subject to criticism by the Ninth Circuit in *Keller Street Development Co. v. Commissioner*.[98]

In *Keller Street Development*, the Ninth Circuit opined that "*Boagni* does not accurately state the origin test. In fact, the criteria listed would be more appropriate for determining the primary purpose of the litigation. This is inconsistent with the Supreme Court's rejection of the purpose test, and it reflects an improper merging of the attribution step with the ultimate characterization decision."[99]

*Keller Street Development* dealt with a fact-pattern wherein taxpayer sold its brewery to another company, Maier, that was wholly owned by taxpayer's majority shareholder, Paul Kalmanovitz.[100] At the time of the sale, taxpayer was having serious cash flow problems.[101] Its minority shareholders wanted to liquidate the company and Kalmanovitz wanted to continue operating the brewery.[102] Maier bought the brewery from the taxpayer after Kalmanovitz resigned from taxpayer's board of directors.[103] The sale was structured with significant deferred payments, without stated interest during the first five years from the sale.[104] Keller Street's minority shareholders brought a derivative action challenging the sale as fraudulent and unfair and seeking rescission.[105] The litigation took ten years and the California state courts made some adjustments to the sale terms.[106] One adjustment, which was the subject of the tax litigation in *Keller Street Development*, was an additional sum of about $2.4 million owed by Maier to the taxpayer as "reasonable compensation—to [Keller Street Development] for the use by [Maier], of such transferred brewery assets during the period subsequent to June 29, 1958 [the day after Keller Street

97. *Id.*
98. Keller St. Dev. Co. v. Comm'r, 688 F.2d 675 at 680 (9th Cir. 1982).
99. *Id.*
100. *Id.* at 676.
101. *Id.*
102. *Id.*
103. *Id.* at 677.
104. *Id.*
105. *Id.*
106. *Id.*

Develoment's board accepted the purchase offer]. . . ."[107] The taxpayer treated this income as a purchase price adjustment and thus capital gain.[108] The Service successfully argued in the Tax Court that this amount should be treated as ordinary income since it was a replacement for lost profit.[109] The Ninth Circuit in *Keller Street Development* affirmed the decision of the Tax Court but for different reasons.[110] The court indicated that "[c]haracterization of a transaction for taxation is a two-step process."[111] The court observed that the first "step is to discover the origin of the claim from which the tax dispute arose. This attribution determination is critical to proper tax characterization because of the inherently factual nature of taxation. Once a transaction is placed in its proper context, the nature of that transaction becomes discernible, and its tax character may be identified. Thus, the second step, the actual tax characterization, is dependent upon the proper resolution of the preliminary attribution question."[112]

The Ninth Circuit in *Keller Street Development* acknowledged that in determining what was the origin of the claim "[t]he Tax Court was correct in noting that the mere fact that the brewery sale was first in the chain of events leading to the tax dispute is not controlling."[113] The court, however, then opined that what was "controlling" as to the origin of the claim was "the fact that the brewery sale was the basis of the shareholders' derivative suit, which led to the tax dispute. . . ."[114] The court stated, "[h]ere, having determined that the sale of the brewery assets was the origin, we identified the nature of the sale as that of a capital transaction."[115]

Thus, according to the Ninth Circuit in *Keller Street Development*, the determination of the origin of the claim was a vital initial part of the process.[116] The tax analysis however didn't stop there. Rather, the tax treatment was predicated on, "how the payment fits into the structure of a capital transaction."[117] The court concluded that based on how the amount of damages

107. *Id.*
108. *Id.*
109. *Id.* at 678.
110. *Id.*
111. *Id.*
112. *Id.*
113. *Id.* at 681.
114. *Id.*
115. *Id.*
116. *Id.*
117. *Id.* at 682.

was determined, the payment received was "analogous either to interest paid to a seller to compensate for delay in the payment of a purchase price, or the rent paid for temporary use of income producing property."[118] As a result, the taxpayer was denied capital gain treatment.[119] The taxpayer's intellectual victory as to the proper origin of the claim was Pyrrhic. *Keller Street Development's* significant legacy lies in how the determination of origin of the claim fits into overall tax analysis of the item in question.

Even without reaching the second step, addressing ambiguities with respect to the origin of the claim may at times be challenging. Professors Schnee and Stara point out that "[i]dentifying the originating activity may not be easy. Since its inception, the origin of the claim test has been applied to relate expenses to remote origins. For example, litigation costs have been related to litigation that was concluded and to litigation that was only threatened. As expenses become less directly associated with litigation, attributing the character of the litigation to the expenses becomes even more problematic."[120] While the second step enunciated by the Ninth Circuit in *Keller Street Development* can add increased complexity to the evaluation of the item's tax treatment, it serves to prevent inequities to taxpayers and the fisc. It can be critically important in certain situations.

## V. THE USE OF THE ORIGIN OF THE CLAIM DOCTRINE WITH RESPECT TO LITIGATION AND SETTLEMENT EXPENSES WITH A CONNECTION TO PROPERTY TRANSFERS & ACQUISITIONS

The origin of the claim doctrine is applied by the courts *inter alia* to litigation and settlement expenses incurred in connection with successful, failed, voluntary and involuntary transfers, as well as transactions where the taxpayer has acquired property through purchase, exchange, divorce, etc. Treasury regulations under section 263, including, significantly, the so called *INDOPCO*[121] regulations,[122] have also incorporated origin of the

118. *Id.*

119. *Id.*

120. *See* Schnee & Stara, *supra* note 81, at 101 (footnotes omitted).

121. In *INDOPCO* the Supreme Court required capitalization of expenses incurred by a target, including investment banking services and legal fees directly related to the takeover. The Court rejected taxpayer's argument that the creation of a separate and distinct asset is a necessary requirement for capitalization. (In the interest of full disclosure, during the time of the Supreme Court decision the author was the General Tax Counsel for Unilever United States, Inc., the indirect parent company of INDOPCO, Inc.). INDOPCO, Inc. v. Comm'r, 503 U.S. 79 (1992).

claim principles including *Woodward* itself,[123] although in some instances results are contrary to some of the case law.

### A. *Property Transfers (Successful, Failed, Voluntary & Involuntary)*

Just after the Supreme Court rendered its decisions in *Woodward* and *Hilton Hotels*, the Eighth Circuit in *Anchor Coupling Co. v. United States*[124] faced a fact-pattern in which the taxpayer claimed an ordinary deduction for payments incurred in settlement of a specific performance lawsuit arising from an alleged asset purchase agreement. The taxpayer entered into negotiations to sell its assets to Borg-Warner Corporation.[125] One of the taxpayer's founders and major shareholders, Charles Conroy, decided to terminate negotiations when it became apparent that Borg-Warner intended to reduce salaries and responsibilities of the taxpayer's executives.[126] Borg-Warner alleged correspondence between the parties constituted a contract of sale, and it filed a complaint in an Illinois state court seeking specific performance of the sale.[127] A settlement was eventually reached for the payment of monetary damages by the taxpayer, Conroy and another shareholder.[128] The taxpayer's share was $600,000 and it deducted the payment as an ordinary and necessary expense.[129] The Service determined the payment was a disallowed nondeductible capital expenditure.[130] The taxpayer won in district court and the Government appealed.[131]

The Seventh Circuit in *Anchor Coupling* reversed the district court and held the settlement payment to be a nondeductible capital expenditure.[132] The court reasoned "[t]he

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122. *See* Treas. Reg. § 1.263(a)-4-(a)-5 (2003). The regulations address the treatment of costs incurred in acquiring, creating, or enhancing intangible assets as well as provide guidance on the requirements for capitalization with respect to costs paid or incurred to facilitate an acquisition of a trade or business, a change in capital structure and other transactions. Treas. Reg. § 1.263(a)-4-(a)-5 (2003). A detailed discussion of the regulations is beyond the scope of this article. For a good analysis of the regulations. *See* Carol Conjura et al., *To Capitalize or Not? The INDOPCO Era Ends with Final Regulations Under Section 263(a)*, 100 J. TAX'N 215(2004).

123. *See* Treas. Reg. § 1.263(a)-4(e)(5) Example 4 (2003).

124. 427 F.2d 429 (7th Cir. 1970), *cert. denied*, 401 U.S. 908 (1971).

125. *Id* at 430.

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.*

130. *Id.*

131. *Id.*

132. *Id.* at 433.

origin and nature of the claim by Borg-Warner, which was liquidated by Anchor's settlement payment, directly concerns Anchor's capital assets. The alleged contract between Anchor and Borg-Warner created a claim on Anchor's assets. . . . Therefore, Anchor protected ownership to its assets by removing Borg-Warner's claim through the settlement payment of $600,000."[133] The Seventh Circuit also rejected application of the "primary purpose" test by the district court.[134] In doing so the court acknowledged that the Supreme Court in *Woodward* "did not intimate the extent to which the primary purpose test, as applied to costs incurred in protecting ownership, has been rejected by the adoption of the objective standard of deductibility in *Gilmore* and *Woodward*."[135] The Seventh Circuit, however, determined the considerations motivating the Court's rejection of the primary purpose test in favor of the origin of the claim doctrine was applicable to the *Anchor Coupling* fact-pattern.[136]

In their leading tax treatise on mergers and acquisitions, Jack Levin, Martin Ginsburg, and Donald Rocap are critical of the Seventh Circuit's Decision in *Anchor Coupling*. They comment that prior to the beginning of negotiations with Borg-Warner ("P"), taxpayer ("T") "had perfectly good title to its assets. T's settlement payment to P allowed T to terminate a disputed business transaction (a possible asset sale to P) that T believed would disadvantage T. Hence after the payment T was no better or worse off than it was before the transaction began."[137] There are perhaps two different ways of viewing the transaction. The court considered the transaction as one whereby the taxpayer defended its title to property. The Seventh Circuit stated in this regard "Anchor protected ownership to its assets by removing Borg-Warner's claim through the settlement payment of $600,000."[138] As such, the payment should be capitalized.[139] This approach is certainly not irrational. Another way of analyzing the taxpayer's actions, however, is that the origin of the claim was an abandoned attempt to sell the business. From this perspective, the origin of the claim remains a capital transaction

133. *Id.*

134. *Id* at 431.

135. *Id.* at 432 (footnote omitted).

136. *Id.*

137. JACK S. LEVIN, MARTIN D. GINSBURG, AND DONALD ROCAP, MERGERS, ACQUISITIONS & BUYOUTS, ¶ 402.12.7 (2014).

138. Anchor Coupling, 427 F.2d at 433.

139. *See*, *e.g.*, Southland Royalty Co. v. United States, 582 F.2d 604 (Ct. Cl. 1978), *cert denied*, 99 S. Ct. 1991 (holding litigation costs concerning the timing of a reversion of a leasehold interest is capitalized as related to defense or perfection of title whether origin of the claim or primary purpose standard is utilized).

but a loss arguably should be permitted under the second step in *Keller Street Development:* "identifying the origin of the claim as a capital transaction does not automatically resolve the tax treatment of the payment at issue. . . ."[140] From this vantage point, the second step, i.e., actual tax characterization, should then permit a loss to be allowed akin to an abandonment loss.[141] This presumably is what Levin and Ginsburg are implying. They do note however that the subsequently issued regulations under I.R.C. section 263 addressing costs allocable to intangible property "can be read as supporting the *Anchor Coupling* result."[142] Finally, they opine that "even if the decision were correct, it should be applied only in those relatively rare situations involving similar facts. For example, had P and T each merely paid their own expenses of evaluating a P-T transaction without a dispute over whether P had a valid contract, both P and T should have been entitled to a loss deduction. . . . In addition, even in the *Anchor Coupling* factual situation, the court's decision should not apply to P's costs, because P was not perfecting title to its assets."[143]

While *Anchor Coupling* was cited favorably by the Tax Court in *Santa Fe Pacific Gold Co. v. Commissioner*[144], in a case decided prior to the issuance of the *INDOPCO* regulations, the court limited its application. The Tax Court in *Santa Fe Pacific Gold* allowed the taxpayer/target to deduct a termination fee paid to end a merger agreement after receiving a higher offer from a hostile acquirer. The court indicated that the determination of whether the costs are deductible is determined by the origin of the claim test and it found the termination fee to be "more closely tied"[145] to the contract with its initial merger partner, Homestake Mining Co. to which the fee was payable, than to the one that ultimately occurred with Newmont USA Limited. The Tax Court reasoned that "[t]he termination fee was intended to protect the Santa Fe-Homestake agreement, to deter competing bids, and to

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140. *Keller Street,* 688 F.2d at 681-82.

141. *See, e.g.*, Rev. Rul. 73-580, 1973-2 C.B. 86; Rev. Rul. 79-2, 1979-1 C.B. 99.

142. LEVIN, GINSBURG & ROCAP, *supra* note 137, at ¶ 402.12.7 (citing *inter alia* Treas. Reg. § 1.263(a)-4(d)(9) and Treas. Reg. §1.263(a)-4(d)(7)(i)). For example, Treas. Reg. § 1.263(a)-4(d)(9)(i) provides, "[a] taxpayer must capitalize amounts paid to another party to defend or perfect title to intangible property if that other party challenges the taxpayer's title to the intangible property." They do point out however that in contrast, under the recently issued repair regulations, costs incurred in an abandoned attempt to sell tangible personal business property would give rise to a recognized loss under I.R.C. § 165. *See* Treas. Reg. § 1.263(a)-1(e)(3) Example 4.

143. *Id.*

144. Santa Fe Pacific Gold Co. v. Comm'r, 132 T.C. 240 (2009).

145. *Id.* at 265.

reimburse Homestake for its time and effort in the event that the deal was terminated . . . [Santa Fe's] major defensive strategy was to engage in a capital transaction with a third party that would prevent Newmont's acquisition."[146] Regulation sections 1.263(a)-5(c)(8) and 1.263(a)-5(l) Example 13 issued as part of the *INDOPCO* regulations would now, however, require capitalization of the fee since the transactions with Homestake and Newmont are "mutually exclusive."

*Helgerson v. United States*[147] was an Eighth Circuit case decided shortly after the Supreme Court rendered its opinions in *Woodward* and *Hilton Hotels*. In *Helgerson*, the court denied an ordinary deduction pursuant to I.R.C. section 212 for attorneys' fees and expenses incurred by taxpayers to protect shares they owned that were held as collateral pending the completion of an installment sale. Unlike *Anchor Holding*, in *Helgerson* the sale occurred. The court held these legal fees and expenses must be capitalized because "they originated in the process of disposition of the controlling stock interest. . . ."[148]

In *Von Hafften v. Commissioner*, the taxpayers owned a house utilized as rental property for which they entered sale negotiations.[149] At some point prior to a written contract, the taxpayers told the perspective buyer they no longer wished to sell the property. The taxpayers, in turn, were sued for specific performance, breach of contract, promissory estoppel and fraud. In successfully defending the lawsuit, the taxpayers incurred legal expenses which they deducted under I.R.C. section 212 for the conservation of property. The Tax Court held that these legal expenses should be capitalized. The Tax Court observed that the sale of property by the taxpayers was "[t]he transaction underlying the litigation. . . ."[150]

*Madden v. Commissioner* involved not a voluntary sale, but a condemnation.[151] The taxpayers owned and operated a commercial orchard. A county public utility condemned part of the Maddens' land for use as a reservoir. The taxpayers incurred legal fees in an unsuccessful attempt to limit the condemnation to the taking of a flowage easement instead of a fee simple interest. The Ninth Circuit denied the taxpayers a deduction for the legal fees. The court reasoned that the lawsuit arose out of

146. *Id.* at 272.
147. *See* Helgerson v. United States, 426 F.2d 1293 (8th Cir. 1970).
148. *Id.* at 1297.
149. Von Hafften v. Comm'r, 76 T.C. 831, 832 (1981).
150. *Id.* at 834.
151. Madden v. Comm'r, 514 F.2d 1149 (9th Cir. 1975), *cert. denied*, 424 US 912 (1976).

the government's attempt "to appropriate taxpayers' land and taxpayers were resisting that attempt. Such a controversy is inherently related to the sale and acquisition of land, even though the ultimate sale, if one is made, is a forced sale."[152] The origin of the claim here was "capital in nature,"[153] i.e., a disposition of property. The Tax Court properly did not differentiate a condemnation from a voluntary sale in determining that the origin of the claim doctrine precluded the taxpayers from deducting their legal expenses. The court did note that the tax treatment would be different if the legal fees arose out of the "taxpayers' business."[154] The court then provided an example of a land-related lawsuit: "a neighbor's suit to enjoin as a nuisance taxpayer's aerial spraying of his orchard."[155]

The rationale of the Ninth Circuit in *Madden* was followed by other courts, including the Tax Court in *Soelling v. Commissioner*.[156] In that case, the county of Stanislaus, California filed a complaint in eminent domain condemning a portion of taxpayer's property for use as a roadway.[157] The taxpayer, concerned that the condemnation would cause the remainder of his property to be landlocked, contested this action and incurred legal and appraisal fees.[158] After the property was condemned, he engaged an attorney and a civil engineer with respect to an application for zoning reclassification as well as to obtain clarification with respect to the status of the property's access.[159] He deducted all these professional fees.[160] The Tax Court denied the deductions, noting first that while the property was not used in a trade or business, barring a deduction under I.R.C. section 162, it was held for investment and income-producing potential—clearing the first hurdle for a deduction under I.R.C. section 212.[161] The court found, however, that the origin of the claim doctrine barred the deduction.[162] The Tax Court indicated that the expenditures were incurred, not as part of operating a business, but instead "arose in connection with a condemnation suit and an attempt to rezone certain property . . .

152. *Id.* at 1151.
153. *Id.*
154. *Id.*
155. *Id.* at n.6.
156. Soelling v. Comm'r, 70 T.C. 1052 (1978).
157. *Id.* at 1053.
158. *Id.* at 1053-54.
159. *Id.* at 1054.
160. *Id.*
161. *Id.* at 1055.
162. *Id.* at 1056.

[the costs were incurred] in an attempt to increase the value of the property."[163] The court went on to opine that expenditures that serve to increase the value of property have "an inherent relationship [with] . . . the ultimate sale of land."[164] Thus, costs incurred relating to disputing the condemnation as well as pursuing the zoning reclassification was required to be capitalized "because the origin and character of the activity from which these expenditures derived were capital in nature."[165] It should be noted that Treas. Reg. §1.263(a)-2(e)(2) Example 1 concludes that amounts paid an attorney to contest condemnation of a portion of taxpayer's real property to be used as a roadway must be capitalized because they were incurred to defend taxpayer's title to the property.

*Baylin* was, as noted above, cited in *Dye* with respect to its approach to the allocation of legal expenses, also involved a condemnation proceeding.[166] In *Baylin*, the petitioner (the tax matters partner) acknowledged that "the portion of the partnership's legal expenses attributable to its attorney's efforts to increase the principal portion of its condemnation award . . . [was] a nondeductible capital expense. . . ."[167] The taxpayer in *Baylin* sought to deduct the portion of its legal expenses related to the interest it received from the condemnation award.[168] The Federal Circuit, however, concluded that since the attorney spent a *de minimis* amount of time addressing the interest portion of the award, the legal fees should all be treated as a capital expenditure added to the basis of the condemned property, reducing the capital gain from the disposition.[169]

One issue in *Neely v. Commissioner*[170] concerned the deductibility of legal expenses incurred in a suit to compel disclosure of financial information brought against a closely held corporation by a minority shareholder. The taxpayer contended that the financial information was necessary to determine the shares' value and whether the company was being properly managed.[171] The taxpayer argued that accordingly the legal expenses should be deductible under I.R.C. section 212.[172] The

163. *Id.* at 1055.
164. *Id.*
165. *Id.* at 1056.
166. *Baylin*, 43 F.3d 1451; *Dye*, 121 F.3d at 1410.
167. *Baylin*, 43 F.3d at 1453.
168. *Id.*
169. *Id.* at 1454.
170. Neely v. Comm'r, 85 T.C. 934 (1985).
171. *Id.* at 955.
172. *Id.* at 954.

Tax Court rejected taxpayer's assertions stressing the importance of looking beyond "the narrow purpose of the suit."[173] The court said that while compelling disclosure of financial information was the immediate objective of the lawsuit, the evidence indicated "that the origin of the claim was Mrs. Neely's desire to determine the value of her stock for the purpose of selling it."[174] That is, the future sale of the stock was the true underlying event that was proximately related to the litigation expense.[175]

*Neely* is an example of a situation where a taxpayer's complaint did not explicitly evidence the origin of the claim.[176] That is, the immediate primary purpose of the litigation, i.e., to obtain financial information, was not determined to be the origin of the claim. While at times the origin of the claim and the primary purpose of the litigation may overlap, they are not concurrent. This distinction is an important one and it reappears in *Ash Grove Cement* among other cases.[177]

The reasoning of the Sixth Circuit in *Brown v. United States*[178] was somewhat comparable to that of the Tax Court in *Neely*. The taxpayer and her sister had received an offer from her brother to purchase their stock in a closely held corporation.[179] In connection with her attorney's investigation she learned that certain transactions conducted by her brother involving transfers of valuable assets were a fraud upon the taxpayer's rights as a shareholder.[180] Furthermore, her brother refused the taxpayer's request to disclose financial information.[181] Because of both what the taxpayer's lawyer uncovered and her brother's refusal to provide relevant financial information, taxpayer brought a derivative action which was eventually settled.[182] As part of the settlement, taxpayer and her sister exchanged their shares for debentures.[183] The taxpayer reported the gain from the transfer of stock but deducted about $55,000 in legal fees against ordinary income under I.R.C. section 212.[184] While the Sixth Circuit

173. *Id.* at 955.
174. *Id.*
175. *Id.*
176. *See id.*
177. *Ash Grove Cement Co.*, No. 11–2546–CM, 2013 WL 451641 (D. Kan. Feb. 3, 2013), *aff'd*, 562 F. App'x 697 (10th Cir. Apr. 22, 2014).
178. Brown v. United States, 526 F.2d 135 (6th Cir. 1975).
179. *Id.* at 136.
180. *Id.*
181. *Id.*
182. *Id.*
183. *Id.*
184. *Id.*

described the case as "borderline," observing that "[l]ooked at from one point of view the expenses which the taxpayer seeks to deduct were incurred in legal proceedings which had their origin in the offer of . . . Dolese [her brother] to purchase taxpayer's stock. . .On the other hand, it can be argued that the offer merely triggered an inquiry into [her brother's fraudulent] transactions and that the true origin of the claim litigated was the necessity to expose the facts concerning those transactions in order to conserve the value of taxpayer's stock." [185]

The Sixth Circuit, in reversing the Tax Court, held the expenses should reduce her capital gain from the exchange of the shares since "the origin of that litigation lay in taxpayer's efforts to determine the value of her stock in Dolese Brothers in order to respond to her brother's offer to purchase the stock."[186] The determination of what the origin of the claim was, as the court readily admitted, not crystal clear, but the court's decision was proper because the purpose of the origin-of-the-claim doctrine is to ensure proper matching of the tax treatment of the item in question and underlying event. The legal expenses here best matched the gain from the share transfer.

*DuGrenier v. Commissioner* dealt with the settlement of a lawsuit in which the estate of a former shareholder asserted that the taxpayer fraudulently concealed certain facts relevant to the value of its stock.[187] As a result, the estate received less than fair market value in the shares redemption. The taxpayer argued that the settlement payment was deductible under I.R.C. section 162.[188] The Tax Court held the settlement payment was a capital expenditure and therefore, not deductible.[189] The court indicated that the origin-of-the-claim doctrine mandated this conclusion.[190] The court opined that "[s]uch doctrine is clearly applicable to the present factual situation and it necessitates the characterization of the payment presently in issue as a capital expenditure."[191] The court observed that the conclusion was also required by *Arrowsmith*, stating that "since the settlement payment was nothing more than an additional portion of the purchase price paid several years later, the *Arrowsmith* decision permits us to look back to the sale year and characterize such payment as a

185. *Id.* at 138.
186. *Id.* at 139.
187. DuGrenier v. Comm'r., 58 T.C. 931, 935 (1972).
188. *Id.* at 931-32.
189. *Id.* at 939.
190. *Id.* at 938.
191. *Id.*

capital expenditure."[192]

A case addressing application of the origin of the claim doctrine to a buy-sell agreement is *Ransburg v. United States*.[193] In *Ransburg*, the taxpayer was a 20% shareholder, director, officer, and highly-paid employee of a family-owned corporation.[194] Since the corporation's formation, the taxpayer and the other family shareholders had a buy/sell agreement providing that in the event of a shareholder's death or attempted share transfer, the corporation would have the first option to purchase the stock.[195] Furthermore, if the corporation didn't exercise its option to purchase the shares, the other shareholders had the right to buy the stock.[196]

After differences arose between the parties, the other family shareholders considered selling their interest in the company to a third-party, which the taxpayer opposed.[197] To circumvent the buy/sell agreement, the other shareholders indicated they would sell the corporation's assets.[198] In response, the taxpayer brought action in state court against the company and other shareholders, seeking both an injunction against the asset sale and a determination of rights under the buy-sell agreement.[199] The case was eventually settled, with the taxpayer selling his shares to the other family members after not exercising his option to purchase their shares.[200] The taxpayer incurred about $89,000 in legal expenses, which he argued were either deductible under I.R.C. section 162 or 212.[201] Alternatively, he asserted that the expenses should be deemed a capital expenditure, increasing the basis which became recoverable on the shares' disposition.[202]

The taxpayer's position in *Ransburg* for an ordinary deduction was that the legal expense was incurred to protect his employment status. The Tenth Circuit rejected this argument. The court first noted that the taxpayer's continuing employment with the company was "tenuous" under any circumstances.[203]

192. *Id*. at 939.
193. *See* Ransburg v. United States, 440 F.2d 1140 (10th Cir. 1971).
194. *Id*. at 1141.
195. *Id*. at 1142.
196. *Id*.
197. *Id*.
198. *Id*.
199. *Id*.
200. *Id*.
201. *Id*. at 1142-43.
202. *Id*. at 1144.
203. *Id*.

More importantly, the court commented that *Gilmore* taught that the origin of the claim, "not the potential consequences on the personal fortunes of the taxpayer" is critical in evaluating the tax treatment of the expense. [204] The Tenth Circuit found that the origin of the claim that formed the basis for the taxpayer's litigation in state court was the buy and sell agreement.[205] Therefore the taxpayer should not receive an ordinary deduction for the legal expenses.[206] This should not be disputable. The court, however, also affirmed the Tax Court's decision not to permit the legal expenses to be treated as a capital expenditure.[207] The Tenth Circuit rationalized that the state court "litigation and the expense attendant thereto did not involve either the acquisition or the preservation and defense of the taxpayer's 20% stock interest in the Corporation and accordingly could not be deemed a capital expenditure to be added to the basis of the taxpayer's stock."[208] This latter holding appears questionable. The litigation expenses were, as the court readily acknowledged, directly related to the buy/sell agreement and the sale of taxpayer's shares was the settlement of this litigation. As such, it would seem that these expenses should be matched with the capital gain from the shares disposition.

### B. *Property Acquisitions*

In *Missouri Pacific Corp. v. United States*,[209] the Claims Court addressed payments made by the taxpayer corporation in settlement of a class action lawsuit brought by its stockholders in connection with an exchange offer. The taxpayer had made a public offering to acquire target (which is referred to by the court as "Mississippi") shares in exchange for its own shares.[210] Class actions were filed *inter alia* against the taxpayer and its directors alleging that the prospectus and offering letter contained false, misleading and incomplete representations that overstated the value of the taxpayer's shares and undervalued target company shares in violation of federal securities laws.[211] The taxpayer asserted that the settlement payments, and an expense incurred for special counsel for the taxpayer's board of directors to review

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204. *Id.*
205. *Id.*
206. *Id.*
207. *Id.* at 1144.
208. *Id.*
209. 5 Cl. Ct. 296 (1984).
210. *Id.* at 306.
211. *Id.*

the agreement, were deductible under I.R.C. section 162(a) as ordinary and necessary business expenses.[212] The government contended that pursuant to *Gilmore*, *Woodward*, and *Hilton Hotels* that the origin of the claim was the purchase of target's stock and thus should be capitalized.[213] In holding for the government, the court cited *Arrowsmith* (a case the Claims Court noted was not cited by either party) under the theory that the settlement payments constituted an adjustment to the amounts paid for the Mississippi stock.[214] The court concluded that "[a]s the original exchange was a capital event giving rise to no taxable income to Mississippi, the adjustment thereof should likewise give rise to no deduction from income but only to an adjustment to the basis of its assets paid in for its stock."[215] The Claims Court did go on to note that "it is immaterial whether the tests applied by *Arrowsmith* or by the *Gilmore - Woodward - Hilton Hotels* line of decisions is applied."[216] The court stated that "[u]nder either test, the price adjustment made by the taxpayer here for the stock it acquired from . . . (target) stockholders must be deemed a capital expenditure rather than an ordinary business expense."[217] In this respect *Missouri Pacific* illustrates the close relationship between the *Arrowsmith* and origin of the claim doctrines. As discussed *below*, this is also exemplified by *DuGrenier*.

*Dana Corp. v. United States*[218] did not involve litigation expenses, but rather the tax treatment of a retainer fee for outside counsel. The taxpayer had an extensive history of paying annual retainer fees to the law firm, Wachtell, Lipton, Rosen and Katz ("Wachtell") to keep the firm from representing clients targeting the taxpayer in takeover situations and in part to represent the taxpayer in other legal matters with a contractual right to offset the retainer fee against the costs of these other services. In the year in dispute, 1984, the taxpayer acquired Warner Electric Brake and Clutch Company and offset a $265,000 charge by Wachtell in connection with the acquisition, by the $100,000 retainer fee. The taxpayer argued that under the origin of the claim test this $100,000 retainer fee incurred in 1984 was deductible "because the origin of the retainer fee was the retainer agreement and retainer fees generally are deductible

212. *Id.* at 308.
213. *Id.* at 308-09.
214. *Id.*
215. *Id.* at 309 (footnote omitted).
216. *Id.* at 310.
217. *Id.*
218. Dana Corp. v. United States, 174 F.3d 1344 (Fed. Cir. 1999).

as business expenses." [219] The Government conceded that "the retainer fee was a deductible, ordinary and necessary business expense in nearly all of the preceding and following years. . . ."[220] For the year in question, 1984, however the Government asserted the fee should be capitalized. The Federal Circuit held the $100,000 legal fee to be a nondeductible capital expenditure. The court stated "that Dana's history of retaining Wachtell through the annual payment of retainer fees cannot establish the 1984 retainer fee as a deductible, ordinary and necessary business expense. . . ."[221] The Federal Circuit agreed with "the IRS characterization of the 1984 retainer fee as, in effect, an advance deposit on future legal bills for a capital acquisition. . . ."[222] The court opined that "the origin of the claim [is] the actual use of the money to offset fees. . . ."[223] The Federal Circuit thus concluded that "the character of the claim underlying the legal expense incurred must be deemed the legal services cost for the capital acquisition, a non-deductible expense."[224] The court correctly focused on the payment's substance instead of its form.[225] *Dana Corp.* also illustrates that some courts have employed the doctrine in addressing tax treatment of expenses with no connection to litigation or settlement.[226]

In *Clark Oil and Refining Corp. v United States*,[227] the taxpayer operated an oil refinery. The taxpayer's neighbor, Richards, operated a paint business. The taxpayer's property surrounded that of Richards on three sides. The Seventh Circuit pointed out that "[t]he existence of a paint factory in the middle of an oil refinery was highly undesirable and very dangerous because of the refinery's activities."[228] Because of the fire hazards and threat of explosions caused by refinery emissions, the taxpayer tried to buy Richards' property, but the parties could not agree on a price. At one point, Richards sued Clark Oil seeking an injunction against alleged nuisances and trespasses

219. *Id.* at 1350.

220. *Id.*

221. *Id.*

222. *Id.* at 1351.

223. *Id.*

224. *Id.* at 1351-1352.

225. *See* Alexander F. Kennedy, *Dana Corporation v. United States: The Deductibility of Legal Retainer Fees Used to Acquire a Corporation*, 17 AKRON TAX J. 43 (2002).

226. This viewpoint of the scope of the origin of the claim doctrine is not however universal. *See*, *e.g.*, ABC Beverage Corp. v. United States, 756 F.3d 438 (6th Cir. 2014) discussed *infra*.

227. Clark Oil and Refining Corp. v. United States, 473 F.2d 1217 (7th Cir. 1973).

228. *Id.* at 1219.

committed by the taxpayer. After the judge informally indicated that he was inclined to grant the injunction, which would be very costly to the taxpayer, the parties agreed to settle with the taxpayer buying Richards' property for a price determined by final and binding arbitration. The arbitrators set the payment at $287,500 and the judge added $35,000 as reasonable attorneys' fees. The taxpayer treated only $25,000 as payment for the property and the balance it deducted under I.R.C. section 162 as payment for liquidating damages.

The taxpayer argued in *Clark Oil* "that the origin and character of the claims made by the Richards in connection with the State court litigation represented a meritorious lawsuit in tort for damages and injunctive relief. The settlement was reached . . . to avoid liability . . . that might arise as a result of Clark's operations."[229] The Seventh Circuit held the settlement payment was a nondeductible capital expenditure. The court stated that the taxpayer's assertion regarding the origin of the claim overlooked "the history of the dealing between these parties which occurred prior to the commencement of the nuisance litigation."[230] The Seventh Circuit observed that "[t]he litigation was commenced only after efforts at reaching an agreeable purchase price for the sale of the property had proved unsuccessful." [231] The Seventh Circuit indicated that while "the law suit represented a serious threat to the successful operation of Clark's business, these potential consequences to its business operations do not . . . control the determination of the tax treatment to be accorded the settlement payments." [232] According to the court, the form of the lawsuit, i.e., an action in tort for damages and an injunction should not be determinative of the origin of the claim. The Seventh Circuit believed that instead "[t]he acquisition of this property was at the heart of the dispute. . . This was the true 'origin and character' of the Richards' claim within the meaning of *Anchor Coupling*."[233] This is arguably different from a case like *Neely* where the litigation related to disclosure of financial information, but was driven by the future stock sale. The "heart of the dispute" here may well be considered not the purchase and sale of a facility but each party's operational requirements for its respective businesses, i.e., Clark Oil's freedom from an injunction and resolution of tort claims and

229. *Id.* at 1220.
230. *Id.*
231. *Id.*
232. *Id.*
233. *Id.*

Richards' safety concerns. While the court's reasoning was not implausible, the taxpayer's position was certainly not devoid of merit. There are indeed "borderline cases" in determining the origin of the claim and this fits within that category.

*Winter v. Commissioner*[234] dealt with legal and consulting fees incurred in maintaining a lawsuit against the seller of a hotel. About two years after the taxpayer purchased a hotel, he filed a complaint alleging breach of contract, intentional misrepresentation, and negligent misrepresentation. His complaint revolved around the representation of the hotel's income in its financial statements. The lawsuit was eventually settled with the taxpayers receiving over $271,400 in damages in the form of a release of a promissory note still owed on the purchase of the hotel. The taxpayers deducted the legal and consulting fees incurred in connection with the lawsuit as an ordinary and necessary business expense. The taxpayers asserted that the expense originated from misrepresentations made by the seller as to the income of the hotel and were not related to the purchase price. It also alluded to the fact that the lawsuit was not brought until two years after the sale and settlement was not reached for another year as further support for its position.[235] The Tax Court required the fees to be capitalized finding that the evidence indicates that the expenses were incurred to recover what the taxpayers believed they overpaid for the hotel.[236] The origin of the claim was the purchase of the hotel. The court indicated that the fact that legal costs were incurred after the purchase does not mean it cannot be connected to the purchase. The taxpayer's claim resulted from misrepresentations that arose in connection with his purchase of the hotel.[237] Unlike, *Clark Oil* and *Brown*, this is not one of the "borderline cases."[238]

While not involving legal or settlement costs, the Sixth Circuit recently decided a case concerning the possible application of the origin of the claim doctrine in connection with a purchase. In *ABC Beverage Corp.*,[239] the taxpayer made and distributed soft drinks and other non-alcoholic beverages for Dr. Pepper Snapple Group Inc. It leased a bottling plant in Missouri.

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234. Winter v. Comm'r, T.C.M. (RIA) 2002-173 (2002).

235. *Id.* at *7-8.

236. *Id.* at *12.

237. *Id.* at *12.

238. Interestingly, the court pointed out in a footnote that had taxpayer "sought and recovered damages solely on the basis of lost profits incurred in reliance on Mr. Meglin's (seller's) misrepresentations, then it appears that . . . the legal fees incurred in recovering the damages might not be directly related to the acquisition of a capital asset. *Id.* at n. 5.

239. *ABC Beverage Corp.*, 756 F.3d 438 (6th Cir. 2014).

After concluding that its rental payments under the lease were too high, it exercised its option to purchase the property.[240] It bought the property for considerably more than its appraised $2.75 million value (without a lease) in order to extinguish its unfavorable lease.[241] The taxpayer capitalized the $2.75 million and deducted "$6.25 million - the difference between the $2.75 million appraisal value of the property and the $9 million ABC calculated it would have to pay for the property with the lease - for buying out the lease."[242]

Among other arguments it made, the Government asserted that pursuant to *Woodward* (including the Court's rejection of the use of taxpayer's primary purpose), the taxpayer's entire cost for the property must be capitalized.[243] The Sixth Circuit affirmed the district court's decision in favor of the taxpayer.[244] With respect to the non-applicability of *Woodward*, the Sixth Circuit stated that "[f]or one, it is not clear that *Woodward*'s 'origin-of-the-claim' test applies outside the specific context of litigation expenses."[245] The court also noted that its authority for allowing the taxpayer/lessee to deduct immediately the portion of the price it paid to buy out the unexpired lease, *Cleveland Allerton Hotel, Inc. v. Commissioner*[246] "did not actually rely on the hotel's motive to determine whether the expense should be capitalized. Rather . . . the lease was a liability the hotel sought to extinguish, and the payment was more akin to liquidated damages for release from contract rather than a capital investment."[247] A somewhat compelling argument for the taxpayer in *ABC Beverage* is the government's concession that ABC could have deducted the lease termination payment if it had first terminated the lease and then bought the underlying property.[248]

It's difficult to reconcile the results in *ABC Beverage* with *Clark Oil*. In both cases the taxpayer is incurring a payment and receiving an asset that far exceeds its stand-alone worth. In the former case, the taxpayer is allowed a deduction for the difference, but in *Clark Oil*, it's required to capitalize the entire settlement payment, even though the underlying dispute may

240. *Id.* at 440.
241. *Id.*
242. *Id.*
243. *Id.* at 443.
244. *Id.* at 447.
245. *Id.* at 445.
246. Cleveland Allerton Hotel, Inc. v. Comm'r, 166 F.2d 805 (6th Cir. 1948).
247. *ABC Beverage Corp.*, 756 F.3d at 445.
248. *Id.* at 447.

properly be characterized as not the purchase price of a paint plant but the operation of the party's respective businesses.

*Hahn v. Commissioner*[249] dealt with legal fees incurred in a divorce proceeding. These fees related to the taxpayer's interest in two business properties, a restaurant/bar and a fishing services business. The taxpayer's position was that seventy-seven percent of her legal fees paid in connection with the divorce litigation were deductible under I.R.C. section 212 since they related to the establishment and obtaining ownership interest in the properties. The Service, citing *Gilmore*, asserted that the taxpayer's claim arose from her marital relationship and therefore none of the legal expenses should be deductible.[250] The Tax Court, while rejecting the Service's contention that *Gilmore* provides a complete bar to deductibility,[251] nevertheless held that legal fees relating to the obtaining of ownership in the restaurant/bar were nondeductible capital expenditures.[252] In contrast, with respect to the fishing services business, where the taxpayer owned fifty percent prior to the divorce and had sought an accounting for her interest, the Tax Court permitted the deduction. The Tax Court reasoned that what she was seeking and what she ultimately received with respect to the restaurant/bar was in the nature of income rather than ownership interest.[253]

### C. *Observations*

In terms of drawing lessons from the foregoing, a few points are worth emphasizing. It is essential to try to determine the "transaction underlying the litigation,"[254] although this may not always be readily apparent. While in certain instances the origin of the claim and the immediate primary purpose of the litigation may overlap, they are not concurrent. Courts may ignore labeling of the expense if the substance does not comport with its form. Capitalization can, with some exceptions, be required if the

249. Hahn v. Comm'r, T.C.M. (P-H) 1976-113 (1976).

250. *Id.*

251. *Id.* The Tax Court indicated in this regard that the Service's position was undercut by its own regulations, i.e., Treas. Reg. § 1.262-1(b)(7) providing that legal fees attributable to the production of alimony income are deductible. *Id.*

252. *Id.*

253. *Id.* The Tax Court also required the taxpayer to capitalize legal fees incurred in connection with a lawsuit brought against her and her ex-husband by a third-party to defend against a claim that the third-party owned twenty percent of the fishing services business. The court stated in this regard that expenses incurred in protecting title to property were non-deductible capital expenditures. *Id.*

254. *Von Hafften*, 76 T.C. at 834.

litigation or settlement payment is proximately related to a failed sale as well as a completed transaction. There is no distinction between voluntary and involuntary dispositions in requiring capitalization if the litigation or settlement payment is proximately related to the transfer. Treasury regulations issued under section 263 in some circumstances have an effect on the result reached under previously decided case law. The origin of claim and *Arrowsmith* doctrines are closely connected and can overlap.

## VI. STOCK REDEMPTIONS, SECTION 162(K) AND THE ORIGIN OF THE CLAIM DOCTRINE

While the article's primary focus is on litigation and settlement payments with a connection to property transactions, it is worth considering some of the background as to the application of the origin of the claim doctrine to stock redemptions because of judicial insights into the principle. As discussed below, one may be able to analogize other expenses with some connection to stock redemptions to litigation and settlement expenses related to other property transactions. With respect to stock repurchase expenses the Code now provides specific rules, but there remains some controversy with stock redemptions occurring in connection with payments to departing participants in an employee stock purchase plan ("ESOP").

### A. *Section 162(k)*

I.R.C. section 162(k) was enacted as part of the Tax Reform Act of 1986[255] and it generally prohibits a corporation from deducting "any amount paid or incurred by a corporation in connection with the reacquisition of its stock or of the stock of any related person. . ."[256] Congress enacted I.R.C. section 162(k) because it "understood that some corporate taxpayers were taking the position that expenditures incurred to repurchase stock from stockholders to prevent a hostile takeover of the corporation by such shareholders—so-called 'greenmail' payments—were deductible business expenses. Congress wished to provide expressly that all expenditures by a corporation incurred in purchasing its own stock, whether representing direct consideration for the stock, a premium payment above the apparent stock value, or costs incident to the purchase, and whether incurred in a hostile takeover situation or otherwise, are

255. P.L. 99-514, section 613.

256. I.R.C. § 162(k)(1).

nonamortizable capital expenditures." [257]The phrase "in connection with" in I.R.C. section 162 (k)(1) has been recognized to have a broad meaning.[258] Its reach however does not extend to situations simply because the expense is paid or incurred at a close time to the repurchase.[259]

There are two primary statutory exceptions to the general rule denying deductibility in I.R.C. section 162(k)(2)(A)(i). First, the section excepts the "deduction allowable under section 163 (related to interest)." Second, I.R.C. section 162(k)(2)(A)(ii), enacted as a retroactive clarification, provides that the "deduction for amounts which are properly allocable to indebtedness and amortized over the term of such indebtedness" are outside the scope of I.R.C. section 162(k)'s deductibility disallowance.[260] Prior to a 1996 amendment adding I.R.C. section 162(k)(2)(A)(ii)[261], there was a split in the courts as to whether I.R.C. section 162(k) disallowed the costs a taxpayer incurred in obtaining a loan to reacquire its stock.

Prior to the enactment of I.R.C. section 162(k)(2)(A)(ii), the Service had had taken the position that the costs of a taxpayer incurred to finance the purchase of its outstanding stock were "in connection with" the corporation's "reacquisition"[262] of its stock and therefore non-deductible under I.R.C. section 162(k). In *Kroy (Europe) Limited v. United States,*[263] the taxpayer decided to go private through a leveraged buyout. In financing the repurchase of its stock it incurred certain fees. The Service disallowed the taxpayer's deduction of these fees. The government's principal argument was "that the plain meaning of the phrase 'in connection with the redemption of its stock' includes the Loan Fees because Kroy incurred the Loan Fees in order to borrow the funds to finance its stock redemption."[264] The Ninth Circuit

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257. Staff of Joint Comm. on Tax'n, 99th Cong., 2d Sess., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 277-78 (Comm. Print 1987).

258. *See, e.g.*, Fort Howard v. Comm'r, 103 T.C. 345, 352 (1994) and the cases cited therein.

259. *See, e.g.*, Chief Industries, Inc. v. Comm'r, T.C.M. (RIA) 2004-45 (2004).

260. Also excluded from the general rule of I.R.C. § 162(k) are: 1) the "deduction for dividends paid (within the meaning of section 561)", and 2) "[a]ny amount paid or incurred in connection with the redemption of any stock in a regulated investment company which issues only stock which is redeemable upon the demand of the shareholder." I.R.C. § 162(k)(2)(A)(iii); I.R.C. § 162(k)(2)(B).

261. P.L.104-188, section 1704(p)(2).

262. I.R.C. § 162(k)(1) initially used the term "redemption". P.L. 104-188, section 1704(p)(3) substituted "reacquisition" for "redemption" in the heading of I.R.C. § 162(k) and section 1704(p)(1) substituted "the reacquisition of its stock or of stock of any related person. . ." for "the redemption of its stock."

263. Kroy (Europe) Ltd. v. United States, 27 F.3d 367 (9th Cir. 1994).

264. *Id.* at 369 (footnote omitted).

agreed with the taxpayer "that for federal tax purposes, two separate and independent transactions are involved, to wit: a stock redemption transaction (to which I.R.C. section 162(k) applies) and a borrowing transaction (to which I.R.C. section 162(k) does *not* apply)."[265] In reversing the district court, the Ninth Circuit opined that "IRC sec. 162(k) and the 'origin of the claim' test are consistent if the expenses which have their 'origin' in a stock redemption transaction are nondeductible, and other expenses having origin in a separate, although related transaction remain deductible as ordinary and necessary business expenses. . . ."[266] Thus, the Ninth Circuit found multiple origins to which to allocate the expenses with loan fees kept in a separate silo from other costs that originated from the stock redemption transaction.

The Tax Court in *Fort Howard Corp. v. Commissioner*, [267] disagreed with the Ninth Circuit decision in *Kroy(Europe)*.[268] In *Fort Howard,* the taxpayer incurred fees in obtaining loans to finance a leveraged buyout.[269] In holding for the Service that I.R.C. section 162(k) disallowed the deduction for these fees, the Tax Court found these expenses to be non-deductible because they were incurred "in connection with" the redemption.[270] Furthermore the Tax Court asserted that its "interpretation is not a reversion to the 'primary purpose' test or a rejection of the origin test, but rather a common sense application of the specific test provided in the statute." [271]

With respect to the *Fort Howard* taxpayer's and *Kroy's* interpretation of the meaning of origin of the claim vis-à-vis the financing fees, the Tax Court observed that:

> [t]he financing costs here correspond to the legal fees in the cited cases. The debt in this case is the analog to the lawsuits. Nevertheless, petitioner would have us end the analysis at this point. Petitioner argues that the origin of the financing costs is in its loan transaction and that we need look no further. This cannot be the end of the analysis. If it were, the Supreme Court in the cited

265. *Id.*

266. *Id.*

267. Fort Howard Corp. v. Comm'r, 103 T.C. 345 (1994).

268. *Id.* at 353. After I.R.C § 162(k)(2)(A)(ii) was enacted with its retroactive application the Tax Court amended its opinion to allow the amortization deductions. Fort Howard Corp. v. Comm'r, 107 T.C. 187, 188 (1996).

269. *Fort Howard Corp.*, 103 T.C. at 349.

270. *Id.*

271. *Id.* at 361.

> cases would have ended its analysis by concluding that the legal fees originated in lawsuits. This would have told the Court nothing. Instead, the Court was forced to look further, to the origin and nature of the lawsuits. . . . If we were to apply the origin test here, we would also be forced to look further to the origin of the financing transaction. When we do so, we find that the loan transaction had its origin in the redemption plan. The financing originated in the planning stages of the redemption and nowhere else. [272]

As discussed below, this is somewhat akin to the courts in *Ash Grove Cement* looking beyond the indemnification obligation to the board of directors to the reorganization transaction which triggered the litigation in the first place.[273] The Tax Court then however rejected the application of the origin of the claim doctrine to the case at bar concluding "[a]t this point, however, the origin of the claim test breaks down. For the redemption was also a consequence of the financing. Thus, the origin test does not help to resolve this case."[274] The court went on to provide that the origin of the claim test "was designed to make substantive distinctions between business and personal expenditures, or between current and capital expenditures. There are no such distinctions to be made here."[275] Whatever the merits of the respective arguments made by the Ninth Circuit in *Kroy(Europe)* and the Tax Court in *Fort Howard*, Congress has resolved the matter by virtue of I.R.C. section 162(k)(2)(A)(ii) by treating financing fees incurred in connection with a stock repurchase outside the scope I.R.C. section 162(k)'s denial of deductibility.

### B. *The ESOP Controversy*

Another controversy involving the application of the origin of the claim doctrine and stock redemptions occurred in connection with payments to departing participants in an ESOP. Under I.R.C. section 404(k), a corporation can generally deduct a dividend payment to its ESOP meeting the statutory requirements for an "applicable dividend."[276] One requirement for an "applicable dividend" is that "in accordance with the plan

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272. *Id.* at 360.

273. *Ash Grove Cement Co.*, No. 11–2546–CM, 2013 WL 451641 (D. Kan. Feb. 3, 2013), *aff'd*, 562 F. App'x 697 (10th Cir. Apr. 22, 2014).

274. *Fort Howard Corp.*, 103 T.C. at 360.

275. *Id.*

276. I.R.C. § 404(k)(2)(2014).

provisions [the dividend]. . .is paid to the plan and is distributed in cash to participants in the plan or their beneficiaries not later than 90 days after the close of the plan year in which paid."[277] Besides meeting the other requirements in I.R.C. section 404(k), I.R.C. section 404(k)(5)(A) grants the Treasury Department and IRS the authority to "disallow the deduction . . . for any dividend if . . . such dividend constitutes, in substance, an avoidance or evasion of taxation."[278] A possible impediment to the I.R.C. section 404(k) deduction is the application of I.R.C. section 162(k), i.e., whether I.R.C. section 162(k) bars the deduction on the grounds that the payments were made "in connection with" the repurchase of the stock.[279]

The Ninth Circuit in *Boise Cascade Corp.* had to decide whether payments made by the taxpayer to redeem stock held by its ESOP were deductible as dividends paid under I.R.C. section 404(k).[280] Prior to the decision, the Service had attempted to buttress its position by issuing Revenue Ruling 2001-6[281] to the effect that I.R.C. section 404(k) did not apply to payments in redemption of stock held by an ESOP including *inter alia* a reference to I.R.C. section 404(k)(5)(A). Since then, the Treasury and Service have issued further guidance disallowing the deduction in these circumstances, including final regulations in 2006.[282]

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277. I.R.C. § 404(k)(2)(A)(ii)(2014).

278. I.R.C. § 404(k)(5)(A)(2014). This was added by P.L. No. 107-16, section 662 (effective for tax years after 12/31/01).

279. Another issue that taxpayers face in obtaining the deduction, albeit not germane to the "origin of the claim" doctrine is whether the payment constitutes a dividend. This in turn depends upon whether the redemption falls under I.R.C. §. 302 and is thus denied dividend treatment. In order that the redemption not fall within the purview of I.R.C. § 302, it is critical that the ESOP (and not the plan participants) be treated as the owner of the stock. If the ESOP is considered to be the owner, then dividend treatment will generally be accorded unless there was a "meaningful reduction of the shareholder's proportionate interest in the corporation." *See* United States v. Davis, 397 U.S. 301, 326 (1970) as to the test in I.R.C. § 302(b)(1) as to whether a redemption is or is not "essentially equivalent to a dividend." For a very good, although somewhat dated article, covering this matter and I.R.C. § 162(k) in general, *see* Shawn Novak & Mark Persellin, *The Disallowance Provision of Section 162(k)*, 35 CORP. TAX'N 3 (2008). Other very good and more recent articles that address this subject include: David Eckhardt, *ESOP Dividends: Arguments for Section 404(k) Dividend Deductions*, 65 TAX LAW. 217 (2012) and Steven J. Arsenault, *AESOP and the ESOP: A New Fable About Dividends and Redemptions*, 31 VA. TAX REV. 545 (2012).

280. Boise Cascade Corp. v. United States, 329 F.3d 751, 752 (9th Cir. 2003).

281. Rev. Rul. 2001-6, 2001-1 C.B. 491.

282. T.D. 9282, 2006-2 C.B. 512 (2006). The regulations include Treas. Reg. § 1.404(k)-3 which provides "that payments (from a corporation) to reacquire stock held by an ESOP . . . are not deductible . . . because . . . those payments do not constitute applicable dividends . . . and [t]he treatment of those payments as applicable dividends would constitute, in substance, an avoidance or evasion of taxation. . . ." The regulations

In *Boise Cascade*, the Ninth Circuit, in holding that the taxpayer was entitled to the deduction under I.R.C. section 404(k)[283], indicated that it "applied 'the origin of the claim test'. . . . Here, we are confronted with two segregable transactions: the stock redemptions by Boise Cascade and subsequent distributions to the Plan Participants by the Trustee. The two are not ineluctably linked. In fact, the transactions were entirely separate."[284] The court declared that "although the Plan provided that redemption of the convertible preferred stock was required upon employment termination, distribution of the amount redeemed did not automatically occur. . . . Second, the redemption of the convertible preferred stock was not a prerequisite to the Trustee's duty to make distributions under the terms of the Plan . . . the terms of the Plan make it plain that the triggering event for the Trustee's duty to distribute payments is the election of the Participant, not the redemption of the stock."[285]

Some other courts, without dwelling on the origin of the claim doctrine, have found that the court in *Boise Cascade* misconstrued the law in this area.[286] For example, in *General*

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also include Treas. Reg. Sec. 1.162(k)-1(a), which provides that "no deduction otherwise allowable is allowed . . . for any amount paid or incurred by a corporation in connection with the reacquisition of its stock. . . ." Prior to the final regulations and after the issuance of Rev. Rul. 2001-6, the Service issued Notice 2002-2, Q&A 11, 2002-1 C.B. 285 and the Office of Chief Counsel issued Notice 2004038 also addressing this subject.

283. In reaching its conclusion, the court first held the distribution to be a dividend by virtue of the fact that the ESOP (and not the plan participants) owned the stock when it was redeemed and the parties had stipulated that under those circumstances the redemption would not be treated as resulting in a "meaningful reduction" of the ESOP's interest in the taxpayer. As a result, I.R.C. § 301 (and no I.R.C. § 302) was determined to be applicable to the redemption. The court also determined that there was sufficient current or accumulated earnings and profits to meet the requirements for a dividend under I.R.C. § 316(a).

284. *Boise Cascade*, 329 F.3d at 757.

285. *Id*. at 758.

286. Some commentators, however, have found the *Boise Cascade* reasoning persuasive. *See*, *e.g.*, Eckhardt, *supra* note 279. For example, Arsenault commented that he "believe(s) that the Ninth Circuit's [*Boise Cascade*] view is more persuasive. The two transactions are not inextricably linked together. Indeed, a careful reading of the facts in the General Mills shows that they are in fact separate transactions. When a participant left employment, the participant could elect a cash or a stock distribution; thus the participant distribution portion of the transaction could be made in stock without the redemptive dividend ever taking place. The benefit payment to a plan participant was due under the terms of the ESOP and did not depend on the redemptive dividend taking place. Likewise, even if a participant elected a cash distribution, it is not necessarily true that a redemptive dividend would be needed. The facts indicate that 'the trust could request that [General Mills] purchase company stock from the trust,' but it was not required; if the trust had sufficient cash on hand, it could cash out the participant without resorting to the redemptive dividend. The redemption was an administrative tool for funding the payment to the plan participant, but it was not a required part of the

*Mills, Inc. v. United States*,[287]the Eighth Circuit, in holding that I.R.C. section 162(k) bars the deduction, defined "an 'applicable dividend' as two connected steps, the redemptive dividend (step 1) *and* the cash distribution redemptive dividend (step 2). Neither step alone is sufficient, and thus neither is an 'applicable dividend' . . . § 404(k)(2)(A)(ii) creates a nexus between the cash distribution redemptive dividend and the stock redemption."[288]

In *Conopco, Inc. v. United States,*[289] the Third Circuit followed the approach taken by the Eighth Circuit in *General Mills* and denied the deduction without discussing the origin of the claim doctrine. The Eighth Circuit similarly denied the taxpayer a deduction for a second time in *Nestle Purina Petcare Co. v. Commissioner*,[290] again without reference to the origin of the claim doctrine.[291]

The Sixth Circuit in *Chrysler Corp. v. Commissioner*,[292] however employed the origin of the claim doctrine to analyze whether the costs taxpayer incurred to redeem its common stock held by a terminated ESOP were deductible. The case dealt with a tax year prior to I.R.C. section 162(k) becoming effective. The court noted that "[t]he Tax Court quoted the origin of the claim test adopted by *Gilmore* . . . and the parties agree that it applies to the issue before us."[293] The taxpayer contended that as to the first step in the *Keller Street* court methodology i.e., determining the origin of the claim, its claim was "the demand by the union in 1985 that the ESOP be terminated in consideration of wage and benefit concessions and that Chrysler do so by repurchasing its members' shares. . . As the company sees it, the origin of the

transaction. Indeed, an applicable dividend can be paid to an ESOP and deducted without any redemption of stock because section 404(k)(1) requires only that a dividend be distributed to the ESOP and paid out to participants. The redemptive dividend is simply one method of funding such a payment." 31 VA. TAX REV. at 565-566 (footnotes omitted).

287. General Mills, Inc. v. United States, 554 F.3d 727 (8th Cir. 2009).

288. *Id*. at 730 (italics are from the opinion).

289. Conopco, Inc. v. United States, 572 F.3d 162, 166 (3rd Cir. 2009). In the interest of full disclosure, during the time of the litigation of this case, the author was Vice President-Tax & General Tax Counsel for Unilever United States, Inc. which was the parent company of Conopco, Inc.

290. Nestle Purina Petcare Co. v. Comm'r, 594 F.3d 968 (8th Cir. 2010*), cert. denied*, 131 S. Ct. 86 (2010).

291. There was however discussion of the origin of the claim doctrine in the Tax Court's decision of this case, *Ralston Purina Co. v. Commissioner*, 131 T.C. 29 (2008) which was affirmed by the Eighth Circuit. The Tax Court cited *Fort Howard Corp. & Subs. v. Commissioner*, 103 T.C. 345 (1994) for rejecting the application of the doctrine to stock repurchases but then said its holding rested on the fact " that Congress expressly intended section 162(k) to prohibit deduction of the funds used to effect a redemption." Ralston Purina Co. v. Comm'r, 131 T.C. 29, 37 (2008).

292. Chrysler Corp. v. Comm'r, 436 F.3d 644 (6th Cir. 2006).

293. *Id*. at 660.

claim in this case cannot be divorced from the clearly compensatory contribution of shares by Chrysler as required by the LGA [the Chrysler Corporation Loan Guarantee Act of 1979[294]] to offset wage concessions made by its employees."[295]

The Sixth Circuit in *Chrysler* affirmed the Tax Court and denied the deduction. In doing so it rejected the taxpayer's argument as to what was the origin of the claim. The Sixth Circuit agreed with the Service that:

> the flaw in Chrysler's argument is its attempt to portray its contribution of stock to the ESOP and its later redemption of the stock as one claim. While Chrysler's stock contributions to the ESOP were compensatory in nature, its agreement with the UAW to terminate the ESOP and to redeem the shares of those participating employees who chose to take cash in lieu of shares represented a distinct, non-compensatory transaction that was not compelled by either the LGA or the terms of the ESOP. Thus, the costs incurred were 'directly related' to the stock redemption, but only tangentially related to the LGA and to the establishment and funding of the ESOP. [296]

### C. *Observation*

The foregoing decisions don't address the origin of the claim doctrine's application to litigation and settlement related expenses with a connection to a property transaction. Furthermore, some of the cases have been superseded by statutory revisions. Nevertheless, there is judicial reasoning in several of the cases considered in this section that can be useful to enhance one's understanding of the utilization of the principle.

## VII. *ASH GROVE CEMENT V. UNITED STATES*

The application of *Woodward* and *Hilton* to a stock reorganization was the subject of fairly recent litigation first by the United States District Court for the District of Kansas in *Ash Grove Cement Company. v. United States* and then in its appeal

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294. An Act to authorize loan guarantees to the CHRYSLER Corporation, Pub. L. No. 96-185, 93 Stat. 1324 (1980).
295. *Chrysler Corp.*, 436 F.3d at 660.
296. *Id.* at 661.

in an unpublished opinion[297] by the Tenth Circuit. Ash Grove Cement is a Kansas corporation that specialized in in the manufacture and sale of cement.[298] Before a corporate reorganization that occurred in 2000, Vinton Corporation owned about 67 percent of Ash Grove Cement.[299] Vinton also then owned a ready-mix concrete company, Lyman-Richey Corporation.[300] Vinton was owned by or for the benefit of members of the Sunderland family.[301] Certain Sunderland family members also owned about 6 percent of Ash Grove Cement directly.[302] Ash Grove Cement's other shareholders were an employee stock ownership plan and 150 other shareholders unrelated to the Sunderland family.[303]

In 2000, the Sunderland family, Vinton and Ash Grove Cement decided to reorganize Ash Grove Cement's structure.[304] Under the corporate reorganization plan, Ash Grove Cement was to acquire Vinton and Lyman-Richey in consideration for additional shares of Ash Grove Cement being given to the Sunderland family.[305] At that point in time, Ash Grove Cement was governed by a board of directors, consisting of four directors who were members of the Sunderland family, three directors who were full-time employees of Ash Grove Cement, and two directors who were neither Sunderland family members nor employees.[306] Because of the board composition, a committee consisting of the two independent directors was appointed to negotiate the deal between the parties.[307] The final corporate reorganization negotiated by the parties resulted in tax-free reorganizations which were completed by the end of 2000.[308]

In 2002, one of the minority shareholders of Ash Grove Cement, Daniel Raider, filed a class action complaint against all

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297. For a good recent article covering *inter alia* the precedential value of unpublished opinions, see Andrew R. Roberson & Randolph K. Herndon,Jr., *The Precedential and Persuasive Value of Unpublished Dispositions,* 66 THE TAX EXEC. 83 (2014). Roberson & Herndon point out that pursuant to Federal Rule of Appellate Procedure 32.1 that "[a] court may not prohibit or restrict the citation of federal judicial opinions . . . designated as 'unpublished' . . . issued on or after January 1, 2007." *Id.* at 83.

298. , 562 F. App'x at 697.

299. *Id.*

300. *Id.*

301. *Id.* at 698.

302. *Id.*

303. *Id.*

304. *Id.*

305. *Id.*

306. *Id.*

307. *Id.*

308. *Id.*

the Ash Grove Cement's directors and Ash Grove Cement in the Delaware Court of Chancery alleging that the reorganization constituted self-dealing by the Sunderland family and unfairly diluted the minority shareholders' interest.[309] Raider sought to rescind the transaction and recover compensatory damages on behalf of class members.[310] The parties settled the litigation in 2005.[311] Under this agreement, Ash Grove Cement paid $15 million into a trust to be divided among the minority shareholders, but neither Ash Grove Cement nor its officers or directors admitted any liability.[312]

Ash Grove Cement claimed in its 2005 consolidated federal income tax return the $15 million payment as well as an additional legal fees and expenses of a little over $43,000 paid by it on behalf of its directors as an ordinary and necessary business expense under I.R.C. section 162.[313] The Service disallowed the expense claiming it should be capitalized pursuant to I.R.C. section 263. Ash Grove Cement paid the tax deficiency and brought an action for a claim for refund in district court.[314]

Ash Grove Cement argued that the expenses were incurred solely in connection with its honoring its indemnity obligations to the directors, that it was the board of directors that had allegedly breached their fiduciary duty, and that there was no allegations in the Raider lawsuit of wrongdoing by Ash Grove Cement.[315] The taxpayer cited *Larchfield Corp. v. United States*,[316] in support of its position that accordingly the indemnification expenses were deductible. In *Larchfield*, the Second Circuit permitted a corporation to deduct certain expenses incurred in a derivative lawsuit.[317] In that case, the shareholder alleged that excessive bonuses were paid and stock was issued for a nominal amount to a controlling shareholder who was also a director.[318] The corporation's bylaws required that directors be indemnified for expenses incurred in defending an action against them except if the director acted negligently or engaged in misconduct.[319] The Second Circuit in *Larchfield* permitted the company to deduct

309. *Id.*
310. *Id.*
311. *Id.*
312. *Id.*
313. *Id.*
314. *Id.*
315. *Id.* at 700.
316. Larchfield Corp. v. United States, 373 F.2d 159 (2d Cir. 1966).
317. *Id.*
318. *Id.* at 160.
319. *Id.* at 162.

expenses in connection with its indemnity obligation.[320]

The district court in *Ash Grove Cement* observed that *Larchfield* pre-dates both *Woodward* and *Hilton Hotels* (but not *Gilmore*[321]), was not controlling on the court since it's decision is appealable to a different circuit court, and perhaps most importantly "applies the rejected 'primary purpose' test."[322] The district court, in *Ash Grove Cement*, in granting the government's motion for summary judgment, also observed that if the taxpayer's position were accepted, "then companies could always deduct litigation expenses as ordinary and necessary business expenses any time a director acting in good faith is sued in connection with a capital transaction so long as the company has an indemnity obligation."[323]

In its appeal of the decision to the Tenth Circuit, the taxpayer contended that plaintiffs in the Raider litigation had no legal claim against Ash Grove from the corporate reorganization.[324] Instead, the expenses deducted in its 2005 consolidated federal income tax return were solely the result of its indemnification obligation to its directors that was mandated by the corporate bylaws.[325] As part of this argument, the taxpayer maintained that the Raider lawsuit "did not assert a claim for which relief could have been granted by the Delaware courts - - and did not plead a cause of action - - against Ash Grove, and thus the payments regarding the litigation were purely pursuant to the indemnification requirements set out in Ash Grove's bylaws." [326] It further declared that Ash Grove was only named as a defendant in the Delaware complaint to invoke the court's jurisdiction for the purposes of any rescission remedy that might be ordered by the court.[327] The taxpayer stated that such remedy was not viable given the long timeframe between the reorganization and the Raider lawsuit.[328]

According to the taxpayer, the indemnification obligation was the origin of the claim.[329] Furthermore, the taxpayer asserted that the Government was attempting to expand the

320. *Id.* at 167.

321. The court pointed out however that *Larchfield* "never cites to or discusses *Gilmore*." *Ash Grove Cement*, No. 11–2546–CM, 2013 WL 451641, at *11 n. 4.

322. *Id.* at *11.

323. *Id.* at *11-12.

324. *Ash Grove Cement Co.*, 562 F. App'x at 699-700.

325. *Id.* at 700.

326. *Id.*

327. *Id.*

328. *Id.*

329. *Id.*

origin of the claim doctrine by focusing on the underlying cause of the potential liability of the directors, i.e., the reorganization, rather than Ash Grove's legal obligations to its directors.[330] The taxpayer again cited *Larchfield*, as well as other authorities, for the proposition that barring an exception to the general rule, indemnification expenses are generally deductible.[331] Specifically, the taxpayer noted that in *Larchfield*, the court not only found the indemnification expenses deductible but stated that the result would be different if the director/controlling shareholder had paid the expense.[332] In the latter case, the director/controlling shareholder would have to have capitalized any legal expenses defending title to his shares.[333] The lesson, the taxpayer contended from this, is that whether to deduct or capitalize an expense must be evaluated based on the circumstance of the particular taxpayer and the claim against the taxpayer.[334]

The government countered that Ash Grove Cement's position to focus on the indemnification obligation was an attempt to resurrect the primary purpose test that was specifically rejected by the Supreme Court in *Woodward*. The government maintained that even if the primary purpose for taxpayer having paid the settlement amount was its indemnification obligation to its directors, it was not the origin of the claim that was settled.

One of the cases that the government relied on in its argument was *Berry Petroleum Co. v. Commissioner*.[335] In *Berry Petroleum*, the taxpayer sought to deduct expenses incurred in defending against a class action for a breach of fiduciary duty claim, brought on behalf of minority shareholders of a company with which taxpayer ultimately merged.[336] The Tax Court in *Berry Petroleum*, determined that "allegations of breach of fiduciary duty alone do not suffice to establish that the expenses to defend the lawsuit are deductible."[337] The court ultimately concluded in *Berry Petroleum*, that because the "litigation had its origins in the process of acquisition culminating in the . . . merger, the costs attributable thereto are not deductible as ordinary and necessary business expenses, but must be

330. *Id.* at 700.

331. *Id.* at 700 n.2.

332. *Id.*

333. *Id.*

334. *Id.* at 700.

335. Berry Petroleum Co. v. Comm'r, 104 T.C. 584 (1995), *aff'd without published opinion*, 142 F.3d 442 (9th Cir. 1998).

336. *Id.* at 587.

337. *Id.* at 617.

capitalized as acquisition costs of the . . . stock."[338] *Berry Petroleum* however is arguably inapposite to *Ash Grove Cement* because the directors were dropped from the class action lawsuit and importantly the expense taxpayer had attempted to deduct was not triggered by an indemnification obligation.[339] As discussed however *infra* in *Dana Corp*., the fact that a type of expense is generally deductible, i.e., legal retainer fees in the case *Dana Corp* and director indemnification expenses in the case of *Ash Grove Cement*, does not make all such payments deductible.

The Tenth Circuit in *Ash Grove Cement* rejected the taxpayer's contention that it was not indispensable to the Delaware lawsuit, but more importantly stated that "we are unconvinced that the extent of Ash Grove's indispensability in Delaware litigation is relevant to our analysis."[340] The court quoted from the Tenth Circuit in *Dye* that "[t]he object of the 'origin of the claim' test is to find the transaction or activity from which the taxable event proximately resulted, or the event that led to the tax dispute."[341] The Tenth Circuit stated that "there can be no dispute in the case at bar that the payments made by Ash Grove were, at a minimum, 'in connection with' Raider's suit and the reorganization" [342] and thus were a nondeductible capital expense.[343]

The courts' determination of the origin of the claim in *Ash Grove Cement* was undoubtedly correct.[344] The indemnification

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338. *Id*. at 622.

339. Neither the district court nor the Tenth Circuit referenced *Berry Petroleum* in their decisions. *See* Ash Grove Cement Co. v. U.S., No. 11-2546-CM, 2013 U.S. Dist. LEXIS 1594 (D. Kan. Feb 6, 2013); Ash Grove Cement Co. v. U.S., 562 Fed. Appx. 697 (10th Cir. 2014).

340. *Id*. at 701.

341. *Id*. at 699 (quoting *Dye*, 121 F.3d. at 1404).

342. *Id*. at 701.

343. In reaching its conclusion the Tenth Circuit rejected the application of *Larchfield* since it was decided prior to the Supreme Court's articulation of the 'origin of the claim' test in *Woodward*." *Id*. at 700 n. 2. The court also pointed out that even "*Larchfield* . . . noted that 'the expense of a suit against directors' are not 'always deductible.'" *Id*.

344. While in accord with this conclusion, Professor John Bogdanski was critical of some omissions by the courts in *Ash Grove Cement*. He writes "[f]or one thing, no mention was made of the regulations that govern the issue. Nicknamed the 'I*ndopco* regs' after another Supreme Court case in the area, these elaborate rules specifically provide, among many other precepts, that any amount paid to acquire corporate stock, or to facilitate the acquisition of stock, must be capitalized. They also state that an amount paid to determine the value of acquired stock is considered part of pursuing the acquisition transaction, thus requiring the amount's capitalization. . . . Another authority that one might have expected to see mentioned in the judicial opinions is Section 162(k)(1) which denies deductions for amounts paid by corporations to reacquire their own stock or to

obligation arose out of a lawsuit challenging the reorganization. The case can be analogized to *Neely*, but substituting director indemnification liability for compelling financial disclosure. In both *Neely* and *Ash Grove Cement* the true underlying transaction, a stock sale in the case of *Neely* and a reorganization in the case of *Ash Grove Cement*, was quite different from the immediate purpose for incurring the expense. Just as in *Keller Street*, where the brewery sale was the basis of the derivative suit, so too was the reorganization the source of the Raider lawsuit. The obligation to indemnify the board of directors proximately resulted from the reorganization transaction. This was, in the words of the Tax Court in *Von Hafften*, "the transaction underlying the litigation."[345] While the immediate triggering of the expense may well be connected with the taxpayer's indemnification duty to its board of directors it occurred only because of minority shareholders dissatisfaction with the reorganization transaction, i.e., the origin of the claim.

## VIII. SOME RELATIVELY RECENT PRIVATE LETTER RULINGS - IS THERE ANY INCONSISTENCY BY THE SERVICE?

Some relatively recent private letter rulings highlight the fact that determination of what is the origin of claim can at times be difficult and subject to legitimate debate. While not dealt with in the Tenth Circuit decision in *Ash Grove Cement* one authority cited by the taxpayer in its brief was Private Letter Ruling 200911002,[346] wherein the Service allowed a deduction for legal and settlement expenses incurred in a securities class action lawsuit. One of the claims involved false statements made in a prospectus involving the issuance of additional shares brought on behalf of purchasers of the stock. In allowing the deduction under I.R.C. section 162, the Service indicated that "[i]t is irrelevant that the settled claims had some connection to a stock offering."[347] The Service observed there that "business expenses are not converted into capital expenditures solely because they

defray costs connected with such reacquisitions. The plaintiffs in the state court action in *Ash Grove Cement* argued that their equity in Ash Grove had been unfairly diluted by the terms of the Vinton and Lyman-Richey deals. In paying them $15 million in satisfaction of their claim, Ash Grove was essentially cashing out part of their equity with corporate funds—the essence of a stock redemption. Viewed in that light, the corporation's deduction would have been barred by the express terms of the Code itself." John A. Bogdanski, Pay *Up Now, Deduct Later (Maybe)-Ash Grove Cement Co.*, 42 CORP. TAX'N 27, 29-30 (2014) (footnotes omitted).

345. *Von Hafften*, 76 T.C. at 834.

346. I.R.S Priv. Ltr. Rul. 127584-08 (March 13, 2009).

347. *Id.*

have some connection to a capital transaction."[348] The Government in its brief to the court of appeals in *Ash Grove Cement*, countered first that citations to informal administrative determinations of the Service are not valid precedent. Furthermore, it argued that the SEC filings were normal business activity and that as such were different from the Raider lawsuit involving a discrete capital transaction in *Ash Grove Cement*. One of the federal securities law violation claims that were settled in Private Letter Ruling 200911002 was made "on behalf of members of the class who acquired Taxpayer's shares. . . . The claim alleges that the Prospectus Supplement contained untrue statements of material fact and/or omitted to state material facts required to be stated therein which were necessary to make the statements therein not misleading. . . ."[349] The Service asserted that "[w]hile the second claim is brought on behalf of purchasers of stock pursuant to a specific stock offering, the allegations involve representations which are part of ordinary business activities, i.e., the SEC filings in which the fraudulent statements occur. Therefore, pursuant to the origin of the claim, the transaction or activity from which the taxable event proximately resulted was to settle claims resulting from ordinary business activities. It is irrelevant that the settled claims had some connection to a stock offering. Rather, the alleged misrepresentations occurred in a number of filings which were produced over a period of time as part of regular business activities. Accordingly, we believe that the second claim also arose in the ordinary conduct of the taxpayer's business."[350] While the Service's position is definitive, there are legitimate questions here as to the origin of the claim. Certainly if financial statements had been accurate there would be no reason for taxpayer to settle. Furthermore financial statements are routinely issued even absent a stock issuance. This claim however arose only because the taxpayer offered its shares to the claimants—a capital transaction. Can't it be justifiably maintained that the claim proximately resulted from the share issuance? Perhaps the Service's position is somewhat inconsistent with its litigating position in e.g., *Missouri Pacific, DuGrenier* as well as the holdings of the courts there.[351]

348. *Id.*

349. *Id.*

350. *Id.*

351. *Id.* The Service specifically sought to distinguish *Missouri Pacific* stating that there (and in *Berry Petroleum*) the court "determined that the claims originated in the Taxpayer's acquisitions of targets' stock, rather than in their ordinary business operations." *Id.*

A similar conclusion was reached in In Private Letter Ruling 200216013.[352] There the taxpayer sold common stock on the NASDAQ National Market System in connection with its initial public offering. A consolidated class action was brought alleging a violation of federal securities laws for a time period after the initial public offering because of false and misleading financial statements that were provided. The complaint stated that taxpayer "decided to prematurely book sales and net income in a manner inconsistent with GAAP. . . [and] that this decision lead to a generation of false and misleading financial statements. . . which in turn inflated Taxpayer's stock price throughout the class (action) period."[353]

The litigation was settled with the taxpayer paying cash and additional shares which the Service ruled to be deductible. In its analysis the Service stated that "[t]he 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."[354] The ruling went on to state that "[n]evertheless, a business expense is not converted into a capital expenditure solely because it is incurred in the context of a corporate reorganization . . . 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)."[355]

A comparable letter ruling to the foregoing rulings is Private Letter Ruling 200742004[356] wherein the Service again permitted a taxpayer to deduct settlement payments in connection with class actions alleging omissions and misrepresentations in financial reports and SEC filings that adversely affected all persons who acquired Taxpayer' securities, either in the open market or in a securities offering. The Service in finding the origin of the claim to be the financial statement

352. I.R.S Priv. Ltr. Rul. 105637-01 (Apr. 19, 2002).

353. *Id.*

354. *Id.*

355. *Id.*

356. I.R.S. Priv. Ltr. Rul. 110963-07 (Oct. 19, 2007).

misrepresentations stated "[i]t is irrelevant that the settled claims had some connection to stock and note offerings or that one stock offering was immediately after and a result of a merger. Capital transactions were not the sine qua non of the allegations in the complaint. Rather, the alleged misrepresentations occurred in a number of reports, statements, filings etc. which were produced over a period of time as part of regular business activities. The Complaint does not indicate that the allegations stemmed from any conduct by Taxpayer involving any acquisitive transaction or merger transactions. Rather the claims focus on alleged misrepresentations and omissions occurring over several years while in pursuit of ongoing business activities."[357]

Shortly before the Tenth Circuit rendered its decision in *Ash Grove Cement*, the Service issued another private letter ruling regarding the origin of the claim doctrine. In Private Letter Ruling 201412002[358], the Service ruled that a corporation's payments of legal fees and other expenses incurred in the settlement of a securities lawsuit are deductible under I.R.C. § 162 even though the alleged misrepresentations giving rise to the lawsuit arose in connection with a merger agreement.[359] The taxpayer in Private Letter Ruling 201412002 was a publicly traded corporation which had executed a stock for stock merger agreement with the target another publicly traded company. After the merger closed, litigation was filed against the taxpayer, the target and other defendants for securities laws violations alleging that defendants made misrepresentations and omissions with regard to certain undisclosed obligations of the target. The ruling did point out that "[n]one of the settlement was allocated to stock acquired from the exchange . . . in the merger."[360] The ruling also noted that "[t]he eventual settlement was paid not only to plaintiffs who held Taxpayer securities at the time of the merger, but also to plaintiffs who acquired Taxpayer securities after the merger."[361] The Service found that "[W]hile the facts of the case involve a capital transaction, the plaintiffs' claims were that the alleged misrepresentations and omissions harmed the value of their investment in post-merger Taxpayer."[362] In holding

357. *Id.*

358. I.R.S. Priv. Ltr. Rul. 121178-13 (Mar. 21, 2014).

359. Comparable to the foregoing rulings are, *e.g.,* I.R.S. Priv. Ltr. Rul. 118469-05 (Dec. 8, 2006); I.R.S. Priv. Ltr. Rul. 9442021 (Oct. 21, 1994); I.R.S. Priv. Ltr. Rul. 9621037 (Feb. 27, 1996).

360. I.R.S. Priv. Ltr. Rul. 121178-13 at 2 (Mar. 21, 2014).

361. *Id.*

362. *Id.*

that the these expenses weren't subject to capitalization, the Service stated that "[t]he origin of the claim here is in the manner and extent to which Taxpayer's board of directors provided information to shareholders in securities filings . . . ."[363]

While there are certainly valid arguments that all of the foregoing private letter rulings are proper, this is an area where at least with respect to some fact-patterns there are legitimate questions as to what is the origin of the claim. Furthermore modifications of some of the facts would lead one to conclude the expenses should be capitalized. Suppose e.g., the rulings were extended to lawsuits by subscribers to the offering or exchange alleging misrepresentations in financial statements specifically prepared in conjunction with the transaction. Under those circumstances the fact-pattern would be comparable to *Winter* where the hotel buyer was seeking a purchase price adjustment because of alleged misrepresentations made on income statements of the business. Other cases discussed above such as *Missouri Pacific* and *DuGrenier* would also be authority for capitalizing the payments. The origin of the claim under this hypothetical circumstance should be the sale or exchange of shares.

## IX. CONCLUSION

While it's been said that the Supreme Court has at times muddled the income tax laws, that's not the case in *Woodward* and *Hilton Hotels*. These cases established the application of the origin of the claim doctrine to expenses incurred in connection with a share purchase and set the framework for its utilization *inter alia* for expenses incurred in litigation and/or settlement of claims relating to property transactions. The origin of the claim doctrine is really all about proper matching. This accounting precept as adopted by the Supreme Court to expenses connected with litigation is sensible and the courts have generally applied it appropriately in cases dealing with litigation and settlement payments linked with property transactions. *Ash Grove Cement* is no exception. There are however situations where the determination of what is the origin of the claim can be problematic. The Service needs to be vigilant that its rulings in this area are completely consistent with its litigating positions and the case law. Finally, it is important to pay heed to the Ninth Circuit's direction in *Keller Street* that the determination of what is the origin of the claim should not always serve to end the tax

363. *Id.*

analysis of the item in question.