Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: June 4, 2013

to: Group Manager Diane C. Stevens,

from: Associate Area Counsel (LB&I),

subject: **Deduction for Indemnification of Liability** **UIL = 162.27-00**

Years 20 and 20

You are currently examining the . At issue is whether certain liabilities of a former subsidiary that agreed to pay when it sold that subsidiary are deductible by .

This memorandum was informally coordinated with Susie Bird of Chief Counsel, Income Tax and Accounting.

This advice responds to your request for assistance. It may not be cited as precedent. This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Facts

In 20 , sold all of its stock in a wholly-owned subsidiary known as to . At the time of the sale, was a defendant in two class-action lawsuits claiming that had failed to properly refund to policyholders certain unearned premiums that the policyholders had paid to .

As part of the contract by which was sold, agreed to indemnify or directly pay whatever obligation was eventually determined to owe as a result of the suits. In tax year 20 , a total settlement of approximately $50 million for both suits combined was agreed upon by the parties. paid the $50 million into a qualified settlement fund (QSF) during 20 .[1]

At the time of the sale of , booked an accrued expense of approximately $38 million for the anticipated amount of the liability. This accrual was for book purposes and did not affect any tax return.

The contract between and by which the stock was sold specified that would be entitled to deduct the settlement payments. It further provided that would reimburse for the amount of "tax savings" lost by (i.e., the amount by which federal income tax would have been reduced if had deducted the settlement payment on its return). In 20 , (as parent of) paid part of the reimbursement promised in this agreement.[2]

In the consolidated return for 20 , claimed the $50 million payment as a deduction from ordinary income. In the return for that same year, also claimed a deduction for the $50 million payment.

Both and are currently under examination for the year 20 .

Issue

Where all the stock in a subsidiary is sold to another company and, as part of the contract of sale, the former parent agrees to pay and does pay a contingent liability of the subsidiary when it comes due, is a deduction allowable on the

[1] Under I.R.C. Sec. 468B, a taxpayer may take a deduction at the time it pays a liability into a "qualified settlement fund," even though "economic performance" does not occur until a later year. In the context of this case, this means that a deduction could be taken in the year (20) that the liability was paid to the QSF, even though the plaintiff/policyholders would not receive their payments until a later year. A taxpayer using this section can thus take a deduction in an earlier year than would otherwise be allowable under I.R.C. Sec. 461(h). In this examination, it is not disputed that the requirements of Sec. 468B were satisfied; at issue is not when the deduction can be taken but by whom.

[2] In rough numbers, the tax effect was determined to be approximately $17.5 million (i.e., a marginal tax rate of 35% times $50 million). Of this sum, has paid approximately $5 million.

return of the former parent or the subsidiary?

Law and Analysis

The legal principle that resolves this controversy is that a taxpayer may take a deduction for its cost of doing business, but it cannot take a deduction for some other taxpayer's cost of doing business.

Under I.R.C. Sec. 162(a), a taxpayer is allowed a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

When a person makes an expenditure on behalf of someone else, as a general rule the person making the payment is not entitled to a deduction for it. The courts do not look upon the payment of someone else's expense or obligation as an ordinary expense of carrying on a trade or business under Sec. 162(a). Thus, the payment by an employee of the expense of an employer, payment by a stockholder for a corporation, or payment by a partner for a partnership, does not constitute an ordinary expense of carrying on the payor's business. When the person who paid the expense of another is not entitled to the deduction, the person for whom the expense was paid may claim it if the expense is one that he would have been entitled to deduct if he had paid it. The payor is treated as making a gift, a loan, a contribution to capital or a capital expenditure, or is acting as an agent of the debtor, depending on the circumstances. In substance, the transaction is the same as if funds were paid directly to the person on whose behalf the expenses were paid, followed by actual payment of the expense by the latter person. See United States Tax Reporter (RIA) ¶1624.104.

For example, in American General Insurance Co. v. United States, (USDC Mid-Dist. Tenn., 1973), an insurance company purchased a radio station from an individual. As a part of this contract of sale, the insurance company agreed to hire the individual as a consultant in the radio business. The insurance company operated the radio station as a wholly-owned subsidiary. For approximately eight years, the subsidiary paid the consultant's salary. The insurance company then "reassigned" the employment contract to itself, paid the salary, and deducted those payments in its returns. All of the services performed by the individual related to the operation and administration of the radio station and not to the business of the insurance company. The sale contract provided that the employment contract could be assigned but that no assignment would release the insurance company of its ultimate obligation to the individual.

The court disallowed the deduction on the insurance company's return. The court held that "expenses paid for the benefit of one taxpayer cannot be deducted by another taxpayer . . . a taxpayer must establish that the item of expense was proximately and directly related to his trade or business." The court stated that the fact that the insurance company remained ultimately liable on the employment contract "has no effect on the deductibility of the payments made thereunder. . . . The mere fact that the expense was incurred under contractual obligation does not, of course, make it the equivalent of a rightful deduction under Sec. 162(a). That subsection limits permitted deductions to those paid or incurred 'in carrying on any trade or business.' The origin and nature, and not the legal form, of the expense sought to be deducted determined the applicability of Sec. 162(a)."

Similarly, in Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943), the parent company paid some of the expenses incurred by a subsidiary and deducted the payments on the parent's return. A contract between the parent and the subsidiary stated that the parent was responsible for all of the subsidiary's "operating deficits." The Supreme Court held that neither the expenses paid nor the operating deficit of the subsidiary were an expense of the parent's business under the Code and therefore were not deductible by the parent. That there was a contractual obligation to pay the operating deficit did not convert the subsidiary's expense into an expense of the parent.

In Windsberg v. Commissioner, T.C. Memo. 1978-101, the fiduciary of two estates paid administration costs of the estates and claimed a deduction on his individual tax return. The court disallowed the deduction under Sec. 162(a), stating that the expenses at issue "are obligations of the estates. If deductible, the expenses are deductible only by the obligated taxpayers, i.e., the estates."

Also similar are Coulter Electronics Inc. v. Commissioner, T.C. Memo. 1990-186 ("Ordinarily, the separate corporate identities of parent and subsidiary preclude the parent from deducting expenses incurred or losses sustained by its subsidiary. The theory is that the payment by the parent to cover such expenses or losses is related to the business of the subsidiary and not to its own business.”); Starrett v. Commissioner, T.C. Memo. 1990-183 (“A taxpayer generally may not deduct expenses incurred for the benefit of another. Thus, an employee who voluntarily incurs expenses of the employer is not entitled to a deduction for such expenditures because they are not considered necessary employee expenses.”); and The Austin Company v. Commissioner, 71 TC 955 (1979)(“Petitioner simply cannot claim as its own expense amounts paid for activities that were concerned with the day-to-day operation of the subsidiary’s business.”)

In the current examination, sold a subsidiary to . At the time of the sale, was the defendant in two class action suits. The wrongdoing, if any, which gave rise to those suits was done by ; only could be found liable by the courts. We freely concede that any payments made by in settlement of these suits would be deductible on the return; such payments would be “ordinary and necessary” business expenses of under Sec. 162(a).

When the suits were settled in 20 , however, the liability was paid not by but by . At that time, was not the parent of but had merely a contractual obligation (under the sale contract of 20) to pay the liability. In accordance with the above precedents, such a contract does not make the settlement liability an “ordinary and necessary” expense of , and the payment is therefore not deductible on the return. We conclude that the liability at issue, being an “ordinary and necessary expense” of , is deductible by on its return for 20 .

We note, however, that both and are currently under examination for 20 . Both companies are adamant that they are entitled to the deduction. Their arguments have not been put forth in writing and are not entirely clear, and there may be relevant facts of which we are unaware. Neither company is willing to execute a closing agreement giving up the deduction. It follows that, due to this uncertainty, you should not allow the deduction on the return of either company; only a subsequent closing agreement, judgment of the court, or expiration of the statute of limitations can definitively conclude this issue.

That a contract between and specified that the liability, when paid, would be deductible by supports our conclusion but is irrelevant to our analysis. While corporations are free to agree to payments and indemnifications between themselves under an almost limitless variety of circumstances, the deductibility of an expense on a tax return is determined by the Internal Revenue Code. A private contract can require indemnification for paying an expense, but it cannot change the "ordinary and necessary expense" of one company into the "ordinary and necessary expense" of another; if it could then the possibilities for extensive avoidance of Sec. 162(a)'s requirements would be obvious. "A taxpayer must establish that the item of expense was proximately and directly related to his trade or business." American General Insurance Co. v. United States, (USDC Mid-Dist. Tenn., 1973). The expenditure is deductible by , not because of the contract provision that so specifies, but because the liability was proximately and directly related to the trade or business of .

Although we conclude that the item is not an ordinary deduction for , the questions remains: "What is the legal status of the payment, for tax purposes, for ?" payment of liability was clearly not a gift from to –- corporations do not make gifts to other corporations. It was not a loan from to , as there is no indication that a loan was intended and there was no obligation by to repay the $50 million or any part of it.

Under Arrowsmith v. Commissioner, 344 U.S. 2 (1952), if the seller of a subsidiary, in connection with the sale contract, indemnifies a contingent liability of that subsidiary by making a payment to the acquiring company, the indemnity is treated as a reduction in the sale price of the stock. See also Central Gas & Electric Co. v. United States, 159 F.Supp. 353 (Ct. Cl. 1958); Federal Bulk Carriers, Inc. v. Commissioner, 66 T.C. 283 (1976); Rev. Rul. 58-374, 1958-2 C.B. 396; Clay v. Commissioner, T.C. Memo. 1981-375; and Nelson v. Commissioner, T.C. Memo. 1971-327. If the seller indemnifies a contingent liability of the subsidiary by making a payment to or on behalf of the subsidiary, however, the payment is treated as a contribution to the subsidiary's capital by the seller, relating back to immediately before the stock sale and thereby increasing the seller's basis in the subsidiary for purposes of determining gain or loss on the sale. See Rev. Rul. 83-73, 1983-1 C.B. 84; G.C.M. 38977 (April 8, 1982). The consequences to the selling corporation are the same regardless of whether the indemnity payment is treated as a reduction in the sale price or as a contribution to capital. In either event, the seller is entitled to a capital loss, rather than an ordinary deduction at the time the indemnity is paid or becomes fixed. The capital loss may be deductible as such, provided it is not disallowed under the consolidated return loss disallowance regulations (Temp. Reg. §1.1502-35T and Reg. §1.1502-36), depending on circumstances.

We conclude, therefore, that requirement to pay the liability of results in a deemed contribution of capital by and an increase in basis in . is entitled to a capital loss--- not an ordinary deduction--- in the year that it paid the indemnity (20). Such a loss is subject to possible disallowance, however, depending on the application of the consolidated return loss disallowance regulations.

is entitled to an ordinary deduction because it is deemed to have received the funds from and paid the settlement itself, in furtherance of its own business. As explained above, however, to avoid a whipsaw situation, the deduction should not be allowed to until concedes, or it is finally determined, that is not entitled to that ordinary deduction.

A further problem arises from the fact that the entities at issue here are insurance companies. Insurance companies, unlike other corporations, are entitled to deduct increases in reserves for certain losses (I.R.C. §§ 805(a)(2), 807, 816(b) and 832), contrary to the general application of the "all events" and "economic performance" rules. As noted above, is not entitled to an ordinary deduction for paying the settlement; it follows that neither is it entitled to a deduction for a reserve for that item. If deducted its anticipated liability for that settlement as an insurance reserve, then an adjustment must be made to disallow that part of the reserve. deduction of a reserve <u>and</u> its deduction of the payment as an ordinary loss on the return for the year paid would be a double deduction where no deduction is allowable. We therefore recommend an investigation into the facts of this matter.

Under the same principles and precedents, payment of the "tax savings" by to are also adjustments to basis in stock, with a consequent effect on gain or loss. What impact the payment of the tax savings by has on the tax returns of is an issue that can only affect the return for 20 , which is not currently under examination. We offer no opinion on that issue.

Conclusion

deduction of the payment in settlement of the class-action suit in 20 should be disallowed on the grounds that, though paid that settlement, was not entitled to the deduction under Sec. 162(a) as the deduction did not arise from business. To avoid a “whipsaw” situation, that deduction should also be disallowed on the consolidated return of and for 20 . The payment should be treated as an adjustment to basis in the stock and consequent adjustment to gain or loss on the sale of that stock. That adjustment should be recognized in 20 .

If you have any questions, please contact the undersigned at .

Steven R. Guest
Associate Area Counsel (LB&I)

By: ______________________________
J. Paul Knap
Attorney

cc: