OFFICE OF
CHIEF COUNSEL

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

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DISTRICT COUNSEL,

CC:
Attn: and

FROM: HEATHER MALOY
Associate Chief Counsel (Income Tax & Accounting)
CC:ITA

SUBJECT: Deductibility of legal judgment against foreign subsidiaries

This Field Service Advice responds to your memorandum dated May 5, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Taxpayer =
Sub1 =
Sub2 =

Sub1/Sub2 =

Corp X =
Corp Y =
$a =
N =
M =

ISSUE:

Whether taxpayer is entitled to deduct the amount of $a transferred to Sub1 for the payment of a legal judgment in said amount against Sub1/Sub2 as an ordinary and necessary business expense under I.R.C. § 162 for the tax year.

CONCLUSION:

Taxpayer has failed to demonstrate the transfer of funds for the subsidiaries' legal judgment was directly related to the taxpayer's own business; therefore, taxpayer may not deduct the amount of the transferred funds as an ordinary and necessary business expense under section 162.

FACTS:

The facts as you have provided are as follows:

Taxpayer is in the business of developing

. In , taxpayer purchased all the shares of Sub1, a N corporation specializing in the and , and the shares of its subsidiaries, including Sub2, a M corporation.

Prior to the purchase of the shares, in , Corp X, an unrelated N manufacturer of , contracted with Corp Y, an unrelated M company, for the design and manufacture of a . Corp Y, in turn, subcontracted with Sub2 for the design and manufacture of a to be incorporated into the .

In , the first test on the revealed that the did not conform to Corp X's requirements. Corp Y requested Sub1/Sub2 improve the performance of the . Still unsatisfied with the performance of the , Corp X canceled its contract with Corp Y on

In , an expert determined that a significant cause for the failure was the improper functioning of the .

On , Corp X sued Corp Y for damages for breach of contract. On , Corp Y sought damages from Sub1/Sub2. On , per an agreement signed by Corp Y and Sub1/Sub2, Corp Y withdrew its claims against Sub1/Sub2. A few days later, Corp Y declared bankruptcy. As a result, Corp X sought damages from Sub1/Sub2. On , based on the findings of the expert, the court rendered a judgment against Sub1/Sub2. The judgment was affirmed by an appellate court on .

In a letter to Sub1, dated , taxpayer confirmed its oral agreement to pay the legal judgment. In the letter, taxpayer stated that Sub2 had become insolvent in , and taxpayer had ceased Sub2's operations and terminated all employees. As the sole shareholder and "successor"[1] of Sub2, taxpayer promised to pay all liabilities arising from the Corp X/Corp Y litigation. Taxpayer stated that "because Sub2 was primarily responsible for the transaction that gave rise to the litigation, it would not be appropriate for Sub1 to shoulder the financial risk of an adverse outcome of the litigation." Taxpayer requested Sub1 pay Corp X the judgment directly and then send taxpayer an invoice for the amount of such payment.

Pursuant to taxpayer's request, Sub1 apparently paid the legal judgment and subsequently sent an invoice to taxpayer on . Via wire transfer, taxpayer paid the amount of the legal judgment to Sub1 on . Taxpayer, on the accrual method of accounting, deducted said amount in .[2]

In Taxpayer's Submission, dated , taxpayer, while generally recognizing a parent corporation may not deduct its subsidiary's expense, argued that in its case, taxpayer should be allowed to deduct the amount it transferred to Sub1 to pay the legal judgment because the transfer of funds to Sub1 was

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[1] Exam advises taxpayer is using the term "successor" loosely. According to taxpayer's Form 10-K, dated , Sub2 was still in existence, although it was listed as "inactive."

[2] [redacted]
As you noted, an expense may not be deducted by two different parties. <u>See</u> <u>Fall River Gas Appliance Co. v. Commissioner, 42 T.C. 850, 858 n.2 (1964), nonacq., 1965-2</u> C.B. 7. [redacted]

compelled by the need to protect taxpayer's business from harm. Taxpayer also claimed the expenditure directly benefitted taxpayer's profit-oriented activities and was necessary for the preservation of taxpayer's existing business.

LAW AND ANALYSIS:

I.R.C. § 162(a) allows a deduction for ordinary and necessary expenses paid or incurred by the taxpayer in carrying on a trade or business. Whether an expense is deductible under section 162 is ultimately a question of fact. See Commissioner v. Heininger, 320 U.S. 467 (1943). Generally, an expense is ordinary if it bears a reasonably proximate relationship to the operation of the taxpayer's business. See Deputy v. du Pont, 308 U.S. 488 (1940); Gill v. Commissioner, T.C. Memo. 1994-92, aff'd without published opinion, 76 F.3d 378 (6th Cir. 1996). An expense is necessary if it is helpful and appropriate in promoting and maintaining the taxpayer's business. See Carbine v. Commissioner, 83 T.C. 356 (1984), aff'd, 777 F.2d 662 (11th Cir. 1985); Gill v. Commissioner, supra.

Deductions are strictly a matter of legislative grace, and taxpayers must satisfy the specific requirements for any deduction claimed. INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992); New Colonial Ice Co. v. Helvering, 292 U.S. 435 (1934).

The Tax Court has considered the issue of whether one taxpayer is entitled to deduct, under section 162, reimbursements made to a wholly-owned subsidiary or other related party for business expenses incurred by the latter. The case law in this area is clear and from your FSA request and Taxpayer's Submission, it appears that both parties are well aware of the seminal cases. Accordingly, we will not repeat the lengthy case discussions, but only allude to the controlling facts and law in the cases as appropriate.

It is well-established that where a taxpayer undertakes to pay the obligations of another taxpayer, such payments are not deductible as ordinary and necessary expenses incurred in the payor's trade or business. See Interstate Transit Lines v. Commissioner, 319 U.S. 590; Deputy v. DuPont, 308 U.S. 488; Columbian Rope Co. v. Commissioner, 42 T.C. 800 (1964); Grauman v. Commissioner, 357 F.2d 504 (9th Cir. 1966).

With respect to a parent-subsidiary relationship, generally a parent corporation is not allowed to deduct expenses of its subsidiary. See Fall River Gas Appliance Co. v. Commissioner, 42 T.C. 850 (1964), aff'd, 349 F.2d 515 (1st Cir. 1965). 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. Fall River Gas Appliance Co., 41 T.C. at 858, citing Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943).

However, reasonable expenditures made to "protect or to promote" a taxpayer's business, and which do not result in the acquisition of a capital asset, are deductible as ordinary and necessary expenses of transacting a trade or business. See Crowder v. Commissioner, 19 T.C. 329 (1952), acq. 1953-1 C.B. 3; L. Heller & Son, Inc. v. Commissioner, 12 T.C. 1109 (1949), acq. 1949-2 C.B. 2; Catholic News Publishing Co. v. Commissioner, 10 T.C. 73 (1948), acq. 1948-1 C.B. 1; Scruggs-Vandervoort-Barney, Inc. v. Commissioner, 7 T.C. 779 (1946), acq. 1946-2 C.B. 5. The crucial and controlling factor lies in determining whether the acts done and expenditures made were motivated by a purpose to protect or to promote the taxpayer's business. See Alleghany Corporation v. Commissioner, 28 T.C. 298, 303 (1957), acq. 1957-2 C.B. 3; First National Bank of Skowhegan v. Commissioner, 35 B.T.A. 876 (1937), acq. 1937-1 C.B. 9. Of course, the burden is upon taxpayers to establish that the expense is proximately related to their business and is both ordinary and necessary. Issues of this type primarily raise questions of fact involving "the appreciation of particular situations, at times with border-line conclusions." Welch v. Helvering, 290 U.S. 111, 116 (1933); Snow v. Commissioner, 31 T.C. 585, 591 (1958), acq. 1959-2 C.B. 5, and acq. 1959-2 C.B. 7; Fishing Tackle Products Company v. Commissioner, 27 T.C. 638, 643 (1957), acq. 1964-2 C.B. 5 and acq. 1964-2 C.B. 7.

Thus, where the parent is able to demonstrate that the payment of an expense incurred by the subsidiary is "directly related" to the parent's own business, the payment qualifies as an ordinary and necessary business expense of the parent, deductible by the parent. See Coulter Electronics, Inc. v. Commissioner, T.C. Memo. 1990-186, aff'd, 943 F.2d 1318 (11th Cir. 1991).

In Coulter Electronics, Inc., the parent corporation was allowed to deduct reimbursements made to Coulter Electronics of Canada, Inc. (CEC), a wholly-owned Canadian subsidiary, for certain warranty expenses under section 162. The Tax Court found the warranty services performed by CEC would affect the parent's sales, and, therefore, the reimbursements were "directly related" to the parent's own business and deductible by the parent. Accord Fall River Gas Appliance Co. v. Commissioner, 42 T.C. 850 (1964), aff'd, 349 F.2d 515 (1st Cir. 1965) (allowing parent to deduct payments for expenses incurred by its subsidiary where payments were directly related to parent's business in that payments were intended to promote its own business wholly apart from that of subsidiary).

In L. Heller and Sons, Inc. v. Commissioner, 12 T.C. 1109 (1949), acq. 1949-2 C.B. 2, the parent corporation, engaged in the business of manufacturing and dealing in jewelry, was allowed to deduct the amount paid for debts of its wholly-owned subsidiary which had undergone a bankruptcy reorganization. The payment was made to protect the parent's standing in the business community, its relationship to the jewelry trade generally, and most importantly, its credit rating. Because the payments were calculated to "protect and promote" the parent's business, the court found the payments were deductible, either as a loss or a business expense. Id.

In Fishing Tackle Products Co. v. Commissioner, 27 T.C. 638 (1957), acq. 1964-2 C.B. 5 and acq. 1964-2 C.B. 7, a parent corporation deducted reimbursements made to a subsidiary for operating losses incurred in the manufacture of a patented fishing rod. The subsidiary was the parent's sole supplier of that particular rod. The court found the reimbursements constituted ordinary and necessary business expenses incurred by the parent in order to maintain and preserve this sole source of supply. The court allowed the deduction by the parent because the reimbursements were clearly a "business necessity." Id. at 644.

In Austin Co. v. Commissioner, 71 T.C. 955 (1979) acq. 1979-2 C.B. 1, the issue was whether a parent corporation could deduct amounts paid to its wholly-owned Mexican subsidiary to reimburse it for Mexican employment taxes incurred with respect to certain personnel. The court noted there was no doubt this relationship enhanced the successful operation of the subsidiary which benefitted the parent as its owner, but this type of "indirect and incidental" benefit was not enough to justify the parent's deduction. It concluded the payment by the parent was a "gratuity" and therefore, not deductible. Id. at 967.

In Columbian Rope Co. v. Commissioner, 42 T.C. 800 (1964), acq. 1965-2 C.B. 4, the court found that a parent corporation was not entitled to deduct one-half of the salaries and related expenses paid to certain employees of a wholly-owned subsidiary in order to induce such employees to accept work in the Philippine Islands. The court noted the parent undertook these payments "simply to aid" its wholly owned foreign subsidiary to obtain the services of needed management personnel. Id. at 815. A successful operation of the foreign subsidiary, through the services of such personnel, would obviously "inure to the benefit" of the parent corporation, and the parent's willingness to undertake this obligation is understandable. But the payments could not be construed as the parent's own business expense. Id.

Payments made by a shareholder of a corporation for the purpose of protecting his interest therein must be regarded as additional cost of his stock and such sums may not be deducted as ordinary and necessary expenses. South American Gold &

Platinum Co. v. Commissioner, 8 T.C. 1297, 1301 (1947), aff'd, 168 F.2d 71 (2d Cir. 1948).

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

In the FSA request, you summarized taxpayer's arguments as outlined in Taxpayer's Submission. You combined many of taxpayer's arguments which were redundant and noted them as follows:

A. Taxpayer argues Sub1/Sub2 were insolvent and unable to pay the legal judgment, and that as of [redacted], Sub1/Sub2 were indebted to taxpayer in the amount of $[redacted].[3] According to taxpayer, had it not paid the legal judgment, Corp X would have seized Sub1/Sub2's assets, shutting down their operations, which, in turn, would have adversely affected taxpayer's business capabilities.

B. Taxpayer asserts the payment of the legal judgment directly benefitted taxpayer's "profit-oriented activities," since Sub1 generated gross profits of almost $[redacted] to taxpayer, manufactures products that are incorporated into taxpayer's products, and provides new technology and products to taxpayer.

C. Taxpayer contends it and Sub1/Sub2 were viewed as a "single, interrelated entity," and that the payment of the legal judgment protected taxpayer's reputation. In support thereof, it states: (a) the activities of the corporations are highly integrated; (b) each operates in overlapping market areas, in terms of geography and customer base; (c) each company performs warranty work on the other's products; (d) the companies maintain an integrated web-site; (e) the companies advertise jointly; and (f) they share common values and culture.

In making such arguments, taxpayer analogizes its situation to that in three cases were parent corporations were allowed to deduct payments made on behalf of their subsidiaries. Coulter Electronics, Inc. v. Commissioner, supra, Fishing Tackle Products Co. v. Commissioner, supra, and L. Heller & Sons, Inc. v. Commissioner, supra. In brief, we concur that despite the lengthy discussion of the cases in its Submission, taxpayer's application of the law to the facts of its case consist primarily of conclusory statements. For instance, taxpayer provides no detail on the extent of the alleged integration and interrelatedness between taxpayer and

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[3] Exam Division advises that in a prior audit cycle, taxpayer took the position, and the Service agreed, that at least $[redacted] of this amount constituted capital contributions, not loans, to Sub1.

Sub1/Sub2. Thus, we agree taxpayer's arguments are unconvincing, inadequate and often irrelevant.

A. Insolvency Argument

To begin with, taxpayer claims neither subsidiary was solvent or otherwise able to satisfy the judgment. According to taxpayer, had it not paid the judgment, Corp X would have seized Sub1/Sub2's assets, shutting down their operations, which in turn would have adversely affected taxpayer's business capabilities. Thus, it was not only a wise economic choice by taxpayer to make the payment on behalf its subsidiaries, it was a "necessary" choice. (Taxpayer's Submission at 20.)

We believe taxpayer's argument is without merit for several reasons. Most significantly, the letter from taxpayer to Sub1, dated [redacted], directly contradicts taxpayer's claim that both subsidiaries were insolvent and unable to satisfy the judgment. In the letter, taxpayer states:

> During [redacted] Sub1 became insolvent and taxpayer as the sole shareholder caused Sub2 to cease operations and terminated all employees ... We informed you [Sub1] orally that taxpayer ... would honor any liabilities of Sub2 which existed ... Specifically, we told you [Sub1] that we would be responsible for any and all current and future liabilities arising out of the Corp Y/Corp X litigation. We did this because Sub2 was primarily responsible for the transaction which gave rise to the litigation and it would therefore not be appropriate for Sub1 to shoulder the financial risk of an adverse outcome of the litigation... We would appreciate it if you [Sub1] could pay Corp X directly and prepare an invoice to us for the amount of such payment.

Pursuant to the letter, Sub1 paid the legal judgment and sent taxpayer an invoice for the amount. Clearly, taxpayer would not have asked Sub1 to pay the judgment and then send it an invoice if Sub1 was insolvent.

Assuming arguendo both subsidiaries were insolvent and Sub1 could not pay the judgment until it received funds from taxpayer, taxpayer would still not be entitled to a deduction. Whether the subsidiaries were insolvent or not, taxpayer must show the payment was "directly related" to its own business. See Coulter Electronics, Inc. v. Commissioner, T.C. Memo. 1990-186, aff'd, 943 F.2d 1318 (11th Cir. 1991); Fall River Gas Appliance Co. v. Commissioner, 42 T.C. 850 (1964), aff'd, 349 F.2d 515 (1st Cir. 1965); Thompson v. Commissioner, T.C. Memo. 1983-487.

Taxpayer has failed to make such a showing. In fact, taxpayer's decision to pay the judgment for the subsidiaries was motivated not by necessity as taxpayer claims, but due to a sense of fairness as stated in its letter. Taxpayer told Sub1 that since the litigation was the result of actions taken by Sub2 "it would not be appropriate for Sub1 to shoulder the financial risk of an adverse outcome of the litigation." Moreover, there was no mention of insolvency in the letter. Rather, taxpayer goes on to ask Sub1 to pay the legal judgment directly to Corp X and then send taxpayer an invoice for the amount paid. Thus, it was not a necessary choice as taxpayer claims but one made in the sense of fairness. Accordingly, we should argue the payment is not deductible because it was nothing more than a "gratuity," see Austin Co., 71 T.C. at 966-968, made "simply to aid" its subsidy. See Columbia Rope Co., 42 T.C. at 815.

B. Benefit to Taxpayer's Profit-Oriented Activities

Next, we address taxpayer's position that the payment of the legal judgment directly benefitted taxpayer's profit-oriented activities. Taxpayer argues that the cost of the judgment ensured a source of products or services used by taxpayer in sales of its own product or services. Most significantly, taxpayer asserts that Sub1/Sub2 was the sole source of supply for one of taxpayer's [redacted] products. (Taxpayer's Submission at 21). In so doing, taxpayer analogizes its situation to that in the Fishing Tackle Products Co. v. Commissioner, 27 T.C. 638 (1957), acq. 1964-2 C.B. 5, and acq. 1964-2 C.B. 7, case arguing taxpayer would have been harmed without the assurance of a continued stream of these products from Sub1/Sub2.

In Fishing Tackle Products Co., a parent corporation was allowed to deduct reimbursements made to a subsidiary for operating losses incurred in the manufacture of a patented fishing rod. The subsidiary was the parent's sole supplier of that particular rod, thus, the reimbursements constituted ordinary and necessary business expenses incurred by the parent in order to maintain and preserve this sole source of supply. The court allowed the deduction by the parent because the reimbursements were clearly a "business necessity." Id. at 644.

Arguably, if Sub1/Sub2 were the sole source of supply for one of taxpayer's [redacted] product helping Sub1/Sub2 keep producing the product could be construed a business necessity. However, in the instant case, there is an immediate and apparent problem with taxpayer's position. Taxpayer fails to indicate which subsidiary, Sub1 or Sub2, produces the essential product. This is a clear example of taxpayer's conclusory statements found throughout its Submission.

Whether we assume Sub1 or Sub2 produces the essential part, we believe taxpayer's argument fails. First, let us assume Sub1 is the sole supplier. According to the [redacted] letter from taxpayer to Sub1, taxpayer had already caused Sub2 to cease operations and terminated all employees. If Sub2 was the sole source supplier of the part, clearly taxpayer would not have ceased its operations, or at the very least, would have ensured that another company would be producing the vital part in the interim. This appears to indicate that Sub2 was not the alleged sole supplier.

If Sub1 was the sole producer of the product, taxpayer's argument is even weaker for Sub1 was still operating, and quite profitably. In fact, taxpayer proudly notes Sub1 generated gross profits of almost $[redacted] for taxpayer. (Taxpayer Submission at 20). Thus, if Sub1 was the sole supplier, taxpayer had no need to pay the judgment to keep Sub1 operating and producing the essential part. Furthermore, it could be argued that Sub1 could have paid the judgment for Sub2 and possibly kept Sub2 operating since taxpayer asked Sub1 to pay the judgment first and then invoice taxpayer. Clearly, taxpayer has failed to demonstrate the business necessity of paying the legal judgment for its subsidiaries and preserving the alleged sole source of supply. Therefore, we believe taxpayer's situation is not analogous to the Fishing Tackle Products Co. case and is without merit.

C. Taxpayer and Sub1/Sub2 Viewed as Single, Interrelated Entity

Taxpayer also contends the payment of the judgment enhanced taxpayer's sales of product or services because the names of taxpayer and Sub1/Sub2 are linked in company advertising and reputation. (Taxpayer's Submission at 23). Taxpayer claims the payment protected its reputation among customers, employees and competitors because taxpayer and Sub1/Sub2 are inextricably intertwined in the eyes of the marketplace and its consumers. For example, they operate an integrated web-site and advertise jointly. (Taxpayer's Submission at 23, 26). Moreover, taxpayer considers Sub1/Sub2 a division of taxpayer even though Sub1/Sub2 is technically termed a subsidiary. (Taxpayer's Submission at 24, 26, 27).

By making these assertions, taxpayer is trying to analogize its situation to that of the parent corporations in L. Heller and Sons, Inc. v. Commissioner, 12 T.C. 1109 (1949), acq. 1949-2 C.B. 2, and Coulter Electronics, Inc. v. Commissioner, T.C. Memo. 1990-186, aff'd, 943 F.2d 1318 (11th Cir. 1991). Taxpayer, in its attempt to analogize to L. Heller and Sons, Inc., argues that because it and Sub1/Sub2 were viewed as a single, interrelated entity, a poor credit report on one would naturally affect the other. Taxpayer claims that in order to protect and maintain its outstanding credit standing, it needed to pay the judgment. (Taxpayer's

Submission at 24). According to taxpayer, because the two entities are viewed by their customers as one single, interrelated entity, a poor credit report on one would naturally affect the other and damage to Sub1/Sub2's credit history would have a negative effect on taxpayer's relations with its suppliers and creditors. Thus, taxpayer argues it was required to make the payment in order to maintain its excellent credit.

In L. Heller and Sons, Inc., the parent corporation, engaged in the business of manufacturing and dealing in jewelry, was allowed to deduct the amount paid for debts of its wholly-owned subsidiary which had undergone a bankruptcy reorganization. The payment was made to protect the parent's standing in the business community, its relationship to the jewelry trade generally, and most importantly, its credit rating. Because the payments were calculated to "protect and promote" the parent's business, the court found the payments were deductible, either as a loss or a business expense. We believe taxpayer's case is not analogous.

With respect to taxpayer's claim that Sub1/Sub2 are considered a division of taxpayer, the only evidence taxpayer offers is an organizational chart. Admittedly, taxpayer does have a website. However, the website does not refer to Sub1/Sub2 as a division, but a subsidiary. There is no reference to Sub1/Sub2 being considered a division of taxpayer. In fact, you have to click on a separate hyperlink in taxpayer's website to reach Sub1/Sub2's internet site. We do note that the Sub1/Sub2 site directs any inquiries about Sub1/Sub2 products or capabilities to a local "Taxpayer Representative."

Although, it could be argued that taxpayer has an integrated web-site, we do not believe this is sufficient to establish the two companies are a single, interrelated entity as taxpayer claims. For example, we find it significant that taxpayer and Sub1/Sub2 attended numerous European trade shows not as a single entity, but rather as separate corporations. Taxpayer provided this information in the form of internal newsletters called [redacted] attached to Taxpayer's Submission. The Service received copies of [redacted] such newsletters covering the years [redacted] and [redacted]. Of the [redacted] trade shows listed in the newsletters, taxpayer and Sub1/Sub2 attended only one show jointly as taxpayer and Sub1/Sub2. Taxpayer and Sub1/Sub2 attended the other [redacted] shows separately, either as Taxpayer or Sub1/Sub2. If as taxpayer claims, the marketplace views taxpayer and Sub1/Sub2 as one entity, why would the companies attend trade shows separately? It seems logical that companies viewed as one entity would attend most if not all trade shows jointly. Because this was not the case for taxpayer, over a period of at least two years, we believe there is a strong argument that taxpayer and Sub1/Sub2 are not as interchangeable as taxpayer asserts.

Furthermore, even if taxpayer and its subsidiaries are linked in advertising and reputation, taxpayer has not established that paying the judgment was a business necessity aimed at protecting and promoting its reputation. As discussed earlier, Sub1 could have and did pay the judgment against Sub1/Sub2 for taxpayer. Consequently, taxpayer was not required to pay the judgment in order to maintain its outstanding credit. Thus, unlike the taxpayer in L. Heller and Sons, Inc., taxpayer has provided no evidence to prove the failure to reimburse Sub1 for the legal judgment would have harmed its reputation or credit rating which in turn would have adversely affected its own business.

Finally, we turn to taxpayer's claim that it warranted Sub1/Sub2's products and services like the taxpayers in Coulter Electronics, Inc. v. Commissioner, T.C. Memo. 1990-186, aff'd, 943 F.2d 1318 (11th Cir. 1991). Taxpayer argues that each company performed warranty work on the other's products and because the companies were viewed as one and operated as one, had taxpayer permitted Sub1/Sub2 to fail, it would have suffered in its ability to provide warranty services to its own customers. Consequently, taxpayer argues that payment of the legal judgment was necessary to protect or promote its own business as in Coulter Electronics, Inc.

In Coulter Electronics, Inc., the parent corporation was allowed to deduct reimbursements made to Coulter Electronics of Canada, Inc. (CEC), a wholly-owned Canadian subsidiary, for certain warranty expenses under section 162. The Tax Court found the warranty services performed by CEC would affect the parent's sales, and, therefore, the reimbursements were "directly related" to the parent's own business and deductible by the parent.

To begin with, we find it significant that you question whether the corporations performed warranty work on each other's products at all. On its [redacted] and [redacted] federal income tax returns, you state taxpayer claimed no deductions for warranty expenses, and on its [redacted] income tax return, it claimed a total warranty expense of $[redacted]. Additionally, Exam informed you that taxpayer's website instructs customers to send products that had been purchased from taxpayer to the taxpayer's location in the United States and does not mention products from Sub1/Sub2.

We also note the following possible argument. Taxpayer was established in [redacted] and apparently has been providing warranty services for a significant length of time prior to its acquisition of Sub1/Sub2 in [redacted] Arguably, even without Sub1/Sub2, taxpayer would have continued to provide existing warranty services to its customers as it had prior to its acquisition of the subsidiaries. Furthermore, since Sub1 was operational, Sub1 could have picked up Sub2's warranty work instead of taxpayer. It seems unlikely taxpayer would have suffered in its ability to provide warranty services to its own customers had it not paid the judgment.

In sum, we are unconvinced taxpayer's payment of the subsidiaries' legal judgment was predicated on business necessity or in any way directly benefitted its own business. Taxpayer's Submission focuses on the importance of Sub1/Sub2 to taxpayer and the many benefits realized by taxpayer from Sub1/Sub2. Although we do not doubt Sub1/Sub2 provided benefits to taxpayer, it has failed to demonstrate that these benefits would have been lost, and that such loss would have adversely affected taxpayer's business had it not paid Sub1 for the legal judgment. Again, we stress the importance of taxpayer's letter to Sub1 indicating taxpayer's decision to pay Sub1 for the legal judgment was motivated by a sense of fairness, not a need to protect its own business. Accordingly, we concur taxpayer has failed to establish its business would have been harmed had it not paid the legal judgment. The payment was not warranted or motivated by the need to protect or promote its own business and any benefit enjoyed by taxpayer from paying the judgment was merely an incidental or indirect one inured to it from aiding a subsidiary. Therefore, we conclude taxpayer's payment is not deductible under section 162 by taxpayer. Rather, it should be considered a contribution to capital.

If you have any further questions, please call the branch telephone number.

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