Office of Chief Counsel
Internal Revenue Service

Memorandum

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subject:

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

Taxpayer Sub =

Old Co =

Sub =

Transfer Co =

New Co =

Substance =

A =

B =

State C =

$X =

Y% =

Z =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Month 1 =

Month 2 =

Year 1 =

Year 2 =

Year 3 =

ISSUES

(1) Whether amounts paid by Taxpayer Sub in settlement of a fraudulent conveyance claim qualify as trade or business expenses under § 162 of the Internal Revenue Code or amounts paid to defend or perfect title to real or personal property that must be capitalized under § 1.263-2(e)(1) of the Income Tax Regulations?

(2) If any of the amounts Taxpayer Sub paid in settlement of a fraudulent conveyance claim qualify as trade or business expenses under § 162, whether they are attributable to product liability for purposes of qualifying as specified liability losses under § 172(f)?

CONCLUSION

(1) The amounts paid by Taxpayer Sub in settlement of a fraudulent conveyance claim are capitalizable under § 1.263-2(e)(1) as amounts paid to defend or perfect title to real or personal property.

(2) The amounts paid by Taxpayer Sub in settlement of a fraudulent conveyance claim do not qualify as specified liability losses under § 172(f) because they are not deductible under § 162.

FACTS

Old Co was in the A business through its subsidiary, Sub. Many of the products Sub produced contained Substance. Sub was also in the B business.

In Month 1, Old Co entered into a series of steps in a reorganization with the intention of separating the A business from the B business, and merging the B business with Taxpayer. Sub created a new, wholly owned subsidiary, temporarily referred to as Transfer Co and ultimately named Taxpayer Sub. Sub transferred all of its assets and liabilities relating to the B business to Transfer Co in exchange for stock in Transfer Co, in a transaction intended to qualify under § 351. The stock of Transfer Co was then distributed to Old Co. Old Co formed a new, wholly owned subsidiary, New Co, and transferred the stock of Sub (which then consisted largely of A business) to New Co. Old Co then spun off New Co to its shareholders in a transaction intended to qualify under § 355 and § 368. As a result, Old Co was left with the stock of Transfer Co as its primary or sole asset. Old Co then merged with Taxpayer and Transfer Co was renamed Taxpayer Sub.

At the time of the merger, Old Co and Sub were defendants in numerous lawsuits for both personal injury and property damages due to Substance. Since the beginning of Year 2, Taxpayer was also the defendant in a number of lawsuits alleging that, as a result of the reorganization, it was responsible for the Substance liabilities of New Co and its subsidiaries. The basis of these suits against the Taxpayer was either that the transfer of the B business was a fraudulent transfer or that the transaction resulted in successor liability.

On Date 1, New Co and its domestic subsidiaries, including Sub, filed for relief under Chapter 11 of the Bankruptcy Code. The Court included in the automatic stay not only litigation against New Co, but any current and future litigation against Taxpayer and Taxpayer Sub related to the Substance liabilities of New Co and its subsidiaries or alleging fraudulent transfer claims.

The Court established two creditor committees, one for Substance personal injury claims, and the other for Substance property damage claims. Although a stay had been entered with respect to prior Substance litigation, the Bankruptcy Court overseeing New Co's petition for chapter 11 relief authorized the two committees representing persons with Substance-related claims to pursue litigation against Taxpayer and Taxpayer Sub with respect to any claims arising from the "transfers", described in the committees' complaint as "(1) the transfer by [Sub] in [Year 1] of its most valuable and profitable operating business (the "[B] Business") to a subsidiary, and (2) the transfer of the subsidiary's stock to its then parent, [Old Co], for wholly inadequate and insufficient consideration." The creditor committees filed the complaint on Date 2.

The creditor committees brought the complaint on behalf of the bankruptcy estate under 11 U.S.C. § 544(b) and other applicable law for the purpose of avoiding the transfers, recovering the property transferred or the value of such property for the benefit of the bankruptcy estate and its creditors, and subjecting Taxpayer and Taxpayer Sub to liability for Substance-related claims against New Co. The creditors did not base their claims upon the fraudulent transfer section of the bankruptcy code, 11 U.S.C. § 548. Instead they based their claims upon the "applicable law" clause of 11 U.S.C. § 544(b), which allows a trustee to avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under "applicable law" by allowable unsecured creditors. They sought a finding that state law causes of action under the Uniform Fraudulent Conveyance Act and the Uniform Fraudulent Transfer Act as adopted in State C be the applicable law under 11 U.S.C. § 544(b).

The complaint listed nine counts. The first three counts alleged constructive fraudulent transfer, which did not include allegations of intentional fraud. The remaining counts included allegations of fraudulent purpose. Count IV was an allegation of intentional fraudulent transfer. Count V alleged successor liability on the grounds that the transfers were undertaken for the fraudulent purpose of escaping Substance-related claims, and asserted that Taxpayer and Taxpayer Sub succeeded by operation of law to unlimited liability for Substance-related claims against Old Co or Sub. Count VI alleged that the corporate veil was pierced because New Co, Sub, and Transfer Co lacked any separate mind, will, or existence of their own and similarly asserted unlimited liability for New Co's Substance-related liabilities. The remaining counts consisted of breach of fiduciary duty, avoidance of transfers to insiders received in breach of fiduciary duty, and punitive damages.

The Bankruptcy Court issued a key ruling on Date 3, which held that the Uniform Fraudulent Transfer Act as enacted by the State C governed as "applicable law" under 11 U.S.C. § 544(b). The State C Uniform Fraudulent Transfer Act allows avoidance of the transfer and any other relief the circumstances may require. Based on the allegations in the complaint, the Court characterized the claims at bar as "state-law causes of action authorized and incorporated into the bankruptcy proceeding" by 11 U.S.C. § 544(b). The Court set the case for trial on Date 4, and ordered that only the allegations of constructive fraudulent conveyance be tried at that time.

The primary issue for the Bankruptcy Court was whether New Co was insolvent or rendered insolvent as a result of the transfer. The Court held that in determining whether New Co was insolvent at the time of the transfer, claims filed after the transfer date could be considered in determining New Co's solvency. Liabilities were not limited to those which could be or were reasonably estimated by New Co at the time of the transfer, and included latent liabilities that emerged in the future.

The insolvency ruling was among the factors which precipitated a settlement of the case, which was effectuated in a settlement agreement executed on Date 5 and approved by the Bankruptcy Court on Date 6. It was scheduled to be implemented upon confirmation of a plan of reorganization. Due to objections, the joint plan was not confirmed until Month 2.

The final plan incorporated the terms of the settlement. The settlement provided for Taxpayer Sub to transfer the sum of $X million in cash, plus interest thereon from Date 7 until paid, at a rate of Y% per annum compounded annually, together with Z million shares of Taxpayer's common stock, subject to certain adjustments, in exchange for a release from all claims under the litigation, as well as any claims asserted against Taxpayer and Taxpayer Sub in any separate action (including claims of successor liability, alter ego, and fraudulent conveyance) that had been stayed as a result of the bankruptcy proceeding. Taxpayer Sub was to make these payments directly to one or more trusts. The transfers were not avoided and the assets transferred to Transfer Co were not returned to Sub, nor put into the trusts. The parties intended that the trusts would qualify as qualified settlement funds under § 468B of the Internal Revenue Code. The settlement did not state an allocation of the transferred amounts amongst the various claims in the complaint. Taxpayer Sub made the payments into the trusts in Year 3.

Taxpayer has requested a Pre-Filing Agreement for the Year 3 taxable year. It seeks approval of its intention to deduct, on its Year 3 consolidated income tax return, the amounts transferred to the qualified settlement funds pursuant to the settlement (the cash and the fair market value of the stock), exclusive of interest, as a § 162 expense, and to carryback the loss to the preceding tax years as a specified liability loss under § 172(f).

LAW AND ANALYSIS

Issue (1):

Section 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

Section 263(a)(1) provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

Section 1.263-2(e)(1) provides that amounts paid to defend or perfect title to real or personal property are amounts paid to acquire or produce property within the meaning of this section and must be capitalized.

The first issue is the tax treatment of fraudulent conveyance claims under the origin of the claim test established in United States v. Gilmore, 372 U.S. 39 (1963). This test generally is applied to determine whether an amount incurred in litigation is currently deductible under § 162(a). See also Woodward v. Commissioner, 397 U.S. 572 (1970); United States v. Hilton Hotels Corp., 397 U.S. 580 (1970). In Gilmore, the Court held 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 [is] 'business' or 'personal' and hence whether it is deductible or not...". Gilmore at 49. Thus, the substance of the underlying claim or transaction out of which the expenditure in controversy arose governs whether the item is a deductible expense or a capital expenditure, regardless of the motives of the payor or the consequences that may result from the failure to defeat the claim. Woodward v. Commissioner, at 578; Newark Morning Ledger Co. v. United States, 539 F.2d 929, 935 (3d Cir. 1976); Clark Oil & Ref. Corp. v. United States, 473 F.2d 1217, 1220 (7th Cir. 1973); Anchor Coupling Co. v. United States, 427 F.2d 429, 433 (7th Cir. 1970).

In applying the origin of the claim test, the taxpayer's purpose in undertaking or defending a particular piece of litigation is not relevant. Woodward at 578. The origin of the claim test is an objective inquiry to determine the origin and character of the claim, taking into account all of the facts and circumstances; it is not a test dependent on the formal titles to pleadings or subjective motives. Thus, while amounts paid by a business in connection with business-related litigation generally are deductible as ordinary and necessary expenses under § 162, amounts with their origin in a capital transaction are required to be capitalized under the origin of the claim test. Thus, payments made in settlement of a lawsuit or potential lawsuits are generally deductible under § 162 if the acts that gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business. See Rev. Rul. 80-211, 1980-2 C.B. 57, and the authorities cited therein. However, litigation costs incurred to defend or perfect title to property are capital expenditures that are not deductible as ordinary and necessary business expenses under § 162. Section 1.263-2(e)(1).

The origin of the claim test does not involve a "mechanical search for the first in the chain of events" but requires consideration of the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the amounts claimed as deductions were expended, and all other facts relating to the litigation. Boagni v. Commissioner, 59 T.C. 708, 713 (1973). Thus, it is inappropriate to look past the fraudulent conveyance claims stated in the complaint to the first in the chain of events that was the reason for the reorganization and transfer of assets to Taxpayer Sub, that is, avoidance of potential Substance liability. Rather, we look to the nature and objectives of the litigation as evidenced by the nine counts of the complaint and other language in the complaint to determine the origin of the claims.

Four of the nine counts included claims for intentional or constructive fraudulent transfer. An intentional fraudulent transfer is a transfer made or an obligation incurred with the intent to hinder, delay, defraud creditors. 5 Collier on Bankruptcy, par. 548.01 at 548-8. A claim for constructive fraudulent conveyance is an assertion that assets have been unfairly or improperly transferred from the debtor, often for inadequate consideration at a time when the debtor is insolvent or nearly so (or made insolvent by the asset transfers), thereby unfairly draining the pool of assets available to satisfy creditors' claims from the debtor's bankruptcy estate; intent to defraud is not required. 5 Collier on Bankruptcy, par. 548.01-548.01[1], at 548-9, 548-10. Any claim for fraudulent conveyance seeks to set aside a transfer and return the disputed property to the bankruptcy estate for the benefit of creditors. Grace v. Bank Leumi Trust Co., 443 F.3d 180, 189 (2nd Cir. 2006) ("The proper remedy in a fraudulent conveyance claim is to rescind, or set aside, the allegedly fraudulent transfer, and cause the transferee to return the transferred property to the transferor.")

The settlement agreement does not allocate the amounts amongst the various claims. To the extent that settlement amounts are attributable to the four fraudulent conveyance claims, they are not deductible under § 162 based on the application of the origin of the claim analysis described above and the applicable caselaw. United States v. Collins (In re Collins), 26 F.3d 116, 118-119 (11th Cir. 1994), revg. on other grounds United States v. Collins (In re Collins), 1992 U.S. Dist. LEXIS 13523, 16-17 (N.D. Fla. 1992) ("The IRS argues that the claim had its origin in a fraudulent conveyance action which is, in essence, a defense of a challenge to title and is subject to the capitalization requirements of § 263"). Fraudulent conveyance claims have their origin in a defense of title to real or personal property under § 1.263-2(e)(1) because they seek to restore improperly transferred property back to the bankruptcy estate; the dispute in each claim is over ownership of, or title to, property. Hauge v. Commissioner, T.C. Memo. 2005-276 (2005) ("we conclude that petitioner paid her share of the settlement payment to preserve or protect her title to real estate and other personal assets against the Government's claim that those assets had been fraudulently conveyed to her."); D'Angelo v. Commissioner, T.C. Memo. 2003-295 ("neither *** involved a dispute as to the validity of ownership interests, or involved a claim to set aside a fraudulent conveyance, as in Lin where the Court concluded that the origin of the claim was to protect, defend, or restore the taxpayers' interest in the stock of the corporations or in other property), citing Lin v. Commissioner, T.C. Memo. 1984-581 (legal fees in two lawsuits, one to recover real property fraudulently conveyed by deed, and one to protect or defend their proportionate interest in the ownership of the stock of the corporations must be capitalized because the costs were incurred to protect, defend, or restore title to property). In contrast, in Scofield v. Commissioner, T.C. Memo 1997-547, the Court applied the origin of the claim analysis to determine the character of a settlement payment stemming from litigation out of claims the petitioner's business creditors brought against him for payment of debts that arose in the ordinary course of their business dealings with petitioner's corporation. In defending against these claims, petitioner was not defending or perfecting title to property. The legal fees were deductible under § 162 since these fees were related to the ordinary conduct of petitioner's business. The Court distinguishes In re Collins because that case involved settlement payments related to a prepetition transfer of property whereas in Scofield the legal fee paid was to defend against claims of creditors for business debts arising from a legal proceeding separate from petitioner's bankruptcy case.

Where a settlement payment has its origin in a fraudulent conveyance claim the essence of the action is a claim for the return of property or a payment in lieu thereof. Part of the controversy settled in this case is over a dispute regarding ownership of property. Amounts paid in settlement of such claims are capital in nature. Therefore, amounts attributable to the four fraudulent conveyance claims are not deductible under § 162.

Issue (2):

Section 172(b)(1)(A)(i) provides that except as otherwise provided in this paragraph, a net operating loss for any taxable year shall be a net operating loss carryback to each of the 2 taxable years preceding the taxable year of the loss.

Section 172(b)(1)(C) provides that in the case of a taxpayer which has a specified liability loss (as defined in subsection (f)) for a taxable year, such specified liability loss shall be a net operating loss carryback to each of the 10 taxable years preceding the taxable year of such loss.

Section 172(f)(1)(A) defines the term "specified liability loss" to mean, in part, the sum of the following amounts to the extent taken into account in computing the net operating loss for the taxable year: any amount allowable as a deduction under §162 or §165 which is attributable to (i) product liability, or (ii) expenses incurred in the investigation or settlement of, or opposition to, claims against the taxpayer on account of product liability.

Section 172(f)(4) defines the term "product liability" to mean the liability of the taxpayer for damages on account of physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer, but only if such injury, harm, or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product.

Section 1.172-13 defines the term "product liability" to mean the liability of a taxpayer for damages resulting from physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer. The preceding sentence applies only to the extent that the injury, harm, or damage occurs after the taxpayer has completed or terminated operations with respect to the product, including, but not limited to the manufacture, installation, delivery, or testing of the product, and has relinquished possession of such product.

Pursuant to § 172(f)(1)(A), an amount can only qualify as a specified liability loss if it is deductible under §162 or §165. As amounts attributable to fraudulent conveyance claims are not deductible under either section, they do not qualify as a specified liability loss.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

This Chief Counsel Advice addresses only the facts pertaining to the Taxpayer. This office does not opine on any situation outside the facts set out above.

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Please call me or Lewis Saideman at (202) 317-5100 if you have any further questions.