Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:JAX:[redacted]:TL-N-5341-00
[redacted] ID# [redacted]:[redacted]

date: JAN 29 2001

to: Team Manager [redacted], LMSB Group [redacted] - [redacted]
(Financial Services and Health Care Division)

from: Associate Area Counsel (LMSB) Area [redacted] - [redacted]

subject: [redacted]
EIN: [redacted]
Cycle: [redacted]
Revision/Amplification to Advisory Opinion

The purpose of this memorandum is to amplify and clarify a portion of a previous Advisory Opinion which was issued to the Internal Revenue Service by memorandum from this office dated November 3, 2000. A copy of the prior Advisory Opinion is attached hereto and incorporated herein by reference. While this memorandum does not change the ultimate conclusion reflected in the prior memorandum (that the legal fees incurred by a predecessor to the above-referenced taxpayer to collect an amount certain from the [redacted] were incurred in connection with the acquisition of a capital asset and thus constitute a capital expense which is not currently deductible), this memorandum is necessary to clarify the position of the Service which supports that conclusion.

The instant memorandum also serves to add a brief discussion regarding the possibility that the taxpayer has changed its method of accounting without prior permission of the Service in violation of I.R.C. § 446(e). This discussion follows and confirms prior discussions between Revenue Agent [redacted] and the undersigned during our prior consideration of this matter, during which Revenue Agent [redacted] indicated that he was aware of and would address this issue.

This memorandum follows review of our earlier memorandum by our national office and incorporates their comments thereon.

ISSUES

1. Whether a "but for" or similar proximate cause analysis should be considered in applying the "origin of the claim doctrine"?

2. Whether the Service should, during the ongoing examination, consider and address whether the claimed current deductions for the capital expenditures discussed in this and the prior memorandum constitute a change in the taxpayer's method of accounting without prior permission of the Internal Revenue Service in violation of I.R.C. § 446(e)?

CONCLUSIONS

1. A "but for" or similar proximate cause test does not comport with a proper origin of the claim analysis. Rather, the characterization of an expense as either related to the taxpayer's trade or business (i.e. currently deductible) or as incurred in connection with the acquisition of a capital asset (which must be amortized or added to the basis in the asset) requires case-by-case analysis of the relationship between the claim to which the expense relates, the asset acquisition and/or the trade or business activities of the taxpayer.

2. It appears that the taxpayer, in claiming current deductions for some costs associated with the acquisition of a capital asset, **may** have committed a change in its method of accounting without prior permission of the Internal Revenue Service in violation of I.R.C. § 446(e). We thus recommend that the Service consider raising this issue in the ongoing examination.

FACTS AND ANALYSIS

In our prior opinion (a copy of which is attached), we responded to a question posed by the Service regarding claimed deductions for legal fees which the taxpayer (and its predecessor) incurred in bringing a lawsuit to collect sums due from the [redacted]. We agreed with the position of the Service that those expenses are not currently deductible; rather those expenses were incurred in connection with the acquisition of a capital asset and thus must be amortized over the life of the asset or added to the tax basis of the asset. In reaching that conclusion, we determined that the expenses were incurred in connection with the taxpayer's acquisition of a capital asset, and cited Woodward v.

Commissioner, 397 U.S. 572 (1970) for the proposition that such expenses must be considered capital expenditures if the claim which resulted in the accrual of the legal fees at issue originated during the process of acquiring the asset (the "origin of the claim doctrine").

Application of the "origin of the claim doctrine" to the issue presented was proper. However, in applying that doctrine to the fact of this case, we reasoned that the legal fees at issue were capital in nature because they would not have been incurred "but for" the transaction whereby the taxpayer acquired the capital asset. The use of this "but for" analysis in this context does not comport with Service position or established law. *See*, Collins v. United States, 26 F. 3d 116, 118 (11th Cir. 1994), which examined the use of a "but for analysis" (which can also be referred to as a "proximate cause analysis") in the context of determining whether payments made during a bankruptcy proceeding were deductible as ordinary and necessary business expenses.[1] Rather, proper application of the origin of the claim doctrine requires examining the **character** of the claim and its **origin**; i.e., as applies to the instant case, did the claim arise in connection with the trade or business of the taxpayer or in connection with the acquisition of the capital asset? *See*, Collins, 26 F.3d at 118.

There follows our revised analysis, under the origin of the claim doctrine, of the legal fees which the taxpayer incurred in order to collect funds due from the [redacted]. Examination of both the character and the origin of the taxpayer's claim against the [redacted] clearly indicates that the claim arose in connection with the taxpayer's acquisition of a capital asset (the bank acquired) rather than in connection with the taxpayer's trade or business. Thus, while collection expenses may in some cases be deductible (for example, if the taxpayer incurred expenses to collect amounts due on a mortgage which it held), these particular expenses must be capitalized. We note in this respect that while the conclusion remains the same as in our prior memorandum, proper application of the claim of origin doctrine could, under certain circumstances, provide a different result than use of a "but for" or proximate cause analysis. We thus suggest that you not rely on that aspect of the prior memorandum in this or in any future case.

---

[1] While Collins utilized the "origin of the claim doctrine" to determine whether an expense was personal or business, the same test is utilized in determining whether an expenditure is capital or business. *Compare* United States v. Gilmore, 372 U.S. 39 (1963) *with* United States v. Woodward, 572 U.S. 397 (1970).

We also wish to take this opportunity to point out that the claimed deductions which are discussed in both the prior and instant memoranda appear to be inconsistent with the manner in which the taxpayer's predecessor (referred to as [redacted] in the prior memorandum) treated those exact same expenses. Based upon our conversations with R.A. [redacted], we understand that [redacted] capitalized all of these same legal fees on the last return which it filed prior to being acquired by the taxpayer ([redacted]).[2]

The treatment of a material item in the same way on two or more consecutively filed tax returns represents consistent treatment of that item and constitutes a method of accounting with respect to that item. *See*, Diebold, Inc. v. United States, 891 F.2d 1579 Fed. Cir. 1989) and Rev. Proc. 90-38, 1990-1 C.B. 57.[3] Moreover, the manner in which the taxpayer treats an item on the first return which reflects the item (which here would be the [redacted] return), if that treatment is proper, can be used to establish a method of accounting, even if the taxpayer treats that item inconsistently on the very next return (i.e. a two-year pattern is not necessary under this scenario). *See*, Treas. Reg. § 1.446-1(e)(1) and Rev. Proc. 90-38, 1990-1 C.B. 57; *see also* Pacific National Co. v. Welch, 304 U.S. 191 (1938).

I.R.C. § 446(e) provides that a taxpayer must receive prior permission from the Service before changing its method of accounting.[4] Treas. Reg. § 1.446-1(e)(2)(ii)(a) provides, inter alia, that a change in a taxpayer's method of accounting includes a change in the treatment of any "material item" used in the overall plan of accounting. A "material item" is defined in that subsection as any item which involves the proper time for the taking of a deduction. There can be no question that the

---

[2] We also understood at the time of that conversation that R.A. [redacted] intended to secure prior returns of [redacted] (dating back to the year in which the first such fees were incurred, which we understand to be [redacted]) to establish that [redacted] consistently treated these expenditures as capital in nature.

[3] We note that consistent treatment of an item on two or more returns, even if erroneous, constitutes a method of accounting for that item. *See*, Treas. Reg. § 1.446-1(e)(2)(iii), Examples (6)-(8); *see also* Fruehauf Corp. v. Commissioner, 356 F.2d 975 (6th Cir. 1966), *cert. denied*, 385 U.S. 822 (1966).

[4] Various penalties may attach if a taxpayer changes its method of accounting without the required prior permission. See, I.R.C. § 446(f) for rules utilized in determining the applicability of any such penalties.

treatment of the legal fees at issue as a capital expense or as a deduction represents a material item for purposes of section 446(e).

We encourage the Service to determine whether [redacted] did in fact capitalize these expenses on returns prior to the last return filed before the acquisition. If the Service can establish in this manner either that [redacted] capitalized these expenses on the [redacted] return (the first return on which these expenses were incurred) or on the [redacted] return (which, in conjunction with the [redacted] return which is already in the possession of R. A. [redacted], would establish a two-year pattern), it would be clear that the taxpayer's claimed current deductions for these same fees on the return currently under examination constitutes a change in the taxpayer's method of accounting within the meaning of I.R.C. § 446(e).

Treas. Reg. § 1.466-1(e)(3)(i) provides generally that a taxpayer must secure prior consent to change its method of accounting by filing an application with the Service on Form 3115 (Application for Change in Accounting Method) within 180 days after the beginning of the tax year in which the taxpayer desires to make the change. To our knowledge, no such request was made by the taxpayer in the instant case.

Based upon the inconsistent treatment of the legal fees at issue on subsequent returns, we believe that it is in the best interest of the Service to continue its consideration of whether the taxpayer has in fact changed its method of accounting without the permission of the Service as regards these legal fees in violation of section 446(e).

This writing contains privileged information. Any unauthorized disclosure of this writing will have an adverse affect on privileges, including the attorney/client privilege. If disclosure becomes necessary, please contact this office for our views.

Please feel free to contact the undersigned at [redacted] if you wish to discuss this matter further or if you seek any further assistance regarding this issue.

[redacted]
ASSOCIATE AREA COUNSEL (LMSB)
[redacted]

By: /s/ [redacted]
[redacted]
Senior Attorney (LMSB)

Attachment:
Copy of Memorandum dated November 3, 2000, as indicated

cc: Grace Matuszeski
CC:DOM:FS:IT&A

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:JAX:[redacted]:TL-N-5341-00
[redacted]

date: NOV 03 2000

to: Team Manager LMSB Group [redacted] ([redacted]
(Financial Services and Health Care Division)

from: Associate Area Counsel (LMSB) Area [redacted]

subject: [redacted]
EIN: [redacted]
Cycle: [redacted]
Advisory Opinion

This responds to your inquiry regarding this case and confirms recent telephone conversations between the undersigned, Team Manager [redacted], and Revenue Agent [redacted].

ISSUE

Whether fees paid by the taxpayer for legal services constitute deductible expenses under I.R.C. §§ 162 and/or 212 or capital expenditures which are not currently deductible under I.R.C. § 263?

CONCLUSION

There are two separate and distinct categories of legal fees which the taxpayer has grouped together and seeks to deduct. While we agree with your position that neither category is currently deductible, we discuss below each category separately since our analysis for each is slightly different.

The first category of fees discussed in this memorandum are legal fees which the taxpayer incurred in establishing a "Final Purchase Price" in connection with its acquisition of [redacted]. These fees constitute ancillary expenses which were incurred in connection with the acquisition of a capital asset. These expenses are thus not currently deductible; we agree with your proposed disallowance of the claimed deduction relating to these fees.

The second category of fees for which the taxpayer seeks a deduction are legal fees which were incurred to collect an amount certain from the [redacted] as the guarantor of the Receiver. We believe that these fees, which clearly would not have been incurred but for the acquisition of a capital asset, are also capital expenses which are not currently deductible. We thus agree with your proposal to disallow the claimed deduction for these fees as well.

FACTS

Your audit team is examining the above-referenced taxpayer's Form 1120 for the taxable year ended [redacted]. That return reflects a deduction for legal fees which were, as is discussed in greater detail below, incurred in connection with the taxpayer's acquisition of [redacted] You propose to disallow the claimed deduction (in the amount of $[redacted] on the basis that the fees are capital in nature; such fees must thus be capitalized as part of the cost of the asset acquired.

Our legal conclusion is based on an understanding of the context in which the fees at issue were incurred. Thus, there follows a fairly detailed recitation of facts setting forth relevant information regarding the underlying transaction (the taxpayer's acquisition of [redacted] which gave rise to the negotiation and litigation from which stem the fees here at issue.

On [redacted], the Receiver for [redacted] ("Receiver") and [redacted], as the guarantor of the Receiver, entered into a contract titled "Agreement And Plan of Merger" (hereinafter "the Agreement"). The purpose of the Agreement was to enable [redacted] to purchase [redacted], including all of its operations, from the Receiver so that [redacted] could be merged into the corporate structure of [redacted].[1] Under the agreement, the [redacted] guaranteed all obligations of the Receiver pertaining to the contract.

---

[1] As is further discussed below, your taxpayer ultimately acquired the corporate entity which survived following the acquisition of [redacted] by [redacted].

Pursuant to the express terms of the Agreement, [redacted] paid to the Receiver at closing a "Preliminary Purchase Price" of almost $[redacted] in cash. Under the Agreement, this "Preliminary Purchase Price" would later be adjusted to a "Final Purchase Price", to be determined following an independent audit to be performed by a specified public accounting firm. The Agreement provided that the parties could file with each other claims seeking appropriate adjustments of the preliminary price. In the event the "Final Purchase Price" exceeded the "Preliminary Purchase Price" which had already been paid, the Receiver (and, pursuant to it's guarantee, the [redacted]) was contractually bound to refund the difference to [redacted]. The Agreement provided that the effective date of the acquisition and merger of [redacted] could occur prior to the determination of the final price; the contract would not be finally closed, however, until the final price had been determined.

The independent audit of [redacted] resulted in a determination that the bank's liabilities were actually greater than the liabilities which had been utilized to compute the "Preliminary Purchase Price" and that a downward adjustment to the preliminary price was thus necessary. In accordance with the terms of the Agreement, [redacted] provided to the Receiver a written claim seeking this downward adjustment (i.e., a refund of amounts already paid) to the "Preliminary Purchase Price" of about $[redacted]. The amount of this claim included about $[redacted] for "servicing fees, which are less than normal." The Receiver refunded to [redacted] the amount of this claim, less all of the aforementioned "servicing fees". In other words, the Receiver refunded approximately $[redacted] of the $[redacted] claim. We do not know why the Receiver refused to honor the claim as regards the "servicing fees".

Following the effective date of the acquisition and merger, but prior to determination of the "Final Purchase Price" (i.e., after the Receiver had been paid the "Preliminary Purchase Price" by [redacted]), [redacted] discovered a shortage in a [redacted] custodial account which it had acquired as part of the purchase of [redacted]. [redacted]'s analysis indicated that this shortage had originated prior to the effective date of the acquisition and merger. The shortage was purportedly created by a failure to properly account for and apply to the custodial account monies received by [redacted] from [redacted]. The claimed amount of the shortage as of [redacted] (the effective date of the acquisition) was slightly more than $[redacted]. The independent audit performed for purposes of determining the "Final Purchase Price" apparently did not discover this shortage.

After the effective date of the acquisition and merger but before determination of the "Final Purchase Price", [redacted] also learned that, prior to the effective date, [redacted] out of [redacted] employees of [redacted]'s branch in [redacted] had resigned to accept employment from a competitor. Those [redacted] employees included the manager of the [redacted] office and all of the [redacted] Officers. The Receiver had allegedly not informed [redacted] of this situation during the negotiations which led to the acquisition. Upon determining this alleged discrepancy, [redacted] filed another claim (as per the procedure outlined in the Agreement) with the Receiver, seeking "reimbursement of losses" incurred due to the situation in the [redacted] branch. For reasons unknown, the Receiver did not respond to this claim.

On [redacted], [redacted] filed a lawsuit against the Receiver, [redacted] (as the Receiver's guarantor) and other individuals involved in the circumstances which led to the employees having left the [redacted] office. [redacted] sought through this lawsuit to recover, inter alia, money damages as an adjustment to the preliminary purchase price in accordance with the Agreement.[2] Shortly thereafter, [redacted] filed yet another claim with the Receiver, estimating that it had spent about $[redacted] in attorneys fees and related expenses to pursue this cause of action through the date of the latest claim. As were the prior claims, this claim was neither approved nor denied by the Receiver.

[redacted] filed a subsequent proposal with the Receiver, seeking to settle the above-referenced litigation, along with all of the other outstanding claims which it had filed with the Receiver pursuant to the Agreement. That proposal was neither approved nor denied by the Receiver and [redacted] proceeded to prosecute the lawsuit regarding resolution of its claims. Following final disposition of the lawsuit in its favor, [redacted] filed a claim with the Receiver for the alleged actual legal fees and expenses which it incurred in the above-described litigation involving the [redacted] Branch. The amount of this claim was $[redacted]. The Receiver failed to act on this claim.

[redacted] next filed a lawsuit against the [redacted] (as guarantor of the Receiver) to collect all of the above claims which had arisen from the acquisition of [redacted] from the Receiver. This lawsuit ("the [redacted] lawsuit") was settled in [redacted] of [redacted], with [redacted] agreeing to pay $[redacted] to [redacted] in settlement of all

---

2 [redacted]

outstanding claims by [redacted] against the Receiver. [redacted] allegedly incurred net legal fees regarding all of the above-referenced claims (including fees incurred in connection with the [redacted] lawsuit) in the aggregate amount of $[redacted].

For tax purposes, all of the above-referenced legal fees were capitalized by [redacted] until the [redacted] lawsuit was ultimately settled. Prior to this settlement, but after the [redacted] lawsuit had been filed, [redacted] was acquired by merger with [redacted], your taxpayer. Your taxpayer was substituted as the plaintiff in the lawsuit and inherited the tax benefits and burdens relating to the acquisition of [redacted]. Following settlement of the [redacted] lawsuit, your taxpayer deducted all of the (previously capitalized) legal fees on its consolidated [redacted] Form 1120.

You propose to disallow the entire claimed deduction for legal expenses on the basis that all of those expenses were incurred in connection with the acquisition of [redacted] and are thus capital in nature. The taxpayer has provided a one page "Response" to your proposed adjustment, claiming that the legal expenses were properly deducted as expenses incurred in order to collect an "overpayment" of the purchase price, rather than to determine the proper price of the assets acquired. The taxpayer thus argues that all of the legal fees at issue are properly deducted as "ordinary and necessary" expenses incurred in connection with its trade or business or for the production of income.

DISCUSSION

As you know, capital expenditures are not immediately deductible; such expenditures must be added to the tax basis in the capital asset with respect to which they are incurred and taken into account for tax purposes either through depreciation or by reducing the capital gain (or increasing the loss) when the capital asset is sold or otherwise disposed of. I.R.C. § 263. If an expense is capital, it cannot be deducted as "ordinary and necessary", either as a business expense under I.R.C. § 162 or an expense incurred for the production of income under I.R.C. § 212. Woodward v. Commissioner, 397 U.S. 572 (1970).

Costs incurred in the acquisition or disposition of a capital asset must be treated as capital expenditures for tax purposes. I.R.C. § 263; Treas. Reg. § 1.263(a)-2(a). It is well established that legal, brokerage, accounting and similar costs incurred in connection with the acquisition or disposition of capital assets are capital expenditures; such expenditures must

be added to the tax basis in the asset rather than being currently deducted. See, e.g., Spangler v. Commissioner, 323 F.2d 913 (9th Cir. 1963). The Supreme Court has expressly held that ancillary expenses such as these which are incurred in acquiring or disposing of an asset are as much a part of the cost of that asset as is the price paid for the asset. Woodward, 397 U.S. at 573-574.

Expenses incurred in "defending or perfecting title to property" are also considered to be capital expenditures. Treas. Reg. § 1.263(a)-2(c). In the context of litigation to defend or perfect title to an asset which a taxpayer already owns, the courts have interpreted this regulation to mean that such expenses are capital in nature when the taxpayer's "primary purpose" in incurring the costs is to defend or perfect title to a capital asset. See, e.g., Industrial Aggregate Company v. United States, 284 F. 2d 639 (8th Cir. 1960). However, when the costs are incurred in connection with the **acquisition** of a capital asset, the proper inquiry is whether the claim which resulted in the fees at issue originated during the process of acquiring the asset (the "origin of the claim doctrine"). Woodward, 397 U.S. 572.

In the instant case, we distinguish between two types of legal fees which the taxpayer seeks to deduct as business expenses. First are those expenses which were incurred in determining the claims to be filed with the Receiver, in actually filing those claims, and in pursuing litigation to establish the "Final Purchase Price" after consideration of those claims. It is clear that these fees were incurred by the taxpayer as part of its acquisition of [redacted].

There is no doubt that the asset which was acquired by the taxpayer ([redacted]) is a capital asset. Pursuant to the express terms of the Agreement, the "Final Purchase Price" was to be determined at the conclusion of a specified claim process whereby both parties to the transaction were empowered to claim offsets against the "Preliminary Purchase Price" based upon certain facts as they became known. Indeed, by its terms, the transaction was not complete until final determination of the various claims and offset of those claims against the preliminary price paid.

These fees were incurred by the taxpayer (through its predecessor in interest) in pursuing these claims and in setting the "Final Purchase Price" to be paid for acquisition of the capital asset. "Where property is acquired by purchase, nothing is more clearly part of the process of acquisition than the establishment of a purchase price." Woodward, 397 U.S. at 579. Thus, the fees incurred in determining, filing and defending the

expenses incurred in the acquisition of a capital asset and must be capitalized.

The legal fees which the taxpayer (and its predecessor) incurred relating to the [redacted] lawsuit, though distinct from the fees previously discussed, must also be added to the taxpayer's tax basis in [redacted] rather than being subject to a current deduction. At the time these fees were incurred, the "Final Purchase Price" had been determined. Unlike the fees discussed in the prior paragraph, these fees were not incurred in connection with setting a price for the capital asset which was acquired in this transaction. Rather, these fees were incurred in connection with the taxpayer's (ultimately successful) attempt to collect the amount due from the [redacted] (as guarantor of the Receiver) from the transaction whereby the taxpayer acquired [redacted], a capital asset. Nevertheless, there is no question that these fees would not have been incurred but for the transaction whereby the taxpayer acquired [redacted]. Thus, under the "origin of the claim doctrine", these expenses also relate to the acquisition of the capital asset and must be considered to be capital expenditures.

We have considered the written "Response" which the taxpayer has provided, in which it indicates disagreement with your position on this issue. We disagree with the Response regarding the legal fees discussed in this memorandum. The Response attempts to distinguish the instant case factually from the transaction which was considered by the Supreme Court in the Woodward case. The Response correctly notes that the expenses at issue in Woodward were incurred "to establish the purchase price." Here, according to the taxpayer's Response, the expenses at issue were incurred to collect an "overpayment of the purchase price made pursuant to a purchase price formula that already was in place." Response, ¶ 4. We believe that this statement is, first, with respect to the "pre-[redacted] lawsuit fees", factually misleading and second, that it misstates the legal principle set forth in Woodward.

First, while the Agreement did set forth a "Preliminary Purchase Price", that same Agreement provided that said price was subject to adjustment through a claim process; the acquisition of [redacted] did not become final until that claim process was finalized. The fees here at issue were incurred during this contractual "claim window" which was a necessary part of determining the "Final Purchase Price" ultimately paid for the asset. Thus, these legal fees were paid in connection with determining the price to be paid for the asset acquired. The Agreement itself anticipated that this amount would differ from the "Preliminary Purchase Price" and provided the process by which that difference would be determined. The fees at issue were incurred to prepare

would be determined. The fees at issue were incurred to prepare and file claims with the Receiver and to pursue those claims in subsequent legal actions. These actions were designed to determine the nature and value of the assets acquired within the parameters of the Agreement. Those fees were incurred in an effort to determine the difference between the preliminary price and the final price paid and are thus part and parcel of the acquisition. Contrary to the implication of the taxpayer's Response, these fees were not incurred in collecting this difference from the [redacted].

Our second point of disagreement with the taxpayer's position as set forth in its Response is the taxpayer's attempt to distinguish this case from the holding in Woodward on a factual basis. Those arguments are misplaced with respect to all of the fees at issue. While the facts of the instant transaction do differ somewhat from the transaction which was involved in the Woodward case, this is a "distinction without a difference." United States v. Hilton Hotels Corporation, 397 U.S. 580, 582 (1970). The key determinant in the Woodward analysis (as regards the "pre-[redacted] lawsuit fees") is whether the costs were incurred in connection with determining the final purchase price of a capital asset. Hilton Hotels, Id. As is discussed above, those fees at issue in the instant case were clearly incurred during the claim process and in litigation to determine the purchase price under the formula set forth in the Agreement. The fees incurred in the [redacted] lawsuit were also directly connected to the acquisition of the capital asset and would not have been incurred but for that acquisition. Those fees must also thus be capitalized under the "origin of the claim doctrine".

This writing contains privileged information. Any unauthorized disclosure of this writing will have an adverse effect on privileges, including the attorney-client privilege. If disclosure becomes necessary, please contact this office (prior to making any such disclosure) for our views.

Please feel free to contact the undersigned at [redacted] if you wish to discuss the above or if you desire any further assistance regarding this matter.

[redacted]
ASSOCIATE ARE COUNSEL (LMSB)
AREA [redacted]

By: [redacted]
[redacted]
Senior Attorney (LMSB)