Office of Chief Counsel
Internal Revenue Service

memorandum

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MTRobus

date: November 20, 2002

to: [redacted] Revenue Agent, LMSB
(Hand Delivery)

from: Area Counsel
(Communications, Technology, and Media: Oakland)

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subject: **[redacted] Corporation and Subsidiaries**
EIN: [redacted]
TYE: [redacted] and [redacted]

Disclosure Statement

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

This memorandum responds to a request for advice concerning the deductibility of legal fees claimed by [redacted] Corporation and Subsidiaries on its federal income tax returns for the years ending December 31, [redacted] and [redacted]. This memorandum has been reviewed by our National Office who are in agreement with the conclusion stated herein.

ISSUE

Is [redacted] Corporation and Subsidiaries (hereinafter referred to as either "Taxpayer" or "Bank") entitled to deduct legal fees in the amounts of $[redacted] and $[redacted] in [redacted] and [redacted], respectively, as business deductions under I.R.C. § 162, or are those fees capital expenditures under I.R.C. § 263, deductible under I.R.C. § 165(f)?

CONCLUSION

The legal fees are capital expenditures under I.R.C. § 263, and are not deductible in [redacted] and [redacted]. Such fees may be taken into consideration as a capital loss under I.R.C. § 165(f) when

the closed and completed transaction requirement of Treas. Reg. § 1.165-1(b) is met.

DISCUSSION OF FACTS AND LAW

FACTS

The following facts are based on documents and statements provided by the taxpayer in response to Information Document Requests ("IDRs").

In [redacted], a group of investors consisting of individuals, corporations and partnerships ("[redacted]") entered into a $[redacted] loan agreement with the Taxpayer Bank. The loan was secured by a deed of trust on certain real property located in [redacted] and commonly known as the "[redacted]." In [redacted], the [redacted] provided the Bank with additional collateral in the way of deeds of trust on two other properties known as the "[redacted]" located in [redacted] and "[redacted]" located in [redacted].

In [redacted], the Bank substituted [redacted] as trustee under the deed of trust, and [redacted] subsequently recorded a notice of default against the [redacted] and posted and published notices of trustee's sales which were postponed from time to time.

In [redacted], the Bank entered into a forbearance agreement with the [redacted], and in connection therewith, the Bank caused to be recorded a substitution of trustee and partial reconveyance which substituted the Bank in place of [redacted] as trustee under the deed of trust.

Despite the substitution of trustee and partial reconveyance, the Bank instructed [redacted] to proceed with foreclosure of the [redacted] and [redacted] conducted a non-judicial trustee's sale of the [redacted] on [redacted]. The Bank submitted a successful credit bid at the foreclosure sale in the sum of $[redacted] leaving an unpaid balance of indebtedness of over $[redacted]. On [redacted], [redacted] recorded a trustee's deed in favor of the Bank, and thereafter the Bank proceeded to market the [redacted] for sale. The Bank also foreclosed on the [redacted] and [redacted] and was the successful bidder on both.

On [redacted], the Bank sold the [redacted]

to [redacted] for $[redacted] in cash, and recognized an ordinary gain in the amount of $[redacted] on its [redacted] federal income tax return.

In [redacted] the [redacted] sued the Bank, alleging that once the foreclosure sale of the [redacted] occurred, the anti-deficiency statutes precluded the Bank from foreclosing on the [redacted] and [redacted] to satisfy the remaining debt due under the [redacted] loan. The Bank moved for summary judgment and its motion was granted on [redacted].

Subsequently, on [redacted], the [redacted] sued the Bank, [redacted] and [redacted] in [redacted] Superior Court, seeing to cancel the trustee's sale and quiet title to the [redacted] in favor of the [redacted] on the grounds that the foreclosure sale conducted by [redacted] was void, since [redacted] did not have authority to conduct the sale. The suit also sought, *inter alia*, declaratory relief as to whether the [redacted] were still obligated under the [redacted] and attorney fees.

The appeal brief later filed by the Bank described the Superior Court action as follows:

[redacted]

A trial in Superior Court was held, lasting from [redacted] through [redacted]. On [redacted] the trial court rendered its judgment, determining that the trustee's sale to the Bank was void, cancelling the [redacted] indebtedness to the Bank, and awarding attorney fees to the plaintiffs.

The Bank filed its appeal of that decision in [redacted] which appeal is still pending. On [redacted], both the Bank and [redacted] were sued by [redacted] in Superior Court, [redacted], seeking judgment for damages in the amount of $[redacted]. The status of that action is not known. The legal fees at issue in this case, however, were incurred in connection with the [redacted] suit.

LAW

I.R.C. § 162(a) allows as a deduction "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." To qualify as an allowable deduction under I.R.C. § 162(a), an item must: (1) be paid or incurred during the taxable year; (2) be for carrying on any trade or business; (3) be an expense; (4) be a necessary expense; and (5) be an ordinary expense. *Commissioner v. Lincoln Savings and Loan Association*, 403 U.S. 345, 352 (1971).

The Supreme Court in *Commissioner v. Tellier*, 383 U.S. 687 (1966) described the term "ordinary" in the context of I.R.C. § 162 as follows:

> The principal function of the term "ordinary" in §162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset.
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> *Commissioner v. Tellier*, 383 U.S. at 689.

Under I.R.C. § 263, no deduction is 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. Treas. Reg. § 1.263(a)-2 provides examples of capital expenditures, one of which is the cost of defending or perfecting title to property. Treas. Reg. § 1.263(a)-2(c).

The primary case in this area is *Woodward v. Commissioner*, 397 U.S. 577 (1970). In *Woodward* the Supreme Court was asked to determine whether expenses in connection with appraisal litigation were capital expenditures incurred in the acquisition or disposition of a capital asset. The court held as follows:

> In our view application of the latter regulation [Treas. Reg. § 1.263(a)-2(c)] to litigation expenses involves the simpler inquiry whether the origin of the claim litigated is in the process of acquisition itself.
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> *Woodward v. Commissioner*, 397 U.S. at 583.

In reaching this conclusion, the court relied on its ruling in *United States v. Gilmore*, 372 U.S. 39 (1963) in which the court examined the origin and character of the claim against

the taxpayer in determining that the legal fees of defending a divorce suit were a nondeductible personal expense, even though the outcome of the divorce case might affect the taxpayer's business reputation.

As observed by the Ninth Circuit in *Madden v. Commissioner*, 514 F.2d 1149 (9th Cir. 1975), even though a taxpayer establishes the nexus between the expenses involved and a business or profit-seeking activity, the taxpayer still cannot be sure of deducting the expenses. "Rather an additional question must be answered: Are the expenses 'capital' in nature under section 263? If they are capital, they cannot be deducted as business expense." *Madden v. Commissioner*, 514 F.2d at 1150. The *Madden* court noted that two of the more common situations giving rise to legal fees were particularly relevant to the case before the court: protection of an ongoing business--a commercial orchard--and the purchase and sale of a capital asset--land. In the *Madden* case, the court posited the appropriate standard as follows: "Where legal fees may have been spent to protect a business, the question is whether the 'suit or action against a taxpayer is directly connected with, or, as otherwise stated * * * proximately resulted from, his business * * *.'" [Citation omitted.] *Madden v. Commissioner*, 514 F.2d at 1150. Under the facts in *Madden* the Court found that the underlying lawsuit did not arise from the taxpayer's business but arose out of the need of a governmental agency for the taxpayer's land. The *Madden* court stated that "[i]n using an 'origin and character' test, the court in *Woodward* implied that such a test should be used to characterize litigation expenses whenever its use would be feasible." *Madden v. Commissioner*, 514 F.2d at 1151.

Paraphrasing *Madden*, we believe that the use of such test is feasible in the Bank's case. Here, the origin and character of the litigation producing the legal fees arose out of the foreclosure sale at which the Bank acquired the [redacted]. The legal fees were expended to defend or protect the title to the property and are capital expenditures under Treas. Reg. § 1.263(a)-2(c).

The Service has released a Market Segment Specialization Program audit guide that contains examination techniques for commercial banking. That guide which is titled, *Internal Revenue Service MSSP Audit Technique Guide on Commercial Banking* (July 9, 2001) (hereinafter "Guide") contains advice regarding how expenses related to a foreclosure are treated. According to the Guide, Banks typically refer to foreclosed property as OREO property, which is an acronym for "other real estate owned." OREO property typically is property obtained by

the bank due to the inability of the debtor to pay off a loan. Legal costs and other similar expenses incurred in connection with the foreclosure proceedings increase the basis of the OREO property. A loss realized upon foreclosure is normally deducted as part of the bank's overall bad debt deduction, while a gain is recognized as ordinary income. Under Rev. Rul. 74-159, 1974-1 C. B. 232, real estate acquired by a bank through foreclosure that was not held for the production of rental income but was advertised and sold as soon as possible, was held primarily for sale in the ordinary course of the bank's trade or business within the meaning of section 1221 of the Code and gain or loss from the sale is ordinary gain or loss. Rev. Rul. 74-159 makes it clear that OREO property is not a capital asset as defined in I.R.C. § 1221 for purposes of determining capital gains and losses.

Ordinarily, these legal expenses incurred by the Bank would be considered to be part of the cost of the property and included as part of the basis of the property until sold. In this case, however, the property was sold before the litigation arose and before the legal expenses were incurred. The question, therefore, arises as to how to treat the legal expenses for tax purposes, since in [redacted] and [redacted] there was no cost basis of property to which the legal fees could be added.

We believe that the case of *Rees Blow Pipe Manufacturing Company v. Commissioner*, 342 F.2d 990 (9th Cir. 1965), *aff'g* 41 T.C. 598 (1964) appears to partially answer this question. The facts in *Rees* are as follows. In 1954 Rees decided to expand its facilities, and, in a three-way transaction, it acquired land in Berkeley, California from Stauffer Chemical Company in exchange for its shop premises in San Francisco, which was acquired by Sanfran Company. In 1955 Sanfran brought suit against Rees to recover its out-of-pocket loss resulting from the wilful or negligent concealment of a certain defect which made the building unusable as a garage. Sanfran secured judgment for twenty thousand dollars damages. In its federal income tax return for 1959, Rees claimed a deduction for payment of the judgment and litigation costs. In its return for 1960, Rees claimed a deduction for payment of additional legal costs.

The Internal Revenue Service disallowed the deductions claimed by Rees on the basis that both amounts were capital expenditures which should be added to the basis of Rees' Berkeley property acquired in the three-way transaction. The taxpayer argued for a deduction under either I.R.C. § 162 or I.R.C. § 165. The Tax Court, however, rejected both the taxpayer's and the Commissioner's positions. Citing the cases

of *Arrowsmith v. Commissioner*, 344 U.S. 6, 8-10 (1952) and *Estate of Shannonhouse v. Commissioner*, 21 T.C. 422, 424 (1953), the Court stated as follows:

> If the expenditures of $17,780.93 and $3,712.43 had occurred prior to the sale of the Berkeley property, it may well be that they would have had to be capitalized and added to the basis of such property for future gain or loss. But, having occurred subsequent to the sale of such property, we think, as stated above, the losses take on the nature of capital losses rather than ordinary losses under the three-way agreement of June 25, 1954. Under section 165(f), *supra*, the said capital losses are "allowed only to the extent allowed in sections 1211 and 1212."

The conclusion reached by the court in *Rees* would also be applicable under the facts in this case, except that the "closed and completed transaction" requirement of I.R.C. § 165(a) is missing. Section 165(a) authorizes a deduction for any loss "sustained" during the taxable year and not compensated for by insurance or otherwise. Under Treas. Reg. § 1.165-1(b), a loss is sustained during the year in which the loss occurs as evidenced by closed and completed transactions, fixed by identifiable events, and...actually sustained during the taxable year.

Section 1.165-1(d)(2) of the income tax regulations provides, in part, as follows:

> (i) if a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances.

Treas. Reg. § Section 1.165-1(d)(2)*(i)*. *See also Parmelee Transportation Company v. United States*, 351 F.2d 619 (Ct. Cl. 1965) (where the taxpayer's loss of goodwill was not deductible because there was a reasonable expectation of recovering the amount of the loss in an antitrust suit against the railroads and the firm which succeeded to the business.)

In *Rees* the legal fees and settlement payment were incurred at the conclusion to the litigation. Here, the litigation is unresolved. In fact, the Bank's opening brief on appeal argues that the trial court erred in failing to award the Bank its attorneys' fees. Consequently, for purposes of I.R.C. § 165, the taxpayer has a reasonable prospect of recovering its legal fees, and it cannot, at this time, deduct a loss for them.

Based on the above, our conclusion is that the legal fees incurred by the Bank in [redacted] and [redacted] are capital expenditures, and not deductible in [redacted] and [redacted]. These fees may be deductible under I.R.C. § 165(f) at some time in the future when the closed and completed transaction requirement of Treas. Reg. § 1.165-(1)(b) is met.

Please call me at (415) 744-9217 if you have any questions.

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