Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFP:CHI:1:TL-N-2494-01 Supplemental
RAVillageliu

date: May 14, 2001

to: Team Manager Edna Manson, Group 1532
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from: Rogelio A. Villageliu
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subject: **LO: [redacted] Supplemental Opinion**
EIN: [redacted]
Consolidated Group
Affiliates Involved: [redacted]

Consolidated Group Taxable Years: [redacted]
Disallowance of claimed legal fees; Constructive Dividends.

This is to supplement our opinion to you dated April 23, 2001 to incorporate the recommendations that have been made so far, by the national office. We already provided you with a copy of the national office Informal Field Assistance (Telephone Call) memorandum of May 8, 2001, which we received on May 9, 2001.

This is to further respond to your request for an advisory opinion. You requested an opinion with respect to the proper treatment of moneys paid by the [redacted] consolidated return group, to [redacted], to reimburse him for attorneys' and other fees that he incurred in his own defense, in a series of legal actions brought by [redacted] and others against [redacted] in connection with his fraudulent conduct in the acquisition of certain parcels of land located in [redacted] and improvements thereon (the [redacted] litigation).[1]

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[1]The acquisition involved approximately [redacted] acres of [redacted] property, including [redacted], and [redacted], on the [redacted] of [redacted]. The property had an appraised value of roughly $[redacted] dollars.

FACTS AND DISCUSSION

At issue are Legal and other fees paid by , and , on behalf of ”), in , , and in connection with the , litigation. These were paid, as follows:

	$	$	$

These payments were deducted in the U.S. corporation consolidated income tax Returns for the taxable years , , and , of the , the common parent, and Subsidiaries group. and were affiliates of the consolidated group, for all three years. The returns show that the common parent, controlled both corporations (80% or more) at all relevant times, as follows: The common parent, , owned % (in , , , &) of the voting power and value of ; and , in turn, owned % (in , and % (in &), of the voting power and value of .

The genesis of these payments was the following. On , , entered into an agreement to purchase the stock or assets of). In , after fruitless discussions with a host of prospective investors, approached . This led to a verbal agreement whereby would provide the funds needed for the purchase in exchange for a controlling interest in a corporation that would be formed to acquire 's stock. was to receive a % interest. did not receive this % interest, but rather a lesser amount. In the litigation it was established, inter alia, that this was due to fraudulent conduct by , who had misled as to what 's percentage of interest would really be (it turned out to be % rather than %).

The taxpayer has presented to the Service a copy of a "Reimbursement Agreement" that purports to have been "made as of the [redacted]." It does not show the actual date that it was drafted or signed. It contains the following recitals:

"[redacted] is alleged to have acted as agent on behalf of the Corporation, among others, in connection with the acquisition from [redacted] of certain parcels of land located in [redacted] and improvements thereon (the "Property")."

"B. As a result of such putative activities, certain disputes have arisen between [redacted], on the one hand, and [redacted] and certain other persons, on the other, which disputes have resulted in litigation known as [redacted] in the federal district court of [redacted] (the "Litigation")."

Paragraph 1. of the Reimbursement Agreement, provides, as follows:

"1. The Corporation shall reimburse [redacted] for reasonable attorneys' and consultants' fees [redacted] incurs in connection with his defense in the Litigation (collectively), the "Litigation Costs"), it being understood that Litigation Costs shall not include any claims, liabilities, losses, damages, costs and expenses whatever in the nature of, or attributable to, a judgment or settlement in respect of the Litigation. Upon presentation by [redacted] of statements, invoices or other reasonable documentation in respect of Litigation costs, the Corporation shall pay such items directly in accordance with the terms thereof."

The taxpayer has not presented any evidence that the purported "Reimbursement Agreement" was, in fact, entered into in [redacted], or at any time prior to the time that [redacted]'s acted fraudulently to acquire the [redacted] property. Corroborating evidence would have been corporate resolutions, agency contracts, etc. If they existed and they were proven to be entered into prior to the acquisition negotiations, the taxpayer's implied argument that [redacted] was acting as an agent of the consolidated group in the acquisition, and, thus, that the litigation expenses were acquired in an agency relationship would be somewhat more credible. As such corroborating evidence does not exist or has not been provided to the Service, there is no reason to give this purported agreement much credence.

One should note that the Reimbursement Agreement is between [redacted] and [redacted]. This office, Counsel, does not know whether a similar agreement between [redacted] and [redacted] exists.

A reading of the facts in the various [redacted] litigation opinions discloses that [redacted] began negotiating for the [redacted] property using only a [redacted] entity named [redacted] apparently, [redacted], was set up later, right before or right at the closing of the [redacted] purchase, to serve as the holding company for the [redacted] stock. As [redacted], apparently, was created after [redacted] had finished his negotiations with [redacted], it would be difficult for the taxpayers to now provide to the Service a principal/agency agreement from a corporation ([redacted]) which, for all appearances and purposes, did not yet exist. But even if [redacted] had been created before [redacted]'s negotiations and such a "Reimbursement Agreement" surfaces, this would not change our conclusion that the legal and other fees paid were personal expenses of [redacted], and not those of [redacted] acting as an agent of [redacted] and/or [redacted].

The payments of legal and other fees at issue in the [redacted] litigation, at least, in form were incurred for defending [redacted] for his personal fraudulent conduct, as the named defendant, and not for defending [redacted] and [redacted] for any fraudulent or other conduct by them. There is nothing in the [redacted] Litigation that supports that the [redacted] Litigation was brought or successfully concluded against [redacted], as the agent for [redacted] or [redacted]. The Final Judgment furnished to the Service by the taxpayer shows the judgment in the [redacted] litigation, including the amounts to be paid for legal and other fees, to have been rendered against [redacted], personally, and not against [redacted] and [redacted]. See also [redacted], where [redacted] explains that he, personally, was the only party found to be liable by the jury and the federal district court's finding that a [redacted] was the only person representing [redacted] and its predecessor in interest [redacted]; [redacted], in contrast, was acting "in common accord" with [redacted] and the other defendants, and not as an agent for anyone.

FURTHER FACTS DISCUSSED ON 5/14/01[2]

During a telephone conference between the national office, field counsel, and Examination it was clarified that we have no evidence that [redacted] held shares of stock in the [redacted] and [redacted] under his own name. The shares appear to have been held by [redacted] family trusts, for the benefit of [redacted] family members. We have no evidence that this has not been the case at all times.

The evidence that exists for a finding that [redacted] can be deemed to be a constructive shareholder of [redacted] and [redacted], for purposes of finding constructive dividends, are the recitals of facts in the various opinions given by the federal district courts and the Court of Appeals for the First Circuit in the [redacted] litigation. The opinions, in pertinent part, found [redacted] to have provided the funds to acquire an [redacted]% interest in [redacted]; that this company acquired the stock of the [redacted]; and. that [redacted] was a new entity on or about [redacted]. The opinions, in pertinent part, further found that on [redacted], a newly minted Delaware Company, also acquired an interest in [redacted]; and, that [redacted] was a [redacted] nominee. See [redacted]; [redacted] [finding that [redacted] was a [redacted] nominee is found in this opinion]; [redacted]; [redacted] [finding that [redacted] held an [redacted]% interest in [redacted] through a nominee, a shell corporation and treatment of [redacted] as if he, himself, were the majority shareholder in [redacted] is found in this opinion]; [redacted] [the finding that [redacted] was the acquiring entity used by [redacted] to purchase [redacted]

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[2]The Informal Field Assistance stated, in pertinent part, as follows: "Submit FSA request to CC:CORP regarding constructive dividend issue." During the May 14, 2001 telephone conference, the national office and the Field discussed the desirability of having to make an FSA request, at this point in the case, since the issue is already in the national office being considered as post-review. It is our understanding from this discussion that no FSA request is needed by CC:CORP and that it may not even be desirable, in order for the national office to complete its review of this case. It is also our understanding that the post-review may automatically be turned into a FSA request, at the national office's option.

is found in this opinion]; and [redacted] [finding that [redacted] was [redacted]'s corporation in found in this opinion].

LEGAL OPINION AND DISCUSSION[3]

In the opinion dated April 23, 2001, we concluded (subject to post-review) that the moneys paid by [redacted] and [redacted] to reimburse the legal fees that [redacted] incurred in the [redacted] litigation represent personal expenses of [redacted]. They are not deductible by the consolidated return group or its affiliates, [redacted] and [redacted] as ordinary and necessary business expenses for [redacted], [redacted], and [redacted]. The claimed deductions should be disallowed for all three years.

The national office review, CC:ITA:1, stated that they generally concur with the opinion that the amounts paid by [redacted] and [redacted] to reimburse fees [redacted] incurred in the [redacted] litigation represent personal expenses of [redacted]. The review, however, recommended that reference be made to the "origin of the claim" test with respect to the legal fees.

The deductibility of legal fees depends on the origin and character of the claim for which the expenses were incurred and whether the claim bears a sufficient nexus to the taxpayer's business or income-producing activities. See United States v. Gilmore, 372 U.S. 39 (1963); Test v. Commissioner, T.C. Memo. 2000-362; Stark v. Commissioner, T.C. Memo. 199-1. The Supreme Court stated that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences on the fortunes of the taxpayer, is the controlling basic test." U.S. v. Gilmore at 49.

In the instant case, [redacted] sued [redacted] because [redacted] originally promised [redacted] a [redacted]% interest, but [redacted] received a lesser amount apparently due to fraudulent conduct by [redacted]. At the time of the agreement, [redacted] and [redacted] were nonexistent. According to the known facts, [redacted] made the acquisition of the [redacted] stock through a newly created entity [redacted] and later acquired a further interest through a newly-created entity [redacted].

In order for the legal fees to be deductible by [redacted]

[3] These are as set forth in the April 23, 2001 opinion, except as specifically modified or supplemented herein.

or [redacted], the origin of those legal fees must have been rooted in their business. Because there is no evidence that the litigation was brought against [redacted] as an agent of [redacted] or [redacted], it is this office's opinion, after national office review, that the legal expenses are not deductible by those companies.

In addition, the national office, CC:P&SI, concludes that amortization under I.R.C. §195 is not available for the payments that were deducted in this case. CC:P&SI concurs that personal expenditures cannot be amortized under I.R.C. §195. CC:P&SI also notes that there are fundamental reasons why I.R.C. §195 would not apply. First, it does not appear that a timely election to amortize start-up expenditures was made. Second, inconsistent positions with respect to the same expenditures cannot be taken. According to the facts, the expenditures were deducted in [redacted], [redacted], and [redacted]. Therefore, CC:P&SI believes the expenditures cannot be amortized under I.R.C. §195.

This leaves the issue with respect to I.R.C. §§ 301 and 316. This issue remains under review by the national office, CC:CORP. On May 14, 2001, we held a telephone conference between Examination, the Field, and the national office, CC:CORP. The national office expressed some of their concerns regarding the fact that [redacted], apparently, did not own shares of stock in [redacted] and [redacted], in his own name, as well, as concerns about the payments being made in the [redacted]s, when Examination's evidence of [redacted] being a constructive shareholder is based on his relationship to the corporations in [redacted].

During the May 14, 2001 telephone conference we presented to the national office the argument that the origin of the claim doctrine takes us back to [redacted], the year in which [redacted] committed the purported fraudulent conduct resulting in the legal fees. Further, it was noted that the various Courts that handled the [redacted] litigation had no problem finding [redacted] to be the controlling shareholder, in substance, and the corporations to be his mere nominees. It was pointed out that one could conclude that this is one more case of form versus substance, but backed up by express recitals of facts, in the reported opinions, as to what the substance of the relationship of [redacted] to the various corporations was. The findings were that he was the controlling owner of these corporations and that these corporations were shells and/or his nominees.

More specifically, it was pointed out that, the evidence that exists for a finding that [redacted] can be deemed to be a constructive shareholder of [redacted] and [redacted]

for purposes of finding constructive dividends, are the recitals of facts in the various opinions given by the federal district courts and the Court of Appeals for the First Circuit in the [redacted] litigation. The opinions, in pertinent part, found [redacted] to have provided the funds to acquire an [redacted]% interest in [redacted]; that this company acquired the stock of the [redacted]; and. that [redacted] was a new entity on or about [redacted]. The opinions, in pertinent part, further found that on [redacted] a newly minted Delaware Company, also acquired an interest in [redacted]; and, that [redacted] was a [redacted] nominee. See [redacted]; [redacted] [finding that [redacted] was a [redacted] nominee is found in this opinion]; [redacted]; [redacted] [finding that [redacted] held an [redacted]% interest in [redacted] through a nominee, a shell corporation and treatment of [redacted] as if he, himself, were the majority shareholder in [redacted] is found in this opinion]; [redacted] [the finding that [redacted] was the acquiring entity used by [redacted] to purchase [redacted] is found in this opinion]; and [redacted] [finding that [redacted] was [redacted]'s corporation in found in this opinion].

The national office is now taking these arguments into account in their continuing review of this case. It needs to be noted, however, that until the national office completes its review and informs us of their conclusions, no final position with respect to the constructive dividend issue is being taken by Chief Counsel. We will keep you appraised of any further determinations that are made in this case.

CONCLUSION

We will inform you or of the results of any further review, orally or by memorandum. If you have any questions, please contact the undersigned at (312) 886-9225, extension 308

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