Office of Chief Counsel
Internal Revenue Service

memorandum

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

date: April 23, 2001

to: Team Manager Edna Manson, Group 1532
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from: ROGELIO A. VILLAGELIU
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subject: **LO:** [redacted]
EIN: [redacted]
Consolidated Group
Affiliates Involved: [redacted]

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

This opinion should not be viewed as final until we inform you, orally or by memorandum, that it has been post-reviewed by the national office and that it does not require further modification. We are mailing a copy of this opinion or transmitting a copy of this opinion by electronic mail to the national office, simultaneously, with our issuing the opinion to you. As soon as we learn that their post-review is complete, we will advise you.

This is to 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.

It is our opinion that the amounts 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 [redacted] years.

Further, for purposes of determining the proper treatment of these payments for [redacted], [redacted] is to be deemed to be a shareholder of the distributing entities, [redacted] and [redacted]. These corporations acted as [redacted]'s nominees through the [redacted] transaction, the [redacted] litigation that followed, and at all relevant times. The [redacted] litigation payments, made on [redacted]'s behalf, represent constructive distributions to him, that are dividends to the extent of the respective paying corporations' E. & P. I.R.C. Sections 301 and 316.

FACTS AND DISCUSSION

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

	[redacted]	[redacted]	[redacted]
[redacted]	$[redacted]	$[redacted]	$[redacted]
[redacted]	[redacted]	[redacted]	[redacted]

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

The genesis of these payments was the following. On [redacted],

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

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

"A. [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.

Therefore, the facts support the Service in taking the position that the legal fees and other costs paid by [redacted] and [redacted] were not the corporations' deductible expenses incurred by [redacted], as their agent, acting within the scope of his agency.

During the [redacted] litigation the United States Court of Appeals for the [redacted] Circuit found that [redacted] was a [redacted] nominee, and a shell corporation, that [redacted] used to hold its controlling interest in [redacted] and the United States Court for [redacted] found that [redacted] was the acquiring entity used by [redacted] to make the [redacted] acquisition that resulted in the [redacted] litigation. See [redacted]; and, [redacted]. Therefore, the determination that [redacted] was a shareholder in substance, if not in form, of [redacted] and of [redacted], for purposes of determining a constructive dividend to him, from these companies paying his personal [redacted] litigation expenses, is supported by the facts.

LEGAL ANALYSIS

It is our opinion that the amounts paid by [redacted] and [redacted] to reimburse the legal fees that [redacted] incurred in the [redacted] litigation represent personal expenses of [redacted]. The legal and other fees were paid for defending [redacted] for his own personal fraudulent conduct against [redacted]. The Court findings in the [redacted] litigation rebut any allegation that [redacted] was an agent of [redacted] and the [redacted], or that he was acting within the scope of any agency relationship. [redacted] was the investor and the [redacted] controlled companies that he used were simply the place were he placed his investment. What we have, although not fully documented, are I.R.C. Section 351 contribution of [redacted]'s investment property to newly formed or existing [redacted] controlled corporations. The legal and other fees were not deductible ordinary and necessary expenses from the operation of these corporations. They claimed corporate expenses should be disallowed for all [redacted] years, [redacted], [redacted], and [redacted].

Further, for purposes of determining the proper treatment of these payments for [redacted], [redacted] can be deemed to be

a shareholder of the paying entities, [redacted] and [redacted]. As the [redacted] litigation noted, for purposes of the [redacted] transaction and the [redacted] litigation that ensued, all of the [redacted] controlled entities that were used were shell company, [redacted]'s nominees. The [redacted] litigation payments made on [redacted]'s behalf represent constructive distributions to him from his controlled [redacted] and [redacted] that are dividends to the extent of the paying corporations', respective, accumulated and current Earnings & Profits. I.R.C. Sections 301 and 316.

Further, as a back-up position to the main position that the [redacted] litigation payments represent non-deductible constructive dividend income or a return of capital to [redacted], the Service should assert that the taxpayer has failed to substantiate that the expenses claimed are not capital acquisition costs; and, conversely, that the taxpayer has failed to show that the expenses are the type of costs that can be amortized, under the guidance provided by Rev. Rul. 99-23, 1999-20 I.R.B. 3.

Assuming, arguendo, that the legal fees and consultation fees were not personal expenses of [redacted], which is not supported by the facts, the legal and any consultation fees incurred in the defense of the [redacted] litigation would not be capitalized under I.R.C. Section 263, and they could be amortized under I.R.C. Section 195, over a period of 60 months or more. However, before the Service could conclude that these fees were amortizable, the taxpayer would have to substantiate that all or a determinable portion of these fees were, in fact, incurred in the defense of the [redacted] litigation. This has not been done. Absent this proof, it is reasonable for the Service to conclude that an undetermined portion of these fees may have been incurred in the actual acquisition of the capital assets (i.e., that they represent legal, brokerage, accounting, appraisal, or similar costs incurred to acquire the [redacted], which are capital assets). In any case, as stated previously, the Service's position is that, absent proof to the contrary, all of these are neither deductible or amortizable, because they represent [redacted]'s personal expenses.

Traditionally, business start-up expenses have been subject to strict limitation. Some courts have used the "carrying on any trade or business" language of I.R.C. Section 162(a) to deny deductions for costs incurred prior to the time when the activity became a "going concern." See Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965), vac'd on other grounds, 383 U.S. 68 (1965). This same approach was followed by the 7th Circuit (that covers Illinois) in Madison Gas and Electric Co. v.

Commissioner, 633 F.2d 512 (7th Cir. 1980), where the Court required the capitalization of pre-opening expenses of a new business venture. Similarly costs of investigating investment opportunities are generally nondeductible. See Weinstein v. United States, 420 F.2d 700 (Ct. Cl. 1970). See also Frank v. Commissioner, 20 T.C. 511 (1953) expenses and legal fees incurred on a trip to investigate various business opportunities preliminary to purchasing such a business were held not deductible under I.R.C. Sections 212 or 162, as they did not relate to an existing business. I.R.C. Section 195, however, liberalized the law to an extent, allowing certain expenses incurred before the establishment of an active business to be amortized.

Rev. Rul. 99-23, 1999-20 I.R.B. 3 provides guidance as to which expenditures will qualify as investigatory costs that are eligible for amortization as start-up expenditures under I.R.C. Section 195. Section 195(a) provides that, except as otherwise provided in Section 195, no deduction is allowed for start-up expenditures. Section 195(b) provides that start-up expenditures may, at the election of the taxpayer, be treated as deferred expenses that are allowed as a deduction prorated equally over a period of not less than 60 months (beginning with the month in which the active trade or business begins).

Section 195(c)(1) defines "start-up expenditure," in part, as any amount (A) paid or incurred in connection with investigating the creation or acquisition of an active trade or business, and (B) which, if paid or incurred in connection with the operation of an existing active trade or business (in the same field as the trade or business referred to in subparagraph (A)0, would be allowable as a deduction for the taxable year in which paid or incurred. Thus, in order to qualify as start-up expenditures under Section 195 (c)(1), a taxpayer's "investigatory costs" must satisfy the requirements in both Section 195(c)(1)(A) and (B). I.R.C. Section 263 and Treas. Reg. Section 1.263(a)-1(a) provide that no deduction is allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Treas. Reg. Section 1.263(a)-2(a) provides that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, a similar property having a useful life substantially beyond the taxable year. Courts have long held that legal, brokerage, accounting, appraisal, and similar costs incurred to acquire a capital asset are capital expenditures under I.R.C. Section 263. See Woodward v. Commissioner, 397 U.S. 572 (1970) and United States v. Hilton Hotels Corp., 397 U.S. 580 (1970).

In this instant case, the taxpayer has not established that [redacted] and [redacted], as opposed to [redacted] or other [redacted] controlled corporations that were not part of the [redacted] transaction, were engaged in the [redacted] business. The taxpayer also has not established what portion of the fees, is not part of the acquisition of the buildings. We do recommend that the Service further support its case by establishing when [redacted] and [redacted] were incorporated. One or both may have been incorporated, after some of these legal and other fees were incurred, which would further show that [redacted] did not incur the fees on behalf of the corporations.

In sum, the taxpayer has not substantiated that the expenses incurred were not personal expenses of [redacted] nor that they are eligible for amortization under I.R.C. Sec. 195, under the guidance provided by Rev. Rul. 99-23, 1999-20 I.R.B. 3.

CONCLUSION

Subject to any modifications or recommendations that may be made by the national office, which will be conveyed to you orally or by a supplemental memorandum, as appropriate, we are closing our legal file in this matter. If you have any questions, please contact the undersigned at (312) 886-9225, extension 308.

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