

# PUBLICATION

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## Expenses Related to Securities Lawsuit Over Stock Offering Can be Deducted as Ordinary and Necessary Business Expense

October 7, 2009

A corporation recently requested guidance from the IRS on whether a deduction under Section 162 of the Code would be allowed for expenses – including legal fees and settlement payments – that it incurred in settling a lawsuit over allegedly fraudulent financial representations in a prospectus. The IRS analyzed the request under the "origin of the claim doctrine" and determined that an ordinary and necessary business expense deduction was appropriate because the origin of the lawsuit involved routine activities of the corporation. The IRS analyzed each individual claim brought pursuant to the lawsuit and determined that all arose from "common and routine activit[ies] in the carrying on of a trade or business." The claims at issue originated from the preparation of financial statements and financial representations in various SEC filings.

A business taxpayer is allowed an ordinary and necessary business expense deduction under Section 162 of the Code for expenses incurred in the ordinary course of the taxpayer's trade or business. Capital expenditures, however, cannot be deducted under Section 162 and must instead be capitalized pursuant to Section 263 of the Code. In the context of expenses resulting from lawsuits, both the courts and the IRS historically apply the origin of the claim doctrine to determine whether the legal expenses are deductible expenses or capital expenditures. Under the origin of the claim doctrine, the classification of an expenditure as a deductible expense or a capital expenditure is determined by analyzing each individual claim brought pursuant to the lawsuit. The purpose, consequence, or result of the expenditure is deemed irrelevant and are not factors in the analysis.

The origin of each specific claim of the lawsuit is important and must be analyzed separately to determine its character. If a claim originated because of actions taken by the taxpayer in its ordinary course of business, then the expenditures are deductible expenses under Section 162 of the Code. If the claim originated from actions of the taxpayer outside of its ordinary course of business then the expenditures are capital expenditures and must be capitalized. Where some claims are the result of activities taking place in the taxpayer's ordinary course of business and some claims are rooted in capital transactions, then the expenses must be apportioned to reflect that fact.

Based on this recent ruling, companies should carefully analyze the origin of each claim within a lawsuit to determine whether a deduction under Section 162 of the Code for expenses is warranted or whether the expenses must be capitalized under Section 263 of the Code.