



What's Deductible?

Case Law Provides Guidance for Celebrities Looking to Deduct Legal Fees

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Celebrities often pay extraordinary legal fees. Winona Ryder's shoplifting charge racked up far larger legal fees than the typical shoplifting case. Michael Jackson reportedly paid up to \$20 million in legal fees in his trial. And telephone-brandishing supermodel Naomi Campbell not only faced assault charges, but also an expensive suit against London's *Daily Mirror* over photos of her leaving a drug treatment center.

Or take Martha Stewart, whose legal fees were huge, eclipsing many times over the amount at stake in her sale of Imclone stock.

She sold 75,000 shares of Martha Stewart Living Omnimedia, Inc. (raising \$4.67 million) to pay legal fees ["Martha Stewart Sells Shares for Legal Fees," *New York Times*, June 12, 2004]. And she sought reimbursement (as an officer and director) for \$3.7 million of fees ["Martha Stewart Starts Appeal," CNNMoney.com, March 17, 2005].

The \$3.7 million was for her successful defense on a single criminal count that she tried to lift her own company's share price by declaring that she was innocent of insider trading.

Huge legal fees should prompt celebrities and their advisers to ask: Are such whopping fees deductible? And if so, how?

DEDUCTIBILITY OF LEGAL FEES

Legal expenses are deductible as "business expenses" if paid in a trade or business.

Deductions for trade or business expenses are much more useful than deductions for investment expenses because of various percentage limitations and the alternative minimum tax.

Much of the tax law surrounding the deductibility of legal fees concerns the line between trade or business expenses and investment expenses. Fees for tax advice always are deductible as investment expenses, even if they are related to divorce

or other personal matters.

Legal expenses of a personal nature yield no deduction. Yet, what is considered "personal" can be debated. Celebrities may be in a unique position regarding legal fees since few personal decisions are not in the public eye, and few are devoid of economic consequences. Let's take a closer look at this area.

PROBLEMS WITH PERSONAL EXPENDITURES

Not all expenses in connection with personal, living or family expenses are deductible, according to IRC Sec. 262. For example, legal fees in connection with a divorce, separation or decree for support by either party are not deductible [Reg. Sec. 1.262-1(b)(7)]. In *United States v. Gilmore*, legal fees and associated expenses

since he was not in the business of selling securities [*Price v. Commissioner*, T.C. Memo. 1973-65 (1973)].

The degree of nexus required is illustrated in *Commissioner v. Tellier*, [383 U.S. 687 (1966)], in which the Supreme Court allowed a deduction for an unsuccessful criminal defense.

Tellier involved a securities dealer convicted of violating the 1933 Securities Act and mail fraud statutes in conducting his business. The decision overturned several lower court cases, and made the success or failure of the defense of the criminal charges irrelevant [See also Rev. Rul. 66-330, 1966-2 C.B. 44 (1966)].

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of divorce litigation were held to be nondeductible personal expenditures, even though an adverse decision would destroy the taxpayer's business [372 U.S. 39, 83 S. Ct. 623 (1963), on remand, 245 F. Supp. 383 (N.D. Cal. 1965)].

The claim's origin was the divorce, rather than its potential consequences to the business.

Cases that deny deductions for legal expenses in connection with criminal representation typically have referred to the lack of a nexus between the crime and the defendant's business.

For example, a management consultant was not allowed to deduct legal expenses incurred in defending a charge against him for fraudulently selling securities,

and the alleged crime is not strong, the deduction will be denied. The fact that a defendant's business will be destroyed if he or she is convicted of a crime is not enough to sustain deductibility [*Hylton v. Commissioner*, T.C. Memo. 1973-262].

Indeed, even though a conviction may disqualify a defendant from engaging in a business or profession, if the claim does not arise out of the business or profession to begin with, the legal fees will not be deductible [*Patch v. Commissioner*, T.C. Memo. 1980-11].

Some taxpayers have argued that legal fees incurred in defending against a criminal prosecution should be deductible as investment expenses, even though they may not rise to the level of an active con-

duct of a trade or business.

In *Accardo v. Commissioner*, Anthony Accardo was prosecuted under the RICO Act for charges involving racketeering in labor unions, including accepting kick-backs and commissions involving employee welfare benefit plans [94 T.C. 96 (1990), aff'd, 942 F.2d 444 (7th Cir. 1991), cert. denied, 12 S. Ct. 1266 (1992)].

He was acquitted and deducted his legal fees.

The Tax Court, however, held that his legal fees were not deductible, even though the indictment sought a forfeiture judgment and Accardo sought to conserve and maintain income-producing assets.

Legal fees paid with respect to a purely personal matter are not deductible, even if the fees affect capital preservation.

The applicable Treasury Regulations state that: "amounts paid as ... attorney's fees and other costs

of suit to recover such damages are not deductible." [Treas. Reg. Sec. 1.262-1(a)(6)].

Sometimes, it's difficult to determine whether the genesis of the suit is business or personal.

For example, in *McDonald v. Commissioner*, a lawyer was denied a deduction for amounts paid to settle a threatened lawsuit to contest a will [592 F.2d 635 (2d Cir. 1978)]. Similarly, in *Solomon v. Commissioner*, an accountant was denied a deduction for expenses resulting from a lawsuit settlement against him for misappropriation of his father's funds (T.C. Memo. 1974-127).

At times, the IRS will seek to dissect a transaction to deny deductions where it would seem that purely personal activities are being pursued.

For example, in *Peters, Gamm, West & Vincent, Inc., v. Commissioner*, the Tax Court considered SEC charges against Peters, a partner in an investment firm (T.C. Memo. 1996-186). Although the firm was not named in the case, charges against Peters were pursued and resulted in the firm paying significant legal fees.

The Tax Court agreed with the IRS that deductions by the corporation should be disallowed, and that the payment should be considered constructively paid by the investment firm to Peters, and in turn, paid by Peters to the lawyers. That meant that

Peters, not his firm, could deduct the fees. However, Peters could do so only as investment expenses under IRC Sec. 212.

The requirement that legal fee expenses be ordinary, necessary and reasonable to be deductible applies under both IRC Sec. 162, trade or business expenses, and IRC Sec. 212, investment expenses. Taxpayers frequently confuse the "ordinary" requirement with the notion that the particular expenses must arise over and over again.

In fact, an ordinary expense may be extremely irregular in occurrence [*Welch v. Helvering*, 290 U.S. 111 (1933)]. Legal fees are ordinary and necessary where engaging attorneys is an act a reasonably prudent man in the same circumstances

might undertake [*Kanelos v. Commissioner*, 2 T.C.M. 806, P-H T.C. Memo. ¶43,429 (1943)].

CELEBRITY CASES

For the typical celebrity defendant, the nexus between conduct and legal expense is likely to be purely personal, whatever the effects on the celebrity's career.

Yet, Naomi Campbell's breach of contract case may be different. Her legal fees arguably arose out of her contract with the *Daily Mirror*. While that deal may have involved solely what she perceived to be her privacy, her case was for breach of contract.

Establishing a business nexus between a breach of contract is easier than with an invasion of privacy suit.

Although it is difficult to see legal fees relating to child molestation charges as business (or even investment) expenses, Michael Jackson may have at least some arguments to lessen the sting of \$20 million in legal fees.

First, he was acquitted. Although conviction vs. acquittal is not the lynchpin of a deduction [*Commissioner v. Tellier*, 383 U.S. 687 (1966)], it can be easier as a practical matter to claim a deduction after an acquittal.

Second, Jackson's legal battle arguably arose, at least in part, out of his own foray

into self-promotion. His problems may not have started with the media, but they certainly got worse because of it.

For example, because Jackson and his handlers likely thought the "Living with Michael Jackson" documentary was a smart public relations move when it first aired in February 2003, Jackson likely deducted the costs of granting the media access. After that broadcast, Neverland Ranch was searched in November 2003 and Jackson was booked and charged in December 2003.

Once Jackson went public with his TV special and appeal, his profile with prosecutors increased. There is some evidence that his management of the media set off the maelstrom. Prosecutor Tom Sneddon

acknowledged that he pursued the case primarily because of what Jackson revealed in his TV saturation.

At a minimum, perhaps one could bifurcate Jackson's

fees and expenses between those related to or arising out of the media blitz, and those caused by the underlying charge.

TRADE OR BUSINESS NEXUS

To address the deductibility of legal fees, the key question is whether the origin of the case is personal or arises out of trade or business or investment activity.

"Origin" sounds like a point easily resolved. Jackson's legal expenses, for example, seem plainly personal. Yet he may have some colorable arguments.

Between the poles of authorities, like *Gilmore* (personal) and *Tellier* (upholding business nexus), how do celebrity legal fees stack up? Like non-celebrities, the answer depends on the facts.

As with non-celebrities, the origin of the claim, not the effects it may have on the celebrity's business or investments, should control. In many cases, such as Robert Downey Jr.'s drug charges, there is no argument that any portion of the legal fees are related to business or investment. In some cases, though, the standard for the deductibility of legal expenses may be somewhat lessened for celebrities.

Put differently, it may be easier for at least some celebrities to make connections between the genesis of legal expenses (rather than their mere effects) and their business or investment activities.

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Martha Stewart's legal expenses arose out of her Imclone stock trading, an investment activity. However, a portion

of those expenses related not just to investments, but to her trade or business, as well.

Managing the Imclone affair involved advertising, image consultants and legal expenses related to her business. She won reimbursement of \$3.7 million in fees attributable to the claim that she had attempted to lift the company's share price by proclaiming her innocence.

This simple example should show that a huge part of the issue here can be allocations of legal bills.

Campbell's legal expenses related to her phone smashing are plainly personal, whatever the effects. But her expenses related to her *Daily Mirror* suit seem to relate to her contract with the tabloid.

Despite the invasion of privacy tenor of the dispute and its focus on photos of the

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model at rehab, that contract arguably arose out of her trade or business.

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Although it may seem that an invasion of a celebrity's right to privacy has personal origins, and thus associated legal fees would not be deductible, arguably a celebrity name and likeness is his or her economic engine. Without being able to protect his or her name and likeness, a celebrity may lose the ability to earn a living. This is important, as many celebrities earn more money from endorsements than from services.

Thus, basketball great Kareem Abdul-Jabbar was able to recover from General Motors when it used his birth name, Lew

Alcindor, in an unauthorized commercial [*Abdul-Jabbar v. General Motors*, 85 F.3d 407 (9th Cir. 1996)]. Similarly,

Vanna White was able to recover when Samsung infringed on her privacy rights when its advertisement showed a robot who resembled her on the game-show set of *Wheel of Fortune* [*White v. Samsung*, 971 F.2d 1395 (9th Cir. 1992)].

Surely, both Abdul-Jabbar and White had strong arguments that their associated legal fees were deductible as trade or business expenses. Celebrities, after all, are different. **CTA**

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