Deducting Acquisition Litigation Expenses

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Complaining about the high cost of lawyers is nearly a national pastime. For individuals and businesses alike, the ability to deduct the fees makes them at least somewhat more palatable. Of course, it does not take a tax specialist to know that not all fees are deductible.

Indeed, one large category of fees related to merger and acquisition costs would be those facilitating the transaction and those incurred in litigation over it. No one wants to be involved in litigation post-closing, and yet it can and does occur. Tax

considerations certainly will not determine if or how it is pursued.

How then does one determine the nature of legal fees and whether they can be treated as ordinary and necessary business expenses or must be capitalized? The origin of the claim test is classically invoked in evaluating the nature of gross receipts recovered in a lawsuit. However, it can be of equal importance in considering deductions.

According to the Supreme Court, the origin of the claim requiring the expense—rather than its potential consequences on the fortunes of the taxpayer—is the controlling test for deductibility. *See D. Gilmore*, SCt, 63-1 USTC ¶9285, 372 US 39, 49, 83 SCt 623. The origin of the claim test does not involve a "mechanical search for the first in the chain of events." See *V. Boagni*, 59 T.C. 708, 713, Dec. 31,873 (1973). Rather, it requires:

- consideration of the issues involved;
- the nature and objectives of the litigation;
- the defenses asserted;
- the purpose for which the amounts claimed as deductions were expended; and
- all other facts relating to the litigation.

Root Cause

The origin of the claim test was most famously enunciated in *F.D. Arrowsmith*, SCt, 52-2 USTC ¶9527, 344 US 6, 73 SCt 71. In that case, the two shareholders of a corporation liquidated and divided the proceeds between them. They treated the distributions of corporate profits as subject to tax at capital gains rates.

However, a judgment was thereafter rendered against the corporation. After paying the judgment on behalf of the old company, the former shareholders sought ordinary and necessary business deductions for the payments. The Supreme Court found that the payments could only be treated as capital losses. The Court found that the liability to make the payments arose entirely from the liquidation proceedings.

A more universal iteration of the origin of the claim doctrine came in *D. Gilmore*, SCt, 63-1 USTC ¶9285, 372 US 39, 49, 83 SCt 623. There, the Supreme Court invoked the origin of the claim doctrine to distinguish business from personal expenses. The Court held that a husband's legal expenses incurred in a divorce proceeding were nondeductible and were personal rather than business.

After all, the Court found, the wife's claims stemmed entirely from their marital relationship. The consequences to a business, we are told, are different from the origin of the claims emanating from the business. As a result, Mr. Gilmore could not deduct his legal expenses, even though his wife's claims might cause him to lose his controlling interest in three GM car dealer franchises.

There was no question that the car dealerships were active businesses and his principal means of livelihood. Yet the Supreme Court found that even Mr. Gilmore's claim that the reputation-damaging charges of marital infidelity might cause GM to exercise its right to cancel his franchises was personal, not business. Those facts did not change the origin of his legal expenses into one emanating from his business.

Capitalize vs. Deduct

The origin of the claim doctrine is also applied to distinguish immediately deductible expenses from those that must be capitalized. Unlike the personal versus business chasm, the division between those expenses is considerably more nuanced. In *F.W. Woodward*, SCt, 70-1 USTC ¶9348, 397 US 572, 583, 90 SCt 1302, the Supreme Court was asked to determine the tax treatment of costs incurred in litigation that may affect a taxpayer's title to property.

The Court said this required a simple "inquiry whether the origin of the claim litigated is in the process of the acquisition itself." That meant capitalizing the fees. Of course, in the hurly burly world of litigation, in which claims may be complex, varied and numerous, applying this concept is harder than it sounds.

The origin of the claim doctrine is applied pervasively by the IRS and courts in the context of business expenses. That often leaves taxpayers with the following menu:

- a nondeductible personal expense;
- an expense that must be capitalized (and possibly depreciated); or
- an expense that is immediately deductible under Code Sec. 162(a), provided it is ordinary and necessary.

Most expenses will fit into one of those boxes.

Consider the Dichotomy

In some cases, the dichotomy will be between business expense treatment under Code Sec. 162(a) and loss treatment under Code Sec. 165. That is a common line of contention where taxpayers seek to deduct restitution payments. Code Sec. 165(c)(1) allows a deduction for losses incurred in a trade or business. Code Sec. 165(c)(2) allows a deduction for losses incurred in a transaction entered into for profit.

Several cases may be cited for the proposition that a repayment of fraudulently obtained funds cannot be deducted under the first subsection. *See J. Kraft*, CA-6, 93-1 USTC ¶50,278, 991 F2d 292; *see also R.L. Mannette*, 69 T.C. 990, Dec. 35,055 (1978). The more limited below-the-line deduction of Code Sec. 165(c)(2) is, however, generally available. *See J.T. Stephens*, CA-2, 90-2 USTC ¶50,336, 905 F2d 667; *see also* Rev. Rul. 65-254, 1965-2 CB 15.

Acquisition Litigation

In the context of litigation over a transaction that has gone bad, there is often at least some flexibility. Even though an application of the origin of the claim doctrine may suggest that the litigation would not have occurred but for the transaction, there are often at least some elements that can be deducted. Taxpayers can often divide bills between ordinary business expenses and capital expenditures where litigation concerns ongoing business operations as well as title to assets.

Such a division can be a way to get half a loaf or more, rather than no loaf at all. One of the most persistent lessons of the Supreme Court's *INDOPCO* decision about acquisition expenses (*INDOPCO, Inc.*, SCt, 92-1 USTC ¶50,113, 503 US 79, 112 SCt 1039) is that dividing expenses in a rational and documented fashion is appropriate.

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