Deducting Legal Fees for Governmental Corporate Investigations

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Payments of attorneys' fees in corporate investigations and prosecutions can raise a number of tax issues. This article examines the circumstances under which such questions arise and the tax consequences to the corporation, officers, directors, agents and employees.

There has been no shortage of scandals in the business world over the last few years—Enron Corp., MCI, Inc., Tyco International, Ltd., Global Crossing, Ltd., Adelphia and Imclone, Inc., to name a few. Indeed, whole industries are in the crosshairs: the securities industry, the mutual fund industry, the hedge fund industry, etc. This article examines the payment of attorneys' fees in such situations and the tax consequences to the corporation, officers, directors and agents involved in the investigations. Indemnity issues can arise for individuals too, although this article primarily explores cases in which both the company and executives (or directors) hire attorneys.

Corporate Investigations

The Justice Department (which frequently coordinates its investigations with other Federal agencies) has been an integral force behind many investigations exposing these scandals. In fact, it has assembled a "corporate task force" to specifically target corporate (and noncorporate, large organization) fraud.

In January 2003, Larry D. Thompson, then Deputy Attorney General, issued a memorandum titled "Principles of Federal Prosecution of Business Organizations."[1] Thompson advocated strict prosecution of organizations that break the law, as well as the individuals within these organizations who assist in carrying out illegal activities. In deciding whether to go after an organization, Thompson suggested that the government should consider the:

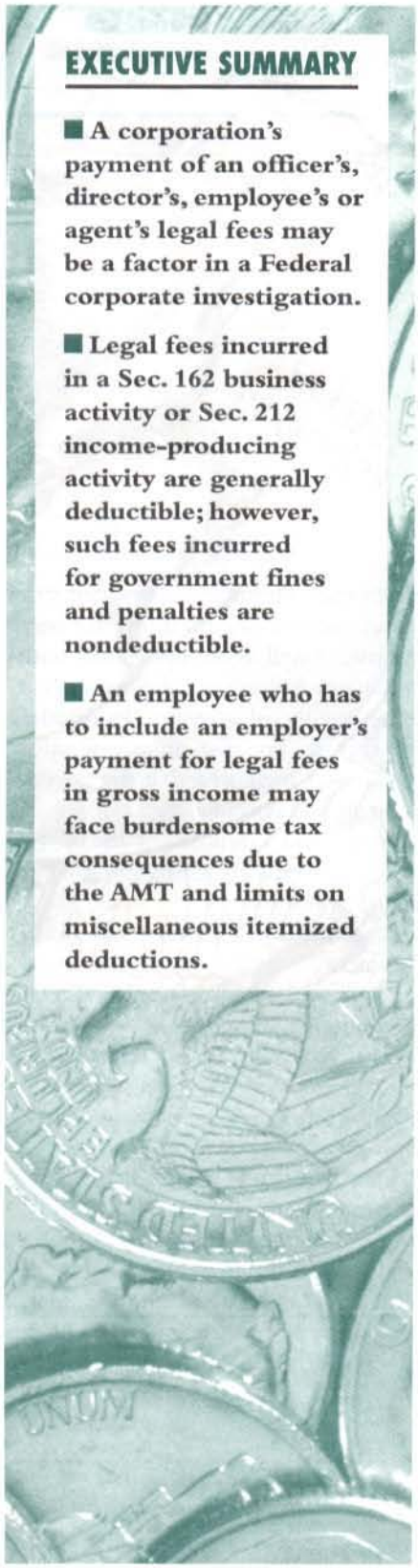
1. Nature and seriousness of the offense;
2. Pervasiveness of wrongdoing within the organization;
3. Organization's history of similar conduct;
4. Organization's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in investigations of its employees and agents (including waiving attorney-client and work-product privileges);
5. Existence and adequacy of the organization's compliance program;
6. Organization's remedial actions;
7. Collateral consequences (such as disproportionate harm to equity holders);
8. Adequacy of prosecution of individuals within the organization who are responsible for its wrongful conduct; and
9. Overall adequacy of remedies.[2]

Payment of Legal Fees

The extent to which the organization is willing to cooperate in an investigation of its employees and agents

[1] See U.S. Dept. of Justice, Office of Dep. Att'y Gen. Memo. (1/20/03), available at www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

[2] See id. at p. 3.



EXECUTIVE SUMMARY

- **A corporation's payment of an officer's, director's, employee's or agent's legal fees may be a factor in a Federal corporate investigation.**
- **Legal fees incurred in a Sec. 162 business activity or Sec. 212 income-producing activity are generally deductible; however, such fees incurred for government fines and penalties are nondeductible.**
- **An employee who has to include an employer's payment for legal fees in gross income may face burdensome tax consequences due to the AMT and limits on miscellaneous itemized deductions.**

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itself raises tax issues. In his memo, Thompson noted that corporate payments of attorneys' fees on behalf of an employee or agent may be a relevant factor in determining the extent and value of its cooperation with the government.[3] In other words, if an organization pays attorneys' fees on behalf of its officers and directors (or even its rank-and-file employees), it may be subject to more stringent prosecution. This connection between fees and the investigation's fervor has not gone unnoticed by organizations being investigated for potential wrongdoing; their lawyers have noticed, too.

Example 1: *E*, an employee of major accounting firm *G*, specialized in its tax shelter marketing efforts. For years, *E* marketed tax shelters that *G* assured him were legal. However, both *E* and *G* are now under investigation by Federal prosecutors and face possible indictment. *E*'s legal fees are likely to be substantial. *G* gives *E* a choice: (1) agree to cooperate with Federal prosecutors (which could result in jail time) and it will pay the legal fees or (2) invoke Fifth Amendment rights and pay your own legal fees.

No matter who pays *E*'s legal fees, the tax consequences to either him or *G* may prove to be significant. What are the tax consequences if *E* decides to cooperate, and *G* pays his legal fees?

Deducting Legal Fees

The Code does not expressly provide a deduction for legal fees. Even so, legal fees arising from a trade or business or Sec. 212 activity are generally deductible if they are (among other things) ordinary, necessary and reasonable, and directly connected to (or proximately result from) the taxpayer's trade or business.

In *Oden*,[4] the Tax Court invoked the "furtherance" test, which requires the expense in question to further the trade or business or Sec. 212 activity (in addition to being ordinary, necessary, etc.). In *Oden*, the Tax Court denied the taxpayer's deduction for legal fees—which were the proximate result of his malicious behavior—because such behavior (making malicious comments about a former employee to a potential employer) was not in furtherance of his trade or business.

Defining "Ordinary"

The "ordinary and necessary" requirement has generated substantial confusion over the years, even though it seems straightforward. Generally, an expense (for legal fees or otherwise) is "ordinary" if a business person would commonly incur it under the particular circumstances.[5] Taxpayers frequently confuse the "ordinary" requirement with the notion that the particular expense must arise over and over again (and, hence, would be ordinary in the usual sense). Thus, the "ordinary" requirement is viewed as synonymous with "recurrent."

However, the courts have been much more expansive in their interpretation of the ordinary and necessary requirement. The Supreme Court, for example, has noted that a so-called ordinary expense may actually be extremely *irregular* in occurrence, stating:

> A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. Nevertheless, the expense is an ordinary one, because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.[6]

Moreover, the Tax Court has noted that employing an attorney satisfies the "ordinary" requirement if

[3] See id. at p. 5.

[4] *Louis Oden*, TC Memo 1988-567.

[5] See *Chicago Dock and Canal Co.*, 84 F2d 288 (7th Cir. 1936) and *S.B. Heininger*, 320 US 467 (1944).

[6] *Welch v. Helvering*, 290 US 111 (1933).

it is consistent with the behavior of a reasonably prudent person in the same circumstances.[7]

Defining "Necessary"

Just as the "ordinary" requirement has been liberally interpreted, the "necessary" requirement has also been given a wide berth. It is not critical to inquire whether a taxpayer really *had* to incur a particular expense, such as paying an employee's or agent's legal fees, if incurring such an expense was "appropriate or helpful."[8]

The "ordinary and necessary" nature of paying legal fees in this context is rarely questioned by the IRS or the judiciary, assuming that the requisite nexus can be established between the lawsuit and the defendant's business.[9] Nevertheless, there is still the issue of an expense's overall "reasonableness."[10] The reasonableness of a payment in this context (pursuant to either a settlement or judgment) will generally not be questioned, because litigation is adversial by its very nature.

Origin-of-the-Claim Doctrine

For an organization to deduct legal fees, they must generally be directly connected to its trade or business.[11] However, the deduction does not depend on the case's success.[12] Instead, deductibility is determined under the origin-of-the-claim doctrine.

This doctrine is merely the sensible proposition that the "origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal' and hence whether it is deductible or not."[13]

Perhaps the most well-known "origin" case is *Gilmore*.[14] In that case, the expenses of divorce litigation were held to be nondeductible personal expenditures, even though an adverse decision in the matter was likely to destroy the taxpayer's business. The origin of the claim was the divorce litigation, not the potential consequences of the divorce to the business. Thus, the litigation expenses were nondeductible personal expenditures.

Determining the deductibility of legal fees begins with identifying the payer. Only the payer is entitled to potentially applicable deductions. For example, if a corporation deducts legal fees arising out of the action of its agents, equity holders or employees, it must pay or incur the amount for its own benefit, rather than theirs.[15] Even so, legal fees and expenses relating to the actions of officers and directors in conducting a corporation's business have generally been held deductible by the paying corporation, on the theory that the matter is proximately related to that business, and the results achieved in litigation are beneficial to the entity.[16]

Nonetheless, corporations have been denied deductions for legal expenses incurred in defending suits against employees that are unrelated to their trade or business.[17] Indeed, when an employee is a major equity holder, it may be best to avoid this type of situation altogether. One way is to have the individual make a capital contribution to the organization for the legal fees. This is generally tax free under Sec. 118, 351 or 721 (if a partnership). In any case, the organization can then use the contribution to pay the legal fees, and deduct them as an ordinary and necessary business expense.

Distinguishing Fines or Penalties

In general, payments are deductible (when paid in a settlement or judgment) if made in the ordinary course of a trade or business (or in the production of income or furtherance of investment activities). In contrast, Sec. 162(f) expressly prohibits a deduction for "any fine or similar penalty paid to a government for the violation of any law."[18] Attorneys' fees incurred in defending against the imposition of fines or penalties have also been held to be nondeductible, on the theory that they are tainted by the nature of the litigation.[19]

Hence, returning to *E* in Example 1 above, some of *E*'s and *G*'s attorneys' fees relating to the Federal investigations may ultimately be disallowed under Sec. 162(f). Regs. Sec. 1.162-21(b) and Sec. 162(f) deny a deduction for both criminal and civil penalties, as well as for sums paid in settlement of a potential liability for a fine or penalty. The latter element of the provision often causes controversy. It may (or may not) be clear that a fine is likely when a potential liability is satisfied.

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[7] See *Harry Kanelos*, 2 TCM 806 (1943).

[8] See *Thomas P. Lilly*, 343 US 90 (1952).

[9] For deductions under Sec. 212, the taxpayer must show the requisite nexus between the income-producing or investment activities and the expense.

[10] See *Aaron Michaels*, 12 TC 17 (1949), acq., 1949-1 CB 3; and *Leo M. Harvey*, 171 F2d 952 (9th Cir. 1949).

[11] See *Samuel J. Kornhauser*, 276 US 145 (1928); *C. Fink Fisher*, 50 TC 164 (1968); and *Northwestern Indiana Tel. Co.*, TC Memo 1996-168, aff'd, 127 F3d 643 (7th Cir. 1997).

[12] See *Walter F. Teillier*, 383 US 687 (1966); *Central Coat, Apron & Linen Service, Inc.*, 298 FSupp 1201 (SD NY 1969); and *Allied Signal, Inc.*, TC Memo 1992-204, aff'd, 54 F3d 767 (3d Cir. 1995).

[13] *Donald Gilmore*, 372 US 39 (1963), rev'g 290 F2d 942 (Ct. Cl. 1961).

[14] *Donald Gilmore*, id., on remand, 245 FSupp 383 (ND Cal. 1965).

[15] See *Esco High Frequency Corp.*, 167 F2d 583 (2d Cir. 1948), *cert.* den., and *Jack's Maintenance Contractors, Inc.*, 703 F2d 154 (5th Cir. 1983).

[16] See *Central Foundry Co.*, 49 TC 234 (1967), acq., 1968-2 CB 2; *Larchfield Corp.*, 373 F2d 159 (2d Cir. 1966); *B.T. Harris Corp.*, 30 TC 635 (1958), acq., 1958-2 CB 5; and *Shoe Corp. of America*, 29 TC 297 (1957), acq., 1958-2 CB 7.

[17] *Jack's Maintenance Contractors, Inc.*, 703 F2d 154 (5th Cir. 1983); *Greenstein & Scheer, PC*, 113 TC 135 (1999); *Lenward C. Hood*, 115 TC 172 (2000); *Northwestern Indiana Tel. Co.*, note 11 supra; and *Capital Video Corp.*, 311 F3d 458 (1st Cir. 2002).

[18] Compare with Sec. 162(a).

[19] See *Burroughs Building Material Co.*, 47 F2d 178 (2d Cir. 1931); see also *Allied Signal, Inc.*, note 12 supra.

In some cases, imposition of a fine or penalty may depend on the perpetrator's intent. However, if the fine or penalty is imposed, denial of the deduction is absolute. It does not matter whether the legal violation was intentional or unintentional; no deduction is permitted for the payment of a fine or penalty, even if the violation is inadvertent, or if the taxpayer must violate the law to operate profitably.[20]

These rules seem to be very visible lately. One can hardly pick up a newspaper without learning about another corporate wrongdoer forced to pay a fine or penalty. In 2003, MCI was fined a record $500 million by the Securities and Exchange Commission for accounting fraud.[21] Roughly $1.5 billion was shelled out by the securities industry in 2003 for its indiscretions.[22] Interestingly, of this amount, only about $450 million was characterized as nondeductible fines or penalties.[23] Thus, there is often some latitude in characterizing the nature of the payment.

Indeed, Exxon Corp. was almost as fortunate as the securities industry players when paying for its Exxon Valdez oil spill catastrophe. The U.S. government's $1.1 billion settlement with Exxon actually cost it a mere $524 million on an after-tax basis. The Congressional Research Service determined that more than half of the civil damages—totaling $900 million—could be deducted on its Federal income tax returns.[24]

Frequently, the line-drawing exercises that take place are imprecise. Ultimately, it is axiomatic that fines or penalties, as well as their corresponding legal fees, are nondeductible under Sec. 162(f). Yet, it is often difficult to tell whether a payment is truly a fine or penalty or is deductible.

Sec. 162 vs. 212

There are many similarities between deducting legal fees under Secs. 162 and 212. Yet, there is one big difference—the alternative minimum tax (AMT). Legal fees deducted under Sec. 212 are subject to disallowance for AMT purposes under Sec. 56(b)(1)(A)(i). Legal fees taken as miscellaneous itemized deductions are also subject to a 2%-of-adjusted-gross-income floor and reduction for high-income taxpayers.[25]

Example 2: *J* is indicted on multiple counts of racketeering, conspiracy, extortion, fraud and obstruction of justice. *J*'s various income-producing activities are engaged in for the production of income. Accordingly, his legal fees ($500,000) may be deducted only under Sec. 212 (instead of Sec. 162), will be disallowed entirely for AMT purposes and be further limited by Secs. 67 and 68.

During the year of his indictment, *J* produced substantial income ($500,000) from his various activities. At trial, he pleads not guilty, claiming he is a law-abiding businessman. However, the jury convicts him on multiple counts of racketeering. On his return, *J* deducts his attorneys' fees under Sec. 212.

Because the Sec. 212 deduction is disallowed entirely for AMT purposes (and further limited by Secs. 67 and 68), *J* owes roughly $136,000 in Federal income taxes (even though his deductions equaled or exceeded his income). Of this amount, over 98% results from the AMT. Had he deducted the fees under Sec. 162,[26] his tax liability would have been approximately $1,000.

Paying Another's Legal Fees

In *O'Malley*,[27] the Tax Court found a pension fund trustee to be in receipt of income when his employer paid his legal fees in a criminal prosecution for conspiracy to commit bribery. Even so, the court permitted the taxpayer to deduct the fees as ordinary and necessary employee business expenses. At trial, he argued that the legal fees were his employer's ordinary and necessary business expenses; accordingly, they should not be included in his gross income. However, the court disagreed, in large part because the pension fund (the employer) was not named as a defendant in the prosecution.[28] Thus, the Tax Court found the legal fees to be personal to the employee. Citing *Old Colony Trust*,[29] it determined that the pension fund's payment of his personal legal fees was income to him. This kind of quandary actually happens frequently.

In Example 1 above, *E* may have to recognize as gross income any amount *G* pays for his legal fees, depending on the exact nature of any future actions taken against either party. Admittedly, this is not likely, because any indictment against *E* would probably name *G* as a co-defendant.

However, what if only *E* is indicted, but *G* pays his legal expenses? *E* would probably have to include the payment in income. Although the gross-income inclusion is a burden, the AMT is worse.

[20] See *Tank Truck Rentals, Inc.*, 356 US 30 (1958).

[21] See Larsen and Michaels, "MCI Fined Record $500M over Fraud Charges," *Financial Times* (5/20/03), p. 1.

[22] See Wood, "Should the Securities Industry Settlement Be Deductible?," 99 *Tax Notes* 101 (4/7/03).

[23] See Zuckerman, "Wall Street Settlement Will be Less Taxing," *Wall Street Journal* (2/13/03) p. C1, C9. The bulk of the securities industry settlement, more than $1 billion, went toward investor restitution, education and dissemination of independent research (all deductible business expenses).

[24] See "Tax Deductions Will Help Exxon Slip Away From Much of its Oil Spill Liability Says CRS," *Tax Analysts Highlights & Documents* (3/21/91), p. 2853.

[25] See Secs. 67(a) and 68(a).

[26] See *Ellis McDonald*, SD AL, 12/23/97.

[27] *Thomas O'Malley*, 91 TC 352 (1988).

[28] See *Frank J. Matula*, 40 TC 914 (1963); and *Irving Sachs*, 32 TC 815 (1959), aff'd, 277 F2d 879 (8th Cir. 1960).

[29] *Old Colony Trust Co.*, 279 US 716 (1929).

Employee business expenses are miscellaneous itemized deductions and subject to complete disallowance for AMT purposes (as well as the reductions mandated by Secs. 67 and 68). As previously demonstrated by Example 2 above, the disallowance of this deduction for AMT purposes can be crippling.

Until recently, *E* might have argued that the fees should be excluded from income under a rationale similar to the former minority view[30] that excluded the contingent-fee portion of a recovery from a plaintiff's gross income.[31] *E* might have claimed that he never had dominion and control over the funds paid to his attorneys and, thus, should not be required to include them in income. However, the Supreme Court recently refuted the minority circuits in a 2005 decision,[32] which requires successful plaintiffs to include the contingent-fee portion of recoveries in gross income. The Service would presumably cite *Old Colony Trust*, as well, to refute this assertion. However, there is at least a plausible argument that *Old Colony Trust* is distinguishable from *E*'s situation; after all, *G* would *not* be attempting to compensate *E*.

Conclusion

Governmental investigations of employees and their firms raise a host of tax issues. The extent to which an organization is willing to cooperate in an investigation of its employees and agents adds to the perspective. The payment of attorneys' fees on behalf of employees or agents may be viewed as relevant in determining the extent and value of an organization's cooperation with the government. On an individual level, the tax effects of a large legal bill, given an unattractive income and deduction equation, can be disastrous. **TTA**

[30] See, e.g., *Ethel West Cotnam*, 263 F2d 119 (5th Cir. 1959); *Est. of Arthur Clarke*, 202 F3d 854 (6th Cir. 2000); *Willie Mae Davis*, 210 F3d 1346 (11th Cir. 2000); and *Sudhir Srivastava*, 220 F3d 353 (5th Cir. 2000).

[31] See, e.g., Wood and Daher, "Attorneys' Fee Saga Continues: Maverick Circuit Says, 'Oregon Good, California Bad,'" 101 *Tax Notes* 91 (9/30/03); Wood and Daher, "Attorney Fees: Rebellious Circuit Don't Need No Stinkin' Lien Law," 101 *Tax Notes* 1427 (12/11/03); and Wood, "Everybody Loves Raymond? Second Circuit Further Fouls Tax Treatment of Attorney Fees," 102 *Tax Notes* 1639 (3/19/04).

[32] See *John W. Banks II*, Sup. Ct., 1/24/05, rev'g 345 F3d 373 (6th Cir. 2003) and 340 F3d 1074 (9th Cir 2003).