Shouldn't All Legal Fees Be Deductible?

By Robert W. Wood • Wood & Porter

Individuals and companies alike complain of rising legal costs. In the business world, virtually everyone thinks all legal fees are deductible. They may be expensive, one reasons, but at least they're deductible! Like so many other misconceptions in our complex tax law, however, there are many situations in which legal fees are not deductible.

First, there is a broad category of legal expenses in the strictly personal category. Unfortunately, they are not deductible. For example, legal expenses of a divorce are nondeductible, since divorce is personal. [*See D. Gilmore*, SCt, 63-1 USTC ¶9285, 372 US 39 (1963).] The one exception is the portion of the legal fees paid pursuant to a divorce that are for tax advice, since fees for tax advice (paid to a lawyer or accountant) are deductible as investment expenses. Of course, investment expenses are not a favored tax deduction, since they are subject to various limitations along with other miscellaneous itemized expenses.

Second, and perhaps of more interest to M&A TAX REPORT readers, legal expenses of a capital nature are not deductible. That makes legal fees to defend title to property, to acquire another company, or to purchase capital assets a good deal more painful. Such expenses must be capitalized over the life of the asset.

Nevertheless, in the vast majority of cases, legal expenses paid or incurred in carrying on a trade or business are deductible as business expenses. A business expense deduction is truly gold plated, offsetting income in much the same way as an adjustment. The business expense versus investment expense dichotomy is important, and represents a factual line that is often litigated.

Consider legal expenses paid or incurred in pursuing investment activities, or activities for the production of income. These are activities that are not active or regular enough to constitute a trade or business, but that nevertheless are conducted with profit-making in mind. Investment legal expenses are deductible only as miscellaneous itemized expenses. That means they are subject to a two percent of adjusted gross income threshold, phase-outs, and are nondeductible for purposes of the AMT.

Same Old Thing

These rules are pretty well defined. How, then, do so many taxpayers get into such frequent and serious trouble over legal fees? The recent Tax Court case of *West Covina Motors, Inc.*, 96 TCM 263, Dec. 57,564(M), TC Memo. 2008-237, provides a window into legal fee deduction disputes. In this case, there was a variety of legal expenses in question.

First, the Tax Court had to decide whether the taxpayer could deduct the legal expenses it incurred in the bankruptcy of its landlord. Second, the Tax Court considered whether the taxpayer could deduct legal expenses related to the purchase of another car dealership. Third, the Tax Court had to evaluate miscellaneous legal expenses that were questioned by the IRS. Fourth, the Tax Court considered whether accuracy-related penalties should apply.

Categorize Your Expenses

For old-school lawyers who are used to billing "for services rendered" and not particularizing their invoices, reading some of the tax cases in this area should be a wake-up call. Only old-school clients are likely to pay "for services rendered" statements. Most clients these days expect their legal bills to be detailed, describing the legal work and the categories of legal expenses, particularly if the client is concerned about the tax impact of such payments.

In *West Covina Motors*, the first category of legal expenses the Tax Court considered related to the landlord of the car dealership. The landlord filed for bankruptcy, not so much to maintain its position as lessee of the dealership, but to expand it. In fact, when the smoke cleared after the bankruptcy reorganization, West Covina was able to expand its business onto two additional parcels of land that the erstwhile bankrupt landlord had acquired as a result of the reorganization.

The taxpayer's legal fees for all of the bankruptcy work thus lead to a significant expansion of the taxpayer's business premises. The Tax Court had a relatively easy time viewing these legal expenses as capitalizable and not currently deductible. Traditionally, legal expenses incurred to defend claims that would injure or destroy a business are classified as ordinary and necessary expenses and thus deductible. [*See S.B. Heininger,* SCt, 44-1 USTC ¶9109, 320 US 467 (1943).] The Tax Court actually said that if *West Covina Motors* had been paying legal expenses in the bankruptcy as a way of ensuring that West Covina would continue to be able to occupy its business premises, those taxpayers would be ordinary and necessary, and thus deductible.

The problem, said the Tax Court, was that West Covina incurred its bankruptcy legal fees not merely to *survive*, but actually to *expand* its business onto several additional parcels. Although West Covina Motors attempted to paint a picture of the bankruptcy-related legal fees as necessary merely for West Covina to *survive*, the Tax Court found otherwise.

Acquisition Legal Fees

Even more obviously, legal fees paid to acquire another company have traditionally been required to be capitalized. You can't deduct them currently, so you must capitalize them along with the purchase price for the assets or company in question. The second tranch of legal fees considered in *West Covina Motors* related to the taxpayer's purchase of the assets of another car dealership. The taxpayer acquired this other dealer's inventory, parts and accessories, fixed and intangible assets. The purchase price was over $6 million.

The purchase agreement required West Covina to assume the seller's legal expenses. In that connection, West Covina paid $100,000 in fees to the seller's counsel as well as approximately $20,000 in fees to its own counsel. The Tax Court had an easy time concluding that these were capital-related legal fees, and that they too had to be capitalized.

Despite the stacked deck against it, West Covina had an ingenious argument. Look, the bulk of the purchase price for the other dealer's assets was allocable to its inventory, went the argument. As the car dealer's inventory usually turned over every 90 to 150 days, the taxpayer's argument continued, it was inappropriate to capitalize the bulk of these legal fees. They could be directly traced to inventory, so had to be ordinary! The Tax Court found this argument creative, but found no factual support for it.

Telling Records

In fact, the Tax Court concluded that less than 40 percent of the purchase price in the dealer's sale was allocable to the inventory. The Tax Court discounted the testimony that was offered, labeling it as self-serving and uncorroborated. The Tax Court pointed out that even the dealership's records showed that the inventory did not turn every 90 to 150 days. Accordingly, the Tax Court ruled that all of the acquisition legal expenses had to be capitalized.

Record-keeping also did the taxpayer in on the approximately $54,000 in miscellaneous legal fees that were next questioned by the Tax Court. These may well have been perfectly legitimate legal expenses incurred in carrying on the West Covina dealership business. Unfortunately, the taxpayer presented no evidence about these legal expenses, so the Tax Court ruled them to be nondeductible.

The taxpayer's last slap in the face from the Tax Court came in the discussion of penalties. The IRS assessed substantial understatement penalties under Code Sec. 6662(b)(2). The taxpayer argued that the return positions it had taken were reasonable, that it had substantially disclosed them, and that in any case it had reasonable cause for its failures. The Tax Court disagreed on every point.

Perennial Lessons

There are surprisingly few new developments concerning legal fees. Most of the trends are well established. Personal legal fees are nondeductible. Legal fees related to the active conduct of a trade or business may be deducted as ordinary and necessary business expenses. Investment legal expenses are deductible as investment expenses. Legal fees related to acquiring or preserving capital assets must be capitalized.

We know all these things, and yet we need reminders. More than that, we need compliance tools. Not infrequently, taxpayers lose out because of a lack of proof.

They cannot produce detailed legal bills showing what work was done. They cannot produce evidence of the requisite nexus between the legal expenses and the ongoing operation of their active trade or business. They cannot produce copies of checks.

Most of these deficiencies are quite curable. Moreover, in many cases difficult situations can be ameliorated with the wisdom of Solomon.

Divide and Conquer

Taxpayers can often bifurcate legal bills between personal and tax (divorce), or between personal and investment (a legal dispute between neighboring homeowners). Taxpayers can also divide bills between ordinary business expenses and capital expenditures, in cases where litigation concerns ongoing business operations as well as title to assets. In the corporate arena, the division will often be a way to get half a loaf or more, rather than no loaf at all.

Recall that one of the earliest and most persistent lessons of *INDOPCO* was bifurcation. Divide and conquer. The same techniques can be used between investment expenses and additions to basis. For example, a legal dispute between neighboring homeowners may affect a nuisance as well as title to property.

Records and documents are key. In fact, documentary evidence—checks, bills, pleadings, correspondence, declarations, and the like—will often keep you from needing to resort to testimony. That is good, since the legal evidentiary standards for testimony may be tougher than the level of informality with which many legal fee tax disputes can be resolved. Keep a good file, and when it comes to bifurcating fees, be reasonable. With any luck, you won't have to go to court to secure your legal fee deductions. If you do go to court, you'd better have more convincing evidence than West Covina Motors did.

Since the Supreme Court's *INDOPCO* decision (*INDOPCO,* SCt, 92-1 USTC ¶50,113, 503 US 79 (1992)) permeated our consciousness about acquisition expenses, bifurcation has often been the ticket to allowability. Be reasonable, and never take the last piece of pie. And, in the inimitable words of Rodney King, "Can't we all just get along?"