Legal Fees, Deals, and the Dilemma of Deductibility

By Robert W. Wood

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In this article, Wood discusses a recent case involving the capitalization of legal fees and points out that the legal fee issue can be surprisingly complex.

Even in this day of supposed innovative law firms and creative alternatives to the billable hour, legal fees add up. And, in a reverse trend, some of the most sought after legal talent is actually charging more, not less. Consider specialized transactions, such as inversions, while the trend lasts.

Whoever provides the legal advice, due diligence, documentation, and structuring work, it can be costly. The most classic way to ameliorate the cost of legal fees is a tax deduction, and the sooner, the better. Yet there are limits.

It does not take a tax expert to understand the basics. Business people and corporate lawyers know that legal fees are deductible. However, they also know that there are many situations in the context of a transaction when all or a part of a deal's costs — including legal fees — cannot be immediately deducted and are capitalized.

If costs are capitalized, it does not mean that their tax benefit is lost forever, but it does mean that the deduction for them may be a long time coming — spread over what can seem like an infinite number of years.

What's Capital?

A recent Tenth Circuit case, *Ash Grove Cement Co. v. United States*,[1] shows that the legal fee issue can be complex. *Ash Grove* was a refund case, and one that did not go well for the taxpayer. Still, it may help other taxpayers negotiate the nuances of deducting legal fees and legal settlements.

Ash Grove Cement Co. manufactures and sells cement. Vinton Corp. owned about two-thirds of its stock. Vinton also owned the Lyman-Richey Corp., a ready-mix cement company. Vinton was wholly owned by the Sunderland family.

While Vinton owned two-thirds of Ash Grove directly, the remainder of the Ash Grove stock was spread among members of the Sunderland family (about 6 percent), the Ash Grove Employee Stock Ownership Plan (2 percent), and about 150 unrelated shareholders.

Under the terms of a reorganization plan, Ash Grove acquired Vinton and Lyman-Richey, and the Sunderland family received Ash Grove stock in return. To execute the plan and negotiate the proposed transaction, Ash Grove's board formed a special committee. That special committee's two members were not members of the Sunderland family nor employees of Ash Grove.

On November 2, 2000, the committee approved the reorganization, with an exchange rate of 876 shares in Ash Grove for each share in Vinton. The transaction was completed on December 31, 2000. At that point, Ash Grove owned Lyman-Richey and the Sunderland family members who had previously owned Vinton stock became direct owners of Ash Grove stock.

Lawsuit and Settlement

On January 18, 2002, Daniel Raider, a minority shareholder in Ash Grove, filed a class action complaint against Ash Grove and each member of its board. Raider (no comments about the serendipity of his name) alleged that the reorganization constituted self-dealing by the Sunderlands and that the special committee of the board was not meaningfully independent of the family.

He claimed that the transaction had unfairly diluted the minority shareholders' interests in Ash

[1]No. 13-3058 (10th Cir. Kan. 2014).

Grove. He sought rescission, imposition of a constructive trust on all the profits and benefits the individual defendants had ''wrongfully obtained,'' and compensation from the individual defendants to himself and the class ''for all losses they ha[d] sustained as a result of the [t]ransaction.''

In August 2005 the case settled, with Ash Grove paying $15 million into a trust for the class. During the 2005 tax year, Ash Grove also paid $43,345 for legal fees incurred in defense of its board members and related to the suit. Ash Grove had previously adopted corporate bylaws that included indemnification rights for directors of the company.

The bylaws stated that ''the Corporation shall indemnify and advance expenses to each person who is or was a director or officer of the Corporation . . . to the full extent permitted by the laws of the State of Delaware.'' Those bylaws would turn out to be important to the company.

Ash Grove filed a consolidated return, in which it deducted the settlement payment and the $43,345 in legal fees as business expenses. The IRS disallowed the deductions, calling them capital expenditures. Ash Grove paid the deficiency and sued for a refund. The district court granted summary judgment for the government, and the plaintiffs appealed to the Tenth Circuit Court of Appeals.

Issues on Appeal

Although the section of the code allowing a deduction for ordinary and necessary business expenses is as big as all outdoors, the capitalization principles in *INDOPCO v. Commissioner*[2] loom large in the court's opinion. Sure, businesses deduct legal settlements and legal fees all the time. But deductions for professional expenses related to changes in corporate structure are different.

Indeed, litigation expenses arising out of the acquisition of a capital asset are considered capital. In general, that is true whether or not the taxpayer's purpose in incurring them is the defense or perfection of a title to property.

Origin of the Claim

Whether litigation expenses are ordinary or capital is governed by the origin of the claim test. That test seeks to find the transaction or activity from which the taxable event proximately resulted or the event that led to the dispute. Courts have repeatedly concluded that litigation costs arising out of corporate reorganizations are capital expenditures.

Ash Grove acknowledged that point but tried to distinguish its situation. Its class action litigation did not involve the purchase of a capital asset, it argued. It did not even involve the setting of the price of a capital asset. Besides, Ash Grove was not the real party in interest, the company contended.

The Tenth Circuit was not convinced. The court noted that the complaint expressly concerned the terms of the reorganization, particularly the purchase price for Vinton and Lyman-Richey.

On behalf of the class, Raider in the complaint sought rescission of the reorganization. To the court, that meant that Ash Grove's legal fees and settlement operated to maintain the reorganization. The court relied on the Supreme Court's conclusion in *United States v. Hilton Hotels Corp.*[3] There, the Court held that a variation in state law changing the relationship between parties in a suit regarding capital expenses did not affect the deductibility of the expenses.

In *Hilton Hotels Corp.*, New York law provided that title to the dissenters' stock passed as soon as they formally registered their dissent. That put them in the relationship of creditors of the company for the fair value of the stock. But under Iowa law, the passage of title was delayed until after the price was settled in the appraisal proceeding.

Did that matter? The Supreme Court said that it did not. And the Tenth Circuit found Ash Grove's issue similar. The complaint filed by Raider sought payment and rescission to ensure that minority shareholders retained the fair value of their stock in the reorganization.

The Tenth Circuit held that it did not matter that Delaware law allows a suit against the board of directors to seek those remedies. That did not change that the suit, and Ash Grove's related payments, proximately resulted from the transaction itself.

Ash Grove also used the director indemnity provisions and the decision in *Larchfield Corp. v. United States*[4] to support its position. In that case, amounts paid for counsel for individual defendants under an indemnification bylaw were deductible even though the same payments would not have been deductible if they had been incurred by the corporation.

The Tenth Circuit was still not convinced. First, it noted that *Larchfield* was decided before cases clarified the origin of the claim doctrine. Moreover, the court said that even *Larchfield* specified that expenses of a suit against directors were not always deductible.

The Tenth Circuit ended up applying the origin of the claim test and not the *Larchfield* test. The court held that expenses of a suit against directors are not always deductible, and this was one of those cases.

[2]503 U.S. 79 (1992).

[3]397 U.S. 580, 583 (1970).

[4]373 F.2d 159 (2d Cir. 1966).

Suit in Name Only

Ash Grove contended that it was named in the class action only to invoke the Delaware Court of Chancery's jurisdiction for rescission. The company argued that the class action had failed to assert a claim on which the Delaware courts could have granted relief. What's more, there was actually no cause of action alleged against Ash Grove, it maintained.

The company said that meant that the indemnification claims were paramount and that the legal fees associated with them were deductible. In dismissing that argument, the Tenth Circuit noted that even if it assumed that the outcome of the origin of the claim test would be different had Ash Grove not been a party to the case and did not have genuine motivations in seeking a settlement for its own benefit, that was not enough. The court held that Ash Grove failed to carry its burden in demonstrating its right to a deduction.

The court went on to state that it was not clear whether Ash Grove's indispensability in the Delaware litigation was relevant to the analysis. The payments made by Ash Grove were unambiguously made in connection with the class action suit and the reorganization. The court said that it did not need to interpret state law on proper joinder of parties to determine the nature of the connection.

The payment settling the class action and the reorganization transaction were related, and quite closely at that. The court therefore concluded that the district court had been correct. The government was entitled to summary judgment. The legal fees and the settlement payment made by Ash Grove were nondeductible capital expenses.

Whose Expense?

Was *Ash Grove* a simple case? In some ways, yes. When it comes to transaction costs, *INDOPCO* stands as a barrier to deductibility. But it is worth remembering that it may be possible to allocate costs among several categories.

Some of the costs may be deductible. In general, the more specific vendors or service providers can be about what they did and to what end, the better. For that matter, sometimes, even allocating costs and benefits between entities can make a difference.

For example, in LTR 200830009, a surviving company was acquired in a merger, and sought to allocate merger transaction costs between itself and the target that merged into it. Most of the actual contracts and costs were at the parent level. The parent paid fees for financial advice, legal services, and due diligence. The question the IRS addressed was which entity could claim credit for those fees.

The letter ruling begins with a recitation of the deduction versus capitalization rules. The regulations under section 263 carve out covered transactions, making it clear that transaction fees to pursue covered transactions must be capitalized. But the question concerned how those fees should be allocated.

The IRS ruled that Survivor could allocate the transaction costs to Target or the acquisition company (which merged into Survivor) based on the entity to which the services were rendered and the entity on whose behalf they were provided. That can allow some flexibility. Indeed, the letter ruling notes that they were lump sum costs from the various vendors. Plus, detailed billing records were not available, said the IRS.

Even so, the IRS found the records sufficient to support an appropriate allocation between the entities. One may be used to the old saw that one taxpayer cannot deduct costs paid on behalf of another. Yet here we are talking only about an allocation of transaction costs, with appropriate sharing based on which entity received the services. The silver lining of LTR 200830009 is simply that transaction costs can be allocated among entities.

That in itself provides some flexibility, even though it is obvious that a current deduction is the real bonanza. On that point, there were some costs that the IRS said could be deducted (for example, some investigatory expenses). Similarly, there were some financing costs related to a securitization financing plan that the IRS ruled were eligible for an abandonment loss under section 165. One financing plan was abandoned. Its abandonment (along with the sunk costs associated with pursuing it) therefore allowed that abandonment loss deduction.

In the current climate, one may be lulled into thinking that all transaction costs must be capitalized. But it is often worth parsing legal, accounting, and banking fees, and other transaction costs. The results of those efforts can be surprising.

Categorizing Expenses

That advice never seems to go out of style. Often, what seems nondeductible can be deductible after all with some forethought, hairsplitting, and good documentation. Parsing might even save a company legal fees. Lawyers tend to be more discerning when they have to be specific.

In *West Covina Motors Inc. v. Commissioner*,[5] a variety of legal expenses were in question. The Tax Court had to decide whether the taxpayer could deduct the legal expenses it incurred in the bankruptcy of its landlord. The Tax Court also had to

[5] T.C. Memo. 2008-237.

consider whether the taxpayer could deduct legal expenses related to the purchase of another car dealership.

Next, the Tax Court had to evaluate miscellaneous legal expenses that were questioned by the IRS. Most clients do not like "for services rendered" statements. Clients generally 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 those 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 had 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 Motors 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 the bankruptcy work thus led to an expansion of the taxpayer's business premises. The Tax Court had an easy time viewing those 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. The Tax Court actually said that if West Covina Motors had been paying legal expenses in the bankruptcy as a way of insuring that West Covina Motors would continue to be able to occupy its business premises, those expenses would be ordinary and necessary, and therefore deductible.

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

Acquisition Legal Fees

Legal fees paid to acquire another company have traditionally been required to be capitalized. One must capitalize them along with the purchase price of the assets or company in question. The second tranche of legal fees considered in *West Covina Motors* related to the taxpayer's purchase of the assets of another car dealership.

The taxpayer acquired another dealer's inventory, parts, accessories, and fixed and intangible assets. The purchase price was more than $6 million. The purchase agreement required West Covina Motors to assume the seller's legal expenses.

Among those legal expenses, West Covina Motors paid $100,000 in fees to the seller's counsel as well as about $20,000 in fees to its own counsel. The Tax Court had an easy time concluding that those were capital-related legal fees and that they, too, had to be capitalized. Despite the stacked deck against it, West Covina Motors had an ingenious argument.

Inventory?

The taxpayer argued that the bulk of the purchase price for the other dealer's assets was allocable to its inventory. The car dealer's inventory usually turned over every 90 to 150 days. Based on that, the taxpayer argued that it was inappropriate to capitalize the bulk of those legal fees. They could be directly traced to inventory, so had to be ordinary. The Tax Court found the argument creative, but found no factual support for it.

The Tax Court concluded that less than 40 percent of the purchase price was allocable to inventory. It discounted the testimony as self-serving and uncorroborated. The court pointed out that even the dealership's records showed that the inventory did not turn over every 90 to 150 days. Accordingly, the Tax Court held that all 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. Those may well have been perfectly legitimate legal expenses incurred in carrying on the West Covina Motors dealership business. Unfortunately, the taxpayer presented no evidence about those legal expenses, so the Tax Court held 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 too.

Talk about an unhappy result. The taxpayer argued that the return positions 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.

West Covina Motors filed a motion for reconsideration.[6] Thereafter, the taxpayer submitted further evidence regarding the fees, including itemized billing statements. Based on the new evidence, the Tax Court found that the legal fees allocated to inventory were allowable as cost of goods sold and thus deductible. The Tax Court also held that legal fees incurred in connection with the purchase of the car dealership must be allocated among all assets and amortized accordingly.

[6]T.C. Memo. 2009-291.

Lasting Lessons

It is hardly a new lesson that legal fees related to acquiring or preserving capital assets must be capitalized. We know that, and yet we need reminders. 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 those deficiencies are curable. Moreover, in many cases difficult situations can be ameliorated with the Wisdom of Solomon: split the baby.

Divide and Conquer

Taxpayers often bifurcate legal bills between personal and tax (for example, as in a divorce), or between personal and investment (say, in a legal dispute between neighboring homeowners). They can divide bills between ordinary business expenses and capital expenditures, in litigation concerning 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.

Bifurcation was one of the earliest and most persistent lessons of *INDOPCO*. The Supreme Court in *INDOPCO* said the legal and investment banking fees of an acquisition had to be capitalized. Since then, parsing legal and other expenses has become the norm: divide and conquer.

The same techniques can be used between investment expenses and additions to basis. Bifurcation has often been the ticket to a deduction, perhaps not as large as one would like, but better than nothing. In making allocations, be reasonable. Records and documents are critical, so it is best to keep a comprehensive file.

Documentary evidence — checks, bills, pleadings, correspondence, declarations, and the like — may keep you from needing to resort to testimony. That is good because the evidentiary standards for testimony may be tougher than the level of informality with which many legal fee tax disputes can be resolved.