Legal Fees and Tax Deductions

By Robert W. Wood[1]

It is unreasonable to expect a law firm's clients to enjoy paying legal fees as much as their lawyers enjoy receiving them. Yet in my experience, clients are much more likely not to object to paying legal fees if they can deduct them. After all, if you pay a deductible legal fee and are in a 40 percent (state and federal) tax bracket, you really are paying only 60 percent of the legal fees. The rest is paid by the government. This is so obvious it seems silly to say it.

Indeed, in my experience, clients tend to assume all legal fees are deductible. For clients operating a trade or business, this myopia is understandable. It is less easy to understand why clients in neighborhood lot line disputes, embroiled in family litigation, or defending criminal or civil charges filed against them may feel likewise. Many clients are simply unaware that personal legal fees cannot be deducted. Some wear rose-colored glasses that give everything a business (or at least investment) hue.

Like so many other misconceptions about our tax law, however, there are many situations in which legal fees are not deductible. That makes them doubly painful. First, there is a broad category of legal expenses in the strictly personal category. Like other personal expenses, they are not deductible.

A classic example is legal fees in a divorce. They are non-deductible because divorce is personal.[2] The one exception is the portion of the divorce legal fees attributable to tax advice.[3] Fees for tax advice are deductible as investment expenses. Investment expenses are miscellaneous itemized deductions and are subject to various limitations, including the alternative minimum tax (AMT).

Second, and perhaps more problematic to those in business, legal expenses of a capital nature are not deductible. Legal fees to defend title to property, to acquire another company or to purchase capital assets must be capitalized over the life of the asset.[4] For example, legal expenses to acquire a commercial building must be added to the cost of the building, and recovered (through depreciation) over 39 years. Similarly, legal expenses incurred in defending title to assets must be capitalized along with the cost of the assets in question.[5]

Nevertheless, in the vast majority of cases, legal expenses paid or incurred in carrying on a trade or business are deductible. A business expense deduction is truly gold-plated, offsetting income in much the same way as an adjustment to gross income. The business expense versus investment expense dichotomy is important and is often litigated. The latter represent activities that are not active or regular enough to constitute a trade or business, but that nevertheless are conducted with a bona fide profit motive.

Yet unlike gold-plated business expense deductions, legal expenses paid or incurred in pursuing investment activities (or activities for the production of income) are at best silver-plated. Investment legal expenses are deductible only as miscellaneous itemized deductions. That means they are deductible only in excess of 2 percent of adjusted gross income, and subject to phase outs for high income earners. Worse still, they are non-deductible for purposes of the AMT.

I. DORIS DAY'S SON

In *Estate of Terence P. Melcher v. Commissioner*,[6] the Tax Court considered legal expenses incurred by Doris Day's son, Terence Melcher. Melcher served as executive producer of his mother's television series, The Doris Day Show. Melcher earned most of his income from the series and his mother's films. He also wrote and produced music (including Beach Boys songs), and held interests in land and oil.

Melcher was married from 1983 through 1998, at which point he went through a bitter divorce. Among the assets in question were his 40 percent interest in Arwin Production, Inc. and various real estate interests. Although Melcher and his wife each had significant separate property, there was a dispute about what was separate and what was not.

In particular, the wife had owned oceanfront land on Martha's Vineyard before marriage. Melcher had built a house on it during marriage and title was put in their joint names. However, the asset became a major subject of dispute in the divorce.

The family court awarded one residence to the first wife, and ordered the sale of the Martha's Vineyard property, the proceeds to be divided between them. The family court agreed to sell it for $12 million in 2001. The ex-wife filed all manner of lawsuits to prevent the sale, eventually even filing for personal bankruptcy to stay it.

II. JARNDYCE v. JARNDYCE*?*

Dickens skewered Britain's legal system in his portrayal of a generations long legal dispute in Bleak House. Still, Melcher's more truncated legal saga was nothing to trifle with. Melcher paid significant legal fees over the years. Their tax impact became controversial.

Some of the legal expenses in question arose out of four separate appeals to the California Court of Appeals brought by his first wife. These proceedings lasted until 2006. During the intervening years, the ownership of the Martha's Vineyard property remained unresolved. In March of 2006, the California Supreme Court denied a petition for further review.

During this time, there were also multiple bankruptcy proceedings, with Melcher trying to collect rental income from the various properties. Melcher paid significant legal fees incurred in the bankruptcy matter as well. That too was protracted: the Tax Court recites that as of 2009 when it issued its opinion, the bankruptcy proceedings were still pending.

Melcher claimed legal expenses in several ways on his 2004 return. He deducted $165,627 of legal fees as un-reimbursed employee expenses on Schedule A. He claimed an additional $191,372 of legal expenses on Schedule C. The IRS disallowed all of the claimed deductions and the matter wound up in Tax Court.

III. ALL ROADS LEAD TO GILMORE

Predictably, the Tax Court begins its analysis with reference to the origin of the claim. The seminal case is *U.S. v. Gilmore*,[7] which held that the origin of a divorce was personal. That made Gilmore's legal fees nondeductible. This was so, said the Supreme Court, even though the consequences of failing in the divorce proceeding might be significant business or investment losses. In Gilmore, as in Melcher, the origin of the dispute was personal, whatever its effects might ultimately prove to be.

The Tax Court noted that Melcher had paid over $200,000 in legal fees in the appellate proceedings. With some force, Melcher argued that the disputes regarded ownership and sale of the beach property were simply not part of the divorce proceedings. Instead, he argued, they represented a legal dispute over income-producing property. Indeed, he argued with some force that it was clear that this legal proceeding occurred after Melcher's divorce was granted.

The IRS, in turn, said the expenses were purely personal in character, flowing directly from the divorce. Melcher not only argued that this dispute about the ownership and sale of property was separate and apart from the divorce, but that it independently involved investment property. According to Melcher, that made the fees deductible under Section 212.

Relying on "but for" causation, the Tax Court asked: would the legal fees have been incurred but for the marriage relationship? The answer had to be no. If the legal claim could not have existed but for the marriage, said the court, the expense of defending it was personal and therefore non-deductible. The history of the relationship was important, with the court concluding that the first wife owned the Martha's Vineyard property prior to marriage.

However, the transfer of title from the first wife's separate property to joint ownership with Melcher, noted the court, was not purely a function of the marriage. As a factual matter, the court found that this could be attributed to Melcher's financial investment in constructing a residence on the property. The origin of these legal expenses, said the Tax Court, was therefore not personal.

Rather, the legal expenses were incurred to establish Melcher's ownership of the Martha's Vineyard parcel. Unfortunately for Melcher, though, the Tax Court did not stop here. Even though this matter was not purely personal, the court recognized that expenses incurred in connection with the defense or perfection of title are non-deductible capital expenditures.

Indeed, the court said that the first wife had appealed the judgment of the family court regarding the transmutation of title to the beach property. The Tax Court found that Melcher's title to the beach property was called into question by the first wife's appeals, with the issue not being resolved until 2006. That meant these expenses had to be capitalized.

Recognizing that some of Melcher's legal fees were to defend title, such legal fees had to be capitalized. In contrast, some of the legal expenses (associated with defending against the first wife's claims regarding spousal support) stemmed entirely from the marriage. Those expenses could not be capitalized, and as they were purely personal in nature, were non-deductible.

The final category of Melcher's legal expenses related to bankruptcy matters. These legal fees, said the court, related to Melcher's attempts to collect rental income from the Martha's Vineyard property and the family residence. They also were incurred to seek approval to sell the Martha's Vineyard property. The Tax Court recited the general rule that such expenses (incurred in connection with the acquisition or disposition of a capital asset) are non-deductible capital expenditures.[8]

IV. CAPITAL EXPENDITURES

Legal expenses related to a sale of property are capital expenditures which must be offset against the sales price. The legal expenses here were of this latter variety. On the other hand, legal expenses that were actually paid to collect accumulated rents from the property would properly be classified as expenses for the production of income. That would make them deductible as miscellaneous itemized expenses.

Nevertheless, the court said it had no basis upon which to allocate the legal expenses between the time spent on the sale of the beach property and the time spent to collect rent. The court recognized that it had no time records. In their absence, the court said it could approximate the allocation and apportionment under the Cohan rule.[9]

To arrive at figures, the Tax Court said that Melcher sought to collect $1 million in rent, and sought to collect approximately $5 million in sales proceeds from the Martha's Vineyard property, yielding a ratio of 1:6. The court therefore bifurcated the legal fees in the bankruptcy matter. It found that of the $72,887 in legal expenses, one-sixth (or $12,147) was expended to collect rent. That rendered the latter amount deductible.

V. PENALTIES

Finally, the Tax Court addressed penalties, reciting the panoply of penalties that could apply. The question was whether Melcher had reasonable cause. Melcher had relied upon the advice of a certified public accountant. Although it is unclear exactly who said what to whom, the Tax Court acknowledged that there were complex issues involved in the tax treatment of the various legal expenses.

The court took into consideration the number of issues raised in the appellate and bankruptcy proceedings, and the complexity involved in determining the tax consequences of each issue. Based on the entire set of circumstances, the court found that Melcher had acted with reasonable cause and in good faith. It therefore rejected the IRS attempt to impose accuracy-related penalties.

VI. FRUIT OF THE TREE

The concept of evidence tainted by an illegal search or seizure (poisonous evidence, the product of a poisoned tree), is a concept familiar to everyone who watches Law & Order. The tax law features the assignment of income doctrine, and some of the cases refer to the difference between the tax consequences of transferring a tree (an income producing asset), and assignments of income (merely fruit from the tree). Tax lawyers, it seems, want to have their own orchard-tending metaphors.

I have long thought the origin of the claim doctrine is overrated. It is much bandied about as the be-all and end-all of the taxation of damage awards and attorney fees. It is relied on to give pithy answers to what sometimes seem to be intractable problems. Yet it is frequently possible to generate disagreement over how the origin of the claim doctrine should be applied to a given set of facts. Given its importance, that is disturbing.

Moreover, even if there is no dispute about the original genesis of something, just how long does it last? Put other way, what kind of intervening events can take over, morphing into a new origin of the claim for tax purposes? Surely at some point the original origin (if you will) must dissipate. Yet the origin of the claim doctrine is sometimes terrier-like in its hold on tax consequences.

On Melcher's facts, one could reasonably argue that any divorce taint had vanished by the time Melcher incurred the 2004 legal expenses. It is true that the real (and perhaps primal) genesis of Melcher's legal woes was the unwinding of his marriage. But that, I would hope, should not mean that every single payment for decades would be so regarded.

In *Jarndyce v. Jarndyce*, we should recall, this scarecrow of a suit had become "so complicated that no man alive knows what it means."[10] The origin of the claim doctrine should be a little more malleable than it was in Melcher. Especially where matters are protracted and take on a life of their own, we should be alert for ostensibly independent elements that may have a new or intervening origin.

ENDNOTES

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2. *See United States v. Gilmore*, 372 U.S. 39 (1963).

3. *See* Treas. Reg. § 1.212-1(a).

4. *See Anchor Coupling Co., Inc. v. U.S.*, 427 F.2d 429 (7th Cir. 1970).

5. *See Winter v. Commissioner*, T.C. Memo 2002-173. For a collection of other capitalization circumstances, *see* Wood, "Attorney Fees: To Deduct or Not to Deduct," Vol. 123, No. 1, Tax Notes (April 6, 2009), p. 65.

6. 2009-210 T.C. Memo (2009).

7. 372 U.S. 39 (1963).

8. *See Woodward v. Commissioner*, 397 U.S. at 575.

9. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930).

10. Charles Dickens, *Bleak House.*