

Wood Responds to Daley on Attorney Fee Puzzles

To the Editor:

Tom Daley's provocative letter to the editor (*Tax Notes*, Jan. 16, 2006, p. 291) explores yet another conundrum concerning the deductibility of attorney fees. Tom's letter brings to the fore an issue without a perfect answer: the extent to which attorney fees paid by plaintiffs in suits of a personal nature are deductible. As Daley suggests, it may be heresy to suggest that these legal fees are not deductible (for regular tax as well as alternative minimum tax purposes), since the plaintiff's gross recovery clearly is taxable. That fundamental mismatch seems inherently unfair.

In fact, the tax liability from a recovery, coupled with large legal fees and costs, could even leave a winning plaintiff with a net loss, the same issue that, on the AMT side, was viewed as anathema in cases such as *Spina*,¹ and that led to the above-the-line deduction provided by the American Jobs Creation Act (P.L. 108-357).

The primary authority Daley discusses is *Colvin*.² That case is troubling, since (as Daley points out) it seems to say that if you incur legal fees to pursue a personal lawsuit, the attorney fees cannot be deducted (even for regular tax purposes), even if your suit produces income. Daley suggests that road less traveled leads to one of three conclusions:

1. *Colvin* is wrong, and everyone is correctly deducting legal fees in these types of cases;
2. *Colvin* is correct, and everyone is erroneously deducting legal fees in these cases and apparently not being challenged by the IRS; or

¹*Spina v. Forest Preserve District of Cook County*, 207 F. Supp. 2d 764 (N.D. Ill. 2002).

²2005 U.S. App. Lexis 2759, Doc 2005-3283, 2005 TNT 33-14 (5th Cir. 2005), *aff'g* T.C. Memo. 2004-67, Doc 2004-5689, 2004 TNT 53-11.

3. *Colvin* is a special case, and there are some other controlling authorities supporting deductibility.

I think the *most* correct of these choices is the second. The authorities suggest that the consequence of a suit is not what is important. Rather, the origin and nature of the claim is what counts. At the same time, I believe virtually everyone deducts these legal fees, and virtually everyone (perhaps with the exception of Mr. Colvin) does so successfully.

Daley points out several examples in which this conundrum exists. Each involves a case of a personal nature that does not involve personal physical injuries or physical sickness described in section 104. They include suits for punitive damages from product liability claims, emotional distress claims, Americans With Disabilities Act (ADA) claims, and Fair Housing claims. There are, of course, countless varieties of non-section 104 claims of a personal nature. In each of those personal (as opposed to business or investment-related) actions, attorney fees incurred by the plaintiff should not be deductible, since section 262 clearly states that no deduction is allowed for personal expenses.

Of course, that raises the question of what is properly classified as "personal." Daley points out that in his experience the vast majority of practitioners believe the attorney fees on a recovery of a nonphysical injury or physical sickness claim (such as a product liability, emotional distress, or ADA claim) are deductible, at least for regular tax purposes. I agree. Conversely, I also agree that most practitioners believe the associated attorney fees are not personal expenses, or they simply don't consider the issue, instead viewing the successful plaintiff by definition as having an investment.

This income-generation position is clearly at odds with the origin of the claim doctrine enunciated in *United States v. Gilmore*.³ The origin of the claim doctrine is no lightweight, and can trace its roots back 30 years before *Gilmore* to such hoary cases as *Knowland v. Commissioner*⁴ and *Raytheon Production Corp. v. Commissioner*.⁵ Under the origin of the claim doctrine, the deductibility of attorney fees hinges on whether the expense arises in connection with a profit-seeking (as opposed to a personal) activity. The deduction does not depend on the consequences that might result to a taxpayer's income-producing property.

Yet the vast majority of taxpayers (and tax advisers) understandably look to the gross income side of the equation. Whenever a recovery constitutes income (emotional distress damages or punitive damages, for example) they deduct the attorney fees as an expense for the production of income. I have been through hundreds of audits and appeals, and I have never heard the legitimacy of such a deduction questioned (though I see that in theory it could be).

Nevertheless, the Fifth Circuit's decision in *Colvin* confirms that the origin of the claim remains the proper test. Over the years, other taxpayers like Colvin have attempted to deduct attorney fees based on the notion

that while the underlying claim may have been personal in nature, they were protecting income-producing assets. For example, in *Accardo v. Commissioner*,⁶ Accardo was prosecuted under the Racketeer Influenced and Corrupt Organizations (RICO) Act. He was acquitted, and he sought to deduct his attorney fees. He argued that since the indictment sought a forfeiture judgment, and since he sought to conserve and maintain income-producing assets, his legal fees were deductible. Both the Tax Court and the Seventh Circuit disagreed, noting that the origin of the claim was a RICO charge, which related to personal matters. This sounds like the criminal version of *Gilmore*.

Accardo's legal expenses arose not out of the prosecution of a personal lawsuit, but out of defense costs in defending against his own indictment. Perhaps it seems less unjust to examine legal expenses in a personal criminal case compared with the costs of bringing a suit for money damages arising out of a personal issue. In the former, there is (and can be) no recovery. In *Accardo*, the sole question was whether Mr. Accardo could deduct legal fees in his RICO prosecution against *other* income. In the four examples Daley cites, there could be gross income produced by the lawsuit itself. It is harder (I think) to justify denying a deduction when the legal fees themselves clearly produce the income. Yet, the origin of the claim point is the same.

The past year (or so) has seen significant changes to the attorney fees landscape. In October 2004 Congress enacted the Jobs Act. A few months later, in January 2005, the Supreme Court decided *Commissioner v. Banks*.⁷ Although both these events brought change, neither *Banks* nor the Jobs Act addressed the dichotomy between (nondeductible) personal attorney fees and (deductible) business/investment attorney fees. *Banks* sets forth only a general rule that attorney fees are includable in the gross income of a plaintiff, and a plaintiff cannot report his recovery on a net basis. The two cases consolidated in the *Banks* decision (the other case being *Commissioner v. Banaitis*⁸) were both employment settlements. The Court did not address attorney fees in the personal context.

The Jobs Act amended section 62 to allow an above-the-line deduction for certain attorney fees. Daley makes an important point about the Jobs Act provision. In his example of a Fair Housing Claim for racial discrimination, which is included in the laundry list of causes of action in the Jobs Act, he notes that attorney fees are deductible above the line only if such fees are deductible in the first place. He laments that a nonemployment claim related to a personal residence shouldn't produce deductible legal fees, and time may prove him right. Yet, notwithstanding *Colvin*, I believe virtually everyone deducts the legal fees.

Of course, I agree with Daley that attorney fees are not deductible when a plaintiff obtains a recovery in a section 104 case. Section 265 (relating to expenses on tax-exempt

³372 U.S. 39 (1963).

⁴29 B.T.A 618 (1933).

⁵144 F.2d 110 (1st Cir. 1944).

⁶94 T.C. 96 (1990), *aff'd*, 942 F.2d 444 (7th Cir. 1991).

⁷543 U.S. 426, *Doc 2005-1718*, 2005 TNT 15-10 (2005).

⁸340 F.3d 1074, *Doc 2004-19359*, 2003 TNT 167-5 (9th Cir. 2003).

income) would prevent a deduction in a section 104 case, since the underlying recovery would be tax-exempt. In some section 104 cases, there could be an overlap with section 262 (relating to personal expenses), which could also prevent a deduction. No matter which section applies, a deduction doesn't make any sense in a section 104 case, since the recovery is excluded from gross income. Here, we are addressing the converse, in which the recovery (if any) would be taxable, and the sole question is whether the legal fees can be deducted.

This brings me to my own theory of these cases, and why they don't come up. My own experience is that clients simply deduct, practitioners agree, and no one fights about this as long as there is positive taxable income from the legal dispute. The only time there is a likely problem is when there is *no* recovery, as in *Accardo* and *Colvin*. It is axiomatic that bad cases make bad law. *Colvin* is a bad case, or at least involves a taxpayer whom the Tax Court did not find too appealing.

Mr. Colvin handled his tax case pro se. Not only that, he also handled pro se much of the legal maneuvering that gave rise to his legal expenses. The suit that was the primary subject of the legal expenses was a federal district court suit (pro se) against his homeowner's association for harassment and retaliation. He eventually got his real estate lawyer to step in, who dismissed the federal suit and brought suit under state law.

Colvin's suit alleged fraud, suppression of facts, negligent representation, libel, slander, abuse of process and violation of civil rights. Under the origin of the claim doctrine, Colvin's attorney fees were not deductible, since they were personal. *Colvin* seems a fairly straightforward application of the origin of the claim doctrine. Yet I'm reasonably confident that most practitioners are deducting legal fees in the types of personal cases Daley describes, as long as there *is* a recovery. I believe Daley is correct that the absence of case law means clients are not being challenged by the IRS.

There is no suggestion that Mr. Colvin ever recovered anything. The deficiency in question in *Colvin* was a whopping \$1,918 for 1997 and \$1,072 for 1998. Colvin argued in Tax Court that *if* he had been successful, he would have received taxable income. Colvin apparently also had legal expenses related to a suit against his employer.

However, he was not able to identify which legal expenses related to his employment case and which related to his rant against the homeowner's association. The Fifth Circuit decision in *Colvin* predictably recites the record, cites *Gilmore*, and concludes (quite correctly) that the Tax Court did not commit clear error in determining that the origin of the lawsuit against the association was personal in nature, given that it involved Colvin's primary residence, and that Colvin's stated purpose in the lawsuit was to stop harassment. Had Colvin been able to show that he had legal expenses related to a suit for unpaid wages against his former employer, the court acknowledged that those would be deductible. The problem was that Colvin could not prove what legal fees, if any, related to this action.

Congress and the courts have spoken a mouthful on the subject of attorney fees, and they will continue to

chew on this. Attorney fees relating to personal matters are nondeductible, and *Banks*, the Jobs Act, and *Colvin* did not change that. Yet there are volumes of authority about the inherently factual line between personal and business — arising in criminal matters, licensing disputes, etc. Plus, there is authority that, notwithstanding the personal origins of divorce, if a taxpayer incurs legal fees to produce income (such as seeking alteration of an alimony provision in divorce documents that results in additional taxable alimony payments), those legal expenses are deductible. See *Ruth K. Wild*, 42 T.C. 706 (1964).

More recently the Tax Court allowed deductions for attorney fees attributable to a wife's claim against her husband's pension plan. See *Laura D. Seidel*, T.C. Memo. 2005-67, *Doc 2005-6688*, 2005 TNT 62-10. In *Seidel*, the court found that a wife's legal fees paid to secure her divorce and property settlement were not deductible. However, the court noted that a portion of the wife's attorney fees were paid to secure the production of income in the form of a distribution from her husband's 401(k) plan. Under section 212 — and the *Cohan* rule — the Tax Court estimated the allocable attorney fees and allowed them as a Schedule A itemized expense.

As Daley's analysis makes plain, determining when an expense is personal or business/investment is tricky. Despite one-sentence summaries of *Gilmore*, it is often not easy to apply the origin of the claims test. Much like asking questions in the positive or the negative, it is sometimes possible to build a case that the origin of an expense is inextricably entwined with its expected consequence. Mr. Gilmore could have won his case, and I believe other taxpayers from time to time win "origin" cases that are weaker than *Gilmore's* was. I believe both taxpayers and the IRS apply the origin of the claim doctrine in different ways at different times. Perhaps that is one of the reasons the important point Daley raises is usually ignored, both by taxpayers and the government.

Notwithstanding the origin of the claim doctrine, and notwithstanding *Colvin*, I believe most taxpayers and most practitioners would not think twice about deducting the attorney fees in a personal lawsuit, as long as there is a net recovery. Clearly, you may be asked to justify the business or investment connection of a suit if you are *unsuccessful* in your suit. That's what happened in *Colvin* and in *Accardo*.

It is far less likely that you'll face scrutiny if you recover, whatever the motive of the underlying suit, but merely use your (miscellaneous itemized) legal expense to effectively absorb *part* of your taxable recovery. I admit that doesn't seem very principled. If I am right about this (unprincipled) net income concept, it may not only put successful and unsuccessful plaintiffs in different tax positions, but it may also put plaintiffs and defendants in different tax positions. In any case, Tom Daley highlights fundamental points about why attorney fees cases should still generate interest.

Very truly yours,

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