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No Free Lunch: When Someone Pays Your Legal Fees

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There may be no such thing as a free lunch, but having someone buy it for you is nearly always preferable to paying for it yourself. In fact, whether it is lunch or something else, having someone pick up your tab is generally a positive experience. When you extend that rationale to legal fees — although few think lawyers' bills ever produce anything as pleasurable as lunch — the same principles surely apply. Having someone else pay is clearly good.

Unfortunately, to a far greater extent than with incidental meal costs picked up by someone else, having your legal fees paid by another should set off alarm bells. I am not suggesting that clients facing significant legal bills don't have a considerable incentive to have their legal fees borne by someone else. However, one should consider whether the positive cash-flow advantages (as well as any psychological benefits) of having someone else pay your legal fees are offset by the complications of a considerably more messy tax position.

These days, there may be regulatory implications of having fees borne by an employer or someone else. Apart from that, there's reason to think there is increasing scrutiny on the tax issues, both for the payer of the fees (who no doubt wants to deduct them) and for the beneficiary of the legal services (usually an employee, officer, or director). Awareness of those issues can sometimes help avoid or ameliorate tax traps.

Despite recent scrutiny, paying some legal bills (those of officers and directors, for example) has been standard practice for years. The important question should not be the amount of those fees, but rather their relationship to the business and to the conduct of the officer or director involved. Consider the recent revelation that Hollinger International, which once had a veritable cadre of celebrity board members, paid the following legal fees on behalf of directors:

Conrad Black	$4,320,420
Barbara Amiel Black	857,235
Richard Burt	692,538
Dan Colson	552,308
Henry Kissinger	56,579
Shmuel Meitar	159,920
Richard Perle	4,655,491
James Thompson	173,339[a]

[a] *See* Justin Lahart, "Big Legal Bills Are Attached to Big Names in Hollinger Pact, but Insurer Will See the Tab," *The Wall Street Journal*, May 13, 2006, p. B3.

Reports suggest that the company paid those director legal fees without adequate oversight.[1] A Securities and Exchange Commission filing flagged the payouts, and a civil shareholder lawsuit was filed against the directors. The civil suit settled for $50 million, but insurers will reportedly pay it once the settlement is approved by the court. Interestingly, the large director legal bills that started the whole flap may be borne by the insurers, too.

Quite apart from express contractual indemnification rights, or indemnity rights created by governing law or corporate articles or bylaws, paying the legal fees of officers, directors, and key (or even rank and file) employees can just be good business if the matter relates to the company's operations and the course and scope of the worker's role within it. Yet, consider the fate of the handful of former KPMG partners indicted on charges of creating and marketing questionable tax shelters. They are engaged in a high-profile battle to prove their conduct was not criminal, and their legal fees are no doubt substantial. Good representation does not come cheap.

Whatever one thinks of KPMG, whatever one thinks of the tax shelter era, and whatever one thinks of both the design and marketing conduct engaged in by many, it seems hard to argue that this was not a firm issue, but rather was merely an individual one based on rogue conduct. That creates great interest in the flap over KPMG's cutting off legal fees for employees and partners who failed to cooperate with the government investigation of shelters. Defense attorneys have asked Southern District of New York Judge Lewis Kaplan to order the government to pay their clients' legal bills from the $456 million in fines paid by KPMG. Alternatively, they want the indictments dismissed.

I have no idea whether there is merit (constitutional or otherwise) to the denial of counsel argument the defense lawyers are making — that the government interfered

[1] *See* Justin Lahart, "Big Legal Bills Are Attached to Big Names in Hollinger Pact, but Insurer Will See the Tab," *The Wall Street Journal*, May 13, 2006, p. B3.

with the individuals' right to counsel by supposedly pressing KPMG to close its wallet. The now-famous "Thompson Memo" lists, among the factors prosecutors should consider in determining whether to file criminal charges against a company, whether the company is bearing the legal fees of employees caught up in the investigation. That memo, and its allegedly *in terrorem* effect, are at the center of this controversy.[2]

Yet, despite this brouhaha, there are many circumstances in which one's legal fees will be borne by someone else. In fact, *The New York Times* reported that the hefty legal bills of at least one former KPMG partner, Gregg Ritchie, are being paid by Gary Winnick, founder and former chair of Global Crossing, the collapsed telecommunications giant.[3] Ritchie, who left KPMG in 1998, apparently now works for Pacific Capital, another company controlled by Winnick. That may explain a lot. Employers frequently pay the legal fees of their employees, although one should enquire whether such an event triggers any tax obligations, an issue we'll explore below.

Whether or not that employment connection is the explanation for Winnick's payments, I don't believe there is anything illegal in such an arrangement. Yet, if (as the press has speculated) Winnick is personally involved in some of the tax shelter scandals as an investor, his funding of Ritchie's personal legal battle may call his motives into question. Motives, press, and appearance can be powerful and damaging in this era of heightened sensitivity to perception. The mere appearance of impropriety can be damaging.

Taxing Questions

A frequently ignored question is whether having someone else pay your legal fees causes any income tax problems. At a minimum, it raises tax questions, both to the payer and to the recipient of the legal services. We can assume the payee (the lawyer) has income in any event when he receives the fees. Lawyers, after all, have to pay taxes too. That means the lawyer (the payee here) generally does not care who ultimately pays his bill. But, both the payer and the beneficiary of the legal services should.

A cynic might say the only good thing about legal fees is that they are usually deductible. Yet, if someone else pays, beware. If you pay someone else's legal fees (or other expenses), they may not be deductible by you. There is a long line of cases focusing on the possibility that someone who pays someone else's expenses cannot deduct them. Having a deduction questioned — or downright disallowed — can sting.

That can make for an unexpected and unhappy problem for the payer. Even if Gary Winnick is paying extra legal bills entirely out of largesse and expects nothing in return, it is a virtual certainty that he'll be upset if he finds he can't deduct them. I would expect that in Winnick's mind those legal fees arise from his trade or business or, at a minimum, from an activity conducted for profit.

The denial of a deduction, clearly a serious problem, can pale in comparison to the problems of the beneficiary. From the beneficiary's perspective, if you incur legal fees but a third party pays them, whether out of altruism, generosity, or even because of an expected quid pro quo, you may have gross income for tax purposes when your obligation is paid by a third party. A well-defined body of case law deals with the discharge of indebtedness and its tax effects on the obligor. Legal fees represent only one of many obligations that raise tax issues when someone else pays for the goods or services you receive.

All of that makes the beneficiary's problem even more serious than the payer's. The attributed income hit can be a true double whammy, adding insult to the already unhappy injury of the legal fees, plus the uncertainties, pressures, and myopia of the legal proceedings that are the genesis of the legal fees in the first place. The problem is widespread, hitting officers, directors, and employees, and covering legal situations as diverse as SEC, IRS, and other regulatory inquires, traffic offenses, marital disputes, and sexual harassment charges.

This article explores the line between the rocky shoals of the payer's deductibility issues and the beneficiary's phantom income concerns.

Generic Expenses

Although my focus here is on legal fees, it is worth noting that it may not matter what type of expense one considers. The tax issues are the same. Indeed, many of the authorities dealing with the appropriateness of a tax deduction for a payment paid on behalf of another party do not concern legal fees, but rather involve some other kind of expense. The important point, it would seem, is the nexus between the identity of the payer and the recipient and beneficiary of the fees, and between the payer and the nature of the goods or services themselves that are the subject of the payment.

The same is true on the income side of the equation. Although we will focus here on legal fees, the beneficiary of a payment made by a third party may have attributed income whether it is legal fees or virtually any other item paid for by a third party. Thus, it is worth bearing in mind that many of the principles discussed here will apply even though the payment is for some item other than legal fees.

Now let's turn to the topic of legal fee deductions.

Legal Fee Primer

A short summary of the tax treatment of paying legal fees is that you: (1) can deduct them if they arise out of your trade or business; (2) can deduct them (subject to limits and thresholds) if they arise out of your investment activity or something you undertake for profit; (3) can deduct them (subject to limits and thresholds) if they relate to tax advice; (4) must capitalize them if they relate to capital assets, either held for investment or use in a trade or business; and (5) cannot deduct them at all (so you receive no tax benefits) if they relate to personal

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[2] *See* Lynnley Browning, "Prosecutor Denies Pressure on KPMG to Cut Off Legal Fees," *The New York Times*, May 9, 2006, p. C7; Paul Davies, "Attorneys Spar Over KPMG Payment of Legal Fees," *The Wall Street Journal*, May 9, 2006, P. C5; and Mark Hamblett, "Judge: Evidence Shows Government Influenced KPMG's Defense Fees Policy," *New York Law Journal*, May 12, 2006.

[3] *See* Browning, "U.S. Says Tax Shelter Client May Be Paying Ex-KPMG Partner's Legal Bills," *The New York Times*, Mar. 7, 2006, p. C-4.

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matters. Thus, much of the lore of legal fees simply relates to placing the legal fees into one of those five categories.

It is axiomatic that taxpayers see those categories in a pecking order of benefits, ranging in desirability from most to least advantageous. Lawyers have not helped this classification dance. All but tax specialists bandy about the ''business expense'' moniker indiscriminately, generally failing to distinguish between true business expenses on one hand and investment expenses on the other. Yet, there are decided tax implications between this fundamental divide.

Similarly, lawyers understandably try to ameliorate the sting of their fees with whatever government subsidy they can muster. Legal fees you pay to your divorce lawyer generally fall into the personal and therefore nondeductible category. Yet, legal fees you pay for tax advice are deductible, even if your divorce lawyer is rendering the tax advice. That makes it understandable that in allocating what portion of their bill is for tax advice, many divorce lawyers will err on the side of categorizing as ''tax advice'' as large a portion of their fees as they feel they can justify. Clients may complain about many other aspects of the legal bill and the representation, but they will surely never complain about having a big part (perhaps too big a part) of their legal bill labeled ''for tax advice'' and therefore tax deductible.

No Express Deduction

Surprisingly, the tax code does not expressly provide a deduction for legal fees. Yet, as strange as that may seem, billions of dollars of legal fees are deducted every year. I expect that most of those fees pass muster without question. Legal fees arising from a trade or business are deductible under the general business expense provision of section 162.

If the legal expenses are not related to a trade or business, but instead arise in an activity that is merely related to investments, the legal fees will be deductible under section 212. That provision allows for deductions related to the production of income or investment activities. To a huge extent, much of the lore of legal fees in the tax arena boils down to that Maginot line of business vs. investment.

True business expenses are almost always preferable to investment expenses under the tax law, at least when the payer is an individual and must contend with the various hurdles to deductibility presented by the rules governing miscellaneous itemized deductions. When one adds personal matters to the spectrum of legal fees, the battleground ranges across the business expense front, the demilitarized zone of investment expenses, and the rear of personal expenses. As with uniformed personnel, so much in this area is about characterization and appearance. Rank counts.

Capitalization

Off to the side of this business-investment-personal troop column is the topic of capitalization, a topic that, despite its importance, I largely want to ignore here. Yet, to paint the landscape of the legal fee battleground, we need to note that legal fees that relate to capital assets must be capitalized.

Usually those fees can be deducted either over time or on the sale of the associated capital asset. One classic example of capitalization being required (historically a constant battleground between taxpayers and the IRS) involves legal fees incurred in a stock or asset acquisition.[4] Yet, in examining the tax treatment of legal fees, one must actually look to the nature of the legal claims. Generally, the treatment of legal fees will follow the treatment of the settlement payment.

Thus, amounts paid to a seller in settlement of a suit for fraud in the purchase of property have been held to be capital expenditures.[5] Litigation over the purchase of stock or assets has generated a great deal of authority. If attorney fees are paid or incurred with respect to the acquisition of a capital asset, or some indefinite future business advantage, capitalization may be required.[6]

Sometimes the requirement to capitalize seems to take on a life of its own. Thus, in *Winter v. Commissioner*[7] the Tax Court found that a couple had to capitalize legal fees paid in connection with litigation over the price of an asset after the sale was completed. The couple purchased a hotel in 1991 and then filed a suit after discovering defects in the financials. The matter was settled in 1994, with the seller agreeing to write off a portion of the money still due under the promissory note the buyers had signed. Not surprisingly, the couple had incurred substantial legal fees, which they deducted on their 1994 Schedule C. The IRS disallowed the legal fee deductions, arguing that they were incurred in connection with the establishment of the hotel's purchase price. The Tax Court agreed with the IRS, noting that the origin of the claim was the acquisition of a new business.

The circumstances in which legal fees may be attached to capital assets are varied. It is safe to say that no taxpayer likes having legal fees treated as capital assets, and that taxpayers much prefer immediate deductions. Sometimes the distinction can turn on subtleties involving preservation vs. sale.

For example, in *Braznell v. Commissioner*[8] the taxpayer's payment of a judgment against him for failure to pay brokerage commissions on negotiations for the sale of real property was held deductible as an expense to preserve the property.[9] Conversely, in *Estate of Shannon House v. Commissioner*[10] amounts paid in the year after a sale of real estate to reimburse the purchaser for the cost of moving a building (which had encroached on the adjoining lot of another owner) were held to be capital losses, because the move occurred after the property had been sold.

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[4]*See INDOPCO v. Commissioner*, 503 U.S. 79, *Doc 92-1849, 92 TNT 44-1* (1992); Treas. reg. section 1.263(a).

[5]*See Redwood Empire Savings and Loan Association v. Commissioner*, 628 F.2d 516 (9th Cir. 1980).

[6]*See INDOPCO v. Commissioner, supra* note 4. *See also Anchor Coupling Cove, Inc. v. United States*, 427 F.2d 429 (7th Cir. 1970), *cert. denied*, 401 U.S. 908 (1971).

[7]T.C. Memo. 2002-173, *Doc 2002-17047, 2002 TNT 141-10*.

[8]16 T.C. 503 (1951), *acq.* 1951-2 C.B. 1.

[9]*See also Swaim v. Commissioner*, 20 T.C. 1022 (1953), *acq.* 1954-1 C.B. 6.

[10]21 T.C. 422 (1953).

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Personal Legal Fees

Unlike the other categories, legal fees of a personal nature are simply not deductible. For example, legal fees incurred in a divorce or for estate planning often fall into this undesirable category. Of course, determining whether legal fees relate to personal matters (or rather should be characterized in another manner) can be difficult, and the IRS has at times fought all the way to the Supreme Court.[11]

No one likes to think of legal fees as nondeductible. Personal legal fees are even worse than capitalized ones, because no tax benefit will ever be available. Legal fees paid in divorce are nondeductible. However, even here there are exceptions.

Legal fees paid for tax advice (and tax advice is often needed in a divorce) are deductible. Note that it will not matter on the deductibility question that a business is involved in the divorce. Even if the divorce will destroy the business, that does not make paying for divorce lawyers deductible as a business expense. It is the origin of the divorce action (which is personal) that controls.[12]

The circumstances in which taxpayers pay personal legal fees are myriad, although my suspicion is that most people view most legal fees as having some business or investment nexus. Business legal fees are always better than investment legal fees (on this distinction, see the discussion of gold plated vs. silver plated deductions below). Yet, here we're talking truly personal. If you defame your next-door neighbor and then are sued for defamation and incur defense costs, it's hard to see how that could relate either to business or investment property. As a personal legal expense, it is simply nondeductible.

However, if you have a dispute with your neighbor over a lot line, it is either an investment expense or must be capitalized along with the underlying property (which presumably qualifies as investment property). Taxpayers often argue for the former; the IRS usually wins with the latter. It does demonstrate, however, that the business/investment/personal hierarchy can sometimes be a fluid one.

Business vs. Investment Legal Fees

Putting capitalized legal fees and personal legal fees to one side, most legal fees fall into the business and investment categories. Several tests apply both to investment-related legal expenses under section 212, as well as to trade or business expenses under section 162. To be deductible under either one of those sections, legal fees must be ordinary, necessary, and reasonable. They must also be directly connected (or proximately result from) the taxpayer's trade or business or investment activities. In practice, those requirements are not too onerous, and they are often given short shrift in the case law.

For example, legal fees incurred in defending against a claim arising out of ordinary business operations, such as an employer's defense against a suit for employment discrimination, are deductible.[13] Similarly, legal fees incurred in defending an indictment related to the one-time purchase of a note are deductible as an investment expense.[14] Practically speaking, the question is often simply one of the connection or nexus between the nature and type of expense on the one hand, and the business or investment activity on the other.

The ''ordinary and necessary'' requirement has generated more than a fair amount of confusion over the years. That is surprising, as it is actually a fairly watered-down test. Generally speaking, an expense (for legal fees or otherwise) will be considered ''ordinary'' if a business person would commonly incur it in the particular circumstances involved.[15] 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 common usage of that word. Taxpayers generally think of the ''ordinary'' requirement as synonymous with recurrent.

Fortunately, the courts have been much more expansive. In fact, the Supreme Court has noted that an ordinary expense of a particular nature may be extremely irregular in occurrence, stating:

> A lawsuit effecting 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.[16]

Paying a lawyer satisfies the ''ordinary'' requirement if it is consistent with the behavior of a reasonably prudent man in the same circumstances.[17] The ''necessary'' requirement is also fairly tepid. It does not mean that the taxpayer really had to incur a particular expense, such as paying legal fees of an employee or agent of the organization. It requires only that incurring such an expense is ''appropriate or helpful.''[18] That means paying the legal fees of an employee (or former employee) can be patently appropriate, and can be tax efficient too.

The payment of an employee's legal fees by his employer is probably a more widespread practice than many practitioners would believe. The current tax scandal that has embroiled KPMG, Deutsche Bank, and other banks and law firms is a high-profile example. Those entities, along with their employees, former employees, partners, and former partners, have been racking up legal fees for years. Those entities have generally been picking up the legal tab for their employees (and partners) and

[11] *United States v. Gilmore*, 372 U.S. 39 (1963).

[12] *See id*.

[13] *Vermont Bank & Trust Co. v. United States*, 296 F. Supp. 682 (D. Vt. 1969).

[14] *Noons v. Commissioner*, T.C. Memo. 2000-106, *Doc 2000-9438, 2000 TNT 61-15*.

[15] *See Commissioner v. Chicago Dock and Canal Co.*, 84 F.2d 288 (7th Cir. 1936); *see also Commissioner v. Heininger*, 320 U.S. 467 (1944).

[16] *Welch v. Helvering*, 290 U.S. 111 (1933).

[17] *Kanelos v. Commissioner*, 2 T.C. Memo. 806, 808 (1943).

[18] *See Lilly v. Commissioner*, 343 U.S. 90 (1952).

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surely have been deducting all of those payments.[19] I find nothing inappropriate about that.

The ordinary and necessary nature of the legal fees being paid in this context is rarely questioned by the judiciary or even by the IRS. All that will generally be expected is some kind of nexus between the lawsuit and the business of the defendant.[20] The overall ''reasonableness'' of an expense in this context is also generally not questioned.[21] Litigation is by its very nature adversarial, and perhaps for that reason the reasonableness of a payment to prosecute or defend a legal matter is rarely questioned.

Despite the generally liberal character of the law on legal fee deductions, there have occasionally been suggestions that the IRS and the courts want to pull up the ladder and make deductions more difficult. Thus, in *Oden v. Commissioner*[22] the Tax Court took the requirements a step further by invoking a ''furtherance'' test. The court suggested that the expense in question must be in furtherance of the trade or business or section 212 activity (in addition to being ordinary, necessary, and so forth) to be deductible.

In *Oden*, the taxpayer had made malicious comments about a former employee and incurred legal fees to get out of hot water. The Tax Court denied the taxpayer's deduction for legal fees — which were the proximate result of the taxpayer's malicious behavior — because the taxpayer's behavior (making the malicious comments about a former employee to a potential employer) was not in furtherance of his trade or business. Fortunately, many courts have declined to follow *Oden*, but it may be worth thinking about the ''furtherance'' test whenever it could potentially apply. (Are you thinking about sexual harassment suits? Read on.)

Yet, the question of identity is nettlesome. For legal fees to be deductible by an organization, they must generally be directly connected to its *own* trade or business.[23] Of course, the appropriateness of a deduction of legal fees is not dependent on the success of the case.[24] Legal fees may be expended in an unsuccessful trial or unsuccessful business deal, but that does not make the fees nondeductible.[25] Instead, the deductibility of legal fees is determined under the origin of the claim doctrine. That turns out to be a pervasive test, one that deserves significant attention.

Origin of the Claim

The origin of the claim doctrine enunciates the sensible proposition that ''the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences on 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.''[26] In *United States v. Gilmore*,[27] 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. That made the litigation expenses nondeductible personal expenditures.

To determine the deductibility of legal fees, one must begin with the identity of the payer. Only the payer is entitled to the deduction. Consider, for example, a corporation that deducts legal fees arising out of the action of its agents, equity holders, or employees. To be deductible, the organization must pay or incur the amount for its own benefit, rather than for the benefit of others.[28] Even so, legal fees and expenses relating to the actions of officers and directors in conducting a corporation's business have generally been held to be deductible by the paying corporation. The theory is often that the matter is proximately related to the business of the corporation, and the results achieved in litigation are beneficial to the corporation.[29]

How connected and how related are matters of degree? Corporations have been denied deductions for legal expenses incurred in defending suits against employees that are unrelated to the company's trade or business.[30]

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[19]*See Graphic Business Systems, Inc. v. Commissioner*, T.C. Memo. 1982-167.

[20]In the case of deductions under section 212, the requisite nexus between the income-producing activities or investment activities of the taxpayer must be shown.

[21]*Michaels v. Commissioner*, 12 T.C. 17 (1949), *acq.* 1949-1 C.B. 3; *Harvey v. Commissioner*, 171 F.2d 952 (9th Cir. 1949).

[22]T.C. Memo. 1988-567, *Doc 88-9711, 88 TNT 252-6*.

[23]*See Kornhauser v. United States*, 276 U.S. 145 (1928); *Fisher v. Commissioner*, 50 T.C. 164 (1968); *Northwestern Indiana Tel. Co. v. Commissioner*, T.C. Memo. 1996-168, *Doc 96-10129, 96 TNT 66-7*, *aff'd*, 127 F.3d 643, *Doc 97-29532, 97 TNT 208-15* (7th Cir. 1997).

[24]*See Commissioner v. Teillier*, 383 U.S. 687 (1966); *Central Coat, Apron & Linen Service, Inc. v. United States*, 298 F. Supp. 1201 (S.D.N.Y. 1969); *Allied Signal, Inc. v. Commissioner*, T.C. Memo. 1992-204, *Doc 92-2903, 92 TNT 74-10*, *aff'd*, 54 F.3d 767, *Doc 95-2752, 95 TNT 47-8* (3d Cir. 1995).

[25]*But see* Wood, ''Wood Responds to Daley on Attorney Fee Puzzle,'' *Tax Notes*, Jan. 23, 2006, p. 413.

[26]*United States v. Gilmore, supra* note 11, at 49, *rev'g* 290 F.2d 942 (Ct. Cl. 1961).

[27]372 U.S. 39, 83 S. Ct. 623 (1963), *on remand*, 245 F. Supp. 383 (N.D. Cal. 1965).

[28]*See Ecco High Frequency Corp. v. Commissioner*, 167 F.2d 583 (2d Cir. 1948), *cert. denied*, 335 U.S. 825 (1948). *See also Jack's Maintenance Contractors, Inc. v. Commissioner*, 703 F.2d 154 (5th Cir. 1983).

[29]*See Central Foundry Co. v. Commissioner*, 49 T.C. 234 (1967), *acq.* 1968-2 C.B. 2; *Larchfield Corp. v. United States*, 373 F.2d 159 (2d Cir. 1966); *B.T. Harris Corp. v. Commissioner*, 30 T.C. 635 (1958), *acq.* 1958-2 C.B. 5; *Shoe Corporation of America v. Commissioner*, 29 T.C. 297 (1957), *acq.* 1958-2 C.B. 7.

[30]*Jack's Maintenance Contractors, Inc. v. Commissioner*, 703 F.2d 154 (5th Cir. 1983); *Sklar, Greenstein & Scheer, P.C v. Commissioner*, 113 T.C. 135, *Doc 1999-27062, 1999 TNT 157-43* (1999); *Hood v. Commissioner*, 115 T.C. 172, *Doc 2000-22234, 2000 TNT 167-11* (2000); *Northwest Ind. Tel. Co. v. Commissioner*, 127 F.3d 643, *Doc 97-29532, 97 TNT 208-15* (7th Cir. 1997); *Capital Video Corp. v. Commissioner*, 311 F.3d 458, *Doc 2002-26464, 2002 TNT 231-4* (1st Cir. 2002).

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Gold Plated vs. Silver Plated Deductions

My tax professor in law school (Walter Blum, who taught for more than 40 years at the University of Chicago) used to refer to above-the-line and below-the-line deductions as "gold plated" and "silver plated," respectively. That was a handy and helpful reference, aptly distinguishing between trade or business deductions (truly gold plated, if not solid gold) and mere investment expenses. In fact, if anything, deductions for activities engaged in for profit (which do not rise to the level of a trade or business) have tarnished quite a lot over the last 25 years.

Indeed, these days the silver has probably turned to bronze (denoting third place in this Olympic year), or worse. Given the impact of the alternative minimum tax, which affects investment expense deductions but not business expense deductions, perhaps lead or basalt (or some considerably less precious metal) reflects a more contemporary metallic metaphor.

There are many similarities between deducting legal fees under section 162 and deducting them under section 212. Yet, there is one big difference — the AMT. Legal fees deducted under section 212 are subject to disallowance for AMT purposes.[31] Legal fees taken as miscellaneous itemized deductions are also deductible only to the extent they exceed 2 percent of the taxpayer's adjusted gross income. They are even phased out for high-income taxpayers.[32] Let's look at a simple example.

> Example: John is indicted on multiple counts of racketeering, conspiracy, extortion, fraud, and obstruction of justice. Assume that John's various activities are indeed engaged in for the production of income. Accordingly, John's legal fees of, say, $500,000 can be deducted only under section 212 (instead of section 162), and will be disallowed entirely for AMT purposes (and further limited by sections 67 and 68). During the year of his indictment, John had been successful in producing substantial investment income, earning $500,000 that corresponds to the amount of legal fees he has paid. At trial, John pleads not guilty, claiming he is a law-abiding businessman. The jury is not convinced and convicts John on multiple counts of racketeering.
>
> On his tax return, John deducts his attorney fees as investment expenses under section 212. But, because the deduction is disallowed entirely for AMT purposes (and limited by sections 67 and 68 as well), John ends up owing roughly $136,000 in federal income taxes (even though he had deductions equal to or greater than his income). Of that amount, over 98 percent results from the application of the AMT.[33] Had John instead been able to deduct his $500,000 of legal fees as business expenses, they would have entirely offset his $500,000 of income and he would owe no tax.

The American Jobs Creation Act of 2004 affected a class of legal fees arising in employment litigation and Federal False Claims Act cases. Although that subject is generally outside the scope of this article, what Congress did was convert a limited class of legal fees from silver plated to gold plated deductions. The reason, of course, was primarily to counteract the adverse affects of the alternative minimum tax, which had resulted in some plaintiffs in employment litigation paying more in tax than they received net in their recovery. After the decision a few months later in *Banks*,[34] that negative result was confirmed for many types of cases and continues to be a problem today (but by statute, not for employment cases and Federal False Claims Act cases).

Paying Legal Fees of Another

It is important to analyze whether a particular expense (whether a legal fee or a payment of a settlement) is made for the benefit of the payer or for someone else. Sometimes the lines can blur. A corporation may pay a settlement or judgment (or legal fees) that can be viewed as either benefiting the corporation or its shareholders. Fortunately, the courts have been relatively flexible in allowing corporate deductions. For example, suppose a corporation pays a judgment or settlement (or legal fees) arising out of an automobile accident involving one of its employees who is acting within the course and scope of his employment.

Here, the corporation should have no difficulty deducting those amounts. The company ultimately has liability for its employee's actions, so the company can legitimately seek to protect its own interest by using (and paying for) its own lawyer to represent its employee too. In all likelihood, both the employer and the employee would be sued, but it should not matter to the employer's tax deduction if one or both are defendants. If the suit is solely against the employee, but its theory is based on *respondeat superior*, the employee's legal fees should still be deductible when paid by the employer.

Legal fees and expenses relating to the actions of officers and directors in shareholder-derivative suits for breach of fiduciary duty in conducting the corporation's business have generally been held deductible by the paying corporation. The basic theory is that the matter is proximately related to the corporation and its business, and the results achieved in the litigation should be beneficial to the corporation.[35]

A related issue involves situations in which one corporation makes the payment but another company arguably benefits. If a corporate taxpayer pays a settlement payment or legal fees arising out of a dispute involving a corporate affiliate, the question may be which taxpayer is entitled to the deduction. If a corporation's obligations are paid by an affiliate, unless the payments are made to

[31] Section 56(b)(1)(A)(i).

[32] Sections 67(a) and 68(a).

[33] *See McDonald v. United States*, 1997 WL 1108454, *Doc 1999-16101, 1999 TNT 86-10* (S.D. Ala. 1997).

[34] 543 U.S. 426, 430, *Doc 2005-1418*, *2005 TNT 15-10* (2005).

[35] *See Central Foundry Co. v. Commissioner*, 49 T.C. 234 (1967), *acq.*, 1968-2 C.B. 2. *See also Larchfield Corp. v. United States*, 373 F.2d 159 (2d. Cir. 1966).

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protect the affiliate corporation's credit standing, perhaps no deduction is available.[36] On the other hand, it is often possible to argue that even though the wrong entity might be paying, that entity is paying for its own benefit.

Thus, in *JRJ Express, Inc. v. Commissioner*[37] the Tax Court allowed a corporation to deduct $2.9 million in expenses, even though the court admitted that the expenses were paid on behalf of other business enterprises. The deduction was allowed because the payments, while made on behalf of other businesses, protected and promoted the taxpayer's own business. The Tax Court specifically referred to a two-part test laid out in *Lohrke v. Commissioner*.[38]

In *Lohrke*, the Tax Court established a two-part test for overcoming the usual requirement that an expense must be incurred in the taxpayer's own business to be deductible. First, the payer's purpose or motive in paying the expenses must be to promote its own business. If it is, the payment of the expenses must be an ordinary and necessary expense of the payer's trade or business. In other words, the expense must be an appropriate expenditure for the furtherance or promotion of the payer's trade or business.

Notwithstanding all of those considerations, the line between paying legal fees for yourself and paying them for someone else is troublesome. The same issues arise regarding both legal fees and settlement payments. For example, in *O'Malley v. Commissioner*[39] the Tax Court found a pension fund trustee to be in receipt of gross income when his employer paid his legal fees in a criminal prosecution for conspiracy to commit bribery. Even so, the Tax Court permitted Thomas O'Malley to deduct those legal fees as ordinary and necessary employee business expenses.

At trial, O'Malley argued that the legal fees were ordinary and necessary business expenses of his employer, and, accordingly, they should not be included in his gross income. However, in large part because the pension fund (his employer) was not named as a defendant in the prosecution, the Tax Court determined that the expenses were not ordinary and necessary business expenses of the organization.[40] Instead, the Tax Court found that the legal fees were personal to O'Malley. Because O'Malley's employer paid his legal fees, the Tax Court determined that the payment of O'Malley's personal legal fees by the pension fund was income to him.[41]

That kind of quandary actually happens more than you might think. *The Wall Street Journal* recently reported on Thomas H. Lee's legal fee conundrum.[42] Lee is prominent in the private equity field, achieving notoriety as head of Thomas H. Lee Partners. That company purchased a majority stake in Refco, Inc. and then helped orchestrate its initial public offering. Lee became a Refco director, although he probably wishes he had never assumed that responsibility. Lee has become the subject of 14 lawsuits since Refco sought bankruptcy protection.

Lee has submitted his claim for payment of legal fees to Refco's insurer, but the bankruptcy creditors' committee has objected to payment. The committee presumably believes that Lee's involvement goes beyond the context in which the insurance coverage would require reimbursement. Typically, director's insurance covers negligent acts committed in the furtherance of directors' duties. The question here may be which acts were committed to pursue proper director functions and which ones went beyond that.

Although the issue is rarely raised with employees, the topic of indemnity for legal fees comes up frequently with officers and directors. Consider a company whose bylaws contain an indemnification clause. Typically, those clauses require the company to indemnify a current (or former) officer or director who is made a party to a suit, or even just threatened to be made a party. That indemnification may also apply to some key employees, although that is usually handled in employment contracts, particularly for nonofficers.

Thus, if a corporate officer incurs legal expenses while in the furtherance of company business, the corporation may be *required* to pay the legal fees, and that should be sufficient to claim a deduction under section 162 and to avoid any income attribution issues for the reimbursed officer, directors, or employee.

Of course, a company may still claim a deduction even if its corporate bylaws don't mandate the payment of its employees', officers', or directors' legal fees. Often, paying the employees' legal fees is just good business. Fortunately, the courts will usually recognize that even if the IRS does not.

Thus, in *Graphic Business Systems, Inc. v. Commissioner*[43] three employee-officers of Arnold Graphic Industries (Arnold) left Arnold to form a new company, Graphic. The three individuals became shareholders, officers, and employees of Graphic. Arnold brought suit against Graphic and the three individuals for various counts of undermining its business. Graphic paid the entire settlement and legal fees, and deducted those amounts.

The IRS asserted that 75 percent of the deduction should be disallowed, arguing that those amounts related to claims against the individuals. Nonetheless, the Tax Court held that Graphic could deduct the full amount. It reasoned that the amounts paid were in furtherance of Graphic's business. The court acknowledged that some of the acts alleged by Arnold were conducted by the individuals, but those acts were performed by the individuals in their capacities as employees of Graphic and while conducting Graphic business.

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[36]*See Fancy Foods of Virginia Inc. v. United States*, 73-1 USTC, para. 9372 (E.D. Va. 1973).

[37]T.C. Memo. 1998-200, *Doc 98-17476, 98 TNT 106-9*.

[38]48 T.C. 679 (1967).

[39]91 T.C. 352, *Doc 88-7247, 88 TNT 176-5* (1988).

[40]*See Matula v. Commissioner*, 40 T.C. 914, 920 (1963); *Sachs v. Commissioner*, 32 T.C. 815, 820 (1959), *aff'd*, 277 F.2d 879 (8th Cir. 1960).

[41]279 U.S. 716 (1929).

[42]*See* Carlos Rebello, "Refco Ex-Director Seeks Payment of Legal Fees," *The Wall Street Journal*, Mar. 23, 2006, p. C5.

[43]T.C. Memo. 1982-167.

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Multiple Goals

There are often several goals achieved by paying the legal fees of another. There is nothing duplicitous about this. In fact, as a business person, I hope virtually every payment I make can serve several goals. That is merely killing two birds with one stone, something both the proverb and society seem to reward. It should come as no surprise that a company may make a payment with a multiplicity of goals, including minimizing its own liability, increasing the focus of a key employee by attending to the employee's legal needs, encouraging employee loyalty, and so on.

However, it is not always easy to say which goal predominates or which goal should prevail for tax purposes. Recently, what appears to be a back-door attempt to prevent companies from paying the legal fees of employees and officers made headlines. Even though the costs of legal fees spent by employers to defend their employees and officers may be deductible, businesses today can face pressure not to pay those legal fees.

According to a 2003 Justice Department memo, federal prosecutors are to take favorable account of companies that cooperate with the government in an effort to avoid indictment.[44] When dealing with the Justice Department, ''cooperation'' has become synonymous with not paying the legal fees of employees and officers. Although the DOJ initiative may hinder the payment of some legal fees, at first glance, it does not appear to have any direct bearing on the tax deductibility of legal fees.

Indeed, the IRS has argued and lost many cases in which a company has claimed a deduction for paying the legal fees of its employee or officer. One of the *in terrorem* objectives in those cases (of the IRS or perhaps the government more generally) has surely been to discourage those types of payments, because they would probably not be made without the expectation of a tax benefit. Because the government cannot seem to prevent many of the deductions claimed for the payment of the legal fees of another, it may now start trying to prevent those types of payments from being made in the first place.

Night of the Living Dead

There is still reference these days to the 2003 Justice Department memo and to its *in terrorem* effect in cooling what some regard as corporate largesse (and others view as simply good business) when a company picks up employees' legal fees, especially when it comes to former (as opposed to current) employees. Yet, if the government hinges its press for indictments on a company cutting loose its employees or former employees to fend for themselves in the legal arena, that act may be unconstitutional. A federal judge in New York suggested as much in the context of a pretrial hearing in New York involving KPMG.[45]

That may indicate that the pressure of this kind of a policy is inappropriate and may be formally attacked. In fact, some of the KPMG defendants have now moved to dismiss the indictment, arguing that the government — through this Justice Department memo and perhaps in other ways — violated the defendants' right to counsel by interfering with KPMG's ability to choose to advance legal fees to defendants. In one case, a defendant is asserting that the government induced KPMG to breach an agreement to advance legal fees. The government denies that.

Yet, interestingly, Judge Kaplan called for limited discovery and an evidentiary hearing on the question. The judge's order noted that the government admitted that in February 2004 the lead prosecutor inquired about KPMG's obligations and plans regarding the payment of legal fees of partners and employees. Against the background of the Justice Department's 2003 memorandum, the court found that this inquiry itself was arguably a signal to KPMG which actions would promote its chances of avoiding prosecution.

Whatever happens to those defendants, one should take note of the course of events and the quandary in which a company may find itself. Here, it is the individuals claiming the government interfered with their right to counsel, long after the fact. If a company is pressured not to pay or even advance employee counsel fees, there may be no choice for the company facing that pressure. Just as the Supreme Court's reversal of the Arthur Andersen conviction could not breathe life back into Andersen's husk, a legal challenge to the Justice Department's policy could require an usually long view of the world, perhaps even a belief in life after (corporate) death.

Ground Rules

Here are some (helpful, I hope) basic rules to guide would-be payers of legal fees and would-be users of legal services. In this list I'll use ''employee'' for simplicity, but the same rules should apply regardless of whether it is an employee, independent contractor, officer, or director, or even many third parties.

1. Cash is king. If securing the needed legal services is critical, as it usually is, do so (whoever pays). You can sort out later whether the payment by the employer is a loan, compensation, or simply the employer's expense. At the same time, it's always best to reach an understanding — and a written agreement — up front. There are too many opportunities for misunderstandings here.

2. If it's personal, it's nondeductible. This rule is simple. If the legal expense in question has nothing to do with the company's business or the role of the employee, officer, or director, it won't matter who pays it. It will still be nondeductible. Sure, the employer can pay it and treat it as compensation to the employee, but that income hit can be messy. Besides, the employer will have FICA obligations on the value of the fees. It's often better to treat such payments as loans, but make sure you document them.

3. Make a record. In my experience, there is often a business justification for an expense that somehow is not written down, no matter how obvious it is. If legal fees are needed to defend the company's TV advertising, and an officer who appears in the ad spots is sued too, conduct some board resolutions finding that it's in the best interests of the company to defend, that the officer

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[44] *See* Nathan Koppel, ''U.S. Pressures Firms Not to Pay Staff Legal Fees,'' *The Wall Street Journal*, Mar. 28, 2006, p. B-1.

[45] *See* ''Corporate Injustice,'' *The Wall Street Journal*, Apr. 6, 2006, p. A14.

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was acting within the course and scope of his employment, and needs (and is entitled to) defense, too. You'd be surprised how helpful those formalities can be if the company is ever questioned about the deduction. It will focus attention on what the business impact really is, or at least how it is perceived, the latter arguably being more important. Remember how helpful resolutions about reasonable compensation could be if those deductions were questioned? The same is true here.

4. Consider the source. If you're determining that you want to cover someone else's legal fees, consider if that is under an express indemnity right (from the articles, bylaws, or a contract), or if it is not required. Just because indemnity is not required under such a document doesn't mean there is anything wrong with a company determining that indemnity is appropriate. Yet, that should invite documentation about the company's business purpose. (See point 3 above.)

5. Bifurcate fees. There will be cases in which 100 percent reimbursement of (or outlay for) the employee's legal fees won't be appropriate. There are many reasons for that, including personal elements to a legal matter, public or regulatory perceptions, and so on. But don't think of that as an all or nothing proposition. The employee's conduct may be 50 percent business and 50 percent personal. Or 60/40. Or 75/25. This is not an exact science, but it requires some good faith weighing of the facts and circumstances.

Much like allocating a settlement payment for tax purposes between several categories, this kind of action can be quite successful. For example, if an executive (and the company) is accused of sexual harassment, having an express finding that 10 percent of the executive's conduct is outside the course and scope of his employment can make it clear who bears which costs. More significantly, it can actually influence the later tax treatment.

Although this may seem circular or like mere window dressing, I do not believe that it is. It really does help. (See point 3 above.) The case law supports allocations of legal fees between those that are deductible and those that must be capitalized, too.[46]

6. Consider a savings clause. If you are entering into an agreement concerning legal fees, or merely documenting what you understand the company's obligations are, consider a savings clause to shift the burden of a nondeductible payment. In other words, if the company picks up the tab for defending an employee against defamation claims, document that (see point 3 above) but consider what should happen if the deduction by the company is denied. Perhaps the parties should treat it as a loan or as compensation.

The main point is to consider that in advance. There's plenty of precedent for savings clauses, from reasonable compensation to golden parachute payments. Here's another place to consider bifurcation. (See point 5 above.)

Be Careful Out There

Paying the legal fees (or other expenses) of another is not uncommon. It occurs most frequently in the employment context. It can, however, create messy tax positions that shouldn't be overlooked. Foresight and planning can often help to mitigate the exposure created by the payments. I don't expect this morass to be cleansed any time soon.

The reason is the inherently factual nature of this area. Whether a payment of legal fees for another gives rise to a valid deduction has turned on the particular facts and on the particular context and industry. Companies will continue to claim these deductions, arguing (generally correctly I suspect) that the payments relate to their business. The IRS will probably continue to contest some taxpayers' deductions, trying to narrow the playing field, limit taxpayers' choices, and increase Treasury revenues.

On the whole, the IRS has not had much success. Indeed, given the decidedly Hobbesian nature of business today, I suspect most payments of legal fees by companies for officers, directors, and employees will continue to successfully find a home on companies' tax returns.

[46]*See Eisler v. Commissioner*, 59 T.C. 634 (1973), *acq.*, 1973-2 C.B. 1.

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