# Consider Who Gets Tax Deduction For Settlement Payments

By Robert W. Wood[1]

Who is entitled to a deduction? Invariably, the payor, it would seem. Yet, the answer to a simple question is often far from simple. Particularly with family members and related companies, determining which taxpayer can claim a deduction can be downright thorny.

If you get stuck paying legal fees, or worse yet paying legal fees and paying a settlement of judgment, you would be more than miffed to find out that you could not deduct them. Partnerships and partners, employees and employers, related companies, family members, and a host of unrelated parties are sometimes caught in this dilemma. Often, being forewarned is enough to spark a little planning that may be enough to ameliorate the situation.

This issue of identity arises for both payors and payees, with income and deductions. It may appear that this would be solely a question of fact, but sometimes the question is a mixture of law and fact, or even solely one of law. When solely a question of law, the taxpayer's identity can be quite difficult to discuss. Just two years ago, the Supreme Court decided *United States v. Galetti*[2] involving this very question.

In *Galetti,* a partnership failed to pay employment taxes, even after the IRS assessed the tax against it. Perhaps anticipating that the IRS would soon be looking to them for payment, several general partners, including Mr. Galetti, filed for bankruptcy. The IRS intervened in the bankruptcy proceedings, petitioning the court to remit the unpaid partnership employment taxes from the partners' bankruptcy estates. The bankruptcy court denied the claim, as did the district court and the Court of Appeals for the Ninth Circuit, each noting that the collection of the partnership taxes could not be enforced against the individual partners. The Supreme Court granted *certiorari.*

By this time, the IRS realized that it might have boxed itself into a corner. The IRS never actually made a direct claim against the bankrupted general partners to collect the unpaid employment taxes. Presumably, it believed that an assessment against the partnership was sufficient to collect against the general partners. Yet, while all of the appeals were moving from court to court, enough time had passed that the general partners raised as a defense that the IRS failed to make an assessment against them within the three-year statute of limitations. Check, but not check matter.

Rejecting the general partners' defense, the Supreme Court held that a proper assessment of tax against the partnership was sufficient to collect from its individual general partners based on their derivative liability for partnership debt under state law. According to the Court, once the IRS made a proper assessment of the tax, the assessment was valid for collection purposes against other taxpayers.

Of course, *Galetti* is a much more complicated case than I have relayed here. Yet, it shows that the question of identity is not obvious. Taxpayers and the IRS may need the assistance of even the highest court to solve them.

### *FARMING IN THE TIME OF CHOLERA*

Recently, in *Hague v. Commissioner,*[3] the Tax Court was faced with a similar issue. It had to decide whether a partnership or its 99.5% partner was the proper taxpayer entitled to claim a deduction. That may sound simple, and besides, it may sound unimportant. Yet, the case reads like a Gabriel Garcia Marquez novel. The story leading up to the Tax Court decision begins way back in the 1970s.

In 1972, Owen M. Cook ("Owen") retired from farming Oregon's Willamette Valley. Upon retirement, Owen leased his wheat farm to two of his sons, Bob and Byron, who along with Byron's wife, Ann, formed a partnership they called Cook Farms. Initially, Cook Farms was a successful farming business. However, business did not remain rosy for long. By the latter part of the 1970s, Cook Farms suffered from adverse weather, higher fertilizer costs, and lower wheat prices. Between 1979 and 1981, Cook Farms (with Bob, Byron, and Ann as co-obligors) borrowed nearly $1 million under programs administered by the U.S. Department of Agriculture (the "farm loans").

Even with the injection of fresh capital, Cook Farms' losses mounted, and it was not able to repay the farm loans as they came due. In June 1982, the Agriculture Department suggested that Cook Farms (as well as Bob, Byron, and Ann) sell their assets to repay the farm loans. Undaunted, eleven months later Cook Farms countered, offering to pay a mere $5,000 to compromise the farm loans.

In a letter to the Agriculture Department as part of their offer, Bob, Byron, and Ann indicated that they each might file for bankruptcy if a compromise could not be reached. Although the decision fails to state whether Bob, Byron or

Ann actually filed for bankruptcy, four years later the Agriculture Department liquidated Cooks Farms. Yet, even after the 1986 liquidation, most of the delinquent farm loans remained unpaid.

***ENTER THE SAVIOR***

In 1981, Bob met Stephanie Jane Hague. Although Bob and Stephanie did not marry until 1991, soon after meeting Bob, Stephanie formed a new general partnership with Bob's father, Owen, ostensibly to produce grass seed. Stephanie and Owen (neither of whom were partners in Cook Farms) each held a 50% interest in the partnership called O.M. Cook Co. ("OMCC"). On paper, it seemed like a perfect match. Owen had many years of farming experience, and Stephanie, a lawyer by training, handled the administrative, record keeping, and personnel matters. OMCC became highly profitable, and Bob and Byron became employees of OMCC. Once Stephanie started receiving profits from OMCC, she began to purchase commercial real estate and large tracts of farmland. Stephanie leased her farmland to OMCC. In fact, OMCC did not own any land.

OMCC's partnership agreement provided that if either Owen or Stephanie died, his or her interest in the partnership would become the sole property of the survivor. Owen was in his 70s when OMCC was formed, so arguably a portion of Owen's interest may have been a gift. Indeed, as it happened, Owen suffered a debilitating stroke in 1989.

After the stroke, Owen substantially reduced his work at OMCC. He also transferred various personal assets to Stephanie, including nearly his entire OMCC partnership interest. Thereafter, Stephanie's interest in OMCC was 99.5%. Despite this substantial transfer, Stephanie did not legally become Owen's daughter-in-law until 1991.

Owen died in 1992 and, contrary to the original partnership agreement, Owen's wife, Mildred, received Owen's remaining one half percent interest in OMCC. This may have been part of some later planning in which the parties desired to keep the OMCC partnership alive upon Owen's death.

***FARM LOAN LAWSUIT***

Even though the Agriculture Department liquidated Cook Farms in 1986, it continued to pursue the outstanding balance on the farm loans. In 1990, Cook Farms agreed to settle the outstanding balance, which by then totaled over $1.6 million (including accrued interest), in exchange for $75,000 to be remitted in four installments. Cook Farms paid the first installment, but failed to pay the remaining three. The Agriculture Department revoked the settlement agreement, and reinstated the full outstanding balance of the farm loans.

In 1996, the United States filed a complaint against Bob, Byron, Ann, and Cook Farms (the "farm loan lawsuit"). See *United States v. Cook,* No. CV96-172-RE (D. Or. 1996). The government sought a judgment that Bob, Byron, Ann, and Cook Farms were obliged to repay the full amount of the farm loan, including accrued interest. The timing of the government filing suit is extraordinary: it was commenced six years after the broken settlement agreement, ten years after the Agriculture Department liquidated the Cook Farms, and fifteen years after the Agriculture Department made the last farm loan. I guess the statute of limitations never expires when debt remains outstanding on a farm loan.

Later that year, the government filed an amended complaint adding Stephanie as a defendant and expanding its legal theories for recovery. The government now alleged that Bob and Byron were secret partners in OMCC (even though technically they were only employees). It further alleged that Owen and Stephanie conspired with Bob and Byron to defraud and hinder the government in its efforts to collect the unpaid farm loans by organizing OMCC and holding all of their business and personal assets in the names of either OMCC or Stephanie. This included the fraudulent conveyance of certain assets used in OMCC's ongoing business operations to conceal Bob's and Byron's interests in OMCC.

The amended complaint is pregnant with the question why it took the government so long to pursue Stephanie. After all, she legally owned virtually all of the assets among these taxpayers. Adding Stephanie to the complaint could hardly be a surprise to her or her family. What is surprising is that it took the government so long to do so. For fourteen years, the government only chased a defunct partnership, while the same cast of characters was successfully farming under the guise of a new partnership.

In 1997, the district court granted partial summary judgment for the government, holding that Bob, Byron, Ann, and Cook Farms were liable for the full amount of unpaid farm loans, plus interest. A few months later, the government filed yet another amended complaint. This time it requested the district court to enter a judgment against Stephanie and OMCC, jointly and severally, for the full amount of the farm loan debt.

***THE FRUITS OF ONE'S LABOR***

Before the government filed the farm loan lawsuit, the Agriculture Department conducted an investigation to identify all of the assets owned by Bob, Byron, Ann, Stephanie, and OMCC. During the investigation and the ensuing litigation, the government issued numerous subpoenas to various individuals and businesses in and around the Willamette Valley farming community. The investigation resulted in adverse publicity for both OMCC and Stephanie. In fact, two landowners terminated land leases with OMCC, and an equipment dealer stopped selling OMCC farm equipment.

This negative publicity apparently brought the parties back to the bargaining table, and in December 1997, another settlement was reached. This settlement required Stephanie to pay that the United States $625,000 within 120 days of the execution of the settlement agreement. This was a long way from the $75,000 payment required under the first settlement agreement executed seven years earlier.

## *JUDGMENT DAY*

Within days of this second settlement, Stephanie and Mildred, as general partners of OMCC, each signed and submitted to the Commercial Bank (the "bank") written authorization for OMCC to borrow up to $1 million. Pursuant to its new line of credit, OMCC borrowed $75,000 from the bank. That same day, Stephanie and OMCC, as co-borrowers, borrowed $550,000 from the bank. As security for this loan, Stephanie transferred to the bank a deed of trust on her house. Shortly thereafter, Stephanie wired the $625,000 to the government.

Throughout the course of the settlement in 1997, OMCC paid legal fees of $83,202 to two law firms related to the farm loan litigation. The first firm, Donaldson, Albert, had billed OMCC. The second firm, Stewart, Sokol, had billed Stephanie. Even though there was separate billing, *OMCC* paid both firms: $26,584 to Donaldson, Albert and $56,617 to Stewart, Sokol.

On its 1997 return, OMCC deducted $625,000 for "litigation" and $87,490 for "legal." It reported a net farm loss of $354,477 and showed Stephanie contributing $25,876 to the partnership. Presumably, Stephanie's contribution related to OMCC's payment of her legal fees.

The IRS challenged OMCC's reporting of the settlement payment and attorneys' fees. It asserted that OMCC could not deduct the $625,000 settlement because Stephanie, not OMCC, made the settlement payment. Alternatively, the IRS contended that neither OMCC nor Stephanie could deduct the settlement payment or legal fees because those payments were capital expenditures made to defend or perfect Stephanie's title to property.[4]

In response, Stephanie individually, and as a 99.5% partner of OMCC, contended that the $625,000 settlement payment and the $83,202 in legal fees were deductible by either Stephanie or OMCC, because those amounts were paid to protect OMCC's ongoing business operations and its reputation.

## *WHO PAID THE SETTLEMENT?*

Determining whether a settlement payment and legal fees are deductible is related to the question of who made the payment. The questions are related, but distinct. Yet, who paid is usually a starting point, and is usually easy to determine.

Even that simple point was not clear here. The IRS asserted that Stephanie paid the settlement because she provided collateral for the $550,000 loan, and because OMCC failed to properly account for the $625,000 as a partnership debt on its books and records. Fortunately for the taxpayers, the Tax Court disagreed. The court was not persuaded that the use of Stephanie's house as collateral proved that Stephanie had paid the entire $625,000 settlement. Although the bank had a right to foreclose on Stephanie's house in the event of a default on the $550,000 loan, there was no indication that a default actually occurred, or that Stephanie thought it ever would.

The court was also not persuaded that OMCC's failure to account for the bank loan as a partnership debt proved Stephanie's responsibility to repay the loan in full. Sure, evidence that OMCC failed to properly account for the bank loan on its books and records was relevant to the question whether Stephanie or OMCC had actually made the settlement payment. However, OMCC's book entries were not conclusive on the point.[5] According to the court, the fact that OMCC and Stephanie *jointly* borrowed $550,000 of the funds used to pay the settlement was compelling evidence that OMCC and Stephanie *jointly* paid that portion of the settlement.

Note that the government made claims against both Stephanie and OMCC in the farm loan litigation. Furthermore, the bank loan records identified Stephanie and OMCC as co-borrowers on the $550,000 loan. Ultimately, the court found that Stephanie and OMCC each paid one-half of the $550,000 that comprised a part of the settlement payment. As to the remaining $75,000 of the $625,000 settlement payment, the court concluded that OMCC paid this $75,000 since it borrowed that amount against its own line of credit. Thus, the court ruled that Stephanie paid $275,000 of the $625,000 settlement payment, and that OMCC paid $350,000.

Regrettably, payment does not always equal a deduction. Once the court determined who made the payment, it turned its focus to how much of its $350,000 payment OMCC could deduct and how much of her $275,000 payment Stephanie could deduct.

## *TRADE OR BUSINESS*

A taxpayer who is carrying on a trade or business may deduct ordinary and necessary expenses incurred in connection with the operation of the business under §162. Similarly, ordinary and necessary expenses incurred in connection with an activity conducted for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income, are deductible under §212 if the taxpayer itemizes deductions. To be deductible under either section, an expense must be directly connected with or proximately result from the taxpayer's business, or from an activity conducted for the production or collection of income.[6] Personal, living, and family expenses, on the other hand, generally may not be deducted.[7] In addition, expenses that would otherwise be deductible under §162 or §212 are not currently deductible if they are capital expenditures.[8]

Whether legal fees and expenses are deductible under §162, under §212, or are nondeductible depends on the origin of the underlying claim, not on its potential effects on the fortunes of the taxpayer.[9] Legal expenses and settlement costs incurred in defending against claims that would injure or destroy a business are ordinary and necessary business expenses.[10] Litigation may be rooted in both the defense or perfection of title (nondeductible expenditures), and in the management of a property or business (deductible expenditures). As a result, an allocation between the two may be appropriate.[11]

## *BIFURCATED RESULTS*

Stephanie contended that the $625,000 payment was deductible regardless of whether it was paid by her or OMCC. On the other hand, the IRS contended that the entire payment was a nondeductible capital expense. Firmly putting its foot down, the court agreed with Stephanie in part and with the IRS in part. It concluded that OMCC could deduct its share of the settlement payment under §162, but that Stephanie had to capitalize her share of the settlement payment.

In identifying the origin of the claim that led to the settlement payment, the court considered the government's original and amended complaints in the farm loan litigation as well as the settlement agreement. The government's original complaint was directed at Cook Farms and its partners, and sought a judgment requiring them to repay all of the farm loans plus interest. Later, the government added Stephanie as a defendant, and added allegations of conspiracy and fraudulent conveyance.

Indeed, the government claimed that Stephanie was conspiring with Bob and Byron to use OMCC's farming operations to hide assets that otherwise would have been available to the government to offset Cook Farms' delinquent farm loans. The government challenged Stephanie's title to real estate she had acquired with her distributive share of OMCC's earnings. Not surprisingly, the government viewed OMCC's and Stephanie's assets as potential sources to repay the farm loans.

The settlement agreement that ended the farm loan litigation revealed that OMCC's interests were taken into account when that action was settled. In particular, the settlement agreement stated that all parties and the government released each other from all civil claims relating to the action. The settlement agreement also stated that the settlement payment was intended solely to buy peaceful continued business operation for OMCC and Stephanie, and to avoid further litigation.

Against this background, the court concluded that OMCC paid its share of the settlement to defend against the government's claims that its current business operations were part of an ongoing conspiracy and that OMCC should be held jointly and severally liable for approximately $2 million due on the unpaid farm loans. OMCC was not named as a defendant in the farm loan litigation. Yet, the second amended complaint and the settlement agreement clearly show that the government treated OMCC as fair game in its hunt for assets to repay the delinquent farm loans.

In fact, the settlement agreement provides that the parties viewed the settlement as a means to ensure that OMCC could continue its farming operations uninhibited by any further litigation or adversarial administrative proceedings at the Agriculture Department. Under these circumstances, the court held that OMCC's payment of $350,000 of the settlement payment was an ordinary and necessary business expense under §162.

In contrast, the court concluded that Stephanie could not deduct her $275,000 share of the settlement payment. The government's allegations in the farm loan litigation regarding the circumstances of the transfer of Cook family assets to Stephanie represented a direct attack on her title to real estate and other assets that she had acquired in her own name over the years. Consequently, the Tax Court concluded that Stephanie had paid her share of the settlement to preserve or protect her title to the real estate and her other personal assets against the government's claim that those assets had been fraudulently conveyed to her. Therefore, Stephanie had to capitalize her share of the settlement payment.[12]

## *LEGAL FEE DEDUCTION*

OMCC paid $83,202 in legal fees in connection with the farm loan litigation. The IRS argued that OMCC could not deduct these legal fees because they were incurred to defend and protect Stephanie's title to real estate and, therefore, were capital expenditures. The taxpayers asserted that the legal fees were fully deductible. Under their theory, legal expenses incurred in defending against claims that a business was being operated fraudulently (i.e., claims that would injure or destroy a business) were ordinary and necessary business expenses and need not be capitalized.[13]

The court noted that its analysis regarding the deductibility of the settlement payment also applied to the disputed legal and professional fees. The court allowed OMCC to deduct the $26,584 in legal fees that it incurred in defending itself against the lawsuit because those expenditures were ordinary and necessary business expenses.

The court did not allow OMCC to deduct the legal fees it paid on behalf of Stephanie. Remember that in 1997, Stewart, Sokol billed Stephanie $56,617 for legal fees, but OMCC paid the bill. Those fees were incurred to protect and defend Stephanie's title to real estate and other personal assets that she acquired in her own name over the years.[14] Thus, neither Stephanie nor OMCC could deduct these fees. Stephanie had to capitalize them.

## *CONCLUSION*

The saga of Cook Farms and OMCC is lengthy. Although Kafka may feel vindicated, the taxpayers surely felt otherwise. Having forsaken a $75,000 settlement in 1990, only to be stuck with a $625,000 settlement six years later, they must have been forlorn. One must credit a tenacious government prosecutor who put in fourteen years of work on this case, a prosecutor who, like Jean Valjean, was dogged in his pursuit.

In any event, now that Byron, Ann, Bob and Stephanie have closed this chapter in their lives, perhaps they will reminisce over the good-old days before they received their farm loans. That was 1979, and the days of skyrocketing oil prices and chaos in Iran. On that note, waxing nostalgic, this case serves as a reminder that careful and contemporaneous planning is important.

The settlement payment would likely have been fully deductible had it been paid entirely by OMCC, even if Stephanie had guaranteed the loan using her house as collateral. The same may be said for the legal fees, presuming, of course, that the fees paid by Stephanie related to her position as a partner of OMCC. No matter how much planning she had done, she might have had trouble deducting legal fees incurred purely to protect her personal assets. Yet, I think planning and forethought here would have carried the day.

## *ENDNOTES*

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2. 541 U.S. 114 (2004).

3. T.C. Memo. 2005-276; 2005 TNT 229-11.

4. See Treas. Reg. §1.263(a)-2(c).

5. See *Est. of Freeman v. Comm'r,* T.C. Memo. 1966-42.

6. *Kornhauser v. United States,* 276 U.S. 145, 153 (1928); *Madden v. Comm'r,* 514 F.2d 1149, 1150 (9th Cir. 1975), *revg.* 57 T.C. 513 (1972); *Stevens v. Comm'r,* T.C. Memo. 1999–259.

7. IRC §262(a).

8. IRC §§263, 261, 161; *Woodward v. Comm'r,* 397 U.S. 572, 575–576 (1970); *BHA Enters., Inc. v. Comm'r,* 74 T.C. 593, 599 (1980).

9. See *United States v. Gilmore,* 372 U.S. 39, 51 (1963) (holding that the taxpayer was not entitled to deduct legal expenses incurred in divorce proceedings in which his spouse sought a share of his controlling interests in three corporations because his spouse's claims stemmed from the marital relationship, not from income-producing activity); see also *Woodward v. Comm'r, supra* at 577-578; *Redwood Empire Sav. & Loan Assn. v. Comm'r,* 628 F.2d 516, 520 (9th Cir. 1980), *affg.* 68 T.C. 960, 976-979 (1977); *Madden v. Comm'r, supra* at 1151; *Reed v. Comm'r,* 55 T.C. 32, 39 (1970).

10. *Commissioner v. Heininger,* 320 U.S. 467, 471-472 (1943); *N. Am. Inv. Co. v. Comm'r,* 24 B.T.A. 419, 420 (1931).

11. *DeMink v. United States,* 448 F.2d 867, 869 (9th Cir. 1971); see *Boagni v. Comm'r,* 59 T.C. 708, 713-714.

12. See *Madden v. Comm'r,* 514 F.2d at 1151; *Reed v. Comm'r,* 55 T.C. at 39-40.

13. See *Commissioner v. Heininger,* 320 U.S. 467, 470 (1943); *Kornhauser v. United States,* 276 U.S. at 153; *N. Am. Inv. Co. v. Comm'r,* 24 B.T.A. at 420.

14. See, e.g., *Hood v. Comm'r,* 115 T.C. 172 (2000).