Attorney Fees: To Deduct or Not to Deduct

By Robert W. Wood

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In a nearly universal lament, individuals and companies alike complain of rising legal costs. Despite the recession, legal costs remain high. As at least some consolation, in the business world, virtually everyone thinks all legal fees are deductible. They may be expensive, one reasons, but at least they're deductible!

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

An example would be legal expenses of a divorce. They are nondeductible because divorce is personal.[1] The one exception is the portion of legal fees paid under a divorce that are for tax advice. Fees for tax advice (paid to a lawyer or an accountant) are deductible as investment expenses. Investment expenses are hardly a favored tax deduction because they are miscellaneous itemized deductible and as such are subject to various limitations.

Second, and perhaps more problematic to those in business, legal expenses of a capital nature are not deductible. That makes legal fees to defend title to property, to acquire another company, or to purchase capital assets a good deal more painful than other legal expenses. Those expenses must be capitalized over the life of the asset. For example, legal expenses to acquire a commercial building must be added to the cost of the building, and recovered (through depreciation) over 39 years. Ouch!

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

Nevertheless, in the vast majority of cases, legal expenses paid or incurred in carrying on a trade or business are deductible as business expenses. A business expense deduction is truly gold-plated, offsetting income in much the same way as an adjustment to gross income. The business expense versus investment expense dichotomy is important, and represents a factual line that is often litigated. Unlike gold-plated business expense deductions, legal expenses paid or incurred in pursuing investment activities, or activities for the production of income, are at best silver-plated.

These are activities that are not active or regular enough to constitute a trade or business, but that nevertheless are conducted with profit-making in mind. Significantly, investment legal expenses are deductible only as miscellaneous itemized expenses. That means they are subject to a 2 percent of adjusted gross income threshold, phaseouts for high income earners, and are nondeductible for purposes of the alternative minimum tax. The AMT is often the real killer, giving what ought to look like silver-plating on a tax deduction more the sheen of lead.

Same Old Thing

These rules are pretty well-defined. How, then, do so many taxpayers get into such frequent and serious trouble over legal fees? The recent Tax Court case of *West Covina Motors, Inc. v. Commissioner*,[2] provides a window into legal fee deduction disputes. In this case, there were a variety of legal expenses in question.

First, the Tax Court had to decide whether the taxpayer could deduct the legal expenses it incurred in the bankruptcy of its landlord. Second, the Tax Court considered whether the taxpayer could deduct legal expenses related to the purchase of another car dealership. Third, the Tax Court had to evaluate miscellaneous legal expenses that were questioned by the IRS. Fourth, the Tax Court considered whether accuracy-related penalties should apply.

Categorize Your Expenses

Old-school lawyers were once used to billing ''for services rendered'' and not particularizing their invoices. If there are any such lawyers left out there, reading some of the tax cases in this area should be a wake-up call. Only old-school clients are likely to pay ''for services rendered'' statements. Most clients these days expect their legal bills to be detailed, describing the legal work and the categories of legal expenses, particularly if the client is concerned about the tax impact of such payments.

[2]T.C. Memo. 2008-237, *Doc 2008-22816*, *2008 TNT 209-8*.

In *West Covina Motors*, the first category of legal expenses the Tax Court considered related to the landlord of the car dealership. The landlord had filed for bankruptcy, not so much to maintain its position as lessee of the dealership, but to expand it. In fact, when the smoke cleared after the bankruptcy reorganization, West Covina Motors was able to expand its business onto two additional parcels of land that the erstwhile bankrupt landlord had acquired as a result of the reorganization.

The taxpayer's legal fees for all of the bankruptcy work thus lead to a significant expansion of the taxpayer's business premises. The Tax Court had a relatively easy time viewing these legal expenses as capitalizable and not currently deductible. Traditionally, legal expenses incurred to defend claims that would injure or destroy a business are classified as ordinary and necessary expenses and thus deductible.[3] The Tax Court actually said that if West Covina Motors had been paying legal expenses in the bankruptcy as a way of insuring that West Covina Motors would continue to be able to occupy its business premises, those expenses would be ordinary and necessary, and thus deductible.

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

Acquisition Legal Fees

Even more obviously, legal fees paid to acquire another company have traditionally been required to be capitalized. You can't deduct them currently, so you must capitalize them along with the purchase price for the assets or company in question. The second tranche of legal fees considered in *West Covina Motors* related to the taxpayer's purchase of the assets of another car dealership. The taxpayer acquired another dealer's inventory, parts, accessories, and fixed and intangible assets. The purchase price was more than $6 million.

The purchase agreement required West Covina Motors to assume the seller's legal expenses. In that connection, West Covina Motors paid $100,000 in fees to the seller's counsel as well as approximately $20,000 in fees to its own counsel. The Tax Court had an easy time concluding that these were capital-related legal fees, and that they, too, had to be capitalized.

Despite the stacked deck against it, West Covina Motors had an ingenious argument. Look, the argument went, the bulk of the purchase price for the other dealer's assets was allocable to its inventory. As the car dealer's inventory usually turned over every 90 to 150 days, the taxpayer's argument continued, it was inappropriate to capitalize the bulk of these legal fees. They could be directly traced to inventory, so had to be ordinary. The Tax Court found the argument creative, but found no factual support for it.

[3] *See Commissioner v. Heininger,* 320 U.S. 467 (1943).

Telling Records

In fact, the Tax Court concluded that less than 40 percent of the purchase price in the dealer's sale was allocable to the inventory. The Tax Court discounted the testimony that was offered, labeling it as self-serving and uncorroborated. The Tax Court pointed out that even the dealership's records showed that the inventory did not turn every 90 to 150 days. Accordingly, the Tax Court ruled that all of the acquisition legal expenses had to be capitalized.

Record keeping also did the taxpayer in on the approximately $54,000 in miscellaneous legal fees that were next questioned by the Tax Court. These may well have been perfectly legitimate legal expenses incurred in carrying on the West Covina Motors dealership business. Unfortunately, the taxpayer presented no evidence about these legal expenses, so the Tax Court ruled them to be nondeductible.

The taxpayer's last slap in the face from the Tax Court came in the discussion of penalties. The IRS assessed substantial understatement penalties under section 6662(b)(2). The taxpayer argued that the return positions the taxpayer had taken were reasonable, that it had substantially disclosed them, and that in any case it had reasonable cause for its failures. The Tax Court disagreed on every point.

Perennial Lessons

There are surprisingly few new developments concerning legal fees. Most of the trends are well-established. Personal legal fees are nondeductible. Legal fees related to the active conduct of a trade or business may be deducted as ordinary and necessary business expenses. Investment legal expenses are deductible as investment expenses. Legal fees related to acquiring or preserving capital assets must be capitalized.

We know all these things, and yet we need reminders. More than that, we need compliance tools. Not infrequently, taxpayers lose out because of a lack of proof.

They cannot produce detailed legal bills showing what work was done. They cannot produce evidence of the requisite nexus between the legal expenses and the ongoing operation of their active trade or business. They cannot produce copies of checks.

Most of these deficiencies are quite curable. Moreover, in many cases difficult situations can be ameliorated with the wisdom of Solomon: split the baby.

Divide and Conquer

Taxpayers can often bifurcate legal bills between personal and tax (divorce), or between personal and investment (a legal dispute between neighboring homeowners). Taxpayers can also divide bills between ordinary business expenses and capital expenditures, in litigation concerning ongoing business operations as well as title to assets. In the corporate arena, the division will often be a way to get half a loaf or more, rather than no loaf at all.

Recall that one of the earliest and most persistent lessons of *INDOPCO*[4] was bifurcation. The Supreme Court in *INDOPCO* said the legal and investment banking fees of an acquisition had to be capitalized. Since then, parsing legal and other expenses has become the norm: divide and conquer. The same techniques can be used between investment expenses and additions to basis. Bifurcation has often been the ticket to allowability. In making allocations, be reasonable.

Yet records and documents are key. In fact, documentary evidence — checks, bills, pleadings, correspondence, declarations, and the like — will often keep you from needing to resort to testimony. That is good because the evidentiary standards for testimony may be tougher than the level of informality with which many legal fee tax disputes can be resolved. Keep a good file, and when it comes to bifurcating fees, be reasonable. With any luck, you won't have to go to court to secure your legal fee deductions. If you do go to court, you'd better have convincing evidence.

[4]*INDOPCO Inc. v. Commissioner*, 503 U.S. 79 (1992).

Final Intercompany Obligation Regs and Debt Extinguishments

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They say it is the intent rather than the gift that embodies the Christmas spirit. Treasury exemplified this maxim by issuing the final intercompany obligation regulations of reg. section 1.1502-13(g)[1] on December 24, 2008. The intent of the new regulations was to revise regulations issued in 1995 that the IRS and Treasury admitted were ambiguous. While the new regulations do solve many problems and uncertainties, it is the authors' view that Treasury has fallen short of its objective of clarity for intercompany obligations extinguished within a consolidated group.

An intercompany obligation is a debt or security of a member of the consolidated group.[2] Debt of a member is any obligation of the member constituting indebtedness under general principles of federal income tax law, but not an executory obligation to purchase or provide goods or services.[3] An intercompany obligation is an obligation between members, but only for the period during which both parties are members.[4] Thus, an intercompany loan between members of the same consolidated group generally qualifies as an intercompany obligation.

Extinguishing intercompany obligations is one of the most common consolidated group transactions. With the current credit crunch, companies are restructuring their equity and financing structures to placate investors and to cleanse their internal balance sheets. As a result, tax professionals must understand the tax consequences from seemingly innocuous intragroup restructuring transactions.

The new regulations apply to three types of transactions:

- those in which an obligation between a group member and a nonmember becomes an intercompany obligation (inbound transactions);

[1]T.D. 9442, *Doc 2008-27108, 2008 TNT 249-6*. Effective for tax beginning on or after December 24, 2008.

[2]Reg. section 1.1502-13(g)(2)(i).

[3]Reg. section 1.1502-13(g)(2)(i)(A) cites examples such as section 108, section 163, or reg. section 1.1275-1(d).

[4]Reg. section 1.1502-13(g)(2)(ii).