taxanalysts tax practice and accounting news

edited by Robert J. Wells and Jon Almeras

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Resolving Litigation by Payments To Charity

By Robert W. Wood

Robert W. Wood practices law with Robert W. Wood, P.C., in San Francisco. He is the author of *Taxation of Damage Awards and Settlement Payments* (3d Ed. 2005), published by Tax Institute and available at http://www.damageawards.org.

Occasionally, it may be possible to resolve legal disputes by plaintiff and defendant agreeing that the defendant will make a payment to a charity. Why would a plaintiff ask for that? The reasons are as varied as the reasons for litigation. Often, though, a plaintiff neither wants nor needs the money generated by a settlement or verdict, but rather brings the suit to make a point. Sometimes, the lawsuit is about principle. Then too, sometimes it is just to punish the defendant.

Demanding that a settlement payment be made to charity can serve a variety of those goals, while also serving a greater good. I first encountered a payment to charity in this context with the enormous Microsoft class action brought in California. One of the elements of that settlement involved Microsoft making contributions to charity. Although I was not representing Microsoft (I was, instead, providing tax advice to the class of plaintiffs), I wondered at the time whether Microsoft could legitimately claim charitable contribution deductions for contributions to charity that were hardly voluntary. Perhaps it is an academic point. I'm rather certain that Microsoft did claim the charitable contribution deductions.

If a plaintiff *could* receive a settlement or judgment but rather directs the defendant to make payment to a charity, there are some interesting assignments of income issues, too. In the case of a judgment, there seems little doubt that a plaintiff cannot avoid the incidence of the income tax by directing that he does not want the payment and rather wants the judgment paid to a charity.[1] A settlement is arguably different, in that the plaintiff has no right to income until he signs the settlement agreement releasing his legal rights.[2]

The recent announcement that Oracle's CEO, Larry Ellison, reached an agreement to pay $100 million to charity to resolve an insider trading lawsuit raises the stakes.[3] That unusual settlement arrangement requires Oracle board approval, and it certainly is possible that it will not be paid as planned. Still, it raises some interesting tax questions if it is ultimately consummated.

In a derivative suit, of course, damages are typically paid directly to the company. The idea of a derivative suit is that the company has been damaged and that the settlement proceeds help to make up for it. In this case, the lawsuit charged that Ellison sold almost $900 million of Oracle shares ahead of news that Oracle would not meet its expected earnings target. After the earnings announcement, that $900 million worth of stock was worth slightly more than half as much. Oops.

Under the terms of this innovative settlement, Ellison would designate a charity and the payments would be made to that charity over five years in Oracle's name. Early news reports suggested that it was unclear whether the payments would be tax-deductible for Ellison. My first reaction is that they would be. The interesting point, it seems to me, is whether they are deductible as a business expense or as a charitable contribution.

As a general rule, taxpayers would rather claim a deduction as a business expense than a charitable contribution. A business deduction is an above-the-line deduction, while a charitable contribution deduction is a below-the-line deduction. Above-the-line deductions are fully deductible, but below-the-line deductions can be subject to limitations, phaseouts, and the dreaded alternative minimum tax.

A charitable contribution, however, is not a typical below-the-line deduction. While it is subject to limitations and phaseouts, it is not subject to the AMT. Moreover, charitable contribution deductions are constrained by myriad rules, some relating to the taxpayer's adjusted gross income and the type of charity to which the payment is being made. In particular, those rules differentiate between individuals and corporate donors when it comes to the maximum allowable annual charitable contribution deduction.

Business Expense

Ellison could claim a business expense deduction under section 162 only if he can demonstrate that his payment to charity was an ordinary and necessary expense paid in his trade or business. Although it may seem like that would be a simple determination, experience suggests that it would be anything but simple in practice. One of Ellison's chief obstacles in making that determination would be deciding the capacity in which he will

[1] *See Doyle v. Commissioner*, 147 F.2d 769 (4th Cir. 1945).

[2] *See Estate of Richards v. Commissioner*, 150 F.2d 837 (2d Cir. 1945).

[3] *See* Glater, "Oracle's Ellison to Settle Insider Trading Lawsuit," *The New York Times*, Sept. 12, 2005, p. A5.

actually make the payment. After all, Ellison is simultaneously an officer, director, and major shareholder of Oracle.

Although there is no statutory definition of what constitutes a trade or business expense for an executive, the regulations acknowledge that services performed as an employee can constitute a trade or business.[4] Courts have expanded on the regulations, providing that the services of corporate officers and directors also constitute a trade or business.[5] In contrast, services performed by a shareholder are not likely to constitute a trade or business.

As I understand the situation, Ellison is accused of selling a significant chunk of Oracle stock ahead of a public earnings announcement. It would seem that his insider knowledge of the corporate earnings came in his capacity as an officer of the company. If indeed he received the information in that capacity, it is likely that Ellison would be treated as engaged in the trade or business of being an officer.

Similarly, if Ellison had advance knowledge of the company's earnings in his role as a director, I would suppose he would be treated as engaged in the trade or business of serving as a director. In contrast, if Ellison were wearing his shareholder hat, it seems unlikely that he would be considered to be engaged in a trade or business at all. Of course, if he were wearing his shareholder hat when he took the action that resulted in this $100 million settlement, he may have more legal troubles than just characterizing that expense for tax purposes.

If Ellison is deemed to be engaged in a trade or business (either as an officer or director), it seems likely that he could obtain a trade or business deduction. After all, the payments here are probably both ordinary and necessary. The determination whether an expense is ''ordinary'' depends on the facts and circumstances of a particular taxpayer, and according to the expense's time, place, and circumstance.[6]

Generally speaking, an expense is ordinary if it would be commonly incurred in the particular circumstances involved. To be ordinary, an expense need not be recurrent. In fact, a one-time expense can be ordinary. A once-in-a-lifetime piece of litigation does not fail to be ''ordinary'' just because it is unusual, unexpected, or unlikely to reoccur. Based on that, I expect that Ellison's payment would be considered ordinary, even though the whole circumstance might best be described as squirrelly.

The determination of whether an expense is necessary is less problematic. The word ''necessary'' imposes only the minimal requirement that an expense be appropriate and helpful to the development of the taxpayer's business.[7] The taxpayer is not required to demonstrate that the expense is the only method to accomplish the business goals. In fact, perhaps the Internal Revenue Code should say that expenses must be ''ordinary and appropriate,'' rather than ordinary and necessary, since the courts have taken a relaxed view of what is necessary to running a business. Yet, courts do require the expense to be reasonable. In any case, I believe there is no doubt that Ellison's charitable settlement payment should meet the ''necessary'' requirement.

Charitable Deduction?

Although my ruminations convince me that Ellison (who doubtless has an array of tax lawyers) could successfully claim a business expense deduction, we all know that there is no certainty in the world of tax. Just ask KPMG. Plus, there are always state tax concerns, which in California, New York, and other high-tax states can be nettlesome.

Hence, it is worth considering an alternative position Ellison may be able to take. Should Ellison not be able to claim a trade or business deduction, he may be able to claim a charitable contribution deduction under section 170. But, is Ellison making the payment with donative intent?

When analyzing whether a charitable contribution deduction is appropriate, courts frequently employ an objective quid pro quo test. That test objectively looks to what the taxpayer may have received in return for making the charitable contribution. The Supreme Court spoke up about this test when it considered a case involving the assignment of insurance premium refunds to a nonprofit organization that had sold the taxpayers their insurance.[8] The Court stated that the sine qua non of a charitable contribution is the transfer of money or property without adequate consideration. If the contributor expects a substantial benefit in return for a payment of money or property, that payment cannot constitute a charitable contribution.

In a more recent case, *Addis v. Commissioner*,[9] the court denied a charitable contribution deduction when a husband and wife jointly claimed a deduction for payments to a charity. The charity actually used the funds to pay premiums on a life insurance policy for the wife, and that just didn't fit with a ''donation.'' Although that type of arrangement may have seemed aggressive at the time, no authority had specifically prohibited it.[10]

The insurance policy in *Addis* was a ''charitable split dollar'' life insurance contract in which the charity was entitled to receive only 56 percent of the death benefits, and the taxpayers' family trust received the remainder. The IRS disallowed all of the charitable deductions to the charity, contending that the taxpayers could not deduct the payments because the taxpayers had received a benefit (44 percent of the death benefits). The taxpayer

---

[4] Treas. reg. section 1.162-17.

[5] *Commissioner v. Peoples Pittsburgh Tr. Co.*, 60 F.2d 187, 189 (3d Cir. 1932).

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

[7] *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966).

[8] *See United States v. American Bar Endowment*, 477 U.S. 105 (1986).

[9] 374 F.3d 881, *Doc 2004-14119*, *2004 TNT 132-7* (9th Cir. 2004).

[10] Two years after the transaction, the IRS issued Notice 99-36, 1999-1 C.B. 1284, *Doc 1999-20718*, *1999 TNT 114-5*, which set forth its view that no charitable contribution would be allowed in this type of transaction. On December 17, 1999, as part of the Ticket to Work and Work Incentives Improvement Act of 1999, Congress enacted section 170(f)(10), which statutorily proscribed that arrangement.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

argued that because the charity did not officially promise (and was not required) to provide any of the death benefits to the taxpayers on contribution, there was no quid pro quo. In siding with the commissioner, the court found that the charity provided consideration for the taxpayers' payments because at the time of the payments the taxpayers expected (even though they were not guaranteed) to receive a percentage of the death benefits.[11]

Doing Good for the Wrong Reason

Historically, many courts have employed a more subjective approach to determine whether a charitable deduction was appropriate. That subjective approach focused on the taxpayer's intent in making the transfer. Just why did you make the transfer? That approach had its genesis in the famous Supreme Court decision in *Commissioner v. Duberstein*.[12]

In *Duberstein*, the Court held that to be a gift, property must be transferred from a ''detached and disinterested generosity, out of affection, respect, admiration, charity and like impulses.''[13] That subjective analysis has not received much support in recent years, as it is considerably more difficult to discern a taxpayer's subjective intent than it is to determine the outcome under an objective quid pro quo test.[14] Nevertheless, courts sometimes do intertwine the two theories.

In *Dejong v. Commissioner*,[15] taxpayers whose children were educated in a private school claimed deductions for ''voluntary'' amounts paid to the school. The court noted that the parents' contributions were made with the expectation of receiving an education for their children in return for the cash. Thus, the amounts paid did not emanate from a ''detached and disinterested generosity'' and were not deductible. That case is simple and clearly correct because the taxpayers received a quid pro quo — education for their children.

Other cases are less obvious. For example, *McConnell v. Commissioner*[16] highlights the extent to which an indirect economic benefit to the donor as a result of a charitable contribution may result in the loss of the charitable deduction. In *McConnell*, a real estate developer donated the streets and sewers of a new subdivision to the municipality in which the subdivision was located. The developer claimed a charitable contribution deduction for the value of the property.

The court disallowed the deduction, holding that the phrase ''charitable contribution'' is synonymous with ''gift.'' The taxpayer had not made a gift, said the court, because the transfer was motivated by some anticipated benefit ''beyond the mere satisfaction flowing from the performance of a generous act.'' In that case, the benefits to the taxpayer, and therefore his motives in transferring his interests in the streets and sewers, were twofold: to avoid responsibility for future maintenance of the streets and sewers and to enhance the value of his interest in the remaining property. The court held that those motives were impermissible. Therefore, the transfer was not a ''contribution or gift'' and the charitable contribution was not allowed.

McConnell suggests that a taxpayer cannot claim a charitable deduction if he receives an indirect benefit. Nevertheless, there is a fine line between indirect benefits that are sufficient to prevent a charitable contribution deduction and those that are not. In *Seldin v. Commissioner*,[17] a developer donated property to the local school district. The IRS argued that a charitable contribution deduction was inappropriate.

The court disagreed, refusing to disallow the taxpayer's charitable contribution merely because the presence of the school enhanced the values of the surrounding properties held by the developer. The *Seldin* court stated that an indirect enhancement of property values as a result of the donation of the school parcel did not invalidate an otherwise valid charitable contribution.

Given those authorities, and the rather clear lack of do-gooder motives serving as the impetus for the Oracle chief's $100 million payment here, I expect that Ellison would have an uphill battle claiming a charitable contribution deduction. Indeed, in donating the $100 million to charity, he is receiving more than an indirect benefit. The contribution is tied to his settling the lawsuit, which clearly points toward a quid pro quo. Donative intent? This is a business deal.

Legal Fees

An interesting side note about the Ellison settlement concerns the legal fees. The judge in the case was apparently favorably disposed to the general outline of the deal, but asked for more testimony about why Oracle shareholders should bear the cost of $22.5 million in legal fees that were included in the proposed settlement.[18] In a shareholder derivative action, of course, any money recovered ordinarily goes back to the corporation as the theoretical victim. This deal seems to hold little value for Oracle shareholders while adding insult to injury by sticking them with the legal fees. The legal fee element of the settlement may be the point that breaks the deal.

In contrast, the charitable contribution aspect of the case seems to raise no eyebrows. Indeed, the plaintiff's lawyer, Joseph Tabacco, had defended the settlement as eminently fair, noting that Oracle's board had endorsed the philanthropic side of the settlement. Apart from Oracle's giving program, which is extensive, Ellison himself supposedly distributes more than $30 million each year through his Ellison Medical Foundation. He also has promised $115 million to fund a research center at Harvard to explore the cost-effectiveness of various investments in global health.

---

[11] *See also* ILM 200435001, *Doc 2004-17301*, *2004 TNT 168-11*; ILM 200238041, *Doc 2002-21401*, *2001 TNT 184-62*.

[12] 363 U.S. 278 (1960).

[13] *Id.* at 284.

[14] *See Hernandez v. Commissioner*, 490 U.S. 680 (1989).

[15] 309 F.2d 373 (9th Cir. 1962).

[16] 55 T.C.M. 1284 (1988), *aff'd without opinion*, 870 F.2d 651 (3d Cir. 1989).

[17] T.C.M. 1969-233 (1969).

[18] *See* Bank, ''Judge Questions Legal-Fee Costs in Oracle Accord,'' *The Wall Street Journal*, Sept. 27, 2005, p. A2.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Of course, with good public relations representatives, I'm guessing that this particular settlement will win Ellison more accolades for his charitable work, even if the impetus for the gifts is settling a bitter lawsuit.

Final Thoughts

It appears that any settlement will entail Ellison making payment to the charity of his choosing. The arrangement is likely to provide Ellison a trade or business deduction under section 162 and not a charitable contribution deduction under section 170. At first glance, that result may seem ironic. After all, Ellison's payment is being made to charity.

I believe, though, that further reflection displaces much of the initial irony. In derivative suits, it is the company that has been harmed and the restitution is supposedly paid *to* the company.[19] With that in mind, perhaps it is appropriate to consider the payment as made from Ellison to Oracle, and then from Oracle to the charity. Indeed, newspaper reports of the settlement say that Ellison's payment to charity will be made in Oracle's name, not his own. That fictional account seems proper, and it should not matter that the payment went directly to charity or that Ellison had the right to select a particular charity.

Under that fictional account, Oracle would be receiving a settlement award from the derivative suit, which, as a general rule, would be gross income (and thus taxable) to it. Although some settlement awards are excluded from gross income and hence nontaxable (for example, awards based on personal physical injury or physical sickness under section 104), it does not appear that any exclusion would apply here. Nevertheless, all is not lost. Oracle and its shareholders should not have to pick up the tab for Ellison's ostensible largess. Even though Oracle may likely have gross income, it may also have a corresponding charitable contribution deduction.

In a perfect world, those two events would wash and Oracle would have no net taxable event. Of course, in the world of the intricate trappings of the Internal Revenue Code, Oracle can only hope for such a common-sense result. In any event, it is clear that a little tax planning before settling can have a tremendous tax benefit. Besides, even billionaires like to save on taxes.

[19] *See, e.g., Thomson v. Mortgage Investment Co.*, 99 Cal. App. 205 (1929).

TAX NOTES WANTS YOU!

Tax Notes has a voracious appetite when it comes to high-quality analysis, commentary, and practice articles. We publish more and better articles than anyone else, and we are always looking for more.

Do you have some thoughts on the American Jobs Creation Act? Tax reform? Tax shelters? Federal budget woes? Recent IRS guidance? Important court decisions? Maybe you've read a revenue ruling that has flown under the radar screen but is full of traps for the unwary.

If you think what you have to say about any federal tax matter might be of interest to the nation's tax policymakers, academics, and leading practitioners, please send your pieces to us at taxnotes@tax.org.

Remember, people pay attention to what appears in *Tax Notes.*

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.