There has been no shortage of scandal in the business world over the last few years. Enron, MCI, Tyco, Global Crossing, Adelphia, ImClone, Martha Stewart, Frank Quattrone, and more. Indeed, whole industries are in the crosshairs: the securities industry, the mutual fund industry, the hedge fund industry, and the list goes on. Indemnity issues can arise for individuals too, though I'm primarily concerned here with cases where both the company and executives (or directors) end up with counsel.

Elliot Spitzer and New York State may get a lot of the press, but a lot of the scrutiny is by the federal rather than by state government. The Justice Department (which frequently coordinates its investigations with other federal agencies) has been an integral force behind many investigations exposing these scandals. In fact, the Justice Department has assembled a "Corporate Task Force" to specifically target corporate (and other non-corporate, large organization) fraud. From a tax perspective, the pervasiveness of investigations raises a host of issues. The extent to which an organization is willing to cooperate in the investigation of its employees and agents itself raises tax issues. In his memo, Thompson notes that the payment of attorneys' fees on behalf of an employee or agent may be considered a relevant factor in determining the extent and value of an organization's cooperation with the government. In other words, if an organization pays attorneys' fees on behalf of its officers and directors (or even its rank-and-file employees), that organization may be subject to more stringent prosecution by the government. I presume that this connection between fees and the vim and vigor of an investigation has not gone unnoticed by organizations being investigated by the government for potential wrongdoing. My guess is their lawyers have noticed too.

An article on the front page of the Wall Street Journal discussed the plight of Jeffrey Eischeid, a one-time brainchild of KPMG's tax shelter marketing efforts. For years, Eischeid marketed tax shelters that KPMG assured him were legal. Now, KPMG is giving Eischeid a Hobson's choice: (1) agree to cooperate with federal prosecutors (which could land him in jail) and we'll pay your legal fees; or (2) invoke your Fifth Amendment rights and pay your own legal fees.

Of course, KPMG has its own problems. Even so, KPMG's solidarity is not awe inspiring. Eischeid's legal fees are likely to be substantial (perhaps even in the millions). No matter who pays Eischeid's legal fees, the tax consequences to either him or to KPMG may prove to be significant.

Requirements for Deducting Legal Fees

Using Eischeid's dilemma as an example, what are the tax consequences if Eischeid decides to cooperate and KPMG pays his legal fees? The Internal Revenue Code does not expressly provide for a deduction for legal fees. Even so, legal fees arising from a trade or business or Section 212 activity are generally deductible under the general business expense provision of Section 162, or under Section 212 (which allows for deductions related to the production of income or investment activities). To be deductible under Sections 162 or 212, legal fees must (among other things) be ordinary, necessary and reasonable, and they must be directly connected (or proximately result from) the taxpayer's trade or business.

In Oden v. Commissioner, the Tax Court took these requirements a step further by invoking the "furtherance" test. The "furtherance" test first adopted in Oden requires that the expense in question be in furtherance of the trade or business or Section 212 activity (in addition to being ordinary, necessary, etc.) to be deductible.
In *Oden*, 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 malicious comments about a former employee to a potential employer) was not in furtherance of his trade or business. Many courts have subsequently declined to follow *Oden*, but it may be worth thinking about the farthest test whenever it could potentially apply. (Are you thinking about sexual harassment suits? Read on.)

The “ordinary and necessary” requirement has generated substantial confusion over the years, though it seems awfully pedestrian. Generally speaking, an expense (for legal fees or otherwise) is “ordinary” if a business person would commonly incur it in the particular circumstances involved. 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. Thus, taxpayers generally think of the “ordinary” requirement as synonymous with recurrent.

However, the courts have been much more expansive in their interpretation of the ordinary and necessary requirement. 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.

Moreover, the Tax Court has noted that the employment of an attorney satisfies the “ordinary” requirement if it is consistent with the behavior of a reasonably prudent man in the same circumstances.

Just as the “ordinary” requirement has been liberally interpreted, the “necessary” requirement has also been given wide berth. It is not necessary to inquire whether the taxpayer really had to incur a particular expense, such as paying legal fees of an employee or agent of the organization, if incurring such an expense is “appropriate or helpful.” Given the authorities, the word “appropriate” or “helpful” might be more apropos than “necessary.”

The “ordinary and necessary” nature of the payment of legal fees in this context is rarely questioned (by the IRS or by the courts), assuming that the requisite nexus can be established between the lawsuit and the business of the defendant. Nevertheless, there is still the question of the overall “reasonableness” of an expense.

The reasonableness of a payment in this context (pursuant to either a settlement or judgment) will generally not be questioned. Since litigation is by its very nature adversarial, the reasonableness of a payment to dispose of litigation is rarely questioned.

For legal fees to be deductible by an organization, they must generally be directly connected to its trade or business. Nonetheless, the deduction of legal fees is not dependent on the success of the case. Instead, the deductibility of legal fees is determined under the origin of the claim doctrine.

Origin of the Claim

The origin of the claim doctrine is merely the sensible proposition that, “the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon 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.”

Perhaps the most well-known “origin” case is *United States v. Gilmore*. There, the expenses of divorce litigation were held 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. Thus, the litigation expenses were nondeductible personal expenditures.

To determine the deductibility of legal fees, one must begin with the identity of the payor. Only the payor is entitled to potentially applicable deductions. Consider, for example, if a corporation 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. Even so, legal fees and expenses relating to the actions of officers and directors in conducting a corporation’s business have generally been held deductible by the paying corporation, on the theory that the matter is proximately related to the business of the corporation, and the results achieved in litigation are beneficial to the corporation.

Nonetheless, corporations have been denied deductions for legal expenses incurred in defending suits against employees which are unrelated to the company’s trade or business. Indeed, where the employee is a major equity holder in the organization, it may be best to avoid this type of situation altogether. One way of doing so is to have the individual make a contribution to capital to the organization for the amount of his legal fees. This is generally tax-free under Section 118, Section 351, or Section 721. In any case, the organization can then use the amount contributed to pay the legal fees, and this amount can be deducted by the organization as an ordinary and necessary business expense.

Distinguishing Fines or Penalties

Now we must shift gears. The general rule is that payments are deductible (either by settlement or judgment) if made in the ordinary course of a trade or business (or payments made in the production of income or in furtherance of investment activities). In contrast, the Internal Revenue Code expressly prohibits a deduction for “any fine or similar penalty paid to a government for the violation of any law.” Attorneys’ fees incurred in defending against the imposition of fines or penalties have also been held to be nondeductible on the theory that they are...
tainted by the nature of the litigation.\textsuperscript{20} Hence, returning to Eischeid and his former firm KPMG, it is possible that some of Eischeid’s and KPMG’s attorneys’ fees relating to the current federal investigations may ultimately be disallowed under Section 162(f). Section 162(f) denies a deduction for both criminal and civil penalties, as well as for sums paid in settlement of a potential liability for a fine or penalty.\textsuperscript{21} It is the latter element of the provision that often causes controversy. It may (or may not) be clear that a fine is likely to be imposed when a potential liability is satisfied.

In some cases, whether a fine or penalty may be imposed may depend on the intent of the perpetrator. If the fine or penalty is in fact imposed, the denial of the deduction is absolute. It does not matter whether the violation of law was intentional or unintentional. In either case, no deduction will be permitted for the payment of a fine or penalty even if the violation is inadvertent, or if the taxpayer must violate the law in order to operate profitably.\textsuperscript{22}

These rules seem to be bubbling to the surface a lot lately. One can hardly pick up a newspaper without learning about another corporate wrongdoer forced to pay a fine or penalty. In 2003, MCI was fined a record $500 million by the SEC for accounting fraud.\textsuperscript{23} Roughly $1.5 billion was shelled out by the securities industry in 2003 for its indiscretions.\textsuperscript{24} Interestingly, of this amount, only about $450 million was characterized as nondeductible fines or penalties.\textsuperscript{25} That indicates a key point about all of this from a taxpayer’s perspective—often there is wiggle room in characterizing the nature of the payment.

Indeed, Exxon was almost as fortunate as the securities industry players when paying for its Exxon Valdez oil spill catastrophe. The U.S. government’s $1.1 billion settlement with Exxon actually cost Exxon a mere $524 million on an after-tax basis. The Congressional Research Service determined that more than half of the civil damages—totaling $900 million—could be deducted on Exxon’s federal income tax returns.\textsuperscript{26} Frequently, the line-drawing exercises that take place here are imprecise. Ultimately, it is axiomatic that fines or penalties, as well as their corresponding legal fees, are nondeductible under Section 162(f). Yet, it is often not so easy to tell if a payment is truly a fine or penalty or is rather a less ostracized type of payment.

The Unkindest Cut of All

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. If my reference to trusted Brutus stabbing Caesar seems overblown, just wait. Legal fees deducted under Section 212 are subject to disallowance for AMT purposes.\textsuperscript{27} Legal fees taken as miscellaneous itemized deductions are also subject to a 2% of AGI floor and cutback for high-income taxpayers.\textsuperscript{28} Let’s look at a simple example.

Assume John is indicted on multiple counts of racketeering, conspiracy, extortion, fraud, and obstruction of justice. Assume further that John’s various income producing activities constitute activities engaged in for the production of income. Accordingly, John’s legal fees ($500,000) may only be deducted 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 quite successful in producing substantial income ($500,000) from his various activities. 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 attorneys’ fees under Section 212. But, because this deduction is disallowed entirely for AMT purposes (and further limited by Sections 67 and 68), John ends up owing roughly $136,000 in federal income taxes (even though he had deductions equal to or greater than his income). Of this amount, over 98% results from the application of the AMT.\textsuperscript{29} Had John instead been able to take advantage of Section 162, his tax liability for the year would have been about $1,000.

Dodging Income: Paying Legal Fees of Another

In O’Malley v. Commissioner,\textsuperscript{30} the Tax Court found a pension fund trustee to be in receipt of gross income where his employer paid his legal fees in a criminal prosecution for conspiracy to commit bribery. Even so, the Tax Court permitted O’Malley to deduct these 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.\textsuperscript{31} Instead, the Tax Court found that the legal fees were personal to O’Malley.

Since O’Malley’s employer paid his legal fees, guess what? Citing Old Colony Trust,\textsuperscript{32} the Tax Court determined that the payment of O’Malley’s personal legal fees by the pension fund was income to him. This kind of quandary actually happens more than you might think.

In fact, on that note, let’s return to our friend Eischeid and KPMG. Depending on the exact nature of any future actions taken against Eischeid and KPMG, he may end up having to recognize as gross income any amount KPMG pays for his legal fees. Admittedly, this is not likely, because it seems probable that any indictment against Eischeid would name KPMG as a co-defendant.

Perhaps it’s a long shot, but let’s take a quick look at what might happen if Eischeid is indicted alone and KPMG nevertheless pays his legal expenses. Eischeid would probably have to include the payment of these legal fees as income. Although the gross income hit is a knock down, the real knock out punch is the AMT. Employee business expenses are miscellaneous itemized deductions and subject to complete disallowance for AMT purposes (as well as the cutbacks mandated by Section 67 and 68). As previously demonstrated by the Section 212 example above, the disallowance of this deduction for AMT purposes can be crippling.
Can the Attorneys’ Fee Cases Save the Day?

Everybody knows the decisions, and even the underlying rationales, of the Circuit Courts of Appeal on the tax treatment of contingent attorneys’ fees. The cases vary wildly, and there is currently a nasty split in the circuits on this issue. The majority has held that contingent attorneys’ fees are gross income to both the attorney and the plaintiff. The minority has held that contingent attorneys’ fees are not gross income to the plaintiff; instead, they are merely taxable to the attorney. Prior to granting certiorari in Banks and Banaitis, the Supreme Court declined to resolve the attorneys’ fee issue on five prior occasions. With this as a background, let’s see how the attorneys’ fee cases might be useful in furthers Eischeid’s case.

Assuming that for some reason these legal fees are not deductible by KPMG (perhaps because only Eischeid is indicted and KPMG is not), might Eischeid be able to use the Cotnam rationale to disclaim (and exclude from his income) any legal fees paid by KPMG? Well, perhaps. Eischeid might argue that he never had dominion and control over the funds paid to his attorneys, and accordingly should not be required to include these funds in gross income. This argument may not hold water (depending on which circuit’s law applies under the Golden rule), but sometimes you have to go with what you’ve got.

The Service would presumably cite Old Colony Trust to refute this assertion. However, there is at least a plausible argument that Old Colony Trust is distinguishable from the situation I contemplate for Eischeid. After all, KPMG would not be attempting to compensate Eischeid, as was the case in Old Colony Trust.

A Farewell to Arms

It will be interesting to see what happens in the federal investigations which are now probing Eischeid and KPMG. Of course, it is possible that neither party will ever be indicted by federal authorities. KPMG has frequently made the news over its tax shelter activities. As one would expect, the vast majority of these news stories are anything but flattering.

Going before Congress with what some reporters called a “catch me if you can” attitude late last year may ultimately prove very costly. Even the ancient Greeks (pre-Brad Pitt) warned of the evils of hubris. In a post-Enron world, hubris can prove to be an organization’s Achilles heel, even with lots of special effects and Brad’s own personal trainer. But on an individual level, the tax effects of a legal bill, given an unattractive income and deduction equation, can be quite as devastating as a Trojan war.

ENDNOTES

2. Id. at 3.
3. Id. at 5.
6. 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).
10. 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.
16. See Ecco High Frequency Corp. v. Commissioner, 167 F.2d 583 (2d Cir. 1948), cert. denied, 335 U.S. 825 (1948).


20. See Burroughs Building Material Co. v. Commissioner, 47 F.2d 178 (2d Cir. 1931); see also, 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 275-3, 95-752, 95 TNT 47-8 (3rd Cir. 1995).


25. See Zuckerman, “Pain of Wall Street Settlement to be Eased by U.S. Taxpayers,” Wall Street Journal (Feb. 13, 2003). The bulk of the securities industry settlement, more than $1 billion, went towards investor restitution, education, and the dissemination of independent research (which are tax-deductible business expenses).


28. See I.R.C. 67(a) and 68(a).


31. 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).

32. 279 U.S. 716 (1929).


37. 279 U.S. 716 (1929).