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Subject: Update 98-4 (Attorneys' Fees; New Damage Awards Book)  
DAMAGE AWARDS UPDATE  
for subscribers to Tax Analysts' Taxation of Damages Discussion Group

Vol. 1, No. 21 \*\*\*\*\* Copyright 1998 \*\*\*\*\* February 18, 1998

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## DEDUCTING ATTORNEYS' FEES—EVEN CRIMINALS DO IT

I have previously written a great deal about the deductibility of attorneys' fees. In many ways, the tax treatment of litigation payments and recoveries (for both the plaintiff and defendant) have become a subspecialty area within the tax field. But the question of how attorneys' fees are handled is often not considered as early as it might be. It is often assumed that attorneys' fees are deductible in every case (they are not) and that there is no special planning that needs to be done in order to assure their deductibility (wrong).

One common myth we can readily dispel. Attorneys' fees are not always deductible because sometimes they must be capitalized. This is the whole INDOPCO mush that has grown up (like mushrooms?) over the past few years and that has made planning for acquisitions (and many other types of transactions) particularly difficult. But aside from this capitalization question, there are other contexts in which attorneys' fees cause problems. One of the other areas is where the attorneys' fees are paid or incurred in the context of a strictly personal matter.

The most famous example of this doctrine (indeed, the leading case on the subject still), is *U.S. v. Gilmore*, 372 U.S. 39 (1963), in which the U.S. Supreme Court found that a divorce action had its roots in the personal conduct of the litigating husband. This meant that he could not deduct his attorneys' fees (which were quite substantial) even though he argued quite persuasively that the attorneys' fees really related to the preservation of his business. Not unlike the recent well-publicized cases of "corporate wife" marital warfare, Gilmore claimed that his business would be destroyed (or at least its value substantially reduced) if he did not "win" in the divorce. Under the "origin of the claims test," the Supreme Court found that the underlying nature of the claim was personal, hence no deduction, even though a side benefit of the vigorous legal defense might have been the preservation of assets.

### Legal Fees in Criminal Matters

Well-founded and long-quoted cases such as *Gilmore* might lead taxpayers to believe that a business expense deduction is allowed for attorneys' fees only when the capitalization rules are not violated (that is, when the legal expenses are not incurred in connection with a capital asset), and also where there is no issue about the expenses being paid or incurred in connection with personal business. It might surprise some who are critics of our tax system to know that there is generally no question about the deductibility of legal fees paid by organized crime figures.

The most recent example of this rather amazing doctrine is *John DiFronzo v. Commissioner*, T.C. Memo 1998-41, Tax Analysts Doc. 98-5117. This case firmly holds that a convicted member of an organized crime family can deduct the legal fees that he incurred in defending against conspiracy and fraud charges. This may not sound so surprising, but let's look briefly at the facts.

In 1993, Mr. DiFronzo was convicted of mail fraud and other offenses for his involvement in the Chicago crime syndicate efforts to control gaming operations on one of the Indian reservations. DiFronzo was found to be a "crew chief" in the Chicago syndicate, through which he participated in various illegal profit seeking ventures.

But the legal costs of such activities can be high. On his 1993 income tax return, Mr. DiFronzo claimed business expense deductions of \$125,000 for legal expenses incurred in the criminal case brought against him. He even supported the deduction with copies of his personal \$50,000 cashier's check to his attorney, his wife's \$25,000 check to the attorney, his attorney's deposit slip for \$50,000 bearing the notation "5/11/93 DiFronzo \$50,000" (perhaps meaning that there had been a cash payment?). Anyway, they totaled \$125,000. The IRS disallowed all of the deductions.

The Tax Court, however, was not so quick to deny a legitimate businessman his business expense deductions. After all, the Tax Court held that Mr. DiFronzo was entitled to deduct these legal fees "as a legitimate business expense" to the extent that he substantiated his expenditures. The court found that he had accomplished this substantiation to the extent of \$50,000. The court noted that Mr. DiFronzo's conviction on the criminal charges established his involvement in an illegal trade or business, and that he had engaged in the scam with a genuine intention of making a profit.

Unfortunately for Mr. DiFronzo, he was only able to substantiate \$50,000 by his check. The judge found that his filing status as married, filing separately, created a burden to demonstrate that he alone made all the payments. Hence, the wife's \$25,000 contribution was insufficient proof, as was the deposit slip for \$50,000 (it had not been clear where that extra \$50,000 had come from).

Ultimately, *DiFronzo v. Commissioner* is not surprising, since legal expense deductions are one of the things that businesses count on to reduce or mitigate the admittedly high cost of legal services. It just seems a little amusing that the fact that someone is convicted of a crime means that they may profitably search for deductions, since the conviction of the crime helps to establish that they were truly in business.

#### Nexus to Crime

Based on the case law in this area, it is clear that the person seeking the legal expense deduction has an incentive to show a nexus between the trade or business and the alleged crime. For example, the mere fact that a defendant's business will be destroyed if he is convicted of a crime is not enough to result in deductibility for the legal costs. See *Hylton v. Commissioner*, 32 T.C.M. 1238 (1973). One has to be really in the business (of carjacking, second story work, or whatever!). A management consultant was therefore not allowed to deduct legal expenses he incurred in defending a charge against him for fraudulently selling securities, since he was not in the business of selling securities. See *Daniel Price v. Commissioner*, 32 T.C.M. 283 (1973).

However, the Supreme Court in *Commissioner v. Tellier*, 383 U.S. 687 (1966), did allow a deduction for the unsuccessful defense of a criminal prosecution of a securities dealer convicted of violating the 1933 Securities Act and Mail Fraud statute in conducting his business. The *Tellier* decision was noteworthy not only in the fact that it overturned several lower court cases, but also in the fact that it made irrelevant the success or failure of the defense of the criminal charge. See also Rev. Rul. 66-330, 1966-2 C.B. 44.

#### Criminal Investment?

Even if the criminal is not sufficiently accomplished (as a criminal) to be considered engaged in a criminal trade or business (high aspirations, yes?), it is possible that he or she may be able to deduct the legal expenses as investment expenses. In the well-known case of *Accardo v. Commissioner*, 94 T.C. 96 (1990); *aff'd*, 942 F.2d 444 (7th Cir. 1991); *cert. denied*, 503 U.S. 907 (1992), the court found that legal costs incurred by a taxpayer in his successful defense of RICO charges were nondeductible. The court agreed that these expenses did not arise in connection with the management, conservation or maintenance of the property held for the production of income. Although *Accardo's* acquittal on RICO charges did mean that the government could not seize his assets, this fact alone was insufficient to support the notion that the substantial expenses he incurred in defending himself were incurred for the preservation of his property.

#### Marching On

Most of us in day-to-day practice confront more pedestrian legal issues, such as how to treat the contingent legal fee portion of a recovery for tax purposes, or determining whether a direct payment of attorneys' fees can obviate income to the recovering plaintiff, or dealing with the INDOPCO-type capitalization issues mentioned at the beginning of this article. Maybe in all of this it will be comforting to know that if one is really in the thick of things and truly meets the tough IRS standards for being a criminal engaged in the trade or business of crime, then legal fees will be deductible, no problem.

Somehow, though, I don't find this all that comforting myself. It suggests a myopic view (a view that it seems increasingly easy to take about much of our tax system). But anyway, it still is a great country. I'm sure that's what Mr. DiFronzo said when his deduction was upheld.

#### Larger Question of Attorneys' Fees

The *John DiFronzo v. Commissioner* case serves as a nice vehicle to bring up the topic of attorneys' fees in general. In my experience, this field is long-neglected by attorneys who focus solely on the tax treatment of the settlement or judgment payments. Plaintiffs' lawyers worry (rightly so) whether the award can properly be pigeon-holed as excludable under Section 104, might constitute a recovery of basis (and therefore not result in taxable income) or, if it is income, might constitute capital gain. Defense lawyers, on the other hand, worry about the deductibility of the settlement or judgment payment. In a business context, there is usually not too much of an issue about the deductibility

to the payor, although clearly some such payments must be capitalized. The classic example is the settlement or judgment payment which relates to title to an asset (for example, a suit to clear a cloud on title to property).

But the attorneys' fees in the matter often receive short shrift. Generally speaking, this is because most people blithely assume that all attorneys' fees are deductible in every circumstance. There are several circumstances where this is not true. One is the case where the attorneys' fees relate to a personal matter (such as divorce). (See discussion of the Supreme Court's Gilmore case above). Another interesting area concerns the question whether legal fees must be capitalized in the context of environmental payments or liabilities.

Along the way of these controversies, there have been some interesting (and sometimes amusing) cases. Take the case of Richard C. Lussy v. Commissioner, T.C. Memo 1995-393 (1995), *aff'd unpub. op.*, 114 F.3d 1201 (1997). There, the Tax Court held that an individual was not entitled to legal fee deductions that he incurred in maintaining a lawsuit against a police officer. The taxpayer was running for election for public office (property tax appraiser) in Florida. He was cited for running a stop sign in an area known for drugs, and remarked to the citing police officer that he was only in the area looking for a woman. (Presumably this was in mitigation of some possibility he was looking for drugs!) The officer included this statement in the court information sheet. The taxpayer then filed suit against the police officer, incurring over \$18,000 in legal fees.

Judgment in the underlying dispute was eventually rendered against the taxpayer in the civil case. Mr. Lussy was not elected (one would have thought that he would have amply demonstrated his sufficiency to hold public office!). At the time he incurred the legal expense, he was self-employed as a real estate appraiser, reporting his income and expenses on Schedule C of his IRS Form 1040. He deducted the legal fees incurred in the lawsuit as ordinary and necessary business expenses. The IRS disallowed them, and the matter wound up in Tax Court. The court held that the taxpayer had not carried his burden of showing that the legal fees were paid for other than personal reasons.

#### Attorneys' Fees and Contingent Fee Litigation

Probably the most topical and to some, controversial, aspect of attorneys' fees and taxes these days concerns contingent fee litigation. In the past, some plaintiffs' lawyers have been very loose about the operation of their trust account. After decisions like *Alexander v. Commissioner*, 1st Cir. 1995, that have made it more attractive for plaintiffs' lawyers to attempt to have their fees paid by the defendant directly (because of the miscellaneous itemized deduction and alternative minimum tax problems to which their plaintiff clients may be exposed), there has been great skittishness among both plaintiff and defense lawyers about such practices. There is no clear decision about precisely what treatment should apply, although most practitioners recognize that there is a risk and an assignment of income type argument to be made in cases where there is not a court ordered award of attorneys' fees from the defendant directly to the plaintiffs' attorneys.

Nonetheless, at least some of this argument may have been mooted by the provisions of the 1997 Taxpayer Relief Act. Under the Taxpayer Relief Act of 1997, for payments made after December 31, 1997, any person engaged in a trade or business and making any payment to an attorney in the course of the taxpayer's trade or business in connection with legal services must file an information return with the IRS and the attorney. In other words, 1099 forms must now be sent to attorneys by clients.

It is quite clear under the new law that the 1099 must be sent even if the payment is a gross amount and it is not known what portion is the attorney's fee. The House Committee Report to this provision (which is contained in Internal Revenue Code Section 6045(f)), indicates that it is anticipated that this "gross proceeds" reporting would be required on Form 1099-B. This form is currently in use by brokers to report gross proceeds. The only exception to the new reporting requirement would be for payments to be reported on either Form 1099-MISC (or would be reported on Form 1099-MISC but for the limitation covering payments under \$600), or on Form W-2.

Interestingly, while professional corporations have previously been entitled to rely on the "corporate" status of such entities (and thus no Form 1099 has been required on a payment to a legal corporation), it is quite clear under the new law that professional corporations are now subject to Form 1099 requirements. Indeed, the legislative history states that the exemptions contained in Reg. §1.6041-3(c) on reporting payments made to corporations will not apply to payments made to attorneys.

The House Committee Report to the provision includes some thoughts that are quite important and that are worthy of attention. The new reporting required for payments made to attorneys regardless of whether the attorney is the exclusive payee. Thus, there could clearly be duplicate 1099s where several law firms are involved. In addition, payments to law firms are considered payments to attorneys for this purpose, and are therefore subject to reporting. (This would seem to be obvious, but the House Committee Report thought it necessary to make sure everyone understood that law firms are covered.)

Another piece of information contained in the House Committee Report is that attorneys are required to promptly supply their taxpayer identification numbers to persons required to file these information reports. While there would not seem to be much question about this, the House Committee Report states that failure to supply a TIN could result in the attorney being subject to penalty, plus the payments could be subject to back up withholding (a true double whammy).

On the positive side, the House Committee Report does state that the IRS should administer this provision so that there is no overlap between reporting under Section 6041 and reporting under Section 6045. As an example, if two payments are made simultaneously to an attorney, one of which is the attorney's fee and the second of which is the settlement with the attorney's client, the first payment would be reported under Section 6041. The second payment would not be reported under either Section 6041 or 6045, since it is known to the payor that the entire second payment represents the settlement with the client. Therefore, it is clear to everyone that no portion of that payment represents income to the attorney.

Note: This last phrase from the House Committee Report is extremely important, even if many plaintiffs' lawyers don't realize it. There has long been reluctance on the part of plaintiffs' lawyers to disclose to payors what their arrangement is with their client and just how much of the settlement (or judgment) is being paid to the lawyer. Now, however (starting January 1, 1998), the attorneys still have an enormous incentive to make exacting disclosure to the other side (the payor) about the extent of the payment to the client and the lawyer. Indeed, for all of the reasons that the Alexander case suggests, this may be yet another reason why separate checks should be cut to the client and the plaintiffs' attorney. Everyone should be clear who is getting what money if the reporting is to avoid confusion in the future.

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