

TAX LITIGATION ISSUES

Expert Analysis

Give Me a Break: Deducting Fees, Financial Penalties in Criminal Cases

In civil cases arising out of business transactions, parties commonly deduct legal fees and judgments. This rule extends to punitive damage awards, an anomaly that is currently the subject of reconsideration.¹ Clients in white-collar investigations frequently ask if their legal fees are likewise deductible. If the case goes badly, they will ask the same question regarding the financial aspects of any resulting judgment. As in civil cases, the deductibility of legal fees in criminal cases depends on whether the fees being paid qualify as “ordinary and necessary” business expenses under §162(a) of the Internal Revenue Code. By contrast, the deductibility of punitive financial judgments in criminal cases is more restrictive. As with most issues in the Code, however, the devil is in the details.

Deductibility of Legal Fees

The seminal case addressing the deductibility of legal fees is *Tellier v. Commissioner of Internal Revenue*.² In *Tellier*, the plaintiff was a securities dealer who deducted legal fees paid in connection with his unsuccessful defense of securities and mail fraud charges. The Internal Revenue Service and the Tax Court rejected the deduction, but the U.S. Court of Appeals for the Second Circuit reversed.

Before the U.S. Supreme Court, the IRS conceded that legal fees were an ordinary and necessary business expense, but argued that they should not be deductible as a matter of public policy. The Supreme Court rejected this argument holding that “the federal tax is a tax on net income, not a sanction against wrongdoing. One familiar facet of the principle is the truism that the [tax] statute does not concern itself with the lawfulness of the income that it taxes.” The Court reasoned that the same basic rule should apply to deductions.³

Considering §162(a), the Court noted that Congress can pass specific laws disallowing deductions falling within the four corners of the statute, but that absent specific legislation, “it is only in extremely limited circumstances that the Court has countenanced exceptions to the general principle [of deductibility].” As articulated by the

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Court, the “test of nondeductibility” focuses on (a) the extent to which allowance of a deduction would “frustrate sharply defined national or state policies proscribing particular types of conduct,” (b) whether the policies to be frustrated [are] “national or state policies evidenced by some governmental declaration,” and (c) “the severity and immediacy of the frustration resulting from allowance of the deduction.”⁴

Noting that the hiring of a lawyer to defend against criminal charges is not “proscribed conduct,” but a constitutional right, the Court concluded that Walter Tellier’s claim fell “far outside that sharply limited and carefully defined category” of deductions that should not be allowed. Finally, the Court opined that given the

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significant punishments already imposed by the government on those convicted of a crime, “we can find no warrant for attaching to that punishment an additional financial burden that Congress has neither expressly nor implicitly directed.”⁵

Application in ‘Gordon’

Recently, Judge Shira A. Scheindlin of the U.S. District Court for the Southern District of New York addressed the rules regarding the deductibility of legal fees. In *Gordon v. United States*,⁶ the taxpayer was the president of Merrill Lynch’s energy trading division, Global Energy Markets (GEM), and its successor Allegheny Energy Supply Company, LLP. In December 2003, he pled guilty to wire fraud, money laundering and conspiracy to falsify GEM’s books and records.

Daniel Gordon incurred more than \$300,000 in legal expenses in defending the criminal case, but had not deducted those expenses on his original 2003 federal income tax return. After the IRS determined that he owed additional taxes for unrelated capital gains, Mr. Gordon paid a revised Notice of Deficiency and sought a refund based on the previously undeducted legal fees and expenses. The IRS rejected the refund, concluding that Mr. Gordon had not established that his legal fees were deductible as ordinary and necessary expenses of a trade or business.

In addressing this issue, Judge Scheindlin noted that, in order to take a deduction under §162(a), a taxpayer must show that “the item claimed as a deductible business expense: (1) [w]as paid or incurred during the taxable year; (2) was for carrying on its trade or business; (3) was an expense; (4) was a necessary expense; and (5) was an ordinary expense.”⁷ An expense is necessary if it is “appropriate and helpful for the development of the business.” It is ordinary if it “relate[s] to a transaction ‘of common or frequent occurrence in the type of business involved.’”⁸

Judge Scheindlin then observed that the Second Circuit has held that legal expenses are deductible where they “arise out of and are immediately or proximately connected with, and are required for, the conduct of a trade or business.” In making this determination, “courts should consider the origin and character of the claim litigated, and not the consequences of the litigation or the taxpayer’s motive for defending the litigation.”⁹

Seeking to escape *Tellier*, the government argued that it did not oppose the deduction on public policy grounds, but on the grounds that Mr. Gordon could not show that the legal expenses were “ordinary and necessary” or incurred in carrying out a trade or business. Mr. Gordon responded that his legal fees were directly connected to his business because they “had their source, or origin, . . . in [his] employment and profit seeking activities when he was president of GEM and Allegheny.”

To address this argument, Judge Scheindlin identified the source of the charges against Mr. Gordon, noting that they arose from two separate schemes—wire fraud and money laundering charges arising out of a scheme to embezzle money from Merrill Lynch and record falsification charges relating to a scheme to falsify GEM’s records to make it appear more profitable to potential buyers. She then analyzed the schemes separately to determine whether legal fees resulting from either

were connected to Mr. Gordon's employment.

Judge Scheindlin first rejected Mr. Gordon's claim that the legal fees relating to the embezzlement scheme "were incurred for the purpose of carrying on his trade or business as an employee of Merrill Lynch or Allegheny." Rather, the judge concluded that the embezzlement scheme was only related to Mr. Gordon's business because he was stealing from his employer. Following Second Circuit case law, Judge Scheindlin concluded that expenses arising from embezzlement charges are not sufficiently related to the carrying out of a trade or business to entitle Mr. Gordon to deduct expenses related to the defense of that portion of the case under §162(a).¹⁰

Judge Scheindlin reached the opposite conclusion with respect to the record falsification scheme. Crediting Mr. Gordon's testimony that his supervisors had directed him to falsify the relevant records, Judge Scheindlin noted that "[a]ctions taken at the direction of one's supervisor are undoubtedly connected with business activities." Further, the court opined that Mr. Gordon's actions maintained the necessary business connection regardless of his supervisor's actions because the falsification was engaged in to further business, and therefore his employer's, interests. "In other words, Merrill Lynch was the direct beneficiary of the Record Falsification Scheme and any personal benefit Gordon may have derived resulted from his status as a Merrill Lynch employee."

Thus, the record falsification scheme was distinguished from the embezzlement scheme, which was directly beneficial to Mr. Gordon and inherently harmful to his employer.¹¹ Because Mr. Gordon was charged with one count relating to the record falsification scheme and two counts relating to the embezzlement scheme, Judge Scheindlin concluded that Mr. Gordon was entitled to deduct one-third of his legal fees.¹²

Payment of Penalties

Closely related to the deductibility of attorney's fees is whether a criminal defendant can deduct financial penalties paid in connection with a conviction. Section 162(f) of the Code specifically provides that fines or penalties paid to a federal, state or local government for a violation of law are not deductible as ordinary and necessary business expenses.

In defining "a fine or similar penalty," the regulations distinguish between criminal fines and civil penalties (such as those assessed under the Internal Revenue Code) on the one hand and civil remedial damages on the other. In other words, a corporation that is convicted of violating the Sherman Act cannot deduct a fine imposed in connection with the criminal case, but it can deduct any compensatory damages imposed in a parallel civil action brought by the Department of Justice.¹³

In *Stephens v. Commissioner of Internal Revenue*,¹⁴ the district court sentenced the defendant to 5 years in prison on several counts and imposed a consecutive 5-year term, which was suspended on the condition that the defendant pay \$1 million in restitution to the victim of his embezzlement. The \$1 million represented \$530,000 in embezzled funds and \$470,000 in interest. Jon Stephens had paid tax on the \$530,000 in the year he stole the money, and he sought to deduct the corresponding

restitution payment.

The IRS denied the deduction, and Mr. Stephens appealed, contending that §165(c)(2) of the Code entitles taxpayers to deduct losses "sustained during the taxable year and not compensated for by insurance or otherwise," to the extent they are "incurred in any transaction entered into for profit, though not connected with a trade or business."¹⁵ The IRS responded that the deduction was barred by §162(f) and, in the alternative, that if §165 applied, the deduction of court-ordered restitution was barred on public policy grounds.

The Tax Court ruled that the deductibility of the restitution payment was governed by §165(c)(2) and that §162(f)'s preclusion of deductions of fines or penalties was inapplicable. Nevertheless, the Tax Court opined that the public policy considerations embodied in §162(f) were relevant to a determination under §165. The Tax Court disallowed Mr. Stephens' deduction because it was "ordered in lieu of an additional prison term and as a condition of probation" and therefore was paid pursuant to a conviction, like a fine or penalty under §162(f).¹⁶

On appeal, the parties agreed, and the Second

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Circuit found, that the deductibility of the restitution payment was governed by §165(c)(2). Citing *Tellier*, however, the court noted that deductions claimed under §165 will be disallowed if they "frustrate sharply defined national or state policies." The court proceeded to analyze the deductibility of the restitution payments in light of public policy considerations, concluding that the test for non-deductibility articulated in *Tellier* was relevant to the analysis under §165.

The court then rejected the IRS's argument that the deduction should be disallowed because the restitution was imposed in lieu of incarceration. Rather, the court noted that Mr. Stephens had received a substantial sentence and that because he had paid taxes on the embezzled funds, denying a deduction for the restitution payment "would in effect result in a 'double sting.'"¹⁷

The court next looked to the provisions of §162 regarding the deductibility of specific business expenses "as an aid in applying [§]165." Reviewing the legislative history of §162, the court noted that Congress intended the exceptions set forth in the statute to be all inclusive. "Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions."¹⁸ In other words, given the express prohibitions set forth in §162, the court was loath to infer that other expenses would not be deductible based on public policy considerations.

The court then noted that "[r]eference to §162(f) supports our conclusion that allowing Stephens a deduction for his restitution payment would not severely and immediately frustrate public policy." The court based this determination on two specific considerations, without deciding whether either

would have been sufficient to justify the deduction standing alone.

First, the restitution payment made by Mr. Stephens was primarily remedial, intended to compensate another party and not a "fine or similar penalty." This was true, the court opined, despite the fact that the payment was made as part of a criminal sentence and a condition of Mr. Stephens' probation. Where a payment arguably serves both punitive and compensatory purposes, the court must determine the primary purpose of the payment. The court concluded that Mr. Stephens' payment was more civil in nature, intended to return the company to the status quo ante rather than to further Mr. Stephens' punishment.¹⁹

Second, the court was persuaded by the fact that Mr. Stephens' payment was made to a private party rather than the government. In relying on this fact, the Second Circuit disagreed with *Waldman v. Commissioner*, a Tax Court decision affirmed by the Ninth Circuit, which held that the fact that a restitution payment had been made to a private person did not preclude the application of §162(f).²⁰ Rather, the Second Circuit concluded that §162(f) precluded the deductibility of fines and penalties paid to "a government" and the fact that the payment was made to a private party was significant.²¹

Conclusion

The rules governing the deductibility of attorney's fees reflects the reality that if the defendant's conduct related to his trade or business, he should be allowed to deduct the cost of defending a criminal case. By contrast, the deductibility of the criminal sanctions turns on both the relationship of the underlying conduct to the defendant's profit-making venture and the purpose of the payment. Thus, a defendant is allowed to deduct financial penalties aimed at restoring his victim to the status quo ante, but not financial penalties aimed at punishing his conduct. While logic may support distinguishing between punitive and remedial financial sanctions, this does not explain the different treatment applied in criminal and civil cases, a distinction Congress is apparently reconsidering.

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1. Floyd Norris, "In Tax Law, an Overdue Overhaul a Step, With Miles to Go," *The New York Times* (Feb. 25, 2010).
2. 383 U.S. 687 (1966).
3. *Id.* at 691.
4. *Id.* at 693-94 (internal citations omitted).
5. *Id.* at 694-95.
6. 2009 WL 4756503 (SDNY Dec. 8, 2009).
7. *Id.* at *3 (citing *DeAngelis v. Comm'r of IRS*, 574 F.3d 789, 817 (2d Cir. 2009)).
8. *Id.* at *4 (citations omitted).
9. *Id.* at *4 (citing *Tellier*, 342 F.2d 690, 695 (2d Cir. 1965)).
10. *Id.* at *6 (citing *Stephens v. Comm'r of IRS*, 905 F.2d 667, 670 (2d Cir. 1990)).
11. *Id.* at *6.
12. 2009 WL 4756503 at *7.
13. 26 CFR §1.162-21(c).
14. 905 F.2d 667 (2d Cir. 1990).
15. 26 USC §165(a), (c)(2).
16. 905 F.2d at 669-70.
17. *Id.* at 671.
18. *Id.* at 672.
19. *Id.* at 673.
20. 88 T.C. 1384, 1389 (1987), *aff'd*, 850 F.2d 611 (9th Cir. 1988).
21. 905 F.2d at 673-74.