MALPRACTICE CLAIM HAS VALUE FOR ESTATE TAX PURPOSES

Must the value of a decedent's interest in a legal malpractice claim be includable in the decedent's gross estate? This issue probably has not come up very often. Still, in this increasingly litigious society, it must not be too uncommon for a person to die while legal claims are pending. This topic allows me to use one of those wonderful antiquated phrases: "a chose in action." Basically, it is a contract right.

In *Estate of Frances C. Glover, et al. v. Commissioner*, T.C. Memo 2002-186, Tax Analysts *Doc. No. 2002-10816, 2002 TNT 150-7*, the Tax Court faced a malpractice claim arising out of an estate plan. Frances Glover met and became good friends with Madelyn Hurley, who began helping Glover. In 1980 Glover hired Richard Ross to serve as her financial adviser. Ross and Hurley worked together and Glover began compensating Hurley. In 1984 Glover suffered a stroke and entrusted all of her financial affairs to Ross and Hurley. At some point in 1987 the pair began to misappropriate Glover's funds. The pair hired Eckell, Sparks, Monte, Aueback & Moses to represent them and to draft a new will for Glover. Glover married Edward Cloud in 1990. She had one brother, Rolfe E. Glover III, who had three children, Rolfe Glover IV, Gordon Glover and Katherine Glover. The Glover children were the residuary beneficiaries under both wills. The new will created a residuary trust to pay Cloud's living expenses during life. On his death, the assets of the trust were to be distributed to the Glover children. In August 1989 Ross died and Eckell Sparks sent the original and a copy of the 1989 will to Hurley. Hurley was his executor and the beneficiary of his estate.

Hurley also retained Eckell Sparks to draft an antenuptial agreement for Glover and Cloud that provided that Glover would leave Cloud a cash bequest of $2 million. The agreement was executed by Glover and Cloud. In 1991 Hurley met with Eckell Sparks to revise Glover's will to include the bequest to Cloud and eliminate the bequest to Hurley. Hurley never gave the will to Glover to execute. Glover died shortly thereafter. Hurley submitted the 1989 will for probate. Cloud petitioned to enforce the antenuptial agreement and the agreement was upheld by an Orphans' Court.

The Glover children sought the removal of Hurley as executrix. The court entered a decree removing Hurley as executix and appointing Kevin Holleran and the Wilmington Trust Co. as administrators pro tem. Hurley paid herself an executrix's commission of $250,000 and a legacy of $50,000. She paid attorney's fees to Eckell Sparks of $247,500. The administrators filed suit against her seeking damages for fraudulent conversion and breach of fiduciary duty. The court issued an opinion dismissing the appeal and finding that the will wasn't the result of undue influence. The Glovers appealed. On January 11, 1996, the superior court affirmed in part and reversed in part the decision. It sustained the finding that the 1989 will was valid but reversed the holding that Hurler's $50,000 was valid, holding that it was induced by fraud. The administrators filed an action against Eckell Sparks seeking damages for malpractice from 1989-1993. The court entered an order dismissing the suit. In 2000 the administrators, the Glover children, and Eckell Sparks settled and Eckell Sparks paid $750,000 for the release of claims. The litigation costs were $203,659.

Tax Court Judge Julian I. Jacobs noted that the malpractice suit against Eckells Sparks related to events before and after Glover's death. The court noted that only the claim for the malpractice before death was includable in the estate. The court, disagreeing with the IRS, concluded that the $247,500 that Eckell Sparks was required to repay as part of the $750,000 settlement wasn't includable in the gross estate, and the estate can't deduct the fees as attorney's fees. Judge Jacobs next concluded that the remainder of the settlement, reduced by legal fees, was includable in the estate as the value of Glover's interest in the malpractice claim against Eckell Sparks.

Judge Jacobs denied the Glover children's argument that 60 percent of the settlement proceeds is deductible as an administration expense or a claim against the estate. The court noted that the agreement wasn't an obligation of Glover existing at the date of her death. The court considered whether the payments by the estate to attorneys representing the residuary beneficiaries or the payments to Rolfe E. Glover IV for his efforts in discovering the misappropriation of the assets are deductible as administrative expenses. Reviewing the evidence presented, the court concluded that 284.15 hours of Rolfe Glover IV's time is attributable to reconstructing Glover's accounts and tracking down missing funds and is deductible at $90 per hour. The court also concluded that $91,192 of the attorney's fees paid by the estate were deductible by the estate.

AMERICANS WITH DISABILITIES ACT RECOVERY TAXABLE

It has long been confusing whether awards under the Americans With Disabilities Act (ADA) should be treated as taxable income or not. Avid readers of this area will remember that the IRS early on suggested that ADA recoveries were excludable from income. This surprisingly liberal IRS largesse came in the wake of the Supreme Court's Burke decision way back in 1992. See Revenue Ruling 93-88, 1993-41 I.R.B. 4, *suspended* by Notice 95-45, 1995-2 C.B. 330 (August 21, 1995). What followed was a series of confusing flip-flops, most occurring in other areas with the ADA given short shrift.

Now, a district court has held that an ADA recovery is taxable income, at least where the award is based on discrimination and not personal injury. The case is *Rodell Johnson v. U. S.*, No. 01-WY-1107-CB, Dist. Colo, July 3, 2002, Tax Analysts *Doc. No. 2002-18643, 2002 TNT 159-7*. In that case, a U.S. district court has held that an employee's recovery of front and back pay under the Americans With Disabilities Act wasn't exempt from taxation because the award was based on discrimination, not personal injury.

Rodell Johnson sued his former employer for failing to make a workplace accommodation for his on-the-job injuries and then firing him. A jury verdict awarded him front and back pay. The employer withheld federal income taxes from the pay, and Johnson filed a Form W-4 declaring 107 withholding exemptions. Johnson failed to claim the front and back pay awards as income and sought a refund of the withheld taxes, arguing that the payment was excludable under section 104 on account of physical injuries and damages. An IRS auditor told him that he wasn't entitled to the refund, and Johnson filed suit, claiming he didn't receive a formal IRS rejection and that he was entitled to the refund. The IRS sent the refund, but counterclaimed in Johnson's suit that the refund was erroneous.

U.S. District Judge Clarence A. Brimmer held that the IRS erroneously issued the refund check and ordered Johnson to repay the amount, plus interest. The court agreed with the government that Johnson's front and back pay wasn't excludable from his gross income under section 104(a)(2) and that the payments were taxable. The court said that although Johnson's suit was brought under the ADA and sounded in tort, the injury for which he recovered was discrimination, not physical injury. The court concluded that the link between Johnson's discrimination-based discharge and his work-related injuries was too tenuous to support exemption from taxation. *Rodell Johnson v. United States*; No. 01-WY-1107-CB (PAC) (3 Jul 2002).

LUMP-SUM ALIMONY PAYMENT DEDUCTIBLE

In Letter Ruling 200233022, Tax Analysts *Doc. No. 2002-19082, 2002 TNT 160-22*, the Service has ruled that a husband may deduct a lump-sum payment paid to his wife as alimony in satisfaction of obligations contained in a pre-1984 settlement agreement, that no gain or loss will be recognized on the transfer to either party, and that no portion of the settlement will be a taxable gift by the husband.

A husband and wife entered into an agreement prior to 1984 providing for their separation and a division and settlement of their marital and property rights. Subsequently, the couple divorced and the settlement agreement was incorporated into the divorce decree. Under the agreement, the wife received an annual sum payable at a monthly rate for support and maintenance. Additionally, at her husband's death, the wife will receive one-third of the husband's net estate and a life interest in a testamentary trust, the principal amount to be determined based on the value of the husband's net estate. "Net estate" is to have the meaning set out in state statute.

A dispute arose regarding the proper method for computing the husband's net estate under the settlement agreement. To liquidate his obligations under the settlement agreement and to avoid future litigation, the husband and wife executed a second settlement agreement containing the payment terms. The husband will pay his wife a lump sum amount in satisfaction of his obligation to make the lifetime payments, and his obligation to make the testamentary transfer. By order of the court, the decree of divorce was amended in accordance with the second agreement.

MILITARY RETIREMENT PAY IN DIVORCE TAXABLE TO WIFE

In *Gay M. Pfister v. Commissioner*, T.C. Memo 2002-198, Tax Analysts *Doc. No. 2002-18453, 2002 TNT 154-13*, the Tax Court held that an individual's half of her former husband's military retirement pay was includable in her gross income because it was deemed her separate property in the couple's divorce decree.

Lewis Pfister retired from the Air Force in 1982. He and his wife, Gay, divorced in 1986. The couple's divorce decree stated that Gay would receive half of Lewis's military retirement pay. She received $13,000 in 1997, but didn't report the amount on her tax return. The IRS determined that the funds were includable in Gay's gross income as pension income under section 61(a)(11). Gay maintained that the payments were a nontaxable division of property.

Tax Court Special Trial Judge Carleton D. Powell held that Gay was required to include in gross income the amounts she received as a division of her former husband's military retirement pay. The court noted that the Uniformed Services Former Spouses' Protection Act (USFSPA), 10 U.S.C. section 1408 (2000), allows state courts to treat military retirement pay either as the service member's property or as the member's and spouse's property. The court held, however, that the USFSPA couldn't limit a court from awarding an ownership interest to the spouse if the court had that power. In Virginia, where the Pfisters lived, a court is authorized to incorporate any valid agreement by the parties into a final order. Thus, the Tax Court held that the divorce decree's direction that Gay was to own and receive half of Lewis's retirement pay as her separate property, rendered the pay includable in her gross income. *Gay M. Pfister v. Commissioner*, T.C. Memo 2002-198.

ATTORNEYS' FEES MESS GETS NEW YORK TIMES COVERAGE

Members of this discussion group well know our preoccupation with discussing the deductibility of attorneys' fees paid to contingent fee lawyers. Most of the circuits that have addressed this issue have come out in favor of the government and decidedly against taxpayers. The result, through a combination of the 2% miscellaneous itemized deduction threshold, the phaseout of exemptions and deductions for high income taxpayers, and most egregiously, the alternative minimum tax, is that taxpayers are penalized heavily. It makes one wonder whether bringing litigation (for example, in the employment context) is really a good idea.

That was exactly the point of a *New York Times* article focusing on a particular employment case where the taxpayer ended up losing money on achieving a large award. With all due credit to the *New York Times*, here is the report:

> **TAX EXCEEDS AWARD TO OFFICER IN SEX BIAS CASE**
> by Adam Liptak
> *New York Times*- August 11, 2002
>
> A police officer in Chicago who won a sex discrimination and harassment lawsuit against her employer may face a tax bill larger than her award. Under federal tax laws, she is responsible for paying taxes on a $300,000 award and almost $1 million in lawyers' fees and costs.
>
> "She loses every penny of the award," said her lawyer, Monica McFadden, "plus she will end up owing the Internal Revenue Service $99,000." The result is a

consequence of amendments to the federal tax laws in 1996 that made awards for some nonphysical injuries taxable. In many states, including Illinois, lawyers fees are considered to belong to plaintiffs, and so the award and the fees are taxable.

"Prior to 1996, the awards in civil rights cases were not taxable at all, said Laura Sager, a law professor at New York University, who said the plaintiff's problem was an increasingly common one. "Since then, the main category of cases that have been affected are employment discrimination cases and civil rights cases generally. It has been a disaster."

Last December, Officer Cynthia C. Spina was awarded $3 million by a federal jury in Chicago in her lawsuit against the Forest Preserve District of Cook County, her employer. It was $1 million more than she had requested. Ms. Spina said she had been berated, belittled and isolated because of her sex. Her colleagues and superiors, she said, put pornography in her mailbox, spread sexual rumors about her and slashed her tires. The harassment continued for eight years.

In May, Magistrate Judge Arlander Keys gave Ms. Spina a choice between a new trial and a reduced award of $300,000, because he said the jury award was excessive. In justifying even the smaller award, Magistrate Keys said the defendants' conduct was "reprehensible" and that he did not know of another case in which a plaintiff "has endured such continuous harassment at the hands of so many different officers and superiors for such an extended period of time."

A lawyer for the defendants did not return a telephone call. Through her lawyer, Ms. Spina declined to comment. Late last month, Ms. Spina was also awarded lawyers' fees of $850,000 and costs of almost $100,000. That was the bad news.

Magistrate Keys was aware of the tax consequences of his decision and said that he was "not unsympathetic to the plaintiff's plight."

"Plaintiff waged a courageous fight for what she believed was just, even though other female officers, who felt similarly victimized, lacked the fortitude to do so," he said. But the law, Magistrate Keys noted, was the law, Ms. McFadden said that she, too, is responsible for paying income taxes on any lawyers' fee award, resulting in double taxation. She said her client had not decided whether to accept the lower award or opt for a new trial. "The result in these cases is unintended," said Stephen Cohen, a law professor at Georgetown University. Professor Cohen said that Congress should act on pending legislation to address the issue.

"Congress should amend the law to allow a deduction in full for attorneys' fees," he said. "It doesn't make any sense not to be allowed to deduct the cost of producing an award. It's an income tax, and costs should be deductible."

> Ms. McFadden said that the tax laws will result in fewer civil rights cases.
>
> "It has an enormously chilling effect," she said. "I have to advise a person coming to me that it is entirely possible not only that any award they achieve will go to the Internal Revenue Service but that they will owe the Internal Revenue Service money."

CAPITALIZING LEGAL FEES RELATED TO ACQUISITION

Whether to deduct or capitalize legal fees has always been a Hobson's choice. The incentives for taxpayer are pretty clear. As high as attorneys' fees can be, they can be made significantly less painful if an ordinary deduction is available. In the wake of such landmark cases as *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 112 S. Ct. 1039 (1992), the circumstances in which legal fees have to be capitalized has been expanded.

A recent Tax Court case, *Jeffrey Winter, et ux. v. Commissioner*, T.C. Memo 2002-173, Tax Analysts *Doc. No. 2002-17047, 2002 TNT 141-10*, deals with a couple who had litigation over the price of an asset after the sale was completed. The Tax Court held that the couple must capitalize legal and consulting fees paid in connection with litigation over the price of an asset after the sale.

On February 20, 1991, Jeffrey and Karen Winter executed a contract offering to purchase the Truckee Hotel for $1.2 million from the Meglin Hotel Partnership (MHP). Gerhard Meglin was the general partner of MHP, which accepted the offer and he provided the couple with income and expense statements for the hotel for 1989-1991. The couple found inconsistencies in the information in a brochure and that provided during escrow. The couple completed the purchase on April 4, 1991. They paid a portion of the purchase price down and executed a promissory note for the balance. After the purchase, more irregularities were found, and the couple filed a complaint for damages in local court against MHP and Meglin. After arbitration failed, the couple had an appraisal of the hotel done and the report valued the hotel at the time of the sale at $800,000.

The parties settled in 1994, and Meglin agreed to pay the couple $271,474 by releasing them from that amount under the promissory note. The couple paid legal and consulting fees for the lawsuit and deducted them on their 1994 Schedule C. In 2000 the IRS issued the couple a deficiency notice disallowing the legal fees deductions because they were incurred in connection with the establishment of the hotel's purchase price and should be capitalized. The couple argued that the fees were postacquisition expenditures not related to the purchase, that the origin of the claim wasn't the purchase, and that acquisition costs must be capitalized only when a new asset is acquired.

The Tax Court Judge noted that just because legal costs are incurred after a capital asset doesn't necessarily mean they weren't incurred in connection with the acquisition. The court dismissed the couple's reliance on *Freeland v. Commissioner*, T.C. Memo. 1986-10, concluding that those fees arose out of a foreclosure action and the fees in this case arose from misrepresentations by Meglin that caused the couple to pay an inflated price for the hotel. Judge Ruwe, rejecting the argument that the acquisition costs can be capitalized only if they create or add value to a capital asset, noted that the test for capitalization doesn't hinge on the amount of value added to the property but looks to the nature of the expense. Thus, Judge Ruwe held that the couple acquired a capital asset and, on discovering that they were overcharged, filed suit for damages for causing them to pay more than the hotel was worth.

DEDUCTING LEGAL FEES FOR CRIMINAL DEFENSE

There has long been interesting authority about the ability of a taxpayer to deduct legal fees paid or incurred in defending against criminal charges. Does it matter whether the criminal defense is successful or not? Does it matter whether the criminal charges relate to the conduct of the business (say RICO violations) or something entirely different (like murder)?

An interesting and important recent gloss on this seemingly endless and inherently factual area was recently offered by the Tax Court in *Capital Video Corp., et al. v. Commissioner*, No. 02-1564 (15 Jul 2002), Tax Analysts *Doc. No. 2002-17308, 2002 TNT 154-38*. The Tax Court found that the company could not deduct as ordinary and necessary expenses the legal fees it paid for its shareholder. Indeed, the shareholder was required to include the payments as constructive dividends.

Capital Video Corp. (CVC) was engaged in the sale of pornographic videotapes. During the 1980s and 1990s, CVC and Kenneth Guarino, CVC's shareholder, made tribute payments to Natale Richichi, a member of the Gambino crime family. Guarino conspired with Richichi to obstruct the IRS's collection of tax. He was indicted on federal criminal charges for the conspiracy and pled guilty to conspiracy to obstruct the lawful functions of the IRS and to evade Richichi's federal income tax liabilities. During 1995-1996 CVC paid the legal fees for Guarino, and some payments were made after an S corporation election had been made for CVC. CVC wasn't a defendant in the criminal case. CVC filed its 1996 corporate return, claiming the legal fees as business expenses. CVC, after becoming an S corporation, also deducted the legal fees. On his 1996 return, Guarino didn't report the legal fees. The IRS issued a deficiency notice to CVC for 1996, disallowing the deduction for the legal fees. The IRS issued Guarino a deficiency notice that treated the legal fees paid by CVC while a C corporation as constructive taxable dividends and increased Guarino's income by the legal expenses paid by CVC as an S corporation.

The Tax Court first noted that the expenses of another generally aren't deductible unless they are paid to protect a business or if the criminal activity sufficiently relates to the business. The court considered whether the purpose or motive of CVC in paying Guarino's legal expenses was to protect or promote the business. The court concluded that the fees weren't paid to protect the business. Thus, the payments weren't deductible by CVC. The court then found that the payment of the legal fees conferred an economic benefit on Guarino without an expectation of repayment. Thus, the legal fees paid by CVC for Guarino in 1996 while it was a C corporation were constructive dividends to Guarino.

The court also held that Guarino failed to show that the payments were sufficiently business-connected to qualify as business expenses for Guarino, and it dismissed his arguments that he was entitled to miscellaneous itemized business expense deductions for the legal fees. (For a summary, see *Tax Notes*, Feb. 18, 2002, p. 864; for the full text, see *Doc 2002-3590 (14 original pages)* [PDF] or *2002 TNT 29-10*.)

On Appeal

Now, the case is before the Fifth Circuit. CVC argues that that it properly deducted the legal fees for Guarino as a business expense. The corporation maintains that the Tax Court drew an erroneous and artificial distinction between payment of tribute and the conspiracy to coverup payment of that tribute. The corporation insists that the two actions -- payment of tribute and cover up of those payments -- are so intertwined that CVC should have been allowed to deduct the legal fees paid to defend Guarino for the charges related to that cover up. In the alternative, CVC insists that Guarino should be allowed to deduct the legal fees as ordinary and necessary business expenses to him as a miscellaneous itemized deduction.

The Fifth Circuit conclusion? The jury is still out, as they say.

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