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The Tax Lawyer

Five True Tales From A Tax Lawyer

Robert W. Wood, 06.09.10, 2:32 PM ET

Branded as accountants, actuaries or worse, we tax lawyers feel inferior. Like Rodney Dangerfield, we get no respect. True, we are hardly lions of the legal community: among Clarence Darrow, F. Lee Bailey, Johnny Cochran and Melvin Belli, not one was a tax lawyer. Even in fiction, we get short shrift: There's no tax lawyer among Perry Mason, Atticus Finch, Ally McBeal, Matlock, or *The Practice*'s brooding Bobby Donnell. Needless to say, Elle, of *Legally Blonde* fame, didn't become a tax lawyer.

The only fictional exception was Tom Cruise as a suave young tax lawyer in *The Firm*. But to make tax lawyers interesting, author John Grisham had to invent a Mafia-run law firm amok in money laundering and murder. What do real life tax lawyers do, anyway?

Most tax lawyers are quick to say they don't prepare tax returns, but beyond that it's unclear. That's a shame, as tax law is far more interesting than most people realize. Here are five examples, all taken from my own decades of tax practice.

1. First comes marriage, then divorce.

Normally, a division of property between divorcing spouses is tax-free, so neither husband nor wife pay tax until they sell the divided property. (Alimony is deductible to the payer, and taxable to the recipient, but that's another story). But if the couple isn't actually married, you can't take advantage of this tax rule, which is why taxes in "palimony" and cohabitation disputes can be a nightmare.

Mary and Bob were divorcing and dividing a whopping $100 million of highly appreciated stock from the sale of a company he founded. Then, a background check revealed that Mary was still married to someone else when they tied the knot 10 years earlier!

That "void" marriage meant if they divvied up the stock, one or both would be liable for a whopping tax. As tax lawyers, we had all sorts of elaborate ideas for how to get around this. But sometimes simplest is best; the couple had a quickie marriage so they could immediately get a quick divorce and divide the stock tax-free! (Not surprisingly, the divorce lawyers insisted on an iron-clad pre-nuptial agreement that preserved the terms of the already agreed divorce settlement.)

2. Zoo animals have to eat, too.

In most states the sales tax isn't applied to food, to lessen the burden of the tax on the poor. A restaurant meal and prepared takeout is usually taxable as is animal or pet food, but not purchases of raw human food. A wholesale produce seller had a contract with San Francisco to deliver fruits and vegetables to city schools, hospitals, and the City Zoo and did so without collecting sales tax. State sales tax auditors hit the wholesaler with a crippling back sales tax bill for produce delivered to the zoo, on the grounds that this was being consumed by animals. (The zoo had human snack bars and a cafeteria, but the wholesaler couldn't show which carrots and bananas were consumed by people and which by other species.)

Efforts to reach a compromise with state auditors failed, so we went to a full-blown hearing with witnesses before the California State Board of Equalization. And we even invited the press--this case had entertainment written all over it. Did you know if you tell a supermarket checker the broccoli you are buying is for your dog, the clerk has no way to charge you sales tax? The more we pointed out such contradictions, the sillier the state's position seemed, and the more the press liked it. We won.

3. Wrongful conviction, wrongful taxes.

Is there any injustice worse than being wrongly convicted of a crime and imprisoned for years? Sometimes such convictions are due to overwhelmed or incompetent public defenders, but some cases involve prosecutors so eager to win they break the law, hiding witnesses or burying evidence. Dozens of Texas inmates have been cleared through DNA tests. Last year Texas passed a law awarding the wrongly convicted $80,000 in compensation for each year they've lost behind bars. Just this month Ohio legislators voted to speed up payments of $47,000 a year for each year of wrongful imprisonment.

As these payments grow, it raises an important question: Are they taxable? Recoveries for personal physical injuries are tax-free. Certain other damage awards--say for back pay or for emotional distress--are taxable. (For "10 Things To Know About Taxes On Damages.")

Many IRS rulings in the past have (sensibly) held that recompense for a loss of liberty (like Japanese Americans who were interned during World War II) is tax-free. In 2007 the IRS revoked all that authority, without taking a position on how these awards should be taxed. A bill introduced in Congress in 2007, the Wrongful Convictions Tax Relief Act, was designed to clarify that wrongful imprisonment awards aren't taxed. But that bill has languished.

Meanwhile, most tax advisers are telling the exonerated to pay tax. I believe that is ridiculous and wrong. It's hard to think of any injury more physical than being denied your physical liberty. As an expert on the taxation of damages (I've written a book on it), I'm telling clients that payment for long-term wrongful imprisonment shouldn't be taxable. I'm willing to go to court if the IRS challenges that position. So far, the IRS hasn't picked up the gauntlet, nor (regrettably) has it issued guidance to clarify the issue.

4. Sex and the single church.

Despite the separation of church and state, the IRS has to bless a church for it to receive a tax exemption. For decades the IRS refused to recognize Scientology as a church. After years of litigation, the IRS eventually relented. Sometimes, though, it's hard to take church claims too seriously.

Take a new and decidedly different spin on religion offered by a group promoting orgies as religious fulfillment. I confess to having a prurient interest in the liturgy and dogma they gave me to review, leading to what they hoped would be a ruling from the IRS agreeing they were a church. From what I could tell though (based, I assure you, solely on reading the material they gave me), all they did during their "services" was engage in wild sex that was supposed to energize their religious "icon" at the center of the room--I mean church. We decided not to ask the IRS for a church ruling and go another route.

5. Call the moving vans (or the hospital jet).

Before you sell your company or settle a big lawsuit, it's only natural to tally up how much you'll pay to the IRS and state government. It can be tempting to save 5% to 10% by moving from a state with a high income tax, such as California or New York, to one without an income tax, such as Nevada or Florida. (For the 10 highest state income taxes, click here.)

But moves should be permanent, and states often try to collect taxes from those who say they have left. Of many residency cases, a few stick out. Take the aging dowager in New York with kids and grandkids out West. New York had a whopping estate tax, and her advisers were able to get her a private hospital jet to move her out of state before she died. Key legal issues were whether she intended to return or not. The case eventually settled, but for a fraction of what New York was trying to collect. (For current state estate taxes, click here.)

Or take the tycoon who left California weeks before his company went public. He took some steps toward a bonafide move correctly, but kept his old residence and left his son there to finish school, and he came back to California too frequently. We hired an investigator to chart every expense he incurred inside and outside California, which made a good case for his un-California connection. It eventually led to a settlement for only 10% of the total tax California wanted.

Legally Blonde?

Tax lawyers may never be swashbuckling fixers ala Michael Clayton. But what we do is interesting and fundamental. More brain than brawn, we dive into the nooks and crannies of the tax law--no one likes to pay more than he has to. President John F. Kennedy admonished that "the phrase 'it's deductible' should pass from our scene," but 50 years on, it's unlikely it ever will. After all, as Winston Churchill put it, "there is no such thing as a good tax."

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