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DANA CORPORATION V. UNITED STATES: THE DEDUCTIBILITY OF LEGAL RETAINER FEES USED TO ACQUIRE A CORPORATION

Alexander F. Kennedy

I. INTRODUCTION

In *Dana Corp. v United States,*[1] the United States Court of Appeals, Federal Circuit, applied the "origin of the claim test" to hold that a legal retainer fee paid by a corporation to a law firm is not deductible where the retainer fee was used to offset nondeductible legal expenses subsequently incurred in the acquisition of another corporation.[2] The United States Supreme Court previously held in *United States v. Gilmore,*[3] that to determine the deductibility of legal fees, courts should look to the origin of the claim giving rise to the legal fees.[4] Legal fees, generally, whether offset against a retainer or not, are either deductible from the taxpayer's income tax as an "ordinary and necessary business expense,"[5] are permanently nondeductible, or are nondeductible but

1. Dana Corp. v. United States, 174 F.3d 1344 (Fed. Cir. 1999).
2. *Id.* at 1345.
3. United States v. Gilmore, 372 U.S. 39 (1963).
4. *Id.* at 44.
5. 26 U.S.C. § 162(a) (1994); *see* Dana Corp. v. United States, 38 Fed. Cl. 356, 360 (Ct. Cl. 1999), *overruled by* Dana Corp. v. United States, 174 F.3d 1344 (Fed. Cir. 1999); *See also* BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 20.3.2 (2d ed. 1989) The authors state:

> The principal function of the term '*ordinary*' in §162(a) is to clarify the distinction, often difficult, between those expenses that are *currently deductible* and those that are in the nature of *capital expenditures*, which, if deductible at all, must be *amortized* over the useful life of the asset . . . . This is because §263(a), denying any deduction for amounts paid for the acquisition, improvement, or betterment of property, explicitly embodies 'the basic principle that a capital expenditure may not be deducted from current income' and takes precedence over §162. Moreover, the distinction between *deductible expenses and nondeductible capital expenditures* is inherent in both the term 'expenses' and the statutory phrase 'in carrying on' any trade or business.

Id. (emphasis added).

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capitalizable as capital expenditures,[6] depending on the origin of the claim.[7] If the legal fees are capital expenditures, they must be amortized or depreciated over the life of the relevant asset.[8]

The IRS gained an important victory in *Dana Corp.* By convincing the Federal Circuit that the legal retainer fee was a nondeductible capital expenditure, the IRS provided that, in the future, companies will find it more difficult to alter their tax liability on capital expenditures by deducting the legal fees arising from the acquisition from a prepaid legal retainer fee as an ordinary and necessary business expense. While *Dana* is a significant case on an important subject in taxation, very little has been written on *Dana* and the retainer fee issue in *Dana.*

This Note discusses the Federal Circuit's holding in *Dana Corp.* Part II details the important history of the deductibility of legal fees leading up to *Dana Corp.*[9] Part III provides the factual background of *Dana Corp.*[10] Part IV explains the court's reasoning in *Dana Corp.*[11] Part V analyzes the court's holding in *Dana Corp.* and explains why it is ultimately correct.[12]

II. HISTORICAL BACKGROUND

A. *United States v. Gilmore and the "Origin of the Claim Test"*

In *Gilmore*, the United States Supreme Court held that the proper test to determine the deductibility of legal expenses is the "origin of the claim test."[13] The plaintiff in *Gilmore* brought suit to recover alleged overpayments of his federal income tax.[14] The plaintiff had recently been divorced from his wife.[15] In the divorce proceeding the plaintiff successfully defended his wife's claims for half his stockholdings.[16] The plaintiff feared that if his wife received half of his stockholdings in the

6. 26 U.S.C. § 263 (1994); *see Dana*, 38 Fed. Cl. at 360.
7. *See Gilmore*, 372 U.S. at 44.
8. *See* Indopco, Inc. v. Commissioner, 503 U.S. 79, 83-84 (1992); Corinne E. Anderson, Note, A.E. Staley Manufacturing Co. v. Commissioner*: Life After* Indopco*: Tax Treatment of Target Corporation's Unsuccessful Hostile Tender Offer Defense Fees*, 31 AKRON L. REV. 409, 414 (1998).
9. *See infra* notes 13-75 and accompanying text.
10. *See infra* notes 76-87 and accompanying text.
11. *See infra* notes 88-103 and accompanying text.
12. *See infra* notes 104-147 and accompanying text.
13. *Gilmore*, 372 U.S. at 49.
14. *Id.* at 42-43.
15. *Id.* at 40.
16. *Id.*

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divorce proceeding, he would lose his controlling stock interest in three corporations, which might cost him his corporate positions – positions that were his principal means of livelihood.[17] The plaintiff also feared that if he were found guilty of his wife's charges of marital infidelity, he might lose his car dealer franchises – once again, principal means of the plaintiff's livelihood.[18] The plaintiff claimed that the portion of his legal expenses used to defend against his wife's community property claims over the plaintiff's stockholdings were deductible as "... ordinary and necessary expenses ... incurred during the taxable year ... for the ... conservation ... of property held for the production of income."[19]

The Commissioner of Internal Revenue, however, found the plaintiff's legal expenses to be nondeductible personal and family expenses.[20] The United States Court of Claims disagreed with the commissioner and held that 80% of plaintiff's legal expenses were due to his defense against his wife's claims on his stockholdings, and were deductible because the expenses were "incurred ... for the conservation ... of property held for the production of income."[21] The court of claims found it especially important in reaching its holding that the plaintiff might be deprived of the means of earning a living if he lost half his stockholdings.[22]

The United States Supreme Court rejected the view of the court of claims, holding that courts should not look at the potential consequences for the taxpayer's fortune, as the court of claims had, in order to determine the deductibility of the taxpayers legal expenses.[23] In so doing, the Court chose to ignore the taxpayer's business motives or purposes for incurring the legal expenses.[24] Rather, the Court held that courts must instead look to the "origin of the claim" with respect to which the legal expense was incurred.[25] The Court derived the "origin of the claim test" from cases like *Kornhauser v. United States*.[26] In *Kornhauser*, the United States Supreme Court, in trying to discover the deductibility of a taxpayer's litigation expenses, examined whether the

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17. *Id.* at 42.
18. *Id.*
19. *Gilmore*, 372 U.S. at 40 (quoting 26 U.S.C. § 23(a)(2) (1952)).
20. *Id.* at 42.
21. *Id.* at 43 (quoting Gilmore v. United States, 290 F.2d 942, 947 (Ct. Cl. 1961)).
22. *Id.*
23. *Id.* at 49.
24. Edward J. Schnee & Nancy J. Stara, *The Origin of the Claim Test: A Search for Objectivity*, 13 AKRON TAX J. 97, 98 (1997).
25. *Gilmore*, 372 U.S at 49.
26. *E.g.*, Kornhauser v. United States, 276 U.S. 145 (1928).

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taxpayer's litigation expenses were "directly connected with" or "proximately resulted from" his business.[27] The *Kornhauser* Court helped establish the important principle that the deductibility of a taxpayer's expenditure depends on "whether or not the claim arises in connection with the taxpayer's profit-seeking activities."[28]

The "origin of the claim," as established by *Gilmore* and *Kornhauser*, means the "'the nature of the activities to which [the legal expenses] relate,'"[29] or, "'the kind of transaction out of which the obligation arose . . .'"[30] In focusing on the "origin of the claim," courts must ignore the impact that nondeductibility of the legal fees might have on the taxpayer's fortune.[31] In other words, it would be improper for a court to consider any possible negative effects that not being able to deduct the expenses would have on the taxpayer.

Applying the "origin of the claim test" to the facts in *Gilmore*, the Court held that the origin of the plaintiff's claim was a divorce and was the result of events in the taxpayer's personal life – not the result of events from income-producing activity, as claimed by the plaintiff.[32] Therefore, the Court held that the legal expenses were not deductible business expenses, but rather nondeductible personal expenses.[33]

B. Woodward v. Commissioner and the Extension of the "Origin of theClaim Test" to Questions Involving Capitalization

In *Woodward v. Commissioner*,[34] the United States Supreme Court extended the "origin of the claim test" formulated in *Gilmore* from merely applying to situations involving deductibility to situations involving disputes over whether legal expenses were *capitalizable*.[35] *Gilmore*, decided just seven years earlier by the United States Supreme Court, had applied the "origin of the claim test" only to determine whether an expense was deductible or not, and not whether it was *capitalizable* or deductible.[36]

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27. *Id.* at 153.
28. *Gilmore*, 372 U.S. at 48.
29. *Id.* at 46 (quoting Lykes v. United States, 343 U.S. 118, 123 (1952)).
30. *Id.* at 48 (quoting Deputy v. duPont, 308 U.S. 488, 494 (1940)).
31. *See id.* at 49; *see also* Schnee & Stara, *supra* note 24, at 98.
32. *Gilmore*, 372 U.S. at 51-52; *See* Schnee & Stara, *supra* note 24, at 100.
33. *See Gilmore*, 372 U.S. at 52.
34. Woodward v. Commissioner, 397 U.S. 572 (1970).
35. *Id.* at 578.
36. Remember that under the Internal Revenue Code, it is possible for an expense to be neither deductible nor capitalizable, rendering the expense simply nondeductible in some circumstances.

In *Woodward*, the plaintiffs controlled a majority of the common stock of Telegraph-Herald.[37] Plaintiffs voted for the perpetual extension of the company's charter.[38] A minority stockholder voted against such a renewal.[39] Under Iowa law the plaintiffs were therefore required to purchase the stock of the minority shareholders voting against renewal.[40] Since the plaintiffs were unsuccessful in negotiating a price at which to purchase the minority shareholder's stock, the plaintiffs were forced to ask a court to set the price.[41] The trial court fixed a value for the stock.[42] After purchasing the stock at a judicially determined price, the plaintiffs sought to deduct the purchase price of the minority stock as "'ordinary and necessary expenses paid . . . for the management, conservation, or maintenance of property held for the production of income.'"[43]

The commissioner for the IRS disallowed the deduction, calling it a capital expenditure incurred in connection with the acquisition of capital stock.[44] The tax court agreed and the court of appeals affirmed.[45]

On further appeal, the United States Supreme Court stated that the "origin of the claim" was the proper test to use to determine the nature of the expense and that the origin was in the acquisition itself.[46] The expense was incurred at trial where the court set the price of the stock to be acquired.[47] The Court held that setting the price of the stock was definitely part of the acquisition.[48] Thus, the legal fees associated with the appraisal of the stock price were capital expenditures and not ordinary and necessary business deductions.[49]

C. Indopco, Inc. v. Commissioner and the "Separate and Distinct Asset" and the "Future Benefit" Tests

In *Indopco, Inc. v. Commissioner*,[50] the United States Supreme Court reaffirmed the principle set forth in *Commissioner v. Lincoln*

37. Woodward, 397 U.S. at 573.
38. *Id.*
39. *Id.*
40. *Id.*
41. *Id.*
42. *Id.*
43. *Id.* at 574 (quoting 26 U.S.C. § 212 (1954)).
44. *Id.*
45. *Id.*
46. *Id.* at 578-79.
47. *Id.* at 579.
48. *Id.*
49. *Id.* at 575.
50. Indopco, Inc. v. Commissioner, 503 U.S. 79 (1992).

Savings & Loan Association,[51] that a taxpayer's expenditure which "serves to create or enhance . . . a separate and distinct" asset should be capitalized under Internal Revenue Code section 263.[52] The Court further held that "a taxpayer's realization of *benefits beyond the year* in which the expenditure incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."[53] Therefore, put more simply, the Court held that while a taxpayer's expenditure that serves to create or enhance a separate and distinct asset should be capitalized, this is not a prerequisite to capitalization. A taxpayer's realization of benefits beyond the year of the expenditure is also an important factor in determining that the expense should be capitalized.[54] These two tests are referred to as the "separate and distinct asset" and the "future benefit" tests.[55]

In *Indopco*, Unilever United States, Inc. purchased Indopco, a publicly held subsidiary corporation, in a friendly transaction.[56] Indopco claimed an ordinary and necessary business expense deduction under Internal Revenue Code section 162 for the investment banking fees involved.[57] The IRS disallowed the deduction and Indopco sought a redetermination in tax court, claiming not only the right to deduct the investment banking fees, but the right to deduct the legal fees and miscellaneous expenses as well.[58] The tax court held that the expenditures were capital in nature and therefore not deductible under Internal Revenue Code section 162 as ordinary and necessary expenses.[59] The tax court, in reaching its holding, focused on the long-term benefits that the taxpayer received from the acquisition of another company.[60] The United States Court of Appeals, Third Circuit, affirmed, holding that the taxpayer would receive significant long-term

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51. Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345 (1971).

52. *Indopco,* 503 U.S. at 86 (quoting Commissioner v. Lincoln Savings & Loan Ass'n, 403 U.S. 345, 354 (1971)); *see* 26 U.S.C. § 263 (1994) ("No deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. . . .")

53. *Indopco,* 503 U.S. at 87 (emphasis added).

54. *Id.* at 88.

55. *See id.* at 87.

56. *Id.* at 80-82.

57. *Indopco,* 503 U.S. at 82. *See also* 26 U.S.C. § 162(a) (1994). ("There shall be allowed as a deduction all the *ordinary and necessary expenses* paid or incurred during the taxable year in carrying on any trade or business, . . .") (emphasis added).

58. *Indopco*, 503 U.S. at 82.

59. *Id.* (citing National Starch & Chem. Corp. v. Commissioner, 93 TC 67 (1989)).

60. *Id.*

benefits from the acquisition.[61] The Third Circuit rejected the argument that just because the acquisition did not create or enhance a separate or distinct asset, it was not a capital expenditure and was thus deductible.[62]

On appeal the United States Supreme Court held that the expenses were not deductible as ordinary and necessary business expenses under Internal Revenue Code section 162, and therefore must be capitalized.[63] The Court stated that if an expenditure "serves to create or enhance . . . a separate or distinct" asset it cannot be deducted as a business expense and must be capitalized under Internal Revenue Code section 263.[64] But, this does not mean that only expenses that create or enhance separate or distinct assets are to be capitalized under section 263.[65] The Court held: "[A] taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."[66] So, even though the expenses do not create or enhance an asset, the expenses might still be nondeductible capital expenditures if they produce benefits to the company beyond the tax year in question.[67]

The Court found that Indopco gained benefits beyond the tax year in question by being purchased by Unilever United States, Inc.[68] These benefits assume several forms. First, Indopco would benefit greatly from access to Unilever's vast resources in areas like basic technology.[69] Second, Indopco would benefit from the synergy that would result from a merger.[70] This synergy would exist because of the unique nature of the Unilever's operations. Third, Indopco would benefit by changing from a publicly held, freestanding corporation into a wholly owned subsidiary of Unilever because Indopco would no longer have the costly shareholder-relations expenses of a publicly traded corporation, nor the reporting and disclosure obligations, derivitive suits, and proxy battles.[71]

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61. *Id.* at 82-83 (citing National Starch & Chem. Corp. v. Commissioner, 918 F.2d 426, 432-33 (1990).
62. *Id.*
63. *Id.* at 88.
64. *Id.* at 86-87; 26 U.S.C. § 263 (1994).
65. *Indopco*, 503 U.S. at 86-87.
66. *Id.* at 87.
67. *See id.*.
68. *Id.* at 88-89.
69. *Id.* at 88 (citing Breif for Petitioner at 39-40).
70. *Id.* (citing Brief for Petitioner at 77-78).
71. *Id.* at 89 (citing Breif for Petitioner at 24).

D. The Relationship Between These Three Cases

The "origin of the claim test" requires a two-part inquiry: first, the originating activity must be defined; second, the activity must be defined as deductible or not.[72] If not deductible, the activity might be a capital expenditure. If not a capital expenditure, the activity is probably simply nondeductible. *Gilmore* established the "origin of the claim test" to determine the origin of legal expenses as regards the deductibility of the expenses.[73] *Woodward* extended "the origin of the claim test" into determinations of the origin of legal expenses as regards the current deductibility versus capitalization of the expenses.[74] *Indopco* reiterated the "separate and distinct asset" and the "future benefit" tests.[75] Once the "origin of the claim" has been determined under the authority of the *Gilmore* and *Woodward* precedent, the two tests from *Indopco*, the "separate and distinct asset" and the "future benefit" tests, assist in the second part of the "origin of the claim test;" that is, once the origin of the activity that resulted in the legal expense has been defined, is such expense deductible?

III. BACKGROUND OF DANA

A. Factual History

Dana Corporation (Dana) paid an annual legal retainer fee to a law firm for sixteen consecutive years.[76] Dana paid the legal retainer fee to the law firm to prevent the law firm from representing other companies in any potential attempts to acquire Dana and also to have the right to offset subsequent legal fees owed to the firm against the legal retainer fee paid for the particular year.[77] The right to offset legal fees against the retainer allowed Dana the option of offsetting both deductible and nondeductible legal fees.[78]

In most years, the IRS allowed Dana to deduct the legal retainer fee as an ordinary and necessary business expense under Internal Revenue Code section 162.[79] In 1984, however, Dana acquired Warner Electric

72. *See* Schnee & Stara, *supra* note 24, at 100-01
73. *Gilmore*, 372 U.S. at 49.
74. *Woodward*, 397 U.S. at 577-79.
75. *Indopco*, 503 U.S. at 86-87.
76. *Dana*, 174 F.3d at 1345.
77. *Id.*
78. *Id.*
79. *Id.*

Brake and Clutch Company (Warner).[80] Dana's law firm billed Dana $265,000 for the services surrounding the acquisition, and offset this charge by the $100,000 retainer.[81] Dana owed the law firm the remaining $165,000, which Dana paid to the firm and then capitalized as part the cost to acquire Warner.[82] Dana then deducted the $100,000 legal retainer fee.[83] The IRS responded by classifying the $100,000 retainer fee as a nondeductible capital cost of the Warner acquisition.[84]

B. Procedural Holding

1. The Court of Federal Claims

The Court of Federal Claims granted Dana's motion for summary judgment, holding that the 1984 legal retainer fee was a deductible ordinary and necessary business expense under Internal Revenue Code section 162 even though it was used to offset the legal fees associated with the acquisition of Warner.[85]

2. The United States Court of Appeals, Federal Circuit

The United States Court of Appeals, Federal Circuit, reversed the grant of summary judgment in favor of Dana.[86] The Court of Appeals held that under the "origin of the claim test" the retainer fee was a capital expense, and therefore nondeductible, because the legal expenses offset by the retainer fee were not ordinary and necessary business expenses, but the costs of a capital acquisition under Internal Revenue Code section 263.[87]

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80. *Id.* at 1346.
81. *Id.* at 1347.
82. *Dana*, 174 F.3d at 1346-47.
83. *Id.* at 1347.
84. *Id.*
85. *Id.*
86. *Id.* at 1345.
87. *Id.* at 1352; *See* 26 U.S.C. § 263 (1994).

IV. THE COURTS' REASONING

A. The Court of Federal Claims

The Court of Federal Claims held that "the [1984] retainer . . . had an origin and character distinct from the legal fees later incurred."[88] In other words, the origin of the claim was asset protection because Dana paid the retainer in part to assure that its law firm did not represent another company in an attempt to acquire Dana; the origin of the claim was not an attempt to acquire assets.[89] The court also focused on Dana's history of paying such retainers.[90] Since the retainers had been deductible in the previous years, the court reasoned that they must be deductible in 1984.[91] Since Dana paid a new legal retainer in January of each new year, the origin of the claim must occur in January when the retainer is paid, and not later in the year when the retainer is used to offset legal fees.[92] The court found that the legal retainer had an "identity separate and distinct" from the legal services performed by the law firm later in the year – services that the retainer was used to offset.[93] The court also found that Dana did not realize any benefits beyond 1984 from the transaction – the lack of future benefits tends to suggest that the expense was not a capital expenditure.[94]

B. The United States Court of Appeals, Federal Circuit

The United States Court of Appeals reversed the Court of Federal Claims's grant of summary judgment in favor of Dana.[95] The Court of Appeals held that under the "origin of the claim test" the 1984 retainer fee was "a nondeductible pre-payment, or deposit, for legal services rendered for a capital purchase."[96] Even though the retainer fees were deductible in other years, the particular use of the 1984 retainer fee determined its deductibility in 1984.[97] The language of the retainer agreement can be particularly helpful in determining the deductibility of

88. *Dana*, 38 Fed. Cl. at 362.
89. *See id.* at 361.
90. *Id.* at 361-62.
91. *Id.* at 361.
92. *Id.*
93. *Id.* at 362.
94. *Id.*
95. *Dana*, 174 F.3d at 1345.
96. *Id.* at 1350.
97. *Id.*

the retainer fee.[98] Dana required the law firm, according to the language of the retainer agreement, to treat the retainer fee as a deposit on any subsequent legal services for that year.[99]

Generally, retainer fees are deductible as ordinary and necessary business expenses, unless there exists the right of offset against future legal fees.[100] In other words, the retainer fee in *Dana* would be a deductible business expense if the retainer agreement merely provided that the law firm would protect Dana from hostile takeover attempts by other corporations; i.e. asset protection. But, since the retainer agreement provided that the retainer would also be used to offset subsequent legal fees, the retainer's deductibility hinges upon the purpose for which the subsequent legal fees are used.[101] Since the retainer fee was used to offset legal fees incurred for a capital acquisition (the acquisition of another company—Warner), the legal fees, and thus the legal retainer used to offset the legal fees, are nondeductible.[102] Because the legal fees were offset by the retainer fee, the retainer fee was not earned until the legal services had been credited.[103]

V. ANALYSIS

Although the lower court's holding in *Dana Corp. v. United States* is supported by limited precedent, the court of appeal's decision was correct for several reasons.

A. Dana Corp. v. United States Followed the "Origin of the Claim Test" in a Manner Consistent with Gilmore and Woodward

In *Dana* the United States Court of Appeals, Federal Circuit used the "origin of the claim test" in accordance with the Supreme Court's mandate in *Gilmore* and *Woodward*.[104] Dana argued that the "origin of the claim" was the payment of the legal retainer itself,[105] which is usually a deductible ordinary and necessary business expense under Internal Revenue Code section 162.[106] This argument might seem persuasive at first because, after all, the IRS allowed Dana to deduct the

98. *See id.* at 1351.
99. *Id.*
100. *See id.*
101. *Dana*, 38 Fed. Cl. at 1350-51.
102. *Id.* at 1350.
103. *Id.* at 1352.
104. *Id.* at 1350-51.
105. *Id.* at 1351.
106. *See* 26 U.S.C. § 162(a) (1994).

legal retainer fee as a business expense in every year from 1976 to 1991, with the exclusion of 1984 in which the IRS disallowed the deduction, giving rise to this action.[107] But, Dana's argument ignores key facts. First, in 1976, 1985-1988, 1990, and 1991, the law firm kept the retainer fee but rendered almost no legal services for Dana.[108] Since the retainer fee was not used to pay for any legal services, the fee was indisputably deductible under section 162 as a business expense.[109] Second, in six other years the law firm rendered legal services for Dana, but all the services were indisputably connected with "deductible (noncapital acquisition) legal service fees."[110]

In three of the years, however, the law firm billed Dana for capital acquisition fees.[111] Capital acquisition fees are nondeductible and must instead be capitalized.[112] In 1978, the law firm billed Dana for capital acquisition fees and for reasons unexplained, the IRS allowed Dana to deduct the majority of the fees.[113] The IRS probably made a mistake. In 1984, the law firm once again rendered capital acquisition services for Dana.[114] The legal fees were offset by the retainer fee as in 1978, but this time the IRS did not allow Dana to deduct the retainer fee as a business expense.[115] In its argument before the court, Dana erroneously assumed that the actual payment of the retainer fee to the law firm in 1984 was the origin of the claim, or "the kind of transaction out of which the obligation arose."[116] In reality, since the legal retainer fee was a prepayment of legal expenses that would arise later in that same year, the origin of the legal retainer was whatever the legal retainer was used to pay for.[117] The court stated: "In each of those years, the retainer fee must be seen as an expense incurred by Dana, not when it was initially paid, but rather when Dana would have had to pay [the law firm] that

107. *Dana*, 174 F.3d at 1350.
108. *Id.*
109. *Id.*
110. *Id.*
111. *Id.* at 1350.
112. 26 U.S.C. § 263 (1994).
113. *See Dana*, 174 F.3d at 1350.
114. *Id.*
115. *Id.*
116. *Gilmore*, 372 U.S. at 48 (quoting Deputy v. duPont, 308 U.S. 488, 494 (1940)).
117. *See Dana*, 174 F.3d at 1350-51.

same fee for its services, if not for the pre-payment under the retainer."[118]

1. The origin of the claim occurred in 1984, the year that Dana paid the legal retainer fee

Dana argued, and the court of claims held, that Dana's history of paying deductible legal retainers to the law firm established the retainer in 1984 as an ordinary and necessary business expense under Internal Revenue Code section 162.[119] The court reasoned that there was a pattern of paying retainer agreements every January; since the retainer agreements were deductible in years prior to 1984, they must be deductible in 1984.[120] This reasoning is incorrect in that the lower court failed to analyze the purpose of the fees each year. If a retainer that is used to offset legal fees is deductible one year, that does not necessarily mean that a retainer that is used to offset legal fees another year is deductible. In the words of the federal circuit, "[T]he deductibility of the retainer fee must rise and fall with the deductibility of the services for which the retainer fee actually paid."[121] As stated earlier, in 1984 the fees were for a capital acquisition, and not for a clearly deductible purpose as in other years.[122]

2. The origin of the retainer fee hinges upon the language of the retainer agreement

As mentioned earlier, Dana's legal retainer fee agreement with the law firm ensured two things: 1) the law firm would not represent a corporate raider in an attempt to acquire Dana; and 2) the law firm would offset the legal fees that Dana incurred later in the year against the pre-paid legal retainer fee from that same year.[123] If the legal retainer agreement had not contained an offset clause for subsequent legal fees, the retainer would probably have been deductible because the retainer fee would have served solely for asset protection.[124] In other words, if the retainer agreement had only provided that the law firm could not represent another company in a hostile takeover of Dana, the

118. *Id.* at 1351.
119. *Dana*, 38 Fed. Cl. at 361; *See* 26 U.S.C. § 162(a) (1994).
120. *Dana*, 38 Fed. Cl. at 361.
121. *Dana*, 174 F.3d at 1351.
122. *Id.* at 1350-51.
123. *Id.* at 1351.
124. *See id.*

court would not have looked at the use of the legal fees that the retainer offset. On the one hand Dana's retainer agreement with the law firm merely provided for deductible asset protection (no representation of a corporate raider), but on the other hand the retainer agreement provided for asset acquisition (where the retainer agreement offsets legal fees incurred in the acquisition of another company).[125]

B. Dana's Legal Expenses Arose in Connection with a Profit-Seeking Activity: the Second Prong of the "Origin of the Claim" Analysis

In *United States v. Gilmore*, the United States Supreme Court stated: "[T]he characterization, as 'business' or 'personal,' of the litigation costs of resisting a claim depends on whether or not the claim arises in connection with the taxpayer's profit-seeking activities."[126] The "arises" part of the previous sentence refers to the "origin of the claim," and the "profit-seeking activities" part of the sentence refers to the deductibility of the "origin of the claim" once the origin has been identified. Therefore, "the origin of the claim test" requires a two-part inquiry; first, the originating activity must be defined; second, the activity must be defined as deductible or not.[127] Previously, this Note explained that the origin of the legal retainer expense in *Dana* was the legal fees which were offset by the retainer fee.[128] Next, the court in *Dana* had to determine the deductibility of the legal fees themselves, under the second part of the "origin of the claim test."[129]

In *Indopco, Inc. v. Commissioner*, the United States Supreme Court reiterated that an expense that creates or enhances a "separate and distinct" asset is sufficient to require capitalization.[130] This test is called the "separate and distinct asset" test.[131] The Court also held, "a taxpayer's realization of *benefits beyond the year* in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization."[132] This test is called the "future benefit" test.[133] Indeed, Internal Revenue Code section 263, the Code's capitalization provision,

125. *Id.*

126. *Gilmore*, 372 U.S. at 48.

127. *See* Schnee & Stara, *supra* note 24, at 100-01.

128. *See supra* notes 76-84 and accompanying text.

129. *Dana*, 174 F.3d at 1351-52.

130. *See Indopco*, 503 U.S. at 86-87 (citing Lincoln Savings & Loan Ass'n, 403 U.S. 345, 351 (1971)).

131. *See id.*

132. *Id.* at 87 (emphasis added).

133. *See id.*

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refers to "permanent improvements or betterments,"[134] suggesting the importance of the duration and extent of the benefits realized by the taxpayer.[135] In other words, if a company incurs a legal fee in order to create a benefit for the company that lasts beyond the current year, it is likely that the legal fee will be capital, rather than deductible. In *Dana*, the court of claims held that Dana did not realize any benefits beyond the year in which the legal retainer was paid.[136] The court of claims failed to see the future benefits Dana would receive from the acquisition because the court of claims completely ignored the offset clause-portion of the retainer agreement, instead focusing on the clause of the retainer agreement that forbade Dana's law firm from representing a corporate raider in an attempt to acquire Dana.[137] Dana obviously did not receive a benefit lasting beyond the year in question from the law firm not being able to represent a corporate raider, because Dana would have to pay a new retainer each year to receive that benefit.

This argument fails, however, because in 1984 Dana's prepaid legal retainer fee offset legal fees incurred later the same year in the acquisition of another company.[138] Acquiring a company, unlike being protected from a corporate raider, certainly benefited Dana beyond 1984 and is therefore a capital expenditure under Internal Revenue Code section 263.[139] By acquiring another company, Dana stood to benefit far into the future from the synergy and hype that the acquisition would create. In *Indopco*, the Court reiterated, "Courts have long recognized that expenses . . . 'incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses.'"[140] This was so obvious to the court of appeals in *Dana* that the court simply stated, without further explanation, "[C]learly, the use was for a capital acquisition, and hence non-deductible."[141]

The Court of Appeals, in using the "origin of the claim test" in *Dana,* did not abandon the "separate and distinct asset" or the "future

134. 26 U.S.C. § 263 (1994).

135. *Indopco,* 503 U.S. at 88.

136. *Dana,* 38 Fed. Cl. at 361.

137. *See Dana,* 174 F.3d at 1351-52.

138. *Id.* at 1346-47.

139. *Dana,* 174 F.3d at 1351; *See also Indopco,* 503 U.S. at 89; A.E. Staley Mfg. v. Commissioner, 119 F.3d 482, 489 (7th Cir. 1997) (citations omitted).

140. *Indopco,* 503 U.S. at 89 (quoting General Bancshares Corp. v. Commissioner, 326 F.2d 712, 715 (8th Cir. 1964) (internal citations omitted)).

141. *Dana,* 174 F.3d at 1351.

benefit"[142] tests from *Indopco*. Rather, the court of appeals first used the Supreme Court's "origin of the claim test" from *Gilmore* to determine that the origin of the claim was the legal fees (which were offset against the legal retainer).[143] Then, the Court of Appeals, had it been necessary, could have used the tests cited in *Indopco*, the "separate and distinct asset" and the "future benefit" tests, to determine the deductibility of the legal expenses. However the legal fees were so clearly capital (once their origin had been determined), because they were used in an acquisition that benefited Dana beyond the year in question, that the *Indopco* tests were largely unnecessary. Or, if needed, the *Indopco* analysis used by the court in *Dana* was so simple that the Court did not bother to include it in the opinion.

C. The Likely Effect of Dana Corp. v. United States

If the Court of Appeals had held that the origin of the claim in *Dana* was the payment of the legal retainer itself, as Dana argued, and as the lower court held, companies would be able to rely on *Dana* to reduce their tax liability for prepaid legal retainer fees. The companies would reduce their tax liability by claiming an ordinary and necessary business expense deduction under Internal Revenue Code section 162 for legal expenses that are actually capital expenditures by simply paying for the capital legal fees by offsetting the fees against a prepaid retainer fee. Remember that "the time value of money renders current deductions significantly more valuable to the taxpayer than future deductions."[144] Putting it differently, the companies' tax liability would be reduced under this scheme because current deductions for ordinary and necessary business expense save the taxpayer-companies more money than do capital expenditures which must be amortized and depreciated over the relevant life of the asset.[145] This scheme would defeat the underlying rationale behind section 162 and section 263 of the Internal Revenue Code, which distinguish between expenditures that are deductible as ordinary and necessary business expenses, and expenditures that must be capitalized as capital expenditures. The rationale behind these sections of the code is to *diminish a taxpayer's ability to manipulate its taxable income.*[146] In *Federal Taxation of Income, Estates and Gifts*, it states:

142. *See Indopco*, 503 U.S. at 87.

143. *Dana*, 174 F.3d at 1351-52.

144. Anderson, *supra* note 8, at 412.

145. *See Indopco*, 503 U.S. at 83-84; *See also* Anderson, *supra* note 8, at 414.

146. *See* Anderson, *supra* note 8, at 413.

"[Section 263] serves to prevent a taxpayer from utilizing currently a deduction properly attributable, through amortization, to later tax years when the capital asset becomes income producing."[147]

But under the "origin of the claim test," as used in *Dana*, companies will find it more difficult to reduce their tax liability through pre-paid legal retainer fees. Under *Dana*, a court can cut to the core of the expenditure to determine the purpose for which the legal fees were incurred. Thus, *Dana* will help to assure that companies do not finesse the tax treatment of their non deductible legal expenses by offsetting them against legal retainer agreements. Under *Dana*, a company's attempt to do this would be futile, because the court would hold that the origin of the claim was not the payment of the retainer, but the legal fees that the retainer offset later in the year in question.

Dana may also discourage some companies from giving law firms pre-paid legal retainer fees in order to offset subsequent legal fees because the companies will understand, in advance, that they cannot use the retainer to transform the nondeductible legal fees into capital expenditures. A retainer agreement with an offset clause could become more of a hindrance than benefit for tax purposes; companies that used retainers as a subterfuge in the past will no longer think it viable. Legal fees paid by corporations, rather than being seen as separate and distinct from retainer fees, could come to be seen as one and the same – provided the retainer exists, at least in part, to offset the legal fees. One might speculate that this is what Dana was consciously attempting to do by claiming its deduction.

VI. CONCLUSION

The decision of the Court of Appeals, Federal Circuit in *Dana* was ultimately correct for several reasons. First, the court correctly applied the "origin of the claim test" to determine that the origin of Dana's claim was not the payment of the legal retainer fee, but the subsequent legal fees that the retainer offset. Second, the fact that the IRS had allowed Dana to deduct the retainer fee as an ordinary and necessary business expense in years past did not mean that the retainer fee was deductible as such in 1984. The court in *Dana* correctly held that it is the use of the retainer fee in a given year that determined the fee's deductibility. Since the retainer fee was used to pay for a capital acquisition, the fee was a nondeductible capital expenditure. Third, the origin of the retainer fee

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147. Bittker, *supra* note 5, at ¶ 20.4.1 (citing Commissioner v. Idaho Power Co., 418 U.S. 1, 16 (1974)).

depended on the language of the retainer fee agreement itself. Since the retainer fee agreement explicitly provided that the retainer fee offset subsequent legal fees, the origin of the claim must necessarily be the legal fees that the retainer offset. Fourth, the court did not abandon the "separate and distinct asset" and the "future benefit" tests. The origin of the claim in *Dana* was so clearly capital that an extensive analysis of the legal fees was simply unnecessary. Fifth, the court adhered to important public policy concerns, decreasing the ability of companies to reduce the their tax liability for legal expenses by simply offsetting the expenses against a pre-paid legal retainer fee.