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**THE ORIGIN OF THE CLAIM TEST:
A SEARCH FOR OBJECTIVITY**

by

EDWARD J. SCHNEE*

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INTRODUCTION

The tax benefit received from a taxpayer's expenditures, particularly in the context of expenditures associated with litigation,¹ depends on their characterization as either currently deductible, nondeductible or capitalizable. This characterization, in turn, depends on the answers to two questions. First, did the expenditures arise in connection with the taxpayers' business or income producing activities rather than their personal activities? Second, did the expenditures arise in connection with the acquisition or disposition of capital assets? To determine whether these connections are made the origin of the claim test is applied; i.e., the nature of the initial claim or transaction characterizes all expenditures incurred with respect to it.²

Recently, the Ninth Circuit Court of Appeals, in *United States v. Kroy (Europe) Ltd.*, used the origin of the claim test to determine the deductibility of financing expenses.³ At approximately the same time, the Tax Court, in *Fort Howard Corp. v. Commissioner*, concluded the use of the origin of the claim test to characterize similar expenditures was inappropriate.⁴ Given this conflict and the extensive use of this test to evaluate the deductibility of expenditures, this article reviews the development of this test and provides an analysis of the potential conflicts and uncertainties in its application.

DEVELOPMENT OF THE ORIGIN OF THE CLAIM TEST

The origin of the claim test was first applied by the Supreme Court in *United States v. Gilmore* to determine if a husband's litigation costs in his divorce proceedings were either currently deductible business expenses or nondeductible

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*** All citations are to the Internal Revenue Code of 1986 and to the regulations thereunder, as amended to the date of publication, unless otherwise noted.

1. *Fort Howard Corp. v. Commissioner*, 103 T.C. 345, 359 n.26 (1994).

2. *United States v. Gilmore*, 372 U.S. 39 (1963).

3. 94-2 U.S. Tax Cas. (CCH) ¶ 50,316 (9th Cir. 1994).

4. 103 T.C. 345 (1994).

personal expenses.⁵ The Supreme Court established that characterization of litigation costs as business or personal depended on “whether or not the claim *arises in connection with* the taxpayer’s profit-seeking activities” rather than on “the *consequences* that might result to a taxpayer’s income-producing property from a failure to defeat the claim.”⁶ By rejecting a test based on consequences, the Supreme Court chose not to consider the taxpayer’s business motives or purposes in undertaking the litigation.⁷ It refused to consider that if the taxpayer failed to defeat the sensational and reputation damaging charges of the claim, his business franchise which was his principal means of livelihood might be canceled.⁸ Rather, the Supreme Court chose to apply the origin of the claim test because “if the relative impact of a claim on the income-producing resources of a taxpayer were to determine deductibility, substantial ‘uncertainty and inequity would inhere in the rule.’”⁹ By applying the origin of the claim test in *United States v. Gilmore*, the Supreme Court found that the origin and character of the litigation costs were personal because they arose in connection with a divorce proceeding which is a product of personal or family life and not a business activity.¹⁰

Initially, the origin of the claim test was limited to characterizing expenses as either deductible business expenses or nondeductible personal expenses. A primary purpose test was used to characterize capital expenditures.¹¹ But, in the companion cases of *Woodward v. Commissioner*¹² and *United States v. Hilton Hotels Corp.*,¹³ the Supreme Court chose to displace the primary purpose test and to extend the origin of the claim test to characterize litigation costs as either currently deductible or capitalizable.

Internal Revenue Code (“I.R.C.”) Section 263 provides that certain expenditures related to property must be capitalized. Treasury Regulation 1.263(a)-2(c) contains a list of examples of these expenditures and includes the “cost of defending or perfecting title to property.” Recognizing that, in one sense, any lawsuit brought against taxpayers may affect their title to property, the courts had developed the primary purpose test to characterize litigation costs.¹⁴ If the

5. *Gilmore*, 372 U.S. at 39 (1963).

6. *Id.* at 48 (emphasis added).

7. *Id.*

8. *Id.* at 50.

9. *Gilmore*, 372 U.S. at 51.

10. *Id.* at 52 n.22. The Supreme Court noted that the “attempted analogy of a marital ‘partnership’ to the business partnership ... is of course unavailing. The marriage relationship can hardly be deemed an income-producing activity.” *Id.*; See also *United States v. Patrick*, 372 U.S. 53, 57 (1963).

11. *Moore Trust v. Commissioner*, 49 T.C. 430, 437-38 (1968), *acq.* 1968-2 C.B. 2.

12. 397 U.S. 572 (1970).

13. 397 U.S. 580 (1970).

14. *Hochschild v. Commissioner*, 47-1 U.S. Tax Cas. (CCH) ¶ 9265 (2nd Cir. 1947).

primary purpose of litigation was to defend or perfect the title to property, its cost was capitalized.¹⁵ But, Tax Court Judge Tannenwald, in a 1968 concurring opinion, questioned the use of the primary purpose test when he wrote:

I think the use of a “primary purpose” test in cases of this type is inappropriate, because it implies that the subjective intent of the parties ought to be taken into account. I believe that, in the area of litigation expenses, it is “the origin and character of the claim with respect to which [the] expense was incurred” which controls. See *United States v. Gilmore*, 372 U.S. 39, 49 (1963). The rationale which underpins this mandate of the Supreme Court is equally applicable in determining whether an expenditure is a non-deductible capital item or a deductible expense within the purview of section 212 and in determining whether the expenditure is a non-deductible personal item or a section 212 deduction.¹⁶

In 1970, the Supreme Court, in *Woodward v. Commissioner*, concurred with Judge Tannenwald noting that “[t]his [primary purpose] test hardly draws a bright line and has produced a melange of decisions, which, as the Tax Court has noted, ‘it would be idle to suggest ... [it] can be reconciled.’”¹⁷ Rather than attempting to reconcile these decisions, the Supreme Court extended the origin of the claim test from *United States v. Gilmore* to characterize litigation costs as either deductible or capitalizable for tax purposes.¹⁸

In the cases of *Woodward v. Commissioner*¹⁹ and *United States v. Hilton Hotels Corp.*,²⁰ the litigation costs were incurred to determine a value for stock which state statutes required the taxpayer-corporation to purchase from minority shareholders who were objecting to certain actions of corporate management. The Supreme Court did not view this appraisal litigation as either defending or perfecting title to the corporate assets even though the minority stockholders were hostile to the interests of the corporation. Rather, it raised the “simpler inquiry [of] whether the origin of the claim litigated is in the process of the acquisition

15. *Iowa S.Util. Co. v. Commissioner*, 64-2 U.S. Tax Cas. (CCH) ¶ 9580, at 93, 357 (8th Cir. 1964), cert. denied, 379 U.S. 946 (1964); *Industrial Aggregate Co. v. United States*, 60-2 U.S. Tax Cas. (CCH) ¶ 9806 (8th Cir. 1960); *Lewis v. Commissioner*, 58-1 U.S. Tax Cas. (CCH) ¶ 9420 (2nd Cir. 1958); *Rassenfoss v. Commissioner*, 47-1 U.S. Tax Cas. (CCH) ¶ 9108 (7th Cir. 1946); *Moore Trust v. Commissioner*, 49 T.C. 430 (1968), acq. 1968-2 C.B. 2.

16. *Moore Trust v. Commissioner*, 49 T.C. 430, 443 (1968), acq. 1968-2 C.B. 2.

17. *Woodward v. Commissioner*, 397 U.S. 572, 576 (1970).

18. *Woodward*, 397 U.S. at 578-79.

19. 397 U.S. 572 (1970).

20. *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970).

itself.”²¹ In so doing, the Supreme Court did not fully reject the primary purpose test in cases to defend or protect title; instead, it found the test was inappropriate for characterization of acquisition costs.²² Subsequently, however, the courts have applied the origin of the claim test to characterize expenditures to defend or perfect title.²³

In *United States v. Gilmore*, the origin of the claim was divorce litigation which was the product of the taxpayer’s personal life.²⁴ Having determined this, the tax characterization of the litigation costs as nondeductible expenses followed naturally. In *Woodward v. Commissioner*²⁵ and in *United States v. Hilton Hotel Corp.*,²⁶ the origin of the transaction was the acquisition of stock. Since business expenditures for the acquisition of assets are capitalized, the costs were characterized as an adjustment to the capital asset.²⁷ The ease of applying this test, however, evaporates when confronted with more complicated factual questions and, in addition, using the origin of the claim test to characterize all expenditures may not always be appropriate.²⁸ These problems become more evident upon a review of cases which have applied the origin of the claim test.

APPLYING THE ORIGIN OF THE CLAIM TEST

In *Keller St. Development Co. v. Commissioner*,²⁹ the Ninth Circuit Court of Appeals described the characterization of an expenditure using the origin of the claim test as a two-step process.³⁰ In the initial step, the origin of the claim from which the tax dispute arose is discovered. In the second step, the expenditure is attributed to its origin to determine its actual tax characterization. “[T]he cost (or income) at issue must be attributed to a business activity to be a business expense, a personal activity to be a personal expense, or a capital activity to be an adjustment in the value of the capital asset.”³¹ The application of the origin of the claim

21. *Woodward*, 397 U.S. at 577; see also *Hilton Hotels Corp.*, 397 U.S. at 583.

22. 397 U.S. at 577.

23. See *Nickell v. Commissioner*, 87-2 U.S. Tax Cas. (CCH) ¶ 9585 (6th Cir. 1987); see also *Anchor Coupling Co., Inc. v. United States*, 70-1 U.S. Tax Cas. (CCH) ¶ 9341 (7th Cir. 1970), cert. denied, 401 U.S. 908 (1970); *Arthur H. DuGrenier, Inc. v. Commissioner*, 58 T.C. 931 (1972); *Reed v. Commissioner*, 55 T.C. 32 (1970); *Heath v. Commissioner*, 46 T.C.M. (CCH) 698 (1983).

24. 372 U.S. 39 (1963).

25. 397 U.S. 572 (1970).

26. *Hilton Hotel Corp. v. United States*, 397 U.S. 580 (1970).

27. See *id.* at 583; see also *Woodward*, 397 U.S. at 575.

28. *Fort Howard Corp. v. Commissioner*, 103 T.C. 345, 359 (1994).

29. 82-2 U.S. Tax Cas. (CCH) ¶ 9601 (9th Cir. 1982).

30. *Keller St. Dev. Co.* at 82-2 U.S. Tax Cas. (CCH) ¶ 9601, at 85,186.

31. *Id.*

test using these steps, necessitates that the originating activity first be identified and, then, defined.

Identifying the originating activity may not be easy. Since its formation, the origin of the claim test has been applied to relate expenses to remote origins. For example, litigation costs have been related to litigation that was concluded³² and to litigation that was only threatened.³³ As expenses become less directly associated with litigation, attributing the character of the litigation to the expenses becomes even more problematic.

Once the originating activity is identified, it must then be defined. While recognizing that primary purpose is irrelevant in applying the origin of the claim test,³⁴ it remains a relevant inquiry in defining either a trade or business,³⁵ an expense incurred in carrying on that trade or business³⁶ or the true character of a transaction which may be disguised.³⁷ Because "carrying on" a trade or business requires that a particular expense be "directly connected with or pertaining to the taxpayer's trade or business,"³⁸ a proximate relationship between the expense and the taxpayer's trade or business must exist.³⁹ In determining if this relationship exists, intent is one factor to be considered.⁴⁰ Similarly, if no substantial business connection is found for payments which personally benefit a shareholder-employee, the payments may be challenged as disguised dividends.⁴¹ It is this intertwining of the business defining issues with the origin of the claim test that adds to the complexity of applying the origin of the claim test.

CHARACTERIZATION: PERSONAL OR PROFIT-SEEKING

When first applied, the origin of the claim test was used to distinguish nondeductible personal expenses from deductible profit-seeking expenses.⁴² To do

32. *United States v. Patrick*, 372 U.S. 53, 55-56, (1963).

33. *Eisler v. Commissioner*, 59 T.C. 634, 637 (1973).

34. *Woodward v. Commissioner*, 397 U.S. 572, 577-78 (1970).

35. Treas. Reg. § 1.183-2 (1996); *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987).

36. *Patterson v. Commissioner*, 27 T.C.M. (CCH) 640, 642 (1968), *rev'd* 436 F.2d 359 (9th Cir. 1971); I.R.C. § 162(a) (1996); Treas. Reg. § 1.162-1(a) (1996).

37. *See Yelencsics v. Commissioner*, 74 T.C. 1513, 1531 (1980), *acq.* 1981-2 C.B. 2; *See also Smith v. Commissioner*, 38 T.C.M. (CCH) 1246 (1979); B. BITTKER AND J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*, Para. 5.03(1) at 5-11 to 5-12 (6th ed.).

38. Treas. Reg. § 1.162-1(a) (1996).

39. *See Patterson*, 27 T.C.M. (CCH) 640, 642, *rev'd*, 436 F.2d 359 (9th Cir. 1971); 267-3d Tax Mgmt. (BNA), *Educational and Professional Expenses - Section 162, A-3-A-4*.

40. *See Baker v. Commissioner*, 51 T.C. 243 (1968) (taxpayer was merely fulfilling his general education aspirations).

41. *See Smith*, 38 T.C.M. (CCH) at 1246 (1979).

42. *See supra* note 5 and accompanying text; I.R.C. §§ 162, 212, 262.

so, however, without considering either the consequences of the litigation or the primary purpose of the activity, necessitated that the form of the originating activity take on increased significance.⁴³ If the form of the originating activity was inherently personal, such as a divorce or will contest, the courts characterized the expenses associated with the activity as personal.⁴⁴ Yet, if the originating activity was litigation which had no inherently personal character, such as a bankruptcy, the courts allowed expenses to be characterized as part personal and part profit-seeking. Because the form of the originating activity may be determinative of its character, careful consideration should be given to the form that litigation takes. The following discussion of cases illustrates the importance of form in characterizing expenditures.

Divorce Litigation

Since the Supreme Court first applied the origin of the claim test to characterize costs incurred in a divorce proceeding as nondeductible personal expenses,⁴⁵ it is reasonable to assume that the test will be applied to characterize costs whenever their origin is a divorce proceeding. Therefore, it is not surprising that, recently, the Tax Court denied the expense incurred to value a partnership interest when the origin of the expense was a division of marital property in a divorce.⁴⁶

In *Melat v. Commissioner*,⁴⁷ the taxpayer attempted to distinguish *United States v. Gilmore*⁴⁸ by arguing that seventy-five percent of the legal and accounting expenses were currently deductible under I.R.C. Section 212(2) because they were incurred to protect "the future stream of income" from his partnership interest. Although the Tax Court acknowledged that one result of the divorce may be the reduction of the taxpayer's income producing assets, the origin of the claim was the divorce which is a personal activity, making the legal fees not deductible.⁴⁹

43. *Dibsy v. Commissioner*, 70 T.C.M. (CCH) 918 (1955) (intent in a like-kind exchange is irrelevant and form will prevail over substance when it is difficult to distinguish a sale from an exchange on any ground other than form).

44. *See, e.g. Callander v. Commissioner*, 75 T.C. 334 (1980). The denial of inherently personal expenses has been without applying the origin of the claim test. *Id.* at 336. For example, the cost of maintaining checking account which was used to pay personal bills not deductible even though it also served as a record of financial transactions. *Id.* Rev. Rul. 82-168, 1982-2 C.B. 56 (cost of wristwatch required by employer not deductible).

45. *See supra* note 5 and accompanying text.

46. *See Melat v. Commissioner*, 63 T.C.M. (CCH) 2868 (1993).

47. *Melat*, 63 T.C.M. (CCH) 2868 (1993).

48. 372 U.S. 39 (1963).

49. *Id.* at 43-44.

Despite the apparent ease with which the test can be applied to characterize litigation expenses incurred in a divorce, the actual application of the test has interesting limitations. One of these is reflected by the Tax Court's holding in *Wild v. Commissioner*.⁵⁰ Ruth Wild allocated \$6,000 out of the \$10,000 of legal fees she incurred during her divorce as the cost of obtaining taxable alimony and deducted that amount under I.R.C. Section 212(1) as an expense for the production of income.⁵¹ The Internal Revenue Service ("Service"), relying on *United States v. Gilmore*, denied its deduction under the origin of the claim test as a nondeductible personal expense.⁵² The majority of the Tax Court in a reviewed decision held the expense to be deductible because Treasury Regulation 1.262-1(b)(7) applied:

Generally, attorney's fees and other costs paid in connection with a divorce, separation, or decree for support are not deductible by either the husband or the wife. However, the part of an attorney's fee and the part of the other costs paid in connection with a divorce ...which are properly attributable to the production or collection of amounts includible in gross income under section 71 are deductible by the wife under section 212.⁵³

The Tax Court refused to apply the origin of the claim test because the Service had not modified this regulation to reflect *United States v. Gilmore*.⁵⁴ It distinguished this Supreme Court case because it had dealt with another subsection of the Internal Revenue Code and had concerned a husband rather than a wife.⁵⁵ The Tax Court has continued to follow the position it adopted in *Wild v. Commissioner*.⁵⁶ But, it has interpreted its position narrowly, restricting its application to permit deduction of "legal expenses *paid by the wife* to obtain alimony payments which were *included in her gross income*."⁵⁷

50. 42 T.C. 706 (1964), *acq.* 1967-2 C.B. 4.

51. *Id.* at 707.

52. *Id.* at 708.

53. *Id.* at 709-10.

54. 372 U.S. 39 (1963).

55. *Wild*, 42 T.C. at 710 n.6 (1964). The court found it significant that the Supreme Court in *United States v. Gilmore*, 372 U.S. 39 (1963) referred to "the first sentence in reg. § 1.262-1(b)(7) but not the second which provides the exception for the deduction of a portion of the legal and other fees incurred by a wife." The Tax Court stated: "This is an unmistakable indication that the Supreme Court in that case was not considering the problem of the deductibility of expenses paid or incurred by the wife in securing the payment to her of alimony which would be includible in her gross income under § 71." *Id.*

56. 42 T.C. at 706; *see* *Sunderland v. Commissioner*, 36 T.C.M. (CCH) 512 (1977); *see also* *Wolfson v. Commissioner*, 47 T.C. 290 (1966).

57. *Sunderland*, 36 T.C.M. (CCH) at 514 (1977).

A second limitation on the actual application of the origin of the claim test in a divorce proceeding is found in *Dolese v. Commissioner* in which the corporations owned by the husband-shareholder were named as defendants.⁵⁸ The Tenth Circuit used the origin of the claim test to permit the deduction by the corporations of their twenty-five percent share of the legal and other expenses of litigation and to deny a similar deduction by the husband-shareholder.⁵⁹ The court was able to reach this decision by bifurcating the litigation, applying the origin of the claim test separately to each part of the litigation.⁶⁰

In *Dolese v. Commissioner* the wife could not receive a property settlement or divorce from the corporations, so the litigation was divided into the divorce action directed against the husband and a mismanagement action directed against the corporations.⁶¹ The court found two facts to be significant:

- (1) the corporations were involuntary parties to the litigation; and
- (2) the litigation restrained the corporations from undertaking certain actions without permission of the court and attempted to remove the husband-stockholder for mismanagement.⁶²

The Tenth Circuit held that the legal expenses paid by the corporations to defend against these actions were deductible.⁶³ The litigation inhibited their conduct of profit making activities and seemed to originate from their business activities. In other words, the origin of the claim was the corporation's business. Having decided this, the court looked to the corporation's purpose in incurring the expenses to determine if they were related to its business and, therefore, deductible.⁶⁴ On the other hand, expenses paid by corporations for appraisals of their assets were nondeductible expenses because these expenses had their origin in the divorce litigation and were done to provide a valuation of the marital property.

This decision is unique because it is one of the first providing for dual origins of the claim. By doing so, it added further complexity to what was supposed to be a simple cause and effect analysis of expenditures.

58. 79-2 U.S. Tax Cas. (CCH) ¶ 9540 (1979), *cert. denied*, 445 U.S. 961 (1980).

59. *Id.* at 87,956-57.

60. *Id.* at 87,957-60.

61. *Id.* at 87,955-56.

62. *Id.* at 87,957-58.

63. *Id.*

64. *Id.* at 87,959.

Inheritance

Although the Tax Court initially applied the primary purpose test in *McDonald v. Commissioner*, on appeal the Second Circuit extended the origin of the claim test to characterize the payments made to settle a will contest.⁶⁵ The case involved William McDonald, Sr., an attorney and friend of Hazel Leckie, who was named as one of the residual beneficiaries under her will.⁶⁶ While Mr. McDonald had not drafted the will, he had drafted a codicil which had removed a specific bequest and increased the amount passing to the residual beneficiaries.⁶⁷ Upon her death, Ms. Leckie's relatives filed objections to the admission of the will into probate alleging that Mr. McDonald had obtained his bequest by using undue influence.⁶⁸ The objections were withdrawn based on a compromise agreement wherein Mr. McDonald agreed to pay \$121,400 to the relatives.⁶⁹ One of the recitals in this agreement stated that:

. . . [T]he compromise had been reached in part because "it appears that the litigation of the issues would engender much publicity and would endanger the reputation of William J. McDonald as an attorney . . ."⁷⁰

The Tax Court applied the primary purpose test and permitted Mr. McDonald to deduct the payment in compromise. While the Service contended that Mr. McDonald's actions were motivated by his desire to preserve some portion of his inheritance, the Tax Court stated that the only evidence before it supported Mr. McDonald's assertion that his actions were to protect his business reputation and future earnings.⁷¹ The effect on Mr. McDonald's business reputation was the same regardless of whether the litigation took the form of a will contest or a malpractice claim for undue influence.⁷²

Based on the reported decision of the Tax Court, the origin of the claim test was neither considered by the Tax Court nor argued by the Service. On appeal, however, the Second Circuit first determined that the test had been applied in a manner sufficiently broad to warrant its application and then applied it. Its application was based on "whether the claim arose in connection with

65. 78-2 U.S. Tax Cas. (CCH) ¶ 9631 (2nd Cir. 1978) *rev'g and rem'g*, 36 T.C.M. (CCH) 852 (1977).

66. *Id.* at 85,072.

67. *Id.*

68. *Id.* at 85,073.

69. *Id.* at 85,073.

70. *Id.*

71. *Id.*

72. *McDonald*, 78-2 U.S. Tax Cas. (CCH) ¶ 9631, at 85,073.

McDonald's friendship for Mrs. Leckie or his 'profit-seeking activities' as her attorney."⁷³ The Court found that, regardless of Mr. McDonald's business motivations for settling, the litigation costs were personal and nondeductible because they arose in a nonbusiness context.⁷⁴

This case illustrates one of the difficulties in applying the origin of the claim test. The form the litigation takes may control the characterization of the expense. Although the consequences of the litigation for Mr. McDonald were the same regardless of whether the litigation was a will contest or a malpractice claim, consequences are not to be considered in characterizing an expense. The origin of the claim was a will contest; the nature of which is inherently personal. The form of the litigation focused, not on his professional actions, but rather on the personal advantage he may have gained under the will because of his use of undue influence.

Bankruptcy

Unlike divorce and inheritance litigation, bankruptcy litigation does not automatically determine the characterization of an expenditure under the origin of the claim.⁷⁵ Bankruptcy litigation, in itself, is neither inherently personal nor profit-seeking. As a result, form plays an important role in characterizing any associated litigation costs. For instance, in *Dowd v. Commissioner*, the Tax Court permitted a taxpayer who was in bankruptcy to deduct as a business expense those litigation costs directly attributable to negotiating an additional payment to be made to business creditors.⁷⁶ But, in *United States v. Collins*, the Eleventh Circuit denied a similar business deduction although business creditors benefitted from the litigation settlement negotiated with the bankruptcy trustee.⁷⁷

The Tax Court permitted the business deduction in *Dowd v. Commissioner* because the taxpayer-debtor negotiated the additional payments with his business creditors so that they would not object to his discharge in bankruptcy. The additional payment was made directly to the creditors and not to the bankruptcy trustee. Because the taxpayer was on a cash basis, payment of the business debts would normally have created a deductible expense. The bankruptcy itself characterized neither the payments nor the associated litigation

73. *McDonald*, 78-2 U.S. Tax Cas. (CCH) ¶ 9631, at 85,073.

74. *Id.*

75. See *United States v. Collins*, 94-2 U.S. Tax Cas. (CCH) ¶ 50,365, at 85,263 (11th Cir. 1994).

76. 68 T.C. 294 (1977).

77. *Collins*, 94-2 U.S. Tax Cas. (CCH) ¶ 50,365, at 85,263.

costs.⁷⁸ The form of the negotiation for the additional payment made the relationship of these payments to the taxpayer's business apparent, and the litigation costs attributable to these payments were easily determinable. Contrast the result in *Dowd v. Commissioner* with *United States v. Collins*.⁷⁹ In the latter case, a bankruptcy trustee sought to set-aside Mr. Collins' discharge in bankruptcy based on a fraudulent transfer of assets by him to a family trust in which he was neither a trustee nor a beneficiary.⁸⁰ Mr. Collins, however, preempted the bankruptcy trustee by filing an action in state court requesting a declaratory judgment holding that the bankruptcy trustee was not entitled to the assets of the family trust.⁸¹ Subsequently, a settlement was reached, and Mr. Collins attempted to deduct the amount paid in settlement and the litigation costs as a business expense because these costs originated in an action by the bankruptcy trustee to recover additional assets to pay business debts owned to the creditors in bankruptcy.⁸² The Eleventh Circuit found that the claim did not arise in connection with the taxpayer's profit-seeking activities.⁸³ Instead, it found that the litigation costs arose in a personal activity; i.e., the protection of family trust assets.

In making its decision, the Eleventh Circuit noted that Mr. Collins neither negotiated with nor made any deal with the business creditors.⁸⁴ His payments had no connection with business creditors and the objection to his discharge in bankruptcy did not spring from his business activities.⁸⁵ The settlement and litigation costs, however, were paid to procure a dismissal of a suit against Mr. Collins' family trust which, by its nature, was personal. Again, form was a determinative factor in characterizing both the settlement and the associated litigation costs as personal.

CHARACTERIZATION: CAPITAL OR PROFIT-SEEKING

The distinction is often close between ancillary costs related to capital assets which are to be capitalized and other related costs which are current operating costs of a profit-seeking activity deductible under I.R.C. Sections 162 or 212.⁸⁶ The origin of the claim test was devised to assist with making that distinction. Yet, it is difficult to apply because the definitions of capital activity and

78. *Id.* at 301.

79. 68 T.C. 294 (1977); 94-2 U.S. Tax Cas. (CCH) ¶ 50,365 (11th Cir. 1994).

80. *Collins*, 94-2 U.S. Tax Cas. (CCH) ¶ 50,365, at 85,262-63.

81. *Id.*

82. *Id.*

83. *Id.* at 85,263-64.

84. *Id.* at 85,264.

85. *Id.*

86. *See Honodel v. Commissioner*, 84-1 U.S. Tax Cas. ¶ 9133, at 83,097 (9th Cir. 1984).

business activity are not themselves clear.

Capitalization takes precedence over current expensing.⁸⁷ Internal Revenue Code Sections 63, 162 and 263 require that expenditures be capitalized unless a specific deduction is allowed.⁸⁸ For an expenditure to be capitalized under I.R.C. Section 263, it must either create or enhance an asset or, even if no distinct asset is created or enhanced, it must produce significant benefits which extend beyond the tax year.⁸⁹

Motivation in purchasing an asset is irrelevant.⁹⁰ Whereas, if a court is asked to resolve whether an expenditure is a profit-seeking expense or personal expense, it must consider primary purpose to determine whether a profit-seeking activity exists from which the expense may have arisen and whether the expense is directly connected with that trade or business.⁹¹ To avoid the complexity which this determination adds, a court may choose to first consider the issue of whether the expenditure is capital and to ignore, initially, whether the capital cost arose in a personal activity or profit-seeking activity.⁹²

Asset Dispositions

While, generally, litigation costs incurred to recover income derived from a capital asset are deductible,⁹³ the origin of the claim test is applied to deny the deduction of litigation costs incurred to receive the sale proceeds themselves.⁹⁴ If expenditures are incurred in the sale of an asset, regardless of whether they are costs to enforce a contract or establish a selling price, they are not deductible.⁹⁵ Rather, these expenditures are to be used to offset realized capital gains.⁹⁶ For instance, legal fees and expenses were part of the sale transaction when incurred:

87. See *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 17 (1974); see also *Boagni v. Commissioner*, 59 T.C. 708, 712 (1973), *acq.* 1973-2 C.B. 1.

88. I.R.C. §§ 63, 162, 263.

89. See *Indopco, Inc. v. Commissioner*, 503 U.S. 79 (1992); see also *Georator Corp. v. United States*, 73-2 U.S. Tax Cas. (CCH) ¶ 9685 (4th Cir. 1973) (noting that an expenditure does not have to be described as a capital asset in § 1221 in order to be classified as a capital expenditure); I.R.C. § 263; Treas. Reg. §§ 1.263(a)-1 to -2.

90. See *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212, 223 (1988); see also *Mitchell v. Commissioner*, 96-1 U.S. Tax Cas. (CCH) ¶ 50,042, at 83,158 (6th Cir. 1996).

91. See *supra* notes 32-38 and accompanying text.

92. See *Mitchell*, 96-1 U.S. Tax Cas. (CCH) ¶ 50,042, at 83,158 (6th Cir. 1996).

93. See *Nickell v. Commissioner*, 87-2 U.S. Tax Cas. (CCH) ¶ 9585 (1987); see also *Boagni*, 59 T.C. at 708 (1973), *acq.* 1973-2 C.B. 1.

94. See *Helgersson v. United States*, 70-1 U.S. Tax Cas. (CCH) ¶ 9445 (8th Cir. 1970).

95. *Id.*

96. See *Estate of Baier v. Commissioner*, 76-1 U.S. Tax Cas. (CCH) ¶ 9344, at 83,839 (3rd Cir. 1976).

(1) to protect the value of security being held in escrow until all installment sale proceeds were received;⁹⁷

(2) to determine the amount to be received by an employee for assigning a patent application over to his employer as required by his employment contract.⁹⁸

In both of these instances, the terms of the sale necessitated the legal fees. In the first case, the purchasers had not received full ownership of the object of the sale because of the escrow which the sale contract established. In the second case, the sale price itself had not been agreed upon. In both situations, the court focused on the capitalization issue avoiding the need to address the personal vs. profit-seeking issue.

When the value of the asset received in liquidation cannot be determined because of an unsettled lawsuit, the open transaction doctrine applies.⁹⁹ The result is similar to the closing of a sale when the sale price itself has not been agreed upon. For instance, the Fifth Circuit in *Estate of Meade v. Commissioner* applied the origin of the claim test and found that the litigation costs were incurred, not to collect income but, rather, to determine the value of the asset received in a liquidation.¹⁰⁰ The only reason the corporation itself was not litigating the lawsuit in *Meade* was because of its liquidation. Having received the lawsuit in the liquidation, the Fifth Circuit found that the shareholder was in no different position than the corporation would have been.¹⁰¹ The proceeds of liquidation were not determinable until the lawsuit was concluded. Again the capitalization issue was the sole issue addressed.

Both the Tax Court and the Service have held, however, that acquisition costs do not include payments under either covenants not to compete or long-standing employment contracts.¹⁰² One example is Letter Ruling 9326001.¹⁰³

97. See *Helgerson*, 70-1 U.S. Tax Cas. (CCH) ¶ 9445, at 83,582.

98. See *Estate of Baier*, 76-1 U.S. Tax Cas. (CCH) ¶ 9344, at 83,839.

99. See *Estate of Meade v. Commissioner*, 74-1 U.S. Tax Cas. (CCH) ¶ 9237 (5th Cir. 1974), cert. denied, 419 U.S. 882 (1974).

100. *Id.*

101. *Id.* at 83, 441-44.

102. *Taylor v. Commissioner*, 64 T.C.M. (CCH) 1322 (1992) (origin of claim followed original agreement which allocated payments between stock and covenant not to compete); Rev. Rul. 73-146, 1973-1 C.B. 61, permitted a corporation to deduct payments to cancel existing stock options as a result of a reorganization; Priv. Ltr. Rul. 9527005 (March 15, 1995), permitted a corporation to deduct a special bonus and other payments designed to make employees "whole" following a leveraged-buyout of the corporation; Priv. Ltr. Rul. 9326001 (March 18, 1993). But see Rev. Rul. 73-580, 1973-2 C.B. 86, which requires payment for services directly connected with a reorganization to be capitalized.

103. Priv. Ltr. Rul. 932600 (March 18, 1993).

In Letter Ruling 9326001, Parent (“P”) acquired Subsidiary (“S”) as a wholly owned subsidiary. Prior to the acquisition, S had employment contracts with key employees that required a lump sum payment following certain events. The acquisition of S was one of these events. Rather than paying under the contract, P negotiated new employment contracts which included an installment payment which approximated the amount due under the prior contract and deducted it for tax purposes when paid.¹⁰⁴ The ruling lists three facts to explain why the origin was the employment relationship and not the acquisition:¹⁰⁵

- (1) the employees had been employed under several contracts that contained the payment based on a triggering event;¹⁰⁶
- (2) the post-merger payment was in lieu of the amount due under the pre-merger contract;¹⁰⁷ and
- (3) the principal motivation for the payment was to assure the continued employment of the recipients.¹⁰⁸

Initially, this third test may appear inconsistent with the application of the origin of the claim test which rejected the “primary purpose test,” but purpose or motivation is relevant when determining whether an expense arose in connection with *carrying on* a trade or business.¹⁰⁹ In other words, once the Service concluded that the origin was the employment of the key personnel and not the acquisition, motivation was considered in relation to the question of whether the expenditure met the requirement of I.R.C. Section 162.¹¹⁰ Was the payment a currently deductible trade or business expense? The consideration of motivation is also illustrated in the recent case of *Mitchell v. Commissioner*.¹¹¹

In the case of *Mitchell v. Commissioner*, the Sixth Circuit was asked to consider whether a restitution voluntarily paid to an employer by an employee in

104. Although P capitalized this payment for book purposes under the “push-down” method of accounting required by the Securities and Exchange Commission, the Letter Ruling noted that compulsory accounting rules of regulatory agencies do not control tax consequences.

105. Priv. Ltr. Rul. 9326001, 3-6 (March 18, 1993).

106. *Id.* at 3-4.

107. *Id.* at 4-6.

108. Priv. Ltr. Rul. 9326001, 6-7 (March 18, 1993).

109. *See supra* notes 31-38 and accompanying text.

110. Payment, in some objective sense, should be intended as compensation for services; *See e.g.* X-L Serv., Inc. v. Commissioner, 32 T.C.M. (CCH) 701 (1973); Annabelle Candy Co., Inc. v. Commissioner, 20 T.C.M. (CCH) 873 (1961), *rem’d on another issue*, 314 F.2d 1 (9th Cir. 1962).

111. 96-1 U.S. Tax Cas. (CCH) ¶ 50,042 (6th Cir. 1996), *aff’g*, 67 T.C.M. (CCH) 3015 (1994).

order for the employee to keep stock which he had obtained in violation of federal banking regulations was a expense incurred in carrying on a trade or business or a capital expenditure. The employee argued that the violation of the federal banking regulation was the origin of the claim, but the Sixth Circuit noted that “this argument fails to address the fact that it was Mitchell’s *original* intent to personally acquire the stock from the beginning of the transaction.”¹¹² Rather, the Sixth Circuit determined that the origin of the restitution was Mitchell’s personal acquisition of the stock, it was paid to protect his ownership of that stock and it must be treated as a capital expenditure.¹¹³

The use of intent by the Sixth Circuit to determine the *true* origin of the claim is similar to the use of intent or primary purpose to determine the true character of a transaction which may be disguised.¹¹⁴ The true origin of the claim was not the employee’s violation of the federal banking regulation because the employee was required to make restitution only if he chose to keep the stock. If he had voided the stock transfer, he would have paid no restitution.¹¹⁵ The employee’s intent, as shown by the facts, was to acquire the stock.

Whether the disposition is voluntary or involuntary is not significant.¹¹⁶ Involuntary dispositions include condemnations and, under the origin of the claim test, legal fees arising from the condemnation are capitalized.¹¹⁷ Although the taxpayer-landowner may incur legal fees to protest a condemnation and protect his or her business, these legal fees are capitalized because the basis for the condemnation is the public need to acquire the taxpayer’s land and that need exists regardless of the taxpayer’s business.¹¹⁸ The taxpayer’s motive or purpose in the condemnation litigation is not to be considered;¹¹⁹ except, it must be considered if the true origin of the claim is disguised.

In a condemnation, efforts to currently deduct a prorata portion of the legal fees incurred in connection with a condemnation by allocating these fees between the condemnation award and the statutory prejudgment interest on that

112. *Mitchell*, 96-1 U.S. Tax Cas. (CCH) ¶ 50,042, at 83,158-59.

113. *Id.* at 83,159.

114. *See supra* notes 34-38 and accompanying text.

115. *Mitchell*, 96-1 U.S. Tax Cas. (CCH) ¶ 50,042, at 83,157.

116. *See Woodward v. Commissioner*, 397 U.S. 572, 579 n.8, (1970); *see also Stokely-Van Camp, Inc. v. United States*, 92-2 U.S. Tax Cas. (CCH) ¶ 50,459 (Fed. Cir. 1992).

117. *See Madden v. Commissioner*, 75-1 U.S. Tax Cas. (CCH) ¶ 9415 (9th Cir. 1975), *cert. denied*, 424 U.S. 912 (1975); *see also Foster v. Commissioner*, 86 T.C. 190 (1986).

118. *See Madden*, at 75-1 U.S. Tax Cas. (CCH) ¶ 9415, at 87,068 (9th Cir. 1975), *cert. denied*, 424 U.S. 912 (1975).

119. *See Baylin v. United States*, 94-1 U.S. Tax Cas. (CCH) ¶ 50,029, at 83,114 (Ct.Cl. 1993), *aff’d*, 95-1 U.S. Tax Cas. (CCH) ¶ 50,023 (Fed. Cir. 1995).

award are not successful. “[T]he proper focus is not the proportional recovery of each type of income, but the ‘origin and character of the claim’ with respect to which the legal fees at issue were incurred.”¹²⁰

Settlements

Depending on the origin of the claim, payments made to settle litigation may be characterized as either a capital cost or a business expense.¹²¹ If the litigation being settled involved the purchase or sale of stock or property, settlement payments are capitalized.¹²² Correspondingly, payments made to settle actions for specific performance are capitalized because they are made to preserve title to the property.¹²³ And, if an asset is preserved, these capitalized payments should be allocated to the affected assets.¹²⁴ In the alternative, if title to an asset is not the subject of the litigation, the settlement will be deductible if it can be associated with daily business activities.¹²⁵ If a settlement which is not capitalized is paid by a corporation, it, generally, will be associated with daily business activities of the corporation because of the nature of the entity itself.¹²⁶

Threatened litigation and not merely lawsuits which have been filed must be considered in determining the origin of the claim. In *Eisler v. Commissioner*, the Tax Court determined that the origin of the settlement was not only the law-

120. *Baylin v. United States*, 95-1 U.S. Tax Cas. (CCH) ¶ 50,023, at 87,108 (Fed.Cir. 1995); see *Fulks v. Commissioner*, 57 T.C.M. (CCH) 242 (1989).

121. See *Anchor Coupling Co., Inc. v. United States*, 70-1 U.S. Tax Cas. (CCH) ¶ 9431 (7th Cir. 1970); see also *Eisler v. Commissioner*, 59 T.C. 634 (1973); Rev. Rul. 80-119, 1980-1 C.B. 40; Priv. Ltr. Rul. 9427002 (March 30, 1994); Priv. Ltr. Rul. 9442021 (July 20, 1994).

122. See, e.g. *Fischer v. United States*, 490 F.2d 218, 74-1 U.S. Tax Cas. (CCH) ¶ 9161 (7th Cir. 1973); see also *Clark Oil and Refining Corp. v. United States*, 73-1 U.S. Tax Cas. (CCH) ¶ 9214 (7th Cir. 1973); *Barrett v. Commissioner*, 96 T.C. 713 (1991); *Dogali v. Commissioner*, 69 T.C.M. (CCH) 1759 (1995).

123. See *Anchor Coupling Co., Inc.* at 70-1 U.S. Tax Cas. (CCH) ¶ 9431, at 83,535.

124. 70-1 U.S. Tax Cas. (CCH) ¶ 9431 at 83,536. The Seventh Circuit agreed with the Service that the settlement should be viewed as a repurchase of its assets at a premium which would then be included in the book value of Anchor’s assets. *Id.* (An allocation similar to that is used in § 1060.)

125. Priv. Ltr. Rul. 9427002 (March 30, 1994), ruled that an anti-trust settlement was deductible because it resulted from the daily operations of a railroad and, in the long-term, did not eliminate competition; Priv. Ltr. Rul. 9442021 (July 20, 1994), ruled that the payment in settlement of a class action suit concerning the adequacy of financial statement disclosures was deductible.

126. See, e.g. *Kopp’s Co. Inc. v. United States*, 80-2 U.S. Tax Cas. (CCH) ¶ 9747 (4th Cir. 1980) (permitting a deduction of a settlement paid by a corporation as a result of an automobile accident in which the car was driven by the child of the corporation’s sole shareholder and president); see also *Naporano Iron and Metal Co. v. United States*, 84-2 U.S. Tax Cas. (CCH) ¶ 9867 (Ct.Cl. 1984) (permitting the deduction of a settlement paid to a former employee who was injured in a brawl with a company official).

suits which had been filed but also the negligence suit that was threatened.¹²⁷ While the lawsuit began with a claim relating to stock purchased under an Employment and Stock Purchase Agreement, the negligence claim was of primary importance to the litigants at the time the lawsuit settled. The character of the controversy was modified during the course of the discovery proceeding although the complaint was never amended to add a negligence count. In Revenue Ruling 80-119,¹²⁸ the Service was even more specific. That ruling states: "Under the origin of the claim test it may be proper for a settlement payment to be allocated to claims that were only threatened as well as those actually made."¹²⁹ Extending the origin of the claim to include threatened litigation was of particular importance in *Eisler v. Commissioner* because the legal fees attributed to the negligence claim were deductible business expenses; whereas, those allocated to the stock purchase were capitalized costs.¹³⁰

Corporate Restructuring

The difficulty in determining the true origin of the claim is particularly apparent in cases involving corporate restructuring; i.e., stock redemptions and reorganizations. To the extent that a taxpayer can relate the expenditure to the operations of the corporation, rather than the restructuring transaction, the more likely the expenditure will be deductible and not capitalized.

Early Cases

One of the early cases which applied the origin of the claim test was *White Star Drive-In Laundry & Cleaners, Inc. v. United States*.¹³¹ A dissident shareholder, who owned fifty percent of the corporation's stock, filed a lawsuit seeking dissolution of the corporation. In settlement, the corporation redeemed the dissident shareholder's stock and deducted the amount as a business expense.¹³² Applying the origin of the claim test, the District Court found the origin of the expenditure was the stock redemption which is a non-deductible capital transaction.¹³³

Unlike the case of *Eisler v. Commissioner*,¹³⁴ the District Court in *White Star Drive-In Laundry & Cleaners, Inc. v. United States* did not find a sec-

127. 59 T.C. 634 (1973).

128. 1980-1 C.B. 40 (1980).

129. *Id.*

130. *Eisler v. Commissioner*, 59 T.C. 634 (1973).

131. 72-2 U.S. Tax Cas. (CCH) ¶ 9683 (N.D. Ill. 1972).

132. *Id.* at 85,686-87.

133. *Id.*

134. 59 T.C. 634 (1973).

ond issue, either stated or threatened, that would support even a partial deduction. Perhaps, if the dissident shareholder's dissatisfaction with the management of the company could have been shown to have arisen from the negligent or fraudulent actions of management, then at least a portion of the settlement may have been deductible.¹³⁵

While *White Star Drive-In Laundry & Cleaners, Inc. v. United States* considered the deduction of the legal fees incurred by the acquiring corporation, *Newark Morning Ledger Co. v. United States*¹³⁶ considered the deduction of legal fees incurred by the shareholder. In this case, the Third Circuit determined that origin of the legal fees incurred by Ledger, a shareholder who owned eighty-seven percent of the stock of Republican, was to protect Ledger's investment from the siphoning-off of Republican's earnings to a pension fund and certain individuals.¹³⁷ The Third Circuit distinguished its ruling from that of other cases because neither the purchase price paid by Ledger for the Republican stock nor the value of the Republican stock were in question:

...Although Ledger's litigation came soon after its acquisition of Republican, the Government has failed to establish a nexus between the litigation and the acquisition. The aforementioned cases all recite price, time of payment, security for the sale, or method of treatment of the proceeds of a sale as the connection that placed the litigation as part and parcel of the acquisition or disposition process. No similar connection exists between Ledger's acquisition and its litigation.¹³⁸

Since neither the acquisition or disposition of stock occurred in *Newark Morning Ledger Co.*, the Third Circuit could more easily find that nexus was missing and look at the nature of the stockholder's derivative suit as being one to protect Republican, in which it owned stock, as well as to protect its investment in Republican.¹³⁹ The Third Circuit noted that expenses of a derivative suit are normally deductible by the corporation itself and, generally, the expenses of a shareholder in a successful derivative suit are chargeable to the corporation itself.¹⁴⁰

135. *White Star Drive-In Laundry & Cleaners, Inc. v. United States*, 72-2 U.S. Tax Cas. (CCH) ¶ 9683 (N.D. Ill. 1972). The District Court in discussing its conclusion noted that the alternative to the redemption settlement would have been a liquidation and that costs of a liquidation would also have been capital in nature. *Id.* This statement, however, was in error. Liquidation expenses, with the exception of expenses relating to sales of an asset are generally deductible. *Id.*; Rev. Rul. 77-204, 1971-1 C.B. 40. This misinterpretation may have influenced the decision of the District Court.

136. 76-2 U.S. Tax Cas. (CCH) ¶ 9523 (3rd Cir. 1976).

137. *Id.* at 84,657-58.

138. *Id.*

139. *Id.*

140. *Newark Morning Ledger Co.*, 76-2 U.S. Tax Cas. (CCH) ¶ 9523, at 84,657.

Hostility

The potential consequences of a claim on the business operations of the taxpayer are not to be considered under the origin of the claim test regardless of how hostile the motivation. In Letter Ruling 9144042,¹⁴¹ a corporation sought to deduct amounts it would pay to redeem stock at a premium to prevent a hostile takeover and to reimburse the corporate raider for its fees and cost related to the failed takeover. The Service denied a deduction for either amount because the origin of the claim, a stock redemption, was a capital transaction.¹⁴² Motivation was not relevant because whether the expense met the requirements of I.R.C. Section 162 was not at issue.

Recently, the Federal Circuit Court of Appeals, applied similar logic to deny a deduction in *Stokely-Van Camp, Inc. v. United States*.¹⁴³ The corporation tried to argue that the premium it paid to redeem its stock was deductible because the redemption was to prevent a disruption in its business activities. The Court rejected this argument considering motivation to be immaterial.¹⁴⁴ The origin of the claim was a stock redemption; i.e., a non-deductible capital transaction.

The corporation in *Stokely-Van Camp* relied on *El Paso Company v. United States*¹⁴⁵ in attempting to deduct the premium it paid. In *El Paso Co.*, the Federal Circuit concluded that at least some of the expenses incurred in formulating two divestiture plans were deductible because the plans, developed to comply with a divestiture ordered by the Supreme Court, subsequently, were rejected by the Supreme Court.¹⁴⁶ In distinguishing *El Paso Co.*, the Federal Circuit in *Stokely-Van Camp* stated:

...Unlike the divestiture in *El Paso*, SVC's decision to redeem its stock was wholly voluntary, a decision it would not have made unless it considered the decision to be in its own best interest.¹⁴⁷

Yet, by choosing to distinguish *El Paso Co.* on this basis, the court left open the argument that some expenses incurred in a court ordered divestiture, which are not held to benefit the corporation, will not be controlled by the origin of the claim test and will be deductible as business expenses.¹⁴⁸

141. Priv. Ltr. Rul. 9144042 (July 1, 1991).

142. *Id.*

143. 92-2 U.S. Tax Cas. (CCH) ¶ 50459 (Fed. Cir. 1992).

144. *Id.* at 85,572.

145. 82-2 U.S. Tax Cas. (CCH) ¶ 9711 (Fed. Cir. 1982).

146. *Id.* at 85,572-74.

147. *Stokely-Van Camp, Inc.*, 92-2 U.S. Tax Cas. (CCH) ¶ 50,459, at 85,572.

148. *El Paso Co.*, at 82-2 U.S. Tax Cas. (CCH) ¶ 9711 (Fed. Cir. 1982). *El Paso Co. v. United*

After Enaction of I.R.C Section 162(k)

In 1986, in response to the corporate take-overs of the 1980's, Congress enacted I.R.C. Section 162(k). It provides that amounts paid or incurred in a stock redemption are nondeductible. A corporation's right to deduct amounts paid to redeem its stock was extremely doubtful before enactment of I.R.C. Section 162(k) due, at least in part, to the development and application of the origin of the claim test.¹⁴⁹

This disallowance provision makes an exception in I.R.C. Section 162(k)(2) for interest expense. In other words, if the origin of the transaction is a stock redemption, the corporation is denied a deduction for all related expenditures other than interest.¹⁵⁰ The application of the origin of the claim test after the enactment of I.R.C. Section 162(k) has been considered in two recent cases; i.e., *United States v. Kroy (Europe) Ltd.*¹⁵¹ and *Fort Howard Corp. v. Commissioner.*¹⁵²

In *United States v. Kroy (Europe) Ltd.*, the taxpayer incurred expenses to borrow money to redeem its own stock and take the company private in a leveraged buy out. The Ninth Circuit agreed with the taxpayer and found that two separate and independent transactions were involved; i.e., a stock redemption and a borrowing transaction.¹⁵³ It then applied the origin of the claim test and found the expenses incurred to borrow the money were deductible.¹⁵⁴ Although the funds were used to redeem the stock, the borrowing was a separate transaction and, under the origin of the claim test, the business purpose for borrowing the funds was irrelevant.¹⁵⁵

States, initially, stated the origin of the claim test was not applicable in a divestiture case when authority existed which was directly on point. *Id.* at 709. Further, it noted that *Woodward v. Commissioner*, 397 U.S. 572 (1970), referred only to acquisitions and dispositions of capital assets. *Id.* Thereby, taking a limited, rather than expansive, definition of the term. *Id.* at 711. See also *Stokely-Van Camp, Inc.*, 92-2 U.S. Tax Cas. (CCH) ¶ 50,459 (Fed. Cir. 1992) (discussing *Woodward v. Commissioner* and noting that the Supreme Court had rejected the argument that expenses incurred involuntarily should not be capitalized.) The court distinguished *El Paso Co.*, it chose to raise the voluntary, as opposed to the involuntary, nature of the expense. *Id.* See also *E.I. du Pont de Nemours & Co. v. United States*, 432 F.2d 1052, 70-2 U.S. Tax Cas. (CCH) ¶ 9645 (3d Cir. 1970) (finding that a forced divestiture did benefit the corporation so that expenses were not deductible).

149. B.BITTKER AND J.EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 5.04(6) n.131. (6th ed. 1994).

150. In 1996, I.R.C. Section 162(k)(2) was amended to exempt expenditures to obtain a loan which are amortizable from nondeductibility. For further explanation of these expenditures see *infra* notes 151-61 and accompanying text.

151. 94-2 U.S. Tax Cas. (CCH) ¶ 50,316 (9th Cir. 1994).

152. 103 T.C. 345 (1994).

153. *Kroy (Europe) Ltd.*, 94-2 Tax Cas. (CCH) ¶ 50,316, at 85,071-72.

154. *Id.*

155. Section 163(d) and (h), as amended in 1986, made the purpose of a borrowing transac-

The Tax Court, however, in *Fort Howard Corp. v. Commissioner* criticized the decision of the Ninth Circuit in *United States v. Kroy (Europe) Ltd.*¹⁵⁶ It disagreed with the assumption made by the Ninth Circuit that the inquiry as to the characterization of financing costs is the same as that contemplated by the origin of the claim test.¹⁵⁷ It noted that the origin of the claim test arose out of a need to determine whether the expenses in defending a lawsuit were business or personal, current or capital.¹⁵⁸ In this case, however, characterization was not the issue. All parties agreed that the financing costs were capital.¹⁵⁹ Rather, the issue was the effect of I.R.C. Section 162(k) on a capitalizable expenditure. It stated that “[t]he origin of the claim test provides no answer to this question.”¹⁶⁰

The Tax Court, however, did go on to discuss the origin of the claim test:

If we were to apply the origin test here, we could also be forced to look further to the origin of the financing transaction. When we do so, we find that the loan transaction had its origin in the redemption plan. The financing originated in the planning stages of the redemption and nowhere else. At this point, however, the origin of the claim test breaks down. For the redemption was also a consequence of the financing. Thus, the origin test does not help to resolve this case. Nor should we expect it to. It was designed to make substantive distinctions between business and personal expenditures, or between current and capital expenditures. There are no such distinctions to be made here.¹⁶¹

This discussion is consistent with *McKay v. Commissioner*,¹⁶² a case decided earlier in 1994, in which the Tax Court was offered the opportunity to characterize costs incurred by the taxpayer-employee to finance litigation related to a wrongful discharge action. The Tax Court did not use the origin of the claim test.¹⁶³

tion relevant by limiting interest deductions for taxpayers, except corporations, if the interest is either investment interest or personal interest. *Id.* A corporation, however, is not required to determine the purpose of its interest payments in order to obtain a deduction. I.R.C. § 163(d) and (n) (1996).

156. 103 T.C. 345 at 353 (1994).

157. *Id.* at 359.

158. *Id.* at 360-61.

159. *Kroy (Europe) Ltd.*, 94-2 U.S. Tax Case. (CCH) ¶ 50,316, at 85,071 (9th Cir. 1994). While it is true that financing costs were capitalized prior to the enactment of § 162(k), they were amortizable. *Fort Howard Corp.*, 103 T.C. at 345. In applying § 162(2) the court determined that the financing costs were incurred “in connection with the redemption of its stock” and denied any deduction of these costs. *Id.* See also Rev. Rul. 70-360, 1970-2 C.B. 103; Rev. Rul. 70-359, 1970-2 C.B. 103.

160. 103 T.C. at 359.

161. 103 T.C. at 360.

162. 102 T.C. 465 (1994).

163. *Id.* at 488-90.

Instead, it stated that the interest expense was related to the taxpayer's business of being an employee and, therefore, the deduction was denied by I.R.C. Section 163(h)(2)(A).¹⁶⁴ In *McKay v. Commissioner* and, again, in *Fort Howard Corp. v. Commissioner*, the Tax Court treated financing as one part of a larger transaction (i.e., business employment in the former and redemption in the latter) and determined the tax character based on this larger transaction.¹⁶⁵

It is interesting to note, however, that the Tax Court in *McKay v. Commissioner* applied the origin of the claim test to characterize other litigation costs incurred by the taxpayer.¹⁶⁶ Specifically, the Tax Court allowed the taxpayer a deduction for costs to defend himself against a shareholder derivative suit.¹⁶⁷ Relying on *Gilmore v. United States*¹⁶⁸ and *McKeague v. United States*,¹⁶⁹ it concluded that litigation costs are to be segregated based on the various individual claims and evaluated individually using the origin of the claim test.¹⁷⁰

FURTHER EXTENSIONS OF THE TEST: LOSSES

Losses may result when either debts become worthless¹⁷¹ or judgments are paid as a result of attempting to sell invalid property rights.¹⁷² If the loss, however, is to be deductible ordinary loss, it must not arise from a capital transaction. If it does, it will be a capital loss for which deductions are limited. The application of the origin of the claim test to losses, however, represents a further extension of this test.

Guarantees

In *First National Bank of Duncanville v. United States*,¹⁷³ the Tax Court used the origin of the claim test to characterize as a deductible bad debt the Bank's payment of a one-hundred percent payroll tax penalty assessed against it under I.R.C. Section 6672 as a responsible officer. A security agreement gave the Bank

164. *Id.* at 495.

165. *McKay v. Commissioner*, 102 T.C. 465 (1994); *Fort Howard Corp. v. Commissioner*, 103 T.C. 345 (1994).

166. *McKay*, 102 T.C. at 494.

167. *Id.* at 488-89.

168. 372 U.S. 39, 49 (1963).

169. 12 Cl.Ct. 671 (1987), *aff'd without published opinion*, 852 F.2d 1294 (Fed. Cir. 1988).

170. 102 T.C. at 490.

171. *See First National Bank of Duncanville v. United States*, 79-2 U.S. Tax Cas. (CCH) ¶ 9561 (D.C. No. Dist. Tx. 1979).

172. *See Boothe v. Commissioner*, 82 T.C. 804 (1984), *rev'd per curiam and rem'd*, 768 F.2d 1140, 85-2 U.S. Tax Cas. (CCH) ¶ 9615 (9th Cir. 1985).

173. 79-2 U.S. Tax Cas. (CCH) ¶ 9561 (N.D. 1979).

a contractual right of contribution from the debtor.¹⁷⁴ But for the debtor-creditor relationship which existed, and the Bank's desire to protect and maintain the collateral, it would not have become directly involved in the debtor's financial affairs and would not have had a I.R.C. Section 6672 penalty assessed against it.¹⁷⁵ Because of the insolvency of the debtor, the Bank could not collect repayment from the debtor under the right to contribution, the debt arising from the I.R.C. Section 6672 penalty became worthless, and the Bank deducted the payment under I.R.C. Section 166.¹⁷⁶ The right to contribution or indemnity converted an otherwise non-deductible penalty into a deductible bad debt.¹⁷⁷

While a loss is permitted on the payment in release of a guarantee, the guarantee must be a true guarantee.¹⁷⁸ For instance, in *Kisska v. Commissioner*,¹⁷⁹ a debtor argued that a separate payment made by the debtor to obtain a release from a contingent liability, in the nature of a guarantee, was deductible as an ordinary loss under I.R.C. Section 165(a). The Tax Court, however, applied the origin of the claim test and found the debtors were not guarantors.¹⁸⁰ Rather the debtors had paid the separate payment to terminate their own obligation on a promissory note which arose in a capital transaction.¹⁸¹ The payment was treated as a capital loss.¹⁸² Similarly, in *Clay v. Commissioner*, the Tax Court held that amounts paid by a seller under a covenant to indemnify a purchaser for any undisclosed liabilities were entitled only to long-term capital loss treatment as the covenant was part of the agreement for sale of certain stock. In neither of these cases, was the taxpayer a true guarantor.¹⁸³ The original contract of the principal and the guarantor were one in the same. The guarantee was not a collateral agreement for the performance of another's undertaking.¹⁸⁴

Theft Loss

In *Boothe v. Commissioner*,¹⁸⁵ a taxpayer claimed a theft loss under I.R.C. Section 165 because the judgment he paid resulted from a breach of warranty

174. *Id.* at 88,042.

175. *Id.* at 88,043.

176. *Id.* at 88,044.

177. *First National Bank of Duncanville*, 79-2 U.S. Tax Cas. (CCH) ¶ 9561, at 88,044.

178. *See Putnam v. Commissioner*, 352 U.S. 82 (1956).

179. *Kisska v. Commissioner*, 42 T.C.M. (CCH) 1651 (1981).

180. *Id.*

181. *Id.*

182. *Id.*

183. *Clay v. Commissioner*, 42 T.C.M. (CCH) 456 (1981).

184. *See* BLACK'S LAW DICTIONARY 7096 (6th ed. 1990) (One to whom a guarantee is made. This word is also used, as a noun, to denote the contract of guaranty or the obligation of a guarantor, and, as a verb, to denote the action of assuming the responsibilities of a guarantor).

185. 82 T.C. 804 (1984), *rev'd per curiam and rem'd*, 85-2 U.S. Tax Cas. (CCH) ¶ 9615 (9th

action. The rights which the taxpayer sold had previously been sold by his predecessor and his subsequent sale was invalid.¹⁸⁶ Although this case was ultimately reversed in a per curiam decision by the Ninth Circuit, it shows the difficulty in determining the origin of the claim and, also, the disagreement within the Tax Court as to its applicability.¹⁸⁷

In a reviewed decision, the Tax Court applied the origin of the claim test to hold that a sale of invalid property rights was the origin with the payment of the judgment resulting in a capital loss.¹⁸⁸ While ten judges joined in the majority opinion, eight judges, in their dissenting opinions, questioned the application of the origin of the claim test.¹⁸⁹ Judge Hamblen's dissenting opinion, in which five judges joined, contended that the origin of the claim test should not be extended to deductions claimed under I.R.C. Section 165:

Theft loss deductions, under section 165(c)(3), are allowed to individuals without regard to whether the losses arise in connection with the taxpayer's profit-seeking activities. Accordingly, the rationale for the origin-of-the-claim analysis, as expressed by the Supreme Court in *Gilmore* and *Patrick*, is irrelevant to the legal and factual setting of the instant case. The majority has confused the origin-or-the-claim test of *Gilmore*, *Patrick*, and their ilk with the "look-back" rule of *Arrowsmith v. Commissioner*. . . .

Similarly, theft loss deductions, under section 165(c)(3), are allowed to individuals without regard to whether what was stolen was a capital asset in the taxpayer's hands. The Congress might have treated such losses as sales or exchanges, but it did not choose to do so. Rather, the Congress chose to allow an ordinary deduction for a theft loss, even if a sale of the stolen asset would have produced a capital loss deduction (or no deduction at all, if the transaction had not been entered into for profit). Accordingly, it is not relevant in the instant case to analyze whether petitioner's expenditures are capital expenditures.¹⁹⁰

Judge Hamblin refused to apply the origin of the claim test because to do so would subordinate legislative expression to a judicial interpretative concept.¹⁹¹

Cir. 1985).

186. *Id.* at 805.

187. 85-2 U.S. Tax Cas. (CCH) ¶ 9615 (9th Cir. 1985).

188. *Id.*

189. *Id.*

190. *Boothe*, 82 T.C. 813.

191. *Id.* at 806-08.

His analysis is of particular interest because the Tax Court recently adopted a similar analysis in *Fort Howard Corp. v. Commissioner*.¹⁹²

Judge Korner's dissenting opinion, in which one judge concurred, separated the events rather than telescoping them into a single transaction.¹⁹³ As the judgment required the taxpayer to repay the original sales price he had received in the invalid sale, paying the judgment restored the taxpayer's original tax basis.¹⁹⁴ This original basis, Judge Korner treated as a theft loss under I.R.C. Section 165(c)(3).¹⁹⁵ The payment ordered by the judgment itself (increased by the reported capital gain on the original sale transaction), he treated as a capital loss under the origin of the claim test.¹⁹⁶ In a subsequent per curiam decision, the Ninth Circuit Court of Appeals adopted Judge Korner's opinion after first noting the sharp differences of opinion within the Tax Court and the unusual facts.¹⁹⁷

The opinions in *Fort Howard Corp. v. Commissioner* and *Boothe v. Commissioner* question the scope of the origin of the claim test.¹⁹⁸ Should it be used beyond its original purpose which was to distinguish personal from business expenditures and deductible from capitalizable costs. As Judge Hamblin pointed out in his dissent in *Boothe v. Commissioner* extending the origin of the claim test to cases involving I.R.C. Sections 165 and 162(k) would negate Congressional intent to permit or deny a deduction.¹⁹⁹ Applying the origin of the claim test to these cases would subject them to a general purpose test rather than to the specific test enacted by Congress.²⁰⁰

LIMITATIONS

The origin of the claim test is a judicial interpretative concept. As such, its use may not always be appropriate. Statutory tests will take precedence. In *Fort Howard Corp. v. Commissioner*, the Tax Court applied the specific test provided in I.R.C. Section 162(k).²⁰¹ It did not view its decision as a reversion to the primary purpose test or as a rejection of the origin of the claim test.²⁰² Yet, the

192. 103 T.C. 345 (1994); see *supra* notes 113-14 and accompanying text.

193. *Boothe*, 82 T.C. at 809-12.

194. *Id.* at 808.

195. *Id.* at 812.

196. *Id.*

197. *Boothe*, 85-2 U.S. Tax Cas. (CCH) ¶ 9615.

198. 103 T.C. 345 (1994); 82 T.C. 813 (1984), *rev'd per curiam & rem'd*, 85-2 U.S. Tax Cas. (CCH) ¶ 9615 (9th Cir. 1985).

199. *Boothe*, 82 T.C. at 812.

200. *Id.* at 812-14.

201. 103 T.C. 345 (1994).

202. 103 T.C. at 361 (1994).

Ninth Circuit, when confronting similar factual situations, has preferred to first separate the events into two distinct transactions and, then to apply the specific statutory test.²⁰³ It did so in *Boothe v. Commissioner* to permit the theft loss deduction.²⁰⁴ It did so in *United States v. Kroy (Europe) Ltd.* to avoid the application of I.R.C. Section 162(k).²⁰⁵

The distinction between positions of the Ninth Circuit and the Tax Court revolves around differing views of the facts. And, as *Boothe* points out, facts can be viewed differently even by judges who sit on the same court. Because the origin of the claim test is a facts and circumstances test, it will remain a difficult test to apply and, in those cases in which the courts view it as the appropriate test, questions will continue to arise as to how to apply it.

Determining the Origin

In 1973, when the Tax Court applied the origin of the claim test to determine if legal fees were deductible in *Boagni v. Commissioner*,²⁰⁶ it stated:

Quite plainly, the “origin-of-the-claim” rule does not contemplate a mechanical search for the first in the chain of events which led to the litigation but, rather, requires an examination of all the facts. The inquiry is directed to the ascertainment of the kind of transaction out of which the litigation arose....Consideration must be given to the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertaining to the controversy....²⁰⁷

This approach to determining the origin has been cited favorably by the Tax Court in subsequent decisions.²⁰⁸ However, it has not been as well received by the Ninth Circuit.

In *Keller Street Development Co. v. Commissioner*, the Ninth Circuit criticized the Tax Court statement of the origin of the claim test saying its consideration of the objectives of the litigation and the purpose of the claimed deductions

203. *Id.* at 358-59.

204. 82 T.C. at 804 (1984), *rev'd per curiam and rem'd*, 85-2 U.S. Tax Cas. (CCH) ¶ 9615 (9th Cir. 1985).

205. 94-2 U.S. Tax Cas. (CCH) ¶ 50,316 (9th Cir. 1994).

206. 59 T.C. 708 (1973), *acq.* 1973-2 C.B. 1.

207. *Id.* at 713.

208. *See* 103 T.C. at 360; *see also* 82 T.C. 804, 807, *rev'd per curiam and rem'd*, 768 F.2d 1140, 85-2 U.S. Tax Cas. (CCH) ¶ 9615 (9th Cir. 1985); *Keller St. Dev. Co. v. Commissioner*,

was inconsistent with the Supreme Court's rejection of the primary purpose test in *Woodward v. Commissioner*.²⁰⁹ Yet, its criticism fails to recognize that a court applying the origin of the claim test must also determine if a profit-seeking activity exists.²¹⁰

The absence of a profit-seeking activity automatically results in expenditures being nondeductible personal expenses. However, if a profit-seeking activity exists, the origin of the claim test is applied to determine if the profit-seeking activity was the source of the expenditure. In determining if a profit-seeking activity exists, the court will apply a primary purpose test. This primary purpose test, however, is not based on subjective intent as was the "primary purpose" test which was used previously to characterize expenses and which was found inappropriate in *Woodward v. Commissioner*.²¹¹ Rather, as Treasury Regulation Section 1.183-2(a) states, the determination that the primary purpose of an activity is profit-seeking "is to be made by reference to objective standards, taking into account all the facts and circumstances of the case".²¹²

While applying the origin of the claim test requires that the chain of events be examined, the first event in the chain may not represent the origin and character of the transaction. This was evident when the Tax Court in *Eisler v. Commissioner* found the origin of a transaction to be the more recently threatened litigation rather than the lawsuit which was filed.²¹³ The origin of the claim test may not be applied mechanically.

When the origin of the claim test was initially stated by the Supreme Court in *United States v. Gilmore*, characterization of a deductible expense depended on whether or not the claim arose "in connection with" the taxpayer's profit-seeking activities.²¹⁴ An expense is incurred in connection with a transaction if it is concurrent with that transaction.²¹⁵ Likewise, one transaction may be incurred in connection with a prior transaction.²¹⁶ Yet, within the chain of events, dominant factors must determine the origin of the transaction, and expenses incidental to that transaction must be characterized by its nature.²¹⁷ A remote or insub-

37 T.C.M. (CCH) 1451, 1460 (1978), *aff'd*, 688 F.2d 675, 82-2 U.S. Tax Cas. (CCH) ¶ 9601 (9th Cir. 1982).

209. *Keller St. Dev.*, 82-2 U.S. Tax Cas. (CCH) ¶ 9601, at 85,188 (9th Cir. 1982).

210. *See supra* notes 32-46 and accompanying text.

211. *See supra* notes 13-19 and accompanying text.

212. *Id.*

213. 59 T.C. 634 (1973).

214. 372 U.S. 39, 48 (1963).

215. *See United States v. Kroy (Europe) Ltd.*, 94-2 U.S. Tax Cas. (CCH) ¶ 50,316 (1994).

216. *See Berry Petroleum Co. v. Commissioner*, 104 T.C. 584, 619 (1995).

217. *See Boagni v. Commissioner*, 59 T.C. 708, 713 (1973), *acq.* 1973-2 C.B. 1.

stantial factor is not to be considered. Yet, the Eleventh Circuit states that using a “proximate cause approach does not comport with *Gilmore*.”²¹⁸ Rather, the examination in the origin of the claim is to be on the character of the claim and its origin.

Whatever origin is suggested or selected, a relatively direct nexus between it and the expenditure is needed.²¹⁹ Using an analysis similar to the step transaction doctrine might be helpful in determining the correct origin. Can the separate steps of a transaction be viewed as interdependent parts of an overall plan? If so, treat them as a single transaction.²²⁰ The expenditure should be interdependent with the stated origin. In other words, the expenditure would not have occurred but for the origin listed. An alternative way of phrasing this test would be: would a prudent business person have anticipated the realistic possibility of the expenditure when he or she undertook the origin listed. If not, then the origin is too far back in the chain of events to be used.

What, however, is the result if the litigation involving the defense or perfection of title is, itself, insubstantial? While a number of courts have held that any litigation in defense or perfection of title is to be capitalized regardless of whether or not the claim is frivolous, others have acknowledged the issue but have not had to decide it to resolve the case before them.²²¹ Likewise, the substantiality of the property rights themselves which are being defended do not appear to be a concern in determining the origin of the claim.²²²

Dual Origins

In applying the origin of the claim test, “[t]he line of demarcation...is often a shadowy one.”²²³ Dual origins necessitates that ancillary costs which are related to capital assets be distinguished from other costs which should be considered ordinary business expenses.²²⁴ This distinction can be close. Under the

218. *United States v. Collins*, 94-2 U.S. Tax Cas. (CCH) ¶ 50,365 at 85,263 (11th Cir. 1994), *rev’g and remanding*, 92-2 U.S. Tax Cas. (CCH) ¶ 50,557 (N.D. Fla. 1992) (proximate cause was not an appropriate test because the foreseeability of a benefit to the business creditor was not relevant for determining the origin or character of the claim).

219. *See supra* note 102 and accompanying text.

220. *See Century Elec. Co. v. Commissioner*, 15 T.C. 581 (1950), *aff’d*, 192 F.2d 155, 51-2 U.S. Tax Cas. (CCH) ¶ 9482 (8th Cir. 1951), *cert. denied*, 342 U.S. 954 (1950).

221. *See Southland Royalty Co. v. United States*, 78-2 U.S. Tax Cas. (CCH) ¶ 9567, at 84,788 n.14 (1978).

222. *Southland Royalty Co.*, 78-2 U.S. Tax Cas. (CCH) ¶ 9567, at 84,788 n.16 (1978).

223. *Boagni v. Commissioner*, 59 T.C. 708, 712 (1973), *acq.* 1973-2 C.B. 1.

224. *See Honodel v. Commissioner*, 84-1 U.S. Tax Cas. (CCH) ¶ 9133, at 83,097 (9th Cir. 1984).

origin of the claim test, an expenditure is characterized by the nature of the underlying claim. Depending on how an underlying claim is structured, it may be viewed as a single transaction or two distinct transactions which provide dual origins. The case of *Honodel v. Commissioner* provides an example.²²⁵

In *Honodel*, FMS performed two general services for the taxpayer; i.e., an advisory function and an acquisition function²²⁶ For its advisory function, FMS charged all clients a monthly retainer fee which was deductible under I.R.C. Section 212.²²⁷ For its acquisition function, it charged an additional fee for each project in which the client chose to invest.²²⁸ This fee was capitalized under I.R.C. Section 263 as the expense originated in the process of the acquisition itself; whereas, the retainer fee did not.²²⁹ The Ninth Circuit found that the additional fee for investment was an ancillary expense, similar to a brokerage fee, incurred to acquire an asset.²³⁰ While the taxpayer attempted to deduct a portion of this additional fee as an ordinary and necessary expense paid for tax advice, the court concluded that tax advice directly related to a capital acquisition or disposition is an expense which must be capitalized.²³¹

The underlying events in *Honodel* supported a structure of two distinct transactions. That distinction, however, cannot be created if the expenditures are ancillary to the acquisition or defense of specific property. An argument for proportional allocation of the expenditures based on each type of income recovered cannot be supported. The proper focus must be the origin and character of the claim for which the expenditures were incurred.²³²

Once the court has decided to characterize any part of an expenditure as a deductible expense rather than a capitalized cost, an additional step is required to allocate the expenditure.²³³ Several methods of allocation have been accepted by the courts.²³⁴ When litigation resulted in an award which was in part taxable and in part nontaxable, the legal expenses have been allocated based on a ratio of nonexempt income to the total amount awarded.²³⁵ But, if the litigation involves different causes of action, legal fee arrangements and hourly billing records may

225. *Id.*

226. *Id.* at 83,096.

227. *Id.*

228. *Honodel*, 84-1 U.S. Tax Cas. (CCH) ¶ 9133, at 83,096.

229. *Id.* at 83,096-98.

230. *Id.* at 83,098.

231. *Id.* at 83,102.

232. *See supra* note 119 and accompanying text.

233. *Id.*

234. *Id.*

235. *McKay v. Commissioner*, 102 T.C. 465, 490 (1994).

provide a precise amount of legal fees attributable to each action.²³⁶ Finally, with regard to a settlement, the express language of the settlement agreement may be used to allocate the payment.²³⁷ The courts, however, are not bound by the settlement agreement if the parties did not engage in “bona fide, arm’s length, adversarial negotiations” or if the allocations are inconsistent with the true substance.²³⁸

Often, an allocation is not allowed because the taxpayer has failed to provide credible evidence upon which to base a reasonable allocation.²³⁹ Again, because the distinction is close between ancillary costs related to capital assets which are to be capitalized and other costs which are current operating expenses, planning and documentation are critical factors. Regardless of the allocation method applied, records are essential. The taxpayer has the burden of proof when the Service disallows a deduction.²⁴⁰

CONCLUSION

The tax benefits received from a taxpayer’s expenditures depend on their characterization as either currently deductible, nondeductible or capitalizable. The origin of the claim test arose from a search for an objective test on which to base this characterization. It represents a rejection of a test based on consequences which would consider a taxpayer’s motives or purposes in undertaking the expenditure. Has it met these objectives?

The origin of the claim test cannot be applied without first identifying and defining the originating activity. Defining the originating activity requires that the taxpayer’s motives or purposes be considered because they are relevant in defining either a trade or business, an expense incurred in carrying on that trade or business, or the true character of a transaction which may be disguised. Identifying the originating activity becomes problematic as expenses become less directly associated with litigation and as any clear distinction between transactions becomes blurred. These issues intertwine with the origin of the claim test adding uncertainty to its application.

236. *Id.* at 491.

237. *Id.* at 482.

238. *Id.* at 482; *see* McDonald v. Commissioner, 78-2 U.S. Tax Cas. (CCH) ¶ 9631 (2nd Cir. 1978).

239. Honodel v. Commissioner, 84-1 U.S. Tax Cas. (CCH) ¶ 9133, at 83,097 (9th Cir. 1984); Kisska v. Commissioner, 42 T.C.M. (CCH) 1651, 1654-55 (1981).

240. Kisska, 42 T.C.M. (CCH) at 1655 (1981) (citing Welch v. Helvering, 290 U.S. 111 (1933) and Rule 142(a), Tax Court Rules of Practice and Procedure.)

To create greater certainty in characterizing a taxpayer's expenditures, the courts have looked to the form of the originating activity and to the appropriateness of the test itself. If the originating activity is inherently personal, the expense is personal. If the originating activity is to acquire or defend title to an asset, the expense is capitalized. If a statute provides a specific test, it is applied to the exclusion of the origin of the claim test.

The origin of the claim test is a facts and circumstances test. As the court cases show, a facts and circumstances test will always provide room for differing views.

