The Clintons' Legal Defense Fund: Income from Payment of Legal Expenses by Another and Deductibility of Such Expenses

John R. Dorocak

California State University, San Bernardino

Follow this and additional works at: https://researchrepository.wvu.edu/wvlr

Recommended Citation
Available at: https://researchrepository.wvu.edu/wvlr/vol104/iss1/7

This Article is brought to you for free and open access by the WVU College of Law at The Research Repository @ WVU. It has been accepted for inclusion in West Virginia Law Review by an authorized editor of The Research Repository @ WVU. For more information, please contact ian.harmon@mail.wvu.edu.
THE CLINTONS' LEGAL DEFENSE FUND: INCOME FROM PAYMENT OF LEGAL EXPENSES BY ANOTHER AND DEDUCTIBILITY OF SUCH EXPENSES

John R. Dorocak

I. INTRODUCTION ................................................................. 2

II. INCOME FROM PAYMENT OF EXPENSES BY ANOTHER .............. 4
   A. Introduction ........................................................................ 4
   B. General Rules of Income Recognition ................................... 5
      1. Old Colony Trust Co. and Pisani ...................................... 5
      2. Duberstein and IRS Rulings (on Transfers to Politicians) .... 7
   C. The Clintons, Nixon, and the Teamsters .............................. 9
      1. The Clintons .................................................................... 9
      2. Teamsters (O'Malley) ................................................... 11
      3. Nixon (Carson) ................................................................ 13
   D. A Crummey Problem (Crummey and Cristofani) .................... 15
   E. Unfairness (Paula Jones) .................................................. 16

III. DEDUCTION OF LEGAL EXPENSES .................................. 16
   A. Introduction: The General Rules—Gilmore and More (Jenkins and Salt) .............................................................. 16
   B. Politicians, Sexual Harassment, and the Gilmore Test

* Professor of Accounting, California State University, San Bernardino; Honors A.B., Xavier University; J.D., Case Western Reserve University; LL.M. (Tax), University of Florida; C.P.A. California and Ohio. The author thanks Marion Wiltjer whose invaluable and professional assistance was essential to the production of these pages and many others. Thank you also to my graduate assistant Pritpaul Singh, M.B.A., California State University, San Bernardino. And, of course, thank you to my wife Tanya, who constantly inspires me, to our cat Mitzi, who constantly diverts me, and to our son Jonathan, who constantly interests me. Additional thanks to participants at Western Region American Accounting Association Annual Meetings, particularly Richard Emery, Linfield College, and John Karayan, California State Polytechnic University, Pomona, and at Pacific Southwest Academy of Legal Studies in Business annual conferences, to all of whom I have been remiss in expressing gratitude formally in writing for their comments, suggestions, and questions.
Bill Clinton appears to be setting himself up for a tax problem. Some may ask, "How is he going to get out of this one?" The President and Hillary

1 The President's legacy of various, and often self-inflicted, turmoil has been chronicled extensively elsewhere. See, e.g., infra, note 164. See also Eric Lichtblau, Clinton Strikes Indictment Deal; Case Is Dropped as President Admits to False Testimony; Politics: Agreement in Lewinsky Sex Scandal Ends all of the Legal Fallout From Impeachment. He Will Lose Arkansas Law License for Five Years and Pay a $25,000 Fine. L.A. TIMES, Jan. 20, 2001, at A1 (regarding the last-day plea bargain); Deborah Zobar-Enko, Clinton's Cloud of Scandal, REUTERS, Jan. 19, 2001 (regarding Whitewater, Travelgate, Vince Foster, Filegate, Web Hubbell, and Monica). According to papers filed in the Arkansas Supreme Court investigation, Clinton's last-minute deal to avoid indictment was to pay $25,000 in costs to the Arkansas Supreme Court's Committee on Professional Conduct, agree to a five-year suspension of his law license, agree not to seek legal fees from the federal government regarding the Monica Lewinsky investigation, and admit that he "knowingly gave evasive and misleading answers" in a deposition. Clinton himself finally stated, "Certain of my responses to questions about Ms. Lewinsky were false." Lichtblau, supra, at A1. And the fun never stops. Although Clinton agreed not to seek reimbursement for Monica-related fees, he might for others, including legal expenses of the impeachment. See Robert L. Jackson, Legal Fund for Clintons Falls Short in

https://researchrepository.wvu.edu/wvlr/vol104/iss1/7
Rodham Clinton set up not one but two trusts to pay their diverse and mounting legal expenses. The second trust they set up, the Clinton Legal Expense Trust, formed in 1998, raised $7.3 million and paid out all but $500,000 in legal expenses by February 2000. However, the Clintons’ tax returns for 1998 and 1999 have not reported income from the legal defense trust when it paid their legal bills, nor deducted those legal expenses.

Final Accounting, L.A. TIMES, Mar. 15, 2001, at A27. Subsequently, the United States Supreme Court suspended Clinton from practicing before the Court. See Mark Helm, Clinton Law Privileges Eroded More; Supreme Court Suspends His License to Argue Before Justices, SEATTLE POST-INTELLIGENCER, Oct. 2, 2001, at A3.


3 See Sheppard, supra note 2, at 473. The legal expenses of Hillary Clinton, as well as Bill Clinton, will be discussed in this Article. At least some of Hillary’s legal expenses have been paid by the trust, but it is not clear which investigations gave rise to which expenses. See Jackson, supra note 1, at A27 and Clinton Legal Defense Trust website, supra note 2. “Whitewater” initially involved an investment in Arkansas by both Hillary and Bill, and presumably could generate deductible legal expenses. Fellow attorney Web Hubbell’s investigation involved Hillary’s employment at the Rose Law Firm and, thus, also potentially deductible legal expenses. Travelgate and Filegale involved Hillary’s alleged machinations as first lady, not an employee position, and, therefore, it seems, legal fees paid on behalf of Hillary are not deductible legal expenses. Vince Foster’s suicide, itself a murky matter, is similarly unclear regarding deductible expenses. But, if Foster were working on the Rose Law Firm records or the Whitewater investment at the time of his death, presumably expenses regarding the subsequent investigation could yield deductions. For more information regarding the various scandals giving rise to Hillary’s legal expenses, see, e.g., Francis X. Clines, The First Lady Under Oath; Hillary Clinton Answers Grand Jury’s Questions About Law Firm’s Billing Records and “Other Matters,” THE AUSTIN AMERICAN-STATESMAN, Jan. 27, 1996, at A1; Steve Barnes, A Draft Indictment Named First Lady; Jury Never Got Starr Aide’s Document, THE AUSTIN AMERICAN-STATESMAN, Mar. 19, 1999, at A3. “Hillary Clinton was named in an indictment drafted by a top aide to Kenneth Starr, the independent counsel, but the document was never presented to a grand jury . . . .” Robert L. Jackson, Travelgate Inquiry Suggests Signs of Lies by First Lady; Politics: Independent Counsel Says He Will Not Seek to Indict Her, But Memos Indicate Hillary Clinton Had a Role in Firings, L.A. TIMES, June 23, 2000, at A1. Jackson also wrote about a prototypical exchange of comments between the independent counsel and the Clinton administration:

There is “substantial evidence” that the First Lady Hillary Rodham Clinton lied under oath . . . But [independent counsel Robert W.] Ray . . . said
This Article will discuss the various legal issues raised by the Clintons’ current situation with the second legal defense fund. The second part of the Article will discuss whether the Clintons have income from the payment of their legal expenses by the legal defense trust. The third part of the Article will discuss whether the Clintons, if they have includible income, can deduct the legal expenses paid by the trust. Then, the Article will turn to a discussion of whether the Clintons have an alternative minimum tax problem because the legal expenses are not deductible for AMT purposes. Finally, the Article will conclude with a discussion of whether a tax penalty should apply against the Clintons for substantial understatement and against their tax preparer for preparing the tax returns.

II. INCOME FROM PAYMENT OF EXPENSES BY ANOTHER

A. Introduction

It has long been established, since the Supreme Court’s opinion in Old Colony Trust Co. v. Commissioner,\(^4\) that payments of the taxpayer’s expenses by another are income to the taxpayer.\(^5\) In a series of revenue rulings, the IRS has similarly ruled that payments of a public official’s expenses are income.\(^6\) In these rulings the IRS refused to accept the argument that these payments were merely gifts to the public official.\(^7\) In doing so, the IRS necessarily dealt with whether the contributor had a sufficiently disinterested motive to support gift treatment under Commissioner v. Duberstein.\(^8\) Therefore, the discussion of Old Colony Trust, Duberstein and subsequent cases are key to the following discussion of whether the legal defense funds are income.

The Clintons’ first legal defense trust fund, the Presidential Legal Expense Trust, was set up in June 1994 by the Clintons themselves.\(^9\) However, he will not seek to indict Mrs. Clinton because he cannot prove beyond a reasonable doubt that any of her testimony was false . . . The White House declares the report a vindication of the first lady . . . There is no evidence the first lady did anything wrong,” said spokesman Joe Lockhart.

Jackson, supra note 1, at A27.

\(^4\) 279 U.S. 716 (1929).

\(^5\) See id. at 731.


\(^8\) 363 U.S. 278 (1960). In Duberstein, the Supreme Court stated that “[a] gift in the statutory sense . . . proceeds from a ‘detached and disinterested generosity.’” Id. at 285.

\(^9\) See Clark, supra note 2, at 114 and accompanying text; Lee A. Sheppard, News Analysis: https://researchrepository.wvu.edu/wvlr/vol104/iss1/7
this trust could not solicit contributions because of federal regulations restricting gifts to the executive branch,\textsuperscript{10} did not accept donations of $1,000 per year for political reasons,\textsuperscript{11} and "suffered from the taint of questionable foreign contributions before organizers voluntarily abandoned it."\textsuperscript{12} This trust was terminated in December 1997. Shortly thereafter, in February 1998, the second legal defense trust fund, the Clinton Legal Expense Trust, was established.\textsuperscript{13} The second trust, which was set up with former Arkansas Senator David Pryor as grantor, can solicit contributions and accept gifts up to $10,000 per donor per year, except from lobbyists, political action committees, and government employees.\textsuperscript{14} The Office of Government Ethics, through its general counsel, has said that when a legal defense fund is set up by a third party, there are no limits on the size of contributions or how the money is solicited.\textsuperscript{15} Therefore, because a third party set up the second legal defense fund, it avoided two of the three problems associated with the first trust and allowed the second trust to be much more successful in raising legal defense funds.\textsuperscript{16}

\textbf{B. General Rules of Income Recognition}

1. \textit{Old Colony Trust Co. and Pisani}

As introduced above, it is well established that a taxpayer has income when another pays the taxpayer's expenses.\textsuperscript{17} In \textit{Old Colony Trust Co. v. Commissioner}, the United States Supreme Court held that officers of a corporation

\begin{flushleft}
\textit{The Tax Treatment of the Clintons' Legal Defense Fund,} 64 TAX NOTES 12, 12-13 (1994).
\end{flushleft}

\textsuperscript{10} \textit{See} Clark, \textit{supra} note 2, at 147 and accompanying text (citing 5 C.F.R. § 2635.201-.304 (1996)).

\textsuperscript{11} \textit{See id.} at 114-16.

\textsuperscript{12} Jackson, \textit{supra} note 1, at A27. \textit{See also} Lewis, \textit{supra} note 2, at A15. The first trust was shut down in December 1997 after it was reported that Yah Lin Trie, an Arkansas restaurateur, showed up in the defense fund's Washington offices trying to donate $460,000 in sequentially numbered money orders. Later he was indicted for campaign finance abuses. \textit{See} Lewis, \textit{supra} note 2, at A15.

\textsuperscript{13} \textit{See} Robert L. Jackson, \textit{Clinton Bills Top Legal Fund by $4 Million Defense: Trustees Say That Despite $6.3 Million in Private Giving, the President and his Wife Owe So Much That Solicitations Will Continue Indefinitely}, L.A. TIMES, Aug. 13, 1999, at A22.


\textsuperscript{16} Although there are no limits on the size of contributions according to the Office of Government Ethics, the second trust only accepts gifts up to $10,000. This limit is probably to ensure that all donations qualify for the gift tax exclusion.

\textsuperscript{17} \textit{See} Old Colony Trust Co. \textit{v. Comm'r}, 279 U.S. 716 (1929).
had additional income when the corporation paid, in addition to their salaries, the income taxes due on their salaries directly to the federal government. The Court reasoned:

The payment of tax by the employers was in consideration of services rendered by the employee and was a gain derived by the employee from his labor . . . . The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed.\(^{19}\)

The Court rejected the argument that the payments, approved by the Board of Directors above and beyond salaries, were gifts.\(^{20}\) According to the Court, “The payment for services, even though entirely voluntary, was nevertheless compensation within the statute.”\(^{21}\) At first glance, this landmark decision appears quite applicable to Bill and Hillary Clinton.

The two main issues from *Old Colony Trust Co.* that arise in later cases and rulings and also the Clintons’ situation are: (1) whether the payments are for services; or (2) whether the payments are a gift. These two issues are, of course, often intertwined. The question of whether a donor to a political figure has made a gift is one of fact. In a relatively recent case, the Second Circuit, in *United States v. Pisani*,\(^ {22}\) attempted to explain the *Old Colony Trust Co.* rule and reconcile prior rulings of the IRS.\(^ {23}\) In *Pisani*, the only question before the court with relevance to this inquiry was whether the funds, which were contributed to the taxpayer’s political campaign and diverted to personal use, were income per se or whether the determination of income was a question of fact.\(^ {24}\) The court held the matter was a question of fact.\(^ {25}\) More specifically, the court quoted the two-part test of Revenue Procedure 68-19:\(^ {26}\) “If it can be shown that the funds were intended for the unrestricted personal use of the political candidate, then the service will apply the principles set forth in *Commissioner v. [] Duber-"

\(^{18}\) See id. at 729-30.

\(^{19}\) Id. at 729.

\(^{20}\) See id. at 730.

\(^{21}\) Id.

\(^{22}\) 773 F.2d 397 (2d Cir. 1985).

\(^{23}\) See id. at 406-07.

\(^{24}\) See id. at 406. According to the Supreme Court, the determination of whether a gift has been made “must be based ultimately on the application of the fact-finding tribunal’s experience with the mainsprings of human conduct to the totality of the facts of each case.” *Duberstein*, 363 U.S. at 283.

\(^{25}\) See *Pisani*, 773 F.2d at 406.

\(^{26}\) 1968-1 C.B. 810.
stein.” Therefore, to establish that a political contribution was a gift, the donee must meet a two-part test: (1) the donor must have intended the funds for unrestricted personal use by the donee political candidate; and (2) the donor must have had a “detached and disinterested generosity” motive per Commissioner v. Duberstein.

The trial court judge in Pisani apparently relied on Revenue Ruling 54-80, which held that political contributions diverted to personal use were taxable income as a matter of law. The appellate court, however, followed Revenue Procedure 68-19, which modified the IRS’s position and ruled that the matter was a question of fact. The Pisani court also analyzed and distinguished Stratton v. Commissioner. The Tax Court in Stratton held that “the line between an outright gift and a campaign contribution is a very thin line.” The court held that funds received by Stratton, a former governor of Illinois, were nontaxable gifts because of the unequivocal testimony of several individuals who said “they ‘intended’ to make outright gifts to [Stratton] to do with as he pleased with no strings attached.” This is, of course, the first part of the two-part Pisani test; the Stratton court also went on to apply what is essentially the second part of the Pisani analysis. The Stratton court held these transfers met Duberstein because they were made “from a ‘detached and disinterested generosity; out of affection, respect, admiration, charity or like impulses.’

2. Duberstein and IRS Rulings (on Transfers to Politicians)

In Duberstein, the taxpayer provided sales leads to a business associate and received a new Cadillac. Both the taxpayer and the associate testified that the leads were the justification for the new car. Justice Brennan set forth the test for a gift, i.e., the donor’s “detached and disinterested generosity.”

---

27 Pisani, 773 F.2d at 406.
28 See id.
29 1954-1 C.B. 11.
30 See Pisani, 773 F.2d at 406 (citing Rev. Rul. 54-80, 1954-1 C.B. 11, 12).
33 Id. at 280.
34 Id. at 281.
35 Id.
37 See id. at 280-81.
38 Id. at 285. The Court did not find the “detached and disinterested generosity” necessary to prove a gift in the facts of Duberstein. See id. Instead, the Court found that despite the fact that the donor was in no way obligated to give the Cadillac, “it was at bottom a recompense for
In a series of rulings the IRS has applied Duberstein to transfers to politicians to determine whether income was present. In Revenue Ruling 60-14, the IRS ruled there was a lack of donative intent by the members of an organization who contributed funds to a committee to pay legal expenses of the taxpayer, an official of the organization. The taxpayer was an elected official of the organization, which was apparently a labor or similar group, but not a government organization. The Ruling was promulgated the same year as Duberstein but does not cite the case. The Ruling does, however, rely on similar reasoning by emphasizing the members’ purpose of the payments and the “professed aim” of the fund-raising committee, which was “to aid the organization in general through defense of one of its officials.” Therefore, the payments by the committee were not gifts to the taxpayer, but rather constituted gross income to him.

In Revenue Ruling 73-356 and two later discussed rulings, the IRS cited Duberstein and again found lack of donative intent. In the Ruling, two congressmen accepted monies to defray costs of newsletters, the first by soliciting subscription fees solely to defray those costs and the second by soliciting contributions to a segregated bank account. The IRS reasoned, “[W]hen a payment is made by a customer to a taxpayer who provides services to insure continuation of those services, that payment is not a gift.”

Revenue Ruling 73-356 is important for two other decisions contained therein. First, the Ruling stated that performing the functions of a public office is a trade or business per Internal Revenue Code § 7701(a)(26). Second, the IRS stated that an elected official, such as a congressman, can deduct these expenses, but they are employee business expenses deducted “below the line,” otherwise referred to as itemized deductions or expenses deducted “from

Duberstein’s past services, or an inducement for him to be of further service in the future.”

---

39 1960-1 C.B. 16.
40 See id.
41 See id. at 17.
42 Id. at 18.
43 See id.
45 See id. at 32.
46 See id.
47 Id.
48 Hereinafter “I.R.C.”
50 See id. at 33 (stating that “expenses attributable to the performance of a trade or business as an employee are deductible only in computing taxable income”).
In Revenue Ruling 75-146,\textsuperscript{52} the IRS ruled that funds solicited by a U.S. congressman for education and training of interns were not gifts, and therefore were income to the congressman.\textsuperscript{53} The Service cited Duberstein and held that the donors did not have a "detached and disinterested generosity" motive, but rather sought a "more efficient public servant."\textsuperscript{54}

Finally, in Revenue Ruling 76-276,\textsuperscript{55} the Service ruled that contributions of funds to a trust, which was set up to pay a congressman and his staff's travel expenses, were income and not gifts.\textsuperscript{56} Again the Service cited Duberstein and reasoned that donative intent was lacking because the contributors wanted to "enable the Member of Congress to become more accessible to constituents, which, in turn, provides constituents with the opportunity of obtaining more effective representation in Congress."\textsuperscript{57} Also important in the Service's ruling was the statement that contributions to the trust affected the income of the Congressman because he could control the trust by controlling the travel.\textsuperscript{58}

C. The Clintons, Nixon, and the Teamsters

1. The Clintons

Based on the above rulings and the Pisani case, it appears likely that the Clintons will have income from contributions to their legal defense trust. In all four rulings, the IRS found a lack of donative intent, the "detached and disinterested generosity" required by Duberstein.\textsuperscript{59} Additionally, the IRS found that the contributors made the contributions with another intent in mind.\textsuperscript{60}

For instance, in Revenue Ruling 60-14\textsuperscript{61} the IRS held that the donors wanted to aid their organization with the professed purpose of the fund-raising
committee to counteract unfavorable publicity.\textsuperscript{62} In Revenue Rulings 73-356, 75-146, and 76-276 the IRS found that contributors were seeking a more efficient public servant by contributing to or subscribing to a newsletter,\textsuperscript{63} contributing to a fund to educate and train congressional interns,\textsuperscript{64} and contributing to a fund for travel expenses.\textsuperscript{65}

This discussion has focused mainly on the second part of the Pisani analysis, \textit{i.e.}, whether the contributions were gifts under \textit{Duberstein}. If, however, taxpayers such as the Clintons do not first adduce evidence of donative intent for \textquote{\textit{unrestricted personal use}},\textsuperscript{66} then, presumably, the \textit{Duberstein} analysis would never be needed. Yet, self-serving evidence of donor intent may be relatively easy to produce in order to meet the \textquote{\textit{unrestricted personal use}} test.\textsuperscript{67}

In addition, the imposition of a trust between the donor and the beneficiary of the donations does not change the fact that there is income to the taxpayer according to Revenue Ruling 76-276.\textsuperscript{68} Rather, \textquote{the questions of control by, and inurement to the benefit of, the taxpayer, are of prime importance.}\textsuperscript{69} Furthermore, the IRS reasoned, \textquote{the taxpayer can control the distribution of trust funds by determining the extent to which the taxpayer or members of the taxpayer's staff will travel in connection with the discharge of the taxpayer's congressional duties and responsibilities.}\textsuperscript{70}

The Clintons may argue that their trustee, rather than themselves, controlled distribution of the funds. However, under the reasoning of Revenue Ruling 76-276, the Clintons controlled the distribution of the funds by determining the extent to which they would be more or less likely to incur attorney's fees.\textsuperscript{71}

\textsuperscript{62} See \textit{id.} at 17.
\textsuperscript{64} See Rev. Rul. 75-146, 1971-1 C.B. 23, 23.
\textsuperscript{66} United States v. Pisani, 773 F.2d 397, 406 (2d Cir. 1985).
\textsuperscript{67} See Stratton v. Comm'r, 54 T.C. 255, 281 (1970) (stating that \"[s]everal . . . witnesses . . . testified unequivocally that they intended to make \textit{outright} gifts . . . \" (emphasis added)). However, even though self-serving evidence may be used to satisfy the unrestricted personal use test, such evidence may not be used to satisfy the \textit{Duberstein} test. See Comm'r v. Duberstein, 363 U.S. 278, 286 (1960).
\textsuperscript{68} See Rev. Rul. 76-276, 1976-2 C.B. 15, 15 (quoting Mount Vernon Gardens, Inc. v. Comm'r, 298 F.2d 712 (6th Cir. 1962) \textquote{\textit{[T]he creation of a trust . . . is not in and of itself sufficient to prevent the trust money from being treated as income.}}\textsuperscript{\textendash}).
\textsuperscript{69} \textit{Id.} at 15 (quoting Mount Vernon Gardens, Inc. v. Comm'r, 298 F.2d 712 (6th Cir. 1962)).
\textsuperscript{70} \textit{Id.}
\textsuperscript{71} The fact that the President may lack willpower to control certain urges and then decides to hire attorneys would not appear to be viable arguments that he could not control distribution of the funds from the trust.
In fact, in *Pisani*, the court, quoting Rev. Proc. 68-19,\(^2\) stated:

The service will presume in the absence of evidence to the contrary that contributions to a political candidate are political funds, which are not intended for unrestricted personal use of such recipient. If it can be shown that the funds were intended for the unrestricted personal use of the political candidate, then the Service will apply the principles set forth in *Commissioner v. []Duberstein . . .*.\(^3\)

One might ask what the Clintons' position could be other than the seemingly glib answer that contributions to the legal trust are gifts. However, their position clearly appears to be that the contributions are gifts. The law firm Sullivan & Cromwell, which drafted the first trust, took the position that the transfers were not made to help a public official carry out official duties because the legal problems arose before the President took office.\(^4\) This argument is apparently attempting to avoid the Revenue Rulings, which indicate that contributions which aid in carrying out official duties lack donative intent. Also, lawyers for the second trust appear to have decided that the transfers are to be treated as gifts to the Clintons rather than income.\(^5\) This line of reasoning leads to an obvious query: Is helping Bill and Hillary Clinton with attorneys' fees related to their official duties because it enables them to function and restore their reputations?\(^6\)

2. **Teamsters (O'Malley)**

It is hard to resist arguing that the Clintons are in a worse position than Thomas O'Malley, a Teamsters pension fund trustee indicted for taking part in a conspiracy to bribe a United States Senator.\(^7\) In *O'Malley v. Commissioner*,\(^8\) the Tax Court held that (1) O'Malley had income when the pension fund paid his legal fees in the unsuccessful defense of the criminal prosecution for con-

\(^2\) 1968-1 C.B. 810.


\(^4\) *See Sheppard, supra* note 9, at 13.

\(^5\) *See Sheppard, supra* note 14, at 1228.

\(^6\) *See id.* at 1229. *See also infra* notes 198-203 and accompanying text. There is some support for the position that, if defending one's business reputation generates legal expenses, such expenses resulted from a legal claim originating from one's trade or business. *See Jenkins v. Comm'r*, 47 T.C.M. (CCH) 238 (1983) (The Conway Twitty case). *See also infra* notes 126-133 and accompanying text.

\(^7\) *See O'Malley v. Comm'r*, 91 T.C. 352 (1988).

\(^8\) 91 T.C. 352 (1988).
sporadic to commit bribery,\textsuperscript{79} and (2) O’Malley could deduct the legal fees, paid by the pension fund on his behalf as ordinary and necessary business expenses of an employee.\textsuperscript{80} O’Malley argued that no income should be attributed to him because the legal expenses were really those of the pension fund.\textsuperscript{81} However, the court disagreed and held that the legal expenses were personal to O’Malley because the pension fund was not a defendant and it was not shown that the pension fund knew or directed O’Malley’s criminal activity.\textsuperscript{82} In fact, the court held that, even if the pension fund knew or directed the activity, it was not a party to the criminal prosecution.\textsuperscript{83} Most of the contributors to the Clintons’ fund, it is hoped, are neither parties to their legal proceedings nor directed or knew of the activities which are the subject of those law suits.\textsuperscript{84} 

The \textit{O’Malley} case is important for an analysis of the Clintons’ tax situation for two other reasons: employee business expenses and the alternative minimum tax, both of which will be discussed below.\textsuperscript{85} The court held that there was “a significant connection between the activities for which Mr. O’Malley was indicted and his employment” and reasoned that “a taxpayer may be in the trade or business of being an employee and, as such, may deduct business expenses which no employer directs him to incur.”\textsuperscript{86} The court also added that “[d]eregulation threatened to affect the profitability of Mr. O’Malley’s employer, and hence, threatened the security of his employment position.”\textsuperscript{87} Consequently, the court held that the legal expenses were deductible as employee business expenses because they were associated closely enough with the taxpayer’s business of being an employee.\textsuperscript{88} Although the court held the deduction was an itemized deduction, there was not an alternative minimum tax problem under the old alternative minimum tax for the 1981 and 1982 income tax years.\textsuperscript{89} Under the current alternative minimum tax, however, the Clintons

\textsuperscript{79} See id. at 361.

\textsuperscript{80} See id. at 366.

\textsuperscript{81} See id. at 359.

\textsuperscript{82} See id. at 359-60.

\textsuperscript{83} See id. at 360.

\textsuperscript{84} The Clinton situation could only involve so many government employees or friends who might contribute and might have their own legal problems. See Ann Devroy & Ruth Marcus, \textit{Clinton Aides Setting Up Defense Funds to Pay Lawyers’ Bills}, WASH. POST, Feb. 29, 1996, at A1; Lewis, \textit{supra} note 2, at A15.

\textsuperscript{85} See infra notes 119-203 and accompanying text.

\textsuperscript{86} \textit{O’Malley}, 91 T.C. at 363-64 (citing Primuth v. Comm’r, 54 T.C. 374 (1970)).

\textsuperscript{87} Id. at 364.

\textsuperscript{88} See id. at 366.

\textsuperscript{89} See id. at 366. See also Groetzinger v. Comm’r, 771 F.2d 269 (7th Cir. 1985).
likely face an AMT problem.  

3. Nixon (Carson)

Rather than relying on a case involving the Teamsters, the Clintons are probably relying on an IRS position refuted in an earlier Tax Court case, Carson v. Commissioner.  

Carson tangentially involved another president who, on a side note, was tied to the Teamsters politically: Richard Nixon. As mentioned, one might regard the Clinton attorneys’ and trustees’ assertions that the contributions to the legal defense fund were gifts rather glib until examining this case, which was apparently used as a stalking horse for cases involving contributors, among others, to the Committee to Re-elect the President (CREEP), which was President Nixon’s fund raising committee.  

In Carson, the taxpayers contributed to, or expended funds for, campaign committees for a number of candidates in and around Kansas City, Kansas, and the IRS asserted a gift tax deficiency against the taxpayers. The taxpayer husband was both an investor in oil and gas producing properties and an attorney in a law firm with prominent governmental clients. The court stated, “These facts do not suggest a gift to the candidate, but the use of petitioner’s resources to promote the social framework petitioner considered most auspicious to the attainment of his objectives in life.”

Thus, the court concluded that petitioner/taxpayer David Carson did not make taxable gifts because he did not have a disinterested motive. In its analysis, the court considered the issue as a question of fact, although the court did not cite Duberstein or Pisani or the IRS rulings discussed above. The court supported its conclusion by reasoning that “[t]his review of the legislative history of the gift tax clearly demonstrates that it was intended to backstop the es-

---

90 The Clintons’ possible alternative minimum tax problem is discussed in Part IV below. See infra notes 204-49 and accompanying text.


94 See Carson, 71 T.C. at 253-54.

95 See id. at 256.

96 Id. at 258.

97 See id.
tate tax." Judge Tannenwald, concurring, joined by Raum and Sterrett, would have held there was no gift "absent a familial or other personal relationship between a candidate and his benefactor." Judge Hall, concurring, joined by Drennan and Goffe, thought an expenditure for "propagation of views of political policy" was "no more a gift to the recipient than is an expenditure for a newspaper advertisement a gift to the paper." The dissenters, Judges Simpson, Chabot, and Quealy, would have held that the transfers benefiting the social framework could be gifts.

The court also noted that, with regard to transfers after May 7, 1974, the gift tax was made inapplicable to transfers to political organizations by I.R.C. § 2501(a)(5). The Carson case remains relevant, however, because the transfers to the Clintons' legal trust are not to a political organization but to individuals. Additionally, although the Tenth Circuit affirmed the Tax Court in Carson, the IRS did not acquiesce in the Carson cases. As mentioned above, the Carson case involved contributions to less prominent politicians and, therefore, may have been used as a stalking horse for contributions to other politicians.

---

98 Id. at 261. Although the Supreme Court in Duberstein may have suggested that there are differences in the definition of "gift" for income tax purposes and gift purposes and despite the fact that the definitional language is different, the two definitions are similar and many courts, including the Carson court, seem to act, with good reason, it seems, as if there is no or little difference. See id.; Comm'r v. Duberstein, 363 U.S. 278, 284. In Duberstein, Justice Brennan, writing for the majority concerning the income tax definition of "gift," stated: "Analogies and inferences drawn from other revenue provisions, such as estate and gift taxes, are dubious." Id. at 286. However, Justice Brennan also rejected "donative intent" and required "an objective inquiry" of a gift. Id. Similarly, in Comm'r v. Wemyss, 65 U.S. 652 (1945), the Supreme Court, in defining "gift" for gift tax purposes rejected, donative intent and required an objective inquiry.

The two definitions of "gift," of course, arise from different statutory sources, I.R.C. § 102 for income tax and I.R.C. § 2512(b) for gift tax. Definitionless § 102 has resulted in interpretations such as Duberstein's "disinterested and detached generosity." On the other hand, § 2512(b) actually provides the definition "less than an adequate and full consideration." If in practicality there is any real difference in these definitions, it seems difficult to fathom. For example, when the court ruled in Carson that transfers to politicians were, by an objective test, to influence the social framework and therefore not gifts under the gift tax, aren't such same transfers not with a disinterested and detached motive to qualify as gifts under the income tax?

99 Carson, 71 T.C. at 264 (Tannenwald, J., concurring).

100 Id. at 265 (Hall, J., concurring).

101 See id. at 275 (Simpson, J., dissenting).

102 See id. at 257 n.5.

103 See id.

104 See Kip Dellinger, Let's See an IRS Ruling on Clinton Legal Defense Fund, 94 Tax Notes Today 141-64 (1994), in which the author explains the following:

In the mid-'70s, I found myself in the ironic position of representing different contributors to each party who were challenged by the IRS.
Thus, the Clintons are apparently relying on an IRS position used against taxpayers and rejected by the Tax Court. This presents an interesting question of whether the IRS will seek to audit the Clintons' tax returns when the Service's own position is that there was no income, only potential gift tax.

D. A Crummey Problem (Crummey and Cristofani)

Even if the Clintons prevail in their argument discussed above, and the transfers to their legal defense trust are gifts, the gifts would still need to be gifts of a present interest for the transferors to claim the gift tax exclusion of $10,000 per donee per year under I.R.C. § 2503(b).\textsuperscript{105} According to Crummey v. Commissioner\textsuperscript{106} and its progeny, the beneficiary of a gift to a trust receives a present interest, which qualifies for the $10,000 annual exclusion, if the beneficiary has a legally unrestricted present right to demand that the trustee distribute the property to him.\textsuperscript{107} In Estate of Cristofani v. Commissioner,\textsuperscript{108} one of Crummey’s progeny, the Tax Court held that five minor contingent remainder beneficiaries received a present interest when they had a right to withdraw funds for a limited time of fifteen days.\textsuperscript{109} Under the Clintons’ second legal defense fund, there is apparently a power to withdraw funds that lapses within thirty days of contribution. This lapsing power would seem to satisfy Crummey and Cristofani.

However, the Clintons have apparently provided a letter to the trustees saying they will not exercise their power to withdraw funds.\textsuperscript{110} It is not clear whether this letter, an advance notice to the Trustees, could deny present interest treatment to the transfers. In Estate of Holland v. Commissioner,\textsuperscript{111} a failure to notify minor beneficiaries constituted merely a factor in the likelihood of with-

The amounts involved exceeded $700,000. Interestingly, our arguments and those made by others challenged on these donations followed along the lines that there was no donative intent involved; that, in fact, the donors intended to gain something from their contributions. That something was to advance their own political and social objectives. The Carson case (Carson v. Comm’r, 71 T.C. 252 (1978), aff’d 641 F.2d 864 (10th Cir. 1981), nonacq 1979-2 C.B. 2) arrived at essentially the same conclusion. In all three of the cases I was involved with, they were placed in suspense and the proposed assessment later withdrawn.


\textsuperscript{106} 397 F.2d 82 (9th Cir. 1968).

\textsuperscript{107} \textit{See id.} at 82.

\textsuperscript{108} 97 T.C. 74 (1991).

\textsuperscript{109} \textit{See id.} at 74.

\textsuperscript{110} \textit{See} Sheppard, \textit{supra} note 14, at 1226.

\textsuperscript{111} 73 T.C.M. (CCH) 3236 (1997).
withdrawal, rather than denial of the right to withdraw.\textsuperscript{112} The court then held there was a present interest.\textsuperscript{113} In dicta, however, the court agreed with the IRS that a tacit understanding in advance not to exercise withdrawal rights might negate a present interest, but found the facts were otherwise.\textsuperscript{114}

The fact that the Clintons may have agreed in advance in writing not to withdraw funds raises the question of whether they received a present interest for gift tax purposes. However, at least one commentator has argued that, when the trust pays the legal bills, there is a constructive distribution to the Clintons, thereby negating their express agreement not to withdraw.\textsuperscript{115}

\textbf{E. Unfairness (Paula Jones)}

One unanswered question from this section is whether the Clintons’ tax returns, which do not report the contributions to the legal defense funds as income, will ever be audited by the IRS in light of its position in Carson that the contributions are gifts. Paula Jones, Bill Clinton’s nemesis in the sexual harassment lawsuit, also established a legal fund.\textsuperscript{116} Her tax return, however, was selected for examination, possibly, according to one commentator, because of her legal fund and the issues associated with it.\textsuperscript{117} As that commentator points out, if the IRS does not audit the Clintons’ returns, an issue of fairness may arise.\textsuperscript{118}

\textbf{III. DEDUCTION OF LEGAL EXPENSES}

\textbf{A. Introduction: The General Rules – Gilmore and More (Jenkins and Salt)}

If the transfers to the Clintons’ legal defense fund are income, then the next logical question becomes whether they can deduct payments made out of that income as a legal expense. In the area of deductions, the Clintons’ potential tax problems seem to involve a number of leading cases, possibly indicating that the nature of these issues go to the fundamentals of tax law. Legal expenses are deductible only if they arise out of a trade or business or an income-producing

\textsuperscript{112} See id. at 3237.

\textsuperscript{113} See id.

\textsuperscript{114} See id. (stating that “if the beneficiaries, trustees, and donor had an agreement or understanding that limited the ability in the legal sense, of the beneficiaries to exercise their right to withdraw the trust corpus, then the beneficiaries may not have received gifts of a present interest”).

\textsuperscript{115} See Sheppard, supra note 14, at 1227-28.


\textsuperscript{117} See id.

\textsuperscript{118} See id.
activity. The determination of whether a claim arises out of a trade or business, deductible under I.R.C. $ 162, or an income-producing activity, deductible under I.R.C. $ 212, depends on several factors.

Interpreting these provisions, the U.S. Supreme Court, in a landmark case, United States v. Gilmore, set forth the basic test for deductibility of legal expenses: the origin of the claim test. The Court stated that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal' and hence whether it is deductible or not." One court has suggested that these factors include "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." Therefore, in determining whether legal expenses are deductible, the issue of whether the expenses are business related or personal depend on how connected the legal expenses are to trade or business or income-producing activity.

Two key cases show how courts have extended the concept of connectedness. In Jenkins v. Commissioner, the Tax Court allowed country western music singer, Conway Twitty, to deduct payments that he made on behalf of his Twitty Burger Restaurants purportedly to protect his music business reputation. The Jenkins court held that "Conway Twitty repaid the investors in Twitty Burger with the primary motive of protecting his personal business reputation" and concluded that "there was a proximate relationship between the payments made to the holders of Twitty Burger debentures and the petitioner's

---

122 See id.
123 Id. at 49.
126 47 T.C.M. (CCH) 238 (1983).
127 Conway Twitty's legal name is Harold Jenkins. See id. at 238.
128 Although these payments were debts to third parties, rather than legal expenses, the case provides guidance for deducting legal expenses because both are deducted as trade or business expenses under I.R.C. § 162 (1994).
129 See Jenkins, 47 T.C.M. (CCH) 238.
130 Id. at 244.
trade or business as a country music entertainer so as to render those payments an ordinary and necessary expense of the business."

In *Jenkins*, there was testimony from a country music expert and the petitioner himself that, in the words of the expert, “a country entertainer’s character, personality, and credit reputation are part and parcel of his role as a singer.” (Or, to suggest a possible lyric to be sung with a deep resonating male voice - ala, say, Waylon Jennings: In country music, your reputation is everything.) Apparently, the testimony was persuasive because the court concluded poetically,

Had Conway not repaid the investors
His career would have been under a cloud,
Under the unique facts of this case
*Held:* The deductions are allowed.

Also, in *Salt v. Commissioner*, the Tax Court allowed a movie script writer to deduct his legal expenses incurred in appearing before the House Committee on Un-American Activities, which was investigating charges of Communist infiltration in the motion picture industry. The *Salt* court explained, in language that also might be helpful to the Clintons:

Applying here the reasoning and expression used in the Heininger case, *supra*, ‘Upon being served’ with a subpoena to appear before the Committee, petitioner ‘was confronted with a new business problem which involved’ his present and future business welfare. Ordinary business prudence demanded that petitioner employ counsel to advise with and represent him in such an emergency.

### B. Politicians, Sexual Harassment, and the Gilmore Test for Deducting Legal Expenses

#### 1. Politicians and Professionals: *McDonald, Lussy, Messina, McDonald, & Soloman*

There are cases involving situations more specific to politicians and

---

131 Id. at 246.
132 Id.
133 Id. at 247 n.14.
134 18 T.C. 182 (1952).
135 See id. at 184-85.
136 Id. at 186.
sexual harassment defendants deducting legal expenses than *Jenkins* and *Salt* that may be even more apropos to the Clintons. In *McDonald v. Commissioner*,\(^ {137} \) for instance, the Supreme Court ruled that a judge seeking office could not deduct campaign expenses as expenditures in his trade or business.\(^ {139} \) Yet, in *Commissioner v. Heininger*,\(^ {140} \) the Supreme Court held that a dentist, who sold dentures by mail and had been charged by the Postmaster General with a fraud order for false claims about his wares, could deduct legal expenses for the unsuccessful fight against the fraud order.\(^ {141} \)

Similarly, in Revenue Ruling 71-470,\(^ {142} \) a public official was permitted to deduct the cost of defending himself against a voter recall. The IRS reasoned in the Ruling that the taxpayer was merely defending his current position rather than campaigning for a new term of office.\(^ {144} \) The Service distinguished campaign expenditures, which are not deductible under *McDonald v. Commissioner*, from the expenses of defending one's business, which are deductible under *Commission v. Heininger*.\(^ {145} \)

In Revenue Ruling 74-394\(^ {146} \) the Service also ruled that a judge could deduct the costs of defending himself against charges of misconduct while in office.\(^ {147} \) The IRS cited another leading case, *Commissioner v. Tellier*,\(^ {148} \) for the

---


138 323 U.S. 57 (1944).


140 320 U.S. 467 (1943). *Heininger* was cited by *Salt v. Comm'r*, 18 T.C. 182 (1952), discussed above. See *supra* notes 134-36 and accompanying text.


142 1971-2 C.B. 121.

143 See *id.* at 121.

144 See *id.*

145 See *id.* (citing *McDonald v. Comm'r*, 323 U.S. 57 (1944) and *Comm'r v. Heininger*, 320 U.S. 467 (1943)).


147 See *id.* at 40. The facts of this ruling differ from *McDonald* because in the ruling the judge was merely defending against charges of misconduct after he was in office, while in *McDonald*, the judge was trying to get elected to office. The trade or businesses of the two taxpayers were different. See *id.*

proposition that legal expenses in the defense of a business-related criminal prosecution, as distinguished from the Postmaster General's fraud order, were deductible as ordinary and necessary business expenses.\textsuperscript{149} In \textit{Tellier}, the taxpayer mounted an unsuccessful defense to a criminal prosecution for violations of the fraud section of the Securities Acts of 1933 and the mail fraud statute.\textsuperscript{150} In the Ruling, the IRS also distinguished \textit{McDonald} as involving expenditures "in seeking election" but "not incurred in carrying on his business of 'judging'."\textsuperscript{151} 

The opposite of an expenditure connected with a trade or business is one which is personal. Personal expenditures are not deductible under I.R.C. § 262.\textsuperscript{152} Often, the cases on deductibility of legal expenses turns on whether they are connected, on the one hand, to a trade or business or, on the other hand, to personal activities. A number of cases have denied deductions of legal expenses where the expenses, according to the courts, were from personal activities. And, somewhat similar to issues that could arise in a Clinton case, these cases even include "sexual perversion" and political candidates, government employees, attorneys, and other professionals. In \textit{Lussy v. Commissioner},\textsuperscript{153} for example, an unsuccessful candidate for local property tax appraiser sued a police officer who noted on a traffic ticket that the taxpayer said he was in an undesirable area looking for a woman.\textsuperscript{154} Taxpayer Lussy later attempted to deduct the legal fees of his suit for defamation, invasion of privacy, and intentional infliction of emotional distress.\textsuperscript{155} The Tax Court held that "the origin of the claim was a personal matter and not connected with petitioner's real estate appraisal business."\textsuperscript{156}

Similarly, in \textit{Messina v. United States},\textsuperscript{157} the taxpayer-plaintiff, an employee of the California Department of Human Resources, tried to deduct legal expenses of defending against an unsuccessful prosecution for sexual perversion.\textsuperscript{158} The Court of Claims explained the \textit{Gilmore} test: "The test might be

\textsuperscript{150} See \textit{Tellier}, 383 U.S. at 687.
\textsuperscript{151} Rev. Rul. 74-394, 1974-2 C.B. 41, 41.
\textsuperscript{152} I.R.C. § 162 (1994). Section 162(a) provides that "[t]here 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." \textit{Id.}
\textsuperscript{153} 70 T.C.M. (CCH) 427 (1995).
\textsuperscript{154} See \textit{id.} at 428.
\textsuperscript{155} See \textit{id.}
\textsuperscript{156} \textit{Id.} at 429. According to the court, "[t]he lawsuit arose from a traffic violation that was unrelated to petitioner's income-producing activities." \textit{Id.}
\textsuperscript{157} 202 Ct. Cl. 155 (1973).
\textsuperscript{158} See \textit{id.} at 157-58. The charge of sexual perversion was not described any further in the reported case. See \textit{id.}
more simply viewed as looking to the origin of the operative facts leading to the litigation rather than the effects of the litigation on the taxpayer.” Then the court denied the deduction, holding that “the legal fees were spent to defend a criminal charge that arose out of personal conduct.”

Although some may claim that Bill Clinton may have been looking for a woman as was taxpayer Lussy, or involved in a situation somewhat similar to Messina, Bill Clinton’s legal problems are easily distinguishable from the situations Lussy and Messina were involved in. Many of his legal expenses were incurred in a civil suit for sexual harassment brought by Paula Jones and for lying under oath, both to the district court hearing the Jones case in Arkansas and to the grand jury in Washington D.C., when he was questioned by the independent counsel regarding the Jones case and his testimony, particularly as it related to White House intern Monica Lewinsky. Thus, applying the Gilmore

159 Id. at 159.
160 Id.
161 See Lussy, 70 T.C.M. at 428.
162 See Messina, 202 Ct. Cl. at 157.
163 See Jackson supra note 13, at A22 (“The Clintons’ legal obligations totaled about $10.5 million from independent counsel Kenneth W. Starr’s inquiry, the Paula Corbin Jones sexual harassment lawsuit and the congressional impeachment battle . . . .”).

If anyone doubts that Clinton lied under oath, District Court Judge Susan Webber Wright, in holding Clinton in civil contempt of court, concluded, “Simply put, the President’s deposition testimony regarding whether he had ever been alone with Ms. Lewinsky was intentionally false and his statements regarding whether he had ever engaged in sexual relations with Ms. Lewinsky likewise were intentionally false.” Jones v. Clinton, 36 F. Supp. 2d 1118, 1130 (E.D. Ark. 1999). Judge Wright later ordered Clinton to pay over $90,000 ($90,686.05) in court costs and opposing counsel’s fees. See Jones v. Clinton, 57 F. Supp. 2d 719, 729 (E.D. Ark. 1999). Judge Wright, and some members of Congress, apparently concluded that Clinton also lied in his grand jury testimony since Judge Wright also wrote, “At his August 17th appearance before the grand jury, the President directly contradicted his deposition testimony by acknowledging that he had indeed been alone with Ms. Lewinsky on a number of occasions during which they engaged in ‘inappropriate intimate contact.’” Jones, 36 F. Supp. 2d at 1128.

In a footnote, she explained as follows:

The President seemed to accept OIC’s characterization of his improper contact with Ms. Lewinsky as “some kind of sex” and as a “physically intimate” relationship. Pres. GJ Test. at 123, 136. Although the President did not disclose any specific sexual acts between himself and Ms. Lewinsky, he did state that oral sex performed by Ms. Lewinsky on himself would not constitute “sexual relations” as that term was defined by plaintiff at his deposition. Id. at 93, 100, 102, 104-05, 151-52, 168. It appears the President is asserting that Ms. Lewinsky could be having sex with him while, at the same time, he was not having sex with her.

Jones, 36 F. Supp. 2d at 1130 n.16.

Also, Judge Wright succinctly summarized the conclusions of the independent counsel, the
test, "[T]he origin[s] of the operative facts leading to the litigation" for Bill Clinton were in employment situations. Paula Jones was an Arkansas state employee when Clinton was employed as governor\textsuperscript{165} and Monica Lewinsky was a White House intern\textsuperscript{166} when Clinton was employed as President. Additionally, it should be noted that Hillary Clinton, however, may have to strain a bit more to connect her legal expenses to employment. She was employed by the Rose Law Firm but not, presumably, by the White House.\textsuperscript{167}

Yet, professionals are not immune to legal expenses being classified as personal. For example, in a different \textit{McDonald v. Commissioner},\textsuperscript{168} this one a Second Circuit case, the court denied an attorney's deduction for a settlement

---

House, and the Senate. \textit{See generally Jones}, 36 F. Supp. 2d 1118. In addition, she called attention to Clinton's settlement payment to Jones of $850,000. \textit{See id.} at 1123.

On September 9, 1998, the Independent Counsel, having concluded there was substantial and credible information that the President committed acts that may constitute grounds for impeachment, submitted his findings from his investigation of the Lewinsky matter to the United States House of Representatives pursuant to 28 U.S.C. § 595(c). The House of Representatives thereupon commenced impeachment proceedings, ultimately passing two Articles of Impeachment against the President, one alleging perjury in his August 17th testimony before the grand jury and the other alleging obstruction of justice in this civil case. The matter then proceeded to trial in the United States Senate. On November 13, 1998, while the impeachment proceedings were taking place in the House of Representatives, the plaintiff reached an out-of-court settlement for $850,000 and withdrew her appeal of this Court's April 1st decision granting summary judgment to defendants. \textit{See Jones v. Clinton}, 161 F.3d 528 (8th Cir 1998); 36 F. Supp. 2d at 1123. Thereafter, on February 12, 1999, the Senate acquitted the President of both Articles of Impeachment.

\textit{See id.} at 1130. Perhaps most damningly, Clinton's own attorney had to admit to Judge Wright that his client's testimony was "misleading and not true."

Indeed, even though the President's testimony at his civil deposition was entirely consistent with Ms. Lewinsky's affidavit denying "sexual relations" between herself and the President, the President's attorney later notified this Court pursuant to his professional responsibility that portions of Ms. Lewinsky's affidavit were reported to be "misleading and not true" and that this Court should not rely on Ms. Lewinsky's affidavit or remarks of counsel characterizing that affidavit. \textit{See Letter of September 30, 1998. The President's testimony at his deposition that Ms. Lewinsky's denial in her affidavit of a "sexual relationship" between them was "absolutely true" likewise was "misleading and not true."

\textit{Jones}, 36 F. Supp 2d at 1130 n.15.

\textit{See Jones}, 36 F. Supp. 2d at 1120 & n.2.

\textit{See id.} at 1121.

\textit{See supra} note 3 and accompanying text.

\textit{592 F.2d 635} (2d Cir. 1978).
paid to avert a threatened lawsuit contesting the will in which several bequests were made to that attorney.\textsuperscript{169} Similarly, in \textit{Solomon v. Commissioner},\textsuperscript{170} not Dr. Soliman's case involving his home office,\textsuperscript{171} the Supreme Court denied an accountant's deduction of expenses to settle a lawsuit for alleged misappropriation of funds of his father's, over which the taxpayer argued he was a trustee.\textsuperscript{172} Yet, Bill Clinton's legal expenses with regard to Paula Jones and Monica Lewinsky do not appear to involve the type of familial situation involved in \textit{McDonald} and \textit{Soloman}, and therefore, would not pose a problem to deductibility.

2. Sexual Harassment and the "Furtherance" Test

Some might argue that Bill Clinton's sexual harassment of Paula Jones while he was governor or lying under oath regarding Monica Lewinsky while he was president did not "further" his business as an employee government official.\textsuperscript{173} The Tax Court adopted this furtherance of the business test in a 1988 memorandum opinion, \textit{Oden v. Commissioner},\textsuperscript{174} in which the court denied deductibility of legal costs incurred defending against a defamation suit.\textsuperscript{175} In \textit{Oden}, the jury found that a sole proprietor florist maliciously defamed a former employee when two prospective employers requested references.\textsuperscript{176} Because the jury found that the defamatory statements were made with malice, the Tax Court held that the legal expenses were not deductible because they did not further the florist's business.\textsuperscript{177} The court distinguished \textit{Tellier}, where a deduction was allowed for legal expenses in a criminal prosecution for violations of fraud under the Securities Act of 1933, because there the fraud furthered the securities business.\textsuperscript{178}

Earlier, in 1934, the Ninth Circuit, in \textit{Pantages Theatre Co. v. Welch},\textsuperscript{179} held that a corporation could not deduct legal expenses incurred while defending its president against a criminal charge of raping a prospective employee during a

\textsuperscript{169} \textit{See id.} at 637-38.

\textsuperscript{170} 33 T.C.M. (CCH) 588 (1974).


\textsuperscript{172} \textit{See Solomon}, 33 T.C.M. (CCH) at 588.

\textsuperscript{173} \textit{See} Brennan & Megaard, \textit{supra} note 137.

\textsuperscript{174} 56 T.C.M. (CCH) 851 (1988).

\textsuperscript{175} \textit{See id.} at 853.

\textsuperscript{176} \textit{See id.} at 851-52.

\textsuperscript{177} \textit{See id.} at 853.

\textsuperscript{178} \textit{See id.}

\textsuperscript{179} 71 F.2d 68 (9th Cir. 1934).
job interview because the legal expenses were not ordinary and necessary as they did not further the corporation's business.\textsuperscript{180} Pantages, however, is somewhat distinguishable, both legally and factually, from Bill Clinton's situation because (1) it predates and conflicts with the leading cases of Gilmore and Tellier; (2) the rape originated from a job interview; (3) there was no liability for the corporation paying the expenses, although there is such liability in sexual harassment; and (4) the Pantages president did not pay his own legal expenses.\textsuperscript{181}

Furthermore, the Tax Court itself, in a 1980 regular opinion, (pre-\textit{Oden}) appears to have rejected, or at least limited, the furtherance test in \textit{Dancer v. Commissioner},\textsuperscript{182} a case in which a taxpayer horse trainer was sued after he hit and injured a child while driving his car from a farm, where he trained horses, to his home office.\textsuperscript{183} The court held that the legal settlement costs were deductible and reasoned that the car trip was integral to the business and, even if it did not further the business, the payment was insignificant.\textsuperscript{184} However, \textit{Dancer} is distinguishable from \textit{Oden} on at least two grounds: the significance of the payment and the fact that the activity (driving versus raping) was a part of the business.

Although the Service appears to have at one point taken an audit position that legal expenses of defending against sexual harassment are not deductible because the sexual conduct does not further the business, other courts still have not adopted this reasoning, and the Tax Court itself has ignored it at times.\textsuperscript{185} In \textit{Clark v. Commissioner},\textsuperscript{186} for example, also an older (1958) regular Tax Court opinion, a magazine subscription company manager paid legal fees in defense of both criminal and civil suits involving an alleged sexual attack on a female applicant during a job interview.\textsuperscript{187} The Court held that the taxpayer-manager was allowed to deduct his legal expenses of defending against the later dismissed criminal charge and his settlement costs in a civil suit.\textsuperscript{188} Also, in 1979, the year before \textit{Dancer}, a General Counsel's Memorandum\textsuperscript{189} stated as follows:

\begin{itemize}
  \item \textsuperscript{180} See id. at 68.
  \item \textsuperscript{181} See Brennan & Megaard, \textit{supra} note 137, at "Problems with the Furtherance Test."
  \item \textsuperscript{182} 73 T.C. 1103 (1980).
  \item \textsuperscript{183} See id. at 1103.
  \item \textsuperscript{184} See id. at 1108-09.
  \item \textsuperscript{185} See id.
  \item \textsuperscript{186} 30 T.C. 1330 (1958).
  \item \textsuperscript{187} See id. at 1332-33.
  \item \textsuperscript{188} See id. at 1336-37.
  \item \textsuperscript{189} Hereinafter "G.C.M."
\end{itemize}
Moreover, even though the particular acts bringing about the criminal charges were beyond the scope of the taxpayer’s duties of employment and were performed for his personal profit to the detriment of the interest of his employer and his position of employment, nevertheless, such charges and the consequent legal costs may find their source in the taxpayer’s profit-seeking activities or the character of the conduct from which such charges arise may be of a “business” nature. If either the source of the charges is in his profit-seeking activities or the character of the charges is of a business nature, the ensuing defense costs will be deductible.  

Two commentators, writing together, have indicated that determining whether legal expenses regarding sexual harassment are deductible depend on the nature of the claim, which taken altogether form a continuum of types of sexual harassment. Claims may arise (1) at the workplace, (2) on business trips, or at business meetings or at a client’s or customer’s work location, (3) with the employer-corporation as defendant, (4) or after work (a romantic relationship) with retaliation at work, or finally, (5) in some way unrelated to the taxpayer’s business.

Along these lines, in *Finger v. United States*, a district court denied the deduction of legal expenses to a doctor-taxpayer incurred in defending against a lawsuit brought by his nurse’s husband for loss of consortium and medical expenses. The husband claimed the taxpayer addicted his wife to narcotics, had sexual relations with her, and performed an abortion on her. The court held the lawsuit arose out of the taxpayer’s personal relations and, therefore, the legal expenses of the lawsuit were not deductible. However, at least one commentary has suggested that the taxpayer in *Finger* could have deducted the legal expenses if the wife-nurse had brought a lawsuit because her claim was related to the doctor’s business, or arose in it, although the husband’s claim was not so business related but rather “personal.”

---

191 See Brennan & Megaard, *supra* note 137, at “Deductions in Harassment Cases.”
192 See id.
194 See id. at 313.
195 See id. at 313-14 n.2.
196 See id. at 314.
197 See Brennan & Megaard, *supra* note 137, at “Deductions in Harassment Cases.”

If a claim arising from personal activities results in a claim unrelated to the taxpayer’s business, however, the legal expenses will be nondeduct-
tary’s intricate interpretation of *Finger*, Bill Clinton’s defense expenses regarding the *Jones* litigation and subsequent grand jury investigation would still be deductible as related to his business of, at least, being governor, or possibly, being President, as discussed immediately below.

C. Gilmore, the Clintons, and Deducting Legal Expenses

Bill Clinton’s legal expenses, arising from testifying to the grand jury when questioned by the independent counsel and from lying in a deposition in the *Jones* case while President, seem clearly connected to, or arising in, his trade or business of being employed as President under the *Gilmore* test of origin of the claim. Furthermore, Bill Clinton’s legal expenses in defending against the sexual harassment lawsuit brought by Paula Jones also are related to a claim with its origin in his trade or business, this time because he was governor of Arkansas at the time of the alleged harassment. Or, as one commentator has suggested, the cost of protecting his reputation while President, by defending against the *Jones*’ lawsuit, may be deductible under *Gilmore* as connected to the trade or business of being President because protection of reputation is necessary to carry on that trade or business.198 There is some authority, such as the *Jenkins* case discussed previously,199 to support the proposition that legal expenses to defend one’s reputation are deductible, where reputation is closely related to the taxpayer’s employment.200 It would be logical to conclude that it is very important for a president to maintain his or her reputation.

The fact that Bill Clinton’s behavior was not in furtherance of his employers’ interests does not appear relevant to deductibility under *Gilmore, Dancer, Clark*, and G.C.M. 38,112, despite *Oden* and *Pantages Theatre*. However, if Bill Clinton’s behavior had to be in furtherance of his employers’ inter-

---

198 See Sheppard, supra note 9, at 15; Sheppard, supra note 14, at 1229-30.
199 See supra notes 126-33 and accompanying text.
200 See generally Jenkins v. Comm’r, 47 T.C.M. 238 (1983) (The Conway Twitty case); Draper v. Comm’r, 26 T.C. 201 (1956); Dorocak, supra note 125.
ests, per *Oden* and *Pantages Theater*, his potential deduction of legal expenses would seem thwarted. Perhaps one way to distinguish *Oden* and *Pantages* from the other authority is that they involve wrongs or crimes, specifically malicious defamation and rape, which are clearly not part of doing business.\(^{201}\) Even this attempted distinction may fail in light of *Gilmore*’s origin of the claim language and similar language in G.C.M. 38,112.\(^{202}\) Consequently, Bill Clinton will probably be able to deduct the legal expenses if they are income. Finally, if any of Hillary Clinton’s legal expenses have been paid by the trusts,\(^{203}\) she would similarly have to link the origin of her expenses to employment of hers. The position of first lady, however, does not appear to be one of an employee or a trade or business, and therefore might have a more difficult time in deducting her legal expenses paid by the trusts.

IV. ALTERNATIVE MINIMUM TAX AND THE EXCLUSION FROM INCOME OF DEFENDANT’S ATTORNEY’S FEES IN TRUST

A. The AMT Problem: Attorney’s Fees as Non-Deductible Miscellaneous Itemized Deductions

At this point, it should seem clear that the Clintons have income under the longstanding rules, such as *Old Colony Trust*, for the payments of their legal expenses by their second legal defense trust and can likely take an offsetting deduction of those legal expenses paid. Legal expenses of an employee are deducted as itemized deductions, below the line, under miscellaneous itemized deductions subject to the 2% of AGI floor.\(^{204}\) Employee business expenses, however, are not deductible for the AMT and thus are added back to taxable income to reach alternative minimum taxable income.\(^{205}\) An AMT problem arises with the deduction of legal expenses, but also may present a solution. Recently, some commentators have argued that winning plaintiffs in a lawsuit could avoid the add back of deductible employee legal expenses, and, consequently, avoid the AMT problem, by arguing that such plaintiff-taxpayers never received income when their attorney’s fees were a contingent percentage of their income.

\(^{201}\) See *Oden v. Comm’r*, 56 T.C.M. (CCH) 851, 851-52 (1988); *Pantages Theatre Co. v. Welch*, 71 F.2d 68, 68 (9th Cir. 1934).

\(^{202}\) See supra notes 121-25, 189-90 and accompanying text.

\(^{203}\) See *Jackson*, supra note 13, at A22. *See also Clines, supra* note 3, at A1; *supra* note 2 and accompanying text.

\(^{204}\) See *Alexander v. Comm’r*, 69 T.C.M. (CCH) 1792 (1995) (citing I.R.C. §§ 162(a) (trade or business expenses deductible), 62(a)(1) (employee business expenses not deducted for AGI), 67(a) (imposing the 2% for miscellaneous itemized deductions)).

\(^{205}\) See *id.* at 1792 (citing I.R.C. §§ 55 and 56(b)(1) (disallowing miscellaneous itemized deductions as defined in 67(b))). See also *Kip Dellinger, The Clinton Legal Defense Fund: The Tax Issue Remains Unanswered*, 97 TAX NOTES TODAY 159-44 (1997); *Sheppard, supra* note 2 at 472-474.
lawsuit proceeds.\(^{206}\)

The Clintons, if they indeed have income from payment of the legal expenses by the trust and a deduction for those expenses, will fall precisely within the AMT disallowance of employee business expenses. However, the Clintons, as defendants, might try an argument that they had no control over the funds of the trust to extend the funds paid attorneys’ fees. This argument has had some success, as discussed below, when winning plaintiffs have argued that they have no control over awards to the extent the awards pay attorneys’ fees.

B. **Cases Excluding Plaintiff’s Attorney’s Fees** – Cotnam, Clarks, Baylin, Coady, and Kenseth

For years taxpayers have faced the problem of income from lawsuit awards and settlements, without always receiving a corresponding deduction for legal expenses. As mentioned above, legal expenses, which are miscellaneous itemized deductions as employee business expenses, are not deductible for the AMT.\(^{207}\) Plaintiff-taxpayers have attempted a variety of creative methods to obtain the deduction or to exclude the portion of an award or settlement paid out as their attorneys’ fees.\(^{208}\) Although the Clintons are, as defendants, distinguishable from the plaintiffs who have succeeded in these attempts, some of the theories used to exclude plaintiffs’ legal fees may be used to exclude or deduct their legal fees as defendants.

1. **Cotnam**

In the leading case for plaintiffs excluding legal fees from an award, *Cotnam v. Commissioner*,\(^{209}\) a purported legatee of an estate sued for a one-fifth share.\(^{210}\) A three-judge panel of the Fifth Circuit agreed that the award was for past services rendered because the deceased had promised the plaintiff Cotnam a


\(^{207}\) See supra notes 204-05 and accompanying text.

\(^{208}\) See supra note 206. This currently hot topic of whether a plaintiff-taxpayer can truly deduct or exclude attorney’s fees from an award or settlement is thoroughly discussed elsewhere. See supra note 206. This topic is raised here only for the proposition that the Clintons might try to use the theories being developed regarding plaintiff’s legal fees to exclude or deduct their defendants’ legal fees.

\(^{209}\) 263 F.2d 119 (5th Cir. 1959).

\(^{210}\) See id. at 119.
one-fifth share of his estate if she cared for him for the rest of his life.\textsuperscript{211} However, the judges disagreed as to whether plaintiff Cotnam could include as income her litigation award net of attorney’s fees.\textsuperscript{212} Judge Wisdom dissented believing that \textit{Helvering v. Horst},\textsuperscript{213} on assignment of income, and \textit{Old Colony Trust}, on payment of one’s expenses by another, controlled and required income recognition.\textsuperscript{214} The majority, in effect, excluded the attorney’s fees from Cotnam’s award by allowing her to include only the net amount on the theories that (1) plaintiff Cotnam had nothing to assign as income because her claim was “worthless without the aid of skillful attorneys”\textsuperscript{215} and (2) her obligation to make payments of attorneys fees was only contingent and therefore outside \textit{Old Colony Trust Co.}\textsuperscript{216} Although Judge Wisdom dissented from the conclusion regarding the attorney’s fees, he wrote for the majority on whether the award was a bequest or payment for past services.\textsuperscript{217} In doing so, Judge Wisdom sought to categorize the majority’s holding on the exclusion of the attorney’s fees from income as dependent upon the Alabama Attorney Lien Statute.\textsuperscript{218}

2. Clarks

The Sixth Circuit has adopted the \textit{Cotnam} result, but the Federal Circuit, Ninth Circuit, Third Circuit, and Tax Court have rejected \textit{Cotnam}.\textsuperscript{219} In \textit{Estate of Arthur Clarks v. United States}\textsuperscript{220} the Sixth Circuit allowed a plaintiff to exclude part of an award paid to his attorneys.\textsuperscript{221} A jury had awarded the plaintiff $5.6 million against K-Mart for head injuries, as well as another $5.7 million in post-judgment interest.\textsuperscript{222} The $5.6 million was excluded as personal injury damages under Internal Revenue Code § 104(a)(2) but the $5.7 million was in-
cludible. The court held that the plaintiff could exclude the $1.9 million of contingent attorney’s fees on the $5.7 million interest by following Cotnam and reasoning that the Michigan Attorney Lien Statute was similar to that of Alabama’s.

3. Baylin

In Baylin v. United States, the Federal Circuit rejected Cotnam and reasoned that an attorney lien statute does not override assignment of income cases. In Baylin, a plaintiff partnership sought a higher evaluation for property seized by the state of Maryland. The court held that no part of the attorney’s fee was allocated to and excluded from an interest recovery but all of the fee was a non-deductible capital expenditure. The Baylin court thereby forced a capital, rather than an ordinary, treatment of the fees which offset gain on the state’s condemnation award.

4. Coady

In Coady v. Commissioner, the Ninth Circuit rejected Cotnam and Estate of Clarks and adopted Baylin. The court reasoned that (1) “attorneys do not have a superior lien or ownership interest” in Alaska, (2) the defendant paid the full amount to the plaintiff and the plaintiff then paid the attorney’s fees, and (3) the assignment of income doctrine applies. At least one commentator has said that these cases use a “three-pronged analysis” of “attorney lien statutes, the assignment-of-income doctrine, and Old Colony Trust analysis.”

See id. at 855-58.
See id. at 856.
43 F.3d 1451 (Fed. Cir. 1995).
See id. at 1454-55.
See id. at 1452.
See id. at 1455.
See id. at 1453-54.
213 F.3d 1187 (9th Cir. 2000).
See id. at 1189-91.
Id. at 1190.
See id.
See id. at 1191 (citing Lucas v. Earl, 281 U.S. 111 (1930); Helvering v. Horst, 311 U.S. 112 (1940)).
Geier, supra note 206, at 549.
5. **Kenseth**

In *Kenseth v. Commissioner*, the Tax Court also held that attorney's fees were not excludable from an award. Kenseth was a member of a class action lawsuit under the Federal Age Discrimination in Employment Act. Under the contingent fee contract, 40% was due the attorneys (46% in the case of an appeal), and Kenseth's award was paid into an attorneys' trust account with Kenseth receiving only the amount net of attorney's fees. In a reviewed opinion, the Tax Court split, with eight judges in the majority opinion and five dissenting. The majority used the assignment of income doctrine and declined to use the attorney lien statute argument in holding inclusion of the full award, including fees, was required. Judge Chabot, in one dissent, rejected the application of the assignment of income cases because of "hardship" and was unwilling to await a change in the alternative minimum tax rules by Congress as was the majority. Judge Beghe, the presiding judge at trial, also rejected the assignment of income cases, but specifically because "Kenseth did not retain enough control over his claim."

6. **The Clintons and Excluding Defendant's Attorney's Fees**

As discussed above, the Clintons fall squarely into an AMT problem if they have income from the trust payments of legal expenses and select to deduct those expenses as employee business expenses. Could the Clintons argue *Cotnam* for themselves as defendants with legal fees, saying that they never had income from a trust, whose proceeds were used to pay their attorneys' fees, because they never had any control over income? This argument was discussed above in the context of Revenue Ruling 76-276 and a potential argument by Bill Clinton that he had no control over trust funds. Still, the Clintons could argue they suffer the same inequity that Judge Chabot was concerned about in his *Kenseth* dissent. That is, if the Clintons have income, they will run into the

---

236 114 T.C. 399 (2000).

237 *See id.*

238 *See id.* at 400.

239 *See id.* at 401-02.

240 *See id.* at 417.

241 *See id.* at 413-14, 413 n.7 and accompanying text.

242 *See id.* at 417-21 (Chabot, J., dissenting).

243 *Id.* at 425 (Beghe, J., dissenting).

244 *See supra* notes 204-05 and accompanying text.

245 *See supra* notes 68-70 and accompanying text.

246 *See Kenseth*, 114 T.C. at 417-21 (Chabot, J. dissenting).
AMT problem that Judge Chabot was willing to repair without congressional intervention.\textsuperscript{247} However, such arguments most certainly fly in the face of \textit{Old Colony Trust Co}. However, \textit{Old Colony Trust Co.} may be distinguished as standing for a third party paying one's expenses, where that third party would otherwise be paying salary or dividends to an individual. Still, such reasoning would bring one back to the question of the motives of the third parties, which was discussed earlier. Do the third parties have the requisite donative intent or disinterested motive of \textit{Duberstein}?

Given this reasoning, the hot issue raised in such recent cases as \textit{Estate of Clarks}, \textit{Kenseth}, and \textit{Coady} seems to require revisiting the venerable cases of \textit{Old Colony Trust Co.} and \textit{Duberstein}, as well as \textit{Helvering v. Horst}. Unless of course, one is as prepared as Judge Chabot in \textit{Kenseth} to reject the application of established judicial doctrines.\textsuperscript{248} Judge Chabot specifically rejected the assignment of income doctrine.\textsuperscript{249} The Clintons, therefore, in all likelihood, would have to hope for a rejection of \textit{Old Colony Trust Co.} and \textit{Duberstein} to avoid an AMT problem.

V. THE CLINTONS' LEGAL EXPENSES AND TAXPAYER PENALTIES, PREPARED PENALTIES, AND PREPAREE ETHICS

The final issue which arises for the Clintons and which this Article will address is whether the Clintons and their tax preparer are subject to any penalties or preparer ethics provisions for their current or possible future return filing positions.\textsuperscript{250} The Clintons' tax returns for 1998 and 1999 did not include any income for contributions to their legal defense trusts nor, apparently, any disclosures relating to the failure to include income.\textsuperscript{251} Similarly, if the Clintons were to include income for contributions to the trust and then deduct the legal expenses, a second issue that arises is whether or not they and their preparer would be subject to any penalties or ethical provisions.

\textsuperscript{247} See id.

\textsuperscript{248} See id. at 420-41.

\textsuperscript{249} See id.


\textsuperscript{251} See supra note 3 and accompanying text.
A. **Taxpayer and Preparer Penalties**

I.R.C. § 6662 imposes a 20% penalty on a taxpayer who substantially understates the tax liability due on a tax return.\(^\text{252}\) The 20% penalty is applied only to the amount of the understatement.\(^\text{253}\) A taxpayer may avoid the substantial understatement penalty, however, if there is (1) substantial authority for the taxpayer’s filing position or (2) disclosure by the taxpayer and a reasonable basis for the taxpayer’s filing position.\(^\text{254}\) “Substantial authority” is a less stringent standard than “the more likely than not” standard\(^\text{255}\) but more stringent than the reasonable basis standard.\(^\text{256}\) The Treasury Regulations provide that “[t]here is substantial authority for the tax treatment of an item only if the weight of the authorities supporting the treatment is substantial in relation to the weight of authorities supporting contrary treatment.”\(^\text{257}\) For purposes of determining substantial authority only certain authority may be relied upon.\(^\text{258}\) Such qualified authority includes the I.R.C., statutes, regulations, revenue rulings, revenue procedures, and court cases.\(^\text{259}\)

\(^{252}\) See I.R.C. § 6662 (1994). A substantial understatement of income tax for a taxable year is an understatement that is greater than 10% of the income tax required to be reported on the taxpayer’s tax return or $5000. See I.R.C. § 6662(d)(1)(A) (1994). For corporations, however, an substantial understatement is an amount that exceeds the greater of 10% of the income tax required to be reported on the tax return or $10,000. See I.R.C. § 6661(d)(1)(B) (1994).

\(^{253}\) See I.R.C. § 6662(a) (1994).


(B) Reduction for understatement due to position of taxpayer or disclosed item.

The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to—

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item if—

(I) the relevant facts affecting the item’s tax treatment are adequately disclosed in the return or in a statement attached to the return, and

(II) there is a reasonable basis for the tax treatment of such item by the taxpayer.

Treasury Regulation § 1.6662-7 (2000) states: “For purposes of sections 1.6662-3 and 1.6662-4(e) and (f) (relating to methods of making adequate disclosure), the provisions of 1.6662-3(b)(3) apply in determining whether a return position has a reasonable basis.”

\(^{255}\) The “more likely than not” standard is met when there is a greater than 50% likelihood of the position being upheld. See Treas. Reg. § 1.6662-4(d)(2)(2000).

\(^{256}\) Defined as reasonable reliance on one or more of the authorities permitted to be used to establish substantial authority. See Treas. Reg. §§ 1.6662-3(b)(3), 1.6662-7(d) (2000).


cédures, and court cases.\textsuperscript{259}

If the taxpayer cannot meet the substantial authority standard, then the penalty may still be avoided if there is a reasonable basis and disclosure.\textsuperscript{260} However, “reasonable basis” is considered to be a “significantly higher” standard than ‘not frivolous.”\textsuperscript{261} Recently, reasonable basis has been defined as an even higher standard than before. In new Regulations §§ 1.6662-7(d) and 1.6662-3(b)(3), reasonable basis is defined as reasonable reliance on one or more of the authorities permitted to be used to establish substantial authority.\textsuperscript{262}

I.R.C. § 6662 also imposes a 20% penalty on a taxpayer for underpayment of taxes if the underpayment is due to the taxpayer’s disregard of rules or regulations.\textsuperscript{263} For a taxpayer to avoid this 20% penalty for disregard of rules and regulations, similar disclosure and reasonable basis for a filing position are both required.\textsuperscript{264}

A taxpayer may avoid all of the 20% penalties imposed under § 6662, including the negligence penalty, by showing reasonable cause and good

\textsuperscript{259} Id.


\textsuperscript{261} Treas. Reg. § 1.6662-3(b)(3) (2000) (“Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper.”). See also Dorocak, supra note 250; Potential Penalties and Ethical Problems of a Filing Position; Dorocak, Potential Penalties and Ethical Problems in Filing An Amended Return, supra note 250.


Reasonable basis is a relatively high standard of tax reporting, that is, significantly higher than not frivolous or not patently improper. The reasonable basis standard is not satisfied by a return position that is merely arguable or that is merely a colorable claim. If a return position is reasonably based on one or more of the authorities set forth in § 1.6662-4(d)(3)(iii) (taking into account the relevance and persuasiveness of the authorities, and subsequent developments), the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard as defined in § 1.6662-4(d)(2).

Additionally, see Treasury Regulation § 1.6662-4(d)(3)(ii) (2000) for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty. In addition, the reasonable cause and good faith exception in § 1.6664-4 may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard. See Treas. Reg. § 1.6662-3(b)(3) (2000).

\textsuperscript{263} See I.R.C. § 6662 (1994).

faith. "The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances." According to the Regulations, the most important factor generally is the extent of the taxpayer's effort to assess his or her proper tax liability.

Tax return preparers are also subject to penalties for an understatement of a taxpayer's liability. I.R.C. § 6694(a) imposes a $250 penalty on a preparer who understates a taxpayer's tax liability based on an unrealistic position. I.R.C. § 6694(b) also imposes a $1000 penalty on a preparer who understates a taxpayer's tax liability willfully or in reckless or intentional disregard of rules and regulations. "Rules and Regulations," according to the Service, include treasury regulations, revenue rulings, and IRS notices.

For a preparer to avoid the $250 unrealistic position penalty, either (1) a realistic possibility of prevailing on the merits (a realistic possibility of success or RPOS), or (2) a non-frivolous position and disclosure is required. RPOS is a one-third or greater likelihood of being sustained on the merits. A frivolous

---

266 Treas. Reg. § 1.6664-1(b) (2000).
267 "Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer." Treas. Reg. § 1.6664-1(b) (2000).
269 See I.R.C. § 6694(a) (1994).
270 See I.R.C. § 6694(b) (1994).

Understatements due to unrealistic positions. If:

(1) any part of any understatement of liability with respect to any return or claim for refund is due to a position for which there was not a realistic possibility of being sustained on its merits.

(2) any person who is an income tax return preparer with respect to such return or claim knew (or reasonably should have known) of such position, and

(3) such position was not disclosed as provided in section 6662(d)(2)B)(ii) or was frivolous, such person shall pay a penalty of $250 with respect to such return or claim unless it is shown that there is reasonable cause for the understatement and such person acted in good faith.


Realistic possibility of being sustained on its merits:

(1) In general. A position is considered to have a realistic possibility of being sustained on its merits if a reasonable and well-informed analysis by
position, on the other hand, is one which is patently improper.\textsuperscript{274}

The standard for practitioners to avoid the $1000 § 6694(b) penalty, for willful understatement or reckless disregard of rules or regulations, does not seem to be very different from the § 6694(a) standard of RPOS or a non-frivolous position and disclosure. The Service has stated that a preparer who takes a position contrary to a revenue ruling or notice is considered to have acted recklessly or intentionally if the position does not have RPOS,\textsuperscript{275} unless the position is non-frivolous with adequate disclosure and good faith.\textsuperscript{276} However, disclosure differs for reckless conduct and an unrealistic position: without a Form 8275 or 8275R, disclosure on the return does not prevent the reckless conduct penalty for a non-frivolous position even where there is good faith.\textsuperscript{277} Concerning RPOS, the regulations indicate that several court cases holding that a revenue ruling is incorrect meets the reasonable possibility standard, but merely one Tax Court case invalidating a regulation does not.\textsuperscript{278}

As with the taxpayer penalties, the tax return preparer penalties of § 6694 may not be imposed if the preparer’s understatement is due to reasonable cause and the preparer acted in good faith considering all the circumstances involved.\textsuperscript{279} However, this reasonable cause and good faith exception “does not apply to an error that would have been apparent from a general review” of the return by the taxpayer.\textsuperscript{280}

B. Application of Penalty Rules to the Clintons and Their Tax Return Preparer

The Clintons’ 1998 and 1999 tax returns, as filed, excluded the contri-


\textsuperscript{275} A one-third or greater likelihood of being sustained on the merits. See Treas. Reg. § 1.6694-2(c)(3) (2000).

\textsuperscript{276} See Treas. Reg. § 1.6694-3(c)(2) (2000).


\textsuperscript{278} See Treas. Reg. § 1.6694-3(d) example 3, 4 (2000).


butions to their legal defense trust.\textsuperscript{281} Those tax returns also apparently do not make a disclosure concerning the exclusion.\textsuperscript{282} Therefore, for the Clintons to avoid the \$ 6662(d) penalty for substantial understatement, they will need substantial authority. The IRS has defined substantial authority as including, among other things, court cases and "notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin."\textsuperscript{283} The most directly applicable court case regarding the Clintons' likely argument that the contributions to their trust were gifts, \textit{Carson v. Commissioner}, ruled against the IRS when it made the argument that similar transfers to individual politicians were gifts.\textsuperscript{284} The Clintons, however, could try to find substantial authority in two IRS pronouncements published in the Internal Revenue Bulletin, the Service's non-acquiescence in \textit{Carson} and Revenue Ruling 72-355.\textsuperscript{285}

However, the Clintons may have difficulty in finding "substantial" authority given that the authorities go both ways, as those authorities are defined by the IRS itself. In the hierarchy of standards, the next lowest for the Clintons to meet to avoid a 20\% substantial understatement penalty would be reasonable

\textsuperscript{281} See \textit{supra} note 3 and accompanying text.

\textsuperscript{282} See \textit{supra} note 3 and accompanying text.


\textit{Types of authority.} Except in cases described in paragraph (d)(3)(iv) of this section concerning written determinations, only the following are authority for purposes of determining whether there is substantial authority for the tax treatment of an item: Applicable provisions of the Internal Revenue Code and other statutory provisions; proposed, temporary and final regulations construing such statutes; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers: General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memoranda issued after October 31, 1976; actions on decisions and general counsel memorandum issued after March 12, 1981 (as well as general counsel memorandum published in pre-1955 volumes of the Cumulative Bulletin); Internal Revenue Service information or press releases and notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin.

\textsuperscript{284} See generally Carson v. Comm'r, 71 T.C. 252 (1978), aff'd, 641 F.2d 864 (10th Cir. 1981), nonacq. 1979-2 C.B. 2. See also \textit{supra} note 91-104 and accompanying text.

basis with disclosure under § 6662(d).\textsuperscript{286} Reasonable basis is, again, a "significantly higher" standard than not frivolous.\textsuperscript{287}

The Treasury Regulations accompanying the preparer penalty provision of §§ 6694(a) and (b) provide two examples which may help illustrate whether the Clintons can meet the reasonable basis standard.\textsuperscript{288} To avoid the preparer penalty, the preparer must have a realistic possibility of success (RPOS)\textsuperscript{289} or a non-frivolous position and disclosure.\textsuperscript{290} Example 4 of Regulation § 1.6694-3(d) presents a situation in which the basis for the tax position is a Tax Court decision that invalidates a final regulation requiring capitalization of certain expenses.\textsuperscript{291} The Service’s conclusion is that the preparer will be subject to the § 6694(b) penalty (reckless and intentional disregard of rules and regulations), even though there may be a realistic possibility of success, unless there is adequate disclosure.\textsuperscript{292} Example 3 of the same regulation poses a situation in which the basis for the tax position is a Revenue Ruling, which holds that expenses must be capitalized, despite several court cases from different courts holding these expenses may be deductible.\textsuperscript{293} In this example, the Service finds a reasonable possibility of being sustained on the merits and a preparer, therefore, may report the position without disclosure.\textsuperscript{294}

The Clintons’ situation may be somewhere between examples 3 and 4 of Regulation § 1.6694-3(d) because one court case is clearly contrary to an IRS Revenue Ruling and non-acquiescence. Thus, the opposite position, at least presumably, would have RPOS or close to it. This may be just the sort of inside-out logic the Clintons are relying on to argue that the Service’s position is also at least RPOS, \textit{i.e.,} a one in three chance of winning, and possibly even a reasonable basis.

The Clintons may also be relying on the plaintiffs’ attorney’s fees cases where some plaintiffs have been successful in arguing that attorney’s fees should in effect be excluded from income or, in other words, only their award

\textsuperscript{286} See \textit{supra} notes 260-63 and accompanying text. One is hard pressed to resist suggesting that the Clintons have had difficulties in meeting even lowered standards.

\textsuperscript{287} See Treas. Reg. § 1.6662-3(b)(3) (2000).

\textsuperscript{288} See Treas. Reg. § 1.6694-3(d) example 3, 4 (2000). See also Dorocak, \textit{Potential Penalties and Ethical Problems of a Filing Position, supra} note 26150.

\textsuperscript{289} Defined as a one-third or greater likelihood of being sustained on the merits. See Treas. Reg. § 1.6694-2(b)(1) (2000).

\textsuperscript{290} A frivolous position is one which is patently improper. See Treas. Reg. § 1.6694-2(c)(2) (2000).

\textsuperscript{291} See Treas. Reg. § 1.6694-3(d) example 4 (2000).

\textsuperscript{292} See \textit{id}.

\textsuperscript{293} See Treas. Reg. § 1.6694-3(d) example 3 (2000).

\textsuperscript{294} See \textit{id}. Interestingly, Treasury Regulation § 1.6662-3(a) (2000) appears to also relieve the taxpayer of the penalty for disregarding rules and regulations for merely RPOS.
net of attorney’s fees should be included in income.\textsuperscript{295} To the extent that some of these cases might bolster the Clintons’ position, they still do not seem to be enough on their own to constitute substantial authority because there are contrary authorities. The IRS anti-Carson position, plus some of the attorney’s fees cases, might be enough to give the Clintons reasonable basis for their position of excluding the contributions to their legal defense trust. However, to avoid the substantial understatement penalty under § 6662(d), these taxpayers would need disclosure of their filing position in addition to reasonable basis.\textsuperscript{296} As previously mentioned, the Clintons’ tax return apparently did not disclose the exclusion of the contributions to the legal defense trust.\textsuperscript{297}

For the Clintons’ preparer to avoid the $250 penalty of I.R.C. § 6694(a) or the $1000 penalty for willful, reckless, or intentional disregard of rules of regulations of § 6694(b), the preparer would need RPOS.\textsuperscript{298} If the Clintons are close to achieving reasonable basis as immediately discussed above, then their preparer may have RPOS, the at least slightly lower standard of a one-in-three chance of winning. Without RPOS, the preparer would need a non-frivolous position and disclosure,\textsuperscript{299} but again the Clintons have not disclosed the receipt of contributions by the legal defense trust on their 1040’s for 1998 and 1999. At least the preparer might be able to avoid a penalty.\textsuperscript{300} The higher $1000 penalty of § 6694(b) appears to be the penalty which the preparer most likely will avoid because the IRS has defined “rules and regulations” to include its own revenue rulings.\textsuperscript{301}

C. Application of Ethical Rules to the Clintons’ Tax Return Preparer\textsuperscript{302}

The preparer ethical standards seem generally to mimic the § 6694 penalty rules.\textsuperscript{303} The standard for litigating a case in Tax Court is a non-frivolous

\textsuperscript{295} See supra notes 209-49 and accompanying text.

\textsuperscript{296} See supra note 254 and accompanying text.

\textsuperscript{297} See supra note 3 and accompanying text.

\textsuperscript{298} See supra notes 27268-71 and accompanying text.

\textsuperscript{299} See supra notes 272-74 and accompanying text.


\textsuperscript{301} See Treas. Reg. § 1.6694-3(f) (2000).

\textsuperscript{302} The Clintons’ tax return preparer is a CPA at Hariton, Mancuso & Jones in Rockville, Maryland. See Sheppard, supra note 2, at 472; Greater Wash. Society of CPAs, Wash. D.C., GWSCPA Scholarship Fund, at http://www.gWSCPA.org/2Pscholarship.htm (Aug. 19, 2001).

\textsuperscript{303} For a general discussion of the ethical standards for preparers see Dorocak, Potential Penalties and Ethical Problems of a Filing Position, supra note 26150, at 246 n.187 and ac-
position.304 Similarly, a preparer can avoid a penalty under § 6694(a) with a non-frivolous position and disclosure.305 Otherwise, the preparer needs RPOS. The preparer clearly faces conflicting standards because, as discussed, to avoid a penalty, the taxpayer needs to meet the higher standards of either reasonable basis and disclosure or substantial authority.

The American Institute of Certified Public Accountants (AICPA), the American Bar Association (ABA), and the IRS have set forth ethical guidelines that are generally in accord with the Tax Court and I.R.C. penalty provisions. For example, neither the old AICPA Statements on Responsibilities in Tax Practice, nor the new AICPA Statements on Standards for Tax Services express the realistic possibility standard in terms of percentage odds.306 However, the realistic possibility standard is accepted in a 1985 ABA Formal Opinion.307 Because the ABA Formal Opinion was issued before I.R.C. § 6694 was enacted,

companying text.

304 I.R.C. § 6673 (2001). Section 6673 states as follows:

(a) Tax Court proceedings

(1) Procedures instituted primarily for delay, etc.

Whenever it appears to the Tax Court that-

(A) proceedings before it have been instituted or maintained by the taxpayer primarily for delay,

(B) the taxpayer’s position in such proceeding is frivolous or groundless, or

(C) the taxpayer unreasonably failed to pursue available administrative remedies,

the Tax Court, in its decision, may require the taxpayer to pay to the United States a penalty not in excess of $25,000.

For a discussion of penalties as a toll charge rather than a standard of conduct, see generally Panel Discussion, American Bar Association Mid-Year Meeting, Section of Taxation, Standards of Tax Practice Committee, New Orleans, Louisiana (Jan. 1996) (Available from ADC Services, 69013 River Bend Drive, Covington, LA 70433, (504) 892-1157).


the opinion fails to mention disclosure for a non-frivolous position. Instead, the opinion prescribes withdrawal when the lawyer does not have a good faith belief that there is a reasonable probability of success. Treasury Department Circular 230, which governs practice before the IRS, states that the standards are now in accord with I.R.C. § 6694, as they require either a reasonable possibility of success or a non-frivolous position and adequate disclosure.

Ethical matters may not be so easily quantifiable. The AICPA once required Certified Public Accountants (CPAs) to follow clear and unambiguous authorities. More recently, in both the old and new Statements, the AICPA grants CPAs latitude to choose well-reasoned constructions of statutory authorities where rules are ambiguous. Yet, the IRS does not appear to grant such latitude to tax return preparers. According to Treasury Regulation § 1.6694-2(b)(3), even judicial construction of an identical statute in another jurisdiction is not substantial authority even though, as with conclusions in treatises and periodicals, the authorities underlying the court's opinion may support a realistic possibility.

As for the Clintons' return preparer and meeting these ethical guidelines, it would appear that the closer the Clintons' filing position comes to RPOS because of the IRS's position on contributions to an individual politician as constituting gifts and some court cases excluding plaintiff's attorney's fees from judicial awards, the closer the preparer will be to avoiding not only a penalty but also any ethical sanction.

VI. CONCLUSION

The Clintons likely have income from payment of expenses by third parties according to Old Colony Trust Co. and a failure to meet the definition of a gift as outlined in Commissioner v. Duberstein. Still, the Clintons will likely be able to deduct their legal expenses as employee business expenses under cases such as Gilmore, Jenkins, and Salt, and more specifically cases dealing with politicians such as McDonald, Lussy, Messina, McDonald and Solomon.
If deducted, the Clintons will likely face an alternative minimum tax because their attorney’s fees are not deductible for AMT.317 However, the Clintons may try to rely on recent cases allowing a prevailing plaintiff to report net awards and thereby exclude their attorney’s fees.318 The Clintons, of course, would try to exclude their attorney’s fees, despite the fact that they were defendants in the cases.319

Furthermore, the Clintons may well be subject to a 20% substantial understatement penalty because their position may not have a substantial authority nor a reasonable basis plus disclosure.320 Even if the Clintons have reasonable basis, their failure to disclose the filing position of not reporting the contributions to the trust would require the penalty to be applied. Finally, the Clintons’ tax return preparer may be able to avoid penalty provisions and ethical violations because the preparer is only required to have a reasonable possibility of success even without disclosure.321

All of these conclusions are, in a sense, predicated on an IRS audit of the Clintons. However, such an audit might never arise because of the IRS’s still published position in the nonacquiesance rejecting Carson v. Commissioner.322 Lack of an audit might be considered a failure to hold the Clintons accountable. At $7.4 million of legal fees paid by the Trust,323 and at roughly a 28% AMT rate and a 20% substantial understatement penalty rate, the Clintons could owe nearly $2.1 million in tax and $420,000 in penalties.

See supra notes 204-06 and accompanying text.

See supra notes 207-43 and accompanying text.

See supra notes 244-49 and accompanying text.

See supra notes 250-67, 281-97 and accompanying text.

See supra notes 268-81 and accompanying text.

See supra notes 91-104 and accompanying text.

See supra note 2 and accompanying text.