Legal Defense Fund Donations Should Get Gift Tax Treatment

By Robert Rizzi (November 18, 2020)

Legal defense funds for executive branch officials are back in the news, but a number of tax and government ethics issues raised since the Clinton administration have never been fully resolved. The current ambiguities are not sustainable.

They will lead to aggressive planning by individuals and protracted disputes over the treatment of legal defense funds in the context of politically weaponized litigation, all prospects that are in no one’s long-term interest. Fortunately, there is a path forward that should work, even though it will not satisfy everyone.

With the change in government, there will almost certainly be an increase in civil and criminal litigation and investigations. Threats of lawsuits already hover over former and soon-to-be-former government officials.

Legal precedents established by state attorneys general and district attorneys in criminal investigations brought against members of the Trump administration will no doubt be hauled out in other states against the Biden administration.

The increase in such cases will raise the prospect of substantial legal expenses to be borne by individuals who may not be independent wealthy. Legal defense funds are an attractive means of dealing with the costs, but donors and recipients are going to face legal, ethical and especially tax uncertainties that date back to the scandals of the 1990s.

Given the highly public nature of some of the investigations — and individuals — involved, one can easily imagine these uncertainties leading to tax and other investigations of the legal defense funds themselves.

From a tax perspective, donors to legal defense funds would like their contributions to be tax deductible, and the officials and former officials tapping into the funds do not want to recognize unnecessary tax.

While certain funds created to defend constitutional or human rights have been granted tax-exempt status, thus permitting the donors a charitable deduction, many funds set up to pay legal fees for current and former government officials might not qualify under this standard.

Furthermore, when an individual owes a debt to a lawyer for fees and some third party pays that debt, under long-standing tax principles, the payment could generate taxable income to the individual. This potential for phantom income — taxable income without cash to pay taxes on it — on relief of debt is similar to what happens to a borrower when a loan is forgiven.

While in the past, the client might be able to claim an offsetting deduction for legal expenses paid or deemed paid, the elimination of unreimbursed employee expenses and other miscellaneous itemized expense deductions in the 2017 tax act has limited this symmetrical — and more logical — treatment.
Characterization of such contributions as ordinary and necessary business expenses by the donor — including by a corporation — is unlikely and could well generate taxable income to the individuals whose legal fees are paid through such contributions.

Another approach would be to treat a payment from a legal defense fund as a nontaxable gift. Recipients of gifts generally do not pay tax.

Such a noncharitable gift would be nondeductible to the donor and could subject the donor to federal gift tax — or use up some of the donor's lifetime gift tax exemption — if the amounts donated are over certain levels.

To qualify as a nontaxable gift, under a venerable U.S. Supreme Court decision, Commissioner v. Duberstein, amounts are supposed to be donated out of detached and disinterested generosity, and without an expectation of a benefit in return.[1]

Contributions to legal defense funds from trade associations, corporations or political action committees may have difficulty meeting this test.

On the other hand, during the Whitewater investigation in the Clinton administration, a major New York firm famously advised the president and his associates that contributions to one of the several defense funds should be treated as nontaxable gifts.[2]

That tax characterization issue is highly fact-intensive under the disinterested generosity standard, however, and many types of donations to legal defense funds may not qualify.

But gift treatment, at least for individual contributions to funds, is clearly the easiest and most straightforward route to resolving the immediate tax issues of such funds. Gift treatment is also consistent with the government ethics analysis of legal defense funds.

Recently, the U.S. Office of Government Ethics has weighed in on a number of the government ethics implications of legal defense funds under the civil and criminal laws governing the conduct of federal employees.

There is currently no statutory government ethics framework for establishing a legal defense fund for executive branch employees, but the OGE has issued a notice of proposed rulemaking to try to address some of the important issues.

These issues include whether and to what extent the identities of donors must be publicly disclosed and whether benefits paid by the funds should be treated as reportable gifts for regulatory compliance purposes.

There is also the risk that payments made by the legal defense funds on behalf of selected beneficiaries could influence the legal strategy of the recipients, creating a two-masters problem for the defendants and their counsel.

Thus far, the OGE has made reasonable accommodations and, for the most part, officials have proceeded to use such vehicles in the manner prescribed by that agency through ad hoc advice. One thing is clear, however: For government ethics purposes, the OGE regards contributions to legal defense funds as gifts and not as income.
The government officials who are beneficiaries of these funds are therefore subject to laws restricting receipt of gifts by public officials and requiring annual reporting of gifts on public financial disclosure reports, but they are not treated as receiving income from outside sources.

This is an important distinction, because if the OGE had determined that contributions should instead be treated as income, questions would arise concerning whether, for example, Section 209 of the Criminal Code, which prohibits supplementation of the salaries of government officials from nongovernmental sources, would apply to both the payor and the payee.[3]

Given the uncertainties that still surround legal defense funds, there has been a risky incentive to push the envelope and to take positions based on the paucity of authority in the area. For example, some legal defense funds have experimented with trying to qualify as political organizations under Section 527 of the Internal Revenue Code.

However, in light of the enhanced scrutiny such funds will receive in connection with various future controversies, all of these gaps need to be addressed, primarily by tax authorities but also by government ethics and other regulators. In the meantime, clients would be well-advised to carefully document their planning to avoid becoming the test cases for future litigation.

Robert Rizzi is a partner at Steptoe & Johnson LLP.

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