

Court Ordered Sanctions Against an Attorney are Not Deductible Under Section 162 as Ordinary and Necessary Business Expenses

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On December 17, 2013, the US Tax Court issued its opinion in **Chaganti v. Commissioner**, TC Memo 2013-285. The interesting issue before the court was whether the taxpayer, an attorney, was allowed under Section 162 of the Code to deduct amounts he was personally ordered to pay a trial court and opposing counsel in a case in which he was representing a client.

Mr. Chaganti was initially ordered to pay a "fine" of \$262, representing the charges of opposing counsel and his court reporter, for his role in his client's failure to appear for a deposition. When he did not pay the fine, the court held Mr. Chaganti in contempt and ordered immediate payment (with a daily penalty for late-payment). About a month later, Mr. Chaganti finally paid the fine (without the late payment penalty). Throughout the case, he engaged in behavior the judge labeled as "unnecessarily protracting and contentious." The court eventually ruled against Mr. Chaganti's client in the case. The other attorney asked the court for sanctions against Mr. Chaganti (not Mr. Chaganti's client) as a result of his "bad faith, unreasonable, and vexatious multiplication of the proceedings." The judge ultimately ordered Mr. Chaganti to pay opposing counsel around \$18,000 (to compensate for the additional attorney fees incurred due to his actions) and to pay the court around \$2,300 for paying the original penalty late.

Mr. Chaganti paid these amounts on December 28, 2007. He had trouble filing his 2007 tax return on a timely basis (*big surprise*). More than three years later, after the Service prepared substitute returns, the taxpayer claimed the court-ordered payments constituted deductible business expenses under Section 162 of the Code. The IRS respectfully disagreed.

Eventually, the case made its way to the US Tax Court and was presented to Judge Paris. Not surprisingly, the taxpayer represented himself.

The court first addressed the amounts paid to the court. Under Section 162(f) of the Code, "[n]o deduction shall be allowed ... for any fine or similar penalty paid to a government for the violation of any law." This deduction disallowance is not limited to criminal fines or penalties. Judge Paris noted, without lengthy discussion, that the court is a government agency. Thus, the fine is nondeductible.

The remainder of the court-imposed sanctions consisted of payments to opposing counsel (rather than a government agency). Thus, the payments are not governed by Section 162(f). So, the issue is whether the payments constitute ordinary and necessary expenses to be deductible under Section 162(a). For an expense to be ordinary, it must be common and acceptable in the taxpayer's particular business, and to be necessary, it must be appropriate and helpful in carrying out his business. Judge Paris quickly concluded from the record of the trial court that ordered the sanctions that they were not ordinary and necessary expenses to carry out Mr. Chaganti's representation of a client. The sanctions were ordered as a result of the taxpayer's "willful and unreasonable protraction of the litigation." They are not ordinary in the practice of law; rather, the order of sanctions against an attorney is extraordinary. "[T]he mere fact that petitioner was ordered to pay opposing counsel attorney's fees ... demonstrates that those amounts were not ordinary and necessary to the practice of law." Mr. Chaganti lost again!

Two take-aways: First, penalties or fines paid to the government or an agency thereof are generally not deductible for income tax purposes. Second, even if the fines or penalties are not paid to the government, unless they are ordinary and necessary, they are not deductible.

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Authored by

[Larry J. Brant](#)

[Principal|Portland](#)

[503.553.3114](tel:503.553.3114) larry.brant@foster.com