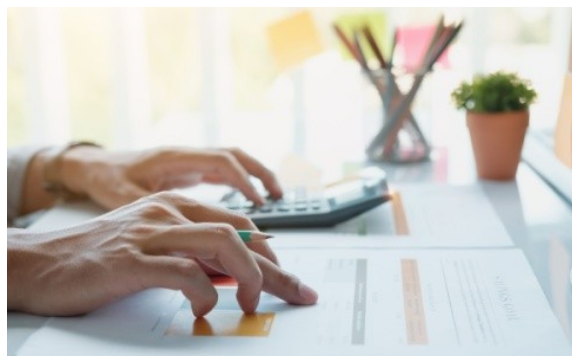


Legal Fees – Deductible as Ordinary Business Expenses or Capitalized?

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This is the question currently on appeal from the Tax Court to the Third Circuit. In *Myland, Inc. v. Commissioner of Internal Revenue* (Case No. 22-1193, 1194 & 1195) the IRS appealed the Tax Court's ruling that Mylan (the taxpayer) was entitled to deduct, as an ordinary business expense under IRC § 162(a), approximately \$50 million in legal expenses it incurred to defend patent infringement actions in connection with its manufacture of generic drugs. The Service contended Mylan's \$50 million in legal expenses should be capitalized under IRC § 263(a) because, in its mind, the expenses were related to the acquisition of a capital asset.

Okay, so what difference does this make? A big one. If Mylan establishes the legal fees were ordinary business expenses, it gets to deduct those fees as they are incurred (which they did on their timely filed tax returns for the years at issue). If not, Mylan must recover its legal fees over a fifteen-year period, through amortization and depreciation deductions (Ouch!). Because Mylan deducted the fees currently as an ordinary business expense, if the Service ultimately prevails and those deductions are denied, Mylan will also incur interest and penalties (salt in the wound).

What is it, an ordinary business deduction or a capital expense? The answer all depends on whether the expense either: (1) creates or enhances a separate and distinct asset; or (2) otherwise generates significant benefits for the taxpayer extending beyond the current taxable year. Yep. About as clear as mud. To provide clarity the Service promulgated Treas. Reg. § 1.263 to provide additional guidance.

Without getting too deep into the weeds, if a taxpayer incurs expenses (including legal fees) to create or improve an intangible asset, which includes "rights obtained from a governmental agency," i.e., trademark, trade name, copyright, license, permit, franchise, or similar right granted by that governmental agency," those expenses are capital expenses that may only be recovered over the useful life of the asset through amortization and depreciation deductions. Treas. Reg. § 1.263(a)-4(d)(9)(i). Although most businesses do not have patents, many do have other intangibles such as trademarks, trade names, and copyrights, to name a few.

The deductibility of legal expenses depends on the nature of the underlying claim for which the legal expenses were incurred, so businesses must look to the substance of the claim or transaction that gave rise to the legal fees to determine whether the expenses are ordinary business expenses (and, therefore currently deductible) or a capital expenditure, recoverable over the useful life of the asset.

With intellectual property becoming ever more important and valuable to businesses of all types and sizes, business owners need to be mindful of how and when legal fees (and other expenses) incurred to create or defend rights in intellectual property are treated for federal income tax purposes—deductible currently as an ordinary business expense or capitalized over the life of the asset.

As for how the Third Circuit will rule? My money is on Mylan.

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