



STATE OF MICHIGAN
TERRI LYNN LAND, SECRETARY OF STATE
DEPARTMENT OF STATE
LANSING

July 8, 2009

Hon. Cathy Garrett
Wayne County Clerk
211 Coleman A. Young Municipal Center
Detroit, Michigan 48226

Dear Clerk Garrett:

The Department of State (Department) acknowledges receipt of your correspondence dated April 8, 2009, in which you asked the Department to issue a declaratory ruling pursuant to the Michigan Campaign Finance Act (MCFA or Act), 1976 PA 388, MCL 169.201 *et seq.*, to resolve the question of whether a candidate committee may use its funds to pay legal expenses incurred by a person who holds elective office. Your letter indicates that the candidate committee of the former Mayor of the City of Detroit, Kwame Kilpatrick, "paid legal fees from the Committee's campaign finance proceeds."

A copy of your request was published on the Department's website beginning April 10, 2009. Written comments were submitted by two attorneys, one of whom is employed by a firm that represented Mr. Kilpatrick in connection with the 2005 mayoral election, and another who represented Mr. Kilpatrick in various matters in 2008. Mr. James C. Thomas, who represented Mr. Kilpatrick in 2008, provided a copy of the candidate committee's annual campaign statement for 2008 as an attachment to his written comments. The campaign statement demonstrates that Mr. Kilpatrick's candidate committee reported a number of expenditures for legal fees on schedule 1C, incidental office expense disbursements, totaling \$976,493.29.

The MCFA and Administrative Procedures Act authorize the Department to issue a declaratory ruling if the person who submits the request is as an interested party, recites a reasonably complete statement of facts, states the legal question presented, and puts forth the request in a signed writing. MCL 24.263, 169.215(2). The omission of a reasonably complete statement of facts from your correspondence precludes the Department from granting your request for a declaratory ruling; however, the Act requires the Department to issue an interpretive statement "providing an informational response to the question presented" as a substitute. MCL 169.215(2). Accordingly, the Department offers the following interpretive statement in response to your request.

You submitted the following question for the Department's consideration: "Does the [MCFA] explicitly or implicitly prohibit the use of campaign finance funds to pay direct or indirect legal expenses associated with the office holder?" Written comments provided in response to the

Department's initial draft of this interpretive statement suggested that instead of answering the precise question you posed, whether the Act explicitly or implicitly bars a public official from using candidate committee funds to pay legal fees incurred by the official, the Department should have determined that Mr. Kilpatrick's use of candidate committee funds to pay legal fees violated the MCFA. This was *not* the question presented. Under a plain reading of the Act, if the payment of an officeholder's legal fees is appropriate according to the Internal Revenue Code (Code), then these expenditures must be recognized by filing officials as acceptable incidental expenses within the meaning of the MCFA. MCL 169.209(1). The Department is not expert in the application of federal tax law and its review of the Code, case law, and revenue rulings cited herein suggests that there are circumstances in which the payments of attorney fees for one's defense in civil and criminal proceedings are properly treated as ordinary and necessary expenses under federal law.

In response to the question, "[d]oes the [Act] explicitly or implicitly prohibit the use of campaign finance funds" in the manner briefly described in your letter, the Department concludes that the Act does not specifically authorize Mr. Kilpatrick to use his candidate committee funds to pay legal fees associated with his defense. For the reasons set forth below, Mr. Kilpatrick must provide you a written statement from the Internal Revenue Service (Service) establishing that the payment of legal fees is "an expenditure that is an ordinary and necessary expense, as described in section 162 of the internal revenue code of 1986, 26 U.S.C. 162," and therefore constitutes an incidental expense under the MCFA. MCL 169.209(1).

The Act authorizes the candidate committee of a person who holds elective office to make expenditures for incidental expenses for that office, and defines the term incidental expense as "an expenditure that is an ordinary and necessary expense, as described in section 162 of the internal revenue code of 1986, 26 U.S.C. 162, paid or incurred in carrying out the business of an elective office." MCL 169.221a, 169.209(1). The statutory definition further provides that "[i]ncidental expense includes, but is not limited to," any of the 16 different types of specific expenditures listed. MCL 169.209(1)(a)-(p).

Whether an expenditure for an incidental expense is permissible under the MCFA must be considered with reference to the Internal Revenue Code (Code), which provides, "[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 [.]" 26 USC 162(a). Neither the written commentary provided to the Department nor its own research revealed the existence of federal regulations, case law, or revenue rulings that are directly on point.

The U.S. Supreme Court has explained, "the term 'necessary' imposes 'only the minimal requirement that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business,' ... [and] to qualify as 'ordinary', the expense must relate to a transaction 'of common or frequent occurrence in the type of business involved'." *INDOPCO, Inc. v Commissioner*, 503 US 79, 85-86, 112 S Ct 1039, 1044 (1992) (internal citations omitted). "The term 'trade or business' includes the performance of the functions of a public office." 26 USC 7701(a)(26).

Courts have on numerous occasions considered whether legal fees incurred by a taxpayer constitute ordinary and necessary expenses for which a deduction is allowed under the Code. To distinguish legal fees that are connected to the taxpayer's business from his or her personal expenses,¹ courts have used the test first announced in *United States v Gilmore*, 372 US 39, 49, 83 S Ct 623, 629 (1963): "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 [.]"² Thus, attorney fees arising from the taxpayer's trade or business may constitute an ordinary and necessary expense within the meaning of section 162(a) of the Code, depending on the nature of the claim.³

The Service confronted a similar question to the one you pose in its Rev Rul 74-394, 1974-2 CB 40, though it involved a civil removal proceeding, not allegations of criminality. There, the Service concluded that section 162(a) of the Code authorized a state court judge, facing professional disciplinary action for allegedly using his office to further the commercial interests of others, to deduct the legal fees he paid to defend himself. Since the allegation of wrongdoing resulted from the judge's discharge of his official duties, "the legal expenses paid by the taxpayer in the instant case in connection with obtaining the dismissal of the charges brought by the Commission are deductible by him as ordinary and necessary business expenses under section 162 of the Code [.]" *Id.*

Mr. Thomas cited *Commissioner v Tellier*, 383 US 687, 86 S Ct 1118 (1966), for the proposition that fees paid for legal services rendered to defend a public official from criminal charges are proper if the payment is made for the purpose of protecting the person's elected position. Mr. Tellier was not an elected official but a securities dealer, charged with and convicted of multiple counts of securities and mail fraud, who claimed a deduction under section 162(a) of the Code for attorney fees he paid in connection with his defense. In *Tellier*, the Service conceded that the taxpayer's legal fees were ordinary and necessary business expenses, but argued that it was contrary to public policy to allow a deduction in these circumstances. The Court disagreed, noting that "the federal income tax is a tax on net income, not a sanction against wrongdoing." *Id.* at 691. Applying the origin-of-the-claim test articulated in *Gilmore*, the Court held that since the charges against Mr. Tellier originated from his business activities, his legal fees were deductible as ordinary and necessary expenses under section 162(a) of the Code. *Id.* at 689.

¹ Under the Code, deductions for personal, living, and family expenses are disallowed unless specifically authorized by another provision of the Code. 26 USC 262(a).

² *Gilmore* concerned a parallel provision of the Code, currently codified at 26 USC 212(1), which allows an individual to claim "a deduction [for] all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income [.]"

³ In measuring whether a public official's deduction for ordinary and necessary expenses incurred in carrying out the functions of his or her office is allowed, the Sixth Circuit has indicated that the outcome does not turn on whether such expenditures are political in nature: "We find untenable the tax court's dichotomy between 'political' and 'business' purposes. As the majority recognized, a Congressman's trade or business is 'quintessentially' political. Congressman Diggs performs a political role as a representative of his constituents, a legislator, an educator, a policymaker, a candidate and a member of a political party." *Diggs v Commissioner*, 715 F2d 245, 250 (CA 6, 1983). "The question we must address, therefore, is not whether the Congressman's activities are political, but whether those activities are sufficiently related to the Congressman's trade or business as a Congressman to qualify for a deduction." *Id.*

The Department is unable to ascertain the extent to which Mr. Kilpatrick's legal fees may have evolved from the performance of his official mayoral duties, or whether the costs of his defense to civil forfeiture proceedings and multiple felony charges (including perjury, obstruction of justice, and conspiracy) qualify as "ordinary and necessary" within the meaning of 26 USC 162(a) and MCL 169.209(1). The resolution of these issues is central to your question as the MCFA does not explicitly authorize the use of candidate committee funds for these purposes.⁴

It is worth noting that the Legal Defense Fund Act, 2008 PA 288, MCL 15.521 *et seq.*, which was enacted after Mr. Kilpatrick resigned from public office, requires an elected official who establishes a legal defense fund to register and file periodic disclosure reports with the Department. It applies to elected officials who are beneficiaries of legal defense funds on or after the date the law became effective, October 6, 2008.

In conclusion, because the attorney fees paid by Mr. Kilpatrick's candidate committee are not specifically authorized by section 9(1) of the MCFA, the filing official designated by law to receive a candidate committee's campaign statements must issue a notice of error or omission requesting an explanation of these expenditures. MCL 169.216(6). The officeholder must demonstrate to the satisfaction of the designated filing official that payment of such expenses from his or her candidate committee's funds is proper.⁵ Uncorrected errors or omissions are reported to the Attorney General. MCL 169.216(8).

In support of a claim that an expenditure is an incidental expense, the filing official ought to require the officeholder to submit documentation supporting his or her position. Such evidence should include a statement from the Service indicating that the legal fees at issue constitute "an ordinary and necessary expense, as described in ... 26 USC 162, paid or incurred in carrying out the business of an elective office [,]" as it is the ultimate authority on tax matters.

Sincerely,



Brian DeBano
Chief of Staff / Chief Operating Officer

⁴ The Act permits an incumbent official's candidate committee to make a disbursement for "[a] fee for accounting, professional, or administrative services for the *candidate committee* of the public official." MCL 169.209(1)(o) (emphasis added). This provision has been interpreted to allow a candidate committee to remit payments for accounting or legal fees incurred by the committee for the purpose of complying with applicable election, campaign finance, and tax laws. However, the legal services rendered in this instance appear to have been procured for Mr. Kilpatrick's own benefit, not that of his candidate committee.

⁵ *Interpretive Statement to Curtis Hertel* (May 10, 1995), *Interpretive Statement to David Murley* (December 17, 2007). The same principle applies under the federal tax laws, where the burden of establishing that a deduction is proper rests with the taxpayer. *INDOPCO, supra*, at 84.