FEDERAL TAXATION: DEDUCTION DENIED UNDER SECTION 212 (2) OF INTERNAL REVENUE CODE FOR LEGAL EXPENSES INCURRED TO RETAIN OWNERSHIP OF INCOME-PRODUCING PROPERTY

In the recent cases of *United States v. Patrick*,[1] and *United States v. Gilmore*,[2] the Supreme Court held that payments to an attorney in connection with divorce proceedings were not deductible expenses, even though the payments in question were made primarily to retain control of income-producing property.

In the *Patrick* case, respondent incurred $19,200 in legal expenses[3] to effect a property settlement agreement in an uncontested divorce action. The agreement provided for transfer of stock, leasing of property, and creation of a trust, in order to permit respondent to maintain control of a family corporate publishing business. The District Court for the Western District of South Carolina held that the expenses were deductible under section 212 (2) of the Internal Revenue Code,[4] and the Court of Appeals for the Fourth Circuit affirmed the judgment.[5] In the *Gilmore* case, respondent paid attorney's fees of $32,500 to protect his controlling stock interest in an atuomobile dealership against community property claims asserted by his wife in her action for divorce.[6] These expenses were likewise held to be deductible by the Court of

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[1] 372 U.S. 53 (1963).

[2] 372 U.S. 39 (1963).

[3] About 50% of this amount was paid by respondent to the wife's attorneys. The Government contended that, in any event, fees paid to the wife's attorneys were nondeductible under previous decisions of the Court. See, *e.g.*, United States v. Davis, 370 U.S. 65 (1962); Magruder v. Supplee, 316 U.S. 394 (1942).

[4] 186 F. Supp. 48 (W.D.S.C. 1960). The INT. REV. CODE OF 1954, § 212, provides that "in the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year . . . (2) for the management, conservation, or maintenance of property held for the production of income . . . ."

The taxable years in question are governed by both the 1939 and 1954 Codes. Since the relevant portions of these Codes are substantially identical, for the sake of clarity reference will be made only to the 1954 Code.

[5] 288 F.2d 292 (4th Cir. 1961).

[6] The wife contended that the earnings retained by respondent's corporations during their marriage were the product of his personal services, and not the result of accretion in capital values, thus rendering his stockholdings *pro tanto* community property under California law. 290 F.2d 942, 944 (Ct. Cl. 1961). See Lenninger v. Lenninger, 167 Cal. 297, 139 Pac. 679 (1914); Pereira v. Pereira, 156 Cal. 1, 103 Pac. 488 (1909).

Claims.[7] The Supreme Court granted certiorari in both cases[8] because of a conflict of views among the lower federal courts and the continuing importance of the question in the administration of federal income tax laws.

Originally, the only general provision authorizing the deduction of the expenses of income-producing activities was the forerunner[9] of the present section 162 (a), which allowed deduction of expenses incurred in carrying on "any trade or business." Giving that provision a narrow construction, the Supreme Court held, in *Higgins v. Commissioner*,[10] that the activities of an individual in overseeing his extensive investments in stocks and bonds did not constitute a "trade or business" in the statutory sense and, hence, his expenses were not deductible.

In the Revenue Act of 1942,[11] Congress responded to the inequity inherent in denying a deduction for the expenses of income-producing activities while taxing the profits from such activities. The requirement of a technical "trade or business" was removed from the 1939 Code and it was provided that an individual might deduct all the ordinary and necessary expenses incurred "for the management, conservation, or maintenance of property held for the production of income."[12] Section 212 (2) of the present code contains a substantially identical provision.

Two divergent lines of authority developed regarding the test to be used in determining the applicability of the new provision. In *Lykes v. United States*,[13] the Supreme Court held that legal expenses incurred in contesting the assessment of a gift tax liability were not deductible, even though property held for the production of income would have to be liquidated in order to pay the deficiency. Noting that the deductibility of attorney's fees "turns wholly upon the nature of the activities to which they relate,"[14] the Court denied the deduction because the gifts which gave rise to the Commissioner's

[7] 290 F.2d 942 (Ct. Cl. 1961).

[8] United States v. Patrick, 368 U.S. 817 (1961); United States v. Gilmore, 368 U.S. 816 (1961).

[9] INT. REV. CODE OF 1939, ch. 1, § 23, 53 Stat. 12 (now INT. REV. CODE OF 1954, § 162 (a)).

[10] 312 U.S. 212 (1941).

[11] Revenue Act of 1942, ch. 619, § 121, 56 Stat. 798.

[12] INT. REV. CODE OF 1939, § 23 (a) (2), added by ch. 619, § 121, 56 Stat. 798 (1942).

[13] 343 U.S. 118 (1952).

[14] *Id.* at 123.

claim were "personal" rather than income-producing transactions.[15] Shortly thereafter, in *Baer v. Commissioner*,[16] the Court of Appeals for the Eighth Circuit allowed the deduction of legal fees incurred to effect an alimony settlement whereby the husband retained controlling stock interest in a corporation. Since the business furnished the husband's principal source of livelihood, the court reasoned that the cost of preserving his interest was an expense of "conserving and maintaining" his income-producing property.

The *Baer* approach has been followed, in dictum or in holding, by the Court of Claims and the Fourth, Fifth, and Ninth Circuits.[17] In sharp conflict stands the decision of the Second Circuit in *Lewis v. Commissioner*.[18] In *Lewis*, the court, having concluded that the *Baer* decision was irreconcilable with *Lykes*, expressly refused to follow it and held that the taxpayer's expenses of negotiating a marital property settlement were nondeductible although incurred to retain ownership of the stock of three wholly-owned corporations.

In the present cases, respondents, relying on *Baer*, claimed deductions under section 212 (2) because the legal fees in question were not incurred to contest their liability, but were allegedly expended to "conserve" the stockholdings upon which their jobs depended. In denying the deductions, the majority, in two opinions by Mr.

[15] Expenses of contesting tax liabilities—the fact situation directly involved in *Lykes*—are now deductible under § 212 (3) of the 1954 Code. That provision, new to the 1954 Code, reflects simply a policy judgment, of obvious appeal, that the expenses of litigating with one's government over tax liabilities ought to be deductible notwithstanding their "personal" character, and is of a piece with, for example, the deduction allowed for extraordinary medical expenses. It in no way detracts from the basic holding of the *Lykes* case that, for purposes of determining deductibility as a "business" expense, the source of the liability rather than the nature of the assets threatened is determinative.

[16] 196 F.2d 646 (8th Cir. 1952).

[17] In addition to the holdings in the *Gilmore* case from the Court of Claims and its companion, the *Patrick* case from the Fourth Circuit, see Owens v. Commissioner, 273 F.2d 251 (5th Cir. 1959); Bowers v. Commissioner, 243 F.2d 904 (6th Cir. 1957); McMurty v. United States, 132 F. Supp. 114 (Ct. Cl. 1955). For dictum distinguishing *Baer* but apparently approving its holding, see Harris v. United States, 275 F.2d 238 (9th Cir. 1960); Tressler v. Commissioner, 228 F.2d 356 (9th Cir. 1955); Howard v. Commissioner, 202 F.2d 28 (9th Cir. 1953). See also Davis v. United States, 287 F.2d 168 (Ct. Cl. 1961), *rev'd on other grounds*, 370 U.S. 65 (1962). The cases following *Baer* have allowed deduction of legal expenses only where the wife's claims, if successful, might have destroyed the husband's capacity to earn a living, through loss of controlling interest in his business. No deduction has been allowed where only diversified securities of the husband have been threatened. There is no support for this distinction in § 212 (2), since diversified securities are no less "property held for production of income" than a large stock in a single company.

[18] 253 F.2d 821 (2d Cir. 1958).

Justice Harlan,[19] held 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 test of whether an expense is deductible. Since the claims asserted by the wives in the divorce actions arose from respondents' marital relationships and not from profit-seeking activities, legal expenses incurred for the purpose of discharging such claims were nondeductible "personal" expenditures.[20]

The test adopted by the Court finds support in a literal reading of section 212 (2). In context, "conservation of property" appears to refer to operations performed with respect to the res itself, rather than to a taxpayer's retention of ownership in the property.[21]

The legislative history of the section further supports the Court's conclusion. The committee reports make clear that the sole purpose of the 1942 amendment was to remove the requirement that expenses be incurred in a technical "trade or business" in order to be deductible.[22] Consequently, deductions under section 212 (2) are still subject to the other restrictions which apply in the case of business expense deductions.[23] Foremost among these restrictions

[19] 372 U.S. 39 & 53 (1963).

[20] INT. REV. CODE OF 1954, § 262, provides, with certain minor exceptions, that: "[N]o deduction shall be allowed for personal, living, or family expenses." Consequently, expenses of divorce litigation, being "personal" expenses, have generally been held to be nondeductible.

The present Treasury regulation, Treas. Reg. § 1.262-1 (b) (7) (1952), provides: "Generally, attorney's fees and other costs paid in connection with a divorce, separation or decree for support are not deductible by either the husband or the wife. However, the part of an attorney's fee and the part of the other costs paid in connection with a divorce, legal separation, written separation agreement, or a decree for support, which are properly attributable to the production or collection of amounts includible in gross income under section 61 are deductible by the wife under section 212."

The "Generally" qualification was added specifically to allow for the single stated exception (the "However" sentence) and not otherwise to qualify the disallowance of such expenses. T.D. 5889, 1952-1 CUM. BULL. 31.

[21] As customarily defined, "conservation" implies a physical safeguarding of the thing, or prevention of change in its state. See Hermann F. Ruoff, 30 T.C. 204 (1958). It is in this sense that "conservation" is used in § 212 (2) to make deductible the cost of a watchman to guard rental property or the fee paid for a safe-deposit box in which to keep securities. See Daniel S. W. Kelly, 23 T.C. 682 (1955). To use "conservation" as including also the avoidance of the need to sell an interest in the thing to satisfy a liability constitutes a rather strained usage.

[22] H.R. REP. No. 2333, 77th Cong., 2d Sess. 75 (1942). See also S. REP. No. 1631, 77th Cong., 2d Sess. 88 (1942).

[23] Trust of Bingham v. Commissioner, 325 U.S. 365 (1945); McDonald v. Commissioner, 323 U.S. 57 (1944).

is the requirement that the expense originate in the income-producing activity.[24]

Aside from history and authority, strong policy grounds justify making the deductibility of legal expenses turn upon the origin or source of the claim, rather than upon the nature of the assets threatened by the claim. If the latter alternative were adopted, capricious and irrational results might follow. For example, the expenses of defending even a personal tort claim would be deductible by a taxpayer on the ground that such defense was made to protect whatever income-producing property he might own. In such a case, the deduction would bear no causal conection with the basis of the suit or the reasons for defending it.[25] Moreover, substantial inequities would inhere by allowing one taxpayer to deduct litigation costs merely because his portfolio contains income-producing property and denying the deduction to another because his capital happens to be invested in a home.[26]

The majority's decision represents a logical corollary of the *Lykes* case, and is entirely consistent with the purposes of section 212 (2). In effect, the *Baer* case has been overruled and an explicit test laid down for the lower federal courts to follow. In the future, individual taxpayers attempting to deduct legal fees can expect courts to closely scrutinize the origin or source of the claim involved. Expenses incurred in marital or other personal settlements will clearly be nondeductible under section 212 (2), although such expenditures might be partially recoverable through utilization of other provisions. For example, the part of the legal fees which can be allocated for tax advice might be deductible under section 212 (3).[27] On

[24] INT. REV. CODE OF 1954, § 162 (a), provides solely for the deduction of expenses "incurred . . . in carrying on any trade or business . . . ."

[25] To the extent that a taxpayer incurs involuntary expenses, such as a tort liability, his ability to pay an income tax is impaired. Consequently, there is substantial reason for allowing the deduction of such expenses in the same manner that analogous casualty losses are deductible under INT. REV. CODE OF 1954, § 165 (c) (3). However, this would require a specific provision by Congress, since § 212 (2) clearly does not allow such a deduction.

[26] Making deductibility of defense costs turn upon the form of investment at the time of the suit would mean that a home-owning defendant could become entitled to deduct the costs of defending a tort action by mortgaging his home and investing the proceeds in securities. The nonsense of a rule turning upon such irrelevancies is evident.

[27] INT. REV. CODE OF 1954, § 212 (3), allows a deduction for the "ordinary and necessary expenses paid . . . in connection with the determination, collection, or refund of any tax." The deduction apparently encompasses only the expenses of the actual taxpayer. Consequently, in United States v. Davis, 370 U.S. 65 (1962), the Supreme

the other hand, the expenses of resisting the wife's contentions as to the existence of specific community property in the *Gilmore* case might be capitalized and added to the basis of the property as a cost of defending respondent's title.[28] Consequently, the Court's holding should not be read as a complete denial of tax relief in *Gilmore-Patrick* situations.

Court disallowed a husband's deduction of legal fees paid to his wife's attorney for tax advice to the wife. The Court intimated no opinion as to the deductibility of the legal expenses for tax advice incurred by the husband in the course of a divorce settlement.

[28] See Harris v. United States, 275 F.2d 238 (9th Cir. 1960); Shipp v. Commissioner, 217 F.2d 401 (9th Cir. 1954).

The legal expenses incurred for leasing arrangements in the *Patrick* case might be capitalized and amortized over a period of years to the extent that the fees were for services on behalf of respondent in his capacity as a lessor. See Commissioner v. Chicago Dock & Canal Co., 84 F.2d 288 (7th Cir. 1936); Helvering v. Manhattan Life Ins. Co., 71 F.2d 292 (2d Cir. 1934).

In both cases, a problem arises from the Court's labeling of the legal expenses as "personal" expenses. Such a classification might preclude capitalization of the expenditures for tax purposes.