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# Income Tax -- Deductibility of Legal Fees Incurred Defending Income Producing Property in a Divorce Action

Herbert Buchwald

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the terms of the previous tenancy, would seem to be unaffected by the time at which the tenancy is modified by agreement. Although Florida has abrogated by statute<sup>31</sup> the common-law rule that holding over gives rise to a tenancy for the same term as the previous lease, this does not negate the existence of a new tenancy which arises by implication of law and which may be modified by contract.

Inasmuch as the instant case decided only the liability of the hold-over tenant who remains silent with respect to a notice that the previous rent will be increased, the Florida courts may have to decide whether their rule should be different in the case of the tenant who excepts to the landlord's demand. Although permitting recovery would seem to violate the principles of contract law by which the instant case was decided, there is much to be said for a rule which allows the property owner to establish the conditions by which another may use his property. If the tenant refuses to pay what the landlord asks, he may vacate the premises and seek a new location, or he may negotiate with the landlord for a different rental more to his liking. The courts, by holding that the tenant may stay on at the same rental as stipulated in the expired lease, make it possible for the tenant to stay on the premises while he shops around for another location at a better rent. In effect, this amounts to a judicial mandate extending the previous lease beyond the term mutually agreed upon by the parties, and moreover fails to give effect to a superseding contract created by an acceptance conforming to the manner provided for in the landlord's offer—*i.e.*, by the tenant's holding over. The severity of such a rule to the tenant could be minimized by allowing him to hold over at the former rental when his continued occupation is due to a bona fide dispute, or when the landlord's demand was prompted by knowledge that the tenant would be unable to vacate the premises on time.

DONALD M. KLEIN

### INCOME TAX—DEDUCTIBILITY OF LEGAL FEES INCURRED DEFENDING INCOME PRODUCING PROPERTY IN A DIVORCE ACTION

When a California wife sued for divorce, her husband filed a cross-claim and won a complete victory. He, not the wife, was granted the divorce and her extensive property claims were completely denied.<sup>1</sup> The

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31. FLA. STAT. § 83.04 (1961). This section provides that the tenancy which results shall be a tenancy at sufferance unless the landlord consents to the tenants' continued occupation, in which case a tenancy at will results.

1. The wife alleged that the earnings accumulated and retained by her husband's three controlled corporations were the product of his personal services, not the result of an accretion in capital values. Therefore she contended that his stockholdings in the enter-

husband was compelled to oppose his wife's demands in order to prevent the loss of his controlling stock interests, the principal source of his income. Furthermore, there was a risk that the General Motors Corporation might find it advisable to exercise its right to cancel his dealer franchises if he were deemed guilty of the reputation-damaging charges of marital infidelity. The husband incurred considerable legal expense in connection with this litigation. The Internal Revenue Service disallowed the deduction of any part of the legal fees, contending that the expenditures were wholly "personal" or "family" expenses.<sup>2</sup> Subsequently, the Court of Claims granted a deduction for 80 per cent of the legal fees as being attributable to the management, conservation and maintenance to property held for the production of income.<sup>3</sup> On appeal to the Supreme Court of the United States, *held*, reversed: the criterion determining whether a legal expense is "personal" or "business" arises from the origin and character of the claim for which the expense is incurred rather than its potential consequences upon the fortunes of the taxpayer. *United States v. Gilmore*, 83 Sup. Ct. 623 (1963).

The task of determining precisely when legal fees should be considered connected with the "management, conservation, or maintenance of income producing property"<sup>4</sup> seems to have perplexed the Supreme Court for many years.<sup>5</sup> The heretofore most recent previous decision, *Lykes v. United States*,<sup>6</sup> involved the deductibility of legal expenses incurred in connection with a dispute over the valuation of property for gift tax purposes when the tax liability, if assessed, would have consumed income producing property of the donor. It was held that an expense having its ultimate source in a voluntary diminution of income producing property would not be considered an expense incurred for the management, conservation or maintenance either of the prop-

prises, under California law, were community property, and that to that extent, as the innocent party in the divorce proceedings, she was entitled to more than a one-half interest. In California, a party who is granted a divorce on grounds of extreme cruelty or adultery may, in the court's discretion, be awarded up to all of the community property of the marriage. CAL. CIVIL CODE § 146; *Barham v. Barham*, 33 Cal. 2d 416, 202 P.2d 289 (1949); *Wilson v. Wilson*, 159 Cal. App. 2d 330, 323 P.2d 1017 (1958).

2. By application of INT. REV. CODE OF 1954, § 24(a)(1).

3. 290 F.2d 942 (Ct. Cl. 1961), applying INT. REV. CODE OF 1954, § 212(2) which states:

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 . . . for the management, conservation, or maintenance of property held for the production of income . . . .

4. The term "management, conservation, or maintenance" is not expressly defined in the congressional committee reports issued in connection with the 1942 enactment nor in the subsequent regulations.

5. *Lykes v. United States*, 343 U.S. 118 (1952); *Bingham's Trust v. Commissioner*, 325 U.S. 365 (1945); *Commissioner v. Heininger*, 320 U.S. 467 (1943); *Van Wart v. Commissioner*, 295 U.S. 112 (1935); *Kornhauser v. United States*, 276 U.S. 145 (1928).

6. 343 U.S. 118 (1952).

erty given away or that which remained.<sup>7</sup> The Court emphasized the *cause* of incurring the expense—the gift itself—and refused to recognize the *effects* of the litigation. This decision has since been legislatively overruled.<sup>8</sup> But the approach in the *Lykes* case was fundamentally the same as the notable decision in *Kornhauser v. United States*.<sup>9</sup> In that case the Court emphasized the operation of the business of a dissolved partnership as being the *cause* of the litigation; the *effect* on the title of the stock was not controlling. Unfortunately, the Supreme Court has been inconsistent. In *Commissioner v. Heininger*,<sup>10</sup> the Court permitted a dentist to deduct legal fees paid in an unsuccessful attempt to set aside a post office fraud order. The dentist's business was selling false teeth through the mails and the postal order was based on an administrative determination that false representations were made in his mail solicitations. In this case, the Court stressed the immediate *effect* of the litigation, which was the destruction of the taxpayer's business, but did not concern itself with the *cause* of the litigation, that is, the illegality of the operation. In a later case, the Court allowed a deduction of attorney's fees paid for resisting an income tax demand by taking cognizance of the *effect* of the demand—the reduction of assets which the trustees were bound to conserve—rather than the underlying cause of the tax demands.<sup>11</sup>

The Supreme Court's inconsistent postures fostered a conflict among the lower courts. The Tax Court repeatedly refused to allow the husband any deduction whatsoever for attorney's fees incurred in connection with divorce proceedings, whether for obtaining a property settlement,<sup>12</sup> for securing the divorce itself,<sup>13</sup> or merely for repayment of attorney's fees to the wife.<sup>14</sup> On the other hand, the Court of Claims consistently

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7. The Court stated that insofar as gifts to members of a donor's family are in the nature of personal or family expenses, it will be considered that expenditures for accounting, legal or other services in making the gifts, are of a like nature.

8. INT. REV. CODE OF 1954, § 212(3) now provides a deduction for ordinary and necessary expenses paid or incurred in connection with the determination, collection or refund of *any* tax.

9. 276 U.S. 145 (1928).

10. 320 U.S. 467 (1943).

11. *Bingham's Trust v. Commissioner*, 325 U.S. 365 (1945).

12. *Charlotte M. Douglas*, 33 T.C. 349 (1959); *James A. Walsh*, 28 T.C. 1274 (1957); *F.C. Bowers*, 25 T.C. 452 (1955), *rev'd*, 243 F.2d 904 (6th Cir. 1957); *Andrew Jergens*, 17 T.C. 806 (1951); *Thorne Donnelley*, 16 T.C. 1196 (1951).

13. 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 71 are deductible by the wife under section 212. *Treas. Reg. § 1.262-1(b)(7)* (1963).

14. The wife may deduct her own unreimbursed attorney's fees to the extent paid to secure alimony. *Treas. Reg. § 1.262-1(b)(7)* (1963). However, the husband's position is less fortunate since it is usually he who pays, not only the alimony, but the legal fees as well.

applied the now maligned "consequence test" to legal fees incurred in litigating property settlements.<sup>15</sup> Some courts of appeals also permitted the deductibility of legal expenses in appropriate circumstances,<sup>16</sup> although others balked.<sup>17</sup> However, even some of those circuits refusing deductibility indicated they would permit a deduction in an appropriate situation.<sup>18</sup> The most renowned court of appeals decision, *Baer v. Commissioner*,<sup>19</sup> resolved the issue by applying a "consequence test." The taxpayer defended against a property settlement that threatened to deter severely his future earning capacity by requiring the disposition of stock holdings which would make him lose control of the corporation from which he was generating his total income. As in the *Gilmore* case,<sup>20</sup> the taxpayer-husband was relatively unconcerned about the divorce. Since the controversy did not go to the *question of liability* but merely to the manner in which the liability *might be met*, the court reasoned that the legal services were incurred for "conserving and maintaining" income producing property. The jurisdictions adopting this rationale have placed little reliance on the obscure distinction between the question of liability and the manner of its discharge. Rather, they have tended to confine themselves to situations where the wife's claims would disrupt completely the husband's capacity to earn a living.<sup>21</sup>

By the decision in the *Gilmore* case, the conflict apparently has been resolved. The Court discarded the "consequence test" by embracing a test of deductibility founded on the origin and nature of the claim for which the expense was incurred.<sup>22</sup> The Court did not perceive a significant distinction between the question of a husband's liability and the manner in which it is discharged. On the contrary, in both instances the husband aims to avoid losing valuable property and therefore, both situations should be treated alike. The majority of the Court regarded

15. *Davis v. United States*, 287 F.2d 168 (Ct. Cl. 1961); *McMurtry v. United States*, 132 F. Supp. 114 (Ct. Cl. 1955).

16. *Owens v. Commissioner*, 273 F.2d 251 (5th Cir. 1959); *Bowers v. Commissioner*, 243 F.2d 904 (6th Cir. 1957); *Baer v. Commissioner*, 196 F.2d 646 (8th Cir. 1952).

17. *Lewis v. Commissioner*, 253 F.2d 821 (2d Cir. 1958); *Richardson v. Commissioner*, 234 F.2d 248 (4th Cir. 1956); *Smith's Estate v. Commissioner*, 208 F.2d 349 (3d Cir. 1953).

18. *Smith's Estate v. Commissioner*, 208 F.2d 349 (3d Cir. 1953); *Howard v. Commissioner*, 202 F.2d 28 (9th Cir. 1953).

19. 196 F.2d 646 (8th Cir. 1952).

20. 83 Sup. Ct. 623 (1963).

21. *Owens v. Commissioner*, 273 F.2d 251 (5th Cir. 1959); *Bowers v. Commissioner*, 243 F.2d 904 (6th Cir. 1957); *Tressler v. Commissioner*, 228 F.2d 356 (9th Cir. 1955). See also *Davis v. United States*, 287 F.2d 168 (Ct. Cl. 1961).

22. A ludicrous decision recently was reversed by the Supreme Court of Oregon when an "origin" test was applied with absurd results. The Oregon Tax Court had permitted a deduction for legal fees incurred by a husband and wife in defending a charge of murder by reasoning that the "origin" of the criminal action was caused by a business dispute with the deceased, thereby rendering the cost of defending the action deductible. In overruling the decision, the Supreme Court of Oregon determined that the expense incurred was not an "ordinary and necessary" business expense. *Sproul v. State Tax Comm'n*, 382 P.2d 99 (Ore. 1963).

the dialectics of the *Baer* case<sup>23</sup> as unsound, since *Baer* failed to justify favorable tax treatment for legal expenses incurred in defending against loss of control of a particular corporation in contrast with instances where the impact would be upon diversified holdings of income producing securities. The diversified security holdings are no less property held for the production of income than a large block of stock in a single company. If the relative impact of a claim on the income producing resources were the determining factor in permitting deductibility, substantial uncertainty and inequity would be inherent in the rule.<sup>24</sup> The Court did not distinguish between the legal fees applicable to the claims of the wife regarding the existence of community property and those involving the actual division of such property,<sup>25</sup> nor did it determine whether the legal expenses were personal or capital expenditures.<sup>26</sup> The Court adhered to the doctrine originally espoused by the *Kornhauser* decision, and later adopted in the *Lykes* case, finding that it was sufficient that the wife's claim stemmed entirely from the marital relationship, and not, under any tenable view, from an income producing activity. Solely on that basis, the legal expenditures could not be deductible.

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23. 196 F.2d 646 (8th Cir. 1952), discussed in text with notes 19-20 *supra*.

24. *Lykes v. United States*, 343 U.S. 118 (1952).

25. Particular problems are encountered in community property situations since it is difficult, if not impossible, to ascertain whether particular property is separate or community property. In *Lewis v. Commissioner*, 253 F.2d 821 (2d Cir. 1958), the Tax Court disallowed a husband's deduction of attorney's fees incurred in defense of an action for an accounting brought by the wife to establish her title to certain securities. In affirming the Tax Court, the Second Circuit determined that the husband's expenses were incurred in connection with defense of his title and, therefore, were not deductible. However, he would then be entitled to increase his basis for the securities by the amount of fees incurred, and thus, for tax purposes, the attorney's fees would not be disregarded entirely, as they might have been had the disallowance been based upon the theory of a personal expense.

26. Since 1918, the regulations have provided that expenditures incurred in defending or perfecting title must be capitalized as a part of the cost of the property. Treas. Reg. § 1.212-1(k) (1957). This so-called "defense of title" rule has been sharply criticized as being inconsistent with the language in 212(2) and incompatible with other provisions of the regulations. However, the major objection to the rule is that it is not supported by the statutory language of § 263(a)(1), which denies a deduction for expenditures paid out for permanent improvements or betterments made to increase the value of any property or estate. Nowhere does it mention expenditures incurred for the defense of title or for recovery of property. The regulation goes beyond the statute by disallowing expenses incurred to defend title or reacquire property even though such expenditures do not in any way increase the value of the property. The regulation conflicts with *Kornhauser v. United States*, 276 U.S. 145 (1928), and *Bingham's Trust v. Commissioner*, 325 U.S. 365 (1945). In *Kornhauser*, the primary issue was the successful defense of a partner's right to retain stock received as a fee. The theory of the Court was that the suit arose out of the taxpayer's business and that therefore, the cost of defending title to the stock was a deductible expense. The Court saw no logical difference between expenses incurred to collect the fee, which are concededly deductible, and those incurred to retain title to a fee previously received. In *Bingham's Trust* it was held that the expenses incurred for the distribution of property by a testamentary trustee and legal expenses incurred in unsuccessfully resisting an income tax deficiency asserted against the trust were deductible as being expenses of management and did not constitute capital expenditures. Again, title to the trust was at issue, but the Court, nevertheless, permitted the deduction.

Presumably, the *Gilmore* case has established a deductibility test for legal expenses incurred in litigating property settlement claims in divorce actions. The legal fee must not only be ordinary and necessary, but must arise from a claim *originating* from the management, conservation or maintenance of property held for the production of income. The significance of the decision may reach far beyond the mere resolution of conflicting views. The case may be indicative of a future emphasis on restricting the deductibility of legal expenses to those matters which are clearly an integral part of business or for the production of income.

One immediate effect of the *Gilmore* decision will be to relieve attorneys representing affluent husbands from the necessity of pro-rating charges for legal fees. Otherwise, the *Gilmore* case continues to demoralize the divorcing husband further by denying him the tax benefits of engaging top legal counsel to stave off his wife's claims to his property while, in contrast, the wife is still allowed to deduct her legal expenses in trying to get the property away from him<sup>27</sup>

HERBERT BUCHWALD

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27. Treas. Reg. § 1.262-1(b)(7) (1958); see notes 13 and 14 *supra*. Furthermore, by virtue of INT. REV. CODE OF 1954 § 212(3), the husband may deduct the cost of legal advice to combat Uncle Sam, but he may not, by reason of the *Gilmore* decision, deduct the cost of legal advice to combat his wife.