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**Income Taxes: Deductibility of Legal Fees Under § 212(3)**

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A husband incurred an attorney fee arising from an uncontested divorce. At least seventy percent of the fee represented a proper allocation to services and advice given in connection with the tax consequences flowing from the divorce. Primarily, the attorney directed his professional efforts to making sure, so far as possible, that the substantial support payments would constitute taxable alimony to the wife and thereby be deductible by the husband. The husband contended that the portion of the attorney fee pertaining solely to services and advice relating to his tax matters should be deductible pursuant to § 212(3) of the Internal Revenue Code of 1954. Held, by the Court of Claims, § 212(3) permits a deduction for legal expenses incurred in connection with the determination, collection or refund of any tax, whether or not contested by the government. Carpenter v. United States, 338 F.2d 366 (Ct. Cl. 1964).

The affluent tax conscious husband obtaining a divorce has long been searching for a means of obtaining a tax deduction for tax advice expenditures incurred in connection with the divorce in order to soften the burden. The Court of Claims, in the face of conflicting views, has always adhered to the principle that legal fees paid for consultation and

1. The tax deduction involved over $150,000 annually. In the absence of evidence indicating the allocation was in bad faith or lacking in reality, the allocation should be accepted. Bryant Heater Co. v. Commissioner, 231 F.2d 938 (6th Cir. 1956); Maine Steel, Inc. v. United States, 174 F. Supp. 702 (D. Me. 1959); Anita M. Baldwin, 10 B.T.A. 1198 (1928); Samuel S. Schahet, 28 Tax Ct. Mem. 213 (1959); International Trading Co., 27 Tax Ct. Mem. 447 (1958).


3. INT. REV. CODE OF 1954, § 212 provides:

   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—
   (1) for the production or collection of income;
   (2) for the management, conservation or maintenance of property held for the production of income; or
   (3) in connection with the determination, collection or refund of any tax. (Emphasis added.)


4a. The Tax Court has repeatedly refused to permit the husband any deduction for attorney fees incurred in connection with divorce proceedings. Charlotte M. Douglas, 33 T.C. 349 (1959); James A. Walsh, 28 T.C. 1274 (1957). The courts of appeals have been in conflict. Compare Owens v. Commissioner, 273 F.2d 251 (5th Cir. 1959); Bowers v. Commissioner, 243 F.2d 904 (6th Cir. 1957) with Lewis v. Commissioner, 253 F.2d 821 (2d Cir. 1958).
advice in tax matters are properly deductible from gross income even though arising in connection with a divorce settlement agreement. In the notable *Gilmore* decision, the Supreme Court established the principle that legal expenses generated by a separation or divorce decree are not deductible under § 212(2) of the Internal Revenue Code of 1954.

But in *Gilmore* the court emphasized its decision was founded on § 212(2), not § 212(3). Therefore, *Gilmore*, did not controvert the prior posture of the Court of Claims.

There are no express provisions in the Internal Revenue Code of 1954 referring specifically to the matter of deductibility of legal or other professional fees. Such expenditures, if deductible at all, must qualify as a business expense under § 162(a), or, in the case of an individual taxpayer, under § 212. Admittedly, dissolution of the marital affinity will involve not only the severence of the personal relationship but the division of property and payment of money as well. As a result, the legal services to be rendered will involve not only a personal element but will also relate to financial matters and production of income. Presumably, one phase of the complex problem has been permanently resolved by *Gilmore.* The test of deductibility under § 212(2) is determined by the origin or source of the claim, not its effect on the income producing property. Fees incurred for defending against a claim based on a marital relation will no longer be deductible under § 212(2) on the theory that

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5. Davis v. United States, 152 Ct. Cl. 805, 287 F.2d 168 (1961). On certiorari, the United States Supreme Court affirmed in part, and reversed in part. United States v. Davis, 370 U.S. 65 (1962). However, in *Davis*, the court did not review the question involved here. The Supreme Court specifically refrained from intimating any opinion on the issue except to state that "as to the deduction of the wife's fees, we read the statute, if applicable to this type of tax expense, to include only the expenses of the taxpayer himself and not those of his wife."


8. Ibid.

9. As being an "ordinary and necessary expense paid or incurred during the taxable year in carrying on any trade or business."

10. This section provides for the so-called "non-business expense" deduction. Although a legal fee may satisfy the requirements of § 162 or § 212, deductibility is still subject to the non-deductibility provisions of §§ 261-273. Thus, a legal fee constituting a capital expenditure may not be deducted. Int. Rev. Code of 1954, § 263(a).

11. Treas. Reg. § 1.262-1(b)(7) (1958) expressly provides, "Generally, attorney fees and other costs paid in connection with a divorce, separation or decree of support are not deductible by either the husband or the wife." Unfortunately, the use of the qualifying term "generally" has in effect left the matter to a case by case resolution in the courts.

12. Prior to *Gilmore* numerous decisions allowed a deduction for legal fees incurred to "conserve" or "protect" a taxpayer's income producing property from his wife's adverse marital claims. 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); McMurtry v. United States, 132 F. Supp. 114 (Ct. Cl. 1955). Contra, Lewis v. Commissioner, 253 F.2d 821 (2d Cir. 1958).

13. This rule precludes a taxpayer from obtaining a deduction for fees incurred in protecting against a wife's community property claims. The claims have been held to be personal—arising out of the marriage relations, "for no such property could have existed but for the marriage relationship." United States v. *Gilmore*, 372 U.S. 39, 52 (1963). See, Note,
the claim is one directly jeopardizing the income producing property. On the other hand, § 212(3) expressly authorizes a deduction for expenses incurred in connection with the determination, collection or refund of any tax. It is significant that Congress has described § 212(3) as being "designed to permit the deduction by an individual of legal and other expenses paid or incurred in connection with a contested tax liability. Any expenses incurred in contesting any liability . . . will be deductible." As a result of this pronouncement, the government has repeatedly contended that § 212(3) was intended to apply only to actual contested tax liabilities—not for expenses incident to the determination of a tax liability prior to the time it becomes contested. Two years ago, the Internal Revenue attempted to implement its interpretation of § 212(3) by denying a taxpayer's deduction for fees incurred in securing an income tax ruling. Taxpayers had deducted their allocable share of the accountants fee and the commissioner disallowed it. The commissioner


14. See supra note 4. In both the Gilmore and Patrick cases, the taxpayer sought to justify the deduction of legal fees as having been incurred to conserve income producing property under § 212(2). In neither case was the deduction sought under § 212(1) as being incurred for the production or collection of income. The facts of Gilmore were not amenable to such an argument. Deduction under § 212(1) is available only when expenses are incurred to create income. The deduction cannot be predicated on "production" when only liabilities or allowable deductions are reduced. Hunter v. United States, 219 F.2d 69 (2d Cir. 1955); Treas. Reg. § 1.212-1(m) (1957). By contrast, Patrick involved fees incurred to arrange a reshuffling and purchase of property interests for the purposes of satisfying the wife's marital claims. If such transfers at divorce were currently productive of income, either as taxable divisions of property between vested owners or as taxable transfers under Davis, the fees incurred to produce such income should be currently deductible under § 212(1). See Treas. Reg. § 1.212-1(b); § 1.262-1(b)(7) (1958). The actual result in Patrick is not necessarily contrary. The disallowance of the legal fees can be explained by the taxpayer's failure to argue for deductibility under § 212(1), having instead unsuccessfully rested his case on the provisions of § 212(2).

15. See Note 3 for full text of § 212.


17. The committee reports made clear that § 212(3) was primarily designed to change the rule established in Lykes v. United States, 343 U.S. 118 (1952) which had held that legal fees paid in connection with the litigation of a gift tax liability were not deductible since it was a gift tax, rather than an income tax, that was being contested. The amendment was intended to allow a deduction for legal expenses incurred in connection with the determination, collection or refund of any tax.

18. Kaufman v. United States, 227 F. Supp. 807 (W.D. Mo. 1963). Three stockholders had decided it would be advantageous to themselves and their estates to make a change in their stockholdings. An agreement was entered into with American Investment Company, a corporation listed on the New York Stock Exchange, under which Kaufman and his associates would receive common and preferred stock in exchange for the stock of their commerce loan company. After executing the agreement an accounting firm was employed to explore its tax consequences and to prepare any necessary data and information needed to obtain a tax ruling on whether or not the transfer of stock would be tax free. The accounting firm submitted a bill in the amount of approximately $8,600 of which $7,600 was applicable to the determination of the tax liability under the agreement for the exchange of stock. The accountants took no part in drafting the exchange agreement or in the negotiation of its terms.
would only recognize as deductible those expenses incurred where the activities are in connection with the determination, collection or refund of a tax such as those involved in the preparation of a tax return or the determination or contesting of the extent of the taxpayers liability or for a return under audit. This view precluded the deduction for any expenses incident to a determination of a tax liability prior to the time when it becomes contested. The federal court rejected the commissioner's argument. Where the legislative history is not in accord with the clear meaning of the words used in the act itself, the court is bound by the clear and commonly understood meaning of the act. Sec. 212(3) is clear when it provides, "in connection with the determination . . . of any tax." "Determination" is only one phase of a tax controversy. Since the purpose of the taxpayer was to determine a question of tax liability, the expenses allocable to such determination must be deductible under § 212(3).

It is significant that the Treasury regulations do not try to limit deductibility of expenses incurred for employment of tax counsel to only those instances involving a contest of a tax liability or the preparation of a tax return. Indeed, the Treasury regulations expressly permit the deduction of expenses paid or incurred for tax counsel. Similarly, the Treasury regulations also provide for the deduction of fees paid to investment counsel. Obviously, a taxpayer does not employ investment counsel after he has made his investments. Similarly, a taxpayer should not be limited in his deduction of expenses for tax counsel to the time when he discovers the tax consequences of circumstances which have already transpired. One of the fundamental purposes of the taxpayer in obtaining tax counsel is to avoid tax contests, not create them.

There is a suggestion in the committee reports that the problem was anticipated by the American Bar Association Section on Taxation. The Association entered an appearance at the Senate hearings and requested that the language of the house committee be modified by adding the word "computation" before the word "determination" in order to make it clear that deductions with respect to taxes would not be limited to contested liabilities. Unfortunately, the Senate Committee on Finance did not

19. Id. at 813.
20. Treas. Reg. § 1.212-1(l) (1957) provides: (l) Expenses paid or incurred by an individual in connection with the tax determination, collection, or refund of any tax, whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus, expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of tax liability or in contesting his tax liability are deductible. (Emphasis added.)
21. Ibid.
24. 1 Hearings before the Senate Committee on Finance on the Internal Revenue Code of 1954 at 487:
adopt this suggestion. However, the significance of their failure to adhere to the suggestion is of dubious weight.\textsuperscript{25}

The results of Carpenter are consistent with the findings in Gilmore and Patrick.\textsuperscript{26} While the "origin test" is applicable to deductibility of an expense incurred for the management, conservation or maintenance of property held for the production of income, the emphasis in § 212(3) is on the expenditure made in connection with the determination of the tax liability. As a result, the "origin" or "source" of the legal expense incurred is from the desire to determine the tax liability, not the achievement of results in the personal divorce litigation. In view of this, the fees incurred can only be in connection with the determination of a tax affecting the taxpayer's income under § 212(3). In Davis, the Supreme Court denied the deduction for attorney fees paid by the taxpayer for his former wife's attorney since they were not in connection with the determination, collection or refund of his tax. This is in accord with the general principle that a taxpayer cannot claim a deduction for payment of expenses of another.\textsuperscript{27}

It is understandable that taxpayers are vitally interested in whether legal and other professional fees are deductible for federal income tax purposes. With our present high tax rate structure the ultimate burden of

While the language of section 212 by itself would appear not to present any particular problems, the language of the committee report on page A59 does raise a new problem with respect to the language of the bill. The language of the committee report appears to confine expenses in connection with tax matters to contested tax liabilities under paragraph (3) of section 212. Since a specific provision ordinarily controls a general provision, this might have the effect of limiting deductions with respect to all taxes, including even income taxes, to contested matters. It is believed that this result was not intended.

This problem might be eliminated by adding the word "computation" before "determination" in section 212(3). In any event, the Senate Finance Committee report should clarify the point that deductions with respect to taxes are not hereafter to be confined to contested taxes.

25. Attempts to use statements submitted to a congressional committee at a hearing as evidence of congressional intent points up the general rule that statements by witnesses before a congressional committee by those seeking enactment of particular legislation is not to be considered in arriving at the intention of Congress. Thomas v. S.B. Vandergrift & Co., 162 Fed. 645 (3d Cir. 1908); Mutual Benefit Life Ins. Co. v. Duffy, 295 Fed. 881 (D.N.J. 1924), aff'd, 3 F.2d 1020 (3d Cir. 1925), aff'd, 272 U.S. 613 (1926). Even statements made by Congressmen during debates in Congress are unreliable in arriving at the intention of Congress. Duplex Printing Press Co. v. Deering, 254 U.S. 443 (1921); Lapina v. Williams, 232 U.S. 78 (1914); United States v. Trans-Missouri Freight Ass'n, 166 U.S. 290 (1897). Nevertheless, the Supreme Court has held that in appropriate instances statements of witnesses who are proponents of particular legislation may be helpful in understanding the enactments which finally emerge in respect to the subject matter. United States v. Ogilvie Hardware Co., 330 U.S. 709 (1947).

26. Discussed in text accompanying notes 5-8 supra.

27. Interstate Transit Lines v. Comm'r, 319 U.S. 590 (1943); McGruder v. Supplee, 316 U.S. 394 (1942); Lewis v. Comm'r, 253 F.2d 821 (2d Cir. 1958). Moreover, such payment may cause the wife to lose a deduction that she might otherwise have had available if she made her own payment, although, arguably, the husband's payment should constitute an indirect payment by the wife so as to entitle her to any deduction she would have otherwise merited by her own payment.
the fees is profoundly affected by the question of deductibility. However, although Carpenter establishes that application of § 212(3) will not be limited only to expenditures incurred in the contesting of a tax liability, no standard is suggested as to how remote the legal expenditure may be in relation to the anticipated tax liability. The decision could be construed to permit an individual taxpayer to deduct counsel fees paid for the general planning of his holdings to minimize income, estate or gift taxes in future years, or even more remotely, for arranging marital or family affairs with a view to tax minimization in the future. Since these expenditures clearly fall outside the purview of § 212(1) and (2) as being purely personal, it would seem advisable to require that a clear congressional intent be manifested before permitting deductions of all expenditures which may be remotely connected with a tax liability. Certainly, the enactment of § 212(3) was not intended to encompass fees incurred for the advice of tax counsel with respect to every intra-family disposition of property, whether by ordinary gift, trust, insurance policy or by will. Many such dispositions are prompted, at least in part, by advice of tax counsel. Many specialists in the field of tax law devote themselves almost entirely to tax planning for gifts and estates. Not every legal fee attributable to the execution of a gift, trust deed, insurance policy, or will should be properly claimed to be attributable in part to the tax planning involved in the drafting of the instrument. This would be going too far. Obviously, a meaningful standard is necessary to provide the taxpayer a reasonable opportunity to predict accurately the tax consequences of deducting the fees incurred. Perhaps the approach of Gilmore and Patrick could be utilized—that is, where the incurrence of the expense originates for the substantial purpose of determining tax liability a deduction should be allowed. While the advisor cannot resolve the problem, a lesson can be derived from the cases. Clearly, the practitioner who is aware of the difficulties lying ahead can perform a valuable service by maintaining careful records of the services he performs. In this way, his clients will be able to make any allocation of his fees which may later become necessary in order to segregate the deductible portion from that which cannot be deducted.

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