1969

Post-Gilmore - Recent Trends in the Deductibility of Professional Fees

Lawrence B. Gibbs

Follow this and additional works at: https://scholar.smu.edu/smulr

Recommended Citation
https://scholar.smu.edu/smulr/vol23/iss4/3

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit http://digitalrepository.smu.edu.
POST-GILMORE — RECENT TRENDS IN THE DEDUCTIBILITY OF PROFESSIONAL FEES

by

Lawrence B. Gibbs

IT HAS been suggested that attorneys and accountants, as well as their clients, have a vested interest in the tax deductibility of professional fees. This enlightened self-interest, together with the fact that the deduction of professional fees is nowhere specifically mentioned in the Internal Revenue Code, may help to explain the almost overwhelming number of cases involving the deductibility of legal and accounting expenses. As the number of recent cases indicates, litigation in this area is not slackening.

Of the nine Supreme Court decisions which have considered the deduction of professional fees, four have been handed down in the last seven years. Even so, the ground rules in this area are by no means settled, so that generalization or categorization as to deductibility of specific types of fees is hazardous. There are, however, certain trends which are becoming apparent to which this Article is addressed.

Traditionally, the taxpayer has attempted to sustain the deduction of professional fees under one of two sections of the Internal Revenue Code: either section 162, dealing with business expenses, or section 212, dealing with an individual’s so-called nonbusiness expenses. Recently, however, deduction has been asserted under other Code sections. Conversely, the Government traditionally has opposed deduction of professional fees in one of two ways: either by arguing that the fees are nondeductible or that they should be capitalized.

1 See generally the cases cited and discussed in the following articles: Brodsky & McKibbin, Deduction of Non-Trade or Non-Business Expenses, 2 TAX L. REV. 39 (1946); Brookes, Litigation Expenses and the Income Tax, 12 TAX L. REV. 241 (1957); Dohan, Deductibility of Non-Business Legal and Other Professional Expenses; Expenses for Creation or Protection of Income or Property, Divorce, etc., N.Y.U. 17TH INST. ON FED. TAX. 579 (1959); Krane, Deducting Legal and Accounting Fees: Selected Problems, 44 TAXES 7 (1966); McDonald, Deduction of Attorneys’ Fees for Federal Income Tax Purposes, 103 U. PA. L. REV. 168 (1954); Schlenker, Tax Deductibility of Legal Fees, 54 A.B.A.J. 199 (1968); Winokur, Deductibility of Legal and Other Professional Fees, S. CAL. 15TH INST. 417 (1963).

2 By this author’s count over eighty cases involving deduction of professional fees have been decided in the last three years.


4 INT. REV. CODE of 1954, § 162.

5 Id. § 212.

DEDUCTIBILITY OF PROFESSIONAL FEES

The nondeductibility approach may take one of several forms. The Government may assert that the fees are not deductible because they are either personal expenses, expenses relating to the production of tax-exempt income, expenses of another taxpayer, or because their allowance would in some way violate public policy. The Commissioner's second line of argument, which usually appears as an alternative to the first, is that the legal fees are capital in nature within the meaning of section 263, with the result that deduction must be deferred to or over a period of time in the future, if not postponed entirely. It is in this area of nondeductible versus capital expense that much of the current tax law relating to professional fees is emerging.

One of the most interesting developments in the professional fees area, which is possibly indicative of a larger trend in the general income tax field, involves the relation of the scope of deductibility of fees under section 162 as business expenses to the scope of deductibility of fees as nonbusiness expenses under section 212. It is well established that these two sections are related in scope and are to be similarly construed. In practice, however, the scope of deduction of professional fees as business expenses has been increasing, while the scope of deduction of professional fees as nonbusiness expenses (with one exception) has been diminishing.

I. THE PRE-GILMORE BACKGROUND

A good indication of this trend may be seen in the Supreme Court decisions involving the deduction of professional fees. Interestingly, the only case in which the Supreme Court has ever denied the deduction of an attorney's fee as a business expense involved a situation in which the fee was clearly a nonbusiness expense. In Van Wart v. Commissioner legal fees and litigation expenses incurred by a guardian to secure income for his ward were deducted as business expenses in the ward's income tax return. The Commissioner disallowed the deduction on the grounds that the fees were personal expenses of the minor. Since this was before the enactment of the nonbusiness expense section, deduction was denied, but the case led to the enactment of the predecessor to what is now section 212(1) and (2) allowing deduction of nonbusiness expenses for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income.
The most recent Supreme Court decision allowing deduction of professional fees as business expenses is the *Tellier* case, which permitted the deduction of legal fees of an unsuccessful defense to a criminal prosecution arising out of the taxpayer's business as a security dealer. The decision has been a popular one, not only with the lower courts and the general bar, but also with the Internal Revenue Service, especially insofar as it vindicates its earlier position that claims and attorneys' fees arising from private suits and settlements under section 4 of the Clayton Act were deductible, a position which had engendered a good deal of congressional dissatisfaction.

Equally as important as *Tellier* is the original Supreme Court decision in this area in the *Kornhauser* case. In *Kornhauser* the Supreme Court permitted deduction of attorney and accounting fees incurred by the taxpayer in defending against a suit for an accounting brought by the taxpayer's former partner in which title to certain stock was in dispute. The Commissioner had argued that the legal expenses were personal in nature, or in the alternative, that they had been incurred in defense of title to stock and should be capitalized. In upholding the deduction, the Court sketched the rudiments of two basic tests, either of which, if met, would permit deduction. The first, the so-called "origin test," allows deduction if the claims which caused the taxpayer to seek professional counsel originated in or proximately resulted from the taxpayer's business. In *Kornhauser* the lawsuit which gave rise to the attorney's fees in question had involved a determination of the amount of business income of the partnership; therefore, the Court held that this test was satisfied. The second test, often referred to as the "consequences test," permits deduction if the consequence of the claims which caused the taxpayer to incur the professional expense involved potential damage to business reputation or loss of specific business assets. In this regard, the Court in *Kornhauser* cited the deductibility of costs incurred by a doctor in defending against a malpractice suit. The Court indicated that since the costs of producing business income were deductible, the costs of conserving it should also be allowed as a deduction.

Since the *Kornhauser* decision, the Supreme Court, as well as the lower courts, has vacillated between these two tests in considering the deductibility of professional expenses. In the business expense area under section

---

19 Kornhauser v. United States, 276 U.S. 145 (1928).
21 276 U.S. at 153.
22 Compare Trust of Bingham v. Commissioner, 325 U.S. 365 (1945), and Commissioner v.
162, the courts have been and still are using both the origin test and the consequences test as the rationale for the allowance of appropriate deductions.\textsuperscript{2} In the nonbusiness area under section 212, however, the trend has been to eliminate the consequences test and to deny deduction unless the origin test could be met.\textsuperscript{3}

\section*{II. The Gilmore Decision}

The culmination of this trend toward elimination of the consequences test in the nonbusiness deduction area came in the \textit{Gilmore}\textsuperscript{5} and \textit{Patrick}\textsuperscript{8} decisions by the Supreme Court in 1963 in which the Court denied deduction of the husbands' legal and accounting expenses relating to the defense and settlement of certain claims made by their wives at the time of divorce. In \textit{Gilmore} the husband incurred legal expenses in successfully litigating his wife's community property claims to the stock of his wholly owned corporation from which he derived virtually all of his income. If the wife had been successful, the husband's stock ownership, as well as his livelihood, would have been jeopardized. In \textit{Patrick} the legal and accounting expenses arose in connection with a New Jersey property settlement under which there were certain exchanges and long-term leases involving the husband's business properties that were necessary for the continuation of his publishing business.

In both cases, the taxpayers initially argued that because the fees were incurred in resisting or settling the wife's claims to certain properties, the expenses were within the statutory framework allowing deduction of expenses for the conservation of property held for the production of income. The Court rejected this argument and indicated that the statutory phrase, "conservation of property," encompassed only safeguarding or upkeep expenses. This narrow construction of section 212 is reminiscent of the Court's restrictive interpretation of nonbusiness expenses in its earlier \textit{McDonald} decision\textsuperscript{7} in which the Court refused to permit a judge's campaign costs for re-election as expenses for the production of income and stated that the nonbusiness expense section of the Code did not enlarge the range of allowable deductions, but merely enlarged the category of income with reference to which expenses were deductible.

The Court in \textit{Gilmore} and \textit{Patrick} also pointed out that the line of reasoning adopted by both taxpayers would mean that the expense of defending almost any claim would be deductible by a taxpayer. The taxpayers countered with the argument, based on a very respectable line of authority involving several circuit court decisions, including a Fifth Circuit decision,\textsuperscript{27}

\begin{thebibliography}{9}
\bibitem{Anchor Coupling Co.} \textit{Anchor Coupling Co.} v. United States, 69-1 U.S. Tax Cas. \textsection{9347} (N.D. Ill. 1969); Smith v. United States, 67-1 U.S. Tax Cas. \textsection{9416} (S.D. Tex. 1967); Mitchell v. United States, 69-1 U.S. Tax Cas. \textsection{9275} (Ct. Cl. 1969).
\bibitem{Meyer J. Fleischman} See an excellent summary of this trend in the nonbusiness expense area in Meyer J. Fleischman, 45 T.C. 439 (1966).
\bibitem{McDonald} McDonald v. Commissioner, 323 U.S. 57 (1944).
\end{thebibliography}
that when specific assets are involved and the claims against these assets, if successful, are so substantial as to threaten the husband's means of livelihood, the fees should be deductible. To this, the Court replied that the origin of the claims giving rise to the professional fees, rather than the consequences of the claims, is controlling, and held that since the wife's claims giving rise to the husband's professional fees stemmed from the marital relationship and not from any profit-seeking activity, the fees were not deductible. Prior origin test authorities, such as Du Pont and Lykes, were relied upon heavily by the Court. Other cases, such as Heininger and Bingham's Trust, in which the Court had adopted a consequences test approach, were not discussed.

The actual holding of the Court is the interesting, and often overlooked, aspect of the Gilmore decision. A casual reading of the decision suggests that the Court considered the professional expenses to be nondeductible, personal expenses under section 262, but closer scrutiny indicates that this was not the gist of the decision. The Court expressly refused to decide whether the expenses were personal or capital and remanded the case to the district court for this determination. The district court, upon remand, held that the expenses were capital, and the Government did not appeal the district court's decision. The reason stated by the Government's attorney in recommending that the case not be appealed was that the Government had stipulated originally in the trial court that defense of title to the stock was involved in the state court divorce action.

If the origin test in Gilmore is determinative as to whether expenses are deductible or personal, it is difficult to understand how the stipulation would affect the situation. In applying the origin test in Gilmore, the Court had clearly stated that the expenses were nondeductible because of their personal origin in the marital dispute. Once this causal relationship is established, the fact that the dispute manifested itself in an argument over title to stock would seem to be irrelevant under the origin test. Stated differently, if in the chain of events under the origin test the personal problems precede the capital questions, then presumably section 262 would take precedence over section 263.

This was certainly the attitude of the Internal Revenue Service and the court of claims in the recent Clapp decision. There, the husband and wife entered into a property settlement agreement in connection with their divorce. The wife later remarried, and at her death, husband No. 2 sued husband No. 1, alleging that husband No. 1 had defrauded the wife at the

28 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. 1951).
33 372 U.S. at 52.
35 Action on Decision Letter, July 26, 1965, Internal Revenue Service Library, Washington, D.C. Ironically, as the AOD indicates, the actual facts were that in the state court the wife was making a claim for reimbursement rather than a claim against the husband's stock.
time of the property settlement, and asserted title to specific properties owned by husband No. 1. Husband No. 1 finally settled the claim, but not before running up a legal bill of $300,000. He attempted to deduct the fees on the theory that they had been incurred in conservation of his property. The court of claims refused, asserting that the fees were personal expenses and were ultimately traceable not to the settlement of husband No. 2's claim, but to the marital difficulties which gave rise to the original divorce.

Despite the compelling logic of the Clapp case, the Government's attorney may have been correct in his analysis of the Supreme Court's decision in Gilmore. His position, and that of the Court, appears to be that in order to determine whether an expense is deductible under section 212 one looks to the origin of the activities giving rise to the expense. If the origin is not the production of income or the conservation or maintenance of property held for the production of income, the expense is not deductible under section 212. In such event, however, one still has to go a step further to determine whether the expense is personal or capital. In making this second determination the origin test is not applicable, according to the California district court in its decision on remand. Viewed in this manner, the holding of the Court in Gilmore is substantially narrowed. Unfortunately, as indicated by the Clapp case, subsequent decisions often have understandably failed to make this subtle distinction.7

III. POST-GILMORE—NONBUSINESS EXPENSES

The capital versus personal nature of the expenses incident to divorce is not the only problem which has been spawned by Gilmore. Possibly more important is the distinction which has arisen in the treatment of expenses incurred by the husband and wife in connection with divorce. Prior to Gilmore, a number of cases had held that the wife's legal expenses at the time of divorce, insofar as they related to obtaining alimony, were deductible as expenses for the production of income.8 Less than three months after the Gilmore decision, the tax court in the Elliott case9 allowed the wife to deduct attorney's fees incurred in collecting unpaid alimony that had been awarded under a prior divorce, and a year later the Government acquiesced in this decision.10

Despite the acquiescence, the Internal Revenue Service went back for a second try in the Wild case,11 which involved the deduction of a wife's attorney fees at the time of divorce in connection with alimony negotiations. In the Wild case the tax court was divided. One judge would have dis-

---

7 Compare Clapp v. United States, 364 F.2d 425 (Ct. Cl. 1966), with Vermont Bank & Trust Co. v. United States, 69-1 U.S. Tax Cas. ¶ 9268 (D. Vt. 1969), and Powell v. United States, 69-1 U.S. Tax Cas. ¶ 9221 (S.D.S.D. 1969). In Powell it is indicated that the Gilmore rationale is not applicable to the question of whether legal expenses must be capitalized.
allowed the deduction and distinguished the *Elliott* case on the grounds that in *Elliott* alimony had already been awarded and Mrs. Elliott was simply trying to collect it, whereas Mrs. Wild's legal fees were incurred at the time of divorce in acquiring the alimony. However, a majority of the tax court upheld the deduction on the grounds that the *Gilmore* decision was limited to section 212(2) involving conservation of property held for the production of income, whereas in *Wild* the legal fees fell under section 212(1) since they related to the collection or production of income. The court’s analysis provides an interesting but questionable study in statutory construction. The Internal Revenue Code of 1954, for purposes of convenience only, separates the two provisions into sections 212(1) and 212(2). In the 1939 Code, they appear together as section 23(a)(2); they were passed at the same time, and the legislative history indicates no basis for distinguishing between the two. Finally, in *Gilmore*, the Court was construing the 1939, not the 1954, Code.

The Internal Revenue Service, however, has acquiesced in the *Wild* decision, so apparently the Service is content to live with the difference in treatment of the husband’s and wife’s professional fees at the time of divorce. This, along with the conceptual problems which the Service seems to be having in prescribing the tax treatment to husband and wife where appreciated property is transferred in exchange for marital rights at the time of divorce, indicates that this is an area in which further developments will hopefully be forthcoming.

The *Wild* decision does not, of course, mean that the wife’s legal expenses at the time of divorce are always deductible. For example, legal fees relating to Texas community property settlements are nondeductible under section 212(2), as they are incident to the acquisition of property rather than income. Several cases also indicate that for the wife’s attorney fees to be deductible, the amounts received by her at the time of divorce must be taxable income to her in the form of alimony.

From the husband’s standpoint, the question now appears to be: Is there any way he can avail himself of the benefits of section 212(1)? This much is clear: the husband cannot obtain a deduction by paying the wife’s legal fees, even though she collected alimony. The Supreme Court resolved this question in the *Davis* case a year before the *Gilmore* decision. With the wife’s success under section 212(1), some husbands may attempt to ma-

---

42 *id.* at 712.
43 See Judge Raum’s convincing dissent in the *Wild* case, *id.* at 711-12.
never from section 212(2) to 212(1) by arguing that their legal expenses were incurred to produce income because if they had failed to contest the alimony claims, they would have had to part with or liquidate substantial income-producing properties and therefore the income from these properties. Cases in related areas, as well as the regulations under section 212, indicate the doubtful success of such a gambit. Even if the husband is content with capitalizing his fees, problems remain. The actual facts of the Gilmore case involving the tax effect of a wife’s claim for reimbursement at the time of divorce raise the interesting question of the extent to which the husband will be permitted to capitalize his expenses in defending against a claim for cash rather than a claim against his properties. If the fees can be capitalized, to which of his properties is the increase in basis attributable, and how is the increase to be allocated?

More interesting still is the tax situation of the wife who incurs attorney’s fees in connection with a property settlement under which she receives only cash. The absurdity of increasing the basis of cash above face is obvious. For this reason, courts in other cases in the capital expense area have permitted deduction of attorney’s fees on the grounds that otherwise deduction of the expense would be lost forever. Where cash is involved, many courts have ignored the problem; others have indicated that ultimate loss of the deduction is unpersuasive.

Another unanswered question raised by Gilmore involves its relationship to the Supreme Court decision in the Davis case in which it was held that the husband’s transfer of appreciated property in exchange for the wife’s marital rights entails capital gain to the husband. When these two cases are considered together, the question arises as to whether the husband’s legal fees can be treated as a sales expense which reduces the amount of his gain. There is, as yet, no case authority in point. Most of the writers have indicated that the husband’s fees should be treated as a selling expense, without much analysis of the problem.

While it is reasonable to assume that since the Internal Revenue Service

50 Treas. Reg. § 1.212-1(m) (1957).
52 See, e.g., Petschek v. United States, 335 F.2d 734 (2d Cir. 1964); California & Hawaiian Sugar Ref. Corp. v. Commissioner, 311 F.2d 235 (Ct. Cl. 1962); Margit Besenyey, 45 T.C. 261 (1965), aff’d on other grounds, 379 F.2d 252 (2d Cir. 1967). See also Spangler v. Commissioner, 323 F.2d 913, 920 (9th Cir. 1963).
53 See, e.g., Helvering v. Stormfelsz, 142 F.2d 982 (8th Cir. 1944); Thomas A. Grabien, 48 T.C. 733 (1967); Daniel S.W. Kelly, 23 T.C. 682 (1955), aff’d, 228 F.2d 512 (7th Cir. 1956); The Pennroad Corp., 21 T.C. 1087 (1955), aff’d on other grounds, 228 F.2d 329 (3d Cir. 1955). See generally Brookes, Litigation Expenses and the Income Tax, 12 Tax L. Rev. 241, 252-53 (1952).
55 See Winokur, Deductibility of Legal and Other Professional Fees, S. Cal. 11th Tax Inst. 457, 520 (1963). See generally Lucas v. Commissioner, 388 F.2d 472 (1st Cir. 1967); Commissioner v. Doering, 335 F.2d 738 (2d Cir. 1964); Commissioner v. Coke, 201 F.2d 742 (5th Cir. 1953). Compare United States v. Mountain States Mixed Feed Co., 365 F.2d 244 (10th Cir. 1966), with United States v. Morton, 387 F.2d 441 (8th Cir. 1968); Alphaco, Inc. v. Nelson, 385 F.2d 244 (7th Cir. 1967), and Lanrao v. United States, 68-2 U.S. Tax Cas. § 9566 (E.D. Tenn. 1968).
is in effect treating the transaction as a sale by the husband, his professional fees should similarly be treated as selling expenses, it is perhaps just as reasonable (and certainly from the husband's viewpoint, closer to what he thought he was doing) to conclude that the expenses were incurred to acquire the wife's marital rights. If the latter approach is adopted, then the question becomes whether the husband acquires an intangible asset ("wife's marital rights") in which event deduction may be eliminated entirely, or whether the wife's marital rights are traceable to certain assets retained by the husband, in which event the fees would presumably be capitalized and allocated among the various assets.56

In assessing the impact of Gilmore on the dichotomy in the treatment of business and nonbusiness expenses, it is interesting to note the differences in the tax treatment of the expenses incident to family squabbles in the form of corporate proxy fights, shareholder derivative suits, and partial or complete liquidations.57 In these situations many of the expenses are deductible while the expenses of domestic squabbles at the time of divorce, as indicated above, normally are nondeductible, or capitalizable. Thus, Gilmore teaches that if the husband is defending his stock investments from the claims of his wife during their divorce, at best the fees will have to be capitalized, and at worst they may be nondeductible. On the other hand, several cases indicate that if the person making the claim was an uncooperative or dissident shareholder, the expenses would be deductible in full.58

Pursuing this further, the distinction in tax treatment of expenses arising in typical business settings under section 162 and those arising in nonbusiness or investment situations under section 212 is brought into sharp focus by a comparison of the Kornhauser case with the Gilmore case. The factual similarity of these two cases is striking. Both involved the breakup of partnerships; both involved title to stock; in both the Government initially asserted that the expenses were personal in nature, or in the alternative, that they were capital items. If there is a distinction, presumably it would be that the dissolution of the partnership in Kornhauser arose in a business context while the divorce in Gilmore arose out of the personal marital difficulties of the spouses.59 As a practical matter, however, causes

---

57 See generally cases and authorities cited in B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 54, 61 (2d ed. 1966).
and origins of partnership dissolution, business or marital, are rarely definable in terms solely business or solely personal. The Buder case underscores this. In that case, the taxpayer was attempting to deduct the costs incurred in defending against a partnership accounting suit brought by his brother. The taxpayer relied upon Kornhauser; the Government upon Gilmore. The court found that personal, as well as business, matters prompted the original accounting suit, and although it admitted that allocation of the fees between business and personal items was difficult and possibly arbitrary, allocation was nevertheless made.

IV. POST-GILMORE—BUSINESS EXPENSES

The Buder case also illustrates another important ramification of the Gilmore decision: its effect on cases involving deductibility of professional fees as business expenses under section 162. What has happened is that the taxpayer, the courts, and the Commissioner have all imported the origin test to sustain or deny deductibility of expenses arising in business settings. For example, it has been fairly well accepted that expenses attributable to recovery for personal injuries are nondeductible, if for no other reason than because these expenses are attributable to the production of tax-exempt income. Nevertheless, an attorney recently borrowed the proximate cause test from Gilmore in an attempt to sustain the deductibility of legal fees attributable to recoveries for personal injuries received by a taxpayer in an automobile accident while employed as a traveling salesman. The argument was that these were business expenses in that, "but for" the taxpayer being on the road at the time of the accident in performance of his services as an employee-salesman, the injuries would not have been received. The tax court, however, rejected this approach and held that the expenses were personal.

One of the most significant cases in this regard is the Second Circuit's decision in the recent Nadiak case, in which an airline pilot was denied deduction of legal expenses incurred by him in defending against claims of assault and battery and grand larceny asserted by his former wife, despite the fact that the wife's claims were admittedly spurious and even though conviction would have resulted in loss of his commercial pilot's license. The court again emphasized the personal origin of the wife's claims rather than the business consequences of the claims to the husband. In contrast, a number of earlier tax court decisions had upheld the deductibility of legal expenses where the taxpayer's livelihood and income-producing capacity were

60 Buder v. United States, 63-2 U.S. Tax Cas. § 9661 (E.D. Mo. 1963).
in jeopardy because of the potential effect of legal proceedings instituted against him, even though the activities which gave rise to the suit had their origin in the personal affairs of the taxpayer.64

The length to which the courts have stretched the origin test in the business expense area is illustrated by the Serino decision.65 In this case a mother was denied deduction of legal expenses incurred to protect her separate business interests from the claims of her son’s creditors, who were asserting that she was a partner in her son’s business. The court merely cited the family relationship between the mother and son, which apparently gave rise to the creditors’ allegations, and failed to consider the legitimate business reasons which prompted the mother to seek legal advice to avoid the creditors’ baseless claims.

The significance of the Gilmore decision in the business expense area is, perhaps, best illustrated by a comparison of the tax court and Fourth Circuit opinions in the Harry L. Peckham case,66 in which the taxpayer, a licensed physician, had incurred legal fees in unsuccessfully defending against a prosecution for the performance of an illegal abortion. The tax court reluctantly disallowed deduction on the grounds of public policy. The circuit court affirmed but, possibly with an eye on the pending Tellier case, did so on the grounds that the taxpayer had failed to introduce evidence establishing that the abortion was proximately related to the practice of medicine.67 In relying upon the business origin rationale, the Fourth Circuit in Peckham accurately forecast the importance of the Gilmore decision in the criminal area which, as indicated by the Tellier decision, can be summarized by saying that proximate cause has replaced public policy. Thus, in a recent Fifth Circuit decision, the court pointed to the personal activities of the taxpayer which gave rise to criminal deportation proceedings against him as a basis for denying deduction of his attorney’s fees in unsuccessfully contesting the criminal charges.68

It is clear that if one is to avail himself of the benefits of Tellier, he must be prepared to show the business or profit-seeking origin of the activities giving rise to the criminal prosecution. This is also the thrust of a recently issued Revenue Service ruling involving legal expenses incurred in the unsuccessful defense of civil or criminal tax evasion charges.69

64 Paul Draper, 26 T.C. 201 (1956), acq’ced in, 1956-2 CUM. BULL. 5; Waldo Salt, 18 T.C. 182 (1952); Lindsay Howard, 16 T.C. 117 (1951).


66 Henry L. Peckham, 40 T.C. 315 (1958), aff’d, 327 F.2d 851 (4th Cir. 1964).

67 40 T.C. at 318.

68 327 F.2d at 857.


70 Rev. Rul. 662, 1968-2 CUM. BULL. 69. See also Raymond Biggs, 27 CCH Tax Ct. Mem. 1177, 1206 (1968); 20 ABA TAX SECTION No. 1, at 200 (1966). For pre-Tellier cases in this
V. POST-GILMORE—TAX ADVICE EXPENSES

In spite of the increasing reliance on the Gilmore decision in the business and nonbusiness deduction cases, there is one area in which its rationale has thus far been rejected by the courts: cases involving deduction of professional expenses for tax advice under section 212(3) of the Code. There has as yet been relatively little attention paid by the courts and the commentators to section 212(3), and the attitude of the Internal Revenue Service, together with the comments made in several recent articles, have caused a good deal of concern and confusion among tax practitioners and the general bar as to the scope of deduction of legal fees for tax advice.21

The permissible area of deduction of tax advice expenses has been plagued with uncertainty for many years. Prior to the adoption of the 1954 Code, a considerable amount of tax litigation involved the deductibility of expenses for tax counsel in a variety of situations.22 The principal problem in these early cases involved the relationship of the tax expense to the production or collection of income or to the conservation, maintenance or management of property. Some relief was afforded by an amendment to the regulations in 1946,23 but many problems remained and litigation continued. Even with the adoption of section 212(3) in 1954, the current status of the deductibility of expenses for tax advice is still unsatisfactory. The Internal Revenue Service previously has taken the position that in addition to deduction of expenses incurred in a tax controversy, the only permissible deduction under section 212(3) is for expenses directly related to the preparation of tax returns.24 Apparently, the position of the Internal Revenue Service is that expenses for tax advice not related to the computation or content of tax liability for completed tax years are not deductible.25 The courts, however, have rejected the Service’s position and have upheld deduction of expenses for tax advice not specifically involving tax litiga-

---

21 Portions of this section have been adapted from a memorandum prepared by the author as Chairman of the Subcommittee on Deductibility of Legal Fees, General Income Tax Committee, Taxation Section of American Bar Association and presented to Internal Revenue Service. See 20 ABA TAX SECTION No. 4, at 78-79 (1967); 19 ABA TAX SECTION No. 4, at 86 (1966); 21 THE TAX LAWYER 708 (1968).

22 Compare the Government’s statement of position in Kaufmann v. United States, 64-1 U.S. Tax Cas. ¶ 9235 (W.D. Mo. 1963), and Carpenter v. United States, 338 F.2d 366, 369 (Ct. Cl. 1964), and the statement of position by the Tax Court in George L. Schultz, 10 T.C. 688 (1968), with 7 CCH STAND. FED. TAX REP. ¶ 91,991; De Castro, Recent Cases Show Liberal Trend in Allowing Deductions For Legal Fees, 23 J. TAXATION 224 (1965); Kabsker, Deductibility of Estate Planning Fees, 14 ILL. B.J. 726 (1966); Scott, Deductions For Cost of Tax Advice Are Often Subject to IRS Attack, 22 J. TAXATION 172 (1965).

23 See Brodsky & McKibbin, Deduction of Non-Trade or Non-Business Expenses, 2 TAX L. REV. 39, 58-64 (1946).

24 1946 1-2 CUM. BULL. 61.

25 Apparently, however, the Internal Revenue Service does not restrict deductible expenses for tax return preparation to the actual cost of preparation. See Rev. Rul. 180, 1958-1 CUM. BULL. 153, allowing deduction for appraisal fees incurred to establish the amount of a casualty loss deduction claimed by the taxpayer, and Rev. Rul. 461, 1967-2 CUM. BULL. 125, allowing deduction of appraisal fees necessary to establish amount of charitable deduction attributable to gift of property to charity. See also Valuation of Donated Property, IRS PUBLICATION No. 561, at 7 (1968).

26 See Kaufmann v. United States, 64-1 U.S. Tax Cas. ¶ 9235 (W.D. Mo. 1963); Carpenter v. United States, 338 F.2d 366, 369 (Ct. Cl. 1964).
tion or preparation of tax returns," but the courts have not been in complete agreement as to the scope of the deduction permitted by section 212 (3). 7

Several recent cases and rulings suggest, however, the possibility that the Internal Revenue Service is reconsidering its position in this area. 7

In order to better understand the basis for the position of the Internal Revenue Service in this area, as well as its possible shift in position, it is necessary to review the tax background of professional fees for tax advice.

Prior to 1945, in reliance upon issued regulations, the Internal Revenue Service had taken the position that expenses for preparing tax returns, resisting proposed deficiencies, or recovering taxes were not deductible management expenses under the nonbusiness expense section of the 1939 Code. 8

The Supreme Court, however, in the Bingham's Trust case 9 held that these provisions of the regulations were unduly restrictive and inconsistent with the provisions of the statute. Following this decision, the regulations under this section were amended to provide, in part, that "expenses paid or incurred by an individual in the determination of liability for taxes upon his income are deductible." 9

Although the 1946 amendment to the regulations allowed deduction for expenses attributable to income tax liability, the amendment expressly denied the deduction of such expenses in situations involving gift tax liability. The validity of the regulations in this respect was upheld by the Supreme Court in Lykes v. United States. 8

The decision of the Supreme Court in the Lykes case was nullified two years later by the adoption of section 212 (3) which specifically allows the deduction of nonbusiness expenses paid "in connection with the determination, collection, or refund of any tax." 3

The House and Senate committee reports 8 of section 212 (3) have occasioned discussion of the intent of the legislature in adopting this section. When the committee reports are read in the context of the administrative and case law which preceded them, it may be fairly said that although section 212 (3) is clearly intended to overturn the result reached by the Supreme Court in the Lykes case, it is not clear that the legislature intended to restrict this section's applicability to expenses attributable to tax litigation and the preparation of tax returns. The only suggestion that such an interpretation was intended appears in a statement made by Thomas N. Tarleau, then Chairman of the

---

7 See Kaufmann v. United States, 64-1 U.S. Tax Cas. § 9235 (W.D. Mo. 1963); Carpenter v. United States, 338 F.2d 366 (Ct. Cl. 1964); Davis v. United States, 287 F.2d 168 (Ct. Cl. 1961).
8 Compare Carpenter v. United States, 338 F.2d 366 (Ct. Cl. 1964), and Davis v. United States, 287 F.2d 168 (Ct. Cl. 1961), with Kaufmann v. United States, 64-1 U.S. Tax Cas. § 9235 (W.D. Mo. 1963), and Leslie Q. Coupe, 12 T.C. 45 (1969).
Taxation Section of the American Bar Association, in commenting upon the language of the House Ways and Means Committee report before the Senate Finance Committee. The later report of the Senate Finance Committee does not discuss Mr. Tarleau's comments but reiterates the statutory language of section 212(3). 87

The final regulations adopted under section 212(3) suggest that the Treasury shares the view that the scope of the new section is not limited to the expenses of tax contests and tax return preparation. The regulations originally proposed under this section provided:

Expenses paid or incurred by an individual in connection with the 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 incurred in connection with the preparation of tax returns or in connection with any proceedings involved in determining the extent of tax liability or in contesting a tax liability are deductible. 88

When the final regulations were issued, however, the second sentence of these proposed regulations was amended to provide: "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 his tax liability or in contesting his tax liability are deductible." 89

The first case to consider specifically the deductibility of expenses under section 212(3) for tax counsel neither connected with litigation nor with the preparation of a tax return was Davis v. United States in which the taxpayer-husband had deducted the fees paid to his wife's attorney for income and gift tax advice incident to the property settlement upon their divorce. The court denied the husband a deduction for the payments to the wife's attorney but upheld the deductibility of the husband's own legal expenses. As a basis for the latter holding, the court said:

We have no doubt that Congress in enacting Section 212, supra, meant to grant a deduction for legal fees in connection with a determination, collection, or refund of any tax. The question then is whether the fees paid by the plaintiff come within the purview of the Act. In the light of the Treasury Regulations promulgated thereunder, we think the question can only be answered in the affirmative. The Regulation, Section 1.212-1, quoted above, specifically provides that expenses paid or incurred for tax counsel '... in connection with any proceedings involved in determining the extent of tax liability ... are deductible.' Therefore it seems clear that the statute and regulations are broad enough to cover the deduction asked for. 90

In a later case, Carpenter v. United States, 91 the deductibility of legal

---

90 287 F.2d 168 (Ct. Cl. 1961).
91 Id. at 170.
92 338 F.2d 366 (Ct. Cl. 1964).
fees for advice concerning tax consequences of the taxpayer's divorce was upheld and the Government's contention that deductions under section 212(3) should be limited to expenses attributable to tax controversies was rejected. After a thorough analysis of the legislative, administrative and case history of the section, the court stated: "To restrict the deductibility of expense for tax counsel to the computation or contest of a tax liability for completed tax years under the particular facts in this case would defeat the clear purpose of Section 212(3) and the regulations Section 1.212-1." 93

The holding in the Carpenter case is significant in that it recognizes the deductibility of fees for tax advice in the nature of prospective tax planning. The legal fees of the taxpayer in the Davis case had been attributable primarily to advice concerning his tax liability for the year in which the divorce settlement was concluded; however, the Carpenter case involved not only the husband's tax liability for the year of the divorce, but also the tax treatment of alimony payments made under the divorce decree in future years.

Not all courts, however, have agreed on the scope of deductibility under section 212(3) of legal fees for advice concerning the future tax consequences of present transactions. In Kaufmann v. United States 94 it was held that the expenses of securing a tax ruling from the Internal Revenue Service on the effect of a corporate reorganization were deductible, but that the expenses of tax advice concerning the basis of stock received in the reorganization were not deductible. The court indicated that the basis of the new stock was not ascertained for any current purpose but for some future use, and that this expense was not incurred "for the purpose of determining any tax." 95

The Supreme Court has not specifically considered the scope of the deduction allowed by section 212(3). In the Davis case, discussed earlier in this Article, the Court affirmed the decision of the court of claims disallowing the husband's deduction for fees paid to the wife's attorney on the ground that the payment had not been shown to be "in connection with the determination, collection or refund" of any tax of the taxpayer. However, the Government failed to appeal the decision of the court of claims allowing a deduction for the fees paid by the husband to his attorney for tax advice, and the Court specifically stated that it intimated no opinion on the deductibility of the husband's fees. 96

In the Gilmore case, the Court stated that "expenses of contesting tax liabilities are now deductible under section 212(3) of the 1954 Code." 97 Taken out of context, this might be cited as authority for the proposition that the deduction under section 212(3) is limited to expenses in connec-

93 Id. at 370.
94 64-1 U.S. Tax Cas. ¶ 9235 (W.D. Mo. 1963).
95 Id. at 91,558.
97 United States v. Gilmore, 372 U.S. 39, 48 n.16 (1962): "Expenses of contesting tax liabilities are now deductible under § 212(3) of the 1954 Code. This provision merely represents a policy judgment as to a particular class of expenditures otherwise non-deductible, like extraordinary medical expenses, and does not cast any doubt on the basic tax structures set up by Congress."
tion with tax litigation; however, when taken in context, it is clear that the Court was distinguishing between the legal expense of tax litigation, which is deductible, and the legal expense of litigation in connection with divorce and property settlement proceedings, which the Court held to be nondeductible.88

The legislative and administrative history of section 212(3) discloses a continuous expansion in the scope of the Code section pertaining to the deductibility of nonbusiness expenses for tax counsel. As the cases discussed above indicate, the courts have also construed the provisions of section 212(3) broadly to allow deduction of expenses for tax counsel in situations not involving litigation or tax return preparation.89 In view of the history of expansion of the scope of this deduction, the Internal Revenue Service’s position that the deduction should be limited to expenses for tax litigation or tax return preparation appears anomalous. For, if adopted, the position of the Internal Revenue Service could have the incongruous result that the deduction of such expenses would be more limited under the 1954 Code than under the 1939 Code. Under the 1939 Code, if tax advice was secured in conjunction with financial advice for the purpose of conserving or maintaining the taxpayer’s property, the expense was deductible, even though the advice involved prospective transactions.90 If the Internal Revenue Service’s interpretation of section 212(3) were upheld, and if the specific provision of section 212(3) with regard to the deductibility of tax advice were considered to control the general provisions of sections 212(1) and (2), the part of the expenses in the above cases attributable to tax advice would become nondeductible under the 1954 Code, even though they had been considered deductible under the 1939 Code.91

The case history in this area suggests additional problems in the Internal Revenue Service’s position with respect to the deductibility of expenses for tax counsel. First, these cases illustrate various situations in which tax counsel is given in conjunction with investment advice or advice concerning the production of income or management of property. Often, the nature of these services unavoidably combines tax, investment and property management advice in such a manner that it is difficult to precisely define the

88 Id. The Supreme Court’s language also suggests that the personal and capital Internal Revenue Code sections are not applicable to § 212(3). In this regard, query whether there are supportable distinctions among litigation expenses relating to the taxability of transfers at divorce, expenses in connection with the preparation of the tax returns of the spouses in the years of divorce, and professional fees for tax advice to the spouses at the time of divorce. Similarly, is there any basis for allowing a deduction for litigation expenses concerning the tax consequences of forming a corporation or partnership but requiring tax expenses incident to the actual formation to be capitalized? But see Leslie Q. Coupe, 52 T.C. 45 (1969).

89 In addition to the Davis, Kaufmann, and Carpenter cases, see also Dooley v. Commissioner, 332 F.2d 463, 468 (7th Cir. 1964) (dicta).

90 See Nancy R. Bagley, 8 T.C. 130 (1947), acquiesced in, 1947-1 CUM. BULL. 1 (attorney’s fees for tax and financial advice in estate planning held deductible); Philip D. Armour, 6 T.C. 359 (1946), acquiesced in, 1946-1 CUM. BULL. 1 (legal fees for general tax advice and planning held deductible); Herman W. Fletcher, 10 CCH Tax Ct. Mem. 793 (1951) (attorney’s fees for tax and investment advice concerning trust and estate taxation held deductible); Andrew Jergens, 2 CCH Tax Ct. Mem. 385 (1943) (attorney’s fees for advice on minimizing individual’s taxes in connection with corporate merger held deductible).

91 This is, in part, the thrust of Mr. Tarleau’s comments to the Senate Finance Committee in the hearings on § 212(3). See note 86 supra.
portion of the expenses attributable to particular types of advice.\textsuperscript{102} Insofar as the position of the Internal Revenue Service would require the taxpayer in the above situations to distinguish the portion of the expense attributable to tax counsel from that attributable to investment or property management advice, the position appears to inevitably involve administrative difficulties in enforcement due to the inherent difficulty of segregating expenses in the above, and in similar, situations. Furthermore, it is difficult to justify a distinction which allows deduction of expenses for “investment counsel” of a prospective nature, but which limits deduction of expenses for “tax counsel” to the computation or contest of tax liabilities for completed tax years.\textsuperscript{103} Finally, to the extent that deduction for tax counsel encourages tax planning to avoid litigation, the Internal Revenue Service, as well as the taxpayer, is benefited; for, as the court in the \textit{Carpenter} case appropriately observed, “one of the purposes of a taxpayer in obtaining tax counsel is to avoid tax contests, not to create them, and this also serves the interest of the Government in collecting taxes.”\textsuperscript{104}

Several years ago the Taxation Section of the American Bar Association formed a subcommittee on deductibility of legal fees to meet with Internal Revenue Service personnel to discuss policy matters in the section 212 (3) area. Reports on this project indicate that discussions with the Internal Revenue Service have thus far produced no policy statements or decisions, but developments along these lines may be forthcoming in the not too distant future.\textsuperscript{105} Despite this, problems remain, the most important being the extent to which expenses of tax advice relating to estate planning will be considered deductible under this section. Traditionally, the expenses of the actual preparation of wills and trusts have been considered nondeductible.\textsuperscript{106} On the other hand, several cases decided under the 1939 Code have permitted deduction for tax advice relating to estate planning under certain circumstances.\textsuperscript{107} As yet, there has been no decision under section 212 (3) involving the deduction of estate planning fees.\textsuperscript{108} In any event, it may be anticipated that deductibility of expenses for tax advice in the state planning area will be a sensitive issue from the standpoint of the Internal Revenue Service.\textsuperscript{109}

\textsuperscript{102} See, e.g., Michael J. Ippolito, 24 CCH Tax Ct. Mem. 894 (1961), in which the court allows deduction of expenses attributable to tax and investment advice under section 212 of the Code without discussing which part of the section the court is relying upon in reaching its decision.


\textsuperscript{104} 338 F.2d at 369.

\textsuperscript{105} See note 71 supra.


\textsuperscript{107} See cases cited in note 100 supra.


\textsuperscript{109} In 1965 Congressman Wilbur Mills introduced legislation sponsored by the ABA Tax Section which would have amended § 212 to permit deduction of ordinary and necessary expenses: “(4) in connection with planning, arranging for, or making, by will, revocable or irrevocable trust, or otherwise a donnative or testamentary disposition of property or any interest therein, including proceeds of insurance, by such individual, whether or not such disposition becomes effective.” H.R. REP. NO. 11440, 89th Cong., 1st Sess. 11 (1965).
VI. Conclusion

Although certain issues involving deductibility of professional fees have been clarified by recent administrative and judicial pronouncements, the area generally continues to be confused, many of the case authorities are inconsistent, and there are very few guideposts that can be relied upon with assurance.

The principal problem in this area, as indicated (although not articulated) by the myriad of cases involving deduction of professional fees, is the task of delineating the boundaries of the broad Internal Revenue Code sections involved in determining whether an expense is personal, capital, or otherwise deductible. In most of the cases in this area, title to property is involved in some manner, but this does not mean that all such expenses are to be capitalized. Often, personal and business matters are intertwined, but this does not mean that all of the expenses involved should be either nondeductible, personal expenses or deductible, business expenses. Certainly, property is conserved to the extent that an asserted liability which would require sale or liquidation of the property is defended, but it does not follow that the cost of defense is always deductible.

It is to the problem of distinguishing the deductible from the nondeductible professional expense in the above situations that the "proximate cause-origin" test of Gilmore is directed. This decision represents an admirable attempt to formulate a test which will be generally applicable to the numerous factual situations that arise in this area, and at the same time be limited enough in application to provide reasonable and predictable results. Unfortunately, as is often the case with the "but for" approach, the Gilmore test has proved to be too broad and, in many instances, has become a source of further confusion. For this reason, the courts continue to use the "primary purpose" test and the "consequences" test in order to rationalize desired results which are not otherwise attainable under a Gilmore approach.10

In many ways, the problems in the professional fees area reflect those involved in the general business expense area under section 162 in determining when expenses are "ordinary" and "necessary." An analysis of the professional expense cases leads one to suspect that the approach of Justice Cardozo to the deduction of general business expenses may inevitably be applicable to the deductibility of professional fees. In the celebrated Welch case, after reviewing the authorities for determining when business expenses were "ordinary" and "necessary," Justice Cardozo concluded as follows:

Here indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.11

---

10 See, e.g., Judge Tannenwald's dissent in support of the "origin" test, rather than the "primary purpose" test, in the capital expense cases in Herman A. Moore Trust, 49 T.C. 430 (1968). See also the post-Gilmore cases cited in note 23 supra indicating continued reliance on the "consequences" test.