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The Deduction of Legal Fees Relating to Crimes, Divorce, and Taxes

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Many questions concerning the deductibility of legal fees remain unanswered. The author reviews the current court decisions as to whether legal fees incident to the unsuccessful defense of a criminal charge, a divorce or separation, or the giving of tax advice will be deductible in any given fact situation and concludes with a presentation of possible future problems inherent in each area.

The Tax Practitioner has always exhorted his fellow attorneys, with varying success, to advise their clients as to what extent the lawyer's charges are deductible for federal income tax purposes. But since the Internal Revenue Code does not specifically mention legal fees in the context of deduction, and since the law in the area is made by judicial and by administrative fiat, the tax practitioner's own counsel that fees are deductible is sometimes given with more hope than conviction. The deduction of legal fees is permitted, if at all, under section 162 of the Code, which allows the deduction of all ordinary and necessary expenses incurred in carrying on any trade or business, or under section 212, allowing the deduction of expenses incurred for the production or collection of income, for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax.

It is clear that a legal fee or related expense is either, for purposes of deduction, (1) an expense described in these sections, and thus deductible, (2) a capital item in connection with title to property, which must be capitalized and thus is not deductible per se, or (3) a personal expense which is not deductible in any event.

1 INT. REV. CODE OF 1954, § 162 [hereinafter cited as CODE].
2 CODE § 212.
as prescribed in section 262.\textsuperscript{3} Corporations, and perhaps partnerships because they are presumed not to make personal expenditures, in most cases have only to resolve the issue of whether the legal fee is an ordinary and necessary expense or must be capitalized. Individuals and entities taxable as individuals, such as trusts, must choose among the three alternatives.

The authorities on the issue of deduction versus capitalization, though legion, lay down no easy or sensible rule because Congress has provided no standards for capitalization beyond the provisions of sections 162 and 212 and the requirement in section 1016 that the tax basis should be increased by expenditures properly chargeable to the capital account.\textsuperscript{4} Thus, any discussion of recent legal developments in that area simply mirrors the unsatisfactory and diverse results of prior decisions,\textsuperscript{5} a situation which will not change until Congress amplifies the law, if a workable amplification is at all possible. Regarding the issue of deduction versus personal expense, however, the courts are in the process of making important revisions particularly involving the deductibility of legal fees in connection with crimes, divorces, and taxes.

I. Legal Fees in Connection With Criminal Prosecutions

The Supreme Court's decision in Commissioner v. Tellier\textsuperscript{6} has added a new and unfamiliar dimension to criminal law. The penal colony, well versed in appeals for new trials on the basis of Escobedo v. Illinois\textsuperscript{7} and later decisions,\textsuperscript{8} must now master claims for tax refunds.\textsuperscript{9} Of course, this rather lame observation is by way of pointing out that the Tellier decision represents a sweeping departure from prior judge-made law. Since 1924 the general rule has been that taxpayers could not deduct legal and related costs incurred in the unsuccessful defense of criminal prosecutions even though

\textsuperscript{3} Code § 262.
\textsuperscript{4} Code § 263 allows no deductions for "any amounts paid out for new buildings or for permanent improvements ... made to increase the value of any property or estate."
\textsuperscript{5} See Note, The Deductibility of Attorneys' Fees, 74 Harv. L. Rev. 1409 (1961).
\textsuperscript{6} 383 U.S. 687 (1966).
\textsuperscript{7} 378 U.S. 478 (1964).
\textsuperscript{9} The Fifth Circuit has gone so far as to overturn, on the basis of Tellier, a trial court's stipulation between the government and the taxpayer denying deduction for legal fees incurred by the taxpayer in unsuccessful defense of criminal indictment. Logan Lumber Co. v. Commissioner, 365 F.2d 846 (5th Cir. 1966).
the criminal activity was clearly connected with the taxpayer's business\(^\text{10}\) because such deduction would violate public policy. The rationale of the rule was based upon the assertion that an act in violation of public policy was either (1) not "ordinary and necessary" within the meaning of sections 162 or 212; or (2) that expenditures necessitated by a criminal charge could only be personal; or (3) simply that such a deduction would frustrate public policy.\(^\text{11}\)

**A. The Beginning**

In 1943 the Supreme Court began the revision of this area by refusing to apply the public policy doctrine to *Commissioner v. Heininger*\(^\text{12}\) and holding that a dentist could deduct legal fees incurred in unsuccessfully resisting a Postmaster-General order which terminated his mail-order denture business on the grounds of fraud.\(^\text{13}\) The Court found that the legal fees were directly connected with the carrying on of the mail-order business\(^\text{14}\) and that no clearly defined governmental policy required denial of the deduction since the expense was ordinary and necessary within the accepted meaning of such terms.\(^\text{15}\) However, probably because *Heininger* drew a distinction between statutes intended merely to protect the public and statutes whose purpose is punitive as well, lower courts continued to ride the unruly horse of public policy,\(^\text{16}\) galloping in all directions.\(^\text{17}\)

\(^{10}\) Thomas A. Joseph, 26 T.C. 562 (1956); Burroughs Bldg. Materials Co., 18 B.T.A. 101 (1929), aff'd, 47 F.2d 178 (2d Cir. 1931); Norvin R. Lindheim, 2 B.T.A. 229 (1925); Sarah Backer, 1 B.T.A. 214 (1924).


\(^{12}\) 320 U.S. 467 (1943).

\(^{13}\) Id. at 475.

\(^{14}\) Id. at 470.

\(^{15}\) Id. at 474.


\(^{17}\) I, for one, protest, as my Lord has done, against arguing too strongly upon public policy; — it is a very unruly horse, and when once you get astride it you never know where it will carry you. It may lead you from the sound law. It is never argued at all but when other points fail. *Richardson v. Mellish*, 2 Bing. 229, 252, 130 Eng. Rep. 294, 303 (1824).
B. The Rule as Modified

The major step in the revision of the general rule that legal fees incurred in the unsuccessful defense of a criminal charge were not deductible came as a result of the Supreme Court's decision in Commissioner v. Tellier. The taxpayer, a securities dealer, was tried and convicted on a thirty-six count indictment charging him with violations of the fraud section of the Securities Act of 1933, with violations of the mail fraud statute, and with conspiracy to violate these statutes. He was sentenced to four and one-half years in jail and was fined eighteen thousand dollars. Perhaps as an afterthought to his difficulties, in 1956 he claimed a deduction in the amount of $22,964.20, representing expenditures incurred in the unsuccessful defense of the criminal charges. The Commissioner's disallowance of this deduction was sustained by the Tax Court on public policy grounds. The Second Circuit reversed, stating that were it not for the time-honored public policy test, there could be no doubt that the taxpayer's legal expenses were ordinary and necessary within the meaning of section 162 of the Code since the criminal indictment sprang directly from his conduct of the securities' business. The court also observed that attempts to apply a public policy rule which seeks to distinguish between civil and criminal liability and successful and unsuccessful defense has caused repeated difficulty in borderline cases. Disbarment proceedings, for example, have been classified as criminal and the legal expenses disallowed. Legal expenses paid on behalf of an employee who has been found guilty of violating certain sections of the California Administrative Code relating to horse racing and who, as a result, lost his license as a trainer have been held de-

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22 United States v. Tellier, 255 F.2d 441 (2d Cir. 1956).
25 Id. at 694.
26 Ibid.
ductible. The court finally noted that it could find no sharply defined public policy against the deduction of legal fees incurred in the unsuccessful defense of a criminal prosecution and thus held that the deduction should be allowed.

The Supreme Court in a brief opinion affirmed, indicating that the Second Circuit was correct in its construction of the "ordinary and necessary" phrase of section 162 in that any expense which has its origin in the conduct of the taxpayer's business meets the statutory test, citing its 1963 decision in United States v. Gilmore. The Court went on to dismiss the public policy issue for two basic reasons: first, the income tax is not a sanction against wrongdoing and as such does not concern itself with the lawfulness of the income that it taxes; and, second, in view of the recent Gideon v. Wainwright decision it is clear that no public policy is offended when a man faced with a serious criminal charge employs a lawyer to assist in his defense.

The reliance of the Second Circuit and the Supreme Court upon legislative history for the proposition that the income tax was designed as a revenue measure and not as a control on the manners and morals of the union is interesting. Both decisions refer to the statement made by Senator Williams during the Senate debate upon the first modern income tax law that "The tax is not levied for the purpose of restraining people from betting on horse races or upon 'futures,' but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year." Today, of course, no one would contend that the motives and purposes of the income tax law are limited in any sense to the production of revenue, since the Code is used, for example, to encourage and reward mineral exploration, to encourage capital development, and to restrain domestic investment abroad. In fact, moral

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30 342 F.2d at 695.
32 Id. at 689.
35 383 U.S. at 691-64.
36 Revenue Act of 1913, 38 Stat. 166.
37 50 CONG. REC. 3849 (1913) (remarks of Senator Williams).
38 CODE § 613.
39 CODE § 38.
40 CODE §§ 4911-14.
considerations are still prominent in the law. Taxpayers are by statute refused deductions for bribes paid foreign officials.\textsuperscript{41} In addition, certain types of lobbying expenses involving appeals to the public in connection with the advancement or defeat of legislation are non-deductible,\textsuperscript{42} as are gambling losses in excess of gambling gains.\textsuperscript{43} But the important distinction which must be made, in this regard is that these rules are established by congressional action and, as yet, Congress has given no authority to the courts or the Commissioner to depart from Senator Williams' thesis.\textsuperscript{44}

Without specific congressional authorization, notwithstanding the above distinction, the Supreme Court until \textit{Tellier} had not always adhered to this doctrine. In \textit{Commissioner v. Sullivan},\textsuperscript{45} the Court permitted the deduction of expenses incurred in an illegal gambling business, reasoning that although an expenditure bears a remote relation to an illegal act this in itself does not make it non-deductible.\textsuperscript{46} However, in \textit{Cammarano v. United States},\textsuperscript{47} the Court refused to permit a liquor dealer to deduct the expenses incurred in an attempt to defeat the passage of state prohibition legislation prior to the enactment of section 162(e) which expressly prohibits such deductions. This decision was in part based upon the premise that the Commissioner's long-standing Regulations on the subject had acquired the force and effect of law,\textsuperscript{48} a theory which may have represented Mr. Justice Frankfurter's influence.\textsuperscript{49} But the logical difference between an expense of an illegal gambling enterprise and the expense of influencing the public concerning legislation vital to one's business is difficult to draw for purposes of section 162 deductions. In any event, \textit{Tellier} and section 162(e) which relates to deduction of lobbying expenses have now pre-empted the field, and only a small area of conflict in the public policy domain remains.

\textbf{C. Conditions for Deductibility}

Of course, the fact that the allowance of a legal expense is not

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{41} \textsc{Code} \textsection 162(c).
\item \textsuperscript{42} \textsc{Code} \textsection 162(e).
\item \textsuperscript{43} \textsc{Code} \textsection 165(d).
\item \textsuperscript{44} \textsc{50 Cong. Rec.} 3849 (1913) \textit{(remarks of Senator Williams)}.
\item \textsuperscript{45} 356 \textit{U.S.} 27 (1958).
\item \textsuperscript{46} \textit{Id.} at 29.
\item \textsuperscript{47} 358 \textit{U.S.} 498 (1959).
\item \textsuperscript{48} Section 162(e) was enacted by \textsc{Pub. Law} 87-834 \textsection 3(a), 76 \textit{Stat.} 973 (1962).
\item \textsuperscript{49} See Mr. Justice Frankfurter's dissent in \textit{Flora v. United States}, 362 \textit{U.S.} 145, 177-78 (1960).
\end{enumerate}
\end{footnotesize}
against public policy does not insure the deduction. The taxpayer must demonstrate that the expense is connected with his business within the meaning of section 162 or is connected with the range of activities described in section 212 and in accord with the criteria most recently enunciated in United States v. Gilmore. Gilmore involved the attempt by an individual to deduct the legal expenses incurred in protecting his stock, representing control of a corporation, from his wife's alimony and property settlement demands. He argued that since the stock represented the source of most of his income by way of dividends and salary as an officer of the corporation, legal fees incurred to protect title to the stock qualified under section 212(2) as expenses in connection with the conservation or maintenance of property held for the production of income. The Supreme Court disagreed, saying that although the legal fees were superficially connected with the conservation of income-producing property, the test of deduction under section 212 goes to the nature and origin of the claim which gives rise to the litigation requiring the expenditure of legal fees rather than to the effect of the litigation upon the taxpayer's business, income, or income-producing property. Since the divorce was entirely personal in nature, as distinguished from a business enterprise or from activity which had its origin in the production of income or the conservation of income-producing property, the expenses arising from the divorce were also personal and, accordingly, not deductible.

In Finger v. United States a physician, sued by the husband of the physician's nurse to recover damages for loss of consortium and for causing the nurse to become an alcoholic and a drug addict, deducted his substantial legal fees on the ground that the suit jeopardized his license to practice medicine. The District Court of South Carolina denied the deduction, saying that what the taxpayer defended was his personal rather than his professional conduct and as such, under the Gilmore decision, the legal fees incident to his defense were not ordinary and necessary business expenses. The

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51 Id. at 42-43.
52 Id. at 49.
53 Id. at 51-52. Although Gilmore is an excellent articulation of the doctrine, the Supreme Court has attempted since the decision of Lykes v. United States, 343 U.S. 118 (1952) to settle the law in this area.
55 Id. at 314.
Court acknowledged that had the taxpayer been sued by a patient for malpractice he would have been allowed a deduction for the legal fees as a business expense but asserted that in the present case it would require "great fertility of imagination . . . to conjure allegations of a more intimate and personal nature.”

Another physician, convicted of criminal abortion, attempted to deduct the legal expenses incurred in his defense. The Tax Court refused in a pre-Tellier case to permit the deduction on the grounds of public policy but also noted that the physician had failed to prove that the expenditure was related to his business, the practice of medicine. It may be imagined that a more vigorous defense could establish a direct relation between the taxpayer's practice of medicine and the abortion, but in any case the decision serves as an example of the absolute necessity of coloring with business purpose the original source of the controversy giving rise to the legal expense. The argument that the result of the litigation or controversy will destroy the source of the taxpayer's income or will destroy his business is not, as the Supreme Court pointed out in Gilmore, sufficient to relate the expenditure to sections 162 or 212.

In Nadiak v. Commissioner an airline pilot, sued for assault and battery and larceny arising from his relationship with a former wife, claimed that since a conviction would result in the loss of his pilot's license and therefore his chief source of income, the expenses of defense were deductible under section 212. The court correctly denied the deduction on the grounds that the claim arose only in connection with the taxpayer's personal activity and not his profit-seeking activity — thus clearly indicating that the legality of the deduction does not depend upon the potential consequences of a taxpayer's failure to defend a criminal prosecution.

It may be that future decisions in this area will attempt to give impetus to the judicial interpretation of community morals by refusing deductions for legal expenses and other expenses incurred in connection with criminal activity. But after Tellier, the decisions must be based upon the business or profit-seeking origin test rather than upon the public policy or standard of the community argument.

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58 Ibid.
57 Henry L. Peckman, 40 T.C. 315 (1963), aff'd, 327 F.2d 885 (4th Cir. 1964).
58 Id. at 317-18.
59 Id. at 317.
60 372 U.S. at 50-51.
61 356 F.2d 911 (2d Cir. 1966).
This development is beneficial to the interpreters of the tax law; it is difficult enough to test deductions against the explicit terms of a complex statute rather than to match the propriety of deductions against vague public policy.

D. Exception

There is one exception to the Tellier doctrine. In Tank Truck Rentals, Inc. v. Commissioner62 and Hoover Express Co. v. United States,63 both decided prior to Tellier, the Supreme Court upheld the disallowance of deductions claimed by taxpayers for fines and penalties imposed for violating state statutes on the rationale first enunciated in Lilly v. Commissioner.64 The Court in Tellier reaffirmed the Tank Truck doctrine by saying that, where the allowance of a deduction would frustrate sharply defined national or state policies proscribing particular forms of conduct, and where the policies frustrated are evidenced by some governmental declaration, the deduction will be denied.65 In this context, the test of nondeductibility always relates to the severity and immediacy of the frustration resulting from the allowance of the deduction. Thus, the Court has recognized a narrow public policy rule applicable only where the deduction would frustrate state or national law. The policy has a practical appeal in situations similar to Tank Truck, that is, where the denied deduction involved fines and penalties imposed under a Pennsylvania statute for the deliberate and continued violation of state maximum-load limitations.66 It would, on the other hand, permit deduction where the expenditure involved was illegal only under the letter of archaic law.67 It would presumably deny deduction for expenditures which are illegal per se, such as bribes to public officials,68 but only if the statute against such expenditures was viable and presently enforced in the community. It would permit deduction of the expenses of an illegal business, for example, the rent of the gambling establishment in Sullivan,69 unless the expenditure itself were illegal.

64 343 U.S. 90 (1952).
65 383 U.S. at 694.
66 356 U.S. at 31.
68 Cf. Code § 162(e).
69 Any inference of disapproval of these expenses [wages and rent] is absent here. The Regulations, indeed, point the other way, for they make the fed-
It could be argued that the disallowance of any deduction on the grounds that the deduction would frustrate state or national law is not consistent with the concept of the income tax as a revenue measure unconcerned with morality. This argument is probably correct in theory. But in the practical world the Supreme Court seems to have struck a sensible balance.

E. Future Practice

It will be interesting to see just how far the courts will carry the Tellier doctrine. The Commissioner has, on the basis of Tellier, already reversed his policy and permitted deduction of attorney fees and related legal expenses paid or incurred in the unsuccessful defense of a prosecution for violation of the Sherman Anti-Trust Act and of claims by the United States under section 4(a) of the Clayton Act. The decision will give new support to the deduction not only of legal fees in connection with criminal prosecution but also to the deduction of various types of expenses, the validity or legality of which is questionable. For example, the Court of Claims is apparently correct in holding that expenditures for entertainment and gifts furnished to state employees were allowable business expenses where state law was not violated. An Alabama court is also correct in deciding that premiums and rebates given to retailers are deductible despite state statutes making it a crime to offer inducements or to extend credit on the theory that the criminal statutes were a "dead letter" not expressive of current community enforcement practices. Presumably, the decision will force reconsideration of such cases as United Draperies, Inc. v. Commissioner which denied a deduction for kickbacks and rebates to the purchasing manager of a customer on the grounds that the mores of the market place do not encompass such payments as an ordinary expense. This seems to us to be recognition of a gambling enterprise as a business for federal tax purposes.

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71 Ibid.
73 ALA. CODE tit. 29, §§ 6, 37, 41, 78 (1958).
75 340 F.2d 936 (7th Cir. 1964).
means of securing or promoting business. The Sixth Circuit probably will reconsider the doctrine of *Acker v. United States* which held that legal fees incurred in defense of a criminal tax evasion prosecution are not deductible, although, as will be discussed, there is some authority in favor of the argument that the act of omitting income from an individual's return or the fraudulent preparation of such a return are personal as opposed to business decisions, and, accordingly, expenses flowing as a consequence of these acts are not sufficiently connected with business to be deductible under section 162 even though the income with which such acts are concerned is derived from the conduct of the business.

II. LEGAL FEES IN CONNECTION WITH DIVORCE

A. Generally

The expense of engaging a lawyer in connection with personal or family affairs is not deductible. Thus, legal expenses incurred in defending a personal injury suit, securing a release from the army, and seeking a divorce have been disallowed as personal expenses. But in recent years the ingenuity of tax practitioners has secured deduction under section 212 for some of the legal fees involved in divorce.

The provisions of section 212, added by the Revenue Act of 1942, were intended to reverse the Supreme Court’s holding in *Higgins v. Commissioner* that investment activity did not constitute a trade or business and therefore that investment expenses were not deductible under the predecessor section of what is now section 162. As might be imagined, the Tax Court and other courts have experienced some difficulty in distinguishing deductible legal expenses from those which were purely personal. The Tax Court in the area of divorce held that a wife could deduct the legal fees

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76 258 F.2d 568 (6th Cir. 1958).
77 See text accompanying notes 108-30 infra.
79 CODE § 262.
81 Robert S. Seese, 7 T.C. 925 (1946).
82 Smith's Estate v. Commissioner, 208 F.2d 349 (3d Cir. 1953).
83 INT. REV. CODE OF 1939, §§ 23(a), 24(a) (5) added by ch. 619, 56 Stat. 816, 819 (1942).
84 312 U.S. 212 (1941).
85 Id. at 216-17.
incurred by her in her effort to obtain alimony from her husband, pursuant to a divorce action on the grounds that, since the alimony was includible in the wife's income, the fees were incurred in an attempt to produce income within the meaning of section 212. But the Tax Court has also denied the deduction of a husband's legal expenses incident to a divorce proceeding as purely personal and therefore non-deductible even where he is under an obligation to pay his wife's legal fees and even though his income-producing property is threatened.

B. Deductibility of Husband’s Legal Fees

Aside from the question of the deductibility of a wife's legal fees incident to divorce, the law with respect to the deduction of a husband's fees has been greatly clarified by the Gilmore decision. Prior to Gilmore at least two circuit courts had held that a husband could deduct those fees paid his lawyer in connection with the divorce action which were allocable to the lawyer's efforts to protect the husband's income-producing property against a wife's financial claims. The courts reasoned that since the property involved represented an important source of income to the husband — in each case the property in question was the controlling stock interest in the corporation employing the husband — fees allocable to protection of this property were deductible under section 212(2) as being expended for the conservation or maintenance of property held for the production of income. Gilmore, as has been discussed before, denied the deduction of similar expenditures to the husband, asserting that the test of deductibility under section 212 first depends upon the origin and nature of the claim requiring the expenditure of legal fees. Since the origin and nature of the claim in a divorce action is purely personal, the fees incident to such a claim are also personal and must be disallowed as a deduction. A companion decision, United States v. Patrick, dispelled any linger-

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86 Elsie B. Gale, 13 T.C. 661 (1949), aff'd, 191 F.2d 79 (2d Cir. 1951), aff'd, 1952-1 CUM. BULL. 2.
87 Id. at 668.
88 Lindsay C. Howard, 16 T.C. 157 (1951), aff'd, 202 F.2d 28 (9th Cir. 1953).
89 Bowers v. Commissioner, 243 F.2d 904 (6th Cir. 1957); Baer v. Commissioner, 196 F.2d 646 (8th Cir. 1952).
90 Bowers v. Commissioner, supra note 89, at 907; Baer v. Commissioner, supra note 89, at 650.
91 See text accompanying notes 50-53 supra.
C. Limiting the Rule

Even though the Regulations\footnote{INT. REV. CODE OF 1939, § 23(a), 53 Stat. 12, as amended, 56 Stat. 819.} explicitly permit the deduction of legal fees incurred by a wife in attempting to collect alimony includible in her income, the Commissioner has used the rationale of \textit{Gilmore} to contest several attempts by wives to deduct legal fees incurred in connection with the collection of income. In \textit{Jane U. Elliot}\footnote{Treas. Reg. § 1.262-1(b)(7) (1958) [hereinafter cited as Reg.].} the Commissioner was unsuccessful in an attempt to disallow deductions for expenses incurred by a wife in a suit to collect back alimony from her former husband. In \textit{Ruth K. Wild}\footnote{40 T.C. 304 (1963).} the Tax Court permitted taxpayer’s deduction of fees allocable to negotiating a separation agreement under which the wife was to receive alimony taxable as income to her. This case, reviewed by all the judges of the Tax Court,\footnote{42 T.C. 706 (1964); cf. Meyer J. Fleischman, 45 T.C. 439 (1966).} expressly separated the deductibility of fees allocable to the securing of alimony from fees allocable to amounts received under a general property settlement agreement not includible in the wife’s income.\footnote{42 T.C. at 711.} As recently as 1966 the Commissioner unsuccessfully attempted to disallow similar deductions,\footnote{Id. at 710.} and in addition there have been reports by tax practitioners in various districts that revenue agents have been instructed to disallow all legal fees in connection with divorce actions.

D. Some Future Problems

It is probable that the Commissioner will not succeed in his attempt through \textit{Gilmore} to overturn the rationale of the old \textit{Elsie B. Gale}\footnote{Hazel Porter, 1966 P-H T.C. Mem. Dec. § 66079, petition for review filed before the 6th Cir. (Sept. 1, 1966) (No. 5839-64).} decision and the present Regulations.\footnote{13 T.C. 661 (1949), aff’d, 191 F.2d 79 (2d Cir. 1951), \textit{acq.}, 1952-1 CUM. BULL. 2.} The attempt to collect alimony, includible in gross income, seems to override the personal character of the divorce, giving a new and separate existence, so to speak, to the income-production attempt. However,
there are some unsettled problems in connection with the wife's
deduction of legal fees incurred in securing alimony. For example,
if one third of the amount received by the wife under a separation
agreement or a divorce settlement is taxable alimony and the re-
mainin two thirds is non-taxable, then obviously one third of the
attorney's fee for work done in connection with the financial ele-
ments of the separation agreement or divorce settlement should be
deductible. The question that arises of course is how the allocation
is to be made. If the wife is entitled to lump sum payments in
addition to alimony, is the deductible portion computed by com-
paring the total amount of the periodic payments to be received
by the wife during her lifetime to the total of all payments, or is
the allocation computed by comparing the taxable alimony to the
total of all payments received in the year in which the attorney's
fee is paid? Obviously, it would be difficult to determine the
total amount of alimony to be received over the wife's lifetime.
Thus, the allocation method which compares amounts received in
the taxable year in which the attorney's fee is paid, although subject
to a great deal of favorable manipulation by the taxpayer, is prob-
ably the simplest method. In any event, the Service and the courts
will be inclined to accept any reasonable allocation worked out by
the parties, since it appears that these matters have not been fully
considered by any recent decisions.

It is interesting to speculate upon an argument for the deduction
of attorney fees incurred by a wife with respect to that situation
where the wife receives no alimony but instead receives a lump
sum settlement or she receives some alimony and a lump sum in
addition. Can the wife contend that even though the attorney's
fee with respect to the lump sum payment is not deductible on
the theory that the lump sum payment is not included in the wife's
income, the fee should nevertheless be deductible because the prop-
erty which she receives — and this argument would be most appli-
cable if such property were securities or other income-producing
property — will produce income to her in years subsequent to the
divorce. Along the same lines, can a husband argue that his attor-
ney's fee incurred in resisting his wife's demands for alimony or
claims against his income-producing property should be deductible
under section 212(1) as having been incurred for the production

103 Sander, Divorce and Separation, 95 Tax Management Portfolio A-26
(1964).
104 Barbara B. LeMond, 13 T.C. 670 (1949).
of income on the theory that any relief from alimony payments to be made or any success in retaining income-producing property represents a production of income to him in subsequent years. These arguments, admittedly, are somewhat esoteric and will probably be dismissed by the courts on the grounds that Gilmore specifically requires that those fees incident to divorce should be characterized as personal expenses unless they have a direct connection in the taxable year with the production or collection of income. But nonetheless there is no certainty in the area, and time will tell.

E. Deductibility of Charges for Tax Advice Incident to a Divorce

Both parties to a divorce action are entitled to deduct attorney fees allocable to tax advice received by each under the specific provisions of section 212(3). Although this point will be discussed in the next section dealing with deduction for tax advice in general,\textsuperscript{106} it may be useful for both the husband and wife to arrange the payment of legal fees in a divorce action in order to take maximum advantage of this provision. For example, in many divorce actions the husband customarily pays the wife's attorney's fees. Since it has been held that the husband cannot deduct legal fees for tax advice to his wife\textsuperscript{106} even though he pays such fees, provision could be made for slightly larger alimony payments during the first one or two years after divorce in an amount equal to such fees, and thus the husband can be afforded a deduction for these legal fees as alimony, while the wife, although such alimony is includible in her income, will have a corresponding deduction for the legal fee for tax advice which she in fact pays.

If a legal fee expended for the protection and preservation of a husband's income-producing property against his wife's property settlement demands is denied under the Gilmore rationale, may the attorney fee be capitalized as incurred in defense of title to the property and added to the basis of the property? Mr. Gilmore, an indefatigable taxpayer, took this approach after he lost his prior case in the Supreme Court and convinced the District Court for the Northern District of California that he was correct,\textsuperscript{107} although the decision is open to some question on the theory that under Gilmore legal fees in divorce actions are purely personal expenses. Where the husband's efforts are directed toward protecting his property in

\textsuperscript{106} See text accompanying notes 111-17 infra.
\textsuperscript{107} United States v. Davis, 370 U.S. 65, 74-75 (1962).
general rather than any specific portion of his property, such as the stock involved in Gilmore, should the same principle apply? That is, should the husband be able to add his legal costs to the basis of his property by some allocation method? Under the rationale expressed by the district court in California, there is no reason why such a result should not follow, although it will be difficult to present any rational allocation approach in a circumstance where the taxpayer holds a number of items and types of property.

III. Legal Fees in Connection With Tax Advice and Determination

While the deductibility of expenses incurred for tax counsel are to some extent guaranteed by section 212(3), the area of personal tax planning expenses presents very difficult questions. The government has always conceded that under section 212(3) an individual's expenses incurred in securing the preparation of a tax return are deductible. However, although the Regulations specifically authorize deduction of expenses paid or incurred in connection with the preparation of tax returns, the Commissioner has taken the position that legal fees for preparation of tax returns are itemized deductions (non-business) and thus must be taken in lieu of the standard deduction. The courts have disagreed with this position in regard to those cases where a substantial amount of the income included on the taxpayer's return was business income as distinguished from his salary or dividends. However, it is at least probable that the Commissioner's position is correct in those situations where the bulk of the income on the return is either so-called passive income, that is, dividends, interest, royalties, etc., or is derived from salary. The government has also acknowledged — an acknowledgment required by both the plain meaning of the statute and the legislative history of section 212(3) — that fees incurred in connection with any tax controversy before the Service, the courts, or in connection with claims for refund are deductible. The troublesome area involves fees for tax advice in connection with tax consequences of transactions which have not yet occurred or in connection with tax liabilities which have not yet arisen.

110 Clyde E. Thomas, 41 T.C. 614 (1964); James J. Standing, 28 T.C. 789, aff'd, 259 F.2d 450 (4th Cir. 1958).
The Regulations interpreting section 212(3) permit deduction of fees for "tax counsel" in addition to other permissible items of deduction, and it would seem that this phrase would encompass any tax advice regardless of whether the tax in question were determined, prospective, or contingent upon a future transaction. However, litigation of the issue in *Davis v. United States* and *Carpenter v. United States* is indicative of the confusion in the area.

In *Davis* the taxpayer, divorced by his wife, attempted to deduct (1) legal fees paid for advice to him in connection with various federal tax matters arising from the negotiation and execution of a separation and property settlement agreement, (2) his wife's attorney's fees paid by the taxpayer and allocable to tax advice rendered to her in connection with the divorce, and (3) his attorney's fees incurred in connection with efforts to effect a minimum property settlement. In any event, the Court of Claims permitted the taxpayer to deduct his own tax legal fees under section 212(3) and the Regulations, but refused the deduction of his wife's tax fees on the quite logical basis that section 212 deductions were limited to the taxpayer's own expenses. In line with the later Gilmore decision, no deduction of those fees allocable to the taxpayer's efforts to effect a minimum property settlement was permitted. The Supreme Court reviewed, affirming only that the taxpayer could not deduct his wife's legal fees and specifically pointing out that it was not passing judgment on the question of whether the deduction under section 212 of his own tax legal fees was correct.

The underlying issue in *Davis* was more properly framed in the subsequent Court of Claims decision in *Carpenter v. United States*. The taxpayer claimed as deductions his legal fees allocable to tax advice in connection with efforts made to guarantee that payments to his wife pursuant to a divorce action were taxable as alimony to her and deductible by him. In other words, the question before the court was whether tax advice in connection with potential tax liability for future years, and pertaining to arrangements which

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113 338 F.2d 366 (Ct. Cl. 1964).
114 The case also involved the question of whether Mr. Davis realized a capital gain on the transfer of appreciated securities to his wife in settlement of her marital rights, an issue upon which the Supreme Court reversed the Court of Claims, holding that the taxpayer was subject to such gain. 370 U.S. at 71-74.
116 370 U.S. at 74.
118 338 F.2d 306 (Ct. Cl. 1964).
have not yet been completed, are deductible within the scope of section 212(3). The court pointed out that because section 212(3) had been enacted, the issue did not concern the usual test of whether the legal fees had their origin in a profit-seeking activity or in an activity connected with property held for the production of income under the Gilmore rationale.  

Referring to the Treasury Regulations interpreting section 212(3), the court permitted the deduction, explaining that section 212(3) and the phrase "tax counsel" found in the Regulations indicated that the statute was intended to permit deduction for advice directed toward the discovery of a contemplated transaction's tax consequences rather than to limit the deduction to tax advice in connection with a transaction which has already transpired.

The government and a dissenting judge argued that because section 212(3) was primarily designed to change the rule in Lykes v. United States, which was that legal fees paid in connection with litigation of a gift liability were not deductible, the section should be construed as limiting deduction to expenses of a contested tax liability.

Whatever the interpretation of the Regulations, the Court of Claims' reference to the "self-enforcement" system of collecting federal taxes is compelling. The court argues that since a taxpayer is required to determine his taxes prior to any payment under the self-assessment system, the word "determination" in the statute and the Regulations must as a practical matter refer to tax advice given before a tax liability has arisen and before such liability is contested. The same principle was applied, if not enunciated, by a Missouri district court in Kaufmann v. United States when a group of stockholder-executives retained accountants to secure a ruling that a proposed reorganization would result in no tax consequence to the shareholders. A favorable ruling was issued, the reorganization

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119 Id. at 368-69.
120 Reg. § 1.212-1(1) (1957).
121 338 F.2d at 370.
122 343 U.S. 118 (1952).
123 Id. at 121-24.
124 The vital words are: "In connection with the determination . . . of any tax . . . expenses paid or incurred by a taxpayer for tax counsel . . . are deductible." Reg. § 1.212-1(1) (1957).
125 338 F.2d at 369.
126 Ibid.
took place, and the stockholders deducted both the accountants' charges incident to obtaining the ruling and the charges for services to determine the taxpayers' basis in the stock obtained in the reorganization. The court permitted the deduction of the fees allocable to the obtaining of the ruling on the theory that the Regulations and the language of section 212(3) go beyond expenses incurred in tax litigation, even though in the present case no tax consequences would result because of the tax-free nature of the reorganization.\footnote{128 Id. at 813-14.} On the other hand, the court disallowed the deduction of that portion of the fee which was allocable to the determination of the basis of the stock, noting that there was no tax controversy concerning the stock basis.\footnote{129 Id. at 815.} The correctness of this distinction is certainly open to question, since basis calculation can always be related to the determination of future tax consequence.

In any event, a liberal view of both Carpenter and Kaufmann indicates that all fees allocable to tax advice in connection with otherwise personal transactions may now be deductible. For example, fees which are allocable to tax advice given in connection with the drafting of wills, estate planning, creation of trusts, charitable and personal donations and gifts, purchase of residences, and many other essentially personal transactions can be deductible under the Carpenter rationale. It is extremely doubtful that the Revenue Service will permit such deductions under the current state of the law, but lawyers and accountants should be sensitive to the possibility in terms of allocation of their fees.

This discussion has ignored the problem of the deduction of fees allocable to tax advice under section 162 dealing with ordinary and necessary business expenses. The question, of course, is whether the fees for tax advice are deductible where clearly other charges for legal advice should be capitalized under existing law, as in the case of the acquisition of property by a corporation. Since section 162 contains no counterpart of section 212(3), it is extremely doubtful that tax advice may be segregated from other legal expenses for purposes of characterization as ordinary and necessary expenses under section 162. For example, since the general rule is that legal fees incurred by a corporation in connection with a reorganization (as distinguished from a complete liquidation or dissolution) are non-deductible in that the expenditures are a continuing benefit
to the company and thus are capital in nature, it seems clear that legal fees allocable to tax advice cannot be segregated from other legal fees for purposes of deduction. Of course, this observation militates against an adoption of the liberal Carpenter view under section 212(3), for there seems to be no reason to give the expenses of tax advice treatment different from that accorded other legal expenses relating to a personal transaction.