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Joseph B. Lynch
Member of the New York Bar

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LEGAL EXPENSES AS DEDUCTIONS FROM INCOME

JOSEPH B. LYNCH†

IT IS readily understandable that an attorney who has been paid a fee, or whose client has incurred legal expense upon his advice, should charge himself with particular responsibility when consulted on the question as to whether or not the item is a deductible expense. In such a case, no one should have a better knowledge than the attorney of the nature of the services, or the facts surrounding the expense, and it would seem that no one should be better qualified to answer an inquiry as to how such fee or expense should be accounted for in the client's income tax return. The question is disarmingly simple. So, too, are the applicable provisions of the Internal Revenue Code. Prior to the enactment of the Revenue Act of 1942, one had merely to prove, to be entitled to a deduction for legal expenses, that they were "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business".[1] As a flood of litigation testifies, however, not only has the simplicity of such general statutory language frequently made difficult its specific application, but even the meaning of so simple a term as "business" has been the subject of conflicting judicial opinion.

Occasional attempts have been made, generally without success, to base a claim for a legal-expense deduction upon the statutory provision permitting deductions for losses. In an early case,[2] the Court dismissed a secondary contention that attorneys' fees paid in defense of an accounting suit were deductible as losses incurred in trade or business, with the remark: "We think it is obvious that the expenditure is not a loss". This did not discourage another taxpayer, who later sought a deduction for an attorney's fee paid in connection with a claim for the refund of estate taxes, from suggesting that if the fee were not allowable as an

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† Member of the New York Bar.

In this article the following abbreviated citations will be used: Acquiescence to a decision of the Board of Tax Appeals by the Commissioner of Internal Revenue will be cited as A. Non-acquiescence will be cited as N.A. The Cumulative Bulletins of the Internal Revenue Bureau will be cited as C.B. The Internal Revenue Bulletins will be cited as I.R.B.

The rulings of the Treasury Department (published in the Internal Revenue Bulletins) will be cited as follows: General Counsel or Assistant General Counsel Memoranda will be referred to as G.C.M. Rulings of the Income Tax Unit will be cited as I.T. The Solicitor's Law Opinions will be cited as L.O. The Opinions of the Attorney General of the United States will be cited as Op. Atty. Gen. Office Decisions will be cited O.D. Treasury Decisions will be cited as T.D. B.T.A. Memo. Op. Dkt. refers to the docket number of the memorandum opinions of the Board of Tax Appeals.

1. INT. REV. CODE, § 23 (a) (1), prior to the enactment of the Revenue Act of 1942.
2. Kornhauser v. U. S., 276 U. S. 145, 152 (1928).

ordinary and necessary expense, it was deductible "as a loss in a transaction entered into for profit",[3] but the Court considered the point "too far-fetched to require more than this indication that it has not been overlooked." About the strangest place in the Code in which to seek a basis for a legal-expense deduction is Sec. 23(e)(3), which allows deductions for "casualty" losses, yet one taxpayer invoked, but without success, the corresponding provision of a prior revenue act in claiming a deduction for attorneys' fees paid to recover property from the Alien Property Custodian.[4] But however obvious the point may be, it seems recently to have been either ignored or overlooked by the Board. In *John T. Furlong*,[5] a participant in a dissolved syndicate contributed his share of the cost of settlement of a tax claim against the syndicate, as well as his share of the incidental attorneys' fees. The Board saw no necessity for deciding whether the syndicate was a corporation or a partnership. It held that the taxpayer, not being in business, was not entitled to an expense deduction, but, "upon authority of *W. R. Hervey*",[6] allowed both amounts as losses in a transaction entered into for profit. The *Hervey* case involved a syndicate transaction but did not relate to attorneys' fees or other expenses. In the *Furlong* case, the taxpayer's share of the attorneys' fees was small. Perhaps for this reason the matter was not given adequate consideration, but at any rate the Board seems to have nodded a bit, as did also the Bureau, which acquiesced, for there can be little doubt that attorneys' fees are not deductible as losses.

Therefore, with the exception of (1) items in the nature of capital expenditures recoverable either over the life or on disposition of the asset to which they relate, and (2) expenses in connection with borrowings which must be spread over the term of the indebtedness,[7] the subject of the deductibility of legal fees and expenses, to the extent that it is based upon statutory provisions, narrows down to a consideration of Sec. 23(a) (1) of the Code as it stood prior to the enactment of the Revenue Act of 1942, and of Sections 23(a) (1) (A) and 23(a) (2) thereof, following such enactment.

3. Monell v. Commissioner, 70 F. (2d) 631, 632 (C. C. A. 2d, 1934).

4. Alice P. Bachofen von Echt, 21 B. T. A. 702 (1930). See also, Walter S. Dickey, 14 B. T. A. 1295 (1929), wherein a taxpayer, sued for malicious prosecution by a person in whose possession his stolen automobile was found, claimed the legal expense of defending the action to be deductible either as a loss arising from theft or as a business expense. The Board characterized the claim that the expense was a loss as "far fetched".

5. 45 B. T. A. 362 (1941), A. 1941-2 C. B. 5.

6. 25 B. T. A. 1282 (1932), A. XI-2 C. B. 5 (1932).

7. W. P. Brown & Sons Lumber Co., 26 B. T. A. 1192 (1932); Emerson Electric Manufacturing Co., 3 B. T. A. 932 (1926).

The first barrier, then, is the phrase "ordinary and necessary expenses". The mental attitude with which the Board and the courts approach the problem is reflected in the following quotation from a recent Board opinion in a case involving a deduction for attorneys' fees and other expenses:

"The cited cases are but a few of the legion in which the courts or this Board have been called upon to determine the difficult and vexing question. Collectively, they 'fail to provide "any verbal formula that will supply a ready touchstone". *Welch v. Helvering*. . . .' *A. Giurlani & Bros. v. Commissioner, supra.* 'To attempt to harmonize (the cases) would be a futile task. They involve the application of particular situations, at times with borderline conclusions.' *Welch v. Helvering, supra.* 'Review of the many decided cases is of little aid since each turns on its own special facts.' *Deputy v. du Pont, supra.* 'The words "ordinary and necessary" are not so clear and unambiguous in their meaning and application as to leave no room for an interpretative regulation.' *Textile Mills Security Corporation v. Commissioner, supra.*"[8]

Of necessity, the phrase "ordinary and necessary expenses" has up to this time been considered by the Board and the courts only in relation to the other phrase "trade or business", which is the second and even more difficult hurdle. Until the Code was amended by the Revenue Act of 1942, it was essential to deductibility, in the case of all taxpayers, corporate and noncorporate, that attorneys' fees be shown both to have been "ordinary and necessary", and to have been paid or incurred "in carrying on any trade or business".

In 1911, in the *Stone Tracy* case,[9] the first of the Corporation Tax Cases arising out of the Federal excise tax law of 1909, the Supreme Court took occasion judicially to adopt as a definition of the term "business":

> "That which occupies the time, attention and labor of men for the purpose of a livelihood or profit."

In 1917, in another case arising under the same law, the Court reiterated and reaffirmed its original comprehensive definition.[10] Accordingly, the Commissioner, as well as the Board and the courts, for years interpreted those provisions of the various income tax laws which allowed deductions for expenses in a trade or business in reliance upon the above quoted broad definition, and a substantial body of law was built up on this foundation.

8. Hales-Mullaly, Inc., 46 B. T. A. 25 (1942), *aff'd.* F. (2d) (C. C. A. 10th, 1942).
9. Flint v. Stone Tracy Co., 220 U. S. 107, 171 (1911).
10. Von Baumbach v. Sargent Land Co., 242 U. S. 503, 514-515 (1917).

The first warning of the approaching storm appeared in 1940 when Mr. Justice Frankfurter announced what the Circuit Court of Appeals[11] later termed the "new spun" definition of the phrase "carrying on any trade or business", and restricted it to "holding one's self out to others as engaged in the selling of goods or services."[12] The following year the Supreme Court handed down two more decisions in which the *Stone Tracy* definition was definitely rejected as a guide for the purposes of Sec. 23(a)(1).[13]

The reaction to these decisions came late in 1941 when, on the floor of the Senate, the Revenue Bill of 1941 was amended to provide for the deduction under Sec. 23(a)(1) of ordinary and necessary expenses "in conserving and conducting the business affairs of the taxpayer". In the Conference Report of September 15, 1941,[14] the amendment was stricken out, but only on the understanding of the conferees that the point would be reconsidered in a later bill, and that the final determination by the Bureau "on issues arising under the *Higgins v. Smith*[15] decision would be deferred pending such later legislation."[16] Thus the matter stood until March 3, 1942, when the Secretary of the Treasury and his tax adviser, Randolph E. Paul, appeared before the Committee on Ways and Means and offered suggestions as to the first revenue act of the war. Mr. Paul thought that it would

> "be equitable to provide for the deduction of expenses incurred in the production of . . . nontrade or nonbusiness income",

and that subject to the statute of limitations, the provision be made applicable to all prior years.[17] Whatever may be one's views as to other recommendations of the Treasury Department, it will be freely conceded that the foregoing was a most wholesome suggestion. It received a ready response from the Congress and resulted in the enactment of Sec. 23(a)(2).[18]

11. Helvering v. Highland, 124 F. (2d) 556, 561 (C. C. A. 4th, 1942).

12. Deputy v. du Pont, 308 U. S. 488, 499 (1940).

13. Higgins v. Commissioner, 312 U. S. 212 (1941); U. S. v. Pyne, 313 U. S. 127 (1941).

14. 1941-2 C. B. 509.

15. This is undoubtedly an erroneous reference to Higgins v. Commissioner, 312 U. S. 212 (1941). Higgins v. Smith, 308 U. S. 473 (1940), merely involved a question of loss on a sale of stock to a controlled corporation.

16. Amendment No. 41.

17. 1 *Hearings before the Committee on Ways and Means on Revenue Revision of 1942*, 88.

18. "(2) Non-Trade or Non-Business Expenses.—In the case of an individual, all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

By the terms of the new provision, a non-corporate taxpayer is afforded a further basis for the deduction of ordinary and necessary expenses.[19] Where not connected with a trade or business, such expenses may be deducted if paid or incurred during the taxable year (1) for the production of income, (2) for the collection of income, (3) for the management of property held for the production of income, (4) for the conservation of such property, or (5) for the maintenance of such property. By its terms, the Revenue Act of 1942 limits the benefits of the new provision to expenses in "the case of an individual", but since, by Sec. 162 of the Code, the income of an estate or trust, with exceptions not here pertinent, is "computed in the same manner and on the same basis as in the case of an individual", the new provision applies in the case of all taxpayers other than corporations.

The amendment is made applicable to all taxable years beginning after December 31, 1938. As the income tax provisions of the Code apply only to taxable years beginning after that date, the amendment is thus made applicable to all years covered by the Code. Moreover, it is made retroactively effective as if a part of the Revenue Act of 1938 (the income tax provisions of which applied only to taxable years beginning after December 31, 1937) and of all prior revenue acts.

Although the foregoing observations with respect to the difficulty of specific application of such terms as "ordinary and necessary expenses" and "trade or business", coupled with judicial differences of opinion as to the meaning of "business" and the absence of administrative interpretation of the newly enacted provision for deduction of certain non-business expenses,[19a] do not suggest encouraging results, nevertheless the question of deduction for legal fees and expense is of such intimate interest to attorneys as to warrant special study with a view to the possibility of at least disclosing a number of signposts to guide the unwary along an admittedly dim highway. It is not, however, intended to imply that the treatment of attorneys' fees is any different from that of other charges, professional or otherwise, which fall within the classification of "ordinary and necessary expenses".

The scope of this paper does not include the subject of legal fees as income to the recipient, nor does it enter the field of estate tax law. It is limited to a consideration of some of the problems in relation to

19. Sec. 23 (a) (1) makes adequate provision for expense deductions of corporations. Hence, as to them, no need existed for further relief.

19a. Subsequent to the preparation of this article, the Commissioner of Internal Revenue issued T. D. 5196, approved December 8, 1942, which amends Regulations 103 and provides for the allowance of non-trade and non-business deductions under the Revenue Act of 1942.

the accounting for attorneys' fees and legal expenses as deductions from income; but as questions of accounting for amounts paid in settlement of litigation and of fines and penalties are frequently interwoven with questions of accounting for attorneys' fees, these matters also are made the subject of incidental discussion.

I.

Public Policy Decisions.

Attorneys' fees and legal expenses in several types of cases are disallowed, not by reason of any specific statutory provision, but solely on grounds of public policy. Before proceeding to a discussion of the application of the Code provisions, it may be well to cover this field.

In the first category are attorneys' fees and legal expenses incurred in the unsuccessful defense of criminal prosecutions. In *Sarah Backer*,[20] the earliest Board case on this subject, the public policy rule was set forth as follows:

> "We do not believe that it is in the interest of sound public policy that the commission of illegal acts should be so far protected or recognized that their cost is regarded as a legitimate and proper deduction in the computation of net income under the revenue laws of the United States."

Similarly, the Circuit Court, having under consideration the deductibility of fines, attorneys' fees and court costs incident to an indictment charging participation in a price-fixing agreement to which the taxpayer pleaded guilty, said:

> "If the fines and costs cannot be deducted, the legal expenses incurred in litigating the question whether the taxpayer violated the law and whether fines should be imposed should naturally fall with the fines themselves. . . . The disallowance may properly rest on a refusal to sanction expenditures of such a character as we have here on grounds of public policy."[21]

The cases holding the expense of an unsuccessful defense against a criminal charge to be nondeductible are uniform, and admit of no exception.[22] A plea of *nolo contendere* to an indictment under the Sherman

20. 1 B. T. A. 214, 217 (1924).

21. Burroughs Building Material Co. v. Commissioner, 47 F. (2d) 178, 180 (C. C. A. 2d, 1931).

22. Columbus Bread Company, 4 B. T. A. 1126 (1926), A. VI-1 C. B. 2 (1927), disallowed attorneys' fees for services in matter of indictment for violation of state anti-trust law, to which taxpayer pleaded guilty; B. E. Levinstein, 19 B. T. A. 99 (1930), A. X-1 C. B. 38 (1931), disallowed atorneys' fees paid in matter of violation of National Prohibition Law, to which taxpayer pleaded guilty; Sanitary Earthenware Specialty Co., 19 B. T. A. 641

Anti-Trust Act followed by the imposition of a fine is to be classified as an unsuccessful defense, and the defendant's attorneys' fees are accordingly not deductible.[23]

No public policy, however, dictates that the expense of the successful defense against a criminal charge should be disallowed. Thus, where a corporation was indicted upon a charge of conspiracy to defraud the United States, an alleged offense which arose directly out of its business, and the Court quashed the indictment, the legal fees paid to defense counsel were deductible.[24] Attorneys' fees incurred in successfully defending a taxpayer against criminal charges involving fraud in a corporate tax return signed by him have also been allowed.[25] It has even been held that a person engaged in the horse-racing business who was indicted for having heroin in his possession and administering it to race horses might, upon dismissal of the indictment for lack of prosecution, properly deduct his attorneys' fees and expenses.[26]

In the *Backer* case, in disallowing attorneys' fees incurred by the taxpayer in his defense against a perjury charge, the Board said that it was "wholly immaterial whether he was innocent or guilty." Although it was in this case that the Board initially announced its public policy rule, the case was actually decided, not on the public policy point, but on the ground that the act whereby the taxpayer laid himself open to the charge had no "proximate connection" with his business, and it was on the latter point that the case was approvingly cited by the Supreme Court.[27] Other cases disallowing the deduction of legal expenses incurred in successful defense against criminal charges have been based upon the same grounds.[28] These decisions, therefore, rest, not on public policy

(1930), disallowed expense of unsuccessful defense of charge of violation of Federal anti-trust law; Estate of John W. Thompson, 21 B. T. A. 568 (1930), *app. dism.*, 62 F. (2d) 1082 (C. C. A., 8th, 1932), disallowed expense of unsuccessful defense against U. S. action for criminal conspiracy.

23. El Camino Refining Co., B. T. A. Memo. Op., Dkt. 106, 202, May 11, 1942.

24. Citron-Byer Co., 21 B. T. A. 308 (1930), N. A. X-2 C. B. 83 (1931).

25. Commissioner v. People's Pittsburgh Trust Co., 60 F. (2d) 187 (C. C. A. 3d, 1932). But see Atlantic Terra Cotta Co., 13 B. T. A. 1289 (1928), in which, without any specific finding as to whether or not the defense was unsuccessful, attorneys' fees incurred in defending a criminal proceeding for anti-trust law violations were disallowed. This case is sound only if the record discloses an unsuccessful defense.

26. Hal Price Headley, 37 B. T. A. 738 (1938), A. 1938-2 C. B. 15.

27. Kornhauser v. U. S., 276 U. S. 145, 153 (1928).

28. George L. Rickard, 12 B. T. A. 836 (1928). See, also, John Stephens, 2 B. T. A. 724 (1925), wherein attorneys' fees incurred in defending the taxpayer against an indictment charging conspiracy to defraud the United States were disallowed in the absence of evidence showing the extent to which the alleged illegal acts of the taxpayer were connected with his business. The taxpayer was exonerated from the charge.

grounds—which are quite independent of statutory provisions—but rather on the ground of taxpayers' failure to meet a requirement of the taxing act.

On the subject of legal expenses in criminal prosecutions, learned authors in a monumental work on taxation have expressed the view:

> "If the act necessitating the expenditure is wholly tainted with criminality, public policy prevails and the deduction is denied. On the other hand, if the act does no great violence, tested by the *mores* of the day, the Court may, sometimes by tortuous reasoning, emerge with a permission to deduct."[29]

In support, the authors referred for comparison to L. O. 1092, I-1 C. B. 270 and L. O. 968, 2 C. B. 212, which related to losses in *ultra vires* transactions, and also to the *Backer* case, wherein, it is true, the Board made reference to acts *mala in se,* and from which reference the authors drew the implication that "the rule may be different in regard to acts *mala prohibita.*" The writer has found no case which would tend to support this opinion, and does not subscribe thereto.[30]

In a recent case,[31] the Board had occasion to pass upon the deductibility of expenses, other than legal, of one engaged in gambling operations which "were illegal in New York by statutory prohibition". It disposed of the taxpayer's argument that the expenses were deductible, as follows:

> "It is wholly immaterial here that the statutory offense involved is *malum prohibitum* rather than *malum in se.* Petitioner's argument in essence is that his gambling operations were only 'a little bit' illegal because the penalty of forfeiture of a bet received if a civil action is brought to recover the bet is only a light penalty. The only merit of the argument is its humor. We must proceed here with recognition that without any doubt betting, receiving, and recording bets . . . and assisting anyone in doing the same, all were illegal under New York statutes."

It would seem that, whether an act is *malum in se* or *malum prohibitum,* the first test to be applied in determining whether attorneys' fees in defense against criminal charges arising out of the act are deductible is whether or not the taxpayer is guilty. If there is guilt, there can be no deduction for the related legal expense. If there is no guilt, no public policy requires that the attorneys' fees be disallowed, and the only

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29. 3 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION (1934) § 23.44.

30. I.T. 1853, II-2 C.B. 124 (1923), distinguishes between transactions which are mere breaches of equitable duty and those "falling within the prohibition of positive enactment, a *malum prohibitum*".

31. Israel Silberman, 44 B.T.A. 600 (1941).

question is whether there is a proximate relationship between the act and the taxpayer's business, income or property.[32]

The same public policy which rules out attorneys' fees and legal expenses in the unsuccessful defense of crime, but not in the successful defense against a criminal indictment, likewise forbids the allowance of attorneys' fees in the defense of a Government suit to restrain illegal acts, such as anti-trust violations, if the defense is unsuccessful, but not if the defense is successful. Moreover, in cases in which the suit is brought by the Government and the defense is only partially successful, an apportionment of the attorneys' fees is necessary to determine the amount unallowable as a deduction on grounds of public policy. A brief sketch of a line of Circuit Court decisions makes this point clear.

The first case[33] involved an anti-trust suit. A notice of complaint had been served by the Federal Trade Commission charging the company with violation of the Sherman Anti-Trust Act. Attorneys were engaged to represent the company, and after a hearing before the Commission the complaint was dismissed. The company claimed as a deduction the fees paid to its attorneys. There having been no violation of the law, the Court saw no reason why the attorneys' fees should not be deducted.[34]

The second case[35] arose out of the disallowance by the Commissioner of attorneys' fees in an equity proceeding instituted by the Attorney General against a company which was alleged to have been engaged in restraint of trade and commerce in violation of the Federal laws. The litigation was terminated by a consent decree. It may be noted that the violation consisted of membership in an association which was dissolved by the decree, and it does not appear that there was anything which the Government sought which the decree did not contain. The Court approved the disallowance of the deduction of the attorneys' fees and expenses incurred in the litigation.[36]

In the third case, *Foss v. Commissioner*,[37] the attorneys' fees were

32. For a study of the policy, its rationale and implications, see Comment (1941) 54 HARV. L. REV. 852.

33. Commissioner v. Continental Screen Co., 58 F. (2d) 625 (C. C. A. 6th, 1932).

34. See also G.C.M. 19, 976, 1938-1 C.B. 120, wherein legal expense incurred in a successful defense against an anti-trust suit brought by a state was allowed as a deduction.

35. Gould Paper Co. v. Commissioner, 72 F. (2d) 698 (C. C. A. 2d, 1934), *aff'g* 26 B.T.A. 560 (1932).

36. In S.B. Heininger, 47 B.T.A. 95 (1942), the legal expenses were incurred in resisting the Postmaster General's "fraud order" barring the use of the mails. In the District Court the company had been successful in obtaining an injunction restraining the enforcement of the "fraud order", but on appeal the Circuit Court reversed. The Board held that the legal expenses were not deductible.

37. 75 F. (2d) 326 (C. C. A. 1st, 1935).

for services rendered in a suit brought by a minority shareholder charging that the taxpayer and others were not only in a combination to waste the assets of the company, but were violating the Sherman Anti-Trust Act. The District Court had enjoined Foss and his associates from doing the illegal acts specified, and also from voting their stock in the company. On appeal in the injunction suit, the Circuit Court vacated only the part of the order relating to the voting of the stock, specifically stating:

> "In the present case nothing illegal has been done, and nothing illegal has been threatened, although the complainants had reason to apprehend that the defendant intended to do these things if he could."[38]

The Court saw no reason to disallow the attorneys' fees as a deduction.

In 1937 there came before the Second Circuit the twin cases of *National Outdoor Advertising Bureau, Inc. v. Helvering*[39] and *General Outdoor Advertising Co., Inc. v. Helvering*.[40] Like the *Foss* case, these related to anti-trust suits. Unlike the *Foss* case, each involved a suit brought on behalf of the United States, rather than an individual, and was terminated by a consent decree. In each, as in the *Foss* case, there had been no finding that the company had committed the acts forbidden by the decree. Nevertheless, the Court took the position that the decree actually restrained the company from "what there was at least an appreciable probability that it might do", and on this record disallowed the deduction of the attorneys' fees insofar as they related to matters covered by the decree.[41] By a concession which faintly suggests the payments to farmers under the Farm Parity Statute for what they fail to produce, the Court allowed as deductions attorneys' charges for services rendered in keeping restrictive provisions out of the decree, or, to quote the Court, for services rendered in "resisting what the Attorney General sought and the decree did not contain", and remanded the cases to the Board. Pursuant to the Court's mandate, the Board weighed the problem and in each case emerged with findings that in each of the two years under review two-thirds of the charges were deductible.[42]

38. Davidson v. American Blower Co., 243 Fed. 167, 170 (C. C. A. 2d, 1917).

39. 89 F. (2d) 878 (C. C. A. 2d, 1937).

40. 89 F. (2d) 882 (C. C. A. 2d, 1937).

41. The Court was in evident disagreement with the decision of the First Circuit in the Foss case, stating that it could not see any distinction "between the unsuccessful defense of a suit by a minority shareholder to enjoin the unlawful conduct of the taxpayer and a suit brought by the sovereign". But it will be noted that in the anti-trust suit under review in the Foss case the Court had specifically found that nothing illegal had been done or threatened.

42. General Outdoor Advertising Co., Inc., B.T.A. Memo. Op. Dkt. 66,511, June 24, 1938;

Another group of decisions comprises those in which, by reason of public policy, fines and penalties imposed in civil proceedings have been disallowed as deductions. To this may now be added a decision that moneys paid the Government by way of damages arising from a fraudulent transaction perpetrated upon the Government are nondeductible.[43] Originally, the Internal Revenue Bureau allowed deductions for penalties imposed for negligence and delinquency;[44] and at one time the Circuit Court weighed the idea of a distinction between penalties involving moral obliquity and those due to innocent mistakes,[45] but the law as it developed drew no such distinction,[46] and in the course of time the Bureau withdrew its earlier ruling and held that all penalty payments, whether on account of negligence, delinquency or fraud were nondeductible.[47] It has been only recently that an exception to the rule has appeared. The Agricultural Adjustment Act provides for the imposition of penalties upon producers who market certain crops in excess of quotas. For example, as to one product, the Act[48] provides for "a penalty of one-quarter of 1 cent per pound on the excess so marketed". Consonant with the statute, the Department of Agriculture Regulations also provide in Section 703 for the payment of a "penalty" on the farm marketing excess. Section 711 is captioned "Report of violations and court proceedings to collect penalty". But Congress did not actually mean

National Outdoor Advertising Bureau, Inc., B.T.A. Memo. Op. Dkts. 65,252, 70,999, June 24, 1938.

43. Standard Oil Co. v. Commissioner, 129 F. (2d) 363 (C. C. A. 7th, 1942), *cert. denied* — Sup. Ct. — (1940): "The fact that the instant judgment was for damages arising out of a tort against the Government, distinguishes it from cases where the damages arise out of a tort against an individual."

44. L.O. 926, 1 C.B. 241 (1919).

45. Burroughs Building Material Company v. Commissioner, 47 F. (2d) 178 (C. C. A. 2d, 1931).

46. Great Northern Railway Co. v. Commissioner, 40 F. (2d) 372 (C. C. A. 8th, 1930), *cert. denied*, 282 U. S. 855 (1930), involving penalties for violation of FEDERAL SAFETY APPLIANCES ACT, HOURS OF SERVICE ACT, LIVE STOCK ACT and customs regulations; Chicago, Rock Island & Pacific Railway Co. v. Commissioner, 47 F. (2d) 990 (C. C. A. 7th, 1931), *cert. denied*, 284 U. S. 618 (1931), involving penalties for violations of FEDERAL SAFETY APPLIANCES ACT, HOURS OF SERVICE ACT, LIVE STOCK LAW, the QUARANTINE LAW, etc.; Terminal R. R. Ass'n of St. Louis v. Commissioner, 61 F. (2d) 166 (C. C. A. 8th, 1932), *cert. denied*, 288 U. S. 604 (1933), involving penalties for violations of Safety Appliances Act and Live Stock Act; Kansas City Southern Ry. Co., 22 B.T.A. 949, 963 (1931) *rev'd* on other issues, 75 F. (2d) 786 (C. C. A. 8th, 1935), involving fine for violation of Federal statutes; Bonnie Bros., Inc., 15 B.T.A. 1231 (1929), involving fine for violation of Federal laws regulating interstate shipment of intoxicating liquors.

47. G.C.M. 11,358, XII-1 C.B. 29 (1933).

48. 52 STAT. 62 (1938), 7 U.S.C.A., § 1356.

what it said when it imposed a "penalty", nor did the Department of Agriculture when it expressly provided for a report of "violations" and for proceedings to collect the "penalty", for the Internal Revenue Bureau has ruled[49] that these are only "so-called penalties" and are imposed, not for "violation" of the statute, but rather for the purpose of "legalizing" the marketing of production in excess of the quota. On the basis of this tenuous distinction, the Bureau has held that such penalties are allowable as deductions from income. Accordingly, the well established principle that penalties are not deductible must now be refined to exclude nonpunitive money penalties. The farmers seem to have been made the beneficiaries of a somewhat liberal interpretation.

In view of the settled state of the law with respect to fines and penalties, what is to be said of legal expenses incurred in unsuccessfully resisting them? No decision has been found which adequately deals with the question of deductibility of legal expenses in civil proceedings brought to collect such fines and penalties, although numerous decisions deny deductions for legal expenses in the unsuccessful defense against criminal indictments resulting in fines,[50] and in one case the Board,[51] analogizing between nondeductible fines for unlawful acts and related legal expenses, cited *Terminal R. R. Ass'n of St. Louis*,[52] which involved civil penalties only.

The soundness of the decisions which disallow as deductions fines and penalties, whether imposed for innocent mistakes or for serious infractions, is not questioned. A fine or a money penalty is a form of punishment, and public policy demands that the offender bear the full brunt of it. To allow an income tax deduction for a fine would place the Government in the anomalous position of itself bearing a portion of the burden. But this is not so as to the incidental legal expenses. Does public policy in all cases require that since fines are disallowed, legal expenses in litigating the question of liability therefor should also be disallowed? If one abandon the role of idealist, and realistically approach the problem of squaring the complexities of the conduct of present day industrial business with the countless technical provisions of existing regulatory laws, each with its concomitant fine or penalty, one is less inclined to insist upon that brand of logic which demands that since a fine is nondeductible, legal expenses incident to the determination of liability there-

49. I.T. 3530, I.R.B. No. 7, p. 2 (1942).

50. See Burroughs Building Material Co. v. Commissioner, 47 F. (2d) 178 (C. C. A. 2d, 1931), and cases cited *supra* footnote 22.

51. B. E. Levinstein, 19 B.T.A. 99, 104 (1930).

52. 17 B.T.A. 1135 (1929).

for must likewise be disallowed, and which further demands that until the question of liability for the fine is determined, the question of deductibility of the legal expenses must remain in abeyance.

In any event, there would seem to be room, both in a civil proceeding for fines or penalties and in a criminal prosecution, for the application of the allocation theory adopted by the Court in the civil anti-trust proceeding in the *National Outdoor Advertising* case. For example, the current, and apparently effective, procedure of the Department of Justice in enforcing the anti-trust laws is to commence with a criminal proceeding, and seek an indictment with a number of counts. Frequently, after the parties have concluded their negotiations, the complaint in the civil proceeding is drawn virtually to reflect their agreement, and the consent decree follows. Just as in a civil anti-trust proceeding the court has deemed it proper to allocate legal expenses so as to permit deduction of the part incurred in keeping out of the consent decree what the Government originally endeavored to include, so it would seem equally proper, if a criminal proceeding is resorted to with an indictment containing many counts, to allocate legal expenses so as to allow as a deduction such as relate to counts ultimately quashed or abandoned, and to disallow such as are allocable to counts with respect to which a plea of guilty or *nolo contendere* is entered and to matters as to which a consent decree grants an injunction.

In civil suits on account of private actionable wrong, no public policy is involved in the allowance of attorneys' fees in defense, and no distinction is drawn between successful and unsuccessful defenses. In a frequently cited case,[53] the Circuit Court, after making reference to a Department ruling,[54] a Board decision,[55] and a leading Supreme Court decision,[56] observed:

> "In none of these rulings is it suggested that if the defendant in a civil suit charging medical malpractice, or tortiously wounding a person, or infringing a patent, is unsuccessful, the private wrong-doing so adjudged infects the payment for its defense."

On the contrary, the Court recognized a distinction

"between the defense of offenses *against the government,* of which governmental

53. Helvering v. Hampton, 79 F. (2d) 358 (C. C. A. 9th, 1935), allowing as an expense, amounts paid in satisfaction of a judgment resulting from a fraudulent transaction. For lack of a proper record the Commissioner's appeal from the Board decision allowing as a deduction attorneys' fees in defending the suit was not considered.

54. S.M. 4078, V-1 C.B. 226 (1926).

55. F. Meyer & Brother Co., 4 B.T.A. 481 (1926).

56. Kornhauser v. U.S., 276 U.S. 145 (1928).

policy prohibits consideration as ordinary incidents of a business, and defending *private wrong-doing* in the course of business, the cost of which is ruled deductible",

and concluded:

"We cannot agree that private wrong-doing in the course of business is extraordinary within the meaning of the taxing statute allowing deductions for 'ordinary and necessary expenses'."

The Board applied the foregoing principles in a case[57] in which a corporate taxpayer and its officers and directors compromised a suit charging that they had unlawfully conspired to restrain and interfere with the plaintiff's business, and allowed as an expense both attorneys' fees in the suit and the amount paid in settlement.[58]

In the absence of supporting judicial authority, one may be permitted to differ with Mr. Mertens' suggestion that,

"if the action incorporates a charge of fraudulent action of the corporation and its officers and the allegations are sustained, the expenses incurred in the defense would probably not be deductible",[59]

although it may be conceded that if the act which occasioned the legal expense were a crime, admitted or proved, the same rule would apply with respect to the deductibility of the legal expenses as in the case of a criminal prosecution.

The deductibility of attorneys' fees paid in connection with attempts to further or defeat legislation is now definitely proscribed. Although no statutory provision prohibits their deduction, long-standing Treasury Regulations provide that sums

"expended for lobbying purposes, the promotion or defeat of legislation, the exploitation of propaganda . . . are not deductible from gross income."[60]

57. International Shoe Co., 38 B.T.A. 81 (1938); A. 1938-2 C.B. 17.

58. See also, Becker Bros. v. U.S., 7 F. (2d) 3 (C. C. A. 2d, 1925), holding deduction of loss incurred on payment of a judgment resulting from infringement of a patent was not to be denied on grounds of public policy; Central Trust Co. v. Burnet, 45 F. (2d) 922 (App. D. C., 1930), allowing a deduction for an amount paid to compromise a decree in an action based upon fraud; Matson Navigation Company, 24 B.T.A. 14 (1931), allowing as a deduction share of legal expense in successful defense of a fraud suit; I.T. 1853, II-2 C.B. 124 (1923), allowing as a deduction an amount paid to compromise a judgment in an action for breach of fiduciary duty; O.D. 1091, 5 C.B. 139 (1921), allowing as a deduction an amount paid to compromise a suit against a former director for alleged dereliction of duty.

59. 4 MERTENS, LAW OF FEDERAL INCOME TAXATION (1942), § 25.37, n. 12.

60. Reg. 103, Sections 19.23 (o-1) and 19.23 (q-1). See also, T.D. 2137, 17 Treas. Dec. Int. Rev., pp. 48, 57-58, and similar regulations under subsequent Acts.

Paul and Mertens[61] have expressed their views as follows:

> "A generalization may be made that lobbying expenses are not deductible. But the term 'lobbying' is here used in an objectionable sense and taxpayers are, under many circumstances, legitimately entitled to be represented before legislatures. Where fees are paid for this *legitimate* type of representation, they may be deducted as an expense of the business."

They cite as authority a case[62] in which the Fifth Circuit found that the taxpayer had employed an attorney who appeared before "various committees of the Legislature, explained and advocated the passage of the bill which he had drawn". The bill was enacted. In what seems a *non sequitur,* the Court concluded that the attorney was not employed "to secure the passage or defeat of any legislation". The Ninth Circuit, however, was more strict in its application of these Regulations, and held that they were to be applied in all cases where the activities in respect of which the expenditures were made might reasonably be said to fall within their terms.[63] Subsequently, a case came before the Board[64] in which the question was the deductibility of attorneys' fees for services in an effort to procure the enactment of Federal legislation. The Board felt that "obligatory application of the regulation would result in misapplication of the statute in the instant case", and with due respect to the Ninth Circuit declined to follow its decision. But the Circuit Court reversed[65] and was upheld.[66] The Supreme Court deemed it immaterial whether or not the arrangement was to spread "insidious influences through legislative halls", and, placing its imprimatur on the Treasury Regulation, determined that the "general policy being clear it is not for us to say that the line was too strictly drawn."

Accordingly, the distinction between legitimate and illegitimate types of legislative representation is no longer recognized, and the conclusion would seem to be inevitable that, however free from taint an effort to influence legislation may be, attorneys' fees incurred for services in this connection run afoul of the Treasury Regulations, and may not be deducted from income. The Court's ultimate decision was based upon the phraseology of the Treasury Regulations. No reason is apparent why they could not and should not be amended.

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61. 3 Law of Federal Income Taxation (1934), § 23.47.
62. Lucas v. Wofford, 49 F. (2d) 1027 (C. C. A. 5th, 1931).
63. Sunset Scavenger Co. v. Commissioner, 84 F. (2d) 453 (C. C. A. 9th, 1936).
64. Textile Mills Securities Corporation, 38 B.T.A. 623 (1938).
65. Commissioner v. Textile Mills Securities Corporation, 117 F. (2d) 62 (C. C. A. 3d, 1940).
66. Textile Mills Securities Corp. v. Commissioner, 314 U.S. 326 (1941).

II.

Period of Deductibility.

As the Code[67] limits deductions for expenses to the taxable year in which "paid or incurred" or "paid or accrued", dependent upon the taxpayer's accounting method, it is fundamental that attorneys' fees may be deducted only in the year in which paid by a taxpayer whose income is computed on a cash basis of accounting, and only in the year in which accrued by a taxpayer on an accrual basis.[68] The first part of the rule requires no comment.

Before developing the subject of the accrual of legal expenses, it may be well briefly to discuss—because it is a law unto itself—the matter of accrual of expenses occasioned by the death of a taxpayer. In those sections of the Code,[69] prior to the 1942 amendments, which related to amounts of income and expenses "accrued" up to the date of death of a taxpayer, and in those sections, subsequent to the 1942 amendments, which relate to such amounts "accrued" only by reason of the death of the taxpayer, the term "accrued" has a peculiar connotation, different from its meaning as employed in other provisions of the Code. The theory of accrual adopted in these particular sections, wholly alien to the normal concept, cannot elsewhere be applied. As the Supreme Court in *Helvering v. Enright*[70] had held that in the return to date of death of a deceased member of a law partnership (both the member and the partnership keeping accounts on a cash basis of accounting) there should be included as income his share of any profits earned, but not received, to that date, to the extent that they were capable of approximate valuation, the Board, in a logical application of the theory, allowed as a deduction in the return to the date of death of the late Lewis C. Ledyard, Jr.,[71] who had also been on a cash basis of accounting, an amount paid more than a year after his death, pursuant to a judgment rendered more than a year after his death in a suit in which liability was predicated upon his conduct more than three years prior to his death; and also allowed as a deduction for such period legal expenses for services rendered in such litigation.

The Third Circuit thought that the *Enright* case by implication dis-

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67. INT. REV. CODE, §§ 23 (a) and 43.
68. O.D. 3, 1 C.B. 109 (1919).
69. INT. REV. CODE, §§ 42 and 43.
70. 312 U.S. 636 (1941); see also, Pfaff v. Commissioner, 312 U.S. 646 (1941).
71. Lewis C. Ledyard, Jr., 44 B.T.A. 1056 (1941).

posed of "such general criticisms of § 42 as that it is unreasonable",[72] but, happily, the Treasury Department,[73] the House Committee on Ways and Means,[74] and the Senate Committee on Finance[75] were of a different mind, and agreed that Sec. 42 worked a "hardship". Hence, Congress has provided that income and expenses accrued only by reason of the death of a taxpayer shall no longer be included in the return of a decedent to the date of death.[76] Even under the amended statute, however, such expenses are given special treatment, being deductible by the decedent's estate or by the recipients of the decedent's property "in the taxable year when paid".[77] If the newly enacted provision were applied to the facts in the *Ledyard* case—it may be thus retroactively applied at taxpayer's option[78]—the judgment and legal expenses there involved would be deductible only in the year of payment. This would also have been the result if the decedent had been on an accrual basis. Hence, in the case of an estate actually following the accrual method of accounting, the amended statute has the paradoxical effect of allowing a deduction for certain legal expenses only in the year of payment.

The general rule is that, on an accrual basis, attorneys' fees are deductible only in the year in which the fees are determined in amount, and that the period during which the services are rendered is not a factor. Attempts to breach this line have met with failure. On occasion, taxpayers have sought to anticipate the fees of counsel, and have taken a deduction for an estimated amount of fees and legal expense.[79] They have also attacked in another direction and sought, after determination of the fee, to allocate a portion of it to a prior year.[80] But the rule is clear that the mere fact that services have been performed does not

72. Bach v. Rothensies, 124 F. (2d) 306 (C. C. A. 3d, 1941), *cert. denied*, 62 S. Ct. 1035 (1942).

73. Statement of Randolph E. Paul, *1 Hearings Before Committee on Ways and Means on Revenue Revision of 1942*, 89.

74. I.R.B., No. 43, p. 56 (1942).

75. I.R.B., No. 44, p. 93 (1942).

76. Revenue Act of 1942, § 134 (a) and (b).

77. INT. REV. CODE, § 126 (b) (1).

78. Revenue Act of 1942, § 134 (g).

79. New Process Cork Co., 3 B.T.A. 1339 (1926); Crown Cork & Seal Co., Inc. v. U.S., 4 Fed. Supp. 525 (1933), *aff'd* 73 F. (2d) 997 (C. C. A. 2d, 1934).

80. Oswald and Hess Company, B.T.A. Memo. Op. Dkt. 105,203, Jan. 5, 1942, *aff'd* 130 F. (2d) 904 (C. C. A. 3d, 1942). In Searles Real Estate Trust, 25 B.T.A. 1115 (1932), A. XI-1 C.B. 6, a deduction was allowed to taxpayer on an accrual basis for legal fees not paid until a succeeding year "because there was no available money." The report does not state the year in which the bills were rendered, but the evidence discloses that the amounts had been agreed upon in the years for which the deduction was allowed.

establish an accrual. The underlying theory is that the determining event is the attorney's decision, communicated to his client, as to the amount of his fee, and the creation thereby of his client's obligation, admitted or enforcible, to make payment. Until the happening of that event, there has been no determination, and, therefore, no accrual. Nor when it does occur can it be related back to a prior year merely because all or part of the services were rendered in that year. If an on-account charge is made by an attorney, whether for services rendered or to be rendered over an indefinite period, the date of accrual would seem to be the date of determination of the fee, if the client's liability therefor is then enforcible or undisputed. But where, either in or prior to the taxable year, a definite retainer is agreed upon, and the period covered by the services definitely established, the fee would seem to be an accrued liability for the period in which the services are to be rendered, apportionable if it covers more than one taxable year.

One case[81] in which the opinion of the Court does not square with the foregoing view may be noted. There, attorneys' fees paid in the taxable year in connection with a sale of property were claimed as a deduction in that year, although the sale was not consummated until January 2nd of the succeeding year. In allowing the deduction, the Court expressed the thought that the fact that the sale was not completed within the year

> "in no wise militates against the view that the services rendered and for which the fee was paid, may lawfully be allocated"

to the prior year. The decision itself is sound, but as much cannot be said for the reasoning. Whether the taxpayer was on a cash or an accrual basis of accounting does not appear. If on a cash basis, the fee was a deduction in the taxable year, because paid in that year; if on an accrual basis, it was also a deduction in the taxable year, because it appears that the amount was agreed upon and by payment recognized as a liability in that year. But the Court seems to have strayed somewhat in resting its conclusion upon the circumstance that the services rendered might "lawfully be allocated" to the year under review.

In the case of contingent fee arrangements, the deduction is normally accruable only in the year in which the contingency occurs. This rule, however, is subject to the modification that if in a particular year a claim is made against a taxpayer which, if definitely established, would be deductible, and in the same year he agrees, if the defense is successful,

81. Smith, et al. v. Russell, 76 F. (2d) 91 (C. C. A. 8th, 1935), *cert. denied,* 296 U.S. 614 (1935).

to pay counsel a fee based upon a percentage of the claim, his liability in the amount agreed upon is fixed in that year, and he is, therefore, entitled to a deduction in such year. In one such case,[82] a corporate taxpayer following the accrual method engaged counsel in 1935 to contest the constitutionality of the Agricultural Adjustment Act, and agreed to pay a fixed percentage of the 1935 taxes which might be saved. The Supreme Court decision invalidating the Act was handed down on January 6, 1936.[83] In allowing the attorneys' fees as a 1935 deduction, the Board correctly pointed out that, to the amount of the fees agreed upon, the taxpayer's economic status was definitely fixed in 1935, as he was obligated to pay that amount either in taxes or in counsel fees.[84]

In the foregoing case the Board sought to buttress its position with another point which it is appropriate to note here. Quoting from *Sanford Cotton Mills, Inc.,*[85] the Board said:

> ". . . an accrual of either income or outgo which is clearly in doubt may, and often should, be adjusted when shortly thereafter in the next year the doubt is removed."

This doctrine is probably bottomed on that portion of Section 43 of the Code which provides for inclusion of deductions in the taxable year in which paid or accrued "unless in order to clearly reflect the income the deductions or credits should be taken as of a different period." Although it has been said to be an administrative necessity, this provision is actually a taxpayer's "No Man's Land". Seldom applied, it is none the less a potential breeder of uncertainty. A taxpayer might well be tempted to paraphrase the Board:

> When an accrual of income or outgo is clearly in doubt, and shortly after the end of the taxable year the doubt is removed, the taxpayer will then be clearly in doubt as to the year of accrual, and if the Commissioner is also in doubt recourse must be had to the Board and the courts where the doubts will be removed.

The Bureau's appraisal of the Board's opinion is reflected in a Memorandum[86] wherein the Chief Counsel stated that the decision should be accepted *as to the result,* but recommended nonacquiescence on the ground that it was

82. The Tobin Packing Co., Inc., 43 B.T.A. 642 (1941).

83. U.S. v. Butler, 297 U.S. 1 (1936).

84. To the same effect are Blaine, Mackay, Lee Co., B.T.A. Memo. Op. Dkt. 101,887, Jan. 17, 1942, and Blaine, Mackay, Lee Co., B.T.A. Memo. Op. Dkt. 103,846, Jan. 17, 1942.

85. 42 B.T.A. 190 (1940), N.A. 1940-2 C.B. 14.

86. G.C.M. 22, 404, 1940-2 C.B. 204.

"a departure from the strict rule that a contingent liability, which is dependent on the last day of the accounting period upon a future event, is not a deductible accrued liability for such accounting period".

If an officer and a member of the board of directors of a corporation which is on an accrual basis renders legal services to it, prepares a bill dated December 30th of one year, and in the succeeding year presents it to another corporate officer who causes it to be paid on January 8th of that year, is the corporation entitled to a deduction in the first or the second year? This question recently came before the Board.[87] In what might be considered a miracle of understatement, the Board, in allocating the deduction to the second year, said that it might

"seem unrealistic to admit that a man possesses knowledge in one capacity while he is totally ignorant of it in another (but), we face an anomalous situation here; and we conclude that the corporation first learned of the lawyer's charge when the bill was presented to a corporate officer other than (the lawyer who rendered the bill)."

As to the period in which deductions are allowable for accrual of legal fees, the following conclusions appear to be warranted:

(1) Except as to items which accrue by reason of the death of the taxpayer now deductible only in the year in which paid, legal fees may be deducted only in the year in which the amount thereof is definitely determined, such determination being generally within the control of the attorney rendering the services.

(2) Legal fees payable pursuant to a retainer covering a definite period are deductible in the period to which the retainer relates.

(3) If liability for a fee is contingent, it is deductible only upon the happening of the contingency; but this does not preclude an earlier deduction where the taxpayer is alternatively liable in an ascertainable amount, either for an asserted claim which, if definitely established, would itself constitute a deductible item, or for a fee for legal services in resisting such asserted liability.

III.

Legal Expenses Not Solely for Taxpayer's Benefit.

It has long since been said, and often repeated,[88] that there must be

87. Motion Picture Corporation of California, B.T.A. Memo. Op. Dkt. 104,651, February 17, 1942.

88. Sarah Backer, 1 B.T.A. 214 (1924); Kornhauser v. U.S., 276 U.S. 145 (1928); Stone's Estate v. Commissioner, 115 F. (2d) 853 (C. C. A. 7th, 1940); Anderson v. Commissioner, 81 F. (2d) 457 (C. C. A. 10th, 1936).

a proximate relationship between the matter out of which the legal expenses arise and the business of the taxpayer. As to corporate taxpayers, this is still the law. As to non-corporate taxpayers, it is essential that such relationship be established if the deduction is sought as a business expense; if claimed as a non-business expense, a proximate relationship must be shown between the subject matter of the expense and the production or collection of taxpayer's income or the maintenance, conservation or management of his property held for the production of income.

No attempt will be made to enumerate the countless factual situations in which the Board and the courts have had occasion to apply the "proximate relationship" test where only the taxpayer was benefited by such expenditures. It is, however, possible, within the scope of this paper, to select and focus attention upon cases in which the subject matter of the expense was not solely an asset of, or an asserted liability against, the taxpayer, and in which, therefore, the amount expended also benefited someone other than the taxpayer. Typical are instances involving the deductibility by a corporation of the cost of settlement of and legal expenses incurred in litigation involving officers, directors and stockholders. Witness the motley array of cases on this point:

(1) Amounts paid for legal services in representing the taxpayer's officers and principal stockholders in unexplained litigation against them, but not against the taxpayer, have been disallowed.[89]

(2) Amounts paid in settlement of litigation predicated upon a charge of conspiracy made against persons who were directors and large stockholders of the taxpayer, the latter being neither a party to the conspiracy nor a defendant in the suit, have been disallowed.[90] The Board in this case was unconvinced by a resolution of the Board of Directors reciting that the directors had acted for and on behalf of the corporation, since nearly all the defendants were themselves directors. But the Circuit Court referred to the "alleged acts" as having been "committed by the defendants as officers and directors".

(3) Amounts paid for attorneys' fees and legal expenses, and in settlement of a suit which charged certain individuals with conspiracy and alleged that the taxpayer had been organized in furtherance of the conspiracy and in which the taxpayer was a defendant, although not

89. Evans-Winter-Hebb, Inc., B.T.A. Memo. Op. Dkt. 106,780, July 21, 1942.

90. Blackwell Oil & Gas Co., 20 B.T.A. 661 (1930); *aff'd* 60 F. (2d) 257 (C. C. A. 10th, 1932).

charged with conspiracy, have been disallowed.[91] In this case, the Board took occasion to say:

"No case has been cited, and we know of none, in which deduction has been allowed for the full amount of a fee paid by one defendant for the benefit of several, and the general rule, certainly in the absence of an agreement to the contrary, would seem to be that deduction should be allowed only for the aliquot portion of the total fee."

(4) Legal expenses and an amount paid by the taxpayer to settle a judgment against its president, resulting from injuries caused by him while driving an automobile owned by the taxpayer, have, in the absence of evidence as to the officer's mission at the time of the accident, been disallowed.[92]

(5) Attorneys' charges and other expenses incurred by a corporation in adjusting personal disagreements in the family of its president and principal stockholder, even though these activities "if continued, would probably have resulted in the ruin of the corporation's business", have been disallowed.[93]

(6) Amounts paid for attorneys' fees in a successful defense of the taxpayer and two of its officers against an indictment based upon acts growing out of taxpayer's business have been allowed, and without apportionment.[94]

(7) An amount paid as attorneys' fees and in settlement of a suit against the taxpayer and certain of its officers and directors charging conspiracy and other unlawful acts has been allowed, and without apportionment.[95]

Before drawing conclusions, two more cases, involving payments by individuals, may be cited:

(a) Attorneys' fees paid by an individual taxpayer in a suit charging the taxpayer and others with misrepresentation and conspiracy in the conduct of the business of a corporation, and payment made by the taxpayer in settlement of the litigation, were held deductible in full, al-

91. Hales-Mullaly, Inc., 46 B.T.A. 25 (1942), *aff'd* —— F. (2d) —— (C. C. A. 10th, 1942).

92. San-Knit-Ary Textile Mills, Inc., 22 B.T.A. 754 (1931).

93. Forty-Four Cigar Co., 2 B.T.A. 1156 (1925); see also, White v. Commissioner, 61 F. (2d) 726 (C. C. A. 9th, 1932), holding that where a partnership paid an amount in settlement of a claim against a partner arising out of a prepartnership transaction, the payment being for the reason that the claim so harassed the partner "that he was unable properly to attend to and assist in carrying on the partnership business", the expense did not have such a relationship to the business of the corporation as to permit a deduction.

94. Citron-Byer Co., 21 B.T.A. 308 (1931), N.A. X-2 C.B. 83 (1931).

95. International Shoe Co., 38 B.T.A. 81 (1938); A. 1938-2 C.B. 17.

though the taxpayer bore the entire burden of the expense and settlement.[96] In this case, the Board took occasion to observe:

"Though the *Kornhauser* case involved only legal fees, we believe the reasoning employed applies equally to the compromise payment made to settle the lawsuit. This expense grew directly out of, and proximately resulted from, the business dealings between the parties. . . . Nor do we believe it important that petitioner, in his individual capacity, paid the entire sum though other persons were named as parties defendant. Petitioner was the real party in interest, the one who stood to suffer most. See *E. L. Potter,* 20 B. T. A. 252; and *Edward A. Pierce,* 18 B. T. A. 447."

(b) Attorneys' fees paid by an individual taxpayer is resisting an action in which he was not a defendant, one of the results of which would have been substantially to affect his business interests by ousting him from control of a corporation, were held deductible.[97]

The cases present two questions, (1) whether the expenses are deductible at all, and (2) if so, whether apportionment is necessary. In the first five cases, the deduction was disallowed because the taxpayer failed to meet the "proximate relationship" test. In the first case, the nature of the litigation which was the subject of the fees did not appear; in the second, the Board apparently treated the acts of the alleged conspirators as not in pursuance of the business of the corporation; in the third, the acts which were the basis of the conspiracy charge antedated the organization of the corporation; in the fourth, there was no proof that the president of the corporation was using the automobile in the corporation's business, and in the fifth, the disagreements were largely personal and family matters. The sixth and seventh cases in which the deductions were allowed without apportionment, and the two individual cases, in one of which the deduction was allowed without apportionment and in the other of which the deduction was allowed in full even though the taxpayer was not a defendant, are sound. The dictum in the third case suggesting the necessity of apportionment is answered by the decisions in the sixth and seventh cases, and the quotation from the first individual case.

Frequently quoted authors, writing in 1934, said:

"The cost of the defense of directors is not deductible by a corporate taxpayer",[98]

96. H. M. Howard, 22 B.T.A. 375 (1931); N.A. X-2 C.B. 90 (1931).

97. E. L. Potter, 20 B.T.A. 252 (1930); N.A. X-1 C.B. 90 (1931).

98. 3 PAUL and MERTENS, LAW OF FEDERAL INCOME TAXATION, § 23.49.

citing the *Blackwell Oil* decision.[99] One of the same authors, writing in 1942, concluded:

> "That part of the cost of defending the action includes defense of officers and directors does not necessarily make such expenditures non-deductible",[100]

citing the *International Shoe* decision.[101] The latter is perhaps another way of saying that a corporation may be entitled to a deduction for all, and not merely an aliquot part, of the legal expense incurred in defending itself, and, incidentally, its co-defendant officers and directors. Indeed, the right of a corporation to deduct legal expenses in defending its officers and directors would seem to lie even deeper, as their defense may itself be a duty of the corporation if the acts complained of were done in the course of the corporation's business.

It may therefore be concluded that if litigation involving a corporation, its officers, directors or stockholders, relates to the business of the corporation, legal expenses and amounts paid in settlement are fully deductible, and there is no necessity for apportioning the cost among the defendants. If the corporation is the real party in interest, and incurs the expense, it is entitled to the deduction, although others may also benefit.[102]

The same rule would seem to be applicable if two related corporations, for example, parent and subsidiary, were sued, and the parent, standing to lose the most by an unfavorable result, bore the entire expense for legal services rendered to it, although such services incidentally benefited the subsidiary.[103] To the extent that the services were rendered to the subsidiary, the charge would obviously not be a deduction to the parent, but to the extent that the services were rendered to the parent for its benefit, and incidentally the same services also benefited the subsidiary, the legal fee should be a deduction to the parent, and there is neither reason nor authority for requiring apportionment. Such a situ-

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99. Blackwell Oil & Gas Co., 20 B.T.A. 661 (1930), *aff'd* 60 F. (2d) 257 (1932).

100. 4 Mertens, Law of Federal Income Taxation (1942), § 25.37.

101. International Shoe Co., 38 B.T.A. 81 (1938).

102. Matson Navigation Co., 24 B.T.A. 14 (1931), is not to the contrary. The taxpayer, one of several stockholders, was allowed as a deduction only a pro rata share of attorneys' fees and court costs of a lawsuit, but that was all it paid and claimed as a deduction.

103. *Cf.* Commissioner v. Hopkinson, 126 F. (2d) 406 (C. C. A. 2d, 1942), where a trustee incurred legal expenses concerning a beneficiary's assignment of her interest, and the question of assignability was of equal interest to the trustee. In determining the distributable income to the beneficiary, the legal fees were held not chargeable to the beneficiary. Whether the legal fees were a deduction to the trustee was not an issue.

ation is clearly to be distinguished from a case in which deduction is disallowed because a payment did not directly benefit the corporate taxpayer, but benefited it only indirectly as a stockholder.[104] Experience proves that the Internal Revenue Bureau looks askance at transactions within a related group, and therefore might not subscribe to the views herein expressed, except, perhaps, in such a case as one in which the subsidiary was financially irresponsible. The sound rule, however, would seem to be that if an amount of legal expenses were incurred by a parent corporation which would have been deductible by it were it the sole defendant, its right to the deduction of the full amount should not be diminished by reason of the circumstance that a related corporation, also a defendant, was thereby benefited.

If a corporation lawfully pays legal expenses in connection with a stockholders' derivative suit against its officers and directors, based upon their conduct of the affairs of the corporation, the fact that the officers or directors derived a benefit from such payment is no valid reason for denial to the corporation of a deduction for the full amount paid.[105]

Cases involving distributees of liquidated corporations present another situation wherein the liability constituting the basis of the expense is not solely that of the taxpayer. If a tax claim arises against a corporation after its liquidation and the stockholders incur legal expense in resisting the claim, the cases hold that such expense is deductible if the tax would have been a charge against the business assets of the stockholders,[106] or if the stockholders as transferees would have been personally liable therefor.[107]

In a case in which the taxpayer was the record owner of less than three-fourths of the stock of a liquidated corporation and bore three-

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104. Daily Journal Co., B.T.A. Memo. Op. Dkt. 105,054, May 11, 1942.

105. See N. Y. Gen. Corp. Law, § 61 (a), as amended by C. 350, Laws of 1941.

106. Joshua C. Kelley, 38 B.T.A. 1292 (1938), A. 1939-1 C.B. (Part I) 19; Fred T. Ley, 21 B.T.A. 216 (1930), N.A. X-1 C.B. 85 (1931); John R. Sproehnle, 20 B.T.A. 417 (1930), N.A. X-1 C.B. 93 (1931), *app. dism.* C. C. A. 7th, June 19, 1931; Flemmon E. Gloyd, 19 B.T.A. 966 (1930), A. IX-2 C.B. 22 (1930), *aff'd* on another issue, 63 F. (2d) 649 (C. C. A. 8th, 1933); H. E. Bullock, 16 B.T.A. 451 (1929), N.A. VIII-2 C.B. 60 (1929).

107. Benjamin P. O'Neal, 18 B.T.A. 1036 (1930), A. IX-2 C.B. 45 (1930); *cf.* Sigmund Spitzer, 23 B.T.A. 776 (1931) (taxpayer's appeal dismissed, C. C. A. 3d, Jan. 29, 1934). A decision allowing legal expense merely on this ground cannot stand the test of Deputy v. du Pont, but under the amended law permitting deduction of nonbusiness expenses it may be possible for a stockholder to deduct such legal expense under such circumstances. As already noted, in John T. Furlong, 45 B.T.A. 362 (1942), a participant in a dissolved syndicate from which he had received profits was denied as a business expense (but allowed as a loss) the amount of legal fees incurred in the settlement of a tax claim against the syndicate. Under the amended statute, the decision would clearly have been in the taxpayer's favor.

fourths of the legal expense of resisting a tax claim against the corporation, the expense so incurred was allowed. Whether the record and beneficial ownership of the stock were identical did not appear.[108] But even if a single stockholder, or a few stockholders, bore the entire legal charge, the deduction therefor should not be disallowed merely because other stockholders, although benefited thereby, did not choose to participate in the litigation.

IV.

Capitalized Legal Expenses.

A long line of cases has upheld the well established Treasury regulation[109] that the cost of defending or perfecting title to property is not a deductible expense. Thus, attorneys' fees and other legal expenses incurred either in connection with the original acquisition of property or the subsequent defense of title thereto have been held to be a capital expenditure, to be added to the cost of the property to which they relate, recoverable over the life of the property, if it has fixed life, or to be taken into account upon sale or other disposition.[110] This rule has been applied to legal expenses incurred with respect to various types of property, *e.g.*, in defending title to a trade name,[111] in acquiring stock previously issued by the corporate taxpayer,[112] in settlement of a suit attacking title to a business,[113] in perfecting the transfer of a stock ex-

108. Flemmon E. Gloyd, 19 B.T.A. 966 (1930).

109. Reg. 103, §§ 19.24-2: "The cost of defending or perfecting title to property constitutes a part of the cost of the property and is not a deductible expense."

110. Farmer v. Commissioner, 126 F. (2d) 542 (C. C. A. 10th, 1942) (attorneys' fees paid in successfully resisting suit attacking taxpayers' rights to property); Owens v. Commissioner, 125 F. (2d) 210 (C. C. A. 10th, 1942), *cert. denied*, 62 S. Ct. 1308 (1942) (amounts paid in settlement of litigation relating to taxpayer's acquisition of interest in oil and gas lands); Murphy Oil Co. v. Burnet, 55 F. (2d) 17 (C. C. A. 9th, 1932), *aff'd* on other issues, 287 U. S. 299 (1932) (attorneys' fees and costs of litigation in defending title); Williams v. Burnet, 59 F. (2d) 357 (App. D. C., 1932) (attorneys' fees in prosecution of claims for awards for condemnation of land); See also Ada B. Storm, B.T.A. Memo. Op., Dkt. 104, 675, June 17, 1942); W. P. Brown & Sons Lumber Co., 26 B.T.A. 1192 (1932) (amount paid for legal services incident to erection of building); Phoenix Development Co., 13 B.T.A. 414 (1928) (legal expense incurred in defending title to property); North American Oil Consolidated, 12 B.T.A. 68 (1928) (amounts paid to attorneys for defending title to property and securing land patents); Saletha A. Thompson, 9 B.T.A. 1342 (1928) (amounts paid for legal opinions upon titles); Frederick McLean Bugher, 9 B.T.A. 1155 (1928) (amounts paid for attorneys' fees, to the extent that they represented expenditures made to acquire an interest in a mine, to enlarge an interest or to defend title thereto).

111. L. J. Skaggs, B.T.A. Memo. Op. Dkts. 107,466-7, May 4, 1942.

112. Evans-Winter-Hebb, Inc., B.T.A. Memo. Op. Dkt. 106,780, July 21, 1942.

113. Chestnut Farms Dairy, Inc., 19 B.T.A. 192 (1930).

change membership,[114] in defending a right to receive oil royalties,[115] and acquiring other types of property and rights to property, in all of which the attorneys' fees were held to be capital expenditures.

In this virtually impregnable stronghold of authority, an apparent breach occurred which has only recently been filled. The point may be of interest as a phase in the development of the law. In *Abel Bliss*[116] the litigation under review arose eleven years after the property was acquired, and related to the right of a party to enter upon certain lands and claim the oil and gas produced therefrom. The question was the deductibility of legal expenses incurred in the litigation. Up to the time of this decision, no distinction had been made as to whether such expenses were incurred prior or subsequent to the acquisition of the property; in either event, they had been held to be capital expenditures. The Board followed the established rule and disallowed the expenses as deductions. The Circuit Court, however, saw a distinction between legal expenses incurred in acquiring property, and such expenses incurred in protecting the owner's right to undisturbed possession and enjoyment thereof. As the litigation related to the latter, the Circuit Court reversed the Board and allowed the expenses as a deduction. This amounted to setting up one rule on offense and another on defense. Thereafter, another case came before the Board[117] in which the question was the allowance of attorneys' fees in a suit to remove a cloud on title arising out of a fraudulent deed recorded some years after taxpayer's testator acquired the property. The case seemed to be directly in the line of the *Bliss* case, but the Board declined to follow the Circuit Court and held that the attorneys' fees constituted capital expense. Member Mellott, apparently impressed with the new theory, in a dissenting opinion made a distinction between expense of litigation conducted as a sword of offense, to add to one's capital, and that conducted as a shield of defense, to protect one's property from those who would deprive the owner of income. The theory collapsed, however, when the case reached the Circuit Court,[118] which, in upholding the Board, stated that to the extent that the *Bliss* case was in conflict, it was overruled. There is no longer any question of modification of the original principle.

114. Albert E. Schwabacher, 43 B.T.A. 1177 (1941).

115. Moynier v. Welch, 97 F. (2d) 471 (C. C. A. 9th, 1938).

116. Bliss v. Commissioner, 57 F. (2d) 984 (C. C. A. 5th, 1932), *aff'g* 20 B.T.A. 35 (1930).

117. Morgan Jones Estate, 43 B.T.A. 691 (1941).

118. Jones Estate v. Commissioner, 127 F. (2d) 231 (C. C. A. 5th, 1942).

V.

Legal Expenses in Corporate Matters.

It is not feasible, within the limitations of this paper, to discuss all of the many types of legal expense which a corporation may incur. However, one class of expense which may be discussed without reference to those cases "of little aid since each turns on its own special facts",[119] is that relating to strictly corporate, as distinguished from business, affairs of a corporation.

So obvious is the proposition that an individual may not deduct as an expense attorneys' fees for services rendered in organizing a corporation that one wonders at the temerity of a taxpayer even to raise the point.[120] Equally well settled is the rule that a corporation may not deduct, in the year in which incurred, legal expenses incident to incorporation,[121] to an increase in authorized capital stock,[122] to a merger,[123] or to a recapitalization.[124]

In an early case,[125] the Board suggested that, since organization expenses are not represented by any saleable asset, it might be good accounting to write them off over a brief period of years, but carefully added the observation that "the income-tax laws are not always in accord with accounting practice".

In the first case to come before it involving the question of the right of a corporation having a limited period of existence to amortize expense of organization over the life of its charter,[126] the Board, reasoning from a previous case,[127] in which it had held that amounts paid for services in selling stock could not be "amortized over the maximum life of the

119. Deputy v. du Pont, 308 U.S. 488 (1939).

120. Clara B. Parker, 30 B.T.A. 1231 (1934), *app. dism.* 75 F. (2d) 1010 (C. C. A. 9th, 1935).

121. Morganite Brush Company, Inc., 24 B.T.A. 776 (1931).

122. Holeproof Hosiery Co., 11 B.T.A. 547 (1928); Emerson Electric Manufacturing Co., 3 B.T.A. 932 (1926).

123. Motion Picture Capital Corporation v. Commissioner, 80 F. (2d) 872 (C. C. A. 2d, 1936); First National Bank of St. Louis, 3 B.T.A. 807 (1926). But upon abandonment of merger plans, the expense has been allowed as a deduction. Doernbecher Manufacturing Co., 30 B.T.A. 973 (1934), A. XIII-2 C.B. 6, *aff'd* on another issue, 95 F. (2d) 296 (C. C. A. 9th, 1938); *see* also Portland Furniture Manufacturing Co., 30 B.T.A. 878 (1934), N.A. XIII-2 C.B. 33 (1934).

124. Skenandoa Rayon Corporation v. Commissioner, 122 F. (2d) 268 (C. C. A. 2d, 1941), *cert. denied,* 314 U.S. 696 (1941).

125. First National Bank of St. Louis, 3 B.T.A. 807, 808-809 (1920).

126. Hershey Manufacturing Company, 14 B.T.A. 867 (1928).

127. Corning Glass Works, 9 B.T.A. 771 (1927).

stock", disallowed the deduction. The Circuit Court, however, reversed the Board, holding that the corporate franchise was a capital asset used in the business, and, as such, properly amortizable.[128]

On the next occasion when this question arose, the Board specifically declined to follow the Circuit Court, and adhering to its earlier reasoning held that the corporation was entitled neither to deduct nor to amortize such expenses.[129] The Circuit Court affirmed, but rested its decision solely upon the insufficiency of the record, and took occasion to state that, just as in the prior case the taxpayer was permitted to amortize "expenses of incorporation, such as attorneys' and charter fees", so, if the record had disclosed the amount, "it would seem that petitioner would be entitled to a deduction for expenses of incorporation".[130]

Although attorneys' fees and legal expenses in relation to a corporation's charter are not deductible as expenses, and are not amortizable except in the comparatively rare instances in which corporations have other than perpetual charters, they are deductible as losses in the taxable year in which, by dissolution or forfeiture, the corporate charter is surrendered.[131] This development in the law was attained not without considerable conflict of opinion. In a Division decision,[132] the Board allowed as a loss in the year of dissolution the organization expenses incurred by a corporate taxpayer in a prior year. The Bureau nonacquiesced. When, in another case, the point came before the full Board for the first time,[133] it adopted the rule established in the earlier case and allowed the loss, but there were two vigorous dissenting opinions, in one of which Member Sternhagen expressed the view that there was

> "no substance in the idea that a corporation suffers a loss of the cost of its corporate existence when it dissolves. Its organization costs are incurred because it desires to exist. It gets what it desires for as long as it wishes and then voluntarily quits. Thereby it loses nothing. To the contrary, it has enjoyed everything which the expenditure contemplated."

Shortly prior to the date of this decision, the Bureau had withdrawn

128. Hershey Mfg. Company v. Commissioner, 43 F. (2d) 298 (C. C. A. 10th, 1930).

129. Surety Finance Company of Tacoma, 27 B.T.A. 616 (1933).

130. Surety Finance Company of Tacoma v. Commissioner, 77 F. (2d) 221 (C. C. A. 9th, 1935).

131. This statement is not inconsistent with the statement that "attorneys' fees are not deductible as losses" (p. 9 *supra*) since the subject matter of the loss is not the attorneys' fees but the capital item in the acquisition of which the fees were incurred.

132. Malta Temple Association, 16 B.T.A. 409 (1929), N.A. VII-2 C.B. 67 (1929), A. XIII-2 C.B. 12 (1934).

133. Pacific Coast Biscuit Company, 32 B.T.A. 39 (1935), A. XIV-1 C.B. 15 (1935).

its nonacquiescence in the earlier case, and in due course it acquiesced in the later decision as well.[134]

The Bureau and the Board, however, are still out of tune on the question of the application of the rule. Under Delaware law,[135] a dissolved corporation continues as a body corporate for the purpose of liquidating "for the term of three years from . . . dissolution". In one case,[136] the Bureau apparently took the position that organization expenses were deductible by a Delaware corporation only on expiration of such three-year period. The Board held otherwise, and allowed the deduction as a loss in the year of dissolution. It is difficult to understand the reason for the Bureau's nonacquiescence. When the right to do business comes to an end the object for which the charter was obtained ceases, and it would seem that the identifiable event which fixes the loss occurs at that time. Under the New York law,[137] the period of existence of a dissolved corporation for the purpose of liquidating its affairs is unlimited, unless the directors voluntarily exercise their right to take steps, three years after dissolution, to terminate it. In such a case, it would seem clear that since the optional procedure to terminate corporate existence may never be adopted, the only appropriate time for recognition of a loss is the date of filing of the certificate of dissolution.

All efforts to vary the established Board rule deferring deduction of organization expenses until the year of dissolution have failed. Legal expenses paid in connection with incorporation are not deductible in the year of retirement of stock,[138] in the year of a merger,[139] or in the year in which a corporation ceases to do business and commences liquidation but does not actually dissolve.[140]

The theory underlying the decisions holding that legal expenses incurred in relation to the charter of a corporation are deductible in the year of dissolution applies to legal expenses incident to any subsequent changes in the corporate charter.[141] Legal expenses incurred in connection with a corporation's dissolution have been held deductible as

134. But see Motion Picture Capital Corporation v. Commissioner, 80 F. (2d) 872, 873 (C. C. A. 2d, 1936), in which the language of the court indicates a point of view similar to that of Member Sternhagen.

135. DEL. REV. CODE (1935), C. 65, § 2074.

136. The Liquidating Company, 33 B.T.A. 1173 (1936), N.A. XV-2 C.B. 39 (1936).

137. N. Y. STOCK CORP. LAW (1941), § 105.

138. *See* The Brown Fence & Wire Company, 46 B.T.A. 344 (1942).

139. Citizens Trust Company, 20 B.T.A. 392 (1930).

140. City & Suburban Mortgage Company, 26 B.T.A. 179 (1932).

141. Pacific Coast Biscuit Company, 32 B.T.A. 39, 41 (1935), A. 1937-1 C.B. 19.

ordinary and necessary expenses.[142] It would seem that legal expenses incurred in qualifying a corporation to do business in a jurisdiction other than that of its domicile should be accounted for as are legal expenses in connection with its corporate charter.[143] Such expenses should, however, be allowed in the year in which the corporation withdraws from such other jurisdiction, and the legal expense of withdrawal should be deductible under Sec. 23(a) in the year in which incurred.

Unlike expenses in relation to the corporate charter which, although not deductible as expenses in the year incurred, are nevertheless allowable as losses in the year of dissolution, legal expenses incurred upon the issuance of stock *for cash* are not deductible in any form at any time.[144] It is, however, well recognized that attorneys' fees incident to the procuring of temporary capital through the flotation of bonds may be written off over the life of the indebtedness.[145]

Legal expenses incurred upon issuance of stock in exchange for assets should be capitalized and treated as a part of the cost of the assets, recoverable, except in the case of a wasting asset, only upon disposition.[146] In at least one case, the Board has held that legal expenses incurred in connection with the organization of a corporation and the authorization and issuance of stock, should be thus capitalized, and treated as part of the cost of the assets acquired.[147] Generally speaking, however, it would seem reasonably clear that legal expenses in connection with mergers, reorganizations and reclassifications, insofar as they relate to the corporate charter, are deductible only in the year of dissolution. It is more doubtful whether legal expenses such as those relating to issuance of rights and stock dividends and issuance of stock in exchange for other stock of the issuing corporation would be deductible on dissolution, as the latter group is more closely analogous to legal expenses upon the issuance of stock for cash.

142. Pacific Coast Biscuit, 32 B.T.A. 39 (1935), N.A. XIV-1 C.B. 35 (1935) and 1937-1 C.B. 45; E. C. Laster, 43 B.T.A. 159 (1940), A. 1941-1 C.B. 7.

143. But see United Carbon Co., 32 B.T.A. 1000 (1935), in which amounts paid to foreign states in the year of qualification were allowed as deductions. It is not clear whether the amounts were paid in connection with original qualification, or for the annual privilege of doing business, and, if the former, whether deductible as taxes.

144. See Pacific Coast Biscuit Company, 32 B.T.A. 39, 41, 42 (1935); The Liquidating Company, 33 B.T.A. 1173 (1936).

145. W. P. Brown & Sons Lumber Co., 26 B.T.A. 1192 (1932); Emerson Electric Manufacturing Co., 3 B.T.A. 932 (1920).

146. Pidgeon-Thomas Iron Co., 27 B.T.A. 642 (1933).

147. *Ibid.*

VI.

Legal Expenses of Individuals, Estates and Trusts.

Like that of corporations, the field of legal expenses of individuals, estates and trusts is so broad that it is not possible in a limited space to do more than select a few situations for discussion. Of particular interest at the moment is the recently enacted legislation designed to benefit taxpayers not engaged in trade or business. By Sections 23(a)(1)(A) and 23(a)(2), respectively, individuals engaged in business and those not so engaged, have, as far as practicable, been placed on an equal footing in the matter of the allowance of expense deductions. There remains one minor discrimination against the nonbusiness taxpayer in that by a curious inconsistency, a business expense claimed under Sec. 23(a)(1)(A) is deductible only to the extent that it is not allocable to wholly tax-exempt income, *excluding* wholly tax-exempt interest, while a nonbusiness expense claimed under Sec. 23(a)(2) is deductible only to the extent that it is not allocable to wholly tax-exempt income *including* wholly tax-exempt interest.[148]

Not wholly unfamiliar is the phrase of the amended statute:

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

In 1934, long prior to the *du Pont* decision, the Internal Revenue Bureau had accepted the principle that ordinary and necessary expenses were allowable as deductions in connection with a trade or business if paid or incurred during the taxable year "in the production of taxable income", and extended it to such expenses with respect to

> "the management, protection, and conservation of properties producing taxable income".[149]

That the Congressional intent was not merely to restore the *status*

148. See *Report of Senate Committee on Finance on Revenue Bill of 1934,* 1939-1 C.B. 586, 606, wherein the conclusion was stated that to disallow expenses incurred in earning tax-exempt interest "might seriously interfere with the sale of Federal and State securities, which would be unfortunate during the present emergency. Accordingly, your committee recommends that the disallowance be applied to all classes of tax-exempt income except interest. Thus, a bank or other financial institution will not be denied a deduction for expenses incurred in earning tax-exempt interest."

Possibly, practical considerations underlie the distinction drawn in the Revenue Act of 1942 between taxpayers receiving tax-exempt interest who are in business and those not in business.

149. I. T. 2751, XIII-1 C.B. 43 (1934).

quo ante the *du Pont* decision is indicated by the Report of the Committee on Ways and Means wherein it was pointed out that the necessity for the amendment was due "partly to the inadequacy of the statute and partly to court decisions".[150] Moreover, there is ample evidence that Congress contemplated a liberal construction, since both the Committee on Ways and Means and the Committee on Finance reported with respect to the amendment as follows:

"The term 'income' for this purpose comprehends not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years, and is not confined to recurring income but applies as well to gain from the disposition of property. Expenses incurred in managing or conserving property held for investment may be deductible under this provision even though there is no likelihood that the property will be sold at a profit or will otherwise be productive of income".[151]

To this the Senate Committee appended the further phrase:

"and even though the property is held merely to minimize a loss with respect thereto."

Add to this evidence of a broad interpretation the further circumstance that it was the Treasury Department which recommended an amendment to the law, and it is reasonable to anticipate that the Internal Revenue Bureau will not be unduly rigid in its application of the provision. This is not to say that the amendment is not without its limitations. Both Committee Reports have expressly stated that expenses of carrying on a transaction "primarily as a sport, hobby, or recreation are not allowable as nontrade or nonbusiness expenses".[152] Moreover, the law still states that no deduction shall be allowed "in respect of—(1) Personal, living, or family expenses".[153] Treasury Regulations[154] have long furnished illustrations of personal expenses. Among such are:

"Amounts paid as damages for breach of promise to marry, attorneys' fees and other costs of suit to recover such damages, attorneys' fees paid in a suit for separation, alimony, and an allowance paid under a separation agreement. . . ."

Doubtless, these provisions will be revised in due course, for, as certain alimony and separate maintenance payments now constitute taxable

150. I. R. B. 1942, No. 43, p. 55.

151. I. R. B. 1942, No. 43, p. 75; I. R. B. 1942, No. 44, p. 84.

152. *Ibid.*

153. INT. REV. CODE, § 24 (a) (1).

154. Reg. 103, § 19.24-1 and prior regulations.

income to a divorced or legally separated wife,[155] attorneys' fees and other costs of a suit brought by a wife to obtain or collect such alimony or separate maintenance payments qualify as expenses incurred in the production or collection of income, and are, therefore, deductible.

It has been said that to distinguish between expenses in carrying on a business and expenses in purely personal affairs is a difficult problem, and that "the point where one class of expenses merges into another is often hard to determine".[156] It will perhaps be even a greater problem to determine where nondeductible personal expenses end and deductible nonbusiness expenses begin.

Legal expenses in relation to income taxes illustrate the point. In cases relating to taxpayers not engaged in business, it has been held that the expense of preparation of income tax returns is a nondeductible personal expense,[157] that legal expenses incurred in resisting a Federal income tax deficiency based upon the disallowance of a charitable contribution are nondeductible personal expenses,[158] and that legal fees expended in State income tax litigation involving the taxability of gain from the disposition of stock are also nondeductible.[159] On the other hand, it has also been held that a taxpayer whose investment activities were sufficiently extensive to qualify as a business under the *Stone Tracy* definition was entitled to a deduction for attorneys' fees in connection with a suit to recover income taxes.[160] In another case, a taxpayer who brought a suit to recover estate taxes paid by an estate of which he was a beneficiary, and expended legal fees in prosecuting the same, claimed a deduction for such expenses.[161] In disallowing the deduction, the Court took occasion to state:

> "If we were to agree with the argument of the petitioner's counsel that the real test of deductibility is whether the expense was an ordinary and necessary one in obtaining income we would take what might be supported as a fair one."

From the foregoing, it would appear that legal expenses in relation to the preparation of an income tax return would not be allowable under Sec. 23(a)(2). If legal expenses are incurred in an income tax controversy, it remains to be determined whether the question of deducti-

155. Revenue Act of 1942, § 120, amending INT. REV. CODE, § 22.
156. Monell v. Commissioner, 70 F. (2d) 631 (C. C. A. 2d, 1934).
157. I.T. 2819, XIII-2 C.B. 129 (1934).
158. G.C.M. 263, V-2 C.B. 162 (1926).
159. Louis Kuhn, 22 B.T.A. 975 (1931).
160. Kales v. Commissioner, 101 F. (2d) 35 (C.C.A. 6th, 1939).
161. Monell v. Commissioner, 70 F. (2d) 631 (C.C.A. 2d, 1934).

bility will turn upon the nature of the item which gives rise to the controversy. But the last quoted statement would tend to support the view that such expenses would qualify as deductions under Sec. 23(a)(2).

Therefore, in weighing the effect of decisions dealing with deductions by individuals under Sec. 23(a), one should always consider whether or not they antedate the *du Pont* case, and, if decided on the basis of the *Stone Tracy* definition, also have in mind the more liberal provision of the Revenue Act of 1942, which relates the expense to *property held for the production of income,* rather than, as did many of the earlier cases, to *income-producing property.*

To be understood and applied, the cases relating to legal expenses as business deductions, of estates and trusts, just as those relating to deduction by individuals, must be evaluated by determining whether they rested on the *Stone Tracy* or the *du Pont* definition of "business". For years, the Board and the courts had held to the theory that the preservation of a trust, or an estate after the normal period of administration, itself constituted the doing of business. While legal expenses paid by executors of an estate in process of administration in defending a suit for an additional Federal estate tax had been classified as "in the nature of pure administration expenses" and, therefore, nondeductible,[162] other decisions held that similar legal fees, when paid by trustees for services in prosecuting a claim for the refund of Federal estate taxes constituted allowable deductions.[163] Attorneys' fees paid by the executors of an estate the administration of which extended over a long period were likewise ruled deductible because the services were recognized as "performed in connection with the preservation and management of the estate."[164] These cases and their underlying theories and distinctions were thoroughly blasted by the *du Pont* and related decisions. This point apparently was not clear to the Court of Claims when it allowed certain legal expenses as a business deduction to a trust.[165] After reciting the *Stone Tracy* definition of "business", and paying lip service to the *du Pont* decision, the Court proceeded to the conclusion that the estate in question was "engaged in business, in the business of conserving the estate and protecting its income". The Supreme Court,

162. James C. Ayer, 26 B.T.A. 9, 12 (1932), petition to review dismissed, 63 F. (2d) 231 (C. C. A. 2d, 1933), *cert. denied* 289 U. S. 752 (1933).

163. Chicago Title & Trust Co., 18 B.T.A. 395 (1930), N.A. IX-2 C.B. 70; Florence Grandin, 16 B.T.A. 515 (1929), N.A. VIII-2 C.B. 63 (1929).

164. George W. Seligman, 10 B.T.A. 840, 844 (1928); H. Alfred Hansen, Extr., 6 B.T.A. 860 (1927).

165. Pyne v. U. S., 35 F. Supp. 81 (Ct. Cl. 1940).

however, did not fail to note the inconsistency of this statement with its own narrow interpretation, and held that the *Stone Tracy* definition could not "be accepted as a guide".[166]

Notwithstanding the limited scope of the term "business" as now judicially determined for the purposes of Sec. 23(a)(1), it is still possible for an estate or trust under extraordinary circumstances to meet the test and obtain a deduction for legal expenses incurred in business. For example, where the executor of a large estate who had broad discretionary power was authorized by the decedent to continue his business, the Court held that the estate was in business, and, consequently, that certain legal expenses arising out of actions brought by the executor to retain control of the estate as a going concern were deductible.[167] The singular facts in this case, however, limit its value as a precedent. It may reasonably be predicted that the number of estates and trusts which henceforth will be allowed legal expenses as business deductions will be quite limited.

Before referring to the advantages accorded to an estate or trust by Sec. 23(a)(2), a word should be said with respect to its limitations. Legal or other expenses in the nature of capital expenditures can no more fulfill the requirements of Sec. 23(a)(2) than of Sec. 23(a)(1)(A). Nor do those which have no proximate relationship to income or property held for its production qualify as deductions under Sec. 23(a)(2). Thus, legal expenses incurred by trustees for the maintenance and operation of an extensive summer residence, the use of which was devised to beneficiaries, have been treated as having no relationship to any business.[168] In this instance, the Board rejected a contention that the expenses "were ordinarily and necessarily incurred for the preservation of the property", which, the Board said, was being retained for an indefinite time "not for purposes of lease or sale nor for any other purpose connected with a pecuniary benefit of the trust". In such a situation, Sec. 23(a)(2) would seem to afford no relief.

It must also be recorded that certain administration expenses are deductible only if the benefit of an estate tax deduction with respect thereto is relinquished, while other administration expenses are nondeductible in any event. Section 162(e) of the Code, as amended by Sec. 161 of the Revenue Act of 1942, provides that no deduction which is allowable for estate tax purposes is allowable under Sec. 23(a)(2) in computing the net income of an estate unless there is filed with the

166. U. S. v. Pyne, 313 U. S. 127 (1941).

167. Helvering v. Highland, 124 F. (2d) 556 (C. C. A. 4th, 1942).

168. St. Louis Union Trust Co., 40 B.T.A. 165 (1939).

Bureau a statement to the effect that the item involved was not claimed or allowed as an estate tax deduction, together with a waiver of the right to have the item allowed. The genesis of this provision is to be found in recent Circuit Court decisions in which legal expenses in relation to business activities of an estate were allowed as income deductions, despite the fact that in computing the Federal estate tax the same expenses had already been allowed as deductions from the gross estate,[169] and in which such legal expenses were allowed as deductions from the gross estate in computing the Federal estate tax, although the same expenses had already been claimed as income deductions.[170]

The Committee on Ways and Means explained the provision which ultimately was adopted as Sec. 161 of the Revenue Act of 1942, as follows:

> "Expenses incurred by an administrator or executor in the administration of the estate of a decedent, such, for example, as expenses in securing the processes and orders of the court having jurisdiction over the probate of an estate, or in adjusting claims against the estate, or in distributing the remaining assets to the beneficiaries, are not deductible under this section. Ordinary and necessary expenses, however, which are paid or incurred during the taxable year by an administrator or an executor for the production or collection of income which must be reported by the estate for income tax purposes, may be claimed as deductions under this section notwithstanding that deductions therefor are allowable under section 812(b) in computing the gross estate subject to the estate tax. Accordingly, subsection (c) of this section amends section 162 to provide that no deduction shall be allowed under section 23(a)(2) in computing the net income of the estate for amounts for which there may have been or has already been allowed a deduction under section 812(b) in computing the net estate of the decedent."[171]

It will be no easy task to distinguish wholly nondeductible administration expenses from administration expenses deductible because incurred either in the pursuit of income or in the conservation of property held for that purpose. The first and last examples of the Committee present no problem. The other illustration—expenses incurred in adjusting claims against the estate—is not so clear. Attorneys' fees in prosecuting an appeal relating to a decedent's liability under a lease have recently been held to be nondeductible as a business expense, be-

169. Helvering v. Highland, 124 F. (2d) 556 (C.C.A. 4th, 1942), *aff'g* Estate of Virgil L. Highland, 43 B.T.A. 598 (1941), and citing with approval Robert J. Kleberg, et al., Extrs., 31 B.T.A. 95 (1934).

170. Adams v. Commissioner, 110 F. (2d) 578 (C.C.A. 9th, 1940).

171. I.R.B. 1942, No. 43, p. 75.

cause "incurred in mere passive conservation of assets".[172] It is not difficult to foresee other instances of litigated claims against an estate adjusted only after the incurring of legal expenses which would thereby affect "the conservation . . . of property held for the production of income", in which event it would seem that the legal expenses would meet the "proximate relationship" test and should be allowed.[173]

To illustrate the type of legal expenses of estates and trusts which are apparently encompassed by Sec. 23(a)(2), one may refer to old Board decisions antedating the *du Pont* case, in which legal fees for services rendered to an estate were allowed when "performed in connection with the preservation and management of the estate",[174] and in which legal expenses of a trust which sought a Federal estate tax refund were allowed as incurred in the performance of the duty of the trustees "to preserve and protect the trust property".[175]

A long-standing Bureau ruling[176] held that expenses incurred by a committee for an incompetent

> "with respect to the management or conservation of income-producing property or funds belonging to the incompetent or with respect to the collection or securing of any income inuring to such incompetent"

were deductible, and although this ruling was outmoded by the *du Pont* case the same result would now be achieved under Sec. 23(a)(2).

The newly enacted provision will also afford relief in guardianship matters. In a decision rendered in 1931, the Second Circuit held that attorneys' fees paid by a guardian in establishing his ward's right to the net income from a trust estate were deductible business expenses.[177] But in a similar case, the Fifth Circuit later reached an opposite conclusion.[178] In view of the conflict, the Supreme Court granted certiorari and affirmed the later decision[179] on the ground that it was the ward who was the taxpayer, and that the ward was not in business. If these cases were to arise under existing law, there is little doubt that the attorneys' fees would be allowed as expenses incurred for the production of income.

172. Stark Est., 45 B.T.A. 882 (1941).

173. See Monell v. Commissioner, 70 F. (2d) 631, 632 (C. C. A. 2d, 1934), and discussion at p. 41 *supra*.

174. George W. Seligman, 10 B.T.A. 840, 844 (1928).

175. Chicago Title & Trust Co., 18 B.T.A. 395 (1929); Florence Grandin, 16 B.T.A. 515 (1929).

176. I.T. 2238, IV-2, C.B. 49 (1925).

177. Commissioner v. Wurts-Dundas, 54 F. (2d) 515 (C.C.A. 2d, 1931).

178. Commissioner v. Van Wart, 69 F. (2d) 299 (C.C.A. 5th, 1934).

179. Van Wart v. Commissioner, 295 U. S. 112 (1935).

It is thus evident that on the question of the deductibility of expense, the body of law built up on the *Stone Tracy* definition is not without value, and that in the determination of whether the necessary nexus exists between the subject matter of the expense and the taxpayer's income or property held for income, these cases will serve as useful precedents.

In considering the effect of the amended statute upon the deductibility of legal expense, mention should be made of the cases in which the legal expenses were incurred by individuals in connection with their conduct as fiduciaries. Such cases may be divided into three classes: (a) those in which the taxpayer could show that he was doing business even within the narrow definition of that term and would, therefore, be entitled to expense deductions under Sec. 23(a)(1), (b) those in which the taxpayer could make no such showing, but where the expenses apparently would be deductible under Sec. 23(a)(2), and (c) those in which the taxpayer could neither meet the *du Pont* definition nor, apparently, the requirements of Sec. 23(a)(2).

Typical of the first group is the case[180] in which trustees purchased an inadequately secured mortgage for a trust. On an accounting, beneficiaries sought to surcharge the trustees and to deny them compensation. To avoid protracted litigation, the taxpayer (one of the trustees) paid $10,000 in settlement, for which he sought a deduction either as a loss or as a business expense. He was an attorney engaged in general practice, and half of his income represented executor's and trustee's commissions. Upon a finding that his "regular business included serving for pay as trustee and as an executor", and without specifying whether it was a loss or a business expense, the Board allowed the payment as a deduction.

In the second group is the case[181] of a taxpayer who paid attorneys' fees in connection with a proceeding in which he was surcharged as a trustee for improvident investments. The record showed that he was entitled to commissions for acting as trustee, but that he did not carry on any business. Hence, a deduction for his attorneys' fees was disallowed. If this taxpayer's case were to arise under Sec. 23(a)(2) it would seem that the deduction would be allowed.

Representative of the third group is a case[182] in which a taxpayer had incurred attorneys' fees to recover for the trust securities forming part

180. John Abbott, 38 B.T.A. 1290 (1938).

181. Stuart v. Commissioner, 84 F. (2d) 368 (C.C.A. 1st, 1936), *cert. denied* 299 U. S. 575. For a case note criticizing this decision see (1936) 50 HARV. L. REV. 362.

182. Adelaide P. Waldo, B.T.A. Memo. Op. Dkt. 100,559, March 20, 1942.

of the corpus which she, as trustee, had improperly lent to another. It was conceded that the taxpayer was neither entitled to nor received compensation for acting as trustee. The Board disallowed the deduction of the attorney's fees as a business expense. The decision, it would seem, could not be otherwise if the case arose under the present law.

Finally, there is the group of cases in which beneficiaries of trusts incur legal expense in proceedings against trustees. The well known case of Marshall Field will serve as an illustration. As beneficiary of a large trust set up by his grandfather, he incurred attorneys' fees of $1,000,000 in a successful effort to free the income of the trust estate from the accumulation provisions of the trust. The Court disallowed a deduction of the expense thus incurred, saying that:

> "expenses of this sort must fall within those general costs of protecting one's property for which the statute makes no allowance."[183]

It appears that Sec. 23(a)(2) now provides for just such a contingency.

The foregoing are only a few of the many cases which might be cited to illustrate the salutary effect of the newly enacted Sec. 23(a)(2). By it, Congress has recognized the inequity of taxing income without allowing as a deduction necessary expenses incident thereto. The provision recognizes realities. Much has been said of the necessity of plugging loopholes created at the expense of the Government. At long last an effort has been made to plug a loophole created at the expense of the taxpayer. The job has been done remarkably well.

VII.

Importance of Proper Allocation.

One cannot review the cases on this subject without noting the number in which the taxpayer failed either to adduce proof of the nature of the legal services involved or, where they related to both business and nonbusiness matters, to make a proper allocation. In most cases the failure has been fatal to the deduction. Time and again the Board and the courts, in dealing with claims for deduction of legal expense, have been obliged to deny them for lack of a proper record. Throughout the cases run such phrases as:

"If any part thereof could be so classified (as business expense) the burden of allocation must be on the petitioner and not on the Board",[184]

183. Commissioner v. Field, 42 F. (2d) 820 (C. C. A. 2d, 1930).

184. Helen S. Pennell, 4 B.T.A. 1039 (1926).

"No method has been suggested whereby we may make such an allocation. Consequently, on this point we must affirm the Commissioner",[185]

"The services should have been explained and itemized. (The petitioner's) mere statement that these services were connected with his business is by itself insufficient to support the claimed deduction",[186]

"the record furnishes no basis for the apportionment . . . we are again confronted with the fact that there is nothing in the record to permit a proper allocation",[187]

"As stated by the Board of Tax Appeals, there is no basis for making such allocation."[188]

When an attorney renders legal services in several matters the fee for which must be variously accounted for in his client's tax return, it would seem preferable that he make a specific charge for the separate items, or that he provide his client with a proper allocation of the entire amount. Generally, the attorney's allocation will be accepted, although if challenged by the Commissioner, it may not, in the absence of supporting evidence, be decisive.[189]

To the rigidly enforced rule that taxpayers claiming deductions under Sec. 23(a) must make or provide a basis for an allocation as between expenses relating to the ordinary conduct of business and other expenses, one exception may be noted. Where the general counsel of a corporation was paid a fee of $10,000 for a year's services which included services in relation to the acquisition of certain property and in connection with building operations to be undertaken under a lease, the Board, after finding that at least half of the amount paid related to other services, held that the fee should not be disallowed

"merely because there are included therein some services which, when standing alone, might more properly be capitalized. . . . When we consider the necessity for, and the recurring nature of, such expenses, as well as the impracticability, if not impossibility, of segregating capital and expense items in such payments, we are unwilling to say that the petitioner is not entitled to the deduction".[190]

But this is too small a raft to carry more than a relatively few taxpayers,

185. Arthur Jordan, 12 B.T.A. 423, 425 (1928).

186. John J. Hoefle, B.T.A. Memo. Op. Dkt. 92,791, July 25, 1940.

187. Murphy Oil Co., 15 B.T.A. 1195, 1201-1202 (1929), *aff'd* on issue involving attorneys' fees and other issues, Murphy Oil Co. v. Burnet, 55 F. (2d) 17 (C.C.A. 9th, 1932), *aff'd* on other issues, 287 U. S. 299 (1932).

188. Murphy Oil Co. v. Burnet, 55 F. (2d) 17, 26 (C.C.A. 9th, 1932).

189. Pidgeon-Thomas Iron Co., 27 B.T.A. 642, 644 (1933).

190. Saks & Co., 20 B.T.A. 1151 (1930), N.A. X-1 C.B. 92 (1930).

nor has its strength been increased by the Bureau's nonacquiescence.

As to taxpayers engaged in business, the Revenue Act of 1942 makes no change which affects the deductibility of legal expenses, but in this respect the steepness of the rates emphasizes the point that a client's taxes may be increased or diminished, depending upon the care which an attorney exercises not only in billing his client but in making and maintaining adequate supporting records of the services rendered. As to taxpayers not in business, the new Revenue Act makes the first provision whereby their legal expenses incurred in the pursuit of income or in connection with property held for income may be deducted. This is the group as to which there is likelihood of a diversity of legal services, fees for only a part of which may be allowed. As to a client in this category, it would seem that an attorney owes a special duty to furnish a proper segregation of deductible expenses, so that his client may have the benefit of the full measure of relief which Congress has provided, and may not be faced, as was the taxpayer in the *Murphy Oil* case, with a denial of all legal expenses because there was "nothing in the record to permit a proper allocation".