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DEDUCTIBLE TAX PLANNING EXPENSES:
THE SCOPE OF INTERNAL REVENUE
CODE SECTION 212-3

In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. *I know these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion . . .* (emphasis added)

Learned Hand

57 YALE L.J. 167, 169 (1947-48)

To Learned Hand, the Internal Revenue Code presented an ingeniously created monster whose complexity remained shrouded in abstract language. The language of the Code may well be abstract, but its impact is very real. For this reason, much effort is expended by the American taxpayer to assess if not reduce his tax burden.¹ The extent and character of such effort is often correlated to the complexity of an individual's affairs. For a majority of taxpayers, the completion of an annual tax return, either individually or by a tax service, is the sum and substance of tax-related expenditures. For others, professional guidance is sought out, either on a temporary or permanent basis, to plan and devise tax-saving strategies prior to the completion of taxable transactions and incurrence of expenditures.

The deductibility of such tax-related expenses, be it tax re-

1. I looked for a loophole, but there did not appear to be any.

I am acquainted with a very opulent man whose house is a palace; whose table is regal; whose outlays are enormous; yet a man who has not income, as I have often noticed by the revenue returns. And to him I went for advice in my distress.

He took my dreadful exhibition of receipts, he put on his glasses, he took his pen, and presto—I was a pauper. It was the neatest thing that ever was. He did it simply by deftly manipulating the bill of deductions.

Letter from Mark Twain, 1870, in Thrower, *Administering the Tax Laws in a Changing Society*, 47 TAXES 729, 730 (1969).

turn service or sophisticated tax planning counsel, depends primarily upon the applicability of Internal Revenue Code section 212(3) which provides:

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses, paid or incurred during the taxable year . . .

(3) in connection with the determination, collection, or refund of any tax.

An understanding of the scope of section 212(3)² requires an examination of several factors: judicial and administrative law developed prior to its enactment; the events which precipitated its enactment; legislative conceptualization of its intended scope; judicial and administrative construction of the statute since its enactment; and the relationship of section 212(3) to other sections of the Code.

Sidney Merians

Notwithstanding considerable case law since its enactment in 1954, the scope of section 212(3) remains an unsettled question.³ *Sidney Merians*,⁴ recently decided by the Tax Court where four concurring and two dissenting opinions were written, illustrates the sharp division among the members of the court on the scope of section 212(3). In that case, the taxpayers sought to deduct their entire legal fee incurred for certain estate planning services,⁵ arguing that "the fee pertained solely to services and advice on tax matters,"⁶ deductible under section 212(3). To a majority of the court speaking through J. Simpson, the only issue in the case was one of allocation based on their interpretation of the Commissioner's concession;⁷ i.e., that any portion of the legal fee which can be

2. INT. REV. CODE OF 1954, § 212(3).

3. As recently as 1968, in the case of *George L. Schultz*, 50 T.C. 688, 700 (1968), the Tax Court stated: "Nor do we have a sufficient basis to justify delving into the apparently unsettled question of the scope of section 212(3)." *Compare Carpenter v. United States*, 338 F.2d 366 (Ct. Cl. 1964) with *Kaufmann v. United States*, 227 F. Supp. 807 (W.D. Mo. 1963).

4. *Sidney Merians*, 60 T.C. 187 (1973), *acq.* 1973-42 CUM. BULL. 6.

5. The legal services included the following: 1) the drafting of a will; 2) the establishment of an irrevocable trust into which corporate stock was transferred; 3) the dissolution of the corporation and the creation of a partnership with the trust as limited partner; 4) the establishment of an irrevocable life insurance trust; and 5) the preparation of gift tax returns with respect to the two irrevocable trusts.

6. *Merians*, 60 T.C. 187, 188.

7. In its brief, the government admitted that "...there is a probability that some of the legal fee represented services which are deductible under 212(3)." *Id.* at 188. Query whether such admission was intended to encompass the majority's broad view of section 212(3). The legal services provided the taxpayers included the preparation of two gift tax re-

found to be attributable to tax advice, irrespective of its nature, is deductible.⁸

The court considered the Commissioner's position in *Merians* to be the same as that adopted in *Rev. Rul. 72-545*.⁹ That ruling advised that any tax counsel expenses incurred in connection with a divorce proceeding, including a property settlement, establishment of a trust to fulfill marital support obligation, and the right to claim children as dependents, is deductible. In support of its position, the court cited *Davis v. United States*,¹⁰ decided by the Court of Claims in 1961, which had pioneered the view that expenses incurred for tax planning¹¹ are fully deductible under section 212(3) and the regulations.¹²

In the first concurring opinion, two judges disagreed with the government's interpretation of section 212(3) reflected in *Rev. Rul. 72-545*, and would have given the taxpayer an opportunity to prove that a portion of the fee was deductible under section 212(2).¹³ In another opinion, three members of the court concurred in the result solely on the basis of the government's concession, rejected the majority's broad interpretation of section 212(3), and would have limited the deduction under that section to

turns, an expense squarely within the provisions of section 212(3). See J. Scott's concurring opinion in *Merians*, 60 T.C. 187, 188.

8. *Merians*, 60 T.C. 187, 188.

9. *Rev. Rul. 72-545*, 1972-2 CUM. BULL. 8.

10. 287 F.2d 168 (Ct. Cl. 1961), *aff'd in part and rev'd in part*, 370 U.S. 65 (1961).

11. The concept of tax planning as used herein encompasses any effort to reduce or otherwise affect tax burden prior to the completion of taxable transactions. See also 2 Institute For Business Planning, Inc., *Tax Planning* 3401 (1972).

12. *Treas. Reg. § 1.212-1(1)* (1957).

13. *Merians*, 60 T.C. 187, 190 (Scott, Goffe, JJ., concurring); INT. REV. CODE OF 1954, § 212(2) provides that: "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—(2) for the management, conservation, or maintenance of property held for the production of income. . . ." In his concurring opinion, J. Fay, citing *Trust of Bingham v. Commissioner*, 325 U.S. 365 (1945) and *Nancy Reynolds Bagley*, 8 T.C. 130 (1947), *acq.* 1947-1 CUM. BULL. 1, agreed with J. Scott's suggestion regarding section 212(2) and went further to state: "In this day of high taxes, when efforts are being made to encourage voluntary compliance with our system of taxation, it seems ludicrous to contend that tax advice of any type is not a proper management function of property held for the production of income."

the expense of preparing gift tax returns.¹⁴

Three dissenting judges did not regard the government's concession as binding on the court and also would have limited the deduction under section 212(3) to the expense of preparing gift tax returns.¹⁵ Citing the House report,¹⁶ the dissent argued that the plain meaning of section 212(3) precluded deductions for tax planning, as opposed to ". . . tax advice after the critical events have occurred."¹⁷ In a separate opinion, a fourth dissenting judge contended that legal expenses in connection with estate planning are non-deductible "Personal expenditures which Congress never intended should be allowed as a deduction for tax purposes"¹⁸ and would have upheld the Commissioner's disallowance of the entire fee.¹⁹

These individual views²⁰ expressed in *Merians* are the first such expressions on the scope of section 212(3)²¹ since *Carpenter v. United States*²² was decided by the Court of Claims in 1964, allowing the taxpayer to deduct under section 212(3) that portion of legal fees which pertained solely to tax advice incident to an uncontested divorce and separation.

NON-DEDUCTIBLE TAX-RELATED EXPENSES UNDER SECTION 23 (a) (2) AND THE ORIGINAL REGULATIONS

After the Supreme Court decided *Higgins v. Commissioner*,²³

14. *Merians*, 60 T.C. 187, 192 (Sterrett, Scott, Wiles, JJ., concurring).

15. *Id.* at 192 (Withey, Hoyt, Irwin, JJ., dissenting).

16. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 29, A59 (1954).

17. *Merians*, 60 T.C. 187, 197.

18. *Id.* at 198.

19. *Id.*

20. Note that JJ. Withey, Hoyt, and Irwin agreed with J. Quealy's dissent disallowing the entire deduction, and yet in his own dissenting opinion, joined by JJ. Hoyt and Irwin, J. Witney would have allowed a deduction for the expense of preparing the two gift tax returns.

21. Under the facts in *Merians*, three views were presented bearing on the deductibility of tax planning expenses under section 212(3) in connection with estate planning: 1) tax advice irrespective of its nature is deductible under section 212(3) (majority); 2) expenses for preparation of gift tax returns only are deductible (Scott, Goffe, Sterrett, Wiles, Withey, Hoyt, Irwin, J.J.); 3) expenses for estate planning are non-deductible personal expenses (Quealy, J.). Thus, seven Tax Court members under the facts in *Merians* would confine section 212(3) to include the preparation of gift tax returns, rejecting the broad view taken by the majority, and one judge would allow no deduction under section 212(3). *But see* De Castro, *Recent Cases Show Liberal Trend in Allowing Deductions For Legal Fees*, 23 J. TAXATION 224 (1965); Gibbs, *Developing Patterns in the Deduction of Professional Fees*, 50 TAXES 771 (1972).

22. 338 F.2d 366 (Ct. Cl. 1964).

23. 312 U.S. 212, 215 (1941), wherein the issue of what constituted a

Congress responded by amending section 23(a)²⁴ of the 1939 Code to provide for the deduction of all ordinary and necessary non-trade or non-business expenses incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.²⁵ Shortly thereafter, regulations promulgated under this new section prohibited the deduction of expenses for preparing tax returns or recovering taxes, except where the tax was on property held for the production of income, or the expense was clearly allocable to taxable recovery of interest or other property.²⁶ By so qualifying the deductibility of tax-related expenses, the regulation was thought to be consistent with Congressional understanding that ordinary and necessary expenses within the context of section 23(a) (2) implied a reasonable amount bearing a reasonable and proximate

trade or business within the meaning of section 23(a) of the Int. Rev. Act of 1932, was resolved against the taxpayer based on the government's argument that ". . . mere personal investment activities never constitute carrying on a trade or business, no matter how much of one's time or of one's employees' time they may occupy." See also *Van Wart v. Commissioner*, 295 U.S. 112, 115 (1935).

24. INT. REV. CODE OF 1939, § 23(a) allowing as a deduction "[a]ll the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business"

25. § 121(a) of the Revenue Act of 1942, 56 Stat. 798, 814 (1942). In its report to the House of Representatives, the Ways and Means Committee stated in H.R. REP. No. 2333, 77th Cong., 2d Sess. 46 (1942) that:

The existing law allows taxpayers to deduct expenses incurred in connection with a trade or business. Due partly to the inadequacy of the statute and partly to court decisions, nontrade or nonbusiness expenses are not deductible, although nontrade or nonbusiness income is fully subject to tax. The bill corrects this inequity by allowing all of the ordinary and necessary expenses paid or incurred for the production or collection of income. Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income it is deductible.

See also S. REP. No. 1631, 77th Cong., 2d Sess. 87-88 (1942).

26. Treas. Reg. § 29.23(a)-15 (1942) in part providing:

Expenditures incurred for the purpose of preparing tax returns (except to the extent such returns relate to taxes on property held for the production of income), for the purpose of recovering taxes (other than recoveries required to be included in income) or for the purpose of resisting a proposed additional assessment of taxes (other than taxes on property held for the production of income) are not deductible expenses under this section, except that part thereof which the taxpayer clearly shows to be properly allocable to the recovery of interest required to be included in income.

relation to the management of income-producing property.²⁷

Pursuant to this regulation, lower courts upheld the Commissioner's interpretation of what constituted management, conservation, and maintenance under section 23(a)(2). Thus, deductions were denied for expenses incurred for the preparation of state and federal income tax returns,²⁸ tax deficiency proposals and investigations,²⁹ and tax litigation,³⁰ while deductions were allowed for legal and accountant's fees in obtaining reduction of local tax assessments,³¹ and expenses properly allocable to the recovery of taxable interest.³²

Although the regulations made specific reference to deductible "investment counsel,"³³ there was no mention of deductible general tax advice or tax planning, in the sense of expenses incurred before the completion of transactions having present or future tax implications. Despite the regulations, the Tax Court early took the position that such advice was a deductible expense if it was proximately related to the management, conservation, or maintenance of income-producing property,³⁴ notwithstanding the fact that

27. See H.R. REP. NO. 2333, 77th Cong., 2d Sess. 75 (1942); S. REP. NO. 1631, 77th Cong., 2d Sess. 88 (1942); *Trust of Bingham v. Commissioner*, 325 U.S. 365 (1945); *Brodsky and McKibbin, Deduction of Non-Trade or Non-Business Expenses*, 2 TAX L. REV. 39, 59 (1946-47).

28. *Don A. Davis*, 4 T.C. 329 (1944); *Frank G. Logan*, 3 T.C. 691 (1944); *Hord v. Commissioner*, P-H T.C. Memo. Dec., par. 43,283 (1943), *aff'd*, 143 F.2d 73, 76 (6th Cir. 1944) where the Circuit Court declared: "It would seem uncontroversial that payments made to an accountant for assistance in the preparation of income tax returns would not be included as deductible expense within the category of the pertinent statute;" *Higgins v. Commissioner*, 2 T.C. 948, *aff'd*, 143 F.2d 654 (1st Cir. 1943); *R.C. Coffey*, 1 T.C. 579 (1943) (denial based on insufficient evidence).

29. *Joseph Hexter*, P-H T.C. Memo. Dec., par. 44,399 (1943); *Cynthia K. Herbst*, P-H T.C. Memo. Dec., par. 43,309 (1943); *John C. Wilmott*, 2 T.C. 321 (1943).

30. *Commissioner v. Kenan*, 145 F.2d 568 (2d Cir. 1944); *Stoddard v. Commissioner*, 141 F.2d 76, 80 (2d Cir. 1944) where the court in referring to the scope of section 23(a)(2), remarked:

To extend this language to make it possible for taxpayers to deduct . . . the expense of litigation over the amount of their income taxes would be too great a stretch in the absence of anything to indicate that Congress intended to so encourage such litigation. . . .
Frank G. Hogan, 3 T.C. 691 (1944); *Charles N. Manning*, 3 T.C. 853 (1944); *Samuel Thorne*, P-H T.C. Memo. Dec., par. 44,323 (1944); *James C. McFaddin*, 2 T.C. 395, 411 (1943), *rev'd in part on other grounds*, 148 F.2d 570 (5th Cir. 1945).

31. *R.C. Coffey*, 1 T.C. 579 (1943).

32. *Samuel Thorne*, P-H T.C. Memo. Dec., par. 44,323 (1944); *Percival E. Foerderer*, P-H T.C. Memo. Dec., par. 43,102 (1943), *aff'd on other grounds*, 141 F.2d 53 (3d Cir. 1944); *Cynthia K. Herbst*, P-H T.C. Memo. Dec., par. 43,309 (1943); *James C. McFaddin*, 2 T.C. 395 (1943).

33. *Treas. Reg. § 39.23(a)-15(g)* (1942).

34. *Don A. Davis*, 4 T.C. 329 (1944) (dictum).

minimizing one's taxes neither affects the actual yield of investment capital nor its appreciation.³⁵ As an example, in *Andrew Jergens*,³⁶ the taxpayer hired an investment firm to advise him on the handling of certain German securities and the adoption of a proposed merger plan, the object of which was to preserve his control of the business and minimize his tax liability. The Tax Court had no trouble in concluding that "[i]t is obvious that he is conserving and maintaining his property."³⁷

However, as to general tax advice not proximately related to income-producing property, the First Circuit Court of Appeals, in affirming a Tax Court decision, declared such expenses to be non-deductible personal expenses "clearly" outside the scope of section 23(a)(2) and the regulations.³⁸

NEW DIRECTION: *Trust of Bingham v. Commissioner*

Despite the weight accorded regulations consistently upheld by judicial interpretation,³⁹ the Supreme Court struck down the regulations under 23(a)(2) in *Trust of Bingham v. Commissioner*.⁴⁰

35. In *Commissioner v. Kenan*, 145 F.2d 568, 570 (2d Cir. 1944), the Second Circuit Court denied a deduction for legal fees incurred by trustees in contesting a tax deficiency based on this rationale; i.e., expenses are non-deductible ". . . when incurred merely to prevent the incidence of taxes which neither affected the yield of investment capital nor its appreciation." On the other hand, in *Cammack v. Commissioner*, 5 T.C. 476, 470 (1945), the Tax Court gave recognition to an "economic benefit" test to determine whether an expense constituted "management." In that case, the taxpayer had unsuccessfully attempted to deduct the bases of worthless stock and subsequently incurred legal fees contesting the disallowance of that deduction. In declaring the taxpayers effort to deduct the worthless stock an act of management, the court states: "The economic benefit resulting from that deduction was the natural—in fact the only—means reasonably left to them of obtaining any such benefit." See also *William v. McGowan*, 152 F.2d 570 (2d Cir. 1945).

36. P-H T.C. Memo. Dec., par. 43,322 (1943).

37. *Id.* at 1014.

38. 2 T.C. 948, *aff'd*, 143 F.2d 654 (1st Cir. 1944).

39. See 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION, § 3.20 (rev. ed. 1966) and the cases cited therein.

40. 325 U.S. 365 (1945). That portion of Treas. Reg. § 29.23(a)-15 invalidated by the Court provided that:

Expenditures incurred . . . for the purpose of recovering taxes (other than recoveries required to be included in income) or for the purpose of resisting a proposed additional assessment of taxes (other than taxes on property held for the production of income) are not deductible expenses under this section, except that part

Relying on the rationale of its earlier decisions under section 23(a)(1),⁴¹ and upon the legislative history of section 23(a)(2),⁴² the Court held that expenses under the latter section need not result in the production of income, so long as they are directly connected with or proximately result from the management, conservation, or maintenance of property held for the production of income. By rejecting the approach taken by the regulations that deductible expenses under 23(a)(2) must result in the production of income, the decision gave substance to the class of expenditures deductible under section 23(a)(2) which, with few exceptions, had been effectively regulated out of existence since its enactment in 1942. Specifically included among deductible expenses to the taxpayer trust in *Bingham* were legal fees for unsuccessfully contesting an income tax deficiency, as well as legal advice in connection with “. . . tax and other problems arising upon the expiration of the trust.”⁴³

The taxpayer in *Bingham* was a trust whose expenses quite properly related to trust property. Nevertheless, following the decision in *Bingham*, lower courts had little difficulty in finding the requisite proximate relationship with “management, conservation, or maintenance” to sustain deductions for the cost of preparing income tax returns,⁴⁴ and contesting income tax deficiencies.⁴⁵ In

thereof which the taxpayer clearly shows to be properly allocable to the recovery of interest required to be included in income.

Compare Higgins v. Commissioner, 2 T.C. 948, *aff'd*, 143 F.2d 654, 656 (1st Cir. 1943), where the court declared:

We believe that the regulations are in complete harmony with the purpose of the statute and that the Commissioner did not exceed his authority in issuing them. The language of the regulations implement the statute and the meaning of the regulations is not strained or artificial.

41. *Commissioner v. Heininger*, 320 U.S. 467, 470-71 (1943); *Kornhauser v. United States*, 276 U.S. 145 (1928), decided under section 214(a)(1) of the Revenue Act of 1918, wherein the Court first promulgated the so-called “direct connection” test in allowing the taxpayer (an attorney) to deduct legal expenses incurred in successfully defending an accounting suit brought by his former law partner respecting shares of stock allegedly received for services before the termination of the partnership. See generally McDonald, *Deduction of Attorney's Fees For Federal Income Tax Purposes*, 103 U. PENN. L. REV. 168 (1954); Note, *Income Tax Deductions For Estate Planning Fees*, 23 VAND. L. REV. 104 (1969).

42. *Supra* note 25.

43. *Trust of Bingham v. Commissioner*, 325 U.S. 365, 368 (1945).

44. *David L. Loew*, 7 T.C. 363 (1946); *Charles Crowther*, 28 T.C. 1293 (1957).

45. *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945); *Stoddard v. Commissioner*, 152 F.2d 445 (2d Cir. 1945), overruling the court's earlier decision against the taxpayer, 141 F.2d 76 (2d Cir. 1944); *Pelham v. Wodehouse*, 8 T.C. 637 (1946), *rev'd on other grounds*, 166 F.2d 986 (4th Cir. 1948), *rev'd*, 337 U.S. 369 (1949); M.J. Donnelly, P-H T.C. Memo. Dec.,

fact, the Tax Court held that expenses incurred in contesting an income tax deficiency were deductible whether or not the income out of which the dispute arose was derived from property held for the production of income.⁴⁶

From the standpoint of tax planning, two Tax Court decisions during this post-*Bingham* period were significant insofar as they represented an application of the "economic benefit" test⁴⁷ enunciated earlier by the Tax Court: 1) *William Heyman*⁴⁸ upheld the deduction of accountant's fees for conferences with representatives of the IRS who were examining the taxpayer's returns from prior years, although the dissent argued that such an expense failed to meet the proximate connection criteria set forth in *Bingham*; 2) In *Philip Armour*,⁴⁹ the taxpayer procured legal advice solely to ascertain the tax implications of the following matters: corporate dividends, annuities, the holding period of securities, and a partial loss deduction. Although the court's stated rationale in *Armour* for allowing this tax advice to be deducted was its "bearing" upon the management of his income-producing property, implicit in the decision was the court's recognition of the potential economic benefit of such tax-related advice to the taxpayer. Certainly, such advice did not affect the yield of his capital investment nor its appreciation,⁵⁰ yet the determination of tax liability was an act of management to the extent that it contributed to reducing the tax cost of holding property for the production of income.

As illustrated by the Tax Court's rationale in these two decisions, the unique characteristic of deductible tax planning advice is that the deduction effectively encourages efforts to devise sophisticated tax strategies, the purpose of which is to reduce tax revenues.⁵¹

par. 48,244 (1948); James A. Connelly, 6 T.C. 744 (1946); *Marshall v. Commissioner*, 5 T.C. 1032 (1945); *Cammack v. Commissioner*, 5 T.C. 467 (1945); *Commissioner v. Goldberger's Estate*, 213 F.2d 78 (3d Cir. 1954). *But see* *Edmunds v. United States*, 71 F. Supp. 29 (E.D. Mo. 1947) where the court denied an heir a deduction for expenses incurred in seeking a refund of federal estate taxes on the decedent's state.

46. *Marshall v. Commissioner*, 5 T.C. 1032 (1945).

47. Note 35 *supra*.

48. 6 T.C. 799 (1946).

49. 6 T.C. 359 (1946).

50. Note 35 *supra*.

51. For this reason, tax counsel have often come under attack, illus-

THE 1946 AMENDED REGULATIONS UNDER SECTION 23 (a) (2)

To reflect the Supreme Court's construction of section 23(a)(2) in *Bingham*, the regulations were amended in May, 1946, to provide in part, that "[e]xpenses paid or incurred by an individual in the determination of liability for taxes upon his income are deductible."⁵² Not only did the amended regulation reflect *Bingham*, but it went beyond *Bingham* by omitting the requirement that such tax determination expenses relate to taxes on income realized from property held for the production of income.⁵³ To what extent this amendment was intended to include expenses for tax planning not proximately related to income-producing property is not clear.

Arguably, the term "determination of liability" suggests tax advice after the fact; that is, after the taxpayer has done everything he can to be entitled to the actual or constructive receipt of income, and after the timing of expenditures has been fixed. Although the term "determination" generally connotes an ending or

trated by the following comments of Senator Douglas of Illinois:

We all know our present tax system has so many loopholes or 'truck holes' that certain favored groups are able to escape taxation on large parts of their income. These exemptions are steadily widened by legislation and perhaps even more by the rise of two well-paid new professions, namely tax lawyers and tax accountants. These gentlemen help citizens avoid and in some cases, to evade the payment of taxes which in all good conscience they should pay. A bewildering variety of tax gimmicks and arguments are developed with which the revenue officials and courts are either unable or unwilling to cope,

in Groh, *Responsibilities in Tax Practice*, 42 TAXES 165, 166 (1964). *Contra*, J. Durfee's majority opinion in *Carpenter v. United States*, 338 F.2d 366 (Ct. Cl. 1964), and Brown, *Responsibilities of a Taxpayer*, 20 U. So. CAL. 1963 TAX INST. 1, 21-22, wherein the author suggests that tax counsel assist in the revenue raising function as well as to help avoid tax contests.

52. Treas. Reg. § 29.23(a)-15 (1946), T.D. 5513, 1946-11 CUM. BULL. 3, providing:

Expenses paid or incurred by an individual in the determination of liability for taxes upon his income are deductible. If property is held by an individual for the production of income, amounts expended in determining a property tax imposed with respect to such property during the period when so held are deductible. Expenses paid or incurred by an individual in determining or contesting any liability asserted against him do not become deductible, however, by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability. Thus, expenses paid or incurred by an individual in the determination of gift tax liability, except to the extent that such expenses are allocable to interest on a refund of gift taxes, are not deductible even though property held by him for the production of income must be sold to satisfy an assessment for such tax liability or even though, in the event of a claim for refund, the amount received will be held by him for the production of income.

53. See Brodsky and McKibbin, *Deduction of Non-Trade or Non-Business Expenses*, 2 TAX L. REV. 39, 58-60 (1946-47).

finality, it has been defined as an estimate; similarly, "liability" is a broad legal term which has been referred to as an obligation or responsibility which is absolute, contingent, or even likely.⁵⁴ If "determination of liability" is viewed as an estimate of likely tax upon projected income, less probable expenditures, the regulation would seem to encompass tax planning in general including the timing of expenses, controlling the characterization of income, and income deferral.⁵⁵ Less than two years earlier, the First Circuit had rejected such an interpretation of section 23(a)(2) as being clearly not within the provisions of the statute.⁵⁶ Thus, while *Bingham* invalidated the original regulations as being too restrictive a construction of that section, it is arguable that the amended regulation was outside the statute's intended scope and, therefore, likewise invalid.⁵⁷

THE IMPETUS FOR SECTION 212(3)

The amended regulations explicitly denied a deduction for expenses connected with gift tax liability, except that portion allo-

54. BLACK'S LAW DICTIONARY 536, 1059 (4th ed. 1951); although dictionary meanings of statutory terms may sometimes be misleading, they do serve the useful function of limiting the range of possible meanings; see *Simmons v. United States*, 308 F.2d 160 (4th Cir. 1962); 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION, § 3.14 (rev. ed. 1966).

55. A maxim or rule of thumb often repeated in construing statutory language is that a word is known by the company it keeps. Interestingly, in the cited portion of the amendment, note 52 above, containing four sentences, the term "determination" is used in two of the four sentences, "determining" in the other two, while "liability" is used in all four. It is not clear from the phrases "determination of liability for taxes" and "determination of gift tax liability" found in the first and fourth sentences respectively, whether the term "determination" encompasses tax planning. However, two other phrases within the cited portion of the amendment, "determining a property tax imposed" and "determining or contesting any liability asserted against," remove, so it could be argued, the term "determination" from the context of an estimate or projection, to that of an evaluation or assessment of the tax implications of given facts or events, though not necessarily mere arithmetical computation. Similarly, the context of other phrases within this regulatory passage, "any liability asserted against," "for the purpose of satisfying such tax liability," "to satisfy an assessment for such tax liability," connote a matured obligation in the sense that its value does not depend on contingent income or likely expenditures. See also 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION, § 3.16 (rev. ed. 1966) and the cases cited therein.

56. *Higgins v. Commissioner*, 2 T.C. 948, *aff'd*, 143 F.2d 654 (1st Cir. 1943).

57. This argument is suggested by Brodsky and McKibbin, *supra* note 53, at 60.

cable to interest on a gift tax refund,⁵⁸ and in so doing, were thought consistent with *Bingham* and the thrust of section 23(a) (2) as originally conceived by Congress.⁵⁹ Logically, by reducing the donor's resources, a gift is the antithesis of the production of collection of income, even though such a gift of income-producing assets could reduce taxable income to the taxpayer donor, and thus fulfill the economic benefit test. However, at this point, the property is no longer being held for the production of income to or for the donor, within the meaning of section 23(a) (2).⁶⁰ Thus, the Tax Court's decision in *Frank M. Cobb*⁶¹ disallowing the deductibility of litigation expenses incurred with respect to gift tax liability, and the Supreme Court's decision in *Lykes v. United States*⁶² sustaining *Cobb's* interpretation of section 23(a) (2), were consistent with the amended regulations.

Arguably, the direct impetus for the enactment of section 212(3) in 1954 was the concluding portion of J. Jackson's strong dissenting opinion in *Lykes* where he stated:

The Treasury may feel that it is good public policy to discourage taxpayers from contesting its unjustified demands for taxes and thus justify penalizing resistance. It is hard to imagine any instance in which the Treasury could have a stronger self-interest in its regulation *I think Congress allows a taxpayer to protect his estate, even against the Treasury. It seems to me a tacit slander of the Nation's credit that need for money should drive us to such casuistry as this.*⁶³

Without citing any authority in his *Lykes* dissent, Jackson rejected the Court's theory of what constituted conservation of property within the meaning of section 23(a) (2);⁶⁴ *i.e.*, legal expenses do not become deductible under that section merely because they shield

58. Treas. Reg. § 29.23(a)-15 (1946), T.D. 5513, 1946-11 Cum. BULL. 3.

59. See *Lykes v. United States*, 343 U.S. 118 (1952) (dictum).

60. See *Hunter v. United States*, 219 F.2d 69, 70 (1955) where the court declared that "production" of income means the creation of increased gross income, not a reduction of liability or an increase of net taxable income by a reduction of allowable deductions in computing net income; *Edmunds v. United States*, 71 F. Supp. 29 (E.D. Mo. 1947); *Thomas A. Grabien*, 48 T.C. 750 (1967); *Bertie Charles Forbes*, 18 T.C. 321 (1952); *Aldo R. Balsam Trust*, P-H T.C. Memo. Dec., par. 44,368 (1944); *Rentschler v. Commissioner*, 1 T.C. 814 (1943). *But cf.* *Hobert J. Hendrick*, 35 T.C. 1223 (1961).

61. 10 T.C. 380 (1949), *aff'd*, 173 F.2d 711 (6th Cir. 1949).

62. 343 U.S. 118 (1952).

63. *Id.* at 128-29 (emphasis added).

64. The regulations have never attempted to define the terms "management, conservation, or maintenance." Compare *Helvering v. Stormfultz*, 142 F.2d 982, 984 (8th Cir. 1944), *rehearing denied*, where the court reasoned that such terms imported the ". . . idea of utilization and preservation of specific property owned and used by the taxpayer."

or conserve the taxpayer's income-producing assets from liability. A sense of fairness to the taxpayer, especially in fact situations such as in *Lykes* where the Commissioner's over-assessment was arguably unreasonable,⁶⁵ motivated Jackson to reject the Treasury's position principally on public policy grounds.

THE SEARCH FOR LEGISLATIVE INTENT

Congress responded in 1954 with the enactment of section 212(3) allowing a deduction for ordinary and necessary expenses incurred in connection with the "determination, collection, or refund of any tax."⁶⁶ Given the 1946 regulations under section 23(a)(2) and the decisions in *Lykes* and *Cobb*, it is undisputed that section 212(3) was intended to overturn established law with respect to gift tax liability expenses.⁶⁷ Unfortunately, the question which is not answered by the chosen language of that section is the extent to which Congress intended to reach beyond the specific holdings in these decisions as to other tax-related expenses.

It is a fundamental proposition that legislative history of a statute, including committee reports, is extremely important and can be of assistance in interpreting the meaning of statutory language.⁶⁸ The often-cited House and Senate committee reports⁶⁹ on section

65. The facts revealed that Lykes initially paid a gift tax in 1940 totaling \$13,032.75, but the Commissioner assessed a gift tax deficiency of \$145,276.50. Lykes subsequently paid \$15,612.75 in settlement of the deficiency pursuant to a finding of the Tax Court.

66. INT. REV. CODE OF 1954, § 212(3).

67. See *Commissioner v. Shapiro*, 278 F.2d 556, n.3 (7th Cir. 1960); Gibbs, *Post-Gilmore: Recent Trends in the Deductibility of Professional Fees*, 23 Sw. L.J. 644, 655-61 (1969); Scott, *Deductions for Cost of Tax Advice are Often Subject to IRS Attack*, 22 J. TAXATION 174 (1965).

68. *United States v. American Trucking Ass'n*, 310 U.S. 534 (1940); *White v. United States*, 305 U.S. 281 (1938); Herbert J. Kent, 35 T.C. 18 (1960). See generally 1 J. MERTENS, LAW OF FEDERAL INCOME TAXATION, § 3.26, 3.29 (rev. ed. 1966) and the cases collected therein.

69. H.R. REP. NO. 1337, 83d Cong., 2d Sess. 29, A59 (1954); S. REP. NO. 1622, 83d Cong., 2d Sess. 218 (1954). The Ways and Means Committee report reads as follows:

Existing law allows an individual to deduct expenses connected with earning income or managing and maintaining income-producing property. Under the regulations costs incurred in connection with contests over certain tax liabilities, such as income and estate taxes have been allowed, but these costs have been disallowed where the contest involved gift-tax liability. A new provision added by your committee allows a deduction for expenses connected

212(3), however, do not unequivocally set forth the legislative intent in enacting that section of the Code. The House Ways and Means Committee report,⁷⁰ after restating sections 212(1)⁷¹ and 212(2)⁷² in capsule form, focuses primarily on tax liability contests, explicitly noting the heretofore non-deductibility of gift tax contest expenses. By so focusing on "contests," the report is logically subject to the interpretation that section 212(3) was intended to be restricted to expenses in connection with a contested tax liability. The American Bar Association Section of Taxation, particularly, acknowledged such an interpretation, but its suggestion that "computation" be added before "determination" was not implemented.⁷³

By contrasting the terminology of this committee report with that of the 1946 regulations under section 23(a)(2),⁷⁴ one can theorize as to what significance, if any, the committee intended to attach to the term "contest." With respect to gift tax, the 1946 regulations make reference to "determination of gift tax liability," and "claim for refund," but not contest or collection. The committee report, on the other hand, makes reference to the 1946 regulations in terms of gift-tax "contests," stating that "[u]nder the regulations . . . costs have been disallowed where the contest involved gift tax liability."⁷⁵

with the determination, collection, or refund of any tax liability.

Paragraph (3) is new and is designed to permit the deduction by an individual of legal and other expenses paid or incurred in connection with a contested tax liability, whether the contest be Federal, state, or municipal taxes, or whether the tax be income, estate, gift, property, and so forth. Any expenses incurred in contesting any liability collected as a tax or as part of the tax will be deductible.

70. *Supra* note 69.

71. INT. REV. CODE OF 1954, § 212(1) providing: "In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—(1) for the production or collection of income;"

72. INT. REV. CODE OF 1954, § 212(2).

73. See *Hearings on H.R. 8300 before the Senate Finance Committee*, 83d Cong., 2d Sess. 487 (1954):

The language of the committee report appears to confine expenses in connection with tax matters to contested tax liabilities under paragraph (3) of section 212. Since a specific provision ordinarily controls a general provision, this might have the effect of limiting deductions with respect to all taxes, including even income taxes, to contested matters. It is believed that this result was not intended. This problem might be eliminated by adding the word 'computation' before 'determination' in section 212(3). In any event, the Senate Finance Committee report should clarify the point that deductions with respect to taxes are hereafter to be confined to contested taxes.

See also *Blades, Deductibility of the Legal Expenses of Divorce*, 14 KANSAS L. REV. 85 (1965).

74. *Treas. Reg. § 29.23(a)-15* (1946), T.D. 5513, 1946-11 CUM. BULL. 3.

75. *Supra* note 69.

If one assumes there is a correlation between the language of the 1946 regulations and the terminology chosen by the committee in its report on section 212(3), it can be argued that the report's use of the term "contest" corresponds not only to a "claim for refund," but also to a "determination of gift tax liability," as those phrases were used in the 1946 regulations. Viewed in this light, the emphasis placed on the word "contest" in the report was not intended to narrow the scope of section 212(3) exclusively to contested tax liabilities, but rather, merely to remove any doubt as to the deductibility of litigation expenses with respect to "any liability collected as a tax."⁷⁶

Against this theory of the committee report and legislative intent must be placed the statutory language of section 212(3). If one compares the phraseology used in the report with that of section 212(3), they are seemingly consistent with each other. However, whereas the report reads "connected with the determination, collection, or refund of any tax liability,"⁷⁷ the statute omits the term "liability." If one assumes that the phrase "determination of tax liability" connotes an evaluation of a matured obligation, the question arises whether the removal of "liability" strengthens the argument that "determination," within the meaning of section 212(3), was intended to encompass tax planning in general. The 1946 regulations, with the exception of the phrase "determining a property tax imposed," only made reference to the determination of liability, not the determination of any tax. Arguably, unless the term "tax liability" is redundant, the determination of a tax rather than of a liability is a broader concept, since a tax is defined in a general sense as a contribution to government, and not as a debt or matured pecuniary obligation (tax liability).

Or, perhaps this line of reasoning is merely an exercise in semantics. The omission of the term "liability" could have been simply to accommodate the inclusion of both "determination" and "refund" in the same statutory provision, since refund of any tax is conceptually more precise than refund of any tax liability. The final regulations⁷⁸ issued under section 212(3) lend support to this accommo-

76. *Id.*

77. *Id.*

78. Treas. Reg. § 1.212-1(1) (1957), providing:

Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing

dation theory, since the terms “determining” and “liability” are used solely in the context of tax proceedings, not in the sense of estimating a likely tax on anticipated income or with respect to future tax-related transactions.

No doubt, the language of the 1946 regulations, the committee report, and section 212(3) is sufficiently correlated to provide a basis upon which to hypothesize as to Congressional intent on the scope of section 212(3). Yet, it is problematical to definitively state what that scope was intended to be based solely on the committee report.⁷⁹ If in choosing the term “determination,” Congress intended to convey a meaning similar to that which it arguably had within the 1946 regulations under section 23(a)(2),⁸⁰ then the addition of section 212(3) would only serve to overturn the *Lykes* holding. If, on the other hand, the omission of “liability” was intended to work a substantive change in the law by enlarging the category of deductible tax-related expenses, then the concept of determining any tax under section 212(3) is, indeed, significantly broad.

JUDICIAL CONSTRUCTION: *Bonnyman, Davis, Carpenter*

The first case to consider the scope of section 212(3) was *Bonnyman v. United States*,⁸¹ in which the donee of stock sought to deduct legal expenses incurred in contesting and settling a gift tax deficiency asserted against the donor. Given the donee’s statutory liability for the deficiency,⁸² the court found a sufficient interest in the assessment to justify a deduction under section 212(3), and at the same time, rejected the taxpayer’s argument that such expenses were also deductible under section 212(2).⁸³ Citing the proposed

authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus, expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of his tax returns or *in connection with any proceedings involved in determining the extent of tax liability or in contesting his tax liability are deductible.*

(emphasis added).

79. In this regard, consider *Herbert v. Riddell*, 103 F. Supp. 369, 383, n.58 (S.D. Cal. 1952) where the court observes: “Regardless of legislative intent, the legislator speaks to the court through the terminology which he adopts in the final legislation. At times it may be contrary to the expressed intent because the words chosen do not express such intent.”

80. *Supra* note 55.

81. 156 F. Supp. 625 (E.D. Tenn. 1957), *aff’d*, 261 F.2d 835 (6th Cir. 1958).

82. INT. REV. CODE OF 1939, § 1012; now INT. REV. CODE OF 1954, § 6324(b).

83. In *Northern Trust Co. v. Campbell*, 211 F.2d 251 (7th Cir. 1954), the taxpayer had sought to deduct legal fees incurred in defending a claim for federal estate taxes asserted against him as transferee of a testamentary

regulations under section 212(3)⁸⁴ and the language of the Senate Finance Committee report,⁸⁵ the court observed: "The language of sub-section 3 is broad. It gives the taxpayer the right to deduct for income tax purposes all ordinary and necessary expenses in the contest of any tax whether state or federal."⁸⁶ This observation, together with other dicta in the opinion suggesting *Lykes* and *Cobb* "may have" prompted Congress to enact section 212(3), essentially paraphrase the committee's report, without providing new insight into the intended scope of section 212(3).

It was not until the Court of Claims decided *Davis v. United States*,⁸⁷ that the deductibility of tax-related expenses under section 212(3), other than tax return preparation and litigation costs, was squarely presented. In *Davis*, the taxpayer husband argued that legal fees paid to both his and his wife's attorney for tax advice incident to negotiation and execution of a separation and property settlement agreement were deductible under section 212(3). Specifically, he cited a portion of the final regulations under section 212(3) providing that fees paid as services for "tax counsel or expenses paid or incurred in connection with the preparation of . . . tax returns . . . are deductible."⁸⁸

Preferring not to cite the legislative history,⁸⁹ or other relevant authority,⁹⁰ the court relied solely on the regulations⁹¹ to reach its

trust. The court sustained the deduction under section 23(a)(2) as being in proximate relation to the conservation of property held for the production of income; *accord*, *Goldberg v. Commissioner*, 31 T.C. 258 (1958).

84. Proposed Treas. Reg. § 1.212-1(1), 22 Fed. Reg. 10052 (1957).

85. *Supra* note 69.

86. *Bonnyman v. United States*, 156 F. Supp. 625, 628 (E.D. Tenn. 1957), *aff'd*, 261 F.2d 835 (6th Cir. 1958); *accord*, *Carlos Marcello*, 23 CCH Tax Ct. Mem. 1847 (1964).

87. 287 F.2d 168 (Ct. Cl. 1961).

88. Treas. Reg. § 1.212-1(1) (1957).

89. Ironically, *A.P. Green Export Co. v. United States*, 284 F.2d 383, 386 (Ct. Cl. 1960), decided by the Court of Claims four months prior to its decision in *Davis*, contains the following dicta: "Bold definitional lines cannot be drawn with the meager legislative history available. We do not feel, however, that the effect of the statute should be severely restricted to the illustration used in the committee report since it in no way appears that the example was used for that purpose. *An explanatory tale should not wag a statutory dog*" (emphasis added).

90. Arguably, *Higgins v. Commissioner*, 2 T.C. 948, *aff'd*, 143 F.2d 654 (1st Cir. 1943).

91. Treas. Reg. § 1.212-1(1) (1957).

conclusion. However, the language of the regulations cited by the court was not that quoted by the taxpayer, but rather, that portion allowing a deduction for “tax counsel . . . in connection with any proceedings involved in determining the extent of tax liability . . . are deductible.”⁹² Based on this language, the court was able to make two conclusory statements: 1) “[I]t seems clear that the statute and the regulations are broad enough to cover the deduction asked for;”⁹³ 2) “[I]t seems obvious that the fees paid by plaintiff for consultation and advice in tax matters arising in connection with the settlement agreement are deductible”⁹⁴

With respect to both statements, even assuming *arguendo* that negotiations between two attorneys over a property settlement constitute “proceedings” as that term is generally understood, it is not clear that the negotiations themselves were involved in determining the extent of “tax liability,” the administrative contextual history of which phrase already has been considered. A fair reading of the regulation suggests that the proceedings must have as their principal purpose the resolution of tax liability, rather than proceedings or negotiations such as in *Davis* where the tax consequences are collateral to the primary issue in dispute; *i.e.*, divorce or separation.

Although the Supreme Court granted certiorari,⁹⁵ the government chose not to appeal the deductibility of the fees paid to the husband’s attorney, and the Court intimated no decision on that particular issue. But as to the fee paid to the wife’s attorney, the Court sustained the denial of a deduction, interpreting section 212 (3) in effect to read “[i]n connection with the determination . . . of any tax of the taxpayer.” As to whether tax planning expenses such as those in *Davis* are properly within the scope of section 212 (3), the Court deferred judgment, only to say that, “[w]e read the statute, if applicable to this type of tax expense, to include only the expenses of the taxpayer himself”⁹⁶

The facts in *Davis* revealed that income and gift tax “consequences” of the various proposals were considered in the negotiations, the expenses of which, said the Court of Claims, are properly deductible under section 212(3). Thus, the question which *Davis* implicitly answered in the negative is whether a valid distinction can

92. *Id.*

93. *Davis v. United States*, 287 F.2d 168, 170 (Ct. Cl. 1961) (emphasis added).

94. *Id.* at 171 (emphasis added).

95. *United States v. Davis*, 370 U.S. 65, 74 (1961).

96. *Id.* at 74 (emphasis added).

be drawn under section 212(3) between prospective tax planning on the one hand, and analyzing the tax implications of completed transactions on the other.

The Court of Claims did not consider the question to be as clear and as obvious when it decided *Carpenter v. United States*.⁹⁷ On facts substantially similar to those in *Davis*, the taxpayer in *Carpenter* contended that the portion of his legal fee properly allocable to advice as to the tax consequences of his uncontested divorce and separation was deductible under section 212(3). Since the Supreme Court's decision in *United States v. Gilmore*⁹⁸ had foreclosed the possibility of deducting legal fees incident to a divorce or separation under section 212(2), the taxpayer relied exclusively on section 212(3).

Citing the committee reports, the government argued that deductibility of tax counsel is limited to proceedings involving tax controversies and, therefore, *Davis* was wrongly decided and should now be overruled. The court disposed of this argument simply by restating the language of section 212(3) which, on its face, is not limited to tax contests. But the court was not willing to rest its decision on a cursory rebuttal of the government's theory, nor on the "tax counsel" language contained in the regulations, which the *Carpenter* court considered "sufficiently clear by itself to allow the deduction sought here."⁹⁹ Rather, the court reasoned that since there was no indication in the regulations that its enumeration of tax-related deductible expenses was meant to be exclusive, a taxpayer *should* not be restricted to a deduction of expenses for ". . . tax counsel solely to discover the tax consequences of what has already transpired or a tax liability already accrued."¹⁰⁰ Thus, the question which *Davis* implicitly answered in the negative—that is, whether a statutory basis exists to distinguish what has been de-

97. 338 F.2d 366 (Ct. Cl. 1964).

98. 372 U.S. 39 (1963) and companion case, *United States v. Patrick*, 372 U.S. 53 (1963); in *Gilmore*, the Court established the principle that the ". . . origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal' and hence whether it is deductible or not under section 23(a)(2)." *Id.* at 49. *Accord*, Meyer J. Fleischman, 45 T.C. 439 (1965). *But cf.* Baer v. Commissioner, 196 F.2d 646 (8th Cir. 1952).

99. *Carpenter v. United States*, 338 F.2d 366, 368 (Ct. Cl. 1964).

100. *Id.* at 369.

defined as tax planning on the one hand, and analyzing completed transactions on the other—was explicitly done so in *Carpenter*.

The *Carpenter* court's analysis of section 212(3) and the regulations is subject to challenge. The court analogizes tax counsel to investment counsel to support its conclusion that tax planning expenses are deductible under section 212(3). The rationale for allowing investment counsel expenses to be deductible under section 212(2) is that such expenses theoretically increase the yield and appreciation of assets. Arguably, this rationale is inapposite to section 212(3) in determining the deductibility of tax-related expenses for the reason that section 212(3) “. . . merely represents a policy judgment as to a particular class of expenditures otherwise non-deductible”¹⁰¹ Neither the legislative history of section 212(3) nor the statutory language itself substantiates the thrust of the court's preference from a public policy standpoint that taxpayers *should* be allowed to freely deduct tax planning expenses.

Secondly, the court's discussion of the terms “determination” and “tax counsel” only in the context of preparing income tax returns, does not square with its pro-taxpayer conclusion that tax planning expenses are properly deductible under section 212(3). As set forth in the concluding portion of its decision, the court would define determination as the *computation* and *payment* of one's tax, initially, by the taxpayer himself, who is then entitled to consult the IRS for advice and/or employ tax counsel to assist him in arriving at this “determination.” This conceptualization of the term “determination” is broader than a tax contest, yet by the court's restrictive definition, would seemingly exclude tax counsel expenses of planning transactions so as to minimize the consequent tax liability.

The fact that it was a legitimate purpose of the taxpayer in *Carpenter* to employ counsel to minimize both his present and future tax burden through deductible periodic alimony payments is not disputed.¹⁰² This assertion, however, begs the question whether such tax planning expenses are properly within the statutory concept of “determination,” even as that term is used by the court in its decision. The taxpayer in *Carpenter* did not seek tax counsel to assist

101. *United States v. Gilmore*, 372 U.S. 39 n.16 (1963). *Contra*, Note, *Income Taxes: Deductibility of Legal Fees Under 212(3)*, 19 *Miami L. Rev.* 506, 509 (1965).

102. It has been frequently stated that a taxpayer has the legal right to minimize his tax burden or avoid it altogether by means which the law permits. See *United States v. Isham*, 84 U.S. (17 Wall.) 496 (1874); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Jones v. Grinnell*, 179 F.2d 873 (10th Cir. 1950); *Herbert v. Riddell*, 103 F. Supp. 369 (S.D. Cal. 1952).

him in preparing his tax return as the court suggests, nor to assist him in the process of self-assessment of tax liability, including the computation and payment of his current tax.¹⁰³

In his dissenting opinion in *Carpenter*, J. Davis makes a strong argument for the proposition that by extending the deduction for tax counsel back to include the period when transactions are in the planning process or “. . . when taxable events are still uncertain and in future,”¹⁰⁴ *Davis* and *Carpenter* broadened the scope of section 212(3) beyond the original legislative understanding. While J. Davis rejected the majority's approach to section 212(3), he did not accept the government's position either, which would limit the scope of that section proceedings involving tax controversies. Instead, he preferred his own analysis of the statutory language:

The words of the Code ('determination, collection or refund of any tax') connote an appraisal of tax liability on the basis of past or settled events, not a molding of future events to minimize taxes. Each of the three words deals with a function related to taxes already due or about to become due, not with planning ahead. The legislative history treats exclusively with a still more restricted problem, a tax contest; and even the Bar Association's proposal to add 'computation' would not, on a normal reading, carry back further than to activities in preparation for a return.¹⁰⁵

J. Davis' interpretation struck a compromise between what, arguably, was a narrow reading of section 212(3) by the government and the far-reaching position adopted by the majority.

Having lost both in *Davis* and *Carpenter*, one can speculate whether the government should have presented this precise issue to the Supreme Court for review, especially in light of *Gilmore*, decided

103. *Davis* and *Carpenter* have been distinguished on the basis that *Davis* involved the deductibility of tax advice pertaining to the taxpayer's potential liability for the current year, whereas *Carpenter* involved the deductibility of advice pertaining not only to his tax liability in the year in which the divorce and separation were concluded, but also for the tax consequences of future support payments pursuant to the divorce decree. Arguably, this factor is a distinction without a difference since in both cases, the tax advice was sought before the taxable event occurred. *Contra*, Gibbs, *supra* note 67; Recent Cases, *Federal Income Tax-Section 212(3) Extended to Attorney's Fees Arising Out of Divorce Settlement*, 18 VAND. L. REV. 1611 (1965).

104. *Carpenter v. United States*, 338 F.2d 366, 371 (Ct. Cl. 1964) (dissenting opinion).

105. *Id.* at 371-72.

by the Court nearly two years before *Carpenter*, which had promulgated the "origin and character of the claim" test under section 212(2), ending any conjecture that section 212(2) was to become a catch-all for litigation expenses in connection with divorce and separation. Nevertheless, *Carpenter* represented the last case where the government contested in principle the deductibility of tax planning advice incident to a divorce, separation, or property settlement.¹⁰⁶ However, the burden remains on the taxpayer to establish that his allocation of the fee to tax advice is reasonable and capable of being substantiated.¹⁰⁷

REGULATIONS UNDER SECTION 212(3)

As noted earlier there was dicta in *Carpenter* for the proposition that the term "tax counsel" in the regulations was "sufficiently clear" in itself to sustain the deductibility of tax planning expenses. Originally, the proposed regulations under section 212(3) did not contain this tax counsel clause, but when the final regulations were issued, such language had been specifically inserted at the beginning of the second sentence. To a majority of the Court of Claims, the term was sufficiently clear, but to the dissent in *Carpenter* and *Merians*, it was "ambiguous if read alone."¹⁰⁸ Certainly, the term tax counsel standing by itself is strong language, sufficiently so to sustain the holdings of all three cases: *Davis*, *Carpenter*, and *Merians*. It should be borne in mind that regulations are presumed to reflect the general understanding of the intended scope of a Code section at the time of its enactment.¹⁰⁹ For this reason, the regulations are entitled to great weight and must be sustained unless they are unreasonable and plainly inconsistent with the statute.¹¹⁰

If the proposed regulations under section 212(3) had not been specifically amended, tax-related expense deductions, at least insofar as that section is concerned, would have been limited to tax re-

106. See *Palmquist v. United States*, 284 F. Supp. 577 (N.D. Cal. 1967); *Munn Jr. v. United States*, 72-1 U.S. Tax Cas. 9255 (Ct. Cl. 1972); *George v. United States*, 434 F.2d 1336 (Ct. Cl. 1970); *Matthews v. United States*, 425 F.2d 738 (Ct. Cl. 1970); *Lyta J. Morris*, 25 CCH Tax Ct. Mem. 1248 (1966); Rev. Rul. 72-545, 1972-2 CUM. BULL. 8.

107. *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930); *Arthur D. McDonald*, 52 T.C. 82 (1969); *Meyer J. Fleischman*, 45 T.C. 439 (1966).

108. *Carpenter v. United States*, 338 F.2d 366, 371-72 (Ct. Cl. 1964) (dissenting opinion), and *Merians*, 60 T.C. 187, 197 (1973) (dissenting opinion).

109. *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); *Maryland Casualty Co. v. United States*, 251 U.S. 342, 349 (1919); *Augustus v. Commissioner*, 118 F.2d 38, 43 (6th Cir. 1941).

110. *Supra* note 39.

turn preparation and tax contests. Assuming Congress intended all non-trade or non-business tax expenses to be deductible under section 212(3) or not at all, then such a regulation, arguably, would have had the anomalous result of disallowing some deductions under the 1954 Code which had been allowed under section 23(a)(2) of the 1939 Code.¹¹¹ On the other hand, if Congress did not intend the specific tax provisions of section 212(3) to preclude deducting appropriate tax-related expenses under the general provisions of section 212(1) and 212(2), the proposed regulations simply would have reflected Congressional intent to only extend the range of deductible tax-related expenses beyond the 1939 Code by allowing the deductibility of gift tax expenses. Arguably, this latter result would be consistent in spirit with the Supreme Court's dicta in *Gilmore* that section 212(3) ". . . does not cast any doubt on the basic tax structure set up by Congress."¹¹²

The logical inference to be drawn from the Treasury's amendment of the proposed regulations is that at least the Treasury understood section 212(3) to preempt sections 212(1) and 212(2) with respect to non-trade and non-business tax-related expenses, but it is debatable whether this premise justified the insertion of language as broad as "tax counsel." As suggested previously, a fair reading of the legislative record under section 212(3) in the context of the judicial and administrative law immediately preceding its enactment, does not reveal a general consensus as to the intended scope of section 212(3). For that matter, the language of the statute itself would not lead one to believe that tax advice regardless of its nature is deductible under that section. In fact, the government's restrictive construction in *Carpenter* of both section 212(3) and the regulations would seem to indicate that the government never intended "tax counsel" to take on the breadth given to it by *Davis* and its progeny.

In essence, the government's approach to the regulation was this:

To take a few words from their context and with them thus isolated to attempt to determine their meaning, certainly would not contribute greatly to the discovery of the purpose of the draftsman of a statute. . . .

. . . .

111. See Gibbs, *supra* note 67, at 659; *Hearings on H.R. 8300 before the Senate Finance Committee, supra* note 73.

112. *United States v. Gilmore*, 372 U.S. 39 n.16 (1963).

. . . A few words of general connotation appearing in the text of statutes should not be given wide meaning, contrary to a settled policy 'excepting as a different purpose is plainly shown.'¹¹³

Nevertheless, whatever understanding of the scope of section 212(3) inspired the draftsman of the amended regulations under that section, to the Court of Claims in *Davis and Carpenter*, a fair and natural reading of the regulatory language, though not necessarily the statutory language of section 212(3), mandated a result that admittedly made new law.

Due perhaps in part to the influence of the ABA's Tax Section¹¹⁴ and interested CPA's,¹¹⁵ the Commissioner has since conceded the deductibility of tax counsel in areas other than divorce and separation.¹¹⁶

NON-DEDUCTIBLE TAX PLANNING EXPENSES UNDER SECTION 263

An area that has not been rendered academic by administrative concession is the relationship of section 212(3) to section 263,¹¹⁷ the latter requiring the capitalization of certain expenditures, principally those incurred in acquiring or disposing of property and in defending or perfecting title to property.¹¹⁸ Treasury regulation section 1.212-1(n) provides that "capital expenditures are not allowable as non-trade or non-business expenses."¹¹⁹ The question raised by this regulation in the context of section 212(3) is whether the latter section precludes characterization of a non-trade or non-business tax-related expenditure as a section 263 capital expenditure.

113. *United States v. American Trucking Ass'n*, 310 U.S. 534, 542, 544 (1940).

114. See 20 ABA TAX SECTION No. 4, at 78-79 (1967); 19 ABA TAX SECTION No. 4, at 86 (1966); 21 THE TAX LAWYER 708 (1968).

115. See De Castro, *supra* note 21; Kabaker, *Deductibility of Estate Planning Fees*, 54 ILL. B.J. 726 (1966); Scott, *supra* note 67.

116. See *Suter v. United States*, 70-1 U.S. Tax Cas. 9389 (S.D. N.Y. 1970) (taxpayer incurred legal fees in proceedings to reinstate himself as beneficiary of trust); Rev. Rul. 67-461, 1967-2 CUM. BULL. 125 (appraisal fee to determine fair market value of property for charitable contribution under section 170(a)); cf. Rev. Rul. 58-180, 1958-1 CUM. BULL. 153 (appraisal fee to establish casualty loss on residential property). *But see* *Dooley v. Commissioner*, 332 F.2d 463 (7th Cir. 1964) (district court disallowed a deduction under section 212(3) for fees paid to a Boston broker who unsuccessfully devised tax-saving schemes involving the supposed deductibility of interest on loans to finance the purchase of government securities.)

117. INT. REV. CODE OF 1954, § 263 providing that: "No deduction shall be allowed for—(1) Any amount paid out for new buildings or for permanent improvements made to increase the value of any property or estate."

118. Treas. Reg. § 1.263(a)-2(a), (c), (e) (1958).

119. Treas. Reg. § 1.212-1(n) (1957).

In *Kaufmann v. United States*,¹²⁰ a case decided after *Gilmore* but before *Carpenter*, this issue was dodged by the district court which relied exclusively on the applicability of section 212(3) to certain tax-related expenditures. In that case, two members of a closely held corporation, which engaged in the small loan business under the name of Commerce Loan Company, were allowed deductions under section 212(3) for accountant's fees incurred incident to an agreement whereby all of the common and preferred stock held by the common stockholders of Commerce would be exchanged for stock in American Investment Company. The services performed by the accounting firm included the following: 1) researching the tax aspects of the various plans for the stock exchange; 2) preparing an application for a tax ruling; 3) conferring with representatives of the Reorganization and Dividend Branch of the IRS; and 4) computing the basis of two classes of stock received by the taxpayers in the exchange.

The Commissioner had disallowed the entire amount on the ground that it constituted a capital expenditure which must be added to the cost of the acquired stock in American. Instead of pursuing the Commissioner's section 263 capitalization theory, the government's contention was simply that such expenses were outside the scope of section 212(3) since the accountant's functions ". . . were not and could not be a determination of the extent of the taxpayer's liability."¹²¹ Just as it later did in *Carpenter*, the government supported its argument that section 212(3) was limited to actual contested tax liability by citing the legislative history of that section.

As summarily set forth in the *Kaufmann* decision, the apparent disparity between the committee report and the statutory language persuaded the court to completely disregard the committee report and pioneer its own interpretation of section 212(3). The court looked to the same clause in the regulations that the Court of Claims in *Davis* had relied upon, even though the court considered that decision not to be controlling since it had not involved an advance ruling by the IRS. To the court's way of reasoning, the sole purpose of the advance ruling was the computation of tax lia-

120. 227 F. Supp. 807 (W.D. Mo. 1963).

121. *Id.* at 813.

bility, and so it logically followed that that portion of the accountant's fee properly allocable to the tax ruling, was clearly within the meaning of the regulatory language, and therefore deductible.

But as to the determination of the stock basis, it was not for the determination of any tax, said the court, but rather for the information or possible future use of the taxpayer. For this reason, that portion of the accountant's fees allocable to the basis determination was non-deductible. It has been argued by several commentators¹²² that the court's rationale for denying a deduction for this portion of the fee was inconsistent with its approach in sustaining the deductibility of the cost of obtaining the Bureau's ruling. Since the ruling was obtained prior to the completion of the stock transaction, strictly speaking, it likewise was obtained merely for the taxpayer's information and future use.

The significance of *Kaufmann* lies not so much in the district court's analysis of the scope of section 212(3), but rather in the court's failure even to address the question of whether a portion if not all of the accountant's expenses should have been capitalized.¹²³ In discussing the tax ruling, the court made this observation:

I think it would not be disputed that the very purpose of setting up the Reorganization and Dividend Branch of the Tax Ruling Division . . . was to advise interested parties of the tax liability arising from a reorganization, such as we are dealing with here. It would seem to be as much of a business expense to determine that question as to determine the actual tax liability after the reorganization.¹²⁴

Arguably, the court's dicta is subject to challenge in the wake of the recent Supreme Court decisions in *Woodward v. Commissioner*,¹²⁵ and its companion case, *United States v. Hilton Hotels*.¹²⁶

122. De Castro, *supra* note 21; Kabaker, *supra* note 115; Scott, *supra* note 67; Note, *supra* note 41.

123. In *James A. Collins*, 54 T.C. 1656, 1666 (1970), the taxpayer sought to deduct tax advice procured in connection with the tax consequences of an apartment house purchase: the Tax Court specifically considered this issue of the capitalization of non-trade or non-business tax advice, and held the expenditures to be deductible under section 212(3). By contrast, in *Leslie Q. Coupe*, 52 T.C. 394, 414 (1969), where the taxpayers sought to deduct legal fees incurred for tax advice in connection with the sale and acquisition of realty, the court summarily concluded: "Both fees pertain to a capital transaction and can therefore only represent a part of the basis of the property acquired, or a selling expense of the property sold." Compare *Michael J. Ippolito*, P-H T.C. Memo. Dec., par. 65,167 (1965) where the Tax Court reversed the Commissioner's disallowance of deductions for expenses incurred for financial and tax advice incident to the purchase of treasury certificates.

124. *Kaufmann v. United States*, 227 F. Supp. 807, 814 (W.D. Mo. 1963).

125. *Woodward v. Commissioner*, 397 U.S. 572 (1970).

126. *United States v. Hilton Hotels*, 397 U.S. 580 (1970).

Although the fact situations in these companion cases are distinguishable,¹²⁷ both cases involved the deductibility of litigation expenses incident to an appraisal of stock. The Court unanimously held in each case that such costs constituted non-deductible capital expenditures. After rejecting the applicability of the "primary purpose" test¹²⁸ to costs incurred in acquiring or disposing of capital assets, the Court predicated its decisions on the *Gilmore* "origin and character of the claim" test. This latter test, said the Court, involves the "... simple inquiry whether the origin of the claim litigated is in the process of acquisition itself."¹²⁹ Both of these cases pertained to the capitalization of litigation expenses, but the fair import of the Court's language suggests that any expenses originating in the process of acquisition must be capitalized.

Certainly, it is arguable that the accountant's fees in *Kaufmann* which were incurred pursuant to negotiations with the IRS and computing the basis of stock, were as much a part of the process of stock acquisition as the ministerial transfer of stock certificates themselves. *Woodward* contains dicta supporting such an argument: "[I]n this case there can be no doubt that legal, accounting, and appraisal costs incurred by taxpayers in *negotiating* a purchase of the minority stock would have been capital expenditures."¹³⁰ Thus, even though the *Kaufmann* expenses were tax-related and arguably within the provisions of section 212(3), the interrelationship of the accountant's services with the stock purchase agreement satisfied the *Woodward-Hilton* capitalization test, and would presumably be non-deductible capital expenditures.

127. In *Woodward*, taxpayer shareholders of the Telegraph Herald, an Iowa publishing corporation, sought to deduct litigation expenses incurred in connection with the appraisal and valuation of stock, which they were required by law to purchase from a minority shareholder who objected to renewal of the corporation's charter. *Hilton*, on the other hand, involved the deductibility of litigation expenses incurred by the taxpayer Hilton Hotels Corporation in connection with a post-merger valuation of stock, which was to be transferred by Hilton to dissenting shareholders of Hotel Waldorf-Astoria Corporation.

128. This test was promulgated with respect to expenditures incurred in defending or perfecting title to property; *i.e.*, such expenses are capital in nature only where the taxpayer's "primary purpose" in incurring them is to defend or perfect title. See generally 4A J. MERTENS, LAW OF FEDERAL INCOME TAXATION, §§ 25.24, 25A.16 (rev. ed. 1966) and the cases collected therein.

129. *Woodward v. Commissioner*, 397 U.S. 572, 577 (1970).

130. *Id.* at 577-78.

Interestingly, concurrent with the expansion of the scope of section 212(3) since *Davis* was decided, the scope of section 263 has likewise been significantly broadened.¹³¹ Despite the *Kaufmann* approach to the characterization of non-trade or non-business tax-related expenditures, the deductibility of such expenses in connection with the acquisition or disposition of assets such as in *Kaufmann*, will no longer depend exclusively on whether the expense is squarely within the scope of section 212(3), but rather on the applicability of the *Woodward-Hilton* capitalization formula.¹³²

CONCLUSION

Given the result in *Merians*, the scope of section 212(3) is significantly broad. To the extent the decision stands for the proposition that tax advice regardless of its nature with respect to estate planning services is deductible under section 212(3), the Tax Court made new law.¹³³ Realistically, even if the concurring and dissenting opinions in *Merians* are theoretically correct in asserting that section 212(3) was unjustifiably expanded by the Court of Claims in *Davis* and *Carpenter*, an administrative retreat from that position would be unpopular from a public policy standpoint. It is difficult to predict what effect the Commissioner's acquiescence in *Merians* will have on the scope of section 212(3) when this issue is squarely presented to the Tax Court.

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131. See Vincent Boagni, Jr., 59 T.C. 708 (1973); Rev. Rul. 67-125, 1967-1 CUM. BULL. 31; Rev. Rul. 67-411, 1967-2 CUM. BULL. 124; Aronson, *The Characterization of Legal Fees as Deductible Expenses or Capital Expenditures—A Need for Clarification in the Law*, 21 SYRACUSE L. REV. 926 (1970); Gibbs, *Legal Fees: Supreme Court Cases Requiring Capitalization will have Broad Impact*, 33 J. TAXATION 201 (1970); Winokur, *Deductibility of Legal and Other Professional Fees*, U. SO. CAL. 1963 TAX INST. 457.

132. But see Comment, *Tax-Advice: A Deductible Expense*, 10 VILL. L. REV. 357, 364 (1965) where the author suggests that section 263 was intended to be inapplicable to non-trade or non-business tax-related expenditures.

133. See also Nancy Reynolds Bagley, 8 T.C. 130 (1947); Arthur D. McDonald, 52 T.C. 82 (1969) (insufficient evidence); George L. Schultz, 50 T.C. 688 (1968).