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# Tax Advice - A Deductible Expense

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### CONCLUSION

Alexis De Tocqueville, the far-sighted prophet of American life, remarked that a decline in our public morals in America would probably result in an abuse of impeachment as a means of crushing political adversaries or ejecting them from office.[60] This statement might well be extended to many of the various legislative remedies against the judiciary discussed here. The titanic struggles between our Congresses and Courts have on two occasions resulted in at least partial victories for the Court (1803 and 1937) and at least once in an almost complete victory for the Congress (1868). The latter event is not usually looked upon by historians as a salutary one in our history.[61]

The doctrine of at least partial separation of governmental powers was framed by Montesquieu with the aim of allowing the judiciary a check on tyranny by an executive or by a legislature temporarily representing the majority.[62] Congress should carefully consider the doctrine before acting against the Court. Patience may well be the best treatment and time the best cure for what the legislature today considers a vital problem. The court has acted with integrity albeit with some rashness in embarking on its present course. However, any attempt by Congress to suddenly change the Court's course by use of the alternatives discussed herein might well endanger our present form of government far more than the disputed opinions of our present Court.

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## TAX ADVICE — A DEDUCTIBLE EXPENSE*

In a recent decision, the United States Court of Claims held that a taxpayer was entitled to deduct that portion of his legal expenses which were allocable to *services and advice as to the tax consequences* arising out of an uncontested divorce and separation.[1] Judge Davis, in his dissent, suggested the possible significance of this decision, when he said:

> The ultimate consequence of the wider view of the regulation, adopted by this court, is that *individual taxpayers will be able automatically to deduct counsel fees paid for the general planning of their holdings and estates so as to minimize income, estate, or gift taxes in the years*

60. Cited by Hare, AMERICAN CONSTITUTIONAL LAW 211 (1889).
61. Dulles, THE UNITED STATES SINCE 1865, 20 (1959).
62. Radin, *The Doctrine Of The Separation Of Powers In Seventeenth Century Controversies*, 86 U. PA. L. REV. 842 (1938).

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1. William K. Carpenter v. United States, Civil No. 192-62, Ct. Cl., November 13, 1964.

> *ahead,* or for arranging marital or family affairs with the same end of tax-minimization in the future, or for planning charitable or foundation gifts (and allocation of assets) for such a purpose. Hitherto, the large share of these costs . . . have been personal expenses . . . I find nothing to intimate that Congress, in adding section 212(3), intended to overturn this accepted position by placing the expenses of trying to reduce one's future taxes in a different category from all the other personal expenses of living.[2] (Emphasis added.)

Insight into the background of the general area is necessary to fully appreciate this decision.

Two Code provisions are significant in determining whether any part of an attorney's fees will be deductible. They are section 162,[3] relating to business expenses, and section 212,[4] relating to deductible "non-trade" or "non-business" expenses. Requirements common to both sections are: (1) the expense must be ordinary, necessary, and reasonable; (2) the expense must be paid or incurred during the tax year; (3) the expenditure must be an expense rather than a capital expenditure; (4) the expense must not be personal in nature; (5) the deductibility of the expense must not be contrary to public policy.[5] This comment will endeavor to limit its discussion to section 212 and will interject cases arising under section 162 only when they provide analogous reasoning helpful in the interpretation of section 212.

Most of the cases involving the question of the deductibility of legal fees by an individual have arisen under section 23(a)(2) of the Internal Revenue Code of 1939 and as later amended in 1942.[6] This section, as its present-day counterpart, section 212(1 & 2), provided for the deduction of all "ordinary and necessary expenses . . . for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income."[7]

In the now famous *Bingham's Trust* case,[8] the question was the deductibility of legal fees concerning litigation in which trustees unsuccessfully contested a deficiency claim based on taxable gain to the estate. The Supreme Court held the expenses deductible as expenses for the management of property held for the production of income. The court pointed out that the deduction for such expenses was not limited to expenses which produce income, but also to expenses *directly connected with or proximately resulting from the production* of such income. This case was subsequently

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2. *Id.* at 9.
3. INT. REV. CODE OF 1954, § 162.
4. INT. REV. CODE OF 1954, § 212.
5. Prior to the 1954 Code, these sections were combined. Int. Rev. Code of 1939, ch. 1, § 23(a)(1)(A), 53 Stat. 12 (now INT. REV. CODE OF 1954, § 162), as amended, Revenue Act of 1942, § 121, 56 Stat. 819 (1942) (now INT. REV. CODE OF 1954, § 212).
6. Presently incorporated into INT. REV. CODE OF 1954, § 212 (1&2).
7. Int. Rev. Code of 1939, ch. 1, § 23(a)(2), 53 Stat. 12, as amended, Revenue Act of 1942, § 121, 56 Stat. 819 (1942) (now INT. REV. CODE, § 212 (1&2)).
8. Bingham's Trust v. Comm'r, 325 U.S. 365 (1945).

relied upon in *Goldberger's Estate*,[9] where the court applied the principle to an estate and said that "the executor holds all the estate assets for ultimate production of income, and all expenses incurred in furtherance of that end are deductible . . . ."[10]

The application of the "proximate connection" test of *Bingham's Trust* permitted the courts to allow fees paid for "investment counsel" as relating to the production of income[11] and attorney's fees paid for reviewing the merits of investment plans.[12] Legal advice rendered with regard to the tax treatment of annuities, dividends, holding period on certain stocks acquired by gifts and partial loss deduction were likewise held deductible.[13] The court said:

> The expenditures appear to have been for legal advice related solely to an ascertainment of proper tax liability and they have a bearing upon the management, conservation, or maintenance of his property held for the production of income.[14]

As the courts strained the interpretation of this section to allow deductions, they often overruled or disregarded prior decisions. One example of this was the allowance of a deduction for legal fees paid in connection with preparation of taxpayers' tax returns.[15] This decision was in direct opposition to a prior case in which the court said "that Congress never intended to allow as a deduction such a purely personal expenditure."[16]

Thus, the area was prepared for *Lykes v. United States*,[17] in which the Supreme Court held non-deductible, the legal fees incurred in connection with a tax dispute involving federal gift taxes. The court's reasoning was simply that the deduction was available only for expenses incurred for the "production or collection of income", and, since a gift was the antithesis of such production or collection, any expenses incurred could not be deductible. This decision created the inequitable situation of allowing a deduction for legal fees when connected with contesting income or estate tax liability, and denying similar expenses if the dispute involved gift taxes.

Thus, one of the avowed purposes of amending section 212 and adding subsection (3) was to overrule the Supreme Court's decision in *Lykes*.[18] However, while the initial force for the enactment of the subsection was to overrule the *Lykes* case, the broad language of the provision and the interpretative Treasury Regulations allow expenses which were previously doubtful.

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9. Comm'r v. Goldberger's Estate, 213 F.2d 78 (3d Cir. 1954).
10. *Id.* at 84. See also, Howard E. Cammack, 5 T.C. 467 (1945).
11. Nancy Reynolds Bagley, 8 T.C. 130 (1947).
12. *Ibid.* Query whether this is not analogous to tax counsel for the determination, collection or refund of any tax.
13. Philip D. Armour, 6 T.C. 359 (1946).
14. *Id.* at 363.
15. Rush v. United States, CCH 59-2 U.S. TAX CAS. ¶ 9752 (D.C. 1959).
16. Higgins v. Comm'r, 143 F.2d 654, 655 (1st Cir. 1944).
17. 343 U.S. 118 (1952).
18. See H.R. Rep. 1337, 83d Cong., 2d Sess., 29 A. 59 (1954); Sen. Rep. 1622, 83d Cong., 2d Sess. 218 (1954).

Section 212(3) 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.[19]

The Treasury Regulations pertinent to this section provides:

> 1.212-1. Nontrade or nonbusiness expenses. (1) Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus, expenses paid or incurred by a taxpayer *for tax counsel* or expenses paid or incurred *in connection with the preparation of his tax returns* or in connection with any proceedings involved *in determining the extent of his tax liability* or *in contesting his tax liability, are deductible.*[20] (Emphasis added.)

Prior to the recent Court of Claims decision in the *William K. Carpenter* case,[21] there was a dearth of cases dealing with the application of section 212(3). In *Bonnyman v. United States,*[22] a taxpayer sought to deduct attorney's fees paid by the donee-taxpayer to contest a gift tax deficiency which had created a lien in favor of the government against the gift. The court ruled the taxpayer was permitted to deduct the counsel fees as "ordinary and necessary expenses" paid in connection with the determination of the gift tax deficiency. The court said:

> The language of subsection [3] is broad. It gives the taxpayer the right to deduct for income tax purposes . . . expenses in the contest of any tax....
>
> That the excess would not have been relinquished without contest goes without saying. That the layman knows almost nothing about contest of tax assessment would seem to be common knowledge . . . Employment of an attorney would, therefore, seem to be an "ordinary and necessary" expense within the meaning of subsection [3] of section 212....[23]

A similar question was presented in *Kaufmann v. United States.*[24] In this case, the taxpayer employed an accounting firm to explore the tax consequences of a reorganization plan and to prepare necessary data for submission to the Tax Ruling Division of the Commissioner of Internal Revenue. The court found that the taxpayer had followed a reasonable

19. INT. REV. CODE OF 1954, § 212(3).
20. Treas. Reg. § 1.212-1(*l*) (1954).
21. William K. Carpenter v. United States, Civil No. 192–62, Ct. Cl., November 13, 1964.
22. 156 F. Supp. 625 (E.D. Tenn., 1957), *aff'd*, 261 F.2d 835 (6th Cir. 1958).
23. *Id.* at 628–29.
24. CCH 64-1 U.S. TAX CAS. ¶ 9235 (E.D. Mo. 1963).

procedure for resolving the intricate problem, and that the sole purpose of the expenditure was the computation of the tax liability. Based on these facts, the court held that the taxpayer was entitled to deduct as much of the expenses as were related to the determination of the tax. The court said, speaking of subsection 3 of section 212:

> Paragraph 3 seems to be rather clear in its intent when it says, "connection with the determination, collection or refund of any tax." The determination is one phase of a tax controversy, the collection is another, and the refund is still another.[25]

It is clear the court considered expenses for *determination of tax liability* as a separate and distinct category of expenses which it held to be deductible.

One case prior to *Carpenter* directly considered the problem of the deductibility of tax advice under this section. *Davis v. United States*[26] involved several tax issues, one of which was a deduction for attorney's fees for tax advice in connection with a divorce and property settlement agreement. It was shown that in negotiation of the separation and property agreement, the taxpayer's attorney had considered the tax consequences which arose from various proposals, and had billed the taxpayer separately for services allocated to these tax matters. The Court of Claims allowed the deduction for the fees paid for the "consultation and advice in tax matters." However, the court rejected the taxpayer's claim that fees paid to his former wife's attorney for similar advice was deductible, despite the taxpayer's legal liability for such fees. The court said: "We think the attorney's fees must be directly and only connected with taxpayer's estate."[27]

Since the Government did not seek review as to the amount paid to the taxpayer's attorney, the Supreme Court on review said that they would "intimate no decision on that point."[28] The only related question before the Supreme Court was the deductibility of fees paid to the wife's attorney for similar advice. This amount was held not deductible under 212(3) as it did not concern a tax of the taxpayer and was not directed to his tax problems. It would seem one implication from this decision is that if the expenses had directly affected the taxpayer, they could have been deducted.

Nevertheless, "on facts substantially identical to those"[29] in the *Davis* case, the Government again contested the deductibility of such fees under section 212(3).[30] The Government's primary argument was that the *Davis* decision should be reversed because there was nothing in the statutes or

25. *Id.* at p. 91,556.
26. 287 F.2d 168 (Ct. Cl. 1961).
27. *Id.* at 171.
28. United States v. Davis, 370 U.S. 65, 74 (1962).
29. William K. Carpenter v. United States, Civil No. 192-62, Ct. Cl., November 13, 1964.
30. *Ibid.*

the regulation to indicate provision for tax counsel except in proceedings involving tax controversies.

In support of this argument, the Government, referring to the legislative history of the subsection, argued that the committee reports specifically stated that the purpose of the deduction was to provide a deduction for expenses connected with "contested tax liability."[31] The rather simple answer to this reasoning was that since the purpose of the enactment of section 212(3) was to change the rule of the *Lykes* case which involved "contested tax liability", it would seem reasonable to expect the committee to refer to "contested tax liability." The court in rejecting this argument, stated that: "This language [of section 212(3)] is clearly not limited in meaning to any contested tax controversy, as construed by defendant."[32]

And the court pointed in its opinion to Treasury Regulation 1.212-1 which provides four separate examples of expenses which are deductible under section 212(3). These are:

(1) expenses for *tax counsel,* or

(2) expenses in connection with the *preparation of tax returns,* or . .

(3) expenses in connection with proceedings involved in *determining the extent of tax liability,* or

(4) expenses in *contesting tax liability.* (Emphasis added.)

There is nothing in the regulations to indicate that these examples limit the deductions available but rather they would seem to be illustrative of a type of deduction.

In the *Davis* case, the court seized upon the words, "tax counsel", in allowing a deduction for tax advice. In an attempt to support this reasoning and to answer the Government's argument that *Davis* was wrong, the court in *Carpenter* turned to subsection 1(g) of the same section of the Regulation. This section provides for the deduction of fees paid for services of "investment counsel." Concerning the meaning of the word counsel as used in the Regulation, the court said:

> Obviously, a taxpayer does not employ investment counsel *after* he has made his investments, and he should not be restricted to deduction of expenses for tax counsel solely to discover the tax consequences of what has already transpired or a tax liability already accrued. One of the purposes of a taxpayer in obtaining tax counsel is to avoid tax contests, not create them, and this also serves the interest of the Government in collecting taxes.[33]

In continued support of the *Davis* decision, the court pointed out that under the prescribed method of the Internal Revenue Code, the taxpayer must determine, in the first instance, by a method of self-assessment, his

31. See H.R. Rep. 1337, 83d Cong., 2d Sess., 29 A. 59 (1954); Sen. Rep. 1622, 83d Cong., 2d Sess. 218 (1954).
32. William K. Carpenter, *supra* note 29.
33. *Ibid.*

tax liability.[34] Under this method, the taxpayer is required, not only to submit tax information, but also to compute his own tax and to pay "such tax."[35]

The *Carpenter* court in this regard argued that:

> No exercise in semantics is required in order to conclude that by this process of self assessment, the Government in the first instance accepts the taxpayers computation and payment of his own tax as a "determination" thereof. It may later challenge or contest the tax liability, but Section 212(3) refers to the "determination . . . of any tax," without restriction to a contested liability.
>
> For advice in arriving at this determination, the taxpayer may consult the Internal Revenue Service, or he may under Treasury Regulation 1.212 employ "tax counsel." One of the *legitimate purposes of plaintiff in employing tax counsel was to minimize insofar as was legally possible the tax consequences to plaintiff*. . . .[36] (Emphasis added.)

This language unquestionably indicates that in the court's mind, the *determination* of tax consequences includes contemplated as well as completed transactions. This would seem to be part of the well-settled principle that taxpayers are not just free to do so, but should conduct their affairs so as to minimize their tax obligations.[37] It is equally reasonable to assume that Congress contemplated such an interpretation when they enacted subsection 3.

Was it reasonable for the Government to argue that Congress intended to distinguish between expenses for "contesting" and expenses for "acquiescence"? Should the deductibility of fees for services in determining whether a capital gain or ordinary income results from a transaction depend upon whether the taxpayer's tax year is over or even whether the transaction is completed or contemplated? Would it be reasonable to suggest that the expenses of finding out that no tax return is required is not deductible whereas the cost of preparing the return is deductible? Was it the intention of the section to require the taxpayer to act without tax guidance during the tax year, only to be forced to retain tax counsel in order to determine the tax consequences of what already had been done and so allow the deduction only to those who can create tax contests?[38]

The obvious answers to these questions indicate the soundness of the court's decision in the *Carpenter* case. Added proof of this can be found in *Waldo Salt v. Comm'r.*[39] In this case, the issue was the deductibility of attorney's fees for advice given the taxpayer in connection

34. INT. REV. CODE, § 6012 (1954).
35. INT. REV. CODE, § 6151 (1954).
36. William K. Carpenter, *supra* note 29.
37. See, *e.g.*, Jones v. Grinnell, 179 F.2d 873, 874 (10th Cir. 1950).
38. Brief for Plaintiff: pp. 16–17, William K. Carpenter v. United States, Civil No. 192–62, Ct. Cl., November 13, 1964.
39. 18 T.C. 182 (1952).

with his *business*. The following is the language in the case dealing with the question of whether litigation is essential to deductibility:

> It is not essential to the deductibility of attorney's fees that there be litigation. Legal services are frequently required in forums other than courts, and also advice of attorneys as to legal rights and procedure is often necessary. The *vital test as to deductibility is whether the services of an attorney are required by the taxpayer* in a matter directly connected with his business.[40] (Emphasis added.)

It would seem impossible to avoid the logic of this test simply because it was derived in a case which determined the deductibility of a business expense under section 162, in contrast with an individual expense under section 212. The Supreme Court has previously expressed the opinion that the sections were in *pari materia* and therefore, have similar effects within their respective ambits.[41]

However, how can this *individual expense* avoid the prohibition of section 262 which disallows "personal, living, and family expenses,"[42] particularly after the Supreme Court decisions in *Gilmore*[43] and *Patrick*?[44] The issues involved in both of these cases was the deductibility of legal expenses in divorce proceedings. The Court laid down what has come to be called the "source test" when it said:

> The characterization, as "business" or "personal," of the litigation costs of resisting a claim depends on whether or not the claim *arises in connection with* the taxpayer's profit-seeking activities.[45]

Applying the "source test" of *Gilmore,* it would seem fees for tax advice given in connection with a divorce settlement would be *personal expenses* and subject to section 262. The answer to the dilemma was given by the Supreme Court in footnote 16 of the *Gilmore* case.

> 16. Expenses of contesting tax liabilities are now deductible under § 212(3) of the 1954 Code. This provision merely represents *a policy judgment as to a particular class of expenditures* otherwise non-deductible, like extraordinary medical expenses, and does not cast any doubt on the basic tax structure set up by Congress.[46] (Emphasis added.)

In comparing section 212(3) expenses to extraordinary medical expenses, it seems reasonable to conclude the court was recognizing a legislative intention to make these expenses an exception to the exclusion rule of section 262.

Having reviewed all the cases directly dealing with section 212(3), it may be possible to derive from the holdings of these cases the rudiments

40. *Id.* at 186.
41. Bingham's Trust v. Comm'r, 325 U.S. 365 (1945).
42. INT. REV. CODE OF 1954, § 262.
43. United States v. Gilmore, 372 U.S. 39 (1963).
44. United States v. Patrick, 372 U.S. 53 (1963).
45. United States v. Gilmore, 372 U.S. 39, 48 (1963).
46. *Ibid.*

of a general principle applicable to all future deductions claimed under 212(3), which could be stated thusly:

> When an individual taxpayer incurs an expense for "tax advice" on the tax consequences of either a contemplated or a completed matter; and where, because of the intricacy of the tax problem or lack of knowledge of the taxpayer, it would be ordinary and necessary to seek such advice; and if the advice is directly connected with the taxpayer's tax liability, such expenses incurred or paid will be deductible, regardless of whether the taxpayer's intention in seeking such advice was to minimize, determine, collect, or refund present or future tax liability, if the procedure followed was reasonably calculated to attain such a result and if the expenses are otherwise reasonable.

However, even if the individual has the right to deduct expenses for tax advice, there remains still another problem before all such expenses can be effectively deducted. For example, what if the services relate not only to tax advice, but also to the preparation of an agreement or contract? The answer involves the principle of allocation.

The regulations provide only for the allocation of expenses to a class or classes of exempt income.[47] In all other cases, the courts look to the *Cohan* rule, which was created by Judge Learned Hand when he said:

> Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent.[48]

Clearly, the burden of allocation is on the taxpayer.[49] Even when this burden is not fully satisfied, many courts have followed the lenient spirit of the *Cohan* rule. However, the Commissioner has been held to have been justified in denying the entire amount where the taxpayer has failed to allocate.[50]

Thus, a taxpayer may find that his legal fees are non-deductible, even though a substantial part of the services were for deductible tax advice. To avoid this danger, the tax attorney should plan his work so that his deductible services can be identified and segregated either in time of performance or in time record descriptions. Allocation is primarily a fact question, and the billing attorney's own allocation will have great weight. To be of maximum benefit, not only should the lawyer strive to allocate the deductible and non-deductible items, but he should also individually price them.

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47. Treas. Reg. § 1.265-1(c) (1958).
48. Cohan v. Comm'r, 39 F.2d 540, 543-44 (2d Cir. 1930). This case involved an allocation between deductible entertainment expenses and non-deductible personal expenses.
49. Ecco High Frequency Corp. v. Comm'r, 167 F.2d 583 (2d Cir. 1948), *cert. denied*, 335 U.S. 825 (1948); Estate of Helen S. Pennell v. Comm'r, 4 B.T.A. 1039 (1926).
50. Arthur Jordon, 12 B.T.A. 423 (1928).