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Federal Income Taxation: Nondeductibility of Husband's Legal Expenses in Contesting Alimony Payments

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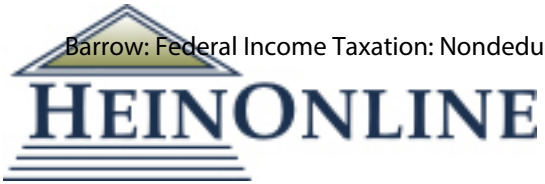

covery may have been inadvertently limited by Section 458.16 and that the Legislature has reversed the trend of liberal pre-trial discovery proceedings.

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FEDERAL INCOME TAXATION: NONDEDUCTIBILITY OF HUSBAND'S LEGAL EXPENSES IN CONTESTING ALIMONY PAYMENTS

Howard v. Commissioner, 202 F.2d 28 (9th Cir. 1953)

Petitioner incurred legal expenses in the unsuccessful defense of an action brought by his divorced wife to collect monthly payments awarded her in divorce proceedings. On his 1943 and 1944 income tax returns he sought to deduct the legal expenses as expenses paid for "the management, conservation, or maintenance of property held for the production of income" within the purview of Section 23 (a) (2) of the Internal Revenue Code.[1] The commissioner disallowed the deduction and determined deficiencies in petitioner's tax liability. The Tax Court upheld the determination of the commissioner as to the deduction.[2] On appeal, HELD, Section 23 (a) (2) affords no basis for the deduction. Judgment affirmed.

The revenue laws have consistently provided for the deduction of trade or business expenses,[3] but under such provisions expenses incurred in collecting or producing income, or managing, conserving, or maintaining property held for the production of income not derived from any trade or business were not deductible.[4] There was

[1]"In computing net income there shall be allowed as deductions: (a) Expenses. —(1) Trade or business expenses.—. . . (2) Non-trade or non-business expenses.—In the case of an individual all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income."

[2]Howard v. Commissioner, 16 T.C. 157 (1951).

[3]INT. REV. CODE §23 (a) (1); Revenue Act of 1918, §214 (a) (1), 40 STAT. 1066 (1919) (first enacted in present form); Revenue Act of 1913, §II B, 38 STAT. 167 (1913) (first provision for deduction of business expenses).

[4]*E.g.*, Kane v. Commissioner, 100 F.2d 382 (2d Cir. 1938); Stuart v. Commissioner, 84 F.2d 368 (1st Cir. 1936); Reese v. Commissioner, 29 B.T.A. 565 (1933).

much litigation as to what constituted trade or business expenses.[5] *Higgins v. Commissioner*[6] placed a strict construction on "trade or business expenses," and as a result Section 23 (a) (2) was added to the Internal Revenue Code.[7]

Section 23 (a) (2) was at first interpreted by the Treasury as not permitting the deduction of legal expenses incurred during litigation.[8] The regulations were amended later[9] to conform to the Supreme Court's decision in *Bingham v. Commissioner*[10] that legal expenses incurred in contesting an income tax deficiency were deductible under this section. The original position of the Treasury prohibited the deduction of counsel fees paid by a wife for services rendered in connection with her efforts to obtain an increase in alimony as well as similar fees paid by the husband in contesting the increase as not being "ordinary and necessary expenses"[11] within the meaning of Section 23 (a) (2).[12] In 1949, however, it was held in two cases[13] that legal expenses paid or incurred in connection with the collection of alimony includible in the gross income of a wife under Section 22 (k) constitute ordinary and necessary expenses for the production or collection of income within the meaning of Section 23 (a) (2) and are therefore deductible. This ruling is now accepted by the Treasury.[14]

The instant case held that legal expenses are not deductible merely because they are paid in an effort to relieve the taxpayer of liability. The court uses the rationale of *Lykes v. United States*[15] that the section applies "to expenses on the basis of their immediate purposes rather than upon the basis of the remote contributions they might make to the conservation of a taxpayer's income producing assets by reducing his general liabilities."[16] The taxing statute not only

[5]*E.g.*, DuPont v. Deputy, 103 F.2d 257 (3d Cir. 1939); Kales v. Commissioner, 100 F.2d 35 (6th Cir. 1939); Monell v. Helvering, 70 F.2d 631 (2d Cir. 1934).

[6]312 U.S. 212 (1941).

[7]H.R. REP. No. 2333, 77th Cong., 2d Sess. 46 (1942).

[8]U.S. Treas. Reg. 111, §29.23 (a)-15 (1943).

[9]T.D. 5513, 1946-1 CUM. BULL. 61.

[10]325 U.S. 365 (1945).

[11]U. OF FLA. L. REV. 136 (1953).

[12]I.T. 3856, 1947-1 CUM. BULL. 23.

[13]LeMond v. Commissioner, 13 T.C. 670 (1949); Gale v. Commissioner, 13 T.C. 661 (1949), *aff'd*, 191 F.2d 79 (2d Cir. 1951), *no cert.* (G), 4 P-H 1951 FED. TAX SERV. ¶71,141 (1951).

[14]U.S. Treas. Reg. 118, §39.24 (a)-1 (1953).

[15]343 U.S. 118 (1951).

[16]*Id.* at 125.

draws a distinction between deductible trade or business expenses and deductible nontrade or nonbusiness expenses but also provides in Section 24 (a) (1) for the nondeductibility of purely personal, living, or family expenses. The consideration here is whether the expense is: (1) for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income and thus deductible;[17] or (2) a strictly personal expense, which is not deductible.[18]

In the *Lykes* case the taxpayer made a gift of stock in a closely held family corporation to members of his family and paid the federal gift tax thereon. Later the Commissioner of Internal Revenue asserted a deficiency of $145,276.50. The taxpayer, through the efforts of his attorney, secured a settlement for $15,612.75. Then the taxpayer attempted to deduct the attorney's fees on his income tax return under Section 23 (a) (2), arguing that if the deficiency had not been contested it would have consumed property held for the production of income; therefore, the legal expenses were incurred for the conservation of income-producing property. This argument was not accepted. If it had been, it would mean that counsel fees incurred in defending any claim would be expenses for the conservation of income-producing property and thus all litigation expenses would be deductible. There are indications that this was not within the intent of Congress when it enacted Section 23 (a) (2).[19] The Court in the *Lykes* case refused to allow the deduction, expressing the view that, since the gift was in the nature of a personal or family expense, the donor's expenses were of a like nature and that the nondeductibility of such expenses is indicated by the express denial of Section 24 (a) (1) and the absence of affirmative allowance under Section 23 (a) (2).[20]

The instant case falls squarely within the purview of the *Lykes* decision. The court, however, mentions *Baer v. Commissioner*[21] as "a good illustration of the proper application of the statute."[22] The *Baer* case must be charily used as authority for the meaning of Section

[17]*E.g.*, Baer v. Commissioner, 196 F.2d 646 (9th Cir. 1952).

[18]*E.g.*, Lykes v. United States, 343 U.S. 118 (1951).

[19]88 CONG. REC. 6376 (1942) (intended to permit the deduction of nontrade or nonbusiness expenses not allowed by §23 as it then existed but not prohibited by §24).

[20]Lykes v. United States, 343 U.S. 118, 121 (1951). *But cf.* McDonald v. Commissioner, 323 U.S. 57 (1944).

[21]196 F.2d 646 (9th Cir. 1952).

[22]At p. 30.

23 (a) (2), as the decision was reached by looking at the end result rather than the origin of the matter giving rise to the litigation. In that case the wife demanded a substantial percentage of the taxpayer's estate as alimony. Since the estate consisted largely of stock in a corporation in which he held control, he was concerned lest his control of and future in the company be affected. Through the efforts of his attorney a satisfactory settlement was reached which protected his interest in the business. The deduction of these attorney's fees was allowed under Section 23 (a) (2) as being directed to the conservation and maintenance of property held by the taxpayer for income-producing purposes. Despite the confusing aspects of the court's approving mention of the *Baer* case in the instant case, the law seems settled at this time. The *Lykes* case points the way, and the lower court's decision in the instant case has won support in two recent cases.[23] The rule evolved is not wholly satisfactory, however. One rather anomalous result is that it is less expensive to seek alimony than it is to contest it. The result of the instant case, while admittedly within the *Lykes* rule, appears unduly harsh with respect to the husband. If a change is to be made, and apparently it should be, the matter is one for Congress. Section 23 (a) (2) might be amended so as to make legal expenses incurred in contesting a wife's claim for alimony specifically deductible, or Section 24 (a) (1) might be amended so as to specifically exclude such expenses from the nondeductible personal category. The first suggestion is the more logical, since it is difficult to percieve how an expense incurred in connection with a separation or divorce can properly be treated as a purely personal, living, or family expense.[24]

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[23]Tressler v. Commissioner, P-H 1953 TC MEM. DEC. ¶53,111 (1953); Donnelly v. Commissioner, 16 T.C. 1196 (1951).

[24]*See* Harris v. Commissioner, 340 U.S. 106, 112 (1950).