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## TAXATION-FEDERAL INCOME TAX-DEDUCTIBILITY OF LEGAL FEES INCURRED IN CONTESTING GIFT TAX DEFICIENCY

Richard B. Barnett S.Ed.  
*University of Michigan Law School*

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TAXATION—FEDERAL INCOME TAX—DEDUCTIBILITY OF LEGAL FEES INCURRED IN CONTESTING GIFT TAX DEFICIENCY—Petitioner gave shares of stock in a closely held family corporation to his wife and children. After paying the federal gift tax, he was notified by the Commissioner of a deficiency of \$145,276. The case was eventually settled by payment of \$15,612. In this controversy petitioner incurred legal expenses which he sought to deduct on his income tax return under section 23(a)(2) of the Internal Revenue Code. When his claim was disallowed by the Commissioner, this suit was brought for refund. *Held*, on certiorari, this expenditure was not “for the production or collection of income” nor incurred in the “management, conservation or maintenance of property held for the production of income,” and hence was not deductible. *Lykes v. United States*, (U.S. 1952) 72 S.Ct. 585.

The Internal Revenue Code provides no specific authorization for deduction of legal expenses; therefore, to be deductible such expenses must be brought within some more general provision of section 23. In this case petitioner claimed deduction was authorized under section 23(a)(2),<sup>1</sup> the “nontrade or nonbusiness” deduction clause. Prior to 1942 as a result both of statutory inadequacy and a narrow construction of section 23(a)(1)<sup>2</sup> by the courts,<sup>3</sup> those engaged in activities which could not be classified as “trade or business” were not permitted to deduct expenses incurred in production of taxable income. Section 23(a)(2) was passed<sup>4</sup> to remedy this defect.<sup>5</sup> The principal case is the third

<sup>1</sup> Section 23(a)(2) provides for deduction from gross income of “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.” 56 Stat. L. 819 (1942), 26 U.S.C. (1946) §23(a)(2).

<sup>2</sup> Section 23(a)(1) provides for the deduction of “All the ordinary expenses paid or incurred during the taxable year in carrying on any trade or business.” 26 U.S.C. (1942) §23(a)(1).

<sup>3</sup> See *Higgins v. Commissioner*, 312 U.S. 212, 61 S.Ct. 475 (1941) (expenses incurred by an individual taxpayer in looking after his income-producing securities held not expenses incurred in trade or business); *City Bank v. Helvering*, 313 U.S. 121, 61 S.Ct. 89 (1941) (testamentary trustee held not engaged in trade or business when managing investments); *Pyne v. United States*, 313 U.S. 127, 61 S.Ct. 893 (1941) (similar activity by an executor held not a business).

<sup>4</sup> Revenue Act of 1942, §121, 56 Stat. L. 798 at 819; I.R.C., §23(a)(2).

<sup>5</sup> “The bill corrects this inequity by allowing all of the ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation or maintenance of property held for the production of income. Thus, whether

Supreme Court decision interpreting the scope of deductions permitted under this section.<sup>6</sup> *Bingham's Trust v. Commissioner*<sup>7</sup> gave the section a broad construction, holding that income tax litigation expenses paid by a trustee and expenses incident to a distribution of trust assets at the termination of a trust were deductible as expenses incurred as a proximate result of the management of property held for the production of income.<sup>8</sup> Two later circuit court decisions<sup>9</sup> allowed deductions for income tax expenses simply on the authority of this case without demanding any substantial showing that these expenses were a "proximate result" of management of income producing property. The result was an amendment of the Regulations permitting a deduction of all expenses incurred by a taxpayer in the determination of income tax liability.<sup>10</sup> In the principal case the district court felt that an extension of the principle of the *Bingham* case to cover expenses incurred in gift tax litigation was justified, commenting that it would be extremely unfair if the Commissioner had the power to levy an excessive deficiency assessment and then force the taxpayer to defend it at his own personal expense.<sup>11</sup> Petitioner's principal argument was that he would have to sell income producing properties to meet the deficiency judgment should he be forced to pay it; therefore, expenses incurred in resisting the deficiency were expenses incurred in the "conservation" of income producing property. This argument had already been rejected in *Cobb v. Commissioner*,<sup>12</sup> but the district court chose not to follow this decision. The Supreme Court accepted the reasoning of the *Cobb* case<sup>13</sup> and pointed out that should petitioner's argument be accepted it would mean that expenses incurred in defending a negligence action would be deductible if there were a possibility that the

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 allowable." H. Rep. No. 2333, 77th Cong., 2d sess., p. 46 (1942).

<sup>6</sup> The other two were *McDonald v. Commissioner*, 323 U.S. 57, 65 S.Ct. 96 (1944) (campaign expenses incurred by a judge in seeking re-election held not deductible); *Bingham's Trust v. Commissioner*, 325 U.S. 365, 65 S.Ct. 1232 (1945), discussed *infra*. See also Brodsky and McKibbin, "Deduction of Non-Trade or Non-Business Expenses," 2 TAX L. REV. 39; Nahstoll, "Non-Trade and Non-Business Expense Deductions: Section 23(a)(2) of the Internal Revenue Code," 46 MICH. L. REV. 1015 (1948).

<sup>7</sup> *Bingham's Trust v. Commissioner*, *supra* note 6.

<sup>8</sup> "The requirement of Sec. 23(a)(2) that deductible expenses must be 'ordinary and necessary' implies they must be reasonable in amount and must bear a reasonable and proximate relation to the management of property held for the production of income." *Bingham's Trust v. Commissioner*, 325 U.S. 365 at 370.

<sup>9</sup> *Williams v. McGowan*, (2d Cir. 1945) 152 F. (2d) 570; *Stoddard v. Commissioner*, (2d Cir. 1945) 152 F. (2d) 445, overruling the court's earlier decision in *Stoddard v. Commissioner*, (2d Cir. 1944) 141 F. (2d) 76.

<sup>10</sup> T.D. 5513, 1946-11, INT. REV. BUL., p. 3, amending Treas. Reg. 111, §29.23(a)15.

<sup>11</sup> *Lykes v. United States*, (D.C. Fla. 1949) 84 F. Supp. 537. The court also felt it strange that under Treasury regulations a taxpayer could not deduct expenses in determining gift tax liability, but could deduct legal fees incurred in determining that gift tax expenses were not deductible.

<sup>12</sup> (6th Cir. 1949) 173 F. (2d) 711, cert. den. 338 U.S. 832, 70 S.Ct. 79 (1949).

<sup>13</sup> Principal case at 589.

taxpayer would have to dispose of income producing property to meet the judgment. The court seems correct in ruling that section 23(a)(2) was not intended to produce such a result. In the *Bingham* case, contesting the income tax deficiency was an integral part of the management of the property held for the production of income. In the principal case the expenses involved were attributable to the making of a gift and, in the words of the circuit court, the effect "upon . . . income producing property was at best indirect, remote and hypothetical."<sup>14</sup> The distinction seems to lie in the closeness of the relationship between the expense involved and the management of the income producing property. The result reached by the court seems to be in harmony with the purpose of the statutory provision and serves as an aid in marking the limits of the applicability of the *Bingham* decision.

*Richard B. Barnett, S. Ed.*

<sup>14</sup> *Lykes v. United States*, (5th Cir. 1951) 188 F. (2d) 964 at 967.