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THE DEDUCTIBILITY OF LEGAL EXPENSES IN COMPUTING INCOME TAX

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Doubtless few laymen, when paying a lawyer's bill, unless it is around the 15th of March, consider whether the payment is deductible on their income tax. However, whether it is or is not deductible may make a great deal of difference in the cost to them of the legal services. For example, if a lawyer charges a fee of $1,000 and the client is in a 50% income tax bracket, if the amount of the fee is deductible, the actual cost to the client is $500 — in effect the Federal Government pays the other $500. This matter is important to clients and to lawyers alike and it should be considered by the lawyer in arriving at the amount of the fee. Moreover, as is usually the case, if the fee covers both deductible and non-deductible items, it should be allocated since if there is no allocation, in such a case, the entire amount will probably be disallowed.[1]

Prior to the 1942 Amendments, Section 23 (a) (1) of the Internal Revenue Code provided that only expenses which were "ordinary and necessary" in carrying on a "trade or business" could be deducted from gross income. Under this section it was held that a lawyer's fee, unless in a business transaction, was not deductible from taxable income. Naturally, all of a taxpayer's income, regardless of whether it came from a "trade or business", had to be reported, but the *expenses* of producing that income were never deductible unless they were "ordinary and necessary" and were incurred in "carrying on a trade or business". Disregarding, for the moment, the question of whether a particular fee was "ordinary and necessary", was it incurred in a "trade or business"? If so, it was deductible — if not, it was not deductible.

Although the Code specifically provided in Section 24 that a personal or capital expense was not deductible from ordinary income, under the decisions of the Court as well as the Commissioner of Internal Revenue it made no difference whether the expense was

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1. Jordan v. Commissioner, 12 BTA 423; Hoefle v. Commissioner, BTA memo. op., Dec. 11,277-A; Evans-Winter-Hebb, Inc. v. Commissioner, BTA memo. op., Dec. 12,592-H; Smith v. Commissioner, 6 TCM 548.

personal or was not incurred in a "trade or business" — it was not deductible in either case.[2]

In 1942 the manifest injustice of requiring a tax to be paid on all income, but allowing the deduction of expenses only if they were "directly connected with or proximately resulted from the conduct of a business" was brought forceably to the attention of Congress as a result of the Supreme Court's decision in the case of *Higgins v. Commissioner*.[3] There the taxpayer had investments of about twenty-five million dollars, separate and apart from his "trade or business". While the gross income from this large investment was taxable, the Court held that the expenses of collecting the income and managing the property were not deductible as they were not incurred in a "trade or business".

Promptly after this decision Congress amended Sec. 23 of the Code to permit the deduction of "ordinary and necessary" expenses incurred not only in business but also in the production of taxable income or in the management, conservation or maintenance of property held for the production of taxable income. The amendment is Sec. 23 (a) (2) of the Code and reads as follows:

> 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.

This amendment opened the door to the deduction of lawyer's fees which were not incurred in "trade or business" but which were necessary for the production of taxable income or the management of property held for investment. Moreover, the amendment was followed in 1944 by the decision of the Supreme Court in the case of *Commissioner v. Higgins*,[4] which greatly enlarged the previous interpretations of what is an "ordinary and necessary" business expense, and in 1945 by the case of *Bingham Trustees v. Commissioner*,[5] which held that what constitutes an "ordinary and necessary" expense was the same, under the Amendment, for non-business as it was under the old law for a business. The Court said:

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2. In McDonald v. Commissioner, 323 U. S. 57, 65 Sup. Ct. 96, 89 L. Ed. 68 (1944), it was held that campaign expenses of a candidate for public office were not "ordinary and necessary", and therefore were not deductible. The Court said that it was unnecessary for it to consider whether or not the expenses were personal.

3. 312 U. S. 212, 61 Sup. Ct. 475, 85 L. Ed. 783 (1941).

4. 320 U. S. 467, 64 Sup. Ct. 249, 88 L. Ed. 171 (1944).

5. 325 U. S. 365, 65 Sup. Ct. 1232, 89 L. Ed. 1670 (1945).

> Section 23 (a) (2) is comparable and in *pari materia* with Sec. 23 (a) (1), authorizing the deduction of business or trade expenses. Such expenses need not relate directly to the production of income for the business. It is enough that the expense, if "ordinary and necessary", is directly connected with or proximately results from the conduct of the business. *Kornhauser v. United States, supra,* 152-153; *Commissioner v. Heininger, supra,* 470-471. The effect of Sec. 23 (a) (2) was to provide for a class of non-business deductions allowed by Sec. 23 (a) (1), except for the fact that, since they were not incurred in connection with a business, the section made it necessary that they be incurred for the production of income or in the management or conservation of property held for the production of income.

These cases will be discussed in some detail later in this article, but it should be noted here, that under the *Bingham* decision the phrase "ordinary and necessary" will be given the same interpretation in a non-business expense as it will in a business expense.

There is, therefore, no longer the taxation of *gross income,* when that income was not incurred in a trade or business. Whether the expense was incurred in a business transaction or not, if it was incurred in connection with the production of taxable income or in the management, etc. of income producing property, it is deductible *unless* it was (1) not ordinary and necessary, (2) personal, (3) capital or (4) violates a public policy.

These possible grounds for denial of the deduction will be separately discussed.

1. *Ordinary and Necessary:*

What is meant by the phrase "ordinary and necessary"?

The courts have always, in determining what is "ordinary and necessary", applied the test of what is normal or usual. However, do they mean normal or usual under the circumstances then prevailing, or do they mean that the events causing those circumstances to arise must be normal or usual? For example, as applied to a legal fee, do they mean that it must be normal or usual to employ an attorney when the taxpayer is arrested, or do they mean that the reasons why the taxpayer is arrested must be normal or usual? Here there is no such uniformity. One of the earliest and perhaps the leading case on the question of when a legal fee is "ordinary and necessary" is *Kornhauser v. United States.*[6] There the tax-

6. 276 U. S. 145, 48 Sup. Ct. 219, 72 L. Ed. 505 (1928).

payer had incurred expenses for legal fees in successfully defending a suit against him for an accounting by his former partner. The petitioner in that accounting suit alleged that the taxpayer had collected fees when the partnership was in existence which he had not turned over to it. The Commissioner refused to allow the taxpayer to deduct from his gross income the expenses he had incurred in defending the suit on the ground that such expenses were not "ordinary and necessary", and were personal. Mr. Kornhauser paid the additional tax assessed against him and brought suit for a refund. The Court of claims upheld the Commissioner in denying the claim, but the Supreme Court reversed and held that the expense was "ordinary and necessary" in the operation of the taxpayer's business and was a proper deduction. The Court said:

> And it was an "ordinary and necessary" expense, since a suit ordinarily and, as a general thing at least, necessarily requires the employment of counsel and payment of his charges. The petition is not as definite as it might have been, but from its allegations, interpreted as the Solicitor General concedes they may be, it appears that the accounting suit presented the question whether the compensation in respect of which the co-partner sought an accounting was for professional services performed by petitioner during the existence of the partnership or after its termination, the defense to that suit being based upon the latter alternative. In either view, the compensation constituted business earnings.

The *Kornhauser* decision, while widely quoted, was confined to its facts, and soon came to be of no value as a precedent, except in an accounting case. The Court said, as has been noted, that ". . . a suit ordinarily and, as a general thing at least, necessarily requires the employment of counsel . . ." But this language was evidently soon forgotten and in both the Bureau and the Courts the matter was considered from the viewpoint of whether the events leading up to the suit were "ordinary and necessary". In other words, the question became one of whether the events requiring the employment of an attorney were "ordinary and necessary", rather than whether it was "ordinary and necessary" to employ an attorney under the circumstances prevailing. As a matter of fact, the legal expenses of defense were even lumped with penalties and fines.

The point of view which developed is well illustrated by the cases of *Burrough Building Material Co. v. Commissioner*[7] and *National*

7. 47 F. 2d 178 (C. C. A. 2, 1931).

Outdoor Advertising Bureau, Inc. v. Helvering.[8] In the *National Outdoor Advertising Bureau, Inc.* case the taxpayer had been named a defendant in a civil suit by the Department of Justice for violation of the Federal Anti-Trust Laws. The suit was terminated by the entry of a consent decree under which the taxpayer was enjoined from committing certain of the unlawful acts charged, but which did not prohibit certain others. (A later finding by The Board of Tax Appeals was that two-fifths of the alleged unlawful acts were prohibited and three-fifths not.) The Court refused to permit the taxpayer to deduct that portion of the legal expenses allocable to the unlawful acts. It said:

> If it is never necessary to violate the law in managing a business, it cannot be necessary to resist a decree in equity forbidding violations, except in cases where an injunction is unjustified.

In the *Burrough's* case, the taxpayer, a New York Corporation, pleaded guilty in a criminal case to a violation of the New York Anti-Trust Statute and was fined a substantial amount. It claimed that the fines as well as its legal fees and costs were deductible. The Court, denying the deduction, lumped the legal fee with the fines, saying:

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8. 89 F. 2d 878 (C. C. A. 2, 1937); see also General Outdoor Advertising Co. v. Helvering, 89 F. 2d 882 (C. C. A. 2, 1937). The taxpayer was charged with illegal price fixing in violation of the Sherman Anti-Trust Act and the Clayton Act. At the trial the taxpayer was acquitted on three charges and found guilty on two charges. It was allowed to deduct three-fifths of its legal expenses. In *Commissioner v. Continental Screen Co.*, 58 F. 2d 625 (C. C. A. 6, 1932) the taxpayer incurred substantial legal expenses in connection with a proceeding brought against it by the Federal Trade Commission on the ground that it was operating in violation of the Sherman Anti-Trust Act. After a hearing, the complaint was dismissed, and the expenses were allowed as a deduction from income. The Court considered that the circumstances required the employment of attorneys, saying:

> In the absence of a statement of all the evidence submitted to the Board we must accept its findings as conclusive (*Commr. v. Continental Screen Co.*, 53 F. 2d 210, C. C. A. 6; *Cogar v. Commr.*, 44 F. 2d 554, 556 (2 U. S. T. C. § 605), C. C. A. 6; *Evergreen Cemetery Ass'n v. Burnet*, 45 F. 2d 667 (2 U. S. T. C. § 620), C of A., D. C.) and when the applicable test (*Kornhauser v. U. S.*, 276 U. S. 145, 152, 153) (1 U. S. T. C. § 284) is applied thereto we have no doubt as to the correctness of the Board's decision. The proceeding before the Trade Commission was undoubtedly an "action" against respondent which was "directly connected with" or which "proximately resulted" from its business. To respondent's board of directors the situation was ominous. The life of the business was endangered. Under such circumstances respondent followed the very natural and ordinary procedure suggested by the vital necessity of the situation. It employed counsel to protect its interest and agreed to pay for their services. Any other course upon the part of its board of directors would have been unusual and would, no doubt, have subjected them to well founded criticism by its stockholders.

> If the fines and costs cannot be deducted, the legal expenses incurred in litigating the question whether the taxpayer violated the law and whether fines should be imposed should naturally fall with the fines themselves.

This refusal to distinguish between legal expenses and penalties is repudiated by the Supreme Court in the *Heininger* case. But in justifying the Court's attitude prior to the *Heininger* decision, Judge Learned Hand has recently said:

> Indeed, to hold otherwise would be to subsidize the obduracy of those offenders who were unwilling to pay without a contest and who therefore added impenitence to their offence; and for this reason in the decisions just cited we held that such legal expenses were never deductible.[9]

This "justification" presupposes that a defendant is guilty, and does not give him, taxwise, the right to defend himself. It is this view which led to the holding that an expense cannot be "ordinary and necessary" unless the events leading up to the employment of the lawyer were usual and normal.

In *Welch v. Helvering*[10] the Supreme Court temporarily came back to the view it had expressed in the *Kornhauser* case. There the Court held that debt repayments by the taxpayer, of debts of a corporation formerly owned by him, made to help reestablish his credit with certain customers, were not "ordinary and necessary" and therefore were not deductible. But the discussion of what is "ordinary and necessary" was authoritative and the Tax Court and lower federal courts since then have always cited this case for any discussion of the question. The Court said that the phrase must be interpreted "according to the ways of conduct and the forms of speech prevailing in the business world". In reaching the conclusion that the payments in that case were not ordinary and necessary the Court said:

> Men do at times pay the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amenities, but they do not do so ordinarily, not even though the result might be to heighten their reputation for generosity and opulence. Indeed, if language is to be read in its natural and common meaning, [citing cases] we should have to say that payment in such circumstances, instead

9. Jerry Rossman Corporation v. Commissioner, 175 F. 2d 711 (C. C. A. 2, July 1949).
10. 290 U. S. 111, 54 Sup. Ct. 8, 78 L. Ed. 212 (1933).

> of being ordinary is in a high degree extraordinary. There is nothing ordinary in the stimulus evoking it, and none in the response.

Here the Court was talking about the circumstances of the *payments* (which were claimed as a deduction), and when it said that it was not usual for one to pay the debts of another, it did not consider or discuss the circumstances giving rise to the debts of the corporation which were paid by the taxpayer. No one can quarrel with this conclusion. It is *not* usual, and therefore not ordinary and necessary, for one to pay the debts of another.

But a few years later in the case of *Deputy v. duPont*[11] the Court held that regardless of whether the expense claimed as a deduction is usual, the circumstances giving rise to the expense must be ordinary and necessary. There the taxpayer, Pierre S. duPont, borrowed shares of stock of the duPont Company in order to sell them to junior executives of the company, pursuant to agreements between the taxpayer and the junior executives. (The Company apparently could not lawfully sell its stock to the executives.) By borrowing the shares he incurred heavy expenses (principally in making up to the owner the dividends which had been paid on the stock during the period of the loan) which he claimed as a deductible expense. The Court did not consider whether it was usual for the borrower of stock to make up to the owner the dividends paid on that stock during the loan. Nor did the Court consider whether it was usual for large stockholders of a company to borrow additional stock to sell to junior executives. It said that it was not "ordinary and necessary" for a stockholder even though a large one, to lend his aid to the financing of stock purchases by employees of the corporation. The Court said:

> The record does not show . . . that a stockholder engaged in conserving and enhancing his estate ordinarily makes short sales or similarly assists his corporation in financing stock purchase plans for the benefit of its executives.

This case reflects the reasoning found in the *National Outdoor Advertising Bureau, Inc. v. Helvering* case, supra, and requires that the initial cause of the expense (here, the stock purchase agreements with the junior executives) be "ordinary and necessary", rather than the expense under the circumstances prevailing (expense of borrowing stock to meet the agreements). Logically, if financing stock purchase agreements with junior executives could have been

11. 308 U. S. 488, 60 Sup. Ct. 363, 84 L. Ed. 416 (1940).

regarded as a proper business activity of the taxpayer the deduction should have been allowed. It would seem "normal" for the borrower of stock to make up to the lender what dividends he has missed as a result of the loan.

In 1944, however, the Supreme Court in the *Heininger* case, *supra,* met this question head-on and held directly that the usualness or normalcy of the circumstances giving rise to the expense was unimportant, so long as the expense was "ordinary and necessary" *under the circumstances then prevailing.* There the Postmaster General, after an investigation, issued an order to Mr. Heininger to show cause why he should not be deprived of the use of the mails in the conduct of his business. Mr. Heininger was engaged in the mail order sale of dental plates, but it was claimed that his advertising was fraudulent and that he was using the mails for the purpose of defrauding the public. After a series of battles before the Postmaster and in the courts, Mr. Heininger was enjoined from the use of the mails in connection with the conduct of his business. Mr. Heininger had incurred very substantial legal expenses in this prolonged litigation and deducted these expenses from income in filing his tax return. The Commissioner, upheld by the Tax Court and the Circuit Court, refused to permit these deductions, saying that it was not "ordinary and necessary" for the taxpayer to conduct his business in such an illegal manner and also saying that the deductions would clearly be against public policy. The Supreme Court, however, decided otherwise. The Court said that when a taxpayer's business was threatened with destruction, it was "ordinary and necessary" for him to hire a lawyer and pay legal fees. But as later proceedings showed, the taxpayer had been conducting a lawful business in an unlawful manner. Of course it was not ordinary and necessary for the taxpayer to conduct his business in an unlawful manner, but it was ordinary and necessary for him to incur legal expenses to defend his business from attack because of the manner in which it had been conducted. The *Heininger* opinion made it abundantly clear that what must be "ordinary and necessary" was the necessity for the employment of counsel under the circumstances prevailing. It was argued by the Bureau and held by the Tax Court that it was not ordinary and necessary for the taxpayer to use fraudulent advertising for the sale of his products through the mail. The Supreme Court however, refused to accept this argument and said that it was ordinary and necessary, i. e., normal, for a taxpayer to defend himself and his business from a charge of fraudulent practices.

Despite this clear statement by the Supreme Court in the *Heininger* case, two recent decisions by the Courts of Appeal, of the Seventh and the Second Circuits, have fallen back into the "fallacy" of the government's argument in the *Heininger* case. In *Commissioner v. Heide,*[12] and *Commissioner v. Josephs,*[13] the Courts refused to allow trustees to deduct their legal expenses in defending themselves from charges of breach of trust. The stated reason, in each case, for disallowing the deduction was that it was not "ordinary and necessary" for a trustee to commit a breach of trust.

The decisions of the Circuit Courts in those cases can only be explained by the fact that the trustees had already repaid to the principal of the trusts the amounts which it was claimed the trustees had lost by the breaches of their fiduciary duties. The theory of the Court in the *Heininger* case — that the taxpayer was not bound to assume guilt until he was proved guilty — conceivably would not apply in that situation, since a repayment by trustees would indicate that the trustees assumed they had been at fault. The extent to which the Tax Court regarded the admonition of the Supreme Court in the *Heininger* case is illustrated by the fact that the Tax Court, in the *Heide* and *Josephs* cases, regarded the *Heininger* case as authority for it to allow deductions for the amounts repaid to the trusts by the trustees, in addition to their legal expenses.

The Tax Court has properly, under the *Heininger* decision, considered the test of what is "ordinary and necessary" to be what is normal and usual *under the circumstances.* Since an "ordinary and necessary" expense is now deductible, regardless of whether it is in a taxpayer's "trade or business", the legal expense resulting from income tax disputes or litigation, or even advice, is uniformly allowed as a proper deduction on the ground that the expense always concerns taxable income.[14] Certainly it would not be accepted

12. 165 F. 2d 699 (C. C. A. 2, 1948).
13. 168 F. 2d 233 (C. C. A. 8, 1948).
14. In Commack v. Commissioner, 5 T. C. 467, the taxpayer incurred legal expenses in claiming a refund of income taxes by reason of charging off a loss of stock originally acquired for income but valueless for that purpose at the time of the income tax dispute. It was held that the stock was originally acquired for income production purposes and that the tax expenses were deductible. In similar circumstances it was held that where the taxpayer was unsuccessful in obtaining the tax refund, the expense was nevertheless deductible. Connelly v. Commissioner, 6 T. C. 744. Wherever the taxpayer is or would be responsible for the tax deficiency he may deduct the legal expense on contesting the liability. Haden Co. v. Commissioner, 165 F. 2d 588 (C. C. A. 5, 1948); National Association of Schools and Publishers, Inc. v. Commissioner, 7 T. C. M. 655. *See* Greene Motor Co., 5 T. C. 314 holding that lawyers and accountants' fees in connection with the settlement of claimed tax deficiencies and penalties were deductible as "ordinary and necessary" business expenses.

that it is usual and customary for a taxpayer to understate his income or overstate his deductions. The Tax Court has recently held that the expenses of income tax litigation are deductible despite the presence of facts justifying a criminal fraud action.[15]

The Tax Court has also held since the *Heininger* case that legal fees spent in defending a company from charges of violating the state anti-trust laws, are ordinary and necessary expenses.[16] Although on appeal the Fifth Circuit Court of Appeals held that fines (as distinct from the legal expenses incurred in defense of the suit) imposed against the taxpayer for violating the state anti-trust laws could not be deducted.[17] The Tax Court rejected, on the basis of the *Heininger* decision, the Bureau argument that it was not normal or usual for the taxpayer so to conduct his business that the laws would be violated. Before the *Heininger* decision, the courts had sometimes said, in denying the deduction of legal expenses in the unsuccessful defense of a criminal action, that it would be against public policy to allow the deduction. But the Court said, in the *Heininger* case, that to deny a deduction on this ground it must appear that the deduction would "frustrate sharply defined policies".

The Tax Court has also held, recently, that it was "ordinary and necessary" for a lawyer to incur legal expenses in seeking to prevent conviction on a charge of obstructing justice,[18] although prior to the *Heininger* case it was held that the legal expenses of an unsuccessful defense in disbarment proceedings were not deductible.[19]

Today, where there is no question of public policy involved, the "ordinary and necessary" legal expenses of a taxpayer directly connected with or proximately resulting from (a) his trade or business, (b) the production of taxable income, or (c) the management, conservation or maintenance of property held for the production of income, are deductible from taxable income. Obviously no one is going to employ an attorney unless it is necessary for him to do so — either for legal advice, guidance or litigation. It would seem that this fact would make a legal expense always "ordinary and necessary", and therefore, always deductible, unless it is (a) personal, (b) capital, or (c) offends a "sharply defined public policy". And so it does — in most cases. In one instance, however, this

15. Charles Goodman, et al. v. Commissioner, 9 T. C. M. 789 (C. C. H. Dec. 17, 867, Sept. 12, 1950).
16. Longhorn Portland Cement Co. v. Commissioner, 3 T. C. 310.
17. Commissioner v. Longhorn Portland Cement Co., 184 F. 2d 276, *cert. denied* 326 U. S. 728.
18. Kaufman, Morgan S. v. Commissioner, 12 T. C. 1114 (1949).
19. Louis S. Levy v. Commissioner, 1 T. C. M. 226; Tinkoff v. Commissioner, 120 F. 2d 564 (C. C. A. 7, 1941).

rule is "easy to state but difficult to apply". That is to say, to distinguish between an expense which is capital (not deductible) and an expense of management, etc. of income producing property (deductible) is sometimes logically impossible. In attempting to make this distinction we meet a conflict between the statute which says that such expenses are deductible when they are "ordinary and necessary" and the decisions which say that such expenses when they involve title, etc. must be capitalized. The opinion of the Fourth Circuit Court of Appeals in *Bowers v. Lumpkin*[20] illustrates this conflict. The Courts have resolved this problem where it has arisen, by holding that if the expense is a capital one it cannot be "ordinary and necessary". This, in a manner of speaking, is putting the cart before the horse. "Ordinary and necessary" are adjectives not nouns. The word "capital" should be compared with the words "business", "non-business" and "personal". It is both illogical and ungrammatical to say that an expense is "capital" and therefore cannot be "ordinary and necessary".

In the chapters that follow, the three grounds — (a) personal, (b) capital and (c) public policy — for possible disallowance will be considered.

2. *Personal Expense:*

Legal expenses in connection with personal matters are specifically not deductible under Sec. 24 (a) of the Code. "Personal" is a word to be compared with "business" and "non-business". In its broad sense (which apparently is the sense in which it is used in the Code) "personal" would seem to mean all activities of a taxpayer which are not entered into for profit or for the production of income (taxable). Business and non-business activities seemingly mean only those activities which are designed to produce taxable income (whether they succeed or not).

Many times legal expenses are incurred in isolated transactions, which have nothing to do with the business or non-business activities of a taxpayer. And these expenses are almost uniformly disallowed on the ground that they are personal expenses. Thus, the cost of an action, or the defense of a suit to recover damages for breach of promise to marry are not deductible.[21] The Courts have held as personal expenses and not deductible: Legal expenses in obtaining or defending proceedings for a separation or a di-

20. 140 F. 2d 927 (C. C. A. 4, 1944) *cert. denied* 322 U. S. 755.
21. I. T. 1804, II-2 CUM. BULL. 61; I. T. 2422, VII-2 CUM. BULL. 186.

vorce;[22] (However, the ruling might be different today. See discussion which follows and footnote 30); legal fees for the preparation of a will;[23] obtaining release from military service;[24] prosecuting suit for slander,[25] Court costs and attorneys' fees paid in settlement of a judgment for personal injuries resulting from an automobile accident (unless the automobile is used for business or income producing purposes);[26] fees arising out of a will contest.[27]

Legal expenses incurred in connection with gift tax proceedings have been ruled deductible by a Florida District Court but have been held non-deductible by the Sixth Circuit Court of Appeals. In the Florida case *(Lykes v. United States)*[28] the taxpayer had made gifts of stock in a family owned corporation to various members of his family. The Commissioner greatly increased the value of the shares shown on the taxpayer's gift tax return and determined a deficiency gift tax due of $145,276.50. The taxpayer engaged an attorney who filed a petition for redetermination of the liability with the Tax Court. Before the trial the matter was settled on the basis of a deficiency of $15,612.75. The taxpayer then claimed, and the Commissioner denied, that the attorney's fees in this matter were deductible from his income under Code Sec. 23 (a) (2) as an ordinary and necessary expense incurred for the management, conservation or maintenance of property held for the production of income. The District Court held that the *Bingham* case, *supra,* was controlling and that the expense was incurred in the management, conservation or maintenance of property held for the production of income. The Court said that the assessment of an excessive tax on the property required, for its conservation, the employment of an attorney to contest such an excessive tax. Furthermore, said the Court, the Bureau regulation to the contrary is invalid:

> To construe the law as giving to the Commissioner the power to assess a taxpayer with a deficiency tax greatly in excess of what he owes and to hold that such law denies to the taxpayer the right to contest such assessment, except at his own personal expense, just isn't justice under law. The statute in question gives the Commissioner no such power and the courts should

22. Robins v. Commissioner, 8 B. T. A. 523; Sanderson v. Commissioner, 23 B. T. A. 304, *aff'd sub. nom.* Sanderson v. Burnet, 63 F. 2d 268 (C. A. of D. C.).
23. Pennell v. Commissioner, 4 B. T. A. 1039.
24. Seese v. Commissioner, 7 T. C. 925.
25. Lloyd v. Commissioner, 55 F. 2d 842 (C. C. A. 7, 1932).
26. Dickason v. Commissioner, 20 B. T. A. 496.
27. Spears v. Commissioner, 6 T. C. M. 303.
28. 84 F. Supp. 537 (D. C. Fla. 1949).

not permit the Commissioner to write such power into the law by a regulation adopted by him.

However, in *Cobb v. Commissioner*[29] on almost similar facts the Sixth Circuit Court of Appeals held that attorneys' fees in connection with gift taxes were not ordinary and necessary in the "management, conservation or maintenance of property held for the production of income". If the District Court is affirmed (and it is now pending on appeal to the Fifth Circuit Court of Appeals) there will probably be a ruling on this question by the Supreme Court of the United States.

Another question that will undoubtedly provoke litigation is the deductibility of lawyers' fees paid in seeking or in resisting alimony. Where the alimony will be taxable income to the wife, legal fees incurred in initially obtaining the alimony or in collecting or increasing it probably will be deductible — as should be fees incurred in resisting the claims. On the other hand, where the alimony income will not be taxable to the wife, because it will be paid up in less than ten years, is not pursuant to a decree or a written agreement, it applies to the period before 1942 (when alimony payments were made taxable to the wife, and allowed as a deduction to the husband) or is support for children in the custody of the wife, the legal expenses of both husband and wife should not be deductible.[30]

A safe rule to follow in considering whether the expenses of prosecuting or defending a non-business lawsuit relate to the production of income and are deductible, or are personal and not deductible, is to determine whether or not a recovery in the suit is (or would have been if the suit had been successful) included in taxable income. Of course recoveries in suits for breach of promise to marry, alienation of affection, non-business slander or libel, and the like, are not taxable income and for that reason, expenses of prosecuting such suits, whether or not they are successful, are personal and not deductible.[31] While the statute (Code Sec. 23 (a) (2)) authorizes the deduction of non-trade or non-business expenses incurred in "production of income" or the management of property held for the "production of income", the legislative history of this section in-

29. 173 F. 2d 711, *aff'g* 10 T. C. 380, *cert. denied* October 10, 1949.
30. I. T. 3856, 1947-1 C. B. 23.
31. (Breach of promise to marry) Lyde McDonald v. Commissioner, 9 B. T. A. 1340; G. C. M. 4363, VII-2 CUM. BULL. 185; I. T. 2422, VII-2 CUM. BULL. 186; I. T. 1804, II-2 CUM. BULL. 61; (Alienation of affection) Hawkins v. Commissioner, 6 B. T. A. 1023; Sol. Op. 132, I-1 CUM. BULL. 92; (Non-business slander or libel) Sol. Op. 132 I-1 CUM. BULL. 92, *Modf'g*, S. M. 957, 1 CUM. BULL. 65.

dicates, and the regulations of the Treasury Department require, that the income be taxable income. The Regulation says:

> Reg. 111, Sec. 29.23 (a)-15. *Nontrade or nonbusiness expenses.* (a) In general. — Subject to the qualifications and limitations in chapter 1 and particularly in section 24, an expense may be deducted under section 23 (a) (2) only upon the condition that:
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> (1) it has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income, which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income; and
>
> (2) it is an ordinary and necessary expense for either or both of the purposes stated in (1) above.

It would seem that the costs of defending such actions should be deductible under Sec. 23 (a) (2) since a judgment obtained against the defendant could be enforced against any property, including income producing property, and the expense was necessary to "conserve" such property. But in *Hexter v. Commissioner*,[32] the Tax Court repudiated such a view and held that such an expense was not deductible, despite the fact that income producing property might have to be sold to satisfy the judgment obtained.

Sec. 23 (a) (2), authorizing the deduction of non-trade or non-business expenses, applies, it will be noted, to expenses incurred in the management, etc. of property held for the production of income. Thus, it is immaterial that a non-trade or non-business legal expense does not relate to the production of taxable income so long as it relates to the management, conservation or maintenance of property which is held for the production of income. In the *Bingham* case it was contended by the Commissioner that the expenses were not deductible since they did not relate to the production of taxable income. The Court said that this fact was unimportant since the expenses did relate to the management (i. e. the devolution) of income producing property. There legal expenses were incurred by trustees in connection with the distribution of the trust corpus to the remaindermen. The Commissioner and the Tax Court denied the deduction on the ground that the expense was incurred in connection with the devolution of the trust property and not with the collection of taxable income. In reversing the Bureau and the Tax

32. 3 T. C. M. 1296.

Court, the Supreme Court said that the expenses were incurred in the *management* of income producing property, because the management of such property, under the terms of the trust, included the final distribution of the property upon expiration of the trust, and that this authorized the deduction. The Court said that Sec. 19.23 (a)-15 of Reg. 103, which authorized a deduction only when the expense was in connection with the actual production of taxable income, was in conflict with Code Sec. 23 (a) (2), because expenses incurred in management, conservation or maintenance of property *held* for production of income also comes within the orbit of deductible non-business deductions. (The Regulation has since been changed.)

Undoubtedly the Bureau had believed that all non-trade or non-business expenses incurred in the management, conservation or maintenance of property should be capitalized or amortized, rather than deducted from income. Probably this belief led the Treasury Department to provide in its Regulation, under Sec. 23 (a) (2) of the Code, for the deduction of non-trade or non-business expenses only when they were incurred in connection with the production of income. However, this view was properly repudiated by the Supreme Court in the *Bingham* case. While it is true that many expenses in the management, conservation or maintenance of property should probably be capitalized or amortized, there are also many expenses that are current which certainly should be deductible. The Regulation, prior to the Supreme Court's decision in the *Bingham* case, would deny the deduction of such expenses and it was proper for the decision, to that extent, to invalidate the Regulation.

3. *Capital charge rather than expense:*

Perhaps the most frequent ground for the denial of a deduction for legal expenses is that the charge is a capital one and should be added to the tax basis of the property, or should be amortized. Where the property is used in business or is held for investment, the addition in 1942 of Sec. 23 (a) (2) of the Code should make no difference in this regard. If an expense is a capital one, it should be added to the tax basis of the property involved, wholly apart from the question of whether the property is used in business, is held for investment, or is held for personal use. For example, if legal fees are incurred in the purchase of a residence, the expense would be "personal", but nevertheless, it would increase the tax basis of the

residence so that the gain upon subsequent disposition would be lower by the amount of the legal fee.[33]

The language of Sec. 23 (a) (2) of the Code authorizes the deduction of "ordinary and necessary" non-trade or non-business expenses incurred in the management, etc., of income producing property. The *Bingham* case says that the interpretation of the phrase "ordinary and necessary" for the purpose of determining deductibility in a "trade or business" must be similar to the interpretations of what is "ordinary and necessary" in "non-trade or non-business". Accordingly, in the consideration of what is an "ordinary and necessary" expense as distinguished from a capital charge, it is unimportant whether the case arises under the "trade and business" subdivision or the "non-trade and non-business" subdivision.

A most difficult question as to whether an expense is a capital one or is "ordinary and necessary" in the conduct of a business is where expenses are incurred in a lawsuit questioning the propriety of business transactions, which is settled before trial. A recent decision of the Tax Court on this question is the case of *Food Fair of Virginia, Inc. v. Commissioner*.[34] There, shortly after the incorporation of the taxpayer, another corporation commenced operating a retail grocery store, advertising and otherwise using the name "Food Fair". This was the taxpayer's corporate name so it sought to enjoin the use of this name by such other corporation. Finally the matter was settled. The taxpayer claimed that it was entitled to the deduction of its legal expenses in seeking the injunction and working out a settlement on the ground that the expense was incurred primarily for the purpose of bringing about a discontinuance of a practice by another corporation, which had resulted in loss of income to the taxpayer. The Tax Court rejected this argument and held that the expenditure was incurred for the purpose of defending or perfecting the taxpayer's right and title to the trade name "Food Fair".

33. Though if the property is sold for a loss, there could be no deduction since the loss will not be recognized. I. R. C., § 23 (e) and § 112. If, on the other hand, the property is used in business, the loss will be recognized as a deduction from ordinary income to the extent that it exceeds gains from other business property or capital assets. I. R. C., § 117 (j). However, if property is used for the production of income but not in the trade or business of the taxpayer, any loss from its disposition is deductible from gains from the disposition of other capital assets or business property, but beyond this, the loss is deductible to a limited extent only, in the case of individuals and not at all in the case of corporations. (In the case of individuals such a loss may be taken to the extent only of $1,000 per year, with a carry-over for five years. I. R. C., § 117 (d) and (e). But for corporations, any net loss from the disposition of a capital asset is not recognized in any event. I. R. C., § 117).

34. 14 T. C. .... No. 121 (June 6, 1950).

In *Levitt & Sons, Inc. v. Nunan*[35] the Second Circuit Court of Appeals held that even though a suit disputed the taxpayer's title to property, if the suit was settled *solely* to avoid unfavorable publicity or harmful effects upon credit and the like, the expense of settling, including attorneys' fees, were properly deductible as an "ordinary and necessary" business expense. If, however, there was any reasonable doubt as to the basis of settlement of such suit, the expense would have to be capitalized.[36] In the recent case of *Lomas and Nettleton Co. v. United States*[37] the Connecticut District Court held that the expenses of settlement of a suit charging business improprieties were deductible from income. There the settlement was made primarily to protect the corporation from adverse publicity and adverse credit reports, but the suit also questioned the taxpayer's title to certain mortgage notes resulting from an alleged breach of fiduciary duty. The Court citing the *Hochschild* case, *infra,* said that where the threat to the taxpayer's title "depended for its validity upon a claimed breach by the taxpayer of a fiduciary duty, the threat to title is incidental only . . ."

The distinction between capital charges and deductible expenses is sometimes finely drawn. This is aptly illustrated by the line of cases in which an accounting and possibly a receivership is requested by a former partner or business associate. In *Kornhauser v. United States,*[38] discussed earlier in this article, a former partner requested an accounting from the taxpayer, claiming that compensation received by the taxpayer after the dissolution of the partnership, was payment for services performed by the partnership. The Court held that the legal expenses of defending this proceeding was properly deductible as a business expense. The holding in this case has been uniformly followed by the Tax Court — most recently in *Siarto v. Commissioner,*[39] although the petition there said that the taxpayer's partnership interest was questioned. In both *Rassenfoss v. Commissioner*[40] and *Marsh v. Squire*[41] the expense of defending partnership accounting suits was allowed, although in both cases the suit, incidentally, questioned also the taxpayer's partnership interest. On the other hand, in *Addison v. Commissioner*[42] the Court indicated that where the basic legal question involved the title to property

35. 142 F. 2d 795 (C. C. A. 2, 1944)-44-1 U. S. T. C. 9333.
36. *Ibid* 160 F. 2d 209 (C. C. A. 2, 1947).
37. 79 F. Supp. 886 (48-2 U. S. T. C. 9362 (1948)).
38. 276 U. S. 145, 48 Sup. Ct. 219, 72 L. Ed. 505 (1 U. S. T. C. § 2841) (1928).
39. 6 T. C. M. 3, 1947.
40. 158 F. 2d 764 (C. C. A. 7, 1946) 47-1 U. S. T. C. § 9108.
41. *Unreported,* D. C. W. D. Wash., 1947, (48-1 U. S. T. C. § 9142).
42. 7 T. C. M. 644.

the expense must be capitalized, even though it incidentally raised an accounting question for proceeds which would have been a deductible expense. In *Hochschild v. Commissioner*[43] legal expenses of a director of a corporation in defending himself from charges of mismanagement were allowed for deduction although Judge Frank dissented on the ground that the suit involved taxpayer's ownership to stock and therefore that his expenses should be capitalized. In *Potter v. Commissioner*[44] it was held that the legal expenses incurred by the president and manager of a hotel corporation were deductible where the action not only involved the corporation's property but sought to oust the taxpayer from control and management. In *Falls v. Commissioner,*[45] it was held by the Tax Court that the expenses of a suit brought against the taxpayer and others for conspiring to infringe certain patents and for an accounting were properly allocated between the capital expenses and the accounting for profits.

In *Sanderson v. Burnet, supra,* the legal fee, disallowed in its entirety, included an amount for advice respecting the apportionment of property between husband and wife. To that extent it was a capital item and, though not deductible, should have increased the tax basis of the property. In *Georgia, Florida & Alabama Railroad Co. v. Commissioner,*[46] it was held that the legal fees for an incorporation should be capitalized. Similarly as to fees to protect the taxpayer's interest in his property;[47] legal expenses incurred in successfully defending the legality of taxpayer's business;[48] legal expenses for recovering ownership of stock alleged to have been taken by duress;[49] legal fees for defending the title of the taxpayer to oil properties;[50] expenses in condemnation proceedings.[51] If, however, the taxpayer is in the real estate business, expenses in connection with condemnation may be a deductible business expense;[52] legal expenses incurred in contesting the building line of real property constitutes a capital charge;[53] attorney's fees paid to procure control of corporate stock for the continuance of corporate manage-

43. 161 F. 2d 817 (C. C. A. 2, 1947).
44. 20 B. T. A. 252.
45. 7 T. C. 66.
46. 31 B. T. A. 1.
47. Vernor v. U. S., 87 Ct. Cls. 435, 23 F. Supp.
48. Crane Merchandise Corp. B. T. A. memo. op., Dec. 12006-B.
49. Kane, et al. v. Commissioner, 6 T. C. M. 222.
50. North American Oil Consolidated Co. v. Commissioner, 12 B. T. A. 68, *rev'd on other grounds,* 50 F. 2d 752 (C. C. A. 9, 1931), *aff'd* 286 U. S. 417.
51. Johnson & Co. v. U. S. 149 F. 2d 851; Petit v. Commissioner, 8 T. C. 228; Washington Market Co. v. Commissioner, 25 B. T. A. 576.
52. Reakirt v. Commissioner, 29 B. T. A. 1296.
53. I. T. 1382, I-2 CUM. BULL. 146.

ment are capital expenditures;[54] attorney's fees to procure clear title to real estate or other property,[55] and this is true even though the title objections are made by or through the United States Government.[56] Where the expenses are incurred in contesting a will so as to obtain title to and possession of property, the expenses must be capitalized.[57] But where the expense is incurred by a committee representing an incompetent in seeking judicial instructions as to whether or not to contest the will, and the instructions are not to contest, the expenses are deductible from income. The Court indicated that if the instructions had been otherwise and property had been obtained from the estate, the expense of the contest might have been non-deductible as a capital charge.[58] The legal expenses of a former owner in defense of a suit alleging fraud in the sale of property are capital expenditures, deductible from the amount received as payment for the property.[59] Litigation expense concerning the ownership of a trade name must be capitalized;[60] expense of foreclosing liens;[61] obtaining correction deeds;[62] cost of clearing title to stock.[63] Where a life tenant incurs expenses to be capitalized, such expenses may be amortized over the life expectancy of the life tenant.[64] Attorney's fees in creating an *inter vivos* trust must be added to the basis of the trust property and are not deductible from income.[65]

The Tax Court has consistently refused to allow deductions in connection with incompetency proceedings.[66] Although the New York District Court allowed an incompetent's committee to deduct

54. Lammle v. Eisner, 275 F. 504; Williamson v. Commissioner, 17 B. T. A. 1112; Crowley v. Commissioner, 89 F. 2d 715 (C. C. A. 6, 1937).
55. Brawner v. Burnet, (C. A. D. C.) 63 F. 2d 129; Hewes, 2 B. T. A. 1279, Dec. 958; Tompson, Seletha, O., 9 B. T. A. 1342, Dec. 3393 (Acq.); Phoenix Development Co., 13 B. T. A. 414, Dec. 4338; Rentie, 21 B. T. A. 1230, Dec. 6631; Elliott Co., 45 B. T. A. 82, Dec. 12, 075; Cohen & Sons Co., 42 B. T. A. 1137, Dec. 11, 370 (Acq.); Porter Royalty Poll. Inc. v. Commissioner, (C. C. A. 6) 165 F. 2d 933. *Cert. denied,* 334 U. S. 833; A. R. R. 284, 3 C-208; Palmer v. Commissioner, 3 B. T. A. 403.
56. S. M. 2423, III-2 CUM. BULL. 157; Owens v. Commissioner, 125 F. 2d 210 (C. C. A. 10, 1942, *cert. denied* 316 U. S. 704; Consolidated Mutual Oil Co., 2 B. T. A. 1067; North American Oil Consolidated Co., 12 B. T. A. 68.
57. I. T. 1689, II-1 CUM. BULL. 122.
58. Kohnstamm v. Pedrick, 66 F. Supp. 410 (D. C. S. D. N. Y., 1946).
59. Murphy Oil Co. v. Burnet, 55 F. 2d 17 (C. C. A. 9, 1932).
60. L. J. Skaggs, et al. v. Commissioner, B. T. A. memo. op., Dec. 12, 517-H.
61. Shaw Hayden Building Co., 18 B. T. A. 949.
62. Sunburst Oil & Refining Co., 23 B. T. A. 829.
63. Ernest Smith v. Commissioner, 5 T. C. M. 7; Kane v. Commissioner, 6 T. C. M. 222.
64. Schick v. Commissioner, 22 B. T. A. 1067.
65. Matthiessen v. Commissioner, B. T. A. memo. op., Dec. 8279-E.
66. Rentie v. Commissioner, 21 B. T. A. 1230; Hinkle v. Commissioner, 47 B. T. A. 670; McHenry v. Commissioner, 6 T. C. M. 1027.

the legal expenses of obtaining instructions from the New York Supreme Court on behalf of the incompetent not to elect to take against the will of the incompetent's spouse.[67] But, as pointed out above, the Court indicated that if the instructions had been to take against the will, the costs of contesting might have been capital charges.

> Had the committee been authorized by the Supreme Court to make the election, and had the exercise of that right resulted in expenses for the vindication of the right, then, perhaps, they would fall into the latter category. Here, however, the committee was not yet asserting any right to property. It was performing its duty to seek judicial instruction preliminary to the assertion of such right.

Where the suit to acquire property is unsuccessful, there is no property to which the expenses of the suit might be added, consequently the legal fees will be regarded as a personal expense. In *McClees v. Commissioner,*[68] it appeared that property was left to a named "granddaughter". In an attempt to void the bequest, in the Probate Court, the taxpayer proved that the legatee was not the "granddaughter" of the testator, but the Probate Court held, nevertheless, that the bequest should stand, since it was based on love and affection. Thus, the taxpayer established his point but received nothing from so doing, and his expenses were deemed to be personal, although they could have been capitalized if there had been any recovery.

In determining whether a given expense is a capital charge or is deductible, one of the most difficult problems arises where the expense was incurred in the protection of the taxpayer's title or possession to income producing property. Title defense has always been held to be a capital charge but the expense of conserving income producing property are deductible under the Code (if "ordinary and necessary"). In the case of *Bowers v. Lumpkin, supra,* the Court sought to avoid this problem by implying that a deductible expense for the conservation of income producing property must be recurrent to be ordinary and necessary. There Mrs. Morris Lumpkin had purchased stock of the Coca Cola Bottling Company in Columbia from the trustees of a trust created under the will of her deceased husband. In a suit by the Attorney General of the State of South Carolina to set aside the sale, she had expended approximately $27,000 in its successful defense. The Court held that the expense was

67. Kohnstamm v. Pedrick, *supra.*
68. 4 T. C. M. 39.

a capital charge and could not be deducted. Mrs. Lumpkin contended that the expense was necessary "to conserve" property held for the production of income and that the Amendment to Section 23 (a) (2) of the Code insofar as it refers to expenses "to conserve" property would have no meaning if the expenses were not deductible. But the Court held that nevertheless, it was not an "ordinary and necessary" expense. In implying that an "ordinary and necessary" expense must be recurrent the Court said:

> But the term "conservation" can be given effect if it is limited to expenses ordinarily and necessarily incurred during the taxable year for the safe-guarding of the property, such as the cost of a safe deposit box for securities.

It would seem that this statement is erroneous. In *Welch v. Helvering, supra,* the Supreme Court said the exact opposite.

> Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack.

The truth of the matter is that there are undoubtedly expenses necessary for the conservation of income producing property which are not necessarily involved in title defense. Although the Court may have properly disallowed the deduction, in doing so it did not need to limit deductible conservation expenses to those similar to the rental of a "safe deposit box for securities". As a matter of fact, this limitation would probably not apply in view of the Supreme Court's decision in the *Bingham* case.

While there are apparently no decisions as yet, it would seem that legal expenses in connection with the *use* of business or income producing property which do not add to the value, such as expenses to abate a nuisance, should be deductible as an expense rather than as a capital charge.[69]

69. In Bliss v. Commissioner, 57 F. 2d 984 (C. C. A. 5, 1932) a situation very similar to that hypothised in the text was decided. There the taxpayer owned several thousand acres of land and an oil driller, on a claim of license, dug oil wells on the property, some of it producing, and some of it was dry. The taxpayer commenced two suits for the purpose of determining whether or not the taxpayer's ownership of the land carried with it ownership of the minerals. The suits were terminated by a final holding that the adverse claims of the well

4. *Policy considerations:*

The Heininger decision prevents the denial of a deduction for legal expenses on the general ground of public policy. Now, assuming it is otherwise deductible, the deduction must be permitted unless the expense "frustrates sharply defined policies". It has recently been said by the Tax Court that the legal expenses incurred by a taxpayer in order to determine whether a contract is or is not contrary to public policy, are so "remotely connected" with the public policy question that such fees should be deductible in any event. In the case of *Thomas B. Lilly, et al. v. Commissioner*[70] the Court said:

> If the payments which are the subject of the present controversy were merely remotely connected with contracts violating public policy — such as fees of attorneys paid in litigation brought to determine the question of that violation — then such payments are deductible. But if these payments were directly connected with contracts contravening the alleged public policy here — payments or the promise to make which were the very consideration of such contracts — they are not deductible as ordinary and necessary expenses.

This is indeed a far cry from the earlier statements of courts which are quoted in the first part of this article.

Expenses of defending a business which is *per se illegal* (as distinct from a legal business operated in an illegal manner) have recently been disallowed.[71] The Regulations expressly deny expenses

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driller were invalid. The Court held that the attorney's fees in the suits, paid out by the taxpayer, were deductible from income on the theory that the expenses were not in connection with the taxpayer's *title* to the land, and did not add to the value of the property, but rather, related to the taxpayer's use of the property. The Court said:

> The above mentioned expenditures for attorney's fees cannot reasonably be regarded as capital investment. They were not payments made in acquiring ownership of lands minerals in or from which were adversely claimed . . . The object of the suits brought was the removal of an obstacle to the recovery or realization of income created by the assertion of adverse claims to it . . . To treat as an addition to the cost of land the amount of an expenditure made, after ownership was acquired, to enable the owner, his agent or lessee to possess and use the land for business purposes, undisturbed by intruders or trespassers, would involve a disregard of the difference between the cost of acquiring ownership of property and expenses paid or incurred to protect the owner's right to undisturbed possession and enjoyment of his property, and what it yields or produces, by himself, his agents or lessees. It seems reasonable to treat amounts expended for services rendered in ejecting or excluding trespassers after ownership has been acquired as expenses incident to the ownership of property and the acquisition and enjoyment of income from it, rather than as additions to the capital investment in the property.

70. 14 T. C. .... No. 120, June 6, 1950.

71. Stralla, et al. v. Commissioner, 9 T. C. 801.

of lobbying.[72] On the other hand, fees paid to an attorney for the preparation and advocacy before state legislative committees of certain legislation which would be favorable to the taxpayer's business, has been allowed.[73]

Prior to the *Heininger* case the legal expenses of unsuccessfully defending a charge of fraud had always been denied on the grounds of public policy. Even if the suit was a civil one — not a criminal one — the expense would not be allowed. Thus, in *Standard Oil Co. v. Commissioner*[74] the taxpayer had expended something over two million dollars in compromising an alleged liability to the government and in payment of legal fees. The suit was based on allegations of fraud and bribery in the lease of government property, arising out of the "Tea-Pot Dome" scandal. Although the action was a civil one and involved business transactions, the deduction was denied on public policy grounds.[75] The *Heininger* decision clearly indicates that this will no longer be the case, and the Tax Court in the *Stralla* case confirmed this. Prior to the *Heininger* case, expenses incurred in unsuccessfully defending a criminal prosecution were also uniformly disallowed.[76] But if the defense was successful, and if the matter arose in the conduct of a trade or business, the entire expense was an allowable deduction as there was no policy consideration on which it should be denied.[77] Since the *Heininger* case, the legal expenses of an unsuccessful defense to a criminal prosecution is an allowable deduction, but any amounts paid to the prosecuting agency in the way of compromise, by consent decrees or otherwise, are not

72. See Textile Mills Securities Corp. v. Commissioner, 314 U. S. 326, 62 Sup. Ct. 272, 86 L. Ed. 249 (1941).
73. Lucas v. Wofford, 49 F. 2d 1027 (C. C. A. 5).
74. 129 F. 2d 363 (C. C. A. 7, 1942), *cert. denied* 317 U. S. 688.
75. The Court said:
> There is involved here another question — a broader question, one of public policy, which bars this asserted deduction . . . We have found no case which permits a taxpayer to successfully claim a deduction paid the Government by way of damages which arose from a fraudulent transaction which the said taxpayer perpetrated upon the Government.
>
> And it is apparent that the case against the allowance of deductions is strengthened, if the facts warrant a finding that the taxpayer made payment to the Government, not alone because of fraud, but because of criminal corruption, to-wit, bribery.
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> The fact that the instant judgment was for damages arising out of a tort against the Government, distinguishes it from cases where the damages arise out of a tort against an individual. Add to this, the distinguishing fact, that the tort in this case arises out of bribery and not a lesser degree tort, like negligence, we can more readily see the necessity of applying the defense of "against public policy".

76. Helvering v. Superior Wines & Liquors, Inc., 134 F. 2d 373.
77. Commissioner v. Continental Screen Co., 58 F. 2d 625 (C. C. A. 6, 1932).

deductible.[78] This rule has even extended to proceedings which were not, but were closely akin to criminal prosecutions.

Under the *Heininger* case, policy considerations should be used in tax cases to discourage the perpetration of a wrong, but not to discourage *bona fide* (albeit unsuccessful) attempts by a taxpayer to disprove accusations of wrong. Thus, a distinction should be drawn under the *Heininger* case between expenses properly incurred by the taxpayer in attempting *bona fidely* to disprove charges of wrong doing against him, and expenses which he incurs as a consequence of his wrong doing.[79] In the *Heide* and *Josephs'* cases *supra,* this distinction was not made and as a consequence the entire expense, both in attempting to disprove the charges against the trustees and repayments which those trustees were required to make as a result of the legal proceedings, were disallowed as deduction. Under the *Heininger* case however, the legal expenses of the trustees in attempting to disprove the charges against them should have been deductible.

Conclusion

Before 1942 the legal expenses of an individual, other than business expenses, were in no case deductible. The 1942 Amendment to the Code, authorizing the deduction of expenses incurred in the production of income or in the management, etc. of investment property, made the deduction of legal expenses for individuals outside of a trade or business co-extensive with those authorized in a trade or business. This Amendment coupled with the *Heininger* and the *Bingham* decisions now authorizes the deduction of all legal expenses, where there is no violation of a "sharply defined" public policy, except those relating to personal matters and those which have to be capitalized. The *Heininger* case repudiated the theory that "ordinary and necessary" refers to the reason for the expense — and pointed out that the phrase properly refers to the expense *under the circumstances prevailing.* There the Bureau argued and the Tax Court held that it was not ordinary for Heininger to sell false teeth with fraudulent advertising. But the Supreme Court said that this was not the point — that the question was whether it was ordinary and necessary for Heininger to defend his business from the fraudulent advertising charges. The *Bingham* case held

78. Universal Atlas Cement Co. v. Commissioner, 9 T. C. 871; *aff'd* 171 F. 2d 294, *cert. denied* 336 U. S. 962; Commissioner v. Longhorn Portland Cement Co., 148 F. 2d 276 (C. C. A. 5, 1945).

79. See the discussion in the case of Jerry Rossman Corporation v. Commissioner, *supra.*

that the non-business deductions under the Amendment were in *pari materia* with the business deductions, and that therefore the *Heininger* decision is equally applicable to non-business as to business deductions.

The *Bingham* case is important also because of its interpretation of the management of property held for the production of income. There the Court held that the phrase means the management of property in its broad sense — that is, as including distribution which, if considered as a segregated transaction, would not be regarded as management. The Bureau, considering its argument in the *Bingham* case and its Regulations prior to that decision, evidently considered that all expenses in the management, conservation, or maintenance of property should be capital expenses and not deductible, despite the Code provisions. The Court, in the *Bingham* case, said that not only was this contrary to the language of the Code, but it also disregarded the established fact that many expenses of managing, etc. property in no way add to or enhance the value of, or concern the taxpayer's ownership of such property.

The distinction between an expense which is deductible and one which must be capitalized in many situations is most elusive. Where the principal relief sought by the action is an accounting or relief from mal-administration by the taxpayer, but the taxpayer's title to property is incidentally raised, as in the *Hochschild* case, *supra,* or in the *Lomas* and *Nettleton* case, *supra,* the expense will be allowed. But, as the Court implied in the *Addison* case, *supra,* if the title to the property is the principal question and the accounting is incidental thereto, the entire expense will be capitalized. Probably the most appropriate method of dealing with this situation, is to allocate the expense between those relating to business, the collection of income or the management, conservation or maintenance of income producing property, and those expenses relating to the retention or perfection of title to the property.

If a deduction is not allowed because of policy considerations, as in the *Heide* and *Josephs'* cases, a distinction must be made based on differences of degree and not of kind.[80] Where the expense was incurred in the defense of a proceeding in which the taxpayer is charged with conducting an illegal business, or conducting a lawful business in such a manner as obviously to disregard the rights of other persons, the expense will probably not be allowed as a deduction. It is unlikely that, in such circumstances, the Courts will wish

80. *See* Welch v. Helvering, 290 U. S. 111, 54 Sup. Ct. 8, 78 L. Ed. 212 (1933).

to lend encouragement to a defense by protecting the taxpayer from paying income taxes upon the sums expended by him for his defense. The Courts will probably feel that, as Judge Learned Hand said in the *Jerry Rossman Corporation* case, *supra,* to allow the deduction would subsidize the obduracy of offenders unwilling to pay without a contest, and would add "impenitence to their offense". On the other hand, if the defense is *bona fide,* the Courts will be unlikely to impose the additional hardship of making the sums expended for defense subject to tax, accordingly the expense will probably be allowed as a deduction. As the Court said in the *Heininger* case:

> So far as appears from the record respondent did not believe, nor under our system of jurisprudence was he bound to believe, that a fraud order destroying his business was justified by the facts or the law. Therefore he did not voluntarily abandon the business but defended it by all available legal means . . . to deny the deduction would attach a serious punitive consequence to the Postmaster General's finding which Congress has not expressly or impliedly indicated should result from such a finding.