North Carolina Law Review

Volume 32 | Number 4 Article 7

6-1-1954

Income Tax -- Deductibility of Attorney's Fees for Tax Purposes

Lewis F. Camp Jr.

injury occurs, and that no violation of the policy shall defeat or void it.[33] This statutory provision would seem to be an unequivocal expression of public policy for the protection of injured parties[34] within policy coverage by making certain that the insurance company cannot avoid payment because of a breach by the insured of some of the policy conditions.[35] This provision, however, does not relieve the insured of any of the pressure which forces him to forward summons and other process immediately to the insurer. For, he would still be liable to the insurer for failure to fulfill his contract obligations if he allowed an unreasonable time to elapse in order to engage a personal attorney before forwarding the process.[36]

R. G. HALL, JR.

Income Tax—Deductibility of Attorney's Fees for Tax Purposes

The deductibility of legal fees for income tax purposes is an important factor to be considered by lawyers and laymen alike. If a client is in the fifty per cent income tax bracket, the Federal Government will, in effect, pay one half of any fee deducted by the client. This may well be an influencing factor in determining the overall financial consequences of employing legal counsel.

In order to be deductible, the fee must fall into the category of business or non-business expenses as set out in the Internal Revenue Code. If the fee covers both deductible and non-deductible items, it should be allocated between the two, and failure to so allocate may result in the disallowance of the entire amount.[1] The provision for business expenses requires that an expense, to be deductible, must be both ordinary and necessary, and incurred in carrying on a trade or business.[2] The pro-

[33] N. C. GEN. STAT. § 20-279(f) (1953).

[34] Courts of other states have construed this provision as an absolute protection of injured third parties. Century Indemnity Co. v. Simon, 77 F. Supp. 221 (D. C. N. J. 1948); Farm Bureau Automobile Ins. Co. v. Martin, 97 N. H. 196, 84 A. 2d 823 (1951); Atlantic Casualty Co. v. Bingham, 10 N. J. 460, 92 A. 2d 1 (1952), affirming 18 N. J. Super. 170, 86 A. 2d 792 (App. Div. 1952); Stonborough v. Preferred Accident Ins. Co. of New York, 292 N. Y. 154, 54 N. E. 2d 342 (1944), affirming 266 App. Div. 838, 43 N. Y. S. 2d 512 (1st Dep't 1944), affirming 180 Misc. 339, 40 N. Y. S. 2d 480 (Sup. Ct. 1943).

[35] Such as breach of the "cooperation clause," or failure to forward immediately all summons and process received.

[36] Where the insurer is absolutely liable to make the injured party whole, because of a statute such as N. C. GEN. STAT. § 20-279(f) (1953), a cause of action accrues against the insured when he fails to fulfill the policy conditions to the prejudice of the insurer. Illinois Casualty Co. v. Krol, 324 Ill. App. 478, 58 N. E. 2d 473 (1944); Service Mutual Liability Ins. Co. v. Aronofsky, 308 Mass. 249, 31 N. E. 2d 837 (1941); American Fidelity & Casualty Co. v. Big Four Taxi Co., 111 W. Va. 462, 163 S. E. 40 (1932).

[1] Jordan v. Commissioner, 12 B. T. A. 423 (1928).

[2] INT. REV. CODE § 23(a)(1)(A) provides for the deduction of "all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ."

vision for non-business expenses allows deduction of those which are ordinary and necessary, and incurred in the production or collection of income or for the management, conservation, or maintenance of income producing property.[3] These sections must be construed *in pari materia*,[4] and any deduction under the non-business provision is subject, except for the requirement of being incurred in connection with a trade or business, to all the limitations that apply to the business expense category.[5]

Whether the expense involved meets the "ordinary and necessary" requirements in relation to a proper business or non-business activity is a question of fact to be determined as such.[6] The test the courts apply in making this determination is *what is normal or usual—ordinary and necessary according to the ways of conduct and the forms of speech prevailing in the business world.*[7] Such expenses need not relate directly to the production of income; it being enough if such expense is directly connected with or proximately results from the conduct of the business.[8]

The question whether to apply the "ordinary and necessary" test to the circumstances then prevailing or to the events causing those circumstances posed a difficult problem. For example, a 1928 case said[9] ". . . a suit ordinarily, and as a general thing at least, necessarily requires the employment of counsel . . .", thereby applying the test to the prevailing circumstances. Later cases[10] have reasoned that it is never necessary to violate the law in managing a business, and have applied the test to the events causing those circumstances. This question was settled in *Commissioner v. Heininger*,[11] the Supreme Court holding that the circumstances then prevailing were controlling.

Prior to the *Bingham Trust*[12] case, legal expenses incurred in income tax litigation were consistently denied.[13] However, legal fees incurred in determining liability on income tax are now uniformly allowed on

[3] INT. REV. CODE § 23(a)(2) provides that "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" are deductible.

[4] Bingham v. Commissioner, 325 U. S. 365 (1945).

[5] McDonald v. Commissioner, 323 U. S. 57 (1944).

[6] Bingham v. Commissioner, 325 U. S. 365 (1945).

[7] "The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle." Welch v. Helvering, 290 U. S. 111 (1933).

[8] Bingham v. Commissioner, 325 U. S. 365 (1945); Kornhauser v. United States, 276 U. S. 145 (1928); U. S. Treas. Reg. 118, § 39.23(a)-15 (1953).

[9] Kornhauser v. United States, 276 U. S. 145 (1928).

[10] Deputy, Administratrix, *et al.* v. du Pont, 308 U. S. 488 (1940); Outdoor Advertising Bureau, Inc. v. Commissioner, 89 F. 2d 878 (2d Cir. 1937); Burroughs Building Material Co. v. Commissioner, 47 F. 2d 178 (2d Cir. 1931).

[11] Commissioner v. Heininger, 320 U. S. 467 (1943).

[12] Bingham v. Commissioner, 325 U. S. 365 (1945).

[13] Higgins v. Commissioner, 2 T. C. 948, *aff'd*, 143 F. 2d 654 (1st Cir. 1944); Coffey v. Commissioner, 1 T. C. 579, *aff'd*, 141 F. 2d 204 (5th Cir. 1944); Hord v. Commissioner, P-H 1945 TC MEM. DEC. ¶ 43,283 (1943).

the ground that the expense always concerns taxable income. These deductible fees may cover preparation of returns, filing refund claims, or litigation of tax deficiencies.[14] Such deduction is allowed despite the imposition of penalties for civil fraud.[15]

Legal fees incurred in contesting gift tax deficiencies are not deductible for the reason that neither the gifts nor the expenses were made for the production or collection of income.[16] Likewise, where an heir incurred legal expenses in obtaining a refund of federal estate taxes, the deduction of such expense was refused because the action was to obtain money due as the result of an inheritance, not taxable income. However, that portion of the attorney's fees allocable to interest involved was deductible.[17]

Other cases have allowed deduction of attorney's fees incurred in reorganization of the taxpayer's estate;[18] dissolution and liquidation of a corporation;[19] seeking to prevent conviction of a lawyer on a charge of obstructing justice;[20] creation of an employee pension plan and advice relating to financial operations;[21] determining the right of a minor actor to his earnings;[22] obtaining reinstatement as co-executor of deceased husband's estate;[23] defending position as a corporate officer and director;[24] defending against a suit for fraud;[25] ascertaining rights under an employment contract;[26] and answering questions by a movie script writer before a Congressional committee investigating communistic infiltration into the movie industry and his business.[27]

Where a legal expense is incurred in a business transaction, produc-

[14] U. S. Treas. Reg. 118, § 39.23(a)-15 (1953); Bingham v. Commissioner, 325 U. S. 365 (1945); Armour v. Commissioner, 6 T. C. 359 (1946); Connelly v. Commissioner, 6 T. C. 744 (1946); Greene Motor Co. v. Commissioner, 5 T. C. 314 (1945).

[15] Goodman v. Commissioner, 9 T. C. M. 789, *aff'd*, 200 F. 2d 681 (2d Cir. 1953).

[16] Lykes v. United States, 343 U. S. 118 (1952); Cobb v. Commissioner, 173 F. 2d 711 (6th Cir. 1949).

[17] Edmunds v. United States, 71 F. Supp. 29 (E. D. Mo. 1947).

[18] Bagley v. Commissioner, 8 T. C. 130 (1947), involved fees for advice to the taxpayer concerning the purchase of bonds, loans to corporate officers for the purpose of protecting taxpayer's investment in the corporation, and the merits and legal aspects of a plan submitted to taxpayer by a firm of estate planners for the rearrangement and reinvestment of the taxpayer's entire estate.

[19] United States v. Arcade Co. *et al.*, 203 F. 2d 230 (6th Cir. 1953). Where there is a partial liquidation in connection with a reorganization, the liquidation and reorganization will be looked at as one transaction and all the expenses incurred will be grouped as a capital expenditure. Mills Estate, Inc. v. Commissioner, 206 F. 2d 244 (2d Cir. 1953).

[20] Kaufman v. Commissioner, 12 T. C. 1114 (1949).

[21] Meldrum & Fewsmith, Inc. v. Commissioner, 20 T. C. No. 113 (1953).

[22] Commissioner v. Estate of Bartholomew, 4 T. C. 349, *aff'd per curiam*, 151 F. 2d 534 (9th Cir. 1945).

[23] Crawford v. Commissioner, 5 T. C. 91 (1945).

[24] Hochschild v. Commissioner, 161 F. 2d 817 (2d Cir. 1947).

[25] Peoples-Pittsburgh Trust Co., *et al.* v. Commissioner, 21 B. T. A. 588 (1930).

[26] Blum v. Commissioner, 11 T. C. 101, *aff'd*, 183 F. 2d 281 (3d Cir. 1950).

[27] Salt v. Commissioner, 18 T. C. 182 (1952).

tion or collection of income, or management, conservation, or maintenance of property held for the production of income, it is deductible unless it is (a) personal,[28] (b) capital,[29] or (c) contrary to public policy.[30]

Legal expenses incurred in isolated personal transactions having nothing to do with the taxpayer's business or non-business activities are generally disallowed. Examples of such personal transactions involving legal expenses are those incurred in defending against a suit by a former wife to enforce a property settlement agreement growing out of a divorce;[31] preparing[32] or contesting[33] a will; settling a judgment resulting from an automobile accident[34] (unless such accident occurred with a vehicle being used in a business activity); contesting a disputed election to establish the right to a public office;[35] obtaining a release from military service;[36] prosecuting a suit for slander;[37] and contesting a suit for breach of promise.[38]

Legal fees expended in connection with divorce and separate maintenance are generally non-deductible personal and family expenses. However, that portion of the fee which is properly attributable to the production or collection of amounts includible in gross income as alimony payments under Internal Revenue Code § 22(k) is deductible as a non-business expense.[39] In *Baer v. Commissioner*[40] it was held that the part of an attorney's fee which could be allocated to the services rendered in connection with financial matters in controversy, as distinguished from the divorce controversy, were deductible. Such services were held to be directly related to the conservation and maintenance of property held by the taxpayer for the production of income.

[28] INT. REV. CODE § 24(a)(1).
[29] U. S. Treas. Reg. 118, § 39.24(a)-2 (1953).
[30] Stralla v. Commissioner, 9 T. C. 801 (1947).
[31] Jergens v. Commissioner, 17 T. C. 806 (1951); Howard v. Commissioner, 16 T. C. 157 (1951).
[32] Pennell v. Commissioner, 4 B. T. A. 1039 (1926).
[33] Hutchings v. Burnet, 58 F. 2d 514 (D. C. Cir. 1932).
[34] Dickason v. Commissioner, 20 B. T. A. 496 (1930).
[35] REV. RUL. 1, I. B. R. 1951-1.
[36] Seese v. Commissioner, 7 T. C. 925 (1946).
[37] Legal fees are not deductible even though taxpayer's duties brought him into contact with customers and the slander would affect his business. Lloyd v. Commissioner, 55 F. 2d 842 (7th Cir. 1932); Kleinschmidt v. Commissioner, 12 T. C. 921 (1949).
[38] U. S. Treas. Reg. 118, § 39.24(a)-1 (1953).
[39] Commissioner v. Gale, 191 F. 2d 79 (2d Cir. 1951), *affirming* 13 T. C. 661; LeMonde v. Commissioner, 13 T. C. 670 (1949); U. S. Treas. Reg. 118, § 39.24(a)-1 (1953).
[40] 196 F. 2d 646 (8th Cir. 1952). The basis for this decision seemed to be that stock held by the taxpayer for production of income would have to be sold unless some satisfactory settlement could be worked out. This settlement was accomplished by the lawyer. It has also been held that the fact that the taxpayer will have to sell property held for the production of income will not allow deduction of such attorney's fees. Hexter v. Commissioner, P-H 1945 TC MEM. DEC. ¶ 44,399 (1944).

A ground frequently used for disallowance of a deduction for legal expenses is that the charge is a capital one and should be added to the tax base of property or should be amortized. Fees expended in defending or perfecting title to property are capital in their nature and must be added to the tax basis of the property.[41] For example, a suit to quiet title comes under this rule. Similarly, fees incurred as a result of a lessee's contesting forfeiture of his lease are to clear the title and are consequently capital.[42] Fees in connection with foreclosing a lien follow the same rule.[43] Where title is in dispute and taxpayer pays a claim solely to avoid unfavorable publicity, the legal fees incurred are deductible,[44] but if there is any doubt, the general rule as to title defense will apply.[45] If the action to obtain the property in question is unsuccessful, the fee incurred is a non-deductible personal expense.[46]

Where the title to property is in litigation along with income from it, that part of the expenses allocable to such income is deductible while the remainder is a capital expense.[47] Similarly, the court in *Helvering v. Stormfeltz*[48] permitted a deduction of that part of a fee allocable to the interest in an action to recover a money judgment from a guardian for guardianship funds wrongfully appropriated. The remainder was a capital expenditure analogous to that in title defense litigation. Several other cases[49] appear to be *contra* in that they have applied a major object rule—that is where title was the major object of the litigation and the income merely secondary, then the entire fee is held to be a capital expense. In an action for income from a trust, as distinguished from title to the trust property, deduction was allowed.[50]

Attorney's fees incurred in connection with incorporation are capital in nature and can be treated as a loss on dissolution of the corporation,[51] but where the corporation is chartered for a stipulated length of time, such legal expenses may be amortized over the period the charter is to run.[52] Expenses in connection with mergers, reorganizations and re-

[41] U. S. Treas. Reg. 118, § 39.24(a)-15 (1953).

[42] Johnson v. Commissioner, 162 F. 2d 844 (5th Cir. 1947).

[43] Shaw-Hayden Building Company v. Commissioner, 18 B. T. A. 949 (1930).

[44] Levitt & Sons, Inc. v. Nunan, 142 F. 2d 795 (2d Cir. 1944).

[45] Levitt & Sons, Inc. v. Commissioner, 160 F. 2d 209 (2d Cir. 1947).

[46] McClees v. Commissioner, P-H 1945 TC MEM. DEC. ¶ 45,019 (1945).

[47] Hochschild v. Commissioner, 7 T. C. 81, *rev'd on other grounds,* 161 F. 2d 817 (2d Cir. 1947); U. S. Treas. Reg. 118, § 39.23(a)-15 (1953).

[48] Helvering v. Stormfeltz, 142 F. 2d 982 (8th Cir. 1944). A similar rule was applied in Vincent v. Commissioner, 18 T. C. 339 (1952).

[49] Safety Tube Corp. v. Commissioner, 168 F. 2d 787 (6th Cir. 1948). If the property belongs to the plaintiff, then so does the income, and the title to both is the object of the suit. Midco Oil Co. v. Commissioner, 20 T. C. No. 79 (1953).

[50] Tyler v. Commissioner, 6 T. C. 135 (1949).

[51] U. S. Treas. Reg. 118, § 39.24(a)-2 (1953); Shellabarger Grain Products Co. v. Commissioner, 2 T. C. 75 (1943).

[52] Hershey Mfg. Co. v. Commissioner, 43 F. 2d 298 (10th Cir. 1930).

capitalizations are likewise capital expenditures,[53] but if the merger plans are abandoned, the legal fees incurred may be deducted in the year of abandonment.[54]

Expenses incurred in issuing bonds are capital, representing part of the cost of borrowing money, and are deductible pro-rata over the life of the bonds.[55] The same rule is applicable to expenses incurred in securing mortgages and other loans.[56] Examples of other legal fees which have been held to be capital expenses include those incurred in defending the title to a patent[57] or copyright;[58] defending the title to stock held for the production of income;[59] obtaining a long term lease;[60] in connection with the construction of a building;[61] in the purchase by a corporation of its own stock;[62] and in obtaining an abstract of, or a legal opinion concerning title to real property.[63]

It should be noted that legal fees which are considered capital are not necessarily lost as far as deductions for tax purposes are concerned, but may be merely delayed deductions which can be taken later in the form of deductions for depreciation, amortized expenses, or capital losses when the capital asset is sold.

Prior to the *Heininger* case, all legal fees incurred in connection with defending against a criminal charge on which the taxpayer was found guilty were disallowed on grounds of public policy.[64] Likewise, all such expenses incurred in defending against an action for civil fraud were denied deductibility.[65] Since the *Heininger* decision, however, such deduction is not disallowed solely on the ground that it was contrary to public policy where the taxpayer was found guilty, if a defense was made in good faith.[66] Two recent decisions have indicated that legal expenses incurred because of a wrongful act committed in a non-business activity would also be deductible if such expenses were necessary to the produc-

[53] Skenandoa Rayon Corp. v. Commissioner, 122 F. 2d 268 (2d Cir. 1941).

[54] Sibley, Lindsay & Curr Co. v. Commissioner, 15 T. C. 106 (1950).

[55] Baltimore and Ohio R. R. v. Commissioner, 30 B. T. A. 194 (1934); W. P. Brown & Sons Lumber Co. v. Commissioner 26 B. T. A. 1192 (1932).

[56] Lovejoy v. Commissioner, 18 B. T. A. 1179 (1930).

[57] Urquhart v. Commissioner, 20 T. C. No. 133 (1953).

[58] U. S. Treas. Reg. 118, § 39.24(a)-2 (1953).

[59] Bowers v. Lumpkin, 140 F. 2d 927 (4th Cir. 1944).

[60] Executor of Estate of Hilton v. Commissioner, 27 B. T. A. 57 (1932); Davidson v. Commissioner, 27 B. T. A. 158 (1932).

[61] Equitable Life Assurance Society of U. S. v. Commissioner, 44 B. T. A. 293, *aff'd*, 137 F. 2d 293 (2d Cir. 1943).

[62] Davenport v. Commissioner, P-H 1950 TC MEM. DEC. ¶ 50,035 (1950).

[63] Thompson v. Commissioner, 9 B. T. A. 1342 (1928).

[64] Superior Wines and Liquors, Inc. v. Commissioner, 134 F. 2d 373 (8th Cir. 1943).

[65] Standard Oil Co. v. Commissioner, 129 F. 2d 363 (7th Cir. 1942).

[66] G. C. M. 24,377, 1944 CUM. BUL. 93, allowed deduction of fees incurred in a defense against a charge of violation of the Sherman Anti-Trust Act. G. C. M. 24,810, 1946-1 CUM. BUL. 55, allowed deduction of fees incurred in connection with defending against a suit brought by the Price Administrator for violation of the Emergency Price Control Act.

tion of income or the management, conservation or maintenance of income producing property.[67] Later decisions have indicated that the expenses of defending a business which is *per se* illegal, as distinguished from a legal business operated in an illegal manner, are not deductible, and any holding to the contrary would frustrate public policy.[68]

LEWIS F. CAMP, JR.

Mortgages—Agency—Power of Dealer to Bind Owner by Mortgage—Indicia of Ownership—Automobile Title Certificates

There has been a practice among used-car dealers in purchasing automobiles to receive title certificates with the assignment form on the reverse side merely signed by the assignor-seller but blank as to the assignee-car dealer. Later when the automobile is resold, the new owner's name is entered in the blank as assignee; and there is an anonymous notarization of the original seller's signature. Thus, the transaction is represented as one solely between the original seller and the new owner, concealing the intermediate ownership of the used-car dealer in direct contravention of the North Carolina Motor Vehicle Registration Act.[1]

Since a sale of personal property is not required to be evidenced by any written instrument in order to be valid, it has been held in North Carolina that there may be a transfer of title to an automobile without complying with the registration statute which requires a transfer and delivery of a certificate of title.[2] Therefore, it seems that a buyer may get good title from a dealer who is an actual owner whether he holds an incomplete title certificate or no certificate at all. The aforementioned practice of receiving blank title certificates may, however, mislead third parties where a dealer is not the actual owner but a limited agent.

Such was the situation in *Hawkins v. M & J Finance Corp.*[3] In this case the plaintiff, owner of an automobile, delivered his car and title certificate, with the assignment form on the reverse side blank as to the

[67] Commissioner v. Josephs, 168 F. 2d 233 (8th Cir. 1948); Commissioner v. Heide, 165 F. 2d 699 (2d Cir. 1948). These cases held that a casual trustee could not deduct the expenses incurred in defending against a charge of breach of duty as a trustee. It would be difficult to reconcile these cases with Bingham v. Commissioner, 325 U. S. 365 (1945).

[68] Thomas v. Commissioner, 18 T. C. 1417 (1951); Stralla v. Commissioner, 9 T. C. 801 (1947).

[1] N. C. GEN. STAT. §§ 20-72 *et seq.* (1953).

[2] Carolina Discount Corp. v. Landis Motor Co., 190 N. C. 157, 129 S. E. 414 (1925). In this case *P* had an unrecorded conditional sale on an automobile which *X* sold "free of encumbrance" to *D*. *X* violated the Motor Vehicle Registration Act by not endorsing and delivering the title certificate to *D*. The title certificate showed the outstanding conditional sale. *P* claimed that title could not pass to *D* without a compliance with the statute. *Held:* title passed to *D*. *P* should have recorded his conditional sale in order to put *D* on notice of the encumbrance.

[3] 238 N. C. 174, 77 S. E. 2d 669 (1953).