

The Deductibility Of Legal Expenses On Individual Tax Returns

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The Internal Revenue Code allows for the deduction of some legal fees on Schedules A, C or E, while disallowing others. Still other legal fees are capitalized on Schedule D. The determination of which fees are either deductible or able to be capitalized is determined by the origin of the claim that gives rise to the legal fees at issue. Those legal fees which are incurred for the production of income, including wages, may be deducted on Schedule A. Those legal fees which arise through a claim connected to the taxpayer's trade, business, rental real estate or royalty activity may be deducted on Schedule C or E as applicable. Finally, those legal fees which are considered capital expenditures in relation to capital property are capitalized on Schedule D.

Schedule A Deduction (Production Of Income)

Section 262 of the Code states that "[e]xcept as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses." On the other hand, Section 212, which is captioned "Expenses for production of income," provides that:

In the case of an individual, there shall be allowed as a deduction all of the ordinary and necessary expenses paid or incurred during the taxable year –

- (1) for the production or collection of income;
- (2) for the management, conservation, or maintenance of property held for the production of income; or
- (3) in connection with the determination, collection, or refund of any tax.

The issue of what activities are considered personal and what are properly considered to be income producing was addressed by the Supreme Court in *United States v. Gilmore*, 372 U.S. 39, 44 (1963). In *Gilmore* the issue was whether the taxpayer/husband was entitled to deduct legal expense incurred in a divorce proceeding in which he sought to protect his income-producing assets from the claims of his wife. The Supreme Court, interpreting the predecessor to the above statute, held that:

For income tax purposes Congress has seen fit to regard an individual as having two personalities: one is as a seeker after profit who can deduct the expenses incurred in that search; the other is as a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption-related expenditures.

The Court went on to hold that a "basic restriction on the availability of a ... deduction is that the expense item must be one that has a business origin." *Id.* at 45. In other words, the Court held, "the only kind of expenses deductible ... are those that relate to a business, that is, profit-seeking purpose." *Id.* at 46. The Court summed up these points holding that:

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The principle we derive from these cases is that the characterization, as business or personal, of the litigation costs depending on whether or not the claim arises in connection with the taxpayer's profit-seeking activities. *Id.* at 48.

The Court concluded that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was business or personal and hence whether it is deductible or not..." *Id.* at 49. The Court, thus, concluded that the origin of the claim giving rise to the fees in *Gilmore*, i.e., a divorce, was personal even though the litigation had a potential business impact.

In terms of what factors are considered in order to identify the origin of the claim, the Tax Court, in *Bradford v. Commissioner*, 70 T.C. 584, 593 (1978), interpreted *Gilmore* to essentially require a facts and circumstances test. The court held:

The origin-of-the-claim rule does not contemplate a mechanical search for the first in the chain of events which led to the litigation but, rather, requires an examination of all the facts. The inquiry is directed to the ascertainment of the "kind of transaction" out of which the litigation arose. Consideration must be given to the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all facts pertaining to the controversy.

While legal fees for a divorce or separation proceeding and for property settlements incident to these proceedings are generally not deductible under the origin-of-the-claim rule, legal fees incident to a proceeding to collect or recover taxable income, such as taxable alimony, are deductible on Schedule A. These legal fees are considered deductible under the origin-of-the-claim rule as the origin and character of a proceeding to collect alimony is considered the collection of income. See Reg. § 1.262-1.

Estate planning legal fees are also commonly deducted on Schedule A to the extent that the legal fees are attributable to tax advice. As estate planning is generally not concerned solely with tax matters, the portion of the fees which are allocable to tax planning should be separated from the portion allocable to other estate planning work. Only the portion which is related to tax advice and planning can be properly deducted on Schedule A.

Schedule C Deduction (Trade or Business Expense)

Section 162 of the Internal Revenue Code states that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business..." For an expense to be deductible on Schedule C under § 162(a), it must meet five elements: (a) it must be ordinary, (b) it must be necessary, (c) it must be paid or incurred by the taxpayer in the taxable year, (d) there must be a trade or business, and (e) the expense must arise in connection with or proximately result from that trade or business. See *Peters, Gamm, West & Vincent v. Commissioner*, T.C. Memo 1996-186; citing *O'Malley v. Commissioner*, 91 T.C. 352, 361 (1988). The courts have ruled that legal expenses are deductible as a business expense when they are directly connected

with, or proximately result from the business. *Holt, Jerry A. v. U.S.*, (2002, DC AZ) 90 AFTR 2d 2002-5082, 2002-2 USTC ¶50522. These expenses can include legal fees for tax advice pertaining to the taxpayer's Schedule C. Rev. Rul 92-99, 1992-1 CB 20. See also I.R.S. Priv. Ltr. Rul. 9234009 (May 20, 1992).

A taxpayer is considered engaged in a trade or business while acting as an employee. However, legal fees which are incurred while engaged in a trade or business while acting as an employee are deducted on Schedule A and are subject to the 2 percent of AGI limitation. See *McKay v. Commissioner*, 102 T.C. 465 (1994), rev'd on other ground, 84 F.3d 433 (5th Circuit, 1996).

Schedule E Deduction (Rental and Royalty Expenses, Unreimbursed Partnership and S-Corporation Expenses, and Trade or Business Expenses in Limited Circumstances)

A taxpayer who reports rental or royalty income on Schedule E, Part I or partnership or S-Corporation income for partnerships or S-Corporations in which he actively participates in on Schedule E, Part II will likewise deduct unreimbursed legal expenses incurred through these activities on Schedule E.

Section 62(a)(4) of the Internal Revenue Code states that "the term 'adjusted gross income' means, in the case of an individual, gross income minus the following deductions...the deductions allowed by part VI (Sec. 161 and following), by section 212 (relating to expenses for production of income), and by section 611 (relating to depletion) which are attributable to property held for the production of rents or royalties." Therefore, legal expenses which arise out of a taxpayer's rental and royalty activities are taken as an above-the-line deduction on Schedule E, Part I. These legal expenses can include legal fees for tax advice pertaining to the taxpayer's Schedule E. Rev. Rul 92-99, 1992-1 CB 20. See also I.R.S. Priv. Ltr. Rul. 9234009 (May 20, 1992).

Note, however, that legal fees paid or incurred to defend or protect title, acquire or dispose, or develop or improve rental property are not to be deducted on Schedule E. Rather, these expenses must be capitalized and added to the property's basis, as is discussed later in this article.

A taxpayer may also deduct unreimbursed ordinary and necessary partnership or S-corporation expenses paid on behalf of the partnership, including legal expenses, on Schedule E, Part II if the taxpayer is required to pay these expenses under the partnership agreement. *Magruder v. Commissioner*, T.C. Memo 1989-169 [¶89, 169 PH Memo TC]. See also the 2009 I.R.S. Instructions for Schedule E (Form 1040).

Finally, in certain cases a taxpayer will be able to deduct legal expenses directly connected, or proximately resulting from, his partnership or S-corporation interest on Schedule E, Part II as an above-the-line deduction under Section 162(a) as a trade or business expense, discussed earlier in this article in the context of a Schedule C deduction. Neither the Code nor the regulations contain a definition of the term "trade or business." In the case of *Kornhauser v. United States*, 276 U.S. 145 (1928), it was held that a general partner who incurred legal fees in the defense of a suit against him for an accounting which was brought against him by his co-partner, could take his legal fees as an above-the-line deduction under a predecessor to Section 162 as the fees resulted from the taxpayer's business.

The taxpayer in this case was a general partner responsible for the management of the partnership's daily business activities. Thus, as held in *Kornhauser*, the taxpayer's activities in the partnership constituted a trade or business, which allowed the legal fees to be deducted above-the-line.

However, in Technical Advice Memorandum 9728002 (July 11, 1997), the Service ruled that a limited partner's legal and accounting fees from litigating a suit against the general partners were not deductible under Section 162 as a trade or business expense, but were deductible under Section 212 as expenses incurred in the collection of income, deductible on Schedule A and subject to the 2 percent of AGI limitation. The taxpayer in this case was a limited partner with no involvement in the management of the partnership. The Service determined that as limited partners, the taxpayers were primarily investors rather than involved in a trade or business, and as such, the legal fees were to be properly deducted on Schedule A rather than Schedule E. Therefore, the nature of a taxpayer's involvement in the operations and management of a partnership must be analyzed in determining if it rises to the level of participation necessitated to allow an above-the-line deduction on Schedule E under Section 162.

Schedule D Capitalization (Capital Expenditures)

Legal expenses which are incurred in defending or perfecting title to capital property, in the acquisition or disposition of capital property, or in developing or improving capital property are not expenses which are deductible and must rather be capitalized. In cases where litigation involves the defense, acquisition, disposition or improvement of capital property, the origin of the claim, not the taxpayer's primary purpose in litigating the claim, is the prevailing test to determine whether fees can be deducted or capitalized. See *Barrett v. Commissioner*, 96 T.C. 713 (1991).

Section 263 of the Code essentially modifies Section 212 by providing that no capital expenditure can be deducted. Instead, "[s]uch expenditures are added to the basis of the capital asset and are taken into account for tax purposes either through depreciation or by reducing the capital gain (or increasing the loss) when the asset is sold." *Woodward v. Commissioner*, 397 U.S. 572, 574-75 (1970).

In *Woodward*, the majority shareholders in a corporation incurred legal, accounting and appraisal expenses in connection with the purchase of stock from a minority shareholder who had dissented from an extension of the corporate charter. The taxpayers argued that the expenses should be deducted currently rather than capitalized since the "primary purpose" for incurring the expenses was to establish the value of the stock rather than to defend or perfect title thereto. 397 U.S. at 577. The Court initially noted that it "has long been recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures." 397 U.S. at 575. The Court then rejected the use of the "primary purpose test" as being too uncertain and difficult to apply. 397 U.S. at 397. The Court went on to state "[s]uch uncertainty is not called for in applying the regulation that makes the cost of acquisition of a capital asset a capital expense. In our view application of the latter regulation to litigation expenses involves the simpler inquiry whether the origin of the claim litigated is in the process of acquisition itself." *Id.* *Accord United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970).