Deductions for Tax Advice — The Commissioner Acquiesces

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The Commissioner acquiesced in *Sidney Merians*,[1] a case in which the Tax Court allowed an individual taxpayer to deduct, as nonbusiness itemized deductions, expenditures for tax services that included tax advice incident to estate planning. The statutory authority for such a deduction is found in Section 212(3):

"In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year . . . in connection with the determination, collection, or refund of any tax."

An analysis of this section of the Code must begin with an explanation of its origin. Prior to the enactment of Section 212(3), the Supreme Court in *Bingham v. Commissioner*[2] held that expenses of income tax litigation were deductible by noncorporate taxpayers under the statutory predecessor[3] of Section 212(1) and Section 212(2), as ordinary and necessary expenses paid or incurred for the production or collection of income or for the management, conservation or maintenance of property held for the production of income. Subsequently, in *Lykes v. Commissioner*,[4] the Supreme Court held that expenses of gift tax litigation were not deductible under this statutory provision because gifts by their very nature neither produce income for the donor nor conserve property of the donor.

In the 1954 Code, Congress sought to overrule the *Lykes* case by enacting Section 212(3). The House Ways and Means Committee and the Senate Finance Committee in their respective reports acknowledged the purpose of the new section, but, in so doing, the reports spoke only in terms of deductions for expenses incurred in "contests" and of "contested tax liability."[5] Consequently, the inference might be drawn from the reports that expenses are not deductible under Section 212(3) unless they are paid or incurred in a tax contest. This inference appeared to be temporarily dispelled by the promulgation of Reg. Sec. 1.212-1(*1*), which provides:

"Expenses paid or incurred by an individual in connection with the determination, collection, or refund of any tax, whether the taxing authority be Federal, State, or municipal, and whether the tax be income, estate, gift, property, or any other tax, are deductible. Thus, expenses paid or incurred by a taxpayer *for tax counsel or* expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of tax liability or in contesting his tax liability are deductible." (Italics added.)

The use of the connective "or" in the Regulation immediately following the phrase "for tax counsel" would seem to indicate fairly clearly that the cost of tax counsel of any type should be deductible. However, despite this seemingly straightforward interpretation, the government for many years sought to interpret the Regulation to mean that fees paid or incurred for tax counsel are deductible only if paid or incurred in connection with a tax contest or tax return preparation.

Cases and Rulings

In an early case litigating this issue, the Court of Claims rejected the government's position. In *Davis v. United States*,[6] the taxpayer paid legal fees for tax advice rendered to him and his former wife in connection with various federal tax matters arising out of negotiations of a separation and property settlement agreement. The Court of Claims held that the portion of the fee paid for tax advice actually rendered to the taxpayer with respect to his own tax problems was deductible by him under Section 212(3). Quoting the Regulations, the court stated that expenses paid or

incurred for tax counsel ". . . in connection with any proceedings involved in determining the extent of tax liability are deductible."

On appeal to the Supreme Court, the government did not again raise the issue of the deductibility of the fees paid for tax advice rendered to the taxpayer; however, the Supreme Court did affirm the Court of Claims disallowance of fees paid by the taxpayer for tax advice rendered to his former wife on the ground that such tax advice must be rendered to the taxpayer with respect to his own tax problems to be deductible by him.

In *Carpenter v. United States*,[7] the Court of Claims again had occasion to consider the issue. The facts were essentially the same as in the *Davis* case except that the pertinent tax advice involved the question of deductibility of alimony payments in future years (rather than the current year tax effect of a property settlement). In allowing the taxpayer to deduct fees paid for tax advice affecting future tax years, the court analogized them to investment counsel fees that are ordinarily deductible under Section 212(2) even though they relate to prospective investments.

The court rejected the argument that Section 212(3) was limited to expenses incurred in actual *contests* of tax liability, pointing out that the word "determination" in Section 212(3) is at least broad enough to include the taxpayer's assessment and computation of his own tax, as required by Section 6151. The court also construed Reg. Sec. 1.212-1(*l*) to allow the deductibility in the alternative, of *either* "tax counsel" fees or expenses "in connection with any proceedings involved in determining the extent of tax liability." The implication was that the fees in question were deductible both because they were tax counsel fees and, in the alternative, because of the necessary *determination* of tax liability in connection with the divorce proceedings.

The Court of Claims followed its *Davis* and *Carpenter* cases in at least two subsequent divorce-related cases in which the relevant issue was merely the determination of the portion of attorneys' fees allocable to tax counsel.[8] In Rev. Rul. 72-545,[9] the Service acceded to the Court of Claims view that fees for tax counsel incident to divorce proceedings are deductible under Section 212(3). Again, the only significant remaining issue in the divorce situation appeared to be the manner of allocation of the total fee between tax advice and other nontax matters.

A district court, although it rejected the government's basic argument, made a distinction between tax advice affecting the current tax year and tax advice that could relate to future tax years. In *Kaufmann v. United States*,[10] the taxpayer had incurred accountants' fees (1) in connection with a request for ruling from the Internal Revenue Service that an exchange of corporate stock would constitute a tax-free reorganization and (2) in connection with the determination of the basis of the stock received in the exchange. The court, in holding that the fees paid for the ruling request were deductible, rejected the government's then recurring argument that fees paid for tax counsel are deductible only when paid in connection with the contest of a tax liability. Instead, the court relied primarily on its apparent belief that the tax ruling process was a "proceedings involved in determining the extent of his tax liability," as provided by Reg. Sec. 1.212-1(*l*).

As some evidence of a determination, the court cited the usual requirement set forth in a private ruling that the ruling be attached to the tax return. The court disallowed the deduction for the portion of the fees paid for determining the basis of the acquired stock on the grounds that (1) there "was no controversy at that time" regarding basis (i.e., no contest) and (2) the information was for "some possible future use, and not for the purpose of determining any tax."

In the recent Tax Court case dealing with the issue, the full court appeared badly split. In *Merians*,[11] the taxpayer attempted to deduct, under Section 212(3), all of the attorney's fees paid for such estate planning matters as planning and drafting wills and trusts, dissolution of a corporation, formation of a partnership, and preparation of a gift tax return. In his brief, the Commissioner stated: "[T]here is a probability that some of the legal fees represented services

which are deductible under Section 212(3).” The Tax Court seized on this statement and concluded that the Commissioner was agreeing that any portion of the fee properly attributable to tax advice of any kind is deductible. The court then proceeded to determine the appropriate allocation of the fee between tax and nontax matters. Seven judges concurred with the decision in four concurring opinions and four judges dissented in two dissenting opinions. Eight judges, four concurring and four dissenting, clearly revealed in their opinions that they believed that tax advice unrelated to tax return preparation or a tax contest should not be deductible under Section 212(3).[12]

Existence of a Proceeding

Most of the cases discussed above in which a deduction for tax counsel was allowed under Section 212(3) involved “proceedings” of some kind that arguably brought the cases within the language in Reg. Sec. 1.212-1(1) referring to “any proceedings involved in determining the extent of tax liability.” The *Kaufmann* case, for example, involved a request for tax ruling that the court characterized as a proceeding. All of the Court of Claims cases, as well as Rev. Rul. 72-545,[13] involved divorce proceedings, although the Court of Claims indicated in *Carpenter*,[14] that it would allow a deduction for the cost of tax counsel irrespective of the presence of a proceeding.

If it were assumed that tax counsel fees must be related to a proceeding, contest, or tax return in order to be deductible under Section 212(3), it seems somewhat far-fetched to characterize divorce proceedings for this purpose as proceedings involved in determining tax liability. Although the alimony and property settlement aspects of a divorce proceeding have tax consequences, the purpose of divorce proceedings and attendant property and alimony matters is obviously not tax determination.

The really basic question though is whether the reference in Reg. Sec. 1.212-1(*l*) to tax counsel fees means all tax counsel fees or only tax counsel fees constituting expenses paid or incurred for tax return preparation, for proceedings involved in determining tax liability, or for a contest of tax liability. The Court of Claims in *Carpenter* construed the Regulations to mean that tax counsel fees and the other types of expenses mentioned were deductible independently of each other. Judge Davis dissenting in *Carpenter*, and four concurring and four dissenting Tax Court judges in *Merians*, took the contrary view.

The Commissioner’s acquiescence in *Merians* appears to lay the issue to rest for the present. The deductible tax services rendered in the *Merians* case did not involve a contest or proceeding of any kind, and although the services in question included the preparation of a gift tax return, it is apparent from a reading of the case that the court allowed a deduction for fees paid for tax advice unrelated to tax return preparation. The court expressly found that 20 percent of the fee was for “tax advice” and was deductible as such.

Other Subsidiary Issues

Merians also appears to lay to rest several other potential subsidiary issues. *Merians* involved tax advice given prior to consummation of the proposed transactions and involved tax advice related to future tax years. Consequently, it would not appear to matter whether tax advice is given before or after the consummation of a proposed transaction or whether the advice relates to a current or future tax year. Similarly, it would appear to be irrelevant whether a proposed transaction is actually consummated or whether the tax advice ultimately proves incorrect. See, for example, *Michael J. Ippolito*,[15] and *James A. Collins*,[16] in which deductions were allowed for tax advice with respect to transactions ultimately held to be sham transactions.

It might still be an open question whether an individual may deduct the cost of advice relating to estate taxes that might ultimately be assessed to his estate. The Merians court in allowing a deduction for “tax advice” did not focus on the estate tax question, although it did appear that

reduction of estate taxes was one of the primary purposes of the tax planning services provided in that case. On the other hand, the Supreme Court in *Davis*[17] specifically held that a taxpayer may not deduct the cost of tax services rendered to another person even though the taxpayer pays for the services. Of course, a taxpayer and his estate are two different persons for tax purposes. Perhaps a rationale for the deduction lies in the fact that an individual's estate is not in existence during the individual's lifetime when the estate tax planning expense is incurred and the individual taxpayer is therefore the only interested person who can directly benefit from the expenditure at that time. It can also be argued that gift tax planning and estate tax planning are so inextricably intertwined in the usual case that they cannot be separated and that gift taxes would clearly be assessable to a donor taxpayer for whom estate planning services are being performed.

Overlap with Sections 162, 212(1) and 212(2)

The addition to the 1954 Code of Section 212(3), allowing a deduction from *adjusted gross income*, does not deprive a taxpayer of a deduction from *gross income* for expenditures for tax advice where the expenditures otherwise qualify as ordinary and necessary business expenses deductible from gross income under Section 162.[18] The tax services need only relate to income or deductions arising out of a trade or business[19] (other than the trade or business of being an employee).[20] Of course, a deduction from gross income is often more desirable than a deduction from adjusted gross income where, for example, the taxpayer takes the standard deduction or attempts to maximize the medical expense deduction or wishes to use the deduction to increase a net operating loss carryback or carryforward.

Similarly, it would appear that the existence of Section 212(3) should not deprive the taxpayer of a deduction under Section 212(1) or 212(2) where an expenditure for tax advice qualifies as an ordinary and necessary expense paid or incurred for the production or collection of income or for the management, conservation or maintenance of property held for the production of income. Many expenditures for tax services were deductible prior to 1954 under the statutory predecessor to Section 212(1) and 212(2). As the court in *Clarence Wood*,[21] noted in allowing an analogous Section 162 deduction, the language of Sections 212(1) and 212(2) are virtually identical to that of their statutory predecessor, and there is no indication that Congress, in enacting Section 212(3), sought to deprive taxpayers of those types of deductions to which they were previously entitled.

Of course, most expenditures for tax advice that are deductible under Section 212(1) or 212(2) would also be deductible under Section 212(3). However, the possibility of deducting an expenditure for tax advice under Sections 212(1) or 212(2) could be important if for some reason a deduction were not available under Section 212(3). For example, it has already been noted that it might be difficult for an individual to obtain a deduction under Section 212(3) for tax advice relating to estate taxes ultimately assessable to his estate. In such a case, it may be possible to argue that the tax advice is related to the conservation of property held for the production of income and that the expenditure is therefore deductible under Section 212(2).[22]

Capitalization of Tax Advice

It does not appear that Section 212(3) authorizes a deduction for expenditures that constitute capital expenditures. Expenditures under Section 212(3) are not expressly excepted from Section 263, which denies a deduction for any amount paid for capital improvements. Reg. Sec. 1.212-1(n) also provides that where ". . . the item may properly be treated only as a capital expenditure . . . , no deduction is allowable under Section 212; . . ." Further, in Rev. Rul. 67-125,[23] the Commissioner required the capitalization of legal fees paid by a corporation for tax advice with respect to a merger, a stock split and a proposed redemption of stock. Although this ruling involved the question of deductibility as ordinary and necessary business expenses under Section

162, the Supreme Court has stated that the statutory predecessor of Section 212 is to be construed as comparable and *in pari materia* with the statutory predecessor of Section 162.[24]

Despite the theoretical justification for the capitalization of expenditures for tax advice in appropriate cases, it may well be that the attributes of an expenditure for tax advice are such that it cannot be easily characterized as giving rise to a capital asset. Certainly, the cases would seem to support this view. In *Carpenter*,[25] the Court of Claims did not require capitalization of any of the cost of tax advice even though some of the advice related to the deductibility of alimony payments in future years. In the *Collins* case,[26] the Tax Court allowed a deduction for expenditures for tax and financial advice, although most of the advice related to the acquisition of an apartment building. Finally, in *Merians*, the deductible tax advice included advice regarding the tax aspects of the taxpayer's ultimate testamentary disposition of his property.

Part of the rationale for not requiring capitalization may be that it is difficult to conceive of tax advice as being in itself a capital asset, and in most cases it is difficult to identify other specific assets that are "improved" by the advice. Tax advice is normally "used up" through action or inaction immediately after the advice is given. It is usually of a general and recurring nature involving overall planning that affects many assets. It may be compared, as in *Carpenter*,[27] to "investment counsel," the deductibility of which is allowed by Reg. Sec. 1.212-1(g).

Another factor worth noting is that Section 212(3) allows a deduction in many cases for the cost of tax advice that would otherwise constitute only a nondeductible personal expense under Section 262. In fact, the Supreme Court has compared the purpose of Section 212(3) to that of Section 213, which provides a deduction for personal medical expenses.[28] Under Section 213, medical expenditures for elevators, air conditioners and like assets for those whose physical condition require them are held to be capitalizable only to the extent of the increase in value of some other asset to which the acquired asset is an improvement (or the acquired asset's actual cost, if less).[29] If the same rule were applied to Section 212(3) expenditures, it would be a rare case indeed in which capitalization would be required. Although tax advice with respect to a specific asset is of value to a taxpayer, the advice would not ordinarily increase the value in the market place of the asset to which the advice relates.

It is also worth noting that, in Rev. Rul. 58-180,[30] the Service allowed a deduction under Section 212(3) for the cost of an appraisal to determine the amount of a casualty loss. The Service did not characterize the deduction as merely additional casualty loss, apparently on the theory that the only reason for the appraisal was to establish the amount of the loss for tax purposes. See also Rev. Rul. 67-461,[31] in which a Section 212(3) deduction was allowed for the expense of appraising property that was the subject of a charitable contribution. It might be generalized from these rulings that any expenditure for tax advice that is necessary only because of the existence of some tax law is deductible under Section 212(3) and may not be characterized as a part of the event or transaction (e.g., capital transaction) out of which the expenditure arose.[32] Such a rule would virtually eliminate any need to capitalize Section 212(3)-type expenditures.

Segregation of Fee for Tax Advice

The accountant or lawyer who bills his client for fees in connection with tax advice has a clear obligation to segregate the portion of the fees attributable to such advice where the bill also includes fees for nontax financial or legal services. In Rev. Rul. 72-545,[33] involving tax advice in divorce and separation cases, the Service gave some indication of its position on fee allocation. The ruling dealt with three separate divorce situations:

(1) A law firm specializing in state and federal taxation was engaged by the taxpayer to deal only with the tax aspects of his divorce;

(2) A law firm that had a department specializing in taxation was engaged by the taxpayer to handle both tax and nontax aspects of the divorce; and

(3) A single practitioner was engaged to handle both tax and nontax aspects of a divorce.

In the first instance, there was no need to make an allocation since all of the service consisted of the rendering of tax advice. In the second instance, the law firm's allocation was based primarily on the time required, the difficulty of the tax questions presented, and the amount of taxes involved. In the third instance, the single practitioner made his allocation based primarily on the relative time required, the fee customarily charged in the locality for similar services, and the result obtained. The Service concluded that, in each of the three situations, ". . . there exists a reasonable basis for allocating to tax counsel a portion of the legal fees incurred in connection with the divorce proceedings."

In the *Carpenter* case,[34] the court accepted the allocation of fees made by the practitioner. The court stated that the allocation was conservative and reasonably accurate and that there was no evidence that in making the allocation the practitioner had acted in bad faith. In *George v. United States*,[35] the court, after noting that the total fee in the divorce case was set by reference to a State Bar minimum fee schedule, proceeded to justify the government's allocation (of only 10 per cent of the fee to tax advice) on the basis of the number of hours spent and the hourly rate customarily charged for tax advice. In *Munn v. United States*,[36] the court accepted the practitioner's allocation, noting in its analysis the proportionate number of items in the bill that were related to tax matters, the complexity of those items, the apparent conservativeness of the allocation, and the lack of any evidence showing that the allocation was made in bad faith. The *Merians* court apparently utilized a *Cohan*-type analysis. The court gave little indication of the factors it took into account, merely stating that, because of the vagueness and lack of specificity in the testimony, the allocation had to be weighted heavily against the taxpayer.

Conclusion

In summary, then, factors deemed important by the Service in making an allocation of fees include consideration of the fee customarily charged in the locality for similar services, the relative time required, the difficulty of the tax questions presented, the amount of taxes involved, and the results obtained. The cases generally recognize much the same factors but, in addition, tend to give considerable weight to the practitioner's allocation where the court believes that the practitioner made his allocation in good faith.

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[1] CCH Dec. 31,966, 60 TC 187 (1973), acq. IRB 1973-42, 5.
[2] 45-2 USTC ¶ 9327, 325 U.S. 365.
[3] Sec. 23(a)(2), 1939 Internal Revenue Code.
[4] 52-1 USTC ¶ 9259, 343 U.S. 118, rehearing denied 343 U.S. 937.
[5] H. Rept. 1337, 83d Cong., 2d Sess., p. A59, 3 *U.S. Code Congressional and Administrative News* (1954), 4017, 4054, 4196; S. Rept. 1662, 83d Cong., 2d Sess., p. 218, 3 *U.S. Code Congressional and Administrative News* (1954) 4621, 4855.
[6] 61-1 USTC ¶ 9276, 287 F.2d 168 (Ct. Cls.), rev'd in part on other issues 370 U. S. 65 (1962).
[7] 64-2 USTC ¶ 9842, 338 F.2d 366 (Ct. Cls.).
[8] *George v. United States*, 71-1 USTC ¶ 9108, 434 F.2d 1336 (Ct. Cls.); *Munn v. United States*, 72-1 USTC ¶ 9255, 455 F.2d 1028 (Ct. Cls.).
[9] 1972-2 CB 179.
[10] 64-1 USTC ¶ 9235, 227 F. Supp. 807 (DC Mo.), appeal dism'd 328 F.2d 619 (CA-8).
[11] Case cited at footnote 1.
[12] Judges Scott, Goffe, Sterrett, Wiles, Withey, Hoyt, Irwin, and Quealy.
[13] Cited at footnote 9.

[14] Case cited at footnote 7.
[15] CCH Dec. 27,444(M), 24 TCM 894 (1965), aff'd 66-2 USTC ¶ 9562, 364 F.2d 744 (CA-2).
[16] CCH Dec. 30,306, 54 TC 1656 (1970), acq. 1971-2 CB 2.
[17] Case cited at footnote 6.
[18] *Clarence Wood*, CCH Dec. 25,086, 37 TC 70 (1961), acq. 1969-2 CB XXV, appeal dism'd (CA-6).
[19] *Commissioner v. Standing*, 58-2 USTC ¶ 9835, 259 F.2d 450 (CA-4).
[20] Sec. 62(a)(1).
[21] Case cited at footnote 18.
[22] Cf. *Bingham v. Commissioner*, cited at footnote 2, in which the Supreme Court allowed a nonbusiness expense deduction for the expenses of final distribution of trust properties to beneficiaries.
[23] 1967-1 CB 31.
[24] *Bingham v. Commissioner*, cited at footnote 2.
[25] Case cited at footnote 7.
[26] Case cited at footnote 16.
[27] Case cited at footnote 7.
[28] See *United States v. Gilmore*, 63-1 USTC ¶ 9285, 372 U.S. 39, footnote 16, therein.
[29] See e.g., *Riach v. Frank*, 62-1 USTC ¶ 9419, 302 F.2d 374 (CA-9); *Ramon Gerard*, CCH Dec. 25,331, 37 TC 826 (1966), acq. 1966-2 CB 5.
[30] 1958-1 CB 153.
[31] 1967-2 CB 125.
[32] This might in some cases run counter to the "origin" test prescribed by the Supreme Court for capital addition cases. See *Woodward v. Commissioner*, 70-1 USTC ¶ 9348, 397 U.S. 572; and *United States v. Hilton Hotels Corporation*, 70-1 USTC ¶ 9349, 397 U.S. 580.
[33] Cited at footnote 9.
[34] Case cited at footnote 7.
[35] Case cited at footnote 8.
[36] Case cited at footnote 8.