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Income Tax Deductions For Estate Planning Fees

I. Introduction

The need to engage the services of a lawyer may arise in a variety of situations, and the possibility of deducting the fees for a lawyer's services from the client's personal taxable income will ultimately depend on which one of several competing policies of the tax law is properly applicable under the particular circumstances. Taxpayers and their attorneys should be aware of the deductibility of expenses incurred for legal services rendered in connection with the planning of the taxpayer's estate. Such estate planning services include the drafting of a will, the arrangement of inter vivos and testamentary gifts, the creation of inter vivos and testamentary trusts, and tax advice in connection with estate planning. This paper will examine the extent of permissible deductions from personal income tax liability for these estate planning fees.

Since there is no explicit provision for attorneys' fees in the Internal Revenue Code of 1954,[1] the deductibility of such expenses depends upon the context in which they are incurred. Legal expenses incurred by an individual taxpayer are deductible from gross income only if he can show that they come within either section 162,[2] which authorizes the deduction of trade or business expenses, or section 212,[3] which permits the deduction of non-trade or non-business expenses. Any individual expenses incurred for estate planning services would not qualify as trade or business expenses, and, therefore, would be deductible only under section 212 of the Code.

Section 212 authorizes the deduction of "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."[4] The requirement that deductible expenses be "ordinary and necessary" implies that they "must be reasonable in amount and must bear a reasonable and proximate relation to the

1. The Code's closest approach to such expenses is a veiled reference in § 212(3), dealing with expenses incurred in the determination of tax liability.

2. INT. REV. CODE of 1954, § 162.

3. INT. REV. CODE of 1954, § 212.

4. *Id.*

production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income."[5]

Because it cannot be reasonably argued that estate planning services are for the production of income within the context of section 212(1), the deductibility of these expenses will be considered only under sections 212(2) and 212(3).

II. DEDUCTIONS UNDER SECTION 212(2)

Prior to 1942 there was no statutory provision for the deduction of nonbusiness expenses. If the expenditure in question was not incurred in conducting a business activity it was not deductible. This rule was strictly applied in the case of *Higgins v. Commissioner*[6] in which the Supreme Court held that expenses incurred by a taxpayer in managing his income producing property were not deductible because the taxpayer's investment activity did not constitute the carrying on of a trade or business. Thus, while the income derived from investment and other forms of nonbusiness activity would be taxable, the expenses incurred in carrying on such activities were not deductible.

Congress acknowledged this inequity and responded by enacting section 23(a)(2) of the Internal Revenue Code of 1939, the predecessor of section 212(1) and (2) of the 1954 Code. The legislative purpose underlying the enactment of section 23(a)(2) was explained as follows:

> The existing law allows taxpayers to deduct expenses incurred in connection with a trade or business. Due partly to the inadequacy of the statute and partly to court decisions, non-trade or non-business expenses are not deductible, although non-trade or non-business income is fully subject to tax. The bill corrects this inequity by allowing all of the ordinary and necessary expenses paid or incurred for the production or collection of income. Thus, whether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or in connection with property held for the production of income it is allowable.[7]

This legislative history demonstrates an intention on the part of

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5. Treas. Reg. § 1.212-1(d) (1957). *See* Trust of Bingham v. Commissioner, 325 U.S. 365, 368, 370 (1945); Northern Trust Co. v. Campbell, 211 F.2d 251, 253 (7th Cir. 1954).

6. 312 U.S. 212 (1941). *See also* United States v. Pyne, 313 U.S. 127, 129, 132 (1941) (attorneys' fees incurred by executors for advice in caring for investment not deductible as business expense); City Bank Farmers Trust Co. v. Helvering, 313 U.S. 121, 124 (1941) (trustees' commissions for management of trust investments not deductible because activity not "carrying on business" within § 23(a) of Revenue Act of 1928, predecessor of § 162 of Internal Revenue Code of 1954).

7. H.R. REP. No. 2333, 77th Cong., 2d Sess. 46, 74-76 (1942). *See also* S. REP. No. 1631, 77th Cong., 2d Sess. 87-88 (1942).

Congress to authorize, under either section 162 or section 212, a deduction for all ordinary and necessary expenses incurred in connection with any activity carried on primarily for the production of taxable income or for the management, conservation, or maintenance of property held for the production of taxable income.

While section 262,[8] which prohibits the deduction from gross income of "personal, family or living expenses," continues to restrict deductions under section 212, a great borderland of doubt still exists. Courts have been unable to formulate consistent and unambiguous tests for distinguishing nondeductible personal expenses from deductible nonbusiness expenses falling within section 212. Consequently, there is no single clear-cut standard that can be applied to determine the deductibility of the expense of estate planning services under section 212(2).

A. The Gilmore *"Origin Test"*

In *United States v. Gilmore*[9] and *United States v. Patrick*,[10] the Supreme Court established the principle that the deductibility of legal fees under section 212(2) depends upon the "origin and character of the claim" with respect to which the expense was incurred. Thus, if the origin and character of the claim is a personal one, as for example, one arising out of the marital relationship of the taxpayer, and not related to a trade or business or other profit-seeking activity, the expense would be characterized as personal and nondeductible.[11]

In both *Gilmore* and *Patrick* the taxpayer-husband had attempted to deduct that portion of the legal expenses incurred in a divorce proceeding allocable to his attorney's efforts to preserve income-producing property (taxpayer's controlling interest in several corporations) demanded by the wife. The taxpayer argued, and the lower courts agreed, that since the expense was incurred not to resist a liability owing to the wife but to satisfy that liability without depriving the taxpayer of income-producing property, it was for the conservation of property held for the production of income. To this position the Supreme Court in *Gilmore* replied "that the deductibility of these expenses turns . . . not upon the *consequences* to respondent [taxpayer] of a failure to defeat his wife's community property claims but upon

8. INT. REV. CODE of 1954, § 262.

9. 372 U.S. 39 (1963). Both cases were decided under Int. Rev. Code of 1939, § 23(a)(2), 53 Stat. 12 (now INT. REV. CODE of 1954, §§ 212(1), (2)).

10. 372 U.S. 53 (1963).

11. INT. REV. CODE of 1954, § 262; Treas. Reg. § 1.262-1(b)(7) (1957).

the *origin* and *nature* of the claims themselves."[12] Therefore, the expense was not deductible as an expense incurred for the conservation of property held for the production of income and was characterized as a nondeductible personal expense.

The decision of the Supreme Court in *Gilmore* was intended to resolve a conflict that had existed in lower court decisions as to the deductibility of legal expenses incurred in the negotiations and property settlements incident to divorce actions.[13] The Court enunciated an apparently clear test for deductions under section 212(2):

> [T]he 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 under . . . [section 212(2)];[14] [therefore]

12. 372 U.S. 39, 43-44 (1963). *See* 15 ALA. L. REV. 624 (1963); 14 KANSAS L. REV. 85 (1965); 13 MERCER L. REV. 432 (1962).

13. The Tax Court and several circuit courts had held that such expenses were nondeductible personal, living, or family expenses covered by the prohibition of § 262 and were not expenses for the management, conservation, or maintenance of income-producing property. Lewis v. Commissioner, 253 F.2d 821 (2d Cir. 1958); Richardson v. Commissioner, 234 F.2d 248 (4th Cir. 1956); Smith's Estate v. Commissioner, 208 F.2d 349 (3d Cir. 1953); Howard v. Commissioner, 202 F.2d 28 (9th Cir. 1953); Dallman v. United States, 191 F. Supp. 478 (N.D. Cal. 1961); Charlotte M. Douglas, 33 T.C. 349 (1959); Estate of James E. Walsh, 28 T.C. 1274 (1957); *accord*, Shipp v. Commissioner, 217 F.2d 401 (9th Cir. 1954) (nondeductible expenses in defense of title to property).

To the contrary, other circuit courts and the Court of Claims had allowed the deduction of legal expenses incurred in an uncontested divorce action not to resist the claims of the wife but to arrange the satisfaction of the liability owing to the wife without depriving the taxpayer-husband of income-producing property. These courts took the position that since the expense was for arranging the manner and form of satisfying the wife's claim, rather than contesting it, they were incurred for the purpose of conserving the husband's income-producing property and were therefore deductible. In Baer v. Commissioner, 196 F.2d 646 (8th Cir. 1952), the court held that since the taxpayer was relatively unconcerned about the divorce itself "[t]he controversy did not go to the question of . . . [his] liability [for alimony] but to the manner in which . . . [that liability] might be met . . . without greatly disturbing his financial structure;" therefore the legal services were "for the purpose of conserving and maintaining" his income-producing property. 196 F.2d at 649-50, 651. Owens v. Commissioner, 273 F.2d 251 (5th Cir. 1959); Bowers v. Commissioner, 243 F.2d 904 (6th Cir. 1957), *reversing*, 25 T.C. 452 (1955); Allen v. Selig, 200 F.2d 487 (5th Cir. 1952); Davis v. United States, 287 F.2d 168 (Ct. Cl. 1961); McMurtry v. United States, 132 F. Supp. 114 (Ct. Cl. 1955); Aller v. United States, 56-2 U.S. Tax Cas. 9867 (S.D. Cal. 1956); Patrick v. United States, 288 F.2d 292 (4th Cir. 1961), *rev'd*, 372 U.S. 53 (1963); United States v. Gilmore, 290 F.2d 942 (Ct. Cl. 1961), *rev'd*, 372 U.S. 39 (1963).

14. Compare present Treas. Reg. § 1.212-1(m) (1957), which provides: "An expense (not otherwise deductible) paid or incurred by an individual in determining or contesting a liability asserted against him does not become deductible by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability." The legal fees in issue in *Gilmore* and *Patrick* were incurred before the adoption of this regulation.

> . . . the only kind of expenses deductible under . . . [section 212(2)] are those that relate to a "business," that is, profit-seeking purpose.[15]

The rationale of the *Gilmore* decision and its origin test apparently would bar the deduction of expenses incurred for estate planning services. However, a close analysis of that decision suggests that the origin test is not the exclusive test of deductibility under section 212(2). Indeed, some lower courts have deemed the *Gilmore* origin test inapplicable to deductions claimed under section 212(1).[16]

As the *Gilmore* Court initially noted, the legislative history of section 212 indicates that the section was enacted to provide a class of deductions coextensive with those permitted by section 162[17] and subject to the same tests formulated for section 162, except that the expense need not be incurred with respect to a business.[18] *Gilmore*'s adoption of the origin test for section 212(2) was based primarily on the notion that previous cases had indicated that an expense must have a business origin to be deductible under section 162. However, *Kornhauser v. United States*, a leading case interpreting section 162 and relied on by *Gilmore*, held that a legal expense was a deductible business expense if the action against the taxpayer was "*directly connected* with, *or* as otherwise stated . . . proximately resulted from, his business . . . ."[19] The expense in question was deductible because

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15. 372 U.S. 39, 46, 49 (1963).

16. In Ruth K. Wild, 42 T.C. 706 (1964), the Tax Court affirmed the continued validity, even in light of *Gilmore*, of cases permitting a woman to deduct that portion of her legal expenses in a divorce action allocable to her attorney's efforts to obtain taxable alimony as an expense "for the production of income." The Tax Court did not accept the government's argument that pursuant to the *Gilmore* decision these expenditures were nondeductible personal expenses since they arose from the marital relationship and not from any profit-seeking activity. *See also* Peckham v. Commissioner, 327 F.2d 855 (4th Cir. 1964); Hazel Porter, 25 CCH Tax Ct. Mem. 448 (1966), *aff'd on other grounds*, 388 F.2d 670 (6th Cir. 1968).

17. "And committee reports make clear that deductions under the new section were subject to the same limitations and restrictions that are applicable to those allowable under § 23(a)(1) [now § 162]. Further, this Court has said that § 23(a)(2) 'is comparable and *in pari materia* with § 23(a)(1),' providing for a class of deductions 'coextensive with the business deductions allowed by § 23(a)(1), except for' the requirement that the income-producing activity qualify as a trade or business. Trust of Bingham v. Commissioner, 325 U.S. 365, 373, 374 (1945)." 372 U.S. at 45.

18. "A deduction under this section is subject, except for the requirement of being incurred in connection with a trade or business, to all the restrictions and limitations that apply in the case of the deduction under section 23(a)(1)(A) of an expense paid or incurred in carrying on any trade or business." H.R. REP. No. 2333, 77th Cong., 2d Sess. 46, 74-76 (1942). *See also* S. REP. No. 1631, 77th Cong., 2d Sess. 88 (1942).

19. Kornhauser v. United States, 276 U.S. 145, 153 (1928) (emphasis added) (legal expenses incurred by taxpayer in successful defense of suit brought by former business partner for accounting of stock received by taxpayer as a fee were deductible because the suit grew out of taxpayer's business).

it had a business origin, but there was no language in the Court's test or decision to compel the conclusion that the origin standard must be exclusive.

The Court in *Gilmore* also found support for the origin test in *Lykes v. United States*[20] in which the Supreme Court denied a claim for the deduction of legal expenses incurred contesting the assessment of a gift tax liability. Rejecting the taxpayer's argument that his expenses were incurred in the "conservation" of income-producing property, and hence deductible, since payment of the tax deficiency would have forced him to liquidate his stockholdings, the Court noted that "deductibility [of expenses] turns wholly upon the nature of the activities to which they relate."[21] The Court concluded that what is now section 212(1) and (2), "has been applied to expenses on the basis of their immediate purposes rather than upon the basis of the remote contributions they might make to the conservation of a taxpayer's income-producing assets by reducing his general liabilities."[22]

Lykes might be used as the basis for denial of deductions claimed under section 212(2) for certain estate planning fees because their origin is the personal gift making or trust creation of the taxpayer. However, the *Lykes* case involved tax advice, and the authority of the decision has been greatly reduced, if not abrogated, by the subsequent enactment in 1954 of section 212(3) which permits the deduction of expenses incurred for the determination of any tax liability.[23]

The refusal of many courts to be limited by the origin test indicates that considerable judicial opinion favors a broader interpretation of section 212.[24] Indeed, most of the Supreme Court decisions which articulated an origin test were dissented to on the ground that the test unduly limits deductibility.[25]

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20. 343 U.S. 118 (1952). *See also* Deputy v. du Pont, 308 U.S. 488, 496 (1940), in which the Court held that "it is the kind of the transaction out of which the obligation arose . . . which is crucial and controlling."

21. *Id.* at 123. Since gifts are the antithesis of the production or collection of income, expenses incurred in connection with them are not deductible.

22. *Id.* at 125.

23. INT. REV. CODE of 1954, § 212(3). *See* section III *infra.*

24. Even under § 162, the source of the "origin" test, taxpayers have been allowed to deduct legal expenses, although not arising from business origin, when the dominant purpose was the protection of business. Paul Draper, 26 T.C. 201 (1956); *accord,* J. Raymond Dyer, 36 T.C. 456 (1961). *See also* Lindsay C. Howard, 16 T.C. 157 (1951), *aff'd on other grounds,* 202 F.2d 28 (9th Cir. 1953).

25. United States v. Patrick, 372 U.S. 53, 57 (1963); United States v. Gilmore, 372 U.S. 39, 52 (1963); Lykes v. United States, 343 U.S. 118, 127 (1958); McDonald v. Commissioner, 323 U.S. 57, 65 (1944) (dissenting opinions). *But see* Deputy v. du Pont, 308 U.S. 488 (1940).

B. The Direct Connection Test

The language of section 212 implies a broader scope than the origin test would permit. It is arguable that since section 212 was enacted in response to the *Higgins* case, and since section 212(1) completely covers the *Higgins* situation, the congressional enactment of section 212(2) is indicative of a concern broader than the injustice of the *Higgins* problem and the origin test.[26] Even the current treasury regulation uses language which is clearly broader than the origin test: "[E]xpenditures directly connected with or pertaining to the taxpayer's trade or business" are deductible.[27] Moreover, the legislative history of section 212 indicates that except for transactions carried on "primarily as a sport, hobby, or recreation," Congress provided a deduction for all ordinary and necessary expenses incurred in the production of income or in connection with the management, conservation, or maintenance of income-producing property.[28]

The legislative history and the judicial pronouncements other than *Gilmore* strongly suggest that Congress did not intend section 212 to be restricted by the origin test: if Congress intended section 212 to be governed by the same standards as section 162, then it must not have viewed either section as being subject exclusively to an origin test. A House Report states: "[W]hether or not the expense is in connection with the taxpayer's trade or business, if it is expended in the pursuit of income or *in connection with* property held for the production of income, it is allowable."[29] It is thus arguable that the origin test enunciated in *Gilmore* does not give full effect to the scope of deductions envisioned by Congress in both sections 162 and 212.[30]

In *Gilmore*, the Court chose to adopt the origin test and to rejeet what may be called the consequence test, which was derived from the lower court decision and from the several eircuit court decisions[31] permitting the taxpayer to deduct expenses when, as a consequence of resisting his wife's claims to income-produeing property, he preserved his property. By limiting its choice of standards for determining

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26. McDonald v. Commissioner, 323 U.S. 57, 67 (1944) (dissenting opinion in 5-4 decision).

27. Treas. Reg. § 1.162-1(a) (1958).

28. *See* note 7 *supra* and accompanying text.

29. H.R. REP. No. 2333, 77th Cong., 2d Sess. 46 (1942) (emphasis added).

30. For an excellent examination of the *Gilmore* Court's reasoning and a thorough discussion of the argument that the origin test is not the exclusive test to be applied to § 212, see Note, *Deductibility of Legal Expenses: The Exclusivity of Gilmore*, 40 N.Y.U.L. REV. 351 (1965).

31. *See* note 13 *supra*.

deductibility under section 212 to the origin and consequence tests, the Supreme Court neglected the direct connection test adopted by *Kornhauser*.

Although *Gilmore* has precluded further application of the consequence test, its failure explicitly to invalidate the direct connection test may provide some basis for the deductibility of estate planning fees that are directly connected with the management, conservation, or maintenance of property held for the production of income. The Court in *Gilmore* apparently was unwilling to abrogate the direct connection test in favor of its origin test, but it may have intended to establish two alternative or concomitant tests. Referring to *Kornhauser* and *Deputy*, the Court stated:

> The principle we derive from these cases is that the characterization, as "business" or "personal," of the litigation costs of resisting a claim depends on whether or not the claim *arises in connection with* the taxpayer's profit-seeking activities.[32]

This statement indicates that the Court intended to affirm the direct connection test, while not applying it to the factual situation presented in *Gilmore*.

C. *The* Trust of Bingham *Case—Application of the Direct Connection Test to Trust Management*

The leading case interpreting section 23(a)(2), the predecessor of section 212, and a case heavily relied on by *Gilmore* for the proposition that sections 162 and 212 are governed by the same limitations,[33] is *Trust of Bingham v. Commissioner*[34] which restated the *Kornhauser* standard that an expense is deductible if it is "directly connected with *or* proximately results from the conduct of the [taxpayers'] business."[35] In the *Bingham Trust* case the Supreme Court held that attorney's fees paid by a trustee in unsuccessfully contesting an income tax deficiency assessment, in obtaining advice in connection with the payment of a cash legacy, and in formally distributing the trust corpus and terminating the trust were deductible expenses for the management, conservation, or maintenance of property held for the production of income. The Court determined that the objections to the deductions failed "to take proper account of the plain language of sections 23(a)(2), and the purpose of the section as disclosed by its statutory setting and legislative history."[36]

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32. 372 U.S. 39, 48 (1963) (emphasis by Court).
33. *See* note 17 *supra*.
34. 325 U.S. 365 (1945).
35. *Id.* at 374 (emphasis added).
36. *Id.* at 369-70. *See also* Herbst v. Commissioner, 2 CCH Tax Ct. Mem. 361 (1943), in

In upholding the deductions as ordinary and necessary expenses incurred for the management of income-producing property, the Court stated that it is not necessary for expenses to result in the collection or production of income.

> To read this section as requiring that expenses be paid for the production of income in order to be deductible, is to make unnecessary and to read out of the section the provision for the deduction of expenses of management of property held for the production of income.[37]

The Court emphasized that the purpose of section 212 was to provide for a class of nonbusiness deductions coextensive with the business deductions except that they must be incurred for the production of income or in the management or conservation of property held for the production of income.[38] Continuing its analogy between business and nonbusiness deductions, the Court enunciated the direct connection test:

> 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. . . .[39]
>
> Since there is no requirement that business expenses be for the production of income, there is no reason for that requirement in the case of like expenses of managing a trust, so long as they are *in connection with* the management of property which is held for the production of income.[40]

After holding that the expenses connected with the devolution of the trust property were deductible, the Court said:

> What we have said applies with equal force to the expenses of contesting the tax deficiency. Section 23(a)(2) does not restrict deductions to those litigation expenses which alone produce income. On the contrary, by its terms and in analogy with the rule under § 23(a)(1), the business expense section, the trust, a taxable entity like a business, may deduct litigation expenses when they are *directly connected with or proximately result from the enterprise—the management of property held for production* of income.[41]

The *Bingham Trust* case thus established that the expenses

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which the Tax Court allowed the deduction of expenses for attorney's services in representing taxpayer in the termination of a trust, preparing a release covering the delivery of trust assets to the trust beneficiary-taxpayer, arranging for the opening of a special investment account, and preparing a custodian agreement for the account.

37. 325 U.S. at 373; *see* note 18 *supra.*

38. 325 U.S. at 373. The Court cited H.R. REP. No. 2333, 77th Cong., 2d Sess. 46, 74-76, and S. REP. No. 1631, 77th Cong., 2d Sess. 87-88 (1942).

39. 325 U.S. at 373-74 (emphasis added). Here the Court cited Kornhauser v. United States, 276 U.S. 145, 152-53 (1928), and Commissioner v. Heininger, 320 U.S. 467, 470-71 (1943).

40. 325 U.S. at 374 (emphasis added).

41. *Id.* at 376, *citing* Kornhauser v. United States, 276 U.S. 145, 152-53 (1928) (emphasis added).

incurred in terminating a trust and disbursing trust assets are within section 212(2) even though such expenses are not incurred with the intent that they will themselves produce income; it is enough that the expense is connected with the management, conservation, or maintenance of property that is held for production of income. The holding of the *Bingham Trust* case and the *Gilmore* Court's explicit recognition of the direct connection test in its reference to *Kornhauser* would seem to affirm the continued applicability of the direct connection test to section 212(2). Additional support for the continued existence of the direct connection test can be found in the fact that the *Lykes* Court recognized and distinguished the *Bingham Trust* case.[42]

Following *Bingham Trust*, the direct connection test was restated by the Seventh Circuit in the form of a "proximate relation" test: "It is not the personal liability but rather the nature of the expense itself, and the *proximate relation to . . . income producing property* of the taxpayer which is the standard for determining whether an expense is deductible under . . . [section 212(2)]."[43] Quoting from *Bingham Trust*, the court held that the legal expense incurred by the remainderman of a trust in successfully contesting the assessment of estate taxes against the property was in proximate relation to the conservation of income-producing property and, therefore, deductible. The trust property was held for the production of income; first by the decedent-grantor, then by the trustees, and finally by the taxpayer as remainderman.

More recently, in 1967, the Eighth Circuit relied heavily on *Bingham Trust* in holding that a trustee's termination fees for the management, conservation, or maintenance of that part of the trust property held for the production of taxable income were deductible by the trust beneficiary under section 212(2).[44] The court also relied on Treasury Regulation section 1.212-1(i) which provides: "Reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses . . . which are ordinary and necessary in connection with the performance of the duties of administration are deductible under section 212 . . . ." In addition, deductions have been allowed for attorneys' fees paid by a trust grantor

42. In Lykes v. United States, 343 U.S. 118, 124 n.11 (1952), the Court stated that the expenses incurred in contesting the income tax deficiency and in winding up the trust "were integral parts of the management or conservation of the trust property for the production of income and, as such, deductible under § 23(a)(2)."

43. Northern Trust Co. v. Campbell, 211 F.2d 251, 253 (7th Cir. 1954) (emphasis added).

44. Whittemore v. United States, 383 F.2d 824 (8th Cir. 1967). *See also* Case v. United States, 66-2 U.S. Tax Cas. 9764 (D. Wyo. 1966).

for services in procuring the reformation of a trust[45] and for fees paid by a trust grantor or beneficiary for the management of a trust fund.[46]

Restrictions on deducting the expense of creating and administering an estate plan before death would seem to be inconsistent with the treasury regulations'[47] practically unrestricted allowance of deductions for all legal expenses incurred in administering, preserving, and distributing the assets of an estate.

Since the expenses incurred in the operation, administration, and termination of a trust are deductible when the trust property is held for the production of income, it is inequitable not to allow similar deductions for expenses incurred by a taxpayer for advice and services in creating and administering an estate plan, so long as such expenses are clearly allocated to that portion of the expense incurred in connection with property held for the production of taxable income. Such expenses are incurred as much for the safeguarding and managing of property as are the expenses of administering a trust.[48]

D. *Estate Planning Fees Analogized to Deductible Investment Counseling Fees*

Estate planning fees may be deductible under section 212(2) as expenses incurred for the management or conservation of income-producing property by analogy to the deductions allowed for the expenses of investment counsel. The treasury regulations specifically provide deductions for investment counsel fees and similar expenses incurred in connection with investments held by the taxpayer if they are for the production of income or for the management, conservation, or maintenance of investments held for the production of income.[49]

Applying the direct connection test of *Bingham Trust*, the Tax Court in *Nancy R. Bagley* allowed deductions for investment counsel fees and attorneys' fees paid for reviewing the merits and legal aspects of various estate plans for the rearrangement of taxpayer's investments.[50] Cases have uniformly held that investment counseling

45. William J. Garland, 2 CCH Tax Ct. Mem. 419 (1943).

46. William Ziegler, 1 B.T.A. 186 (1924); Rev. Rul. 58-53, 1958-1 CUM. BULL. 152.

47. Treas. Reg. §§ 1.212-1(i) & 20.2053-3(a),(c),(d) (1957). *See also* Miller, *Estate Tax Deductions*, 102 TRUSTS & ES. 859, 862 (1963).

48. United States v. Gilmore, 372 U.S. 39, 44 (1963). *See also* A.J. CASNER, ESTATE PLANNING 121 (3d ed. 1961); 4 A.J. MERTENS, LAW OF FEDERAL INCOME TAXATION ¶ 25.09, at 19-20 (rev. ed. 1960). Such a deduction was permitted by the Tax Court in Nancy R. Bagley, 8 T.C. 130 (1947), *acquiesced in* 1947-1 CUM. BULL. 1.

49. Treas. Reg. § 1.212-1(g) (1957).

50. Nancy R. Bagley, 8 T.C. 130 (1947), *acquiesced in* 1947-1 CUM. BULL. 1.

fees, such as fees paid for information furnished to a taxpayer as to which investments to buy, sell, or keep, are generally deductible.[51] Also deductible are the cost of managing investments,[52] and the expenses of accounting and auditing services incurred in connection with the taxpayer's investment activities.[53] Where expenses for legal advice concerning the tax treatment of annuities, dividends, holding periods on certain stocks acquired by gifts, and partial loss deductions were likewise held deductible, the Tax Court stated that "[t]he expenditures appear to have been for legal advice related solely to an ascertainment of proper tax liability and they have a *bearing* upon the management, conservation, or maintenance of his property held for the production of income."[54] Similarly, a district court, in holding that the expenses of legal advice obtained for the protection of taxpayers' investments were deductible as ordinary and necessary expenses incurred in the management and conservation of income-producing property, stated that deductibility should depend upon the necessity of obtaining counsel to protect the investments.[55] More recently, the Court of Claims held that the expenses of investment advice obtained for the *purpose* of rearranging and diversifying the taxpayers' personal investments in order to improve their capacity to produce income were deductible as expenses incurred for the management of income-producing property.[56]

It can be argued that the legal fees incurred in estate planning are distinguishable from the deductible investment counseling fees on the ground that the latter directly contribute to the production of income while the estate planning services make only a remote contribution to income production. Estate planning services, however, bear upon and are ordinarily incurred for the purposes of managing and conserving income-producing property to the same extent as investment counseling services.

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51. Elma M. Williams, 3 T.C. 200 (1944); Edward Mallinckrodt, Jr., 2 T.C. 1128 (1943), *aff'd on other grounds*, 146 F.2d 1 (8th Cir.), *cert. denied*, 324 U.S. 871 (1945); Amelia E. Collins, 3 CCH Tax Ct. Mem. 223 (1944); Andrew Jergens, 2 CCH Tax Ct. Mem. 385 (1943); Estate of Winifred L. Milner, 1 CCH Tax. Ct. Mem. 513 (1943).

52. Frederick B. Rentschler, 1 T.C. 814 (1943); Ezra Winter, 1 CCH Tax Ct. Mem. 274 (1942); Barbara S. Kirkland, 1 CCH Tax Ct. Mem. 99 (1942). *But see* Stoddard v. Commissioner, 141 F.2d 76 (2d Cir. 1944).

53. Edward Mallinckrodt, 2 T.C. 1128 (1943), *aff'd on other grounds*, 146 F.2d 1 (8th Cir.), *cert. denied*, 324 U.S. 871 (1945); Estate of Winifred L. Milner, 1 CCH Tax Ct. Mem. 274 (1942).

54. Philip D. Armour, 6 T.C. 359, 363 (1946) (emphasis added).

55. Straub v. Granger, 143 F. Supp. 250 (W.D. Pa. 1956) (fees were paid to an attorney who advised taxpayer, a family group of minority shareholders in a closely held corporation, to purchase additional stock in order to protect their prior investment in the corporation against changes in the operation of the corporation which the controlling directors contemplated making).

56. Picker v. United States, 371 F.2d 486 (Ct. Cl. 1967).

Apparently observing this strong similarity, the Tax Court in the case of *Hobart J. Hendrick*[57] allowed a taxpayer who had a vested remainder in the corpus of an estate to deduct attorneys' fees paid to keep the taxpayer-remainderman advised as to the management of the estate corpus even though the taxpayer received no income from the estate during the taxable year. An earlier case had held that attorneys' fees paid for services rendered in attending to taxpayer's interest as income beneficiary and remainderman of a trust and to his interest in connection with his father's estate were deductible expenses.[58] Both courts stated that the taxpayers' interests constituted property held for the production of income, and any expense conducive to the preservation and maintenance of such property was deductible. The courts found the taxpayers' attorneys' services comparable to investment advice since the purpose of the legal advice was both to enhance the income of the taxpayers' property and to aid in preserving it.

These cases permitting deductions for legal advice rendered in connection with property interests owned by the taxpayer and from which he receives or will in the future receive taxable income suggest that the expenses of any legal services, including will drafting, incurred in connection with a taxpayer's property are deductible under section 212(2) provided the taxpayer himself does or will receive the income from the property. Indeed, in *Nancy R. Bagley*[59] the court denied a deduction for the expenses of legal services rendered in the creation of a trust by the taxpayer for the benefit of her daughter, but allowed a deduction for an identical expense incurred for the creation of trusts for the management of the taxpayer's property for her own benefit, the income being reserved to her for life.

E. Deductions Under Section 212(2) for Estate Planning Fees

The *ratio decidendi* of the *Bingham Trust*[60] case, of the cases allowing deductions of all investment management expenses[61] and of the fees for attending to taxpayers' interest as estate or trust beneficiaries,[62] and of the *Nancy R. Bagley* case[63] needs only a slight extension to permit the deduction of the expense of estate planning

57. 35 T.C. 1223 (1961).
58. Herman W. Fletcher, 10 CCH Tax Ct. Mem. 793 (1951).
59. 8 T.C. 130 (1947). *See* text accompanying notes 47-48 *supra.*
60. *See* text accompanying notes 35-42 *supra.*
61. *See* text accompanying notes 49-55 *supra.*
62. *See* text accompanying notes 57-58 *supra.*
63. *See* text accompanying notes 50 & 59 *supra.*

services rendered in connection with property which is owned by and provides income for the taxpayer. Thus to the extent that the attorney's activities relate to the investment management,[64] rearrangement, or reinvestment[65] of the taxpayer-client's income-producing property or to the creation,[66] reformation,[67] or termination[68] of a trust, or to the drafting of a will[69] involving property held for the production of income for the taxpayer, the attorney's fees should be deductible under section 212(2) as expenses incurred for the management, conservation, or maintenance of property held for the production of income. The expenses sought to be deducted will have to be carefully allocated to services relating to property held for the production of income for the taxpayer. Expenses which are not deductible under section 212(2) because they arise from a primarily personal activity[70] or because they do not relate to the management of income-producing property[71] may, nevertheless, be deductible under section 212(3)[72] as expenses for the determination of a future tax liability.

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64. *See* cases cited in notes 49-55 *supra* and accompanying text.

65. *See* Picker v. United States, 371 F.2d 486 (Ct. Cl. 1967), and text accompanying note 56 *supra*. *See also* Gordon, *Are Legal Fees Deductible?*, 44 MICH. S.B.J., 11 (1965).

66. *See* Nancy R. Bagley, 8 T.C. 130 (1947), and text accompanying notes 50 & 59 *supra*. *See also* A.J. CASNER, ESTATE PLANNING 121 (3d ed. 1961); Kabaker, *Deductibility of Estate Planning Fees*, 54 ILL. B.J. 726, 730 (1966).

67. *See* William J. Garland, 2 CCH Tax Ct. Mem. 419 (1943) (attorney's fees incurred for services in procuring reformation of a trust deductible).

68. Trust of Bingham v. Commissioner, 325 U.S. 365 (1945); text accompanying notes 35-42 *supra*.

69. The only case concerning the deduction of the legal fee of writing a will was decided prior to the enactment of Int. Rev. Code of 1939, ch. 1, 23(a)(2), 53 Stat. 12 (now INT. REV. CODE of 1954, § 212). In the case of Helen S. Pennell, 4 B.T.A. 1039 (1926), the Board of Tax Appeals held that attorney's fees paid for advice relating to the protection of taxpayer's rights in her husband's property, investment counseling, writing a will, and management of taxpayer's personal affairs were not deductible expenses incurred in carrying on a trade or business as provided in § 214(a)(1) of the Revenue Act of 1918, ch. 18, 214(a)(1), 40 Stat. 1066. The taxpayer there failed to allocate that portion of her legal expenses attributable to the conservation of income-producing property and that attributable to purely personal activity.

70. *See* United States v. Gilmore, 372 U.S. 39 (1963), and United States v. Patrick, 372 U.S. 53 (1963), discussed in text accompanying notes 9-12 *supra*; Lykes v. United States, 343 U.S. 118 (1952), discussed in text accompanying notes 20-22 *supra*.

71. The expenses incurred in making any kind of gift thus would not be deductible under § 212(2) because the property given away by the taxpayer is no longer held by the taxpayer for the production of income. *See* Lykes v. United States, 343 U.S. 118 (1952), discussed in text accompanying notes 20-22 *supra*.

72. In United States v. Gilmore, 372 U.S. 39 (1963), discussed in text accompanying notes 9-12 *supra*, the possibility of a deduction under § 212(3) apparently was overlooked since no portion of the fees was specifically allocated to tax planning incident to the separation and property settlement arrangements.

III. DEDUCTIONS UNDER SECTION 212(3)

Almost all estate planning problems involve the issue of taxes. Solutions are sought which will attain the objectives of the client-taxpayer as to the arrangement, management, and distribution of his property and at the same time minimize the tax burden on his estate and family. The trend of recent decisions indicates that at least that portion of legal fees incurred for estate planning purposes in connection with the consideration of tax problems are deductible under section 212(3) of the *Internal Revenue Code of 1954*, which provides that:

> 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 . . . .
> (3) in connection with the determination, collection, or refund of any tax.[73]

Prior to the enactment of this section, the Supreme Court, in *Lykes v. United States*,[74] held that legal expenses incurred in connection with litigation of federal gift tax liability, unlike those resulting from a contest over the assessment of income or estate taxes, were not deductible under the predecessor of section 212(2) as expenses for the management, conservation, or maintenance of income-producing property because the gift was not for production or collection of income. The *Lykes* decision was apparently a judicial reaction to lower court decisions which had strained the interpretation of section 212(2) and the direct connection test of *Bingham Trust*[75] so as to disregard prior decisions. Thus one court allowed a deduction for legal fees paid for the preparation of taxpayers' tax returns[76] in direct opposition to an earlier judicial statement "that Congress never intended to allow as a deduction such a purely personal expenditure."[77] However, the *Lykes* decision created the inequitable situation of denying deductions for legal fees connected with contesting gift tax assessments while identical legal expenses were deductible if incurred in connection with the determination of income tax[78] or estate tax[79] liability.

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73. INT. REV. CODE of 1954, § 212(3).

74. 343 U.S. 118 (1952). *See also* discussion in text accompanying notes 20-23 *supra.*

75. Trust of Bingham v. Commissioner, 325 U.S. 365 (1945). *See* text accompanying notes 35-42 *supra.*

76. Rush v. United States, 59-2 U.S. Tax Cas. ¶ 9752 (N.D. Ala. 1959); David L. Loew, 7 T.C. 363 (1946).

77. Higgins v. Commissioner, 143 F.2d 654, 655 (1st Cir. 1944).

78. Trust of Bingham v. Commissioner, 325 U.S. 365 (1945); Stoddard v. Commissioner, 152 F.2d 445 (2d Cir. 1945); Harry Dunitz, 7 T.C. 672 (1946), *aff'd without discussion*, 167 F.2d 223 (6th Cir. 1948); James A. Connelly, 6 T.C. 744 (1946); Philip D. Armour, 6 T.C. 359 (1946); Howard E. Cammack, 5 T.C. 467 (1945).

79. Northern Trust Co. v. Campbell, 211 F.2d 251 (7th Cir. 1954).

Thus one of the purposes of adding subsection (3) to section 212 was to change the rule of the *Lykes* case[80] so that an individual could deduct all ordinary and necessary expenses paid in connection with the determination, collection, or refund of *any* tax.[81] The Internal Revenue Service has adopted the position that deductions under section 212(3) are restricted to legal expenses incurred for tax advice in connection with actual tax controversies or completed transactions and that expenses incurred in connection with future or prospective taxes or contemplated transactions are not deductible. This position is apparently based upon the report of the House Ways and Means Committee on the then-proposed section which stated that section 212(3) "is designed to permit the deduction . . . of . . . expenses paid . . . in connection with a *contested* tax liability . . . . Any expenses incurred in contesting any liability collected as a tax . . . will be deductible."[82] Thus, until recently, the deductibility of attorneys' fees incurred for tax planning and counseling services relating to proposed transactions has been in doubt.[83]

Notwithstanding the attempt of the Internal Revenue Service to limit the deduction under section 212(3) to expenses incurred for tax counsel in connection with completed transactions or actual tax controversies, recent cases have indicated that the deduction under section 212(3) is not to be so limited.

A. The Davis *Case*

In *Davis v. United States*,[84] the Court of Claims held that

80. The report of the House Ways and Means Committee on the then proposed section states: "Existing law allows an individual to deduct expenses connected with earning income or managing and maintaining income-producing property. Under the regulations costs incurred in connection with *contests* over certain tax liabilities, such as income and estate taxes, have been allowed, but these costs have been disallowed where the *contest* involved gift-tax liability. A new provision added by your committee allows a deduction for expenses connected with determination, collection, or refund of any tax liability." H.R. REP. No. 1337, 83d Cong., 2d Sess. 29 (1954) (emphasis added). *See also* S. REP. No. 1622, 83d Cong., 2d Sess. 218 (1954).

81. H.R. REP. No. 1337, 83d Cong., 2d Sess. A59 (1954) states further: "Paragraph (3) is new and is designed to permit the deduction by an individual of legal and other expenses paid or incurred in connection with a *contested* tax liability, whether the *contest* be Federal, State, or municipal taxes, or whether the tax be income, estate, gift, property, and so forth. Any expenses incurred in contesting any liability collected as a tax or as a part of the tax will be deductible." (Emphasis added).

82. *Id.; see* Bonnyman v. United States, 156 F. Supp. 625 (E.D. Tenn. 1957), *aff'd*, 261 F.2d 835 (6th Cir. 1958).

83. *See* De Castro, *Recent Cases Show Liberal Trend in Allowing Deductions for Legal Fees*, 23 J. TAX. 224 (1965).

84. 287 F.2d 168 (Ct. Cl. 1961).

attorneys' fees incurred for the purpose of examining the tax aspects of a proposed separation and property settlement agreement were properly deductible from gross income. The court specifically relied on the language of Treasury Regulation section 1.212-1(l), which provides that "expenses paid or incurred by a taxpayer for tax counsel . . . in connection with any *proceedings* involved in determining the extent of his tax liability . . . are deductible."[85] The Court of Claims made specific reference to the fact that the taxpayer's attorney's bill had allocated a portion of his fees to services regarding the separation agreement and a portion to services in regard to tax matters. Presumably such an allocation will avoid the rule of section 262 prohibiting the deduction of personal, family, or living expenses.[86] The court did not state whether the "proceeding" involved, namely the divorce and separation, was necessary to its decision in light of the language of the Treasury Regulation which it cited.

B. The Kaufman *Case*

In *Kaufman v. United States*,[87] a federal district court permitted three taxpayers to deduct accountants' fees incurred for consultation concerning the tax consequences of alternative proposed plans for exchanging their stockholdings in a closely held corporation and fees for obtaining an Internal Revenue Service advance ruling on the tax consequences of the exchange. The court denied a deduction for the fees allocable to a determination of the basis of the stock received by the taxpayers under the plan of reorganization.

Citing a report of the House Ways and Means Committee,[88] the government contended that the legislative history of section 212(3) indicated a congressional intent to limit the deductions under that section to only those expenses incurred in the preparation of tax returns and in the actual determination and contesting of tax liability, thereby precluding any deduction for expenses incident to a determination of tax liability prior to the time it becomes contested. The court specifically rejected this argument and replied that when the legislative history does not agree with the language of the Act itself, "then the

85. Treas. Reg. § 1.212-1(l) (1957), *cited at* 287 F.2d 170 (emphasis added).

86. INT. REV. CODE of 1954, § 262. Treas. Reg. § 1.262-1(b)(7) (1958) provides that "attorney's fees and other costs paid in connection with a divorce, separation, or decree for support are not deductible. . . ."

87. 227 F. Supp. 807 (W.D. Mo. 1963).

88. H.R. REP. No. 1337, 83d Cong., 2d Sess. 29, A59 (1954). *See* notes 80-81 *supra*.

court is bound by the clear and commonly understood meaning of the Act."[89]

Relying on the clear language of subsection (3), the court noted that the determination, collection, and refund of a tax liability are separate and distinct phases of a tax controversy. The court stated that under Treasury Regulation section 1.212-1(l) "the taxpayer is entitled to deduct expenses paid or incurred in connection with the preparation of his tax return, 'or in connection with any *proceedings* involved in determining the extent of his tax liability,'"[90] and held that the request for a ruling was a "proceeding," the expense of which was properly deductible.[91]

Denying the deduction for fees incurred in connection with the computation of stock basis, the court stated: "There was no *controversy* at that time as to the tax base of the new stock . . . . The base was computed for the information of the taxpayers or *for some possible future use*, and not for the purpose of determining any tax."[92] This last statement seems to be an acceptance by the court of the government's argument that a tax contest or a completed transaction is a prerequisite to deductibility under section 212(3) and that expenses incurred in connection with future taxes or contemplated transactions are not deductible. Such a position appears inconsistent with the theory of the court in allowing the deduction of the remaining portions of the accountant's fees.[93] The ruling as well as the computation of the basis of the stock was "for the information of the taxpayers" and for their "future use." Surely the basis of the stock would be a significant factor in the taxpayers' consideration of any later disposition of their stock and in the determination of their tax liability upon such disposition.

The court's reference to a controversy and its denial of the deduction in connection with the computation of stock basis is inconsistent with the Treasury Regulation[94] providing that expenses

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89. 227 F. Supp. at 813-14.

90. *Id.* at 814, *citing* Treas. Reg. § 1.212-1(l) (1957) (emphasis added).

91. "[T]he sole purpose of the expenditure was the computation of the tax liability, if any, which would arise from the exchange." 227 F. Supp. at 815.

92. *Id.* (emphasis added).

93. De Castro, *Recent Cases Show Liberal Trend in Allowing Deductions for Legal Fees*, 23 J. TAX. 224 (1965); *see* Kabaker, *Deductibility of Estate Planning Fees*, 54 ILL. B.J. 726 (1966); Scott, *Deductions for Cost of Tax Advice Are Often Subject to IRS Attack*, 22 J. TAX. 174 (1965).

94. "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

incurred for tax counsel alone are deductible. This Regulation and the remainder of the *Kaufman* opinion would indicate that the sale of the stock or a controversy as to its basis should be irrelevant to the deductibility of the expense.[95] It is arguable that the fees for the computation of the stock basis could be deducted on the authority of Treasury Regulation section 1.212-1(g),[96] which specifically allows the deduction of investment counseling fees.

In the final analysis, however, it is apparent that the court really disallowed the deduction of the accountant's fees for the computation of the stock basis because that service or tax counsel was not related to any immediate tax determination, but was only "for some possible future use." Such rationale would appear to prohibit the deduction under section 212(3) of expenses for tax counsel in connection with estate planning not relating to an immediate tax liability, such as drafting a will and setting up a revocable inter vivos trust resulting in no gift tax to the grantor-settlor. However, the expenses of such legal services may still be deductible under section 212(2) if incurred in connection with income-producing property held by the taxpayer.[97]

In both *Davis* and *Kaufman* the immediate tax consequences arose out of a "proceeding," namely a divorce and a request for a revenue ruling to determine the tax consequences that would occur immediately upon consummation of the transactions in question, but neither court intimated whether some type of proceeding was a prerequisite to deductibility under section 212(3). In the case of *Carpenter v. United States*[98] the Court of Claims made no mention of a tax proceeding.

C. *The* Carpenter *Case*

The *Carpenter* case, on facts similar to those in the *Davis* case, held that the legal fees incurred in examining the tax aspects of a proposed property settlement agreement in a divorce action were deductible under section 212(3) as an expense in connection with the determination of the taxpayer's income tax liability.[99]

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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." Treas. Reg. § 1.212-1(l) (1957).

95. *See* Scott, *Deductions for Cost of Tax Advice are Often Subject to IRS Attack*, 22 J. TAX. 174 (1965).

96. Treas. Reg. § 1.212-1(g) (1957); *see* note 49 *supra*.

97. *See* notes 60-70 *supra* and accompanying text.

98. 338 F.2d 366 (Ct. Cl. 1964).

99. The taxpayer's attorney's efforts were directed primarily to ensuring that the support payments agreed to be made by taxpayer to his former wife would constitute taxable income to the latter and hence be deductible by taxpayer.

The Government argued that the decision of the *Davis* case should be overruled because there was nothing in the statute or regulations[100] to indicate provision for tax counsel except in proceedings involving tax controversies, and because the *Gilmore* decision[101] precluded the deduction of legal expenses arising out of divorce and property settlements. The court rejected those arguments noting that the *Gilmore* decision was based upon section 212(2) and that the Court there distinguished section 212(2) from section 212(3).[102] Stating that the plain language of section 212(3) is not limited to contested tax controversies or the preparation of tax returns, the court relied on Treasury Regulation section 1.212-1(l) which provides four separate examples of expenses which are deductible under section 212(3). These are: (1) expenses for tax counsel; (2) expenses in connection with the preparation of tax returns; (3) expenses in connection with any proceedings involved in determining the extent of tax liability; and (4) expenses in contesting tax liability.[103] The court asserted that there is nothing in the regulations to suggest that these four examples are exclusive; they are merely illustrative.

In support of the *Davis* decision's allowance of a deduction for tax counsel, the court in *Carpenter* analogized tax counsel fees to investment counsel fees, which are specifically allowed by Treasury Regulation section 1.212-1(g), and noted that investment counseling is certainly prospective in nature.

> Obviously, a taxpayer does not employ investment counsel *after* he has made his investments, and he should not be restricted to deductions of expenses for tax counsel solely to discover the tax consequences of what has already transpired or a tax liability already accrued. One of the purposes of a taxpayer in obtaining tax counsel is to avoid tax contests, not to create them, and this also serves the interest of the Government in collecting taxes.[104]

In further support of the *Davis* decision, the court pointed out that under the present procedure of tax collection, the taxpayer must determine his own tax liability by a method of self-assessment, and, for advice in arriving at this determination, the taxpayer may, under

100. In support of this position the Government again relied on Senate and House Committee reports, S. REP. No. 1622, 83d Cong., 2d Sess. 218; H.R. REP. No. 1337, 83d Cong., 2d Sess. 29, A59. *See* notes 80-81 *supra*. "Any expenses incurred in contesting any liability collected as a tax or as part of a tax will be deductible." H.R. REP. No. 1337, 83d Cong., 2d Sess. A59 (1954).

101. 372 U.S. 39 (1963). *See* notes 9-12 *supra* and accompanying text.

102. *Id.* at 48 n.16. The Supreme Court stated: "Expenses of contesting tax liabilities are now deductible under section 212(3) of the 1954 Code."

103. Treas. Reg. § 1.212-1(l) (1957), quoted in full in note 94 *supra*.

104. 338 F.2d at 369.

Treasury Regulation section 1.212-1(l), deduct the fees of tax counsel. The court concluded:

> To restrict the deductibility of expense for tax counsel to the computation or contest of a tax liability for completed tax years under the particular facts in this case, would defeat the clear purpose of [s]ection 212(3) and the Regulations [section] 1.212-1.[105]

This language unquestionably indicates that the *Carpenter* court considered the *determination* of tax consequences to include contemplated as well as completed transactions.

D. Deductions Under Section 212(3) for Estate Planning Fees

The primary problem in the *Davis* case was the inclusion in income for the specific tax year involved of the gain from the use of appreciated property in a lump sum divorce property settlement. The *Carpenter* case, on the other hand, was concerned not only with the taxpayer's tax liability for the year in which the divorce settlement was concluded, but also the annual deductibility from income of alimony payments made in future years. While the tax consequences of certain estate planning activity, such as the making of gifts and the creation of inter vivos trusts, will be immediate, other estate planning services, such as will drafting and the creation of testamentary trusts, will result only in future tax consequences not unlike those considered in the *Carpenter* case.

While no decision has yet considered the restrictive position of the Internal Revenue Service under section 212(3) as it relates to fees for estate planning services, it should be remembered that *Nancy R. Bagley*[106] allowed deductions under the forerunner of section 212(2) for attorneys' fees paid for review of the taxpayer's estate plan, the creation of certain trusts, and other alterations in the taxpayer's income-producing assets, all of which were designed to increase the earning power of the taxpayer's assets and to reduce taxes. The court stressed the fact that the taxpayer would enjoy immediate tax benefits from the reorganization of her estate. The same case, however, denied a deduction for the expense of legal services in determining what assets the taxpayer should use in a gift program.[107] The *Davis, Kaufman*, and

105. *Id.* at 370.

106. 8 T.C. 130 (1947), *acquiesced in* 1947-1 CUM. BULL. 1. *See* notes 50 & 59 *supra* and accompanying text.

107. "We are unable to see what possible connection the disposition of part of petitioner's income-producing securities by way of gift in trust could have with the production or collection of income; nor do we think that it can properly be said to have a proximate connection with the management, conservation, or maintenance of such property." 8 T.C. at 135.

Carpenter decisions would seem to cast serious doubt on the continuing significance of this second *Bagley* holding. The expenses for tax advice concerning proposed donative transfers, where the gift tax liability of the donor is affected by the character of the property used in the donative program, may be allowed under section 212(3) rather than under 212(2), thus avoiding the *Bagley* decision.

Since estate planning fees are clearly personal expenses, at first glance they may seem to be within the prohibition of section 262,[108] which disallows deductions for "personal, living, and family expenses." Under the "origin test" of *Gilmore*, estate planning fees for tax advice would seem to be classified as personal expenses subject to section 262. This possibility was negated, however, by a footnote to the *Gilmore* decision where the Supreme Court stated:

> Expenses of contesting tax liabilities are now deductible under [section] 212(3) of the 1954 Code. This provision merely represents a policy judgment as to a particular class of expenditures otherwise non-deductible, like extraordinary medical expenses . . . .[109]

It seems evident that the Court was recognizing a legislative intention to make the expenses of tax counsel an exception to the rule of section 262.

The rationale of the *Davis*, *Kaufman*, and *Carpenter* cases would permit deductions under section 212(3) for expenses of tax counseling which takes place after the occurrence of the transactions or events and for tax counseling which contemplates immediate and certain occurrence of the event from which tax consequences will ensue. However, it is questionable whether the *Carpenter* decision can be extended to allow a deduction for the expense of tax counseling where the taxable events are uncertain and in futuro, as would be the case of estate planning services for the arranging of future or testamentary gifts by the client-taxpayer, the drafting of a will to become effective at the client-taxpayer's death, the creation of testamentary trusts, and other property dispositions. The dissent in *Carpenter* would limit the application of section 212(3) to deductions for tax counsel employed in connection with the preparation of tax returns or with tax proceedings since these are based on past or settled events.[110] The

108. INT. REV. CODE of 1954, § 262.

109. United States v. Gilmore, 372 U.S. 39, 48 n.16 (1963).

110. "It is not entirely clear whether the regulation [Treas. Reg. § 1.212-1(l)] extends further back to the period when the transactions are still in the process of being planned or the taxable events are still uncertain or *in futuro*. . . . I interpret it, however, not as authorizing the deduction of expenses paid for *any* tax counsel, but only for tax counsel employed in connection with the preparation or consideration of tax returns or with tax proceedings, i.e., tax advice given

majority adopted a broader meaning of section 212(3) allowing the taxpayer to deduct the expense of tax counsel employed before the events had been settled, *i.e.* before the divorce, separation, and alimony decree, and for tax consequences which would occur in future years.

If the reasoning of the *Carpenter* court is broadly construed, the decision will have far-reaching implications in the area of estate tax planning. It may be argued that the court in *Carpenter* intended that expenses incurred by a taxpayer for tax counsel be deductible in any situation.[111] This would encompass all planning efforts directed toward the determination or minimization of any taxes. Therefore, expenses incurred in all tax planning involving personal holdings and estates, which were heretofore barred from deduction under section 262 as personal expenses,[112] would be deductible. However, a limiting factor on such broad deductibility is indicated in the *Carpenter* decision. The court pointed out that the taxpayer employed tax counsel to minimize the tax consequences concerning the tax year when the divorce property settlement was concluded, as well as the taxpayer's future annual alimony payments. The court stated:

> These tax consequences were the result of the same transaction, which had to be considered in toto in 1957 when plaintiff employed tax counsel. If plaintiff is entitled to deduct expenses for legal assistance in preparing his 1957 tax return, this legal assistance or counsel had to consider and evaluate the entire tax problem, in which 1957 was an inseparable part.[113]

Thus, it is arguable that the *Carpenter* decision encompasses only expenses for tax counseling concerning past events and tax counseling which contemplates the certain and immediate occurrence of future taxable events.

While the *Davis, Kauffman,* and *Carpenter* cases each involved the deductibility of legal fees representing services with respect to the current income tax liability of the taxpayer, the *Carpenter* decision recognized that the tax counseling involved applied not only to tax

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after the critical events have taken place or been settled. Tax counsel designed to help future transactions or arrangements is not covered. . . .

. . . The words of the Code ('determination, collection, or refund of any tax') connote an appraisal of tax liability on the basis of past or settled events, not a molding of future events to minimize taxes. Each of the three words deals with a function related to taxes already due or about to become due, not with planning ahead." Carpenter v. United States, 338 F.2d 366, 371-72 (Ct. Cl. 1964) (dissenting opinion).

111. *See* 18 VAND. L. REV. 1611 (1965).

112. INT. REV. CODE of 1954, § 262: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

113. Carpenter v. United States, 338 F.2d 366, 370 (Ct. Cl. 1964).

liability of the current year, but also to tax liability of future years, and the court did not use that distinction to disqualify the deduction.

No case has been decided allowing a deduction for the expense of tax counseling services that are in no way connected with the current tax liability of the taxpayer, but relate only to future or prospective tax consequences. However, the dissenting opinion in the *Carpenter* case may be as significant as the holding itself. This opinion states:

> The ultimate consequence of the wider view of the regulation [Treas. Reg. 1.212-1(*l*)], adopted by this court, is that individual taxpayers will be able automatically to deduct counsel fees paid for the general planning of their holdings and estates so as to minimize income, estate, or gift taxes in the years ahead, or for arranging marital or family affairs with the same end of tax-minimization in the future, or for planning charitable or foundation gifts (and allocation of assets) for such a purpose.[114]

In light of the forcgoing discussion, it may be possible to derive from the holdings of the *Davis, Kaufman,* and *Carpenter* cases a standard or principle applicable to future deductions claimed under section 212(3). The expense incurred by an individual taxpayer for counsel concerning the tax consequences of either a contemplated or a completed matter will be deductible if the advice is directly connected with the taxpayer's tax liability, regardless of whether the purpose of such advice was to minimize, determine, collect, or refund any present or future tax liability, if the procedure followed was reasonably calculated to attain such a result and if the expenses are otherwise reasonable.[115] Accordingly, the expense of any estate planning services which directly relate to the client-taxpayer's tax liability would be deductible under section 212(3). Such deductions would not include fees for the drafting of a will or other instruments connected with estate planning since the instruments themselves do not affect the client's tax liability, but the property arrangements and dispositions embodied in those instruments create tax consequences to the taxpayer-client.

One writer has suggested that "the deductibility of fees for estate planning services may depend on the particular devices or instruments employed."[116] Thus expenses incurred in connection with the creation of a funded revocable or irrevocable trust would be deductible under section 212(3) as an expense for the determination of tax consequenees if the creation of the funded trust immediately affects the income, gift, or estate tax liabilities of the settlor.

114. *Id.* at 372 (dissenting opinion).
115. *See* 10 VILL. L. REV. 357, 365 (1965).
116. Kabaker, *Deductibility of Estate Planning Fees*, 54 ILL. B.J. 726, 731 (1966).

The expense of creating an unfunded revocable trust, such as an insurance trust or a testamentary trust, may be deductible on the basis of possible estate and gift tax savings upon the death of the settlor and thereafter. While such tax consequences are entirely prospective, section 212(3) refers to "the determination . . . of *any* tax." As the *Carpenter* decision has pointed out, "any tax" is not limited to present tax. "The minimization of future income and estate taxes should fall within the purview of the section to the same extent as deductions relating to current tax problems."[117] The court in *Carpenter* rejected the government's interpretation of section 212(3) which would limit deductions to current tax situations.

While it is not clear that estate tax liability has been "determined" within section 212(3) in a situation where the settlor may later revoke the plan, the dissenting opinion in *Carpenter* suggests that the majority holding would permit the deductibility of expenses in such situations. Unless and until the settlor takes further positive action, he has determined his future estate tax liability. The expense of drafting a will may also be deductible under section 212(3) to the extent that the property arrangements and dispositions contained therein may offer tax savings upon the death of the testator. In drafting a will, the attorney normally analyzes the holdings of his client in order to determine potential gift and estate tax liability,[118] and, if properly allocated, that portion is deductible.

It should be noted that the expenses of drafting a will and of certain other estate planning services which may not qualify for a deduction under section 212(3) because no tax liability of the taxpayer is involved may be deductible under section 212(2) as expenses for the management of income-producing property. For example, the creation of certain types of trusts, such as a funded revocable trust, may affect no tax liability of the settlor, and, consequently, a deduction claimed under section 212(3) would be disallowed. A deduction might be allowed under section 212(2), however, if the property involved produces income taxable to the settlor or if the settlor acquires professional investment supervision of the trust asset through the nomination of a corporate trustee.[119]

IV. Conclusion

It would seem safe to state as a general principle that the

117. *Id.*

118. For an excellent discussion of the deductibility of fees for drafting a will containing an estate tax marital deduction gift, see *id.* at 732.

119. *Id.* at 730, 731.

deduction of most estate planning service expenses should be allowed under either section 212(2), section 212(3), or a combination of both sections. The expenses are deductible under section 212(2) as expenses for the management, conservation, or maintenance of property held for the production of income if the planning services directly relate to property which produces income taxable to the taxpayer-client. Alternatively, the expenses are deductible under section 212(3) if they are solely for tax counsel directly related to the taxpayer-client's tax liability. Expenses which are not deductible under section 212(3) because there is no tax liability involved or because the tax consequences are too uncertain should be deductible under section 212(2) if the services were rendered in connection with property which produces income to the taxpayer. Nevertheless, some expenses, such as fees for the drafting of a will, may be disallowed as nondeductible personal expenses because they are not genuinely related to the management of income-producing property.

Because certain estate planning fees will be nondeductible personal expenses, allocation is the key to deductibility under section 212. Since the burden of allocation is clearly on the taxpayer,[120] the attorney can be of great assistance to a client by carefully preparing and itemizing his statement of services rendered. The attorney should apportion his charges to services for the consideration of tax problems, the management of income-producing property, the drafting of instruments, and personal advice. So long as the allocation is reasonable and made in good faith the deduction should be allowed.

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120. Ecco High Frequency Corp. v. Commissioner, 167 F.2d 583 (2d Cir.), *cert. denied*, 335 U.S. 825 (1948); Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930); Helen S. Pennell, 4 B.T.A. 1039 (1926).