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Thomas Franklin McCoy
West Virginia University College of Law

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Income Taxation—Denial of Deduction of Business Expenses Incurred in Personal Litigation

P's overriding concern in his divorce litigation, because of California community property law and his wife's claims, was the protection of the assets of his three corporations against these claims. P sought to deduct eighty percent of the legal fees incurred in this litigation as expenses incurred for the conservation of property held for the production of income. The Commissioner contended that all of the expenditures were personal and as such, non-deductible. The government appealed from a Court of Claims ruling allowing the deduction. Held, reversed. The legal expenses incurred in resisting the wife's claims stemmed from the marital relationship and not from P's profit seeking activities. United States v. Gilmore, 83 Sup. Ct. 623 (1963).

This case is of importance primarily because of the perception displayed by the Court in formulating a rule, in regard to business deductions allowed by Int. Rev. Code of 1954 § 212(2), which is easily understood and applied.

The rule, as stated by Mr. Justice Harlan, is that the characterization as "business" or "personal" of the litigation costs of resisting a claim depends, not on the resulting consequences to the taxpayer's income-producing property for failure to defeat the claim, but rather on whether the claim arises in connection with the taxpayer's profit-seeking activities. In Lykes v. Commissioner, 343 U.S. 118 (1952), the Court stated that the test of deductibility was whether or not the expenses were reasonably and proximately related to the management, conservation and maintenance of income-producing property—that is, "deductibility turns wholly upon the nature of the activities to which they relate." This is the case that provided the rationale for the Gilmore rule.

Prior to the decision in the principal case there was a definite split of authority in the lower courts concerning the test to be used in construing the Int. Rev. Code of 1954 § 212(2). This section is substantially the same as Int. Rev. Code of 1939 § 23 (a) (2), as to the deductibility of expenses incurred in resisting claims affecting the taxpayer's income-producing property. One line of cases has followed the decision in Baer v. Commissioner, 192 F.2d 646 (8th Cir. 1952), which reached exactly the opposite conclusion from that reached by the Court in Lykes v. Commissioner, supra, although both courts based their decisions on the same test. The distinction
made in those cases following the rationale of the Baer decision, is that, though the reason for the litigation is personal, the portion of the costs attributable to the protection of income-producing property in connection with that litigation should be deductible as a business expense under the Int. Rev. Code of 1954 § 212(2). United States v. Patrick, 288 F.2d 292 (4th Cir.), rev’d 83 Sup. Ct. 618 (1963); Owens v. Commissioner, 273 F.2d 251 (5th Cir. 1959); Deem v. United States, 209 F. Supp. 369 (D. Colo. 1962).

The cases following the rule as set forth in Lykes v. Commissioner, supra, have not made the distinction between personal and business expenses which have arisen because of personal litigation, and consequently have disallowed deduction of any part of the expenses which arose because of the personal litigation. Ditmars v. Commissioner, 302 F.2d 481 (2d Cir. 1962). These decisions were predicated on the assumption that Int. Rev. Code of 1954 § 212 allows deduction of a business expense only when incurred during some profit-seeking activity, and that the cost of protecting one’s assets as a result of personal litigation is not, actually, a profit-seeking activity. United States v. Patrick, supra. The Gilmore rule, as applied in the Patrick case, was extended to include those business expenses incurred in forestalling a personal claim. The Court stated that it would be unsound to make deductibility turn on the nature of the measures taken to forestall a claim rather than the source of the claim itself.

The opinions in the principal case and in United States v. Patrick, supra, are almost a replay of the opinion in Lykes v. Commissioner, supra, which in turn simply reiterated a rule of construction established by the Court in 1927. Kornhauser v. United States, 276 U.S. 145 (1927).

The only distinct difference in the rule in the principal case and that stated in Lykes v. Commissioner, supra, is that the Gilmore rule has stated in clear, understandable words that business expenses incurred as a result of personal litigation are not deductible under § 212(2) of the Int. Rev. Code of 1954.

In retrospect, the holdings seem easily predictable, and the previous attempts by the lower courts to give the husband a break on his legal expenses now, unfortunately, have no possible legal home.

Thomas Franklin McCoy