THE WORST KIND OF LEGAL FEES

We spend much of our time looking at the recipient's side of the litigation equation. And, it normally follows that the tax treatment of attorneys' fees should be based on the tax treatment of the underlying settlement or judgment. In the case of a payor, payors typically may assume that all legal fees are deductible. But from a very early time, we knew that all attorneys' fees were not deductible. Those associated with purely personal matters, for example, are not. The most famous example of this is *United States v. Gilmore*, the 1961 Supreme Court case in which the Court found that the origin of Mr. Gilmore's legal fees was his divorce from his spouse (a purely personal concern), not his desire to save his business (which was one of the assets over which there was substantial expense in litigating the divorce).

The origin of the claim analysis does provide help. But unfortunately, the result that is achieved is not always the one that the taxpayer wants. In the case of *Ruby Jean Stephens v. Commissioner*, T.C. Memo 1999-259, Tax Analysts Doc. No. 1999-26049 (Aug. 4, 1999), the Tax Court found that legal fees incurred in connection with litigation involving a trust of which she was the trustee and beneficiary were nondeductible capital expenditures under Section 263. (At least they were not treated as purely personal expenses). The case arose out of the establishment of a revocable grantor trust in 1990 by the taxpayer's husband, Red.
Red died in 1991, at which time the trust became irrevocable and Ruby (the taxpayer) became the successor trustee. She made two required distributions to children, and the remaining trust property was distributed to her as trustee of a marital trust for her benefit. As beneficiary of this marital trust, she was entitled to receive net income plus discretionary distributions of corpus. She also had a general testamentary power of appointment. Failing her exercise of that power, all trust income and corpus would be distributed on her death to Red and Ruby's daughter, Sedra.

A son from a prior marriage popped into the scene and sued Ruby in 1993, both individually and as a beneficiary and trustee of the marital trust. His complaint even named Sedra as defendant. Garland alleged that his father lacked mental capacity and that the defendants misled or unduly influenced him into signing the documents. Ruby was advised by lawyers that it was her duty as trustee to defend against the lawsuit, and Ruby did so successfully—but she racked up a large legal bill.

So, on her 1993 and 1994 tax returns, she deducted the professional fees that she incurred in connection with the lawsuit. The IRS disallowed all of them, determining that they were capital expenditures.

Tax Court Speaks
The Tax Court agreed with the IRS that the fees were not deductible under Section 212.

The Tax Court reasoned that Ruby's defense of the lawsuit was to protect the trust's title to the property, and not to protect, safeguard or maintain physical assets. Ruby asserted that none of Garland's claims for relief related the acquisition or defense of title to property, and in fact she insisted that she defended the lawsuit in her capacity as income beneficiary to prevent the impairment of the production and collection of trust income.

"Origin of the Claim" Lives On

I've said before that the origin of the claims test is easy to recite, but not always easy to apply. Sometimes, one scratches one's head trying to figure out precisely what the origin of the claim truly is. Judge Marvel in *Ruby Jean Stephens v. Commissioner*, tried to apply the origin of the claim analysis here. He relied upon *Estate of Kincaid v. Commissioner*, T.C. Memo 1986-543 (86 TNT 226-37), a case in which the legal claim alleged mismanagement and waste of trust assets by the trustee. In *Ruby Jean Stephens*, though, the court found that the lawsuit did not allege abuses in the administration of the trust. Rather, the lawsuit questioned the validity of the trust from the get-go. Garland sought to invalidate the trust from the beginning. Thus, the Tax Court found that the origin of the claim was capital, and had to be considered capital expenditures under Section 263.