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Income Tax—Deductibility of Legal Expenses

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34 would require that the statement of facts be filed within ninety days after the entry of judgment even though a motion for a new trial was pending and was not determined until after the expiration of the ninety days. Should the motion be denied, unless the appellant has filed his statement of facts before the ruling, he would find himself with a right of appeal, given under Rule 33(5), but with no right to present his statement of facts. Consequently, he would have little hope of a favorable decision, since in the absence of a statement of facts, the Supreme Court refuses to rule on assignments of errors which do not appear on the face of the record. *Lilly Co. v. Parrino,* 18 Wn. 2d 128, 138 P. 2d 206 (1943); *Wheatley v. Washington Jockey Club,* 39 Wn. 2d 163, 234 P. 2d 878 (1951). On the other hand, if, fearing such an eventuality, he had proceeded to file his statement and later the motion for a new trial was granted, he would have been put to useless trouble and expense.

In view of these possibilities, the holding of the instant case, insofar as it dates the time for taking an appeal and the time for filing the statement of facts from the same event, seems only reasonable. Its apparent conflict with the wording of Rule 34 is mitigated if the reasoning of the court in *Reeves v. Wilson,* 105 Wash. 318, 177 Pac. 825 (1919) is applied: "The motion for a new trial suspends the effect of the judgment until after the determination of the motion and filing of the order denying the motion." In other words, the judgment does not become *final* until the motion is determined.

While consistent with dicta in cases decided under the rule in effect from 1938 until the present rules were adopted in 1951, the decision in the *Dunseath* case embodies the first direct holding reconciling the present rules. Since the time for filing had expired, statements in the earlier cases to the effect that the time should be computed from the denial of the motion for a new trial were not decisive of any issue presented therein. See *Lilly Co. v. Parrino, supra; State* ex rel *Grange Store v. Riddell,* 27 Wn. 2d 134, 177 P. 2d 78 (1947); *Wheeler v. Birch & Sons Const. Co., supra.*

The language of the present holding may raise a question as to the status of a party whose motion for a new trial has been denied, but against whom judgment has not been entered. However, since an order denying a motion for a new trial is not appealable, it is unlikely that the court would interpret its ruling in the *Dunseath* case to mean that the appellant must file his statement of facts within ninety days after the denial of such a motion when there exists no judgment or order from which he can take an appeal.

In view of the holding, is an appeal premature if it is taken after entry of final judgment but before the denial of the motion for a new trial? Conceivably a respondent could be harmed if he had expended the effort necessary to prepare his brief, and the new trial was subsequently granted. However, if the appellant is allowed to wait until after the determination of his motion before taking his appeal, the probability of such an occurrence is not as great as it would be if he were required to carry it through from the date of entry of judgment. The question is not discussed in the main case; rather *D*'s earlier appeal is "treated as abandoned." Presumably an appeal taken before denial of a motion for a new trial is not untimely.

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Income Tax—Deductibility of Legal Expenses. *P* made a gift of 1,000 shares of stock to members of his family and paid the federal gift tax thereon. Thereafter *P* was notified by the Commissioner of Internal Revenue of a gift tax deficiency of $145,276.50. Through his attorney, *P* secured a settlement of the deficiency for $15,612.75. He did not deduct the legal expenses of the gift tax controversy from his gross income but later claimed an income tax refund on the ground that the legal fee should have been deducted under INT. REV. CODE § 23(a)(2). The District Court held for *P*. The Court of Appeals reversed. On certiorari, *Held:* affirmed. The non-deductibility of such expenditures is indicated both by the absence of any affirmative allowance of their deductibility under INT. REV. CODE § 23(a)(2) and the express denial of the deductibility of all personal and family expenses under INT. REV. CODE § 24(a)(1). *Lykes v. United States,* 343 U.S. 118 (1952).

Taxpayers are permitted under INT. REV. CODE § 23(a)(1) to deduct from gross income the ordinary and necessary expenses of carrying on any trade or business. As a result of the narrow interpretation of the words "trade or business," particularly in *Higgins v. Commissioner,* 312 U.S. 212 (1941), the deductions permitted by § 23(a)(1) were not available to taxpayers, such as investors who, although taxable on income derived from investments, were not engaged in a trade or business. Congress recognized that this result was inequitable as to such taxpayers and enacted the present § 23(a)(2) to correct that inequity. H. R. REP. No. 2333, 77th Cong., 2d Sess. 46 (1942). § 23(a)(2) provides for the deduction of ordinary and necessary expenses incurred for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. The Congressional discussion of the present § 23(a)(2) indicates that it was intended to permit the deduction of those non-trade or non-business expenses neither permitted as deductions by § 23 as it then existed nor prohibited as deductions by § 24. Rep. Disney in 88 CONG. REC. 6376 (1942).

The first Treasury Regulation interpreting § 23(a)(2) stated that legal expenses incurred by a taxpayer in tax litigation were not deductible expenses under that section. U. S. TREAS. REG. 111, § 29.23(a)-15(b) (1943). The United States Supreme Court, however, took a more liberal view in *Bingham's Trust v. Commissioner,* 325 U.S. 365 (1945), where it was held that a taxpayer was entitled under § 23(a)(2) to deduct legal expenses paid in contesting an income tax deficiency. Following that decision, the Treasury Regulation was amended by T.D. 5513, 1946-1 CUM. BULL. 61, which expressly recognized the deductibility of legal expenses incurred in the determination of income tax liability and of liability for property taxes upon property held for the production of income. The same Treasury Decision further provided that legal expenses incurred in the determination of liability for other taxes were not deductible. The non-deductibility of legal expenses incurred in connection with such other taxes has been recognized by the courts. *Cobb v. Commissioner,* 173 F. 2d 711 (C.A. 6th 1949), *Cert. denied,* 338 U.S. 832 (1948) (gift tax); *Edmunds v. United States,* 71 F. Supp. 29 (E.D. Mo. 1947) (estate tax).

The basis of the distinction between those taxes giving rise to legal expenses which may be deducted under § 23(a)(2) and those taxes giving rise to legal expenses which may not be deducted under that section is suggested in the *Bingham* case. There the court first considers the deductibility of an expense under § 23(a)(1) and states that an expense is not deductible under that section unless it proximately results from the conduct of the business. The conduct of a business is an activity expressly within § 23(a)(1). The court then holds that the deductibility of a non-trade or non-business expense under § 23(a)(2) is to be determined in the same manner. Following this reasoning, an expense is not deductible under § 23(a)(2) unless it is directly connected with or proximately results from the conduct of an activity within that section. Basically the same test is announced in the instant case where the court holds that the deductibility of the legal expenses there involved turns wholly upon the nature of the activities to which those expenses relate. The court then finds that the making of gifts is not an activity which is contemplated by any of the terms of § 23(a)(2). In conrast, the litigation of income tax liability is within the area of action comprehended by the words "collection of income."

The argument for the deductibility of the legal expense in the instant case is that the gift tax deficiency, if uncontested, would have consumed property held by the taxpayer for the production of income, hence the legal expense was for the conservation of property held for the production of income. This approach does not consider the nature of the activity to which the expense relates but considers only the result of incurring the expense. The legal expenses incurred in defending any claim which could be asserted against a taxpayer would be expenses for the conservation of the taxpayer's property, hence, following this approach, all legal expenses would be deductible. It is submitted that this goes far beyond the intent of Congress in the enactment of § 23(a)(2) and that the preferable result is that reached in the instant case.

In the recent case of *Baer v. Commissioner,* 196 F. 2d 646 (C.A. 8th 1952), it was held that a taxpayer's legal expenses incurred in arranging a property settlement following the taxpayer's divorce were deductible expenses under § 23(a)(2). There the court considers the *Lykes* case as clearly a family transaction which had nothing to do with the conservation or maintenance of property held by the taxpayer for income producing purposes. The legal expenses in the *Baer* case are distinguished as being directed to the conservation and maintenance of property held by the taxpayer for income producing purposes. It is submitted that the majority there adopts the approach unsuccessfully urged in the *Lykes* case and, as the dissent points out, the two cases should turn on the same principle. The *Baer* case indicates an apparent lack of sympathy with the interpretation of § 23(a)(2) employed in the *Bingham* and *Lykes* cases. Conceding that it may be inequitable to forbid the deduction of legal expenses such as those incurred by Baer and by Lykes, the remedy should come from further amendment of the Internal Revenue Code by Congress, not an unwarranted interpretation thereof by the courts.

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Income Tax—Funds Received by Extortion as Income. *T* was an associate of *X* during prohibition when they were bootlegging liquor. After the partnership split up, *T* demanded money from *X*. When *T* threatened the lives of *X* and his family, *X* paid *T* $250,000. *Held:* The extorted funds are taxable to *T* as income since they were obtained under a "semblance of a bona fide claim of right" and in effect, without obligation to repay since *X* was not likely ever to press demand for a return of the money. *Rutkin v. United States,* 343 U.S. 130 (1952).

In 1916 the word "lawful" was omitted from the then existing definition of net income in section 22(a) of the Internal Revenue Code. Since that time there has been a constant stream of cases determining which income resulting from unlawful activities may be taxable and which may not. On the one hand are the cases which hold the funds not taxable since it is like a loan due to the obligation to repay the owner, *Wilcox v. Commissioner,* 148 F. 2d 933 (C.A. 9th 1945) (embezzlement); *McKnight v. Commissioner,* 127 F. 2d 572 (C.A. 5th 1942) (embezzlement). On the other hand, there are the cases in which the funds are held taxable because they were received under a claim of right, *U.S. v. Currier Lumber Co.,* 70 F. Supp. 219 (App. D.C. 1947) (majority stockholder theft of company checks); *Kurrle v. Helvering,* 126 F. 2d 723 (C.A. 8th 1942) (profits from embezzled funds); *Moore v. Thomas,* 131 F. 2d 611 (C.A. 5th 1942) (excessive fees charged); *Barker v. Magruder,* 95 F. 2d 122 (App. D.C. 1937) (usurious interest); *North American Oil Consolidated v. Burnet,* 286 U.S. 417 (1932) (litigated funds); or because legal title had been passed by the owner having given over the funds "voluntarily" although by reason of fraud, *Akers v. Scofield,* 167 F. 2d 718 (C.A. 5th 1948) (swindling); *Humphreys v. Commissioner,* 125