30 T.C. 734 (1958)

A taxpayer cannot deduct legal fees paid by their controlled corporation when the taxpayer subsequently reimburses the corporation, as the expense was incurred by the corporation, and the reimbursement is not deductible in the year it was made.

Summary

Irving Segall sought to deduct legal fees he paid in 1950 to his controlled corporation. The corporation had previously paid the fees in 1947 for legal services rendered to Segall. The IRS disallowed the deduction, arguing that the payment was a contribution to the corporation's capital, not a deductible expense for Segall. The Tax Court agreed, holding that the legal fee was incurred and paid by the corporation in 1947, and Segall's 1950 payment was not deductible. Furthermore, the court held that an issue regarding adjustment under section 3801 of the 1939 Code was not properly before the court because it was not raised in the petition.

Facts

Irving Segall was the principal stockholder of Lynn Buckle Mfg. Co., Inc. (the corporation). In 1947, the corporation paid $10,278.57 to a law firm for legal services related to Segall's personal income tax liabilities for the years 1942-1945. Segall was aware that the corporation made these payments. In 1950, after the IRS disallowed the corporation's deduction for the legal fees, Segall paid the corporation an equivalent amount and claimed a deduction on his individual tax return for the 1950 tax year. The corporation credited the amount to its surplus.

Procedural History

The Commissioner of Internal Revenue disallowed Segall's claimed deduction for the legal fees in 1950. Segall petitioned the United States Tax Court, contesting the disallowance and alternatively claiming a portion should be allowed based on time allocation. The Tax Court ruled in favor of the Commissioner.

Issue(s)

1. Whether Segall could deduct the $10,278.57 paid to his controlled corporation in 1950 as a legal fee.

2. Whether the Court should consider the issue of adjustment under section 3801 of the 1939 Code, which was not raised by assignment of error in petition.

Holding

1. No, because the legal fee was incurred and paid by the corporation in 1947, not Segall in 1950.

2. No, because the issue was not properly raised in the petition and therefore not before the court for decision.

Court's Reasoning

The court applied Section 23 (a) (1) of the Internal Revenue Code of 1939, which allows deductions for ordinary and necessary business expenses paid or incurred during the taxable year. The court reasoned that the legal fee was incurred in 1947 when the corporation paid it and was not incurred in 1950, when Segall reimbursed the corporation. The court noted that the payment by Segall could be a contribution to capital or repayment of a loan from the corporation, neither of which is deductible in 1950. Furthermore, the court emphasized that the legal fee was not paid entirely for services on behalf of the petitioner; the retainer agreement set forth that the law firm's services were engaged for the purpose of representing both the petitioner Irving and his brother, Harry, who was also subject to an income tax investigation. The court held that since the deduction for 1950 must be disallowed in toto it was unnecessary to consider arguments relating to the effect of the criminal phase of the case. The court cited the case *Robert B. Keenan*, 20 B.T.A. 498, which held that expenses are deductible in the year incurred and paid, not when borrowed money used for the payment is repaid. The court declined to consider a 1947 deduction because the issue wasn't raised in the petition.

Practical Implications

This case underscores the importance of the timing of expense recognition for tax purposes. It demonstrates that expenses are generally deductible in the year they are incurred and paid, regardless of the source of the funds used for the payment. For attorneys and their clients, this case provides guidance on the proper timing of expense deduction, especially when related entities or third parties are involved. The case also highlights the necessity of proper documentation and the critical importance of raising issues in the initial pleadings to ensure they are properly before the court for consideration. Specifically, the case cautions that payments made by a corporation on behalf of a controlling shareholder may be considered non-deductible contributions to capital, especially when the shareholder reimburses the corporation at a later date. Later cases may cite this case for the principle that the substance of a transaction, not its form, dictates the tax consequences, and for principles of the timing of income or expense recognition.

