Reed v. Commissioner, 55 T. C. 32 (1970)

Legal fees and related expenses incurred in acquiring or perfecting title to property are not deductible as ordinary and necessary expenses.

Summary

Stass and Martha Reed sought to deduct legal fees incurred in two lawsuits against the Robilios. The first lawsuit aimed to impose a constructive trust and reconveyance of a partnership interest, while the second sought to rescind a partnership agreement restricting the transfer of Martha's interest. The Tax Court held that these expenses were capital in nature and not deductible under sections 162(a) or 212 of the Internal Revenue Code, as they pertained to the acquisition or perfection of property title rather than the production of income.

Facts

Martha Reed inherited a 19. 34% interest in the Robilio & Cuneo partnership from her mother, Zadie. After her father's estate sold a 30. 66% interest in the partnership to the Robilios, Martha filed a lawsuit seeking to impose a constructive trust on this interest and to rescind a partnership agreement that restricted the transfer of her own interest. The legal fees and related expenses incurred were substantial and were the subject of this tax case.

Procedural History

The Reeds filed joint Federal income tax returns claiming deductions for the legal fees and related expenses. The Commissioner of Internal Revenue disallowed these deductions, leading to the Reeds' appeal to the Tax Court. The Tax Court consolidated the cases for trial, briefing, and opinion.

Issue(s)

1. Whether the legal fees and related expenses incurred in attempting to impose a constructive trust and reconveyance of the 30. 66% partnership interest are deductible under section 162(a) or section 212 of the Internal Revenue Code.
2. Whether the legal fees and related expenses incurred in attempting to rescind the partnership agreement restricting the transfer of Martha's 19. 34% interest are deductible under section 162(a) or section 212 of the Internal Revenue Code.

Holding

1. No, because the expenses were capital in nature, incurred in the process of acquiring title to the 30. 66% interest.
2. No, because the expenses were capital in nature, incurred in perfecting title to the 19. 34% interest by removing restrictions on its transfer.

Court’s Reasoning

The Tax Court applied the “origin-of-the-claim” test, established by the Supreme Court in *Woodward v. Commissioner*, to determine the deductibility of the legal fees. The court found that the first cause of action aimed at acquiring title to the 30. 66% interest, making the expenses capital in nature. The second cause of action, although not directly affecting Martha’s income interest, sought to perfect her title by removing restrictions on the transfer of her 19. 34% interest, thus also making the expenses capital in nature. The court rejected the Reeds’ arguments that these expenses were for the production of income, citing the Supreme Court’s decisions in *United States v. Gilmore* and *Woodward v. Commissioner* as support for the application of the origin-of-the-claim test.

Practical Implications

This decision clarifies that legal fees related to acquiring or perfecting title to property are not deductible as ordinary and necessary expenses. Practitioners should advise clients that such expenses must be capitalized rather than deducted. The ruling reinforces the importance of distinguishing between expenses related to income production and those related to capital assets. Subsequent cases have continued to apply the origin-of-the-claim test in determining the deductibility of legal fees, further solidifying its role in tax law.

