

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ESTATE OF AUGUST J. MARTZ,)
DECEASED, SUSANNE M.)
STEVENSON, EXECUTRIX)

Appearances:

For Appellant: A. W. Wallace
Attorney at Law

For Respondent: Paul J. Petrozzi
Counsel

O P I N I O N

This appeal is made pursuant to section 18594 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of the Estate of August J. Martz, Deceased, Susanne M. Stevenson, Executrix, against a proposed assessment of additional personal income tax in the amount of \$1,400.00 for the year 1966.

Appeal of Estate of August J. Martz, Deceased,
Susanne M. Stevenson, Executrix

The issue is whether all or any portion of a claimed deduction for attorney's fees should have been allowed.

August J. Martz owned substantial rental properties for a number of years prior to 1965. From 1949 until his death, the law firm of Wallace and Wallace handled all of his legal affairs and all matters concerning the management of his rental properties. These duties included the negotiation and drafting of leases, collection of rent when requested, and repossession of the property when tenants went bankrupt. Mr. Martz' attorney apparently never sent him an itemized bill for these services. The attorney was instead given a yearly retainer in or around April of each year, which was considered as compensation for services rendered in the prior year. In each of the years 1964 and 1965, Mr. Martz paid his lawyer \$6,000.00 for work done in 1963 and 1964, respectively.

Sometime in 1964 Mr. Martz requested his lawyer to advise him whether or not to dispose of his property. After an analysis of Mr. Martz' financial situation the lawyer advised him to sell, and the property was listed with a broker. In connection with the sale, the lawyer conferred with numerous brokers for prospective clients in order to discuss the desired price and terms and to negotiate their commission. It appears from the record that the sale was completed in August 1965. Mr. Martz then asked his lawyer how best to invest the proceeds of the sale, and was advised to put the money in a savings account.

During the early part of 1966, Mr. Martz' attorney did some research for him in order to determine the tax basis of the property sold. Since the property had previously been involved in litigation, the required research seems to have been quite extensive. Mr. Martz reported a \$400,000.00 loss from the sale on his 1965 California personal income tax return.

Mr. Martz paid his attorney \$20,000.00 in 1966, apparently as compensation both for services performed in 1965, and for the tax work done in 1966. He claimed a deduction for that

**Appeal of Estate of August J. Martz, Deceased,
Susanne M. Stevenson, Executrix**

fee on his federal and California income tax returns for the year 1966. The Internal Revenue Service did not audit his federal return. Respondent did audit his California return, however, and decided that the fee was not deductible. Accordingly, it issued a **proposed assessment of \$1,400.00 additional tax. Mr. Martz had died in the meantime, but his estate protested the assessment. This appeal followed respondent's denial of that protest.**

Revenue and Taxation Code section 17252 authorizes a deduction for ordinary and necessary expenses incurred for the production of income. ^{1/} Expenditures made in connection with the disposition of a capital asset, on the other hand, are not allowed as a deduction, but are instead applied to reduce the seller's gain or increase his loss on the transaction. (Melvin F. Albergottie, T. C. Memo., Jan. 15, 1973.) This rule is based on the principle that related expenditures and receipts should be accorded consistent tax treatment. (Spangler v. Commissioner, 323 F. 2d 913, 918.)

The deductibility of legal expenses depends on the nature of the activities to which they relate. (Lykes v. United States, 343 U. S. 118, 123 [96 L. Ed. 791].) If the fees are paid for purposes related to the production of income, they may be deductible under section 17252; but if they are incurred in connection with the purchase or sale of a capital asset, they are capital expenses and thus not deductible. (Dwight A. Ward, 20 T. C. 332, aff'd, 224 F. 2d 547; James A. Collins, 54 T. C. 1656.) In order to resolve the question

1/ Section 17252 provides:

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year--

- (a) For the production or collection of income;
- (b) For the management, conservation, or maintenance of property held for the production of income; or
- (c) In connection with the determination, collection, or refund of any tax.

Appeal of Estate of August J. Martz, Deceased,
Susanne M. Stevenson, Executrix

on this appeal, therefore, we must determine the purpose of the legal services for which the fee was paid. As is the case with any claimed deduction, the taxpayer bears the burden of proof on this issue. (Warner Mountains Lumber Co., 9 T. C. 1171, 1174; New Colonial Ice Co. v. Helvering, 292 U. S. 435, 440 [78 L. Ed. 1348].)

The parties have argued this case on the assumption that the entire fee is either deductible or nondeductible as a whole. Respondent disallowed the deduction on the ground that the expense was incurred in connection with the sale of capital assets. On brief it points out that Mr. Martz' attorney has not responded to inquiries concerning the services he performed. Since the burden of proof is on the taxpayer, respondent asks us to conclude that the entire fee was paid for legal services incident to the sale of Mr. Martz' property. The record before us, however, indicates that at least part of the fee was for work unconnected with the sale. Some of it represented compensation for tax research done in 1966, and some was compensation for managing the property in 1965 prior to the sale.

In urging that the entire fee is deductible, appellant relies on the federal rule that litigation costs are not capital expenses if the "primary purpose" of the suit is not to defend or perfect title to a capital asset. (See, e.g., Sergievsky v. McNamara, 135 F. Supp. 233; Industrial Aggregate Co. v. United States, 284 F. 2d 639.) The argument here seems to be that the "primary purpose" of the legal services in question was to manage Mr. Martz' income producing property. The "primary purpose" test, however, is designed to determine the deductibility of litigation costs where title to a capital asset is directly or indirectly involved in a lawsuit. Since the fee in question was not a litigation cost, the "primary purpose" test is not applicable. (Woodward v. Commissioner, 397 U. S. 572, 577 [25 L. Ed. 2d 577].) The fees paid by Mr. Martz represented compensation for a variety of legal services, and although payment was made in one lump sum, the entire amount is not deductible unless each such service was related to the production of income. (See Dwight A. Ward, supra; Harrison E. Spangler, T. C. Memo., Dec. 26, 1961, aff'd, 323 F. 2d 913.)

Appeal of Estate of August J. Martz, Deceased,
Susanne M. Stevenson, Executrix

Since this case was argued on the question of the deductibility of the legal fee as a whole, the parties have made no attempt to allocate the **fee among** the various services performed. As can be seen from the above discussion, however, such allocation is necessary to resolve the case correctly. Accordingly, we must estimate the portion of the fee attributable to each service on the basis of the available facts. (Cohan v. Commissioner, 39 F. 2d 540; Brown v. United States, 26 Am. Fed. Tax R. 2d 70-5087; Sidney Merians, 60 T. C. 187;)

It is not disputed that, during 1965 prior to the sale, Mr. Martz' attorney was retained to perform the same services regarding management of the **property as** in previous years. The attorney had been paid \$6,000.00 per year as a retainer for the **preceeding** two years, and this amount prorated for the eight months of 1965 prior to the sale would be \$4,000.00. We find this latter **amount** to be a reasonable fee, and deductible as an expense for the "management, conservation, or maintenance of property held for the production of income; . ." (Rev. & Tax. Code, § 17252, subd. (b); see Lilly Harris, T. C. Memo. , March 13, 1969.) After the sale, the attorney advised Mr. Martz how to invest the **sale proceeds**, and also did some extensive tax research for him. Legal fees for such purposes are deductible expenses. (Rev. & Tax. Code, § 17252, subds. (a), (c); Nancy Reynolds Bagley, 8 T. C. 130; James A. Collins, i n k i t i s not unreasonable to **attribute one-tenth** of the total fee, or \$2,000.00, to these services.

A total of at least \$6,000.00 was therefore deductible for legal expenses on Mr. Martz' 1966 return. As to the remainder of the fee, no error has been shown in respondent's determination that it was incurred in connection with the sale of Mr. Martz' property. Consequently, since the burden of proof is on the taxpayer, we hold that \$14,000.00 of the fee was a nondeductible **capital expense**. (Warner Mountains Lumber Co., supra.)

Appeal of Estate of August J. Martz, Deceased,
Susanne M. Stevenson, Executrix

For the above reasons, the action of the Franchise Tax Board must be modified to allow a deduction for attorney's fees in the total amount of \$6,000. 00 for the year 1966.

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of the Estate of August J. Martz, Deceased, Susanne M. Stevenson; Executrix, against a proposed assessment of additional personal income tax in the amount of \$1, 400. 00 for the year 1966, be and the same is hereby modified to reflect allowance of \$6, 000. 00 of the claimed deduction for attorney's fees. In all other respects the action of the Franchise Tax Board is sustained.

Done at Sacramento, California, this 4th day of February, 1975, by the State Board of Equalization.

John W. Lynch, Chairman
William B. Dennis, Member
Robert B. Kelly, Member
Robert B. Kelly, Member
Robert B. Kelly, Member

ATTEST: W. W. Denlop, Secretary