

FREDDIE & DONNA NEWMAN
3259 COUNTY ROAD 239
ELBA, AL 36323-7705,

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

Taxpayers, §

DOCKET NO. INC. 11-575

v. §

STATE OF ALABAMA §
DEPARTMENT OF REVENUE.

FINAL ORDER

The Revenue Department assessed Freddie and Donna Newman (together “Taxpayers”) for 2007 Alabama income tax. The Taxpayers appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(b)(5)a. A hearing was conducted on February 2, 2012. The Taxpayers attended the hearing. Assistant Counsel Billy Young represented the Department.

The Taxpayers deducted legal fees and other expense relating to the division of real property in 2007. The real property in issue had been co-owned by Donna Newman (individually “Taxpayer”) and her sister. The issue is whether the fees and expenses can be deducted pursuant to Code of Ala. 1975, §40-18-15(a)(14). That statute adopts the federal deduction at 26 U.S.C. §212 for all 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 Taxpayer co-owned approximately 298 acres of farm land with her father and sister until 1999, when the father passed away. The Taxpayer and her sister inherited their father’s interest in the property at that time. The property was and is currently used to grow pine trees, as a cattle farm, and as cropland.

The Taxpayer's sister petitioned for a sale for division of the property in 2006. The Taxpayer opposed the sale, and hired an attorney to represent her interest in the matter. The two sisters eventually agreed to a division of the property, but not before the Taxpayers had incurred \$40,000 in legal fees and \$5,502 in appraisal, surveying, and other related expenses.

The Taxpayers deducted the \$45,502 on their 2007 Alabama income tax return. The Department allowed \$250 concerning a loan processing fee, but disallowed the balance. The Department concedes that the Taxpayers incurred the expenses. It argues, however, that the expenses should be treated as capital expenditures, and thus added to the Taxpayers' basis for the property.

As indicated, Alabama law adopts by reference the federal deduction at 26 U.S.C. §212 for expenses relating to the management, conservation, or maintenance of property held for the production of income. Section 212 must, however, be read in conjunction with 26 U.S.C. §263(a), which specifies that capital expenditures are nondeductible. As explained in Treas. Reg. 1.263(a)-2(c), an example of a capital expenditure includes "the cost of defending or perfecting title to property."

Treas. Reg. §1.212-1(k) also affirms that expenses paid to defend or perfect title to real property cannot be deducted, but rather must be treated as a capital expenditure and added to the taxpayer's basis in the property. The above regulation reads as follows:

Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property constitute a part of the cost of the property and are not deductible expenses. Attorneys' fees paid in a suit to quiet title to lands are not deductible: but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to

the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one's right to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible.

In *Kelly v. Commissioner of Internal Revenue*, 228 F.2d 512 (1956), the taxpayer incurred legal expenses in a law suit involving title to income producing property. The taxpayer claimed that the expenses were deductible. The Court held that the expenses relating to the title dispute were not deductible.

As to the taxpayer's contention that he comes clearly within Sec. 23(a)(2) because his expenditures directly and proximately related to the preservation of his interest in income producing property, it must be admitted that, in a sense, every lawsuit to establish or perfect title to property is designed to preserve the plaintiff's interest in that property. However, we agree with the statement of the court in *Brown v. Commissioner of Internal Revenue*, 5 Cir., 215 F.2d 697, 699 where it was stated: "Of course, when property is held for the production of income, any expenditure which relates to the perfection or defense of the taxpayer's title to the property can, in one sense, be said to have been an expenditure for the conservation of the property. On the other hand, it seems equally as sound to say that any such expenditure is more properly an element in the cost of acquiring or preserving the legal right to the income produced by the property, and therefore must be considered a capital expenditure."

* * *

We hold the taxpayer's claim that he was the owner of a one-half interest in the property formerly owned by this father was not incidental to his South Dakota suit, but was one of the principal issues there litigated, and any legal expenses incurred in trying to establish that right were not deductible from his income tax.

Kelly v. Commission of Internal Revenue, 228 F.2d at 515.

The expenses incurred by the Taxpayer were clearly incurred to protect and preserve the Taxpayer's interest in the subject property. As indicated in Treas. Reg. §1.212-1(k) – "Attorneys' fees paid in a suit to quiet title to lands are not deductible, . . . Expenses paid or incurred in protecting or asserting one's rights to property of a decedent

as heir. . . , are not deductible.” The expenses in issue thus must be treated as nondeductible capital expenditures.

The final assessment is affirmed. Judgment is entered against the Taxpayers for 2007 tax, penalty, and interest of \$1,792.65. Additional interest is also due from the date the final assessment was entered, July 8, 2011.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered March 6, 2012.

BILL THOMPSON
Chief Administrative Law Judge

bt:dr

cc: Warren W. Young, Esq.
Freddie & Donna Newman
Tony Griggs