

# VALUATION OBSERVATIONS

*Some practical observations from a practicing  
business appraiser.*

VLC

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## LEGAL FEES ARE THEY DEDUCTIBLE?

Generally, attorney's fees and expenses incurred in connection with obtaining a divorce are considered a personal expense because divorce is considered a personal proceeding. However, those divorce-related fees allocable to collection of income and tax advice may be deductible under IRC §212.

Both the IRS and Tax Court have determined that counsel fees allocable to the determination and collection of alimony, which is taxable income under §71, are deductible under §212. So what does this all mean? Individual taxpayers are allowed to deduct ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income which, when realized, is required to be included in income. Additionally, the IRS has ruled that fees for tax advice rendered incident to a divorce, such as advising as to the tax consequences of the provisions of a settlement or divorce decree, are deductible.

The rules specify that the expense must be "ordinary and necessary," which is defined in the regulations as "reasonable in amount and ... bear a reasonable and proximate relation to the production or collection of the taxable income."

Consider the divorced couple who receive a deficiency notice regarding a prior year joint tax return, and the divorce decree is silent with respect to allocation of contingent tax liabilities. The alleged deficiency is \$1,000. Unable to cooperate, each retains separate attorneys to challenge the IRS's determination, and the parties' combined attorneys' fees exceed \$3,000. In this scenario, the IRS may argue that the fees are unreasonably high as they exceed the amount of the disputed tax, and therefore challenge the fees as nondeductible.

Who has the burden? The taxpayer of course. That may sound fine, but it is the attorney who must allocate and record the time spent performing divorce-related services and services related to the collection of income items or tax advice. Sufficient documentation to provide a reasonable basis for allocating a portion of the legal fees to income collection or tax advice is essential. Absent adequate records, the deduction may be disallowed in its entirety. Well, this does create quite a burden on the attorneys.

Not all is lost however. In Revenue Ruling 72-545, the IRS provides guidance for allocating fees by approving apportionment of services based on subjective standards, such as fees charged by other attorneys in the community. But the best substantiation is the attorney's own contemporaneously recorded time records with a complete description of each service rendered and the time taken to perform the service.

So how does this allocation work? In one case, a separation agreement provided for both alimony and property division. The Tax Court held that the legal fee should be allocated one-half to the alimony (deductible) and one-half to procuring title to the assets (nondeductible), based upon the relative value of the alimony payments and the properties.

Similarly, another case involved a taxpayer who was defending a suit filed against him and some business associates alleging that they had conspired to deprive the plaintiff of certain patented inventions. The suit sought to compel the defendants to transfer the patents to the plaintiff corporation, and to account for and pay over royalties already received on the inventions. The Tax Court held that the legal fees incurred in connection with the suit were allocable between nondeductible fees (relating to the title and disposition of the patent) and deductible fees (relating to the production and collection of the royalty income), in the proportion that the value of the royalties and the value of the patents each had to the aggregate value of both the royalties and the patents.

It is imperative to remember that to be deductible the professional fees must be incurred to secure the right to alimony (which is taxable income). Fees expended to reduce alimony are not deductible, because the effort does not produce any amounts that are includible in gross income. On that same note, costs paid in connection with the receipt of child support are also nondeductible, again on the theory that child support does not result in taxable income.

Now here's one aspect of the rule that you don't want your client to get caught up in – If one spouse pays the other spouse's professional fees attributable to the collection of an income item or tax advice in a manner that qualifies for alimony treatment, the payment may be includible in the payee's (obligee's) gross income and deductible by the payor (obligor) as alimony. It sounds good on the surface, but if the payor has obligated himself personally to see to the payment of his spouse's attorney fees, lumping the alimony and attorney fee payments together could subject the payor to double liability (payment of attorney fees twice) if the payee does not in fact pay the attorney with the funds received that were "classified" as alimony. Although this scenario is unlikely, it is possible.

An unpopular aspect of these rules is that legal and other professional fees incurred in connection with a divorce property settlement are nondeductible personal expenses because the expenses derive from the marital relationship instead of the other spouse's activities in holding income-producing property. The theory here is that the property settlement, or claims under it, would not exist "but for" the marital relationship. This general nondeduction rule applies if the spouse is seeking an ownership right in the business property itself; but in such a case the expenses may be capitalized. If, however, legal and other professional fees are expended in connection with one spouse seeking to obtain a right to the income from that property, the fees are deductible.

All in all, the theory behind the rules is that the professional fees are deductible only to the extent they relate somehow to "taxable income." The IRS is all about quid pro quo – they will not give anything up unless they are getting something in return.

If you would like additional information, or have a question, please do not hesitate to call.

Very truly yours,

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Terri Lastovka is the founder of Valuation & Litigation Consulting, LLC. Her practice focuses on business valuations and litigation consulting in the areas of domestic relations, gift and estate tax, probate, shareholder disputes, economic damages, and forensic accounting. She draws from a wide range of experiences, including public accounting, law, banking, and CFO. She has received extensive training from the American Society of Appraisers in the area of business valuation and works closely with members of the bar to effectuate practical settlements. Terri also serves as the Director of Legal & Finance for Journey of Hope, a grass roots non-profit organization providing financial support to cancer survivors.