

DEDUCTIBILITY OF LEGAL FEES

By: Melvin Sternberg, Esq.
Certified Specialist in Family Law
Sternberg & Singer, Ltd.

INTRODUCTION

Deductions being a matter of legislation, it is necessary to relate any would-be deductible expense to an Internal Revenue Code provision. Sec. §212 which relates to expenses which covers profit-seeking activities and tax-related expenses:

An individual may deduct nonbusiness legal fees, e.g., attorney's fees, court costs, etc., if incurred to produce income, preserve income-producing property, etc. (Reg §1.212-1(k)) as a miscellaneous itemized deduction.

Nonbusiness legal expenses incurred to acquire, perfect, or defend title to property are not deductible, but any of those costs that are allocable to collecting accrued rents on the property may be deducted. (Reg §1.212-1(k)).

Legal expenses in connection with divorce, separation or a support decree are personal expenses which cannot be deducted by either spouse (Reg §1.262-1(b)(7)):

-the part of legal fees attributable to the production or collection of taxable spousal maintenance is deductible by the payee spouse (Reg §1.262-1).

-taxpayer can deduct fees paid to his attorney for tax research and advice relating to a divorce and property settlement if the fee for the tax work is segregated, but not legal fees he pays to his spouse's attorney for tax advice given to the spouse.

Since these expenses are categorized as miscellaneous itemized deductions, the individual taxpayer must itemize them (rather than claim the standard deduction). They are allowable only to the extent that in the aggregate, together with all of the taxpayer's other miscellaneous deductions for the year, they exceed 2 percent of adjusted gross income.

The burden is upon the taxpayer to establish grounds for deductibility; the burden of proper substantiation can most easily be met with a good faith allocation prepared by the attorney who performed the services. Where the attorney's fee is for both personal non-tax matters and tax planning advice, an itemized bill

provides the client with the basis for claiming a deduction. (The tax advice area raises in addition the ethical question of how much leeway legal counsel has in allocating the fee between the costs relating to personal matters, which are nondeductible, and the costs relating to a client's tax or business affairs, which are deductible.)

Finally, to the extent that any part of an attorney's bill in a divorce or separation cannot be deducted, it may be possible to increase the basis of specific property the ownership of which was retained or obtained through the efforts of counsel. While no immediate tax cognizance of such capitalized expenses will be available, there will at least be a reduction in taxable gain realized upon a later sale, or possible increased depreciation deductions with reference to property used in a trade or business or held for the production of income.

FEEs ALLOCABLE TO TAX MATTERS ARE DEDUCTIBLE:
§212(3)

§212(3) grants deductibility to expenses associated with determining a tax liability. The significance of this statement is that legal fees, associated with attempts at limiting one's tax liability, are deductible regardless of their origin. The personal nature of such expenses is immaterial. Therefore, a spouse may deduct fees paid to his or her attorney for tax research and advice in connection with a divorce and Property Settlement Agreement.

A taxpayer who engages the services of a law firm that "limits its practice to matters involving state and federal taxation," from whom the taxpayer client seeks advice concerning "the Federal income tax consequences to him [or her] of a proposed property settlement agreement" has incurred a fully deductible legal fee.

If a law firm that "also handled certain non-tax aspects of the divorce" is being called upon to advise the taxpayer client of "the Federal income, gift, and estate tax consequences to him [or her]," the non-tax matters are nondeductible by the payor spouse, but the fees for tax advice are deductible.

The tax matters were referred to and were handled by a department in the firm that specializes in taxation. The firm's statement to the taxpayer must allocate a portion of the total fee

to tax matters. The allocation was based primarily upon the time required, the difficulty of the tax questions presented, and the amount of taxes involved.

A sole practitioner is representing a taxpayer client in connection with obtaining a divorce. The attorney's services also "included tax counsel concerning the right of the taxpayer to claim the children as dependents for Federal income tax purposes in the years subsequent to the divorce." Although this scenario entailed no separate tax department, let alone a separate law firm, dealing with the tax aspects of divorce, the ruling nevertheless allows deductibility of the fees allocable to those tax aspects. The practitioner's statement to the taxpayer allocated the fee between the tax advice and other nontax matters, based primarily on the amount of the attorney's time attributable to each, the fee customarily charged in the locality for similar services, and the results obtained in the divorce negotiations.

It is clear from the ruling that the Service appreciates how the bill for professional efforts for tax advice and planning may be based not only on time spent, but also upon the difficulty of tax matters, the amount of taxes potentially at stake, the success of the work done, and community practice.

ALLOCATING FEES TO TAX MATTERS:
THE TAXPAYER'S BURDEN OF PROOF
AND THE PROFESSIONAL'S RESPONSIBILITY
IN ITEMIZED BILLINGS

A legitimate concern of counsel involves the proper allocation of a fee as between nondeductible personal services and deductible tax matters. What is reasonably allocable to legal expenses for tax advice, "turns upon the facts of a given case and must be measured by the best available evidence of the extent and value of the tax advice. Such evidence may be opinion evidence giving an allocation derived from reliable records of services performed."

The issue of allocability is customarily controlled by counsel, by itemizing the bill between fees for deductible and nondeductible services. The taxpayer's counsel must act in good faith. Because the professional will, by an allocated bill, provide the client with the basis for claiming a deduction, the

problem shifts to an ethical plane.

**MEETING TAXPAYER'S BURDEN WITHOUT AN ITEMIZED
BILL OR SPECIFIC PROOF**

Legal fees for consultation and advice in tax matters arising out of divorce and separation proceedings are deductible under §212(3), but the burden of proof is upon the taxpayer to show "a reasonable basis for allocating a portion of his [or her] legal fees to tax counseling advice." A good faith allocation by the attorney who performed the services may be sufficient to meet the taxpayer's burden. The difficult case for deductibility arises when the attorney's bill is not itemized, and testimony from the attorney cannot provide specific information as to the hours worked on tax advice as compared to other legal matters.

**LEGAL FEES TO OBTAIN A SPOUSAL MAINTENANCE
AWARD, INCREASE AN EXISTING AWARD,
OR ENFORCE AN AWARD ARE DEDUCTIBLE UNDER §212(1)**

The portion of legal fees attributable to the production or collection of taxable spousal maintenance is deductible by the recipient of the spousal maintenance as a nonbusiness expense. Reg §1.262-1(b)(7).

1. OBTAINING AND COLLECTING AWARDS.

Legal expenses of collecting spousal maintenance were expressly allowed full deductibility under §212(1).

Attorney's fees and other costs paid in connection with a divorce, separation or decree for support are not deductible by either the husband or the wife. However, the part of an attorney's fee and the part of the other costs paid in connection with a divorce, legal separation, written separation agreement, or a decree for support, which are properly attributable to the production or collection of amounts includible in gross income under section 71 are deductible by the [recipient spouse] under section 212.

The Internal Revenue Code language which refers

exclusively to "the production or collection of income" (§212(1)) Reg §1.212-1(k). Thus, if the payee spouse's receipts are nontaxable, the legal fees will be nondeductible, if the payor's receipts are partially nontaxable and partially taxable, legal fees will have to be apportioned between such payments in order to ascertain what amount is allocable to taxable income and therefore deductible.

2. INCREASING AN AWARD.

Just as the costs of obtaining or enforcing an spousal maintenance award are deductible under §212(1), so too are expenses associated with securing an increased spousal maintenance allowance in a subsequent proceedings. If no portion of the lawyer's fees could be allocated to a nontaxable receipt, such as an increase in child support, the fees were exclusively associated with increased income, therefore, a deduction of the entire amount will be allowed. Otherwise, an allocation between fees incurred for the increase of child support and an increase in spousal maintenance must be made.

3. UNSUCCESSFUL EFFORTS TO INCREASE AN AWARD.

If the taxpayer's attempts to secure additional spousal maintenance are in vain, may legal fees yet be deducted? Arguably, they can. Although there is no authority directly on point, an analogy could be drawn to "headhunter" expenses incurred in an unsuccessful effort to gain a higher salaried employment position. Provided that an income stream is already running to the taxpayer, some revenue rulings (see Rev Rule 77-16, 1977-1 CB 37; Rev Rule 75-120, 1975-1 CB 55) that permit deductions in that area seem to bode well for spousal maintenance recipients who seek to improve their lot.

4. CHILD SUPPORT CHARACTERIZATION OF AN AWARD.

What then of legal fees incurred for the purpose of imprinting a child support characterization upon one's receipts in order to increase the after-tax amount of the payments? Since legal costs expended to obtain a nontaxable receipt -- e.g. property settlement or child support -- would not generally be deductible in the first place, the same nondeductible treatment would seem to be in order when the objective is to effect a change in the nature of payments being received from taxable to nontaxable.

5. SEPARATE RETURNS ARE REQUIRED.

There is one final, rather subtle point relative to the deductibility of legal fees incurred to obtain, increase, or enforce an spousal maintenance award. Since the includibility of spousal maintenance in income under §71(a) depends upon the divorced or legally separated spouse's living apart and filing separate income tax returns, and since the deductibility of legal expenses under §212(1) requires that there be a relationship between such expenses and the production or collection of income, legal fees are rendered nondeductible if the estranged spouse files jointly.

ALLOCATING FEES TO TAXABLE SPOUSAL MAINTENANCE RECEIPTS

Because a recipient spouse will rely upon §212(1) for the deductibility of legal fees, and the statutory language refers to expenses linked to the production or collection of income, it will be necessary to allocate fees between taxable and nontaxable receipts wherever both are present.

Allocation can be expected in any case where there are taxable and nontaxable receipts -- such as where an spousal maintenance awardee also receives a nontaxable property settlement, or where payments are in part taxable spousal maintenance and in part nontaxable child support.

In Jernigan v. Commissioner, 34 TCM (CCH) 615 (1975), the taxpayer spouse incurred \$75,000 of legal fees in connection with the divorce proceedings. By mutual agreement, the payor spouse paid \$25,000 of these costs, without deduction, while the taxpayer paid \$33,333.28 in the year 1969 and \$16,666.72 in 1970. The Tax Court allocated the \$75,000 in the following manner:

Two thousand dollars of the \$75,000 legal fees was incurred in connection with [the taxpayer's] securing the divorce. Of the remaining \$73,000 balance, \$50,000 was incurred by [the taxpayer] for the production or collection of amounts includable in [the taxpayer's] gross income under §71 of the Internal Revenue Code of 1954, and \$23,000 was incurred by [the taxpayer] in connection with the property settlement.

Without more, the taxpayer's payment of \$50,000 would likely have been attributed proportionately to personal matters

(divorce), income receipts (spousal maintenance), and nontaxable receipts (property settlement). However, in fact, there was more.

Pursuant to the mutual agreement incorporated in the final divorce decree, the [payor spouse] paid \$25,000 of the legal fees which the [taxpayer] and [the payor spouse] agreed were incurred in connection with the divorce and property settlement and the [taxpayer] paid the remaining \$50,000 in legal fees which [the taxpayer] and [payor spouse] agreed were incurred in connection with the production or collection of spousal maintenance. (emphasis added)

Despite this interspousal agreement, the Internal Revenue Service pressed for a proportionate allocation of the taxpayer's \$50,000 payment. The interspousal agreement's allocation was upheld.

What with the allocation of attorney's fees between deductible and nondeductible matters being an oft-questioned area, an agreement along the lines of that in Jernigan would seem most desirable for the recipient spouse to negotiate as a part of the settlement.

Remember that even to the extent attorney's fees are attributable to a nontaxable receipt, they may be deducted under §212(3) as relating to tax advice. Counsel would be well advised, in keeping records of the hours to be billed, to include notations indicating how the time devoted to a client's situation was spent -- on income-generating efforts or tax matters, for example -- because these professional business records can serve as strong evidence of the deductibility of fees.

LEGAL EXPENSES TO OBTAIN BUSINESS PROPERTY

The question considered in this chapter is one of line drawing between the nondeductible category of personal or capital expenses and the area of business or income receipts where legal expense deductibility is allowed. Fundamentally, the issue boils down to whether ownership rights are established by virtue of attorney assistance, in which case the legal fees are properly capitalized rather than being deducted. If income rights, in contrast to property ownership, are secured, the associated costs of obtaining or collecting that income stream may be deducted.

FEEES IN DEFENSE OF OWNERSHIP OR TO ACQUIRE
ASSETS MAY BE CAPITALIZED

Whenever legal fees incurred incident to a marital dispute are concluded to be nondeductible, the next question that arises is whether any tax cognizance at all can be taken of such costs. If the fees relate to the taxpayer's retention of assets or to the obtaining of assets in a nontaxable property settlement, they may be considered as capital in nature and may be added to the basis of the subject assets. This conclusion has been reached by courts in various situations. For example:

1. Legal costs paid by one spouse in defending against the other spouse's accounting action (brought for the purpose of obtaining a property settlement) were considered capital outlays in defense of ownership which increased the basis of the targeted assets.

2. One spouse's legal expenses in recovering property that the other spouse had fraudulently concealed in a divorce action, were considered capital outlays to increase the basis in the recovered properties.

3. Expenses of a divorce action which jeopardized one spouse's ownership of stockholdings in business and threatened to depress the value of the companies through possible loss of customers were "costs incurred in defending ... ownership" so that legal expenses were to be capitalized and added to basis of stock despite their personal origin and nature.

As can be seen from this trio of cases, attorney's fees which are nondeductible may nonetheless be recognized for tax purposes as an addition to the basis of properties the ownership of which is either defended or acquired in divorce. In this connection, it matters not whether the subject property is an income-producing or a personal asset.