# DEDUCTIBILITY OF LEGAL FEES

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## 1. INTRODUCTION

Due to deductions being a matter of legislative grace, it is necessary to relate any would-be deductible expense to an Internal Revenue Code provision which authorizes deducting legal fees in a divorce. §212 which relates to expenses which covers profit-seeking activities and tax-related expenses:

1. For the production or collection of income,

2. For the management, conservation or maintenance of property held for the production of income, or

3. In connection with the determination, collection or refund of any tax.

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.

## 2. 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.

In Carpenter v. United States, 338 F2d 366 (Ct Cl 1964), the Court of Claims had an opportunity to reexamine its grant of deductibility to tax determination expenses in separation and divorce under the United States v. Gilmore, 372 US 39 (1962) holding. It continued to allow deductibility, as in United States v. Davis, 370 US 65 (1962). At least 70 percent of Mr. Carpenter's $10,031.21 legal bill was "properly allocable to services and advice as to the tax consequences flowing from the divorce and separation." Referring to the regulations, which state that expenses of "tax counsel" are deductible, the Court found clear support for the allowance of deductibility in Carpenter and saw nothing indicating to the contrary in either the Davis or Gilmore opinions from the Supreme Court.

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.

## 3. 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. To what extent may the bill legitimately be loaded toward deductibility? A worthwhile case study in this regard is Munn v. United States, 455 F2d 1028 (Ct Cl 1972).

> [The taxpayer,] in the present case, has adduced evidence which indicates that one-third of the bill in question relates to tax matters. Obviously, some portion of the bill related to tax matters. [The government], in attempting to rebut [the taxpayer's] evidence, merely asserts that [the taxpayer's] allocation is unreasonable, but offers no evidence to show that Mr. Young made his allocation in bad faith or erroneously and offers no evidence to show that its own allocation is correct. [The government's] evidence merely indicates that all of the fee in question is not allocable to tax matters, which [the taxpayer] concedes, and that some of the services performed on behalf of [the taxpayer] were not of a complex nature.

Munn demonstrates how counsel plays a role that is effectively outcome determinative in matters of the deductibility of legal fees that a client pays in the marital dispute context. The opinion also points up how a greater portion of any lawyer's bill may be deducible than would merely represent the relative number of billed hours allocable to tax planning and advice. Based on the complex nature of tax law, one-quarter of the hours spent by attorney's in Munn accounted for one-third of the legal fees.

## 4. 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.

The court in Hall v. United States, 78-1 USTC (CCH) paragraph 9420, denied altogether the deductions claimed for tax advice under §212(3), due to a lack of proof that any part of the attorney's fees was so allocable. The taxpayer's attorney performed services in the divorce action but did not render tax advice. The attorney "stated that he was an experienced domestic relations practitioner and when income tax questions arose, he referred them to others."

## 5. LEGAL FEES TO OBTAIN AN ALIMONY AWARD, INCREASE AN EXISTING AWARD, OR ENFORCE AN AWARD ARE DEDUCTIBLE UNDER §212(1)

The alimony awardee's expenses related directly to the production or collection of that income stream are appropriately granted deductibility by §212(1) inasmuch as federal income tax is levied not against gross receipts but rather upon income.

### OBTAINING AND COLLECTING AWARDS

Legal expenses of collecting alimony were expressly allowed full deductibility under §212(1) in Elliott v. Commissioner, 40 TC 304, 314 (1963).

In Wild v. Commissioner, 42 TC 706 (1964), 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)). 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.

### INCREASING AN AWARD

Just as the costs of obtaining or enforcing an alimony award are deductible under §212(1), so too are expenses associated with securing an increased alimony allowance. If no portion of the lawyer's efforts or fee could be allocated to obtaining the divorce or receiving a nontaxable receipt under those circumstances since the fees were exclusively associated with increased income, therefore, a deduction of the entire amount will be allowed.

UNSUCCESSFUL EFFORTS TO INCREASE AN AWARD

If the taxpayer's attempts to secure additional alimony 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 Rul 77-16, 1977-1 CB 37; Rev Rul 75-120, 1975-1 CB 55) that permit deductions in that area seem to bode well for alimony recipients who seek to improve their lot.

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.

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 alimony award. Since the includibility of alimony 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.

In Wolfson v. Commissioner, 47 TC 290 the Court said the very essence of those regulations is that the deduction is allowed only in connection with amounts expended for the production or collection of amounts includable in gross income under §71. And the only alimony which the [taxpayer] received here was alimony pendente lite, or temporary alimony, for a period of about 6 months, which would have been includable in gross income, if at all, only under [former §71(a)(3), before the 1984 Act revisions] ... But in this case, such temporary alimony was not includable in gross income because the parties filed joint returns for 1961 and 1962, and [former] §71(a)(3) explicitly provides that "This paragraph shall not apply if the husband and wife make a single return jointly."

## 6. ALLOCATING FEES TO TAXABLE ALIMONY 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.

Thus, in LeMond v. Commissioner, 13 TC 670 (1949), acq in 1952-1 CB 3, the Tax Court required a recipient spouse to allocate legal expenses "on the basis of the proportion of the total nontaxable alimony to the total amount of alimony received or receivable." On these bases, the Tax Court reasoned as follows:

> Inasmuch as the [taxpayer] actually received alimony in the amount of $69,300 in the year 1943 and was required to include only $21,900 of that amount in her gross income, it is clear that she received $47,400 in 1943 which was not subject to Federal tax and yet was secured as a result of the financial settlement negotiated by her attorneys, whose fees she seeks to deduct herein. Therefore, the legal expenses claimed by the [taxpayer] in each of the years 1943 and 1944 should be allocated ... As the taxable alimony constitutes approximately 80 percent of the total alimony received or receivable by [the taxpayer], that percentage of the deduction claimed for legal fees in each year should, in our judgment, be allowed.

This same sort of allocation can be expected in any case where there are taxable and nontaxable receipts -- such as where an alimony awardee also receives a nontaxable property settlement, or where payments are in part taxable alimony 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 (alimony), 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 alimony. (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.

## 7. 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.

Application of these principles is well illustrated by Hahn v. Commissioner, 35 TCM (CCH) 509 (1976). During the approximately 21 years of their marriage, Genevieve Hahn worked with her husband, first in a restaurant business and later in a waterfront facility offering food, fishing supplies, and dock and boat rentals. She served in various capacities until their divorce, during which Mrs. Hahn expended $14,451.34 in attorney's fees. She treated 77 percent of her legal costs as deductible under §212, on the ground that that portion was "related to the establishment and obtaining of her ownership interests in the restaurant and the Docks properties and her rights to the income therefrom."

In denying deductibility of those fees whereby the taxpayer had obtained a one-third interest in the restaurant business, the record ownership of which had been in Mr. Hahn alone, the Tax Court explained:

> It is true that [the taxpayer's] obtaining of a one-third ownership interest in the restaurant resulted in her becoming entitled to direct participation in one-third of the future rental

> income therefrom. However, the income which the [taxpayer] will receive from the property results directly from her establishing her right to ownership of the property, and accordingly the legal fees in connection therewith must be treated as capital expenditures.

Mrs. Hahn's legal expenses had also secured for her the right to one-half of the income from the waterfront dock operation, of which property she was already half-owner. The expenses so allocable resulted not in her obtaining ownership to property, but in her securing an income stream that would be taxable to her just as alimony under §71.

> Thus, to the extent that the divorce litigation related to the Docks, it was not for the purpose of establishing [the taxpayer's] right to ownership, as it was in the case of the restaurant. [The taxpayer's] claim with respect to the Docks was more in the nature of seeking the right to possession of, or participation in the income from, the property which she jointly owned. Costs of litigation in which the primary issue was not ownership, but rather the right to possession, have been held properly deductible under §212.

Accordingly, that portion of Mrs. Hahn's attorney's fees which could be allocated to the collection of income were deductible. Since the attorney's bill did not provide any breakdown of the 77 percent of the fee which related to the restaurant and dock business properties together, an approximation was made. On the basis of the record, reports of the special master and other documents in the case, 30 percent of the entire fee was allowed as a deduction.

A final issue in Hahn involved legal expenses that Mrs. Hahn had incurred with her husband in defending their ownership and income rights to the waterfront dock operations. Because these costs related to defending title, there were held nondeductible.

## 8. LEGAL FEES TO REDUCE ALIMONY PAYMENTS ARE NONDEDUCTIBLE

While the expenses paid by a recipient spouse for the purpose of obtaining an increase in alimony income were held deductible, the attorney's fees incurred by a payor spouse who obtained a reduction in the alimony payment obligations were held nondeductible in Hunter v United States, 219 F2d 69 (2d Cir 1955), affg 123 F Supp 763 (EDNY 1954). Both cases dealt with the deducibility of legal fees under §212(1). The glaring disparity in results follows directly from the language of that subsection -- "production or collection of income."

Mr. Hunter's case for deduction of the legal costs was that, since "the settlement reduced the amount of his liability for alimony and thus increased

his taxable net income, it constituted the 'production of income,'" quoting language appearing in §212(1). Rejecting this argument, the district court held for the government. Legal expenses do not become deductible under the predecessor to §212(1) merely because they are paid for services which relieve a taxpayer of liability. For deductibility under these circumstances, recourse must be made to §212(3), provided that some of the legal expenses are reasonably allocable to tax matters.

## 9. FEES 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 (Lewis v Commissioner, 253 F2d 821 (2d Cir 1958)).

2. One spouse's legal expenses in recovering property that the other spouse had fraudulently concealed in a divorce action, beyond the amount deductible as incurred for production of alimony income, were considered capital outlays to increase the basis in the recovered properties (Commissioner v Coke, 201 F2d 742 (5th Cir 1953), affg 17 TC 403 (1951), nonacq in 1973-2 CB 4, withdrawing acq 1953-2 CB 3, withdrawing nonacq 1952-1 CB 5).

3. Expenses of a divorce action which jeopardized one spouse's ownership of stockholdings in automobile dealerships and threatened to depress the value of those companies through possible loss of auto manufacturer's franchise 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 (Gilmore v. United States, 245 F Supp 383, 384 (ND Cal 1965).

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.