

The Practitioner Family Law

Taxing Breakups

Deductibility of Attorney Fees in Dissolution Matters

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As April 15th approaches, attorneys dread the task of getting their tax documents together for their tax preparers and worry about whether — or how much more — they might have to pay Uncle Sam. But what of their clients, dissolution clients? How might at least some of what these clients have paid in attorney fees be deductible in the Internal Revenue Service's eyes?

The overriding rule on deducting legal expenses is that the expense must be related to either tax advice or to the production of taxable income. Internal Revenue Code Sections 212(1) and 212(3). Generally, the IRS requires that a deduction for legal expenses, as with almost any other deduction, must be taken in the year the taxpayer actually pays the expense, unless the taxpayer uses an accrual accounting method. Section 461.

Further, since these particular expenses fall under the category of miscellaneous itemized deductions, they are deductible by a taxpayer only to the extent that the total amount exceeds two percent of that individual's adjusted gross income. Section 67.

However, if the taxpayer's adjusted gross income is over \$100,000, or \$50,000 in the case of a separate return by a married person, then other rules apply. Section 68. The term "adjusted gross income" itself is an IRS term of art, defined in great detail at Section 62.

According to the IRS, dissolution proceedings and dissolution property settlements are nondeductible. However, obtaining spousal support is deductible from adjusted gross income. Section 71. Of course, when dealing with the law and taxes, things are rarely short and simple, as there is much more to this information than meets the eye.

For starters, note that obtaining spousal support is deductible because it relates directly to the first rule: A deductible legal expense is one that relates to either tax advice or to the production of taxable income. Spousal support is taxable to the recipient as additional income, thus attorney fees incurred in obtaining spousal support relate to the production of taxable income.

This leaves three important unstated items in need of mention: Since child support is not included in income, legal fees relating to obtaining, enforcing and collecting child support are not deductible. Section 71(c). Second, despite what every parent knows about the cost of child rearing, fees relating to child custody are considered to have nothing to do with income or expenses, as they are deemed to have originated entirely from the marital relationship

itself, and thus are strictly nondeductible.

Also, although fees incurred in obtaining spousal support are deductible, fees incurred in opposing the obligation of a spousal-support order are not. Along this same vein, the expenses of resisting a delinquent support enforcement action, seeking a decrease in the amount of one's support obligation or fighting an order to show cause for an increase in spousal support are all nondeductible expenses. Hence, the payor spouse not only has to pay the spousal support but cannot deduct any legal fees relating to it.

There are instances other than spousal support where legal fees are incurred for

ed to a tax-planning deduction. Common examples include: structuring a community-property division to create a certain desired tax effect, preparing a written separation agreement to ensure that the support payments are deductible, allocating who claims the dependency exemptions and calculating the adjusted basis of assets in a property settlement that are apportioned to one party from the other.

The first and last examples merit additional comment: How might structuring a community-property division be a deductible expense? It is when the attorney's work in negotiating or litigating the property division is a part of defending or claiming title to an asset that then is retained or acquired by the taxpaying party. However, this type of cost is not a deduction from adjusted gross income. Instead it is capitalized and added to the basis of the cost of the property. Section 1016(a); *Serianni v. Commissioner of Internal Revenue*, 765 F.2d 1051 (11th Cir. 1985).

This deduction applies to real property as well as other types of property, such as stocks. However, one must not attempt to capitalize the cost of obtaining cash, since the basis of such liquid asset cannot be increased. *Spector v. Commissioner of Internal Revenue*, 641 F.2d 376 (5th Cir. Unit A. Apr. 1981).

A simple example of adding to the basis of an asset would be where one spouse asserts a community-property interest in a rental apartment that is held as separate property, through premarital acquisition, by the other spouse. The defending spouse then successfully retains the property as her separate holding and incurs \$15,000 in attorney fees to do so. If the property was originally purchased for \$250,000, then later sold for \$350,000, her capital gain is only \$85,000, rather than \$100,000, as the \$15,000 expended in attorney fees to successfully defend her separate property is added to the \$250,000 basis, bringing it to \$265,000.

As an additional service to the client, attorneys can itemize their bills in a manner that makes it clear to the client and the IRS the portion of the fees that qualify for a deduction. An attorney should remind the client of the two categories of fees that are deductible costs: Those paid in connection with determining, obtaining a refund of or collecting any tax and those paid in connection with producing or collecting income, especially spousal support.

Further, when discussing any tax issue with a client, one must remember to advise the client to keep any invoices for the three-year limitations period for tax-review purposes. Since an attorney may be called to testify in tax court, one must also remember to keep good records to back up any bills one may be called upon to justify.

In sum, the basic rule remains that attorney fees relating to spousal support, as well as defensible — especially in an audit — costs connected to income production and tax advice, are deductible to the savvy taxpaying dissolution client. All other fees are nondeductible.

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the production or collection of income in a dissolution proceeding. Specific examples include the cost of obtaining royalties from an author or patent holder's community-property work or that of gaining an interest in the other party's profit-sharing or pension plan. The latter usually means the cost incurred in preparing a qualified domestic relations order.

The commonality in this diverse list remains that all the items on it are, or become, monies that are taxable upon receipt.

Another important area of dissolution practice where attorney fees may be deductible for an income-producing activity is where one of the spouses operates a business. In *United States v. Gilmore*, 372 U.S. 39 (1963), the Supreme Court established the limus test that is still the rule today, over 35 years later: If an expense arose from profit-seeking activities, and not personal activities, then it is deductible. Thus, if control of the business, or issues regarding the management or maintenance of it, arise within the dissolution proceeding, then those costs are deductible. However, merely determining the value of a business, a task that often takes place within the context of a dissolution, is nondeductible.

The other category of deductible cost comes under the category of tax planning and advice. This would include advice on structuring payments so that they constitute deductible spousal support. *United States v. Carpenter*, 336 F.2d 366 (Cl. Ct. 1964). However, family law attorneys or general practitioners who are unschooled in the area should be wary of providing tax advice, given that the IRS has the power to audit a tax return. Allocating a fee as a deductible item must be reasonable in the eyes of the IRS, and if such a deduction is successfully challenged, well-intending attorneys may find themselves subject to malpractice exposure.

Nonetheless, many experienced family law practitioners regularly provide information, services and advice to their clients, the cost of which may be allocat-

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