



Treatment of Divorce Costs

By

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It is often wondered whether divorce-related legal, accounting, and other professional fees are deductible for tax purposes. Although in most circumstances professional fee type expenses related to a divorce are generally not deductible, there may be an opportunity to include the expense in the basis of an asset. Generally, there are three aspects of a divorce that could generate the payment of professional fees – alimony, child support and custody, and equitable distribution of the assets. We will explore each one to determine how these fees could be reviewed in each case.

As a general rule divorce related professional fees are deductible under the Internal Revenue Code (IRC) when there is an attempt at procurement or collection of taxable (alimony) income (even if not successful). In addition, tax advice from an accountant, attorney, or other professional is deductible as a miscellaneous itemized deduction. Keep in mind that even though these expenses are deductible, they are only allowed on a personal tax return as a miscellaneous itemized expense. As a miscellaneous itemized expense, only the amount that is greater than 2% of the taxpayer's adjusted gross income (AGI) is actually deductible. In many cases an individual cannot benefit from the deduction or the full amount of the deduction as the taxpayer may not itemize, may not meet the AGI threshold if they do itemize, or itemized deductions could phase out due to high income. Furthermore, this category of expense is subject to the alternative minimum tax.

If professional fees are paid to an attorney or accountant associated with requesting alimony (alimony is defined under IRC Section 71 and must meet seven rules to qualify) or tax advice related to the alimony, these are deductible. However, if payment is made to the former (or to be former) spouse's attorney or other professional then these are not deductible as expenses. Yet, if it is part of the alimony agreement that clearly states that both parties agree that these are being paid on behalf of the former spouse and will count as alimony (and meets the alimony rules) then the payor may deduct these fees paid as alimony. In return, the recipient would report the income as alimony and be able to deduct the expenses as if the expense was directly paid by them. However, if those same expenses are paid on behalf of a former spouse and there is no alimony agreement designating these expenses as agreed to alimony, then the expenses are nondeductible by the payor or the recipient. In addition, if payments are made for legal and accounting professionals to provide assistance to reduce or eliminate paying alimony, these would not be deductible because taxable income is not the goal of the litigated matter.

If expenses relating to arranging child custody and receiving child support were incurred, these would not be deductible. Although receiving child support would provide a cash flow, the associated expenses to obtain it would not be deductible since the income is not taxable.

If professional fees are paid to assist with equitable distribution of the marital assets these expenses are not deductible (although tax advice associated with equitable distribution is). Even if you have had expenses in an attempt to retain income producing property this does not result in a deductible expense. However, you could add such expenses to the basis of the property to reduce your gain on the sale of the asset at a later time. The established general rule has been that costs for defending title to an asset can be added to the basis as a capital expenditure. In order to add to the asset basis one must



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be able to specifically trace the expenses to the work performed to obtain that asset and not simply be total of all legal expenses paid during a divorce.

In regard to the legal fees being added to basis of assets received in divorce settlement, there are prominent cases, but not in recent times. The original decision on this issue is *United States v. Gilmore* 372 U.S. 39 (1963) which was a California case discussing community property and did not allow legal expenses to be added to the business basis since the legal fees were from a personal litigation (divorce) not business. However, in an appeal as *Gilmore v. United States* 245 F. Supp 383 (N.D.Cal. 1965) it was found that the capitalization of the legal expenses was allowed and added to the basis of the Husband's stock for retention of the business asset. Prior to this time many cases had left open the issue and did not state that capitalization of expenses was allowed. But in *Gilmore*, the Supreme Court stated that the government's position in the initial case (which was that all expenses related to a divorce action should not receive a tax benefit) is not a blanket position that can be taken. Thirteen years later, *Spector v. Commission of Internal Revenue*, US Tax Court, 71 TC No 1017 (T.C. 1979) found that the legal fees associated with settlement could be allocated prorata among the assets (including cash). Note that when allocated to cash that portion of the legal expense becomes nondeductible (cash cannot have a different basis than what its value is) and therefore unrecoverable. Contemporaneous documentation of the professionals' time spent on equitable distribution (including specific assets) best supports the basis addition for these costs. This is sometimes straightforward as a business appraisal impacts just one or several designated assets.

When trying to determine what may be recovered in regard to tax savings for professional expenses paid during a divorce, one must take care in analyzing the situation. Overall there are only two situations where expenses can create a tax benefit. The first is a miscellaneous itemized deduction can be taken for the expenses generated in attempting to receive alimony and for tax advice. The second is that if the expenses can truly be traced to assets then those amounts can be added to the basis of that asset. The fact that one cannot deduct the professional fees as an itemized deduction does not allow it to automatically fall into the category of increasing an asset basis.

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