PERSPECTIVES ON
Litigation SUPPORT

Deductibility of Legal Fees Connected with Divorce

Clients often ask how legal fees paid with respect to a divorce or separation are treated for federal tax purposes. In general, legal fees relating to a divorce or separation are considered nondeductible personal expenses. However, careful documentation by the attorney can mean at least part of the fees may be deductible.

Tax Advice

Legal fees paid for tax advice are deductible, within tax law limits. Generally, they are treated as miscellaneous itemized deductions which, together with all other similar expenses, are subject to a 2%-of-adjusted-gross-income floor. With many divorces and separations, a final settlement is at least in part determined by the tax aspects of the breakup. In addition, those tax consequences must usually be analyzed and explained to the parties. To the extent the attorney's fee represents work done relating to these tax issues, it is deductible.

Alimony Collection

Legal fees incurred in the collection of taxable income are deductible, so taxpayers may deduct that portion of legal fees relating to securing alimony. Those fees might cover the legal work involved in setting up the alimony payments (through inclusion of provisions in the separation agreement or divorce decree). Also deductible are any legal fees paid to enforce collection, if payments are missed. However, legal fees incurred by the paying party to contest alimony claims are nondeductible personal expenses.

Capitalization of Fees

Where legal work involves acquiring marital assets in a divorce or separation, an allocable part of the fee can be added to the tax basis of the assets acquired. Capitalization is not as beneficial as a deduction, but it should save taxes when the assets are eventually sold or otherwise disposed of.

Determining the Deductible Amount

To obtain tax benefits from legal fees in connection with divorce, the client must be able to establish what part of the fee to allocate to the deductible (or capitalized) legal work. The taxpayer has the burden of proof to show the proper allocation.

Divorce attorneys can help their clients meet this burden of proof. If all the attorney provides is an unitemized legal bill, the client may not be allowed any deduction. Instead, by separating out and documenting the time spent on each of the above three categories and itemizing the bill to show all potentially deductible or capitalizable time spent on the case, the attorney can provide the documentation the client needs to support the tax benefits.

If our firm can be of assistance to you or your clients regarding the tax aspects of a divorce or separation, please let us know. ◆

Customer Base Quality Can Affect Valuation

Not only is the sheer size of the customer base important in determining a company's value, but the quality of customers also can have an impact.

Look Beyond the Symptoms

Valuing a company traditionally begins with a review of a company's cash flow and profits — the same indicators CEOs and investors use to gauge a company's performance. When a company is doing poorly, its cash flow and profits do indeed decline. However, falling cash flow and profits are merely symptoms of a larger problem. Customer defection may be the root cause.

Lost customers today signify lost revenues in the future. Therefore, customer defections are an important predictor of future performance and can affect a valuation. To make up for lost revenues, companies must acquire new customers. Unfortunately, attracting new customers is expensive and they are generally less profitable than existing customers.

Studying Customer Defection

Because of the high cost of attracting new customers, savvy managers continually study both the trends and the causes of customer defections. The goal of these ongoing studies is to minimize losses and, in turn, maximize company value.

Retaining Customers

Although studying customer defections is valuable, the ideal situation would be to prevent customer defections in the first place. The best retention strategy is to provide customers with quality products and services in an efficient and reliable manner at reasonable prices.

Satisfying customers one time is generally not enough to maximize value. The most valuable companies have *loyal* customers. Put another way, customer loyalty creates a valuable intangible asset called "brand equity." Here are three other strategies that produce customer loyalty and, therefore, brand equity.

Customer Complaint Management. Customers who *receive satisfying responses* to their complaints are among those most loyal to a company. Unfortunately, few customers ever complain when they are dissatisfied, and even fewer complain to the right person. Instead, they silently choose another vendor for future purchases. To maximize customer loyalty, a company should give its customers a means to complain to the right person. Further, management should personally review and respond to the complaints.

Interviewing defecting customers can provide them with another opportunity to complain. Unfortunately, such interviews often come too late and require a lot of effort from both management and the customer.

Long-term Contracts. The existence of long-term contracts with customers can be another indicator of value worth investigating. Negotiating a long-term contract with a customer is a common way to ensure their retention for a finite period of time. In many industries, long-term contracts are commonplace and beneficial to both parties. In fact, the widespread use of just-in-time systems has made long-term contracts increasingly popular, especially in the manufacturing sector.

Switching Costs. When it is difficult and costly for a customer to switch to a competitor, that customer is less likely to defect. A company that creates switching costs improves its chances of retaining customers. One example of creating switching costs is convincing a customer to buy a customized product, such as a computerized ordering system unique to that particular company.

Another type of switching cost is created when a company develops a "learning relationship" with its clients using information technology. As a company learns what each customer wants, it can customize its offerings, as well as make suggestions for additional products or services that match the customer's needs. If the customer switches to a competitor, the new company will not know as much about the customer. Consequently, the customer will lose out on the customization the original vendor provided.

The switching cost strategy works in only a few industries. Nevertheless, valuators would be wise to look at the existence and magnitude of switching costs when assessing a company's value.

Conclusion

When valuing a company, its customer defection experience should be considered. Whether the business implements customer retention strategies and the likely impact of those strategies should also be determined. ◆

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Challenging the Assumptions of Your Opponent's Expert Witness

Financial experts can present a number of challenges for even the most skilled litigators. Not only is the expert likely to be a knowledgeable and experienced witness, but his or her testimony is often full of jargon and can be difficult for jurors to understand. However, most financial testimony is vulnerable to attack, especially when it comes to the assumptions made by the expert.

Typically, an expert is asked to predict what would have happened in a specific case absent the actions of the defendant. In making these predictions, the expert relies upon certain assumptions to arrive at an opinion of what would have happened had the defendant's actions not affected the plaintiff. These assumptions lend themselves to close examination and, many times, can be successfully challenged by opposing counsel.

Identify the Key Assumptions

The first step is to identify the primary assumptions on which the expert's opinion relies. In calculating damages, for instance, there are several different approaches that may be used. Examining which method or methods the expert uses and the major assumptions utilized in applying those methods is essential.

Check the Expert's Support for the Assumptions

Look at the underlying support for the assumptions used by the expert in her/his report. Sometimes the support may be weak or nonexistent. Other times, the assumption is based on erroneous or inconsistent support. Each key assumption in the report should be closely examined by counsel's own expert for inconsistencies, errors, or failure to take into account actual factors that may have an impact on the assumption used.

Example: Expert assumes that Plaintiff's business would have retained its market share after Defendant's wrongful action. The fact that a new strong competitor entered Plaintiff's market shortly after Defendant's action likely would have affected Plaintiff's market share and revenues and should have been taken into account by Expert.

Contest the Assumptions at Trial

Attorneys contesting an expert's assumptions at trial can take a variety of approaches. One approach is to confirm the assumptions used by the expert in her/his report (and perhaps confirmed during deposition) and then challenge those assumptions based on additional factors the cross examiner's own expert has discovered.

If there is little or no support for the expert's assumptions, it is essential to establish that fact. An important issue counsel can raise is whether the expert had enough support for her/his assumptions — and whether the expert did whatever was necessary to obtain adequate support.

Follow Up

Usually, counsel will then present his or her own expert who challenges the support for the assumptions and/or methodology used in the opposing expert's report and presents an alternative opinion.

Whether you are representing a plaintiff or defendant in cases where financial expert testimony is a key, you need a financial expert who has the knowledge and experience to provide the professional analysis and testimony required. Our firm can provide litigation support on a wide variety of financial issues. Please contact us to learn more about what our professionals can do for you and your clients. ◆

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15 Corporate Circle, Albany, NY 12203
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Briefs

▶ *Murphy* Ruling Vacated and Rehearing Ordered

In August 2006, the U.S. Court of Appeals for the D.C. Circuit found that IRC Section 104(a)(2), which calls for taxation of compensation for a personal injury where the compensation is unrelated to lost wages and earnings, is unconstitutional. In December, the Court, on its own motion, vacated its prior ruling and ordered a rehearing (*Murphy v. IRS*, CA-Dist. Col., 12/22/06).

▶ Cash Balance Plan Not Age Biased

Another federal appeals court has rejected a claim that a pension plan sponsor violated the age discrimination provisions of federal pension law by switching to a "cash balance" plan. The Third Circuit Court of Appeals borrowed heavily from last summer's *IBM* decision, an appeal from which was turned down by the U.S. Supreme Court (*Register et al. v. PNC Financial Services*, CA-3, 1/30/07). ◆

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