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AMT Problems For Attorney Fees Remain

With passage of the [Alternative Minimum Tax \(AMT\) Patch](#) as part of the [Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010](#), are all your AMT problems solved? Hardly. In fact, as I've [noted](#) repeatedly, AMT issues for many taxpayers are huge.

As IRS Commissioner [Doug Shulman](#) recognized, that makes the AMT portions of the recently passed tax bill more important for many taxpayers than marginal tax rates. AMT can sneak up on you and bite in unexpected ways. Want an example?

One perennial problem with lawsuit recoveries is the tax treatment of attorney fees.

Example: You are yelled at by a City employee and sue the City for intentional infliction of emotional distress. Your contingent fee lawyer will receive 40%. When the City offers \$100,000, you accept. Do you have \$100,000 of income or only \$60,000?

Usually \$100,000, which means you must figure a way to deduct the \$40,000 paid to your lawyer. Miscellaneous itemized deductions for legal fees are the norm. They are deductible only to the extent they exceed 2% of your adjusted gross income (meaning you can't deduct that 2%). Plus, miscellaneous itemized deductions are subject to phase-outs at certain income levels which apply to many taxpayers. These several limitations reduce your deduction so you're actually paying tax on money paid directly to your lawyer.

Most insidiously, though, the legal fees are not deductible—at all—for purposes of the AMT. The AMT is a separate tax calculation. Once you've computed your regular tax due, you still must determine your Alternative Minimum Taxable Income ("AMTI") by adding back certain tax preference items—like legal fees—and then applying a 28% rate. Your AMT is the amount by which these alternative taxes exceed your regular tax.

If much of your income is offset by deductions—like legal fee deductions—you'll often pay AMT. It's hard (if not impossible) to estimate AMT liability, so you have to run the numbers. And the bigger the lawsuit recovery and legal fees, the bigger the AMT problem. The higher exemptions in the new law for 2011 and 2012 will help, but not with a big recovery or big fees. See [AMT Patch Nicely Embroidered](#).

If you run examples with a \$1 million or \$10 million recovery and with higher legal fees, say 50%, the AMT can be downright shocking. Costs (travel, court fees, transcripts, copies, expert fees, jury consultants) are treated the same as legal fees, so legal fees can (combined with costs) climb to 70% or 80% in some cases. Some clients actually **lose** money after tax by winning a lawsuit. See [Spina v. Forest Preserve Dist. of Cook County](#).

Some taxpayers are able to get around the AMT problem with attorney fees by one or more of these potential (but not always foolproof) solutions:

1. Try to avoid the income inclusion on the attorney fees in the first place, which may be possible in certain types of litigation;
2. Qualify for an above-the-line deduction rather than a miscellaneous itemized deduction (often possible in employment, civil rights and certain other litigation); or
3. Keep litigation within the confines of a trade or business where legal fees can be deducted "above-the-line" (that is, not as miscellaneous itemized deductions).

For more, see:

[The Only Good Legal Fees Are Tax Deductible Legal Fees](#)

[Legal Fee Tax Rules Every Lawyer Faces](#)

[10 Things To Know About Taxes On Damages](#)

[Legal Fees and Tax Deductions](#)

[Attorney Fees: To Deduct or Not to Deduct](#)

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