PERSPECTIVE

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Ever-Increasing Legal Fees Are Deductible, Right?

By Robert W. Wood

Legal costs keep rising, and top lawyer hourly rates are soaring. How you feel about this may depend on where you fit on the continuum, and whether you are a provider or consumer of legal services. You might feel really conflicted if you are both!

It is unlikely that most of us will occupy the rarified atmosphere of the most expensive lawyers. Not long ago $1,000 seemed astoundingly high. Today, some legal fees have crossed a stratospheric $1,500 an hour.

In some cases, it matters who is paying. A tech entrepreneur can surely pay whatever he wants, but public entities — and even public companies — could be questioned. The city of Baltimore recently took flak for paying outside lawyers up to $1,200 an hour in its Justice Department probe.

For most clients, tax write-offs clearly help pare the cost of high bills. But is everything in the “legal” category really tax deductible? Not quite.

Businesses are used to reducing their legal bills by deducting the fees and costs on their taxes. In effect, the government shares the cost. A $1,500-an-hour lawyer *really* only costs you about $900 an hour after tax deductions. But not all lawyers’ fees are deductible.

Clients cannot deduct personal legal bills. In the tax system, “personal” usually means “nondeductible.” That’s certainly true with legal fees. In that sense, the least desirable legal expenses are those of a purely personal nature.

Examples include divorce fees; divorce is considered personal even though it may involve fighting over assets. However, if you pay for *tax advice* as part of a divorce, that is deductible. Some divorce lawyers work with outside tax advisers. Some will divide their invoices and say what part of their fees is for tax advice.

Personal legal fees can arise in many contexts. If a family member sues you for slander, that is surely personal. But some legal matters of a personal nature can impact business or investments, making some deductible. Is a dispute with your neighbor over your back lot line personal or investment, because your hope is appreciating in value?

You can’t deduct these fees, but you can add them to your basis in your house for a *future* tax benefit. With many personal vs. investment fees, it can be a confusingly slippery slope. As you might expect, some people push the envelope. A good example is some celebrities and their legal fees, who may argue that everything they do is about image.

Legal fees for tax advice are deductible, whether you pay for tax planning or a tax dispute, even if the taxes are personal. What’s more, *any* tax qualifies, including income, estate, gift, property, sales, use and excise tax. Note how broad this rule is. In fact, despite the general rule that personal legal fees are non-deductible, tax fees are deductible even if the taxes are purely personal.

Legal fees you pay in your trade or business are deductible. However, some fees must be capitalized and added to the basis of assets. For example, say you are trying to sell your business and spend $50,000 in legal fees. Can you deduct it against your income or must you add it to your basis in your company?

Usually the latter. Some investment legal fees must also be capitalized to the basis of the assets (such as legal fees for the purchase of investment property). If legal expenses don’t relate to your business but only to investments, you can still deduct them.

But they generally qualify only as a miscellaneous itemized deduction. That means a 2 percent threshold, phase-outs and (worst of all) Alternative Minimum Tax (AMT). When plaintiffs talk about having to pay taxes on their lawyer’s fees — money the client never sees if the case is settled by the usual payment to a lawyer’s trust account — it is usually because of AMT.

Tax deductions for contingent lawyer’s fees can be tricky. If you recover $1 million in a lawsuit and owe 40 percent to your contingent fee lawyer, you might assume you have $600,000 of income. How could you *possibly* have to pay tax on the full $1 million?

Answer: In *Commissioner v. Banks,* 543 U.S. 426 (2005), the U.S. Supreme Court ruled that you have income when your lawyer is paid. That means you need to worry about how to deduct the fees on your taxes. In a pure personal physical injury case (say an auto accident or slip-and-fall), the entire recovery is tax-free. In that context, it doesn’t matter whether you consider the recovery including legal fees or the net.

Unfortunately, there is often confusion about what is tax-free. Most employment settlements are either wages (on a Form W-2) or non-wage income (on a Form 1099). If the lawyer takes 40 percent, the client still must include 100 percent in his income. However, the client can deduct the legal fees “above-the-line,” before reaching adjusted gross income. In an employment case, the client does not pay tax — no regular tax and no AMT — on the legal fees.

In business, most things are deductible unless they fall within the rules require capitalization to an asset. And in a business context, unlike some other business expenses, there is probably not much chance you will be denied a deduction for legal fees that are lavish or extravagant. Entertainment expenses are another matter. Over the top parties even in a business context may not be deductible.

How about high legal fees? It an absolute sense, sometimes legal fees are unreasonably high. But heck, with fees for some top lawyers now cresting $1,500, maybe the sky’s the limit?

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