

TAX ALERT

BY ROBERT W. WOOD



No one likes paying legal fees, but tax deductions make them less painful. For example, if your combined state and federal tax rate is 40%, \$10,000 in legal fees cost you only \$6,000. Here are 10 rules you need to know about taxes and legal fees.

1. Contingent Lawyer's Fees Are Income

Before addressing tax deductions, there's one big *income* worry: You may only consider deducting legal fees you pay yourself, as by writing a check. However you should also consider legal fees *someone else* pays your lawyer. Since a payment to your lawyer discharges your obligation, you must consider the income side of the equation.

Suppose you are a plaintiff in a lawsuit and recover \$1 million, and your contingent fee lawyer keeps 40%. You might assume your largest tax problem will be \$600,000 of income. How could you possibly have to pay tax on the full \$1 million?

Answer: The Internal Revenue Code is not always logical. The U.S. Supreme Court ruled in 2005¹ that "as a general rule" you've got income when

ROBERT W. WOOD is a tax lawyer with a nationwide practice (www.woodporter.com). The author of more than 30 books including *Taxation of Damage Awards & Settlement Payments* (4th ed. 2009 www.taxinstitute.com), he can be reached at wood@woodporter.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

Can Tax Rules Cut Legal Bills?

your lawyer is paid, even if you never touched the money and it was paid by a third party (like the defendant). That means you need to worry about how to deduct the fees.

2. You Can't Deduct Personal Legal Fees

The least desirable legal expenses are those of a purely personal nature. The best legal fees are business expenses. As you review the other categories of legal fees listed below, you may start to think that *nothing* is purely personal – but you'd be wrong. If you incur legal expenses to get divorced or because you insult a family member who sues you for slander, the legal fees you pay would generally be regarded as purely personal and therefore non-deductible.

But distinguish between purely personal expenses and investment expenses. For example, suppose you are a local businessman and you coach a little league team. You defame one of the parents at the game. You pay \$25,000 in legal fees to resolve the case. Can you deduct it?

Even though the expense arose out of a personal activity, you'll argue that you had to incur the expense because of your business and reputation. That could make it a business expense, or at least an investment expense (for the difference, see below). You may succeed, but the Internal Revenue Service wins many such cases.

3. Legal Fees in Personal Physical Injury Cases Are Tax-Free

If a client hires a contingent fee lawyer in a pure personal physical injury case (say an auto accident or a slip-and-

fall), *both* the legal fees and the net recovery are tax-free to the plaintiff. Put another way, if the recovery is tax-free, it doesn't matter whether you consider the gross recovery including legal fees or the net after legal fees.

Unfortunately, there is often confusion about what is and is not tax-free. The basic rule is that recoveries for personal physical injuries and physical sickness are tax-free, but punitive damages are taxable, as is interest (even in a physical injury case). So a settlement or judgment may be part tax-free and part taxable.

4. Legal Fees in Employment Cases Are Fully Deductible

Most employment lawsuit recoveries are taxable income. They may be wages (subject to withholding and employment taxes), or they may simply represent non-wage income (typically reported on an IRS Form 1099). Even in an employment case, payment for physical injuries or sickness is tax-free, but in most employment cases the monies are simply split between wages and other income. In an employment case, if the client receives 60% and the lawyer receives 40%, the client is still treated as receiving 100%.

But fortunately, due to a 2004 change to the Internal Revenue Code, the client can deduct the legal fees "above-the-line." The client includes the 40% legal fee in gross income, but then subtracts it before reaching adjusted gross income. That means the client isn't paying any tax – no regular tax and no alternative minimum tax – on the legal fees. (See item 7 below for more about the AMT.) Still, people often foul this up on their tax returns, so be careful.

5. Business Legal Fees Are Fully Deductible

Legal fees incurred in running a trade or business are fully deductible by corporations, LLCs, partnerships and proprietorships. Proprietorships report federal income tax on Schedule C to their IRS Form 1040. Schedule C tallies up income and expenses and arrives at net profit or loss from the business. That net profit or loss then goes on the face of the Form 1040. The legal fees on Schedule C operate like an above-the-line deduction, so the client pays no tax (no regular tax and no AMT) on the lawyer fees.

6. Investment Legal Fees Are Miscellaneous Itemized Deductions

If the lawsuit does not involve personal physical injury or employment, and does not arise in a trade or business, the client has a tax problem. The client can deduct the legal fees only as a miscellaneous itemized deduction on Schedule A of the client's Form 1040. That triggers numerous limitations.

First, the legal expenses are deductible only in excess of 2% of the client's adjusted gross income. Second, clients with higher incomes have their miscellaneous itemized deductions and personal exemptions phased out. Then there's the dreaded AMT!

7. AMT Liabilities Can Be Big

If you claim legal fees as miscellaneous itemized deductions, they are non-deductible for purposes of the AMT. The tax applies at a 28% rate and can effectively tax most or all your legal fees. When people talk about "paying tax on the lawyer fees," this is invariably what they mean.

Clearly, taxpayers have an incentive to try to net their legal fees. Some people file a Schedule C, claiming to be a proprietor. A recent example is the case *Purdy v. Commissioner*.² Purdy was an employee and received a Form W-2. After an employment dispute, Purdy received an award of wages, and paid his lawyer a \$120,000 fee.

Notably, this occurred in 2003, prior to the enactment of the above-the-line deduction for employment claims. Because of that, Purdy put the lawyer's expense on his Schedule C, claiming he could report income and expense as a proprietor. The Tax Court easily concluded that Purdy was an employee so he could not deduct legal fees on Schedule C. He could deduct them only as a miscellaneous itemized deduction, so he paid AMT.

8. You Must Capitalize Some Legal Fees

Another big category of legal expenses are those that must be capitalized. If a legal expense relates to your investments or to your business, watch out for capitalization. In either case, to deduct those legal fees you need to be able to show that the fees relate to your current business operations or to the ongoing maintenance of your investment property – not to something fundamental.

For example, if you are trying to sell your business and spend \$50,000 in legal fees, can you deduct it against other income, or must you add it to your basis in your company? Usually, the latter. Similarly, suppose you incur legal expenses to resolve a lot line dispute between your house and your neighbor's. Is that purely personal or is it investment-related, since your house is arguably an investment? Probably the latter.

Yet, even though these legal expenses should qualify as investment-related rather than purely personal, you can't deduct them. Instead, you must capitalize them, by adding them to your cost, just as you would handle the costs of a kitchen remodel. You only get a tax benefit later if you sell the house, when the legal expense can shield additional sales proceeds from tax.

9. Legal Fees for Tax Advice Are Deductible

Legal fees for tax advice are in a separate category and are always deductible (that means paying your tax lawyer is never as painful as paying other lawyers!). The rule covers legal fees for

all taxes – income, estate, gift, property – even excise tax or sales and use tax. The taxes may be either personal or business. The advice may involve tax planning or tax controversies.

But there's a downside. Fees for tax advice deducted by individuals are only miscellaneous itemized expenses. That means you incur the same limitations and the same AMT trap discussed above. If the tax advice relates to your business, you are better off treating the legal fees as business expenses (fully deductible) rather than as tax fees (miscellaneous itemized).

On the other hand, sometimes you can deduct purely personal legal fees as tax advice. Divorce is personal, but the portion of your divorce legal fees related to tax advice is still deductible. A miscellaneous itemized deduction is better than nothing.

10. Allocate Fees in Combined Cases

If you receive tax-free and taxable damages, you'll generally need to bifurcate your attorney fees too. Some of the legal fees in a contingent fee case will be income, so you want to find a way to deduct them. Punitive damages and interest often raise this problem.

Employment cases also often involve multiple types of recoveries and multiple types of attorney fees. A case may involve some deductible legal fees and some that must be capitalized. Even divorce cases can involve hybrids.

Conclusion

Clients can be forgiven for not wanting to pay legal fees without deducting them, because tax deductions alleviate some of the pain. The tax analysis can be sophisticated, and you'll often find that the facts are ambiguous and that you may incur legal fees that fall into more than one category. Fortunately, there are often several ways of allocating fees, so planning can pay off. ■

1. *Commissioner v. Banks*, 543 U.S. 426 (2005).

2. T.C. Summary Op. 2010-26 (Mar. 8, 2010), available at <http://www.ustaxcourt.gov/InOpHistoric/purdy.sum.WPD.pdf>.