

Looking for year-end tax deductions? Pay your lawyer

By Robert W. Wood

No one likes paying legal fees, but even pricey fees can look a lot less unreasonable when you can deduct them: \$10,000 in legal fees costs only \$6,000 if the client pays a combined 40 percent tax rate. And reports suggest that a good number of California taxpayers will be paying a combined federal and California rate exceeding 50 percent in 2013. With those rates, deductions matter.

When it comes time to collect their fees, lawyers benefit from these rules. But all fees are not created equal when it comes to tax deductions. In fact, if a client pays legal fees to get divorced or because a family member sues for slander, the fees are purely personal and non-deductible.

Distinguish purely *personal* from *investment* expenses. Legal fees paid to help the client's business reputation could be business or investment expenses. Business legal fees are the best, as they are fully deductible by individuals, corporations, LLCs, and partnerships. Fully deductible means not subject to limitations or alternative minimum tax (AMT). But a client must *really* be in business.

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What's personal and what's business or investment may not be clear. Take the huge legal fees John Edwards incurred for his criminal defense. Although it was a criminal trial, the charges related to his conduct in his chosen trade or business: politics. That arguably makes the legal fees deductible as a business expense.

Many taxpayers try to find a business connection to most any legal mess. Whether they'll succeed depends on the facts and what motivated the payment. If the legal matter doesn't relate to your business or profession, it's tougher to claim deductions based on preserving your reputation.

Who might argue legal fees are deductible even though arguably personal? Perhaps Winona Ryder over alleged shoplifting, Robert Blake who was accused of killing his wife, telephone-brandishing supermodel Naomi Campbell. Perhaps even Lindsay Lohan over two DUIs, multiple probation violations, alleged theft of a necklace, and her recent arrest for third-degree assault.

Martha Stewart paid huge legal fees on an obstruction of justice charge from the sale of Imclone stock. She sold 75,000 shares of Martha Stewart Living (raising \$4.67 million) to pay legal fees. Yet she sought reimbursement from her company (as an officer and director) for \$3.7 million of fees for successfully defending charges that she tried to lift her company's share price by declaring she was innocent of insider trading.

Michael Jackson's acquittal of child molestation carried estimated legal expenses as high as \$20 million. It's hard to see how he could deduct them. Ironically, though, Dr. Conrad Murray could probably deduct his own legal fees as a business expense even though he was convicted in connection with Jackson's death. He was treating

Michael Jackson for pay and his legal expenses related to that trade or business.

The specific type of tax deduction matters to your bottom line. For many individuals not regularly filing as proprietors, even business orientated legal fees are generally treated as miscellaneous itemized deductions. Miscellaneous itemized deductions face numerous limitations, especially the dreaded AMT, a separate 28 percent tax. Some people avoid it by filing a Schedule C to their Form 1040 claiming to be a proprietor, but they must *actually* be in business.

Suppose a client hires a *contingent* fee lawyer and recovers \$1 million in a lawsuit with their contingent fee lawyer keeping 40 percent. You might assume that the client has \$600,000 of income. Actually, he has \$1 million of income and must consider how to deduct the \$400,000 of fees.

To determine how big a tax problem this is you need to factor in the nature of the lawsuit. In a personal physical injury case (say a serious auto accident), the client's *entire* recovery should be tax-free. That means the client need not worry about deducting legal fees. Personal physical injury and physical sickness recoveries are tax-free, but punitive damages and interest are taxable. Unfortunately, there is great confusion about what is tax-free.

Most employment lawsuit recoveries are income and don't qualify for the physical injury/sickness exclusion. But fortunately, the client can deduct the legal fees "above-the-line" so there's no AMT and none of the other limitations that apply to miscellaneous itemized deductions. If you receive tax-free and taxable damages (such as punitive damages and interest that are always taxable), you'll need to apportion your attorney's fees.

Example 1: Client settles a suit for intentional infliction of emotional distress against his neighbor and collects \$100,000. His lawyer keeps \$40,000. Client thinks he has \$60,000 of income. Instead, he has \$100,000 of income, followed by a \$40,000 miscellaneous itemized deduction. Client faces numerous limitations, including the AMT that can whittle the deduction down to nothing. That's why many clients say they are paying tax on money (the lawyer's fees) they never received.

Example 2: Client is seriously injured and recovers \$500,000 in compensatory damages and \$500,000 in punitive damages from the City. Her lawyer gets 40 percent. Since punitive damages are taxable, half the lawyer's fees are income, and she can deduct them only as a miscellaneous itemized deduction.

Some business and investment expenses must be "capitalized." If you are trying to sell your business and spend \$50,000 in legal fees, you must add them to your basis. Ditto if you pay legal fees to resolve a lot line dispute with your neighbor. You must add the legal fees to your basis in your home.

Legal fees for tax advice — income, estate, gift, property, excise or sales and use tax — are deductible. The fees may involve tax planning or controversies. Even fees for purely personal tax advice qualify.



Robert W. Wood is a tax lawyer with a nationwide practice (www.WoodLLP.com). The author of more than 30 books including "Taxation of Damage Awards & Settlement Payments" (4th Ed. 2009 With 2012 Supplement www.taxinstitute.com), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.