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The Only Good Legal Fees Are Tax Deductible Legal Fees

No one likes paying legal fees, but tax deductions make them a lot less painful: a 40% tax rate means \$10,000 in legal fees costs you only \$6,000. But personal legal fees are non-deductible, and that makes them the least desirable ones.

If you pay legal fees to get divorced or because a family member sues you for slander, your legal fees are purely personal and non-deductible. For tax rules on divorce, see [How To Make Divorce Less Taxing](#).

But distinguish purely personal expenses from investment expenses. Legal fees paid to help your business reputation could be a business or investment expense. Business legal fees are the best, for they are fully deductible by everyone: corporations, LLCs, partnerships and even proprietorships.

Fully deductible means not subject to limitations or alternative minimum tax (AMT). But you really must be in business. For many individuals not regularly filing as proprietors, even business orientated legal fees are generally treated as miscellaneous itemized deductions, and that triggers numerous limitations: legal fees up to 2% of the client's adjusted gross income aren't deductible, deductions are phased out at higher incomes, and you get no deduction when computing the dreaded AMT, a separate 28% tax. To avoid it, some people file a [Schedule C](#), claiming to be a proprietor, but you must actually be in business to make this work.

Tax deduction rules for legal fees are very important, and one reason is *contingent* fee lawyers. If you recover \$1 million in a lawsuit and your contingent fee lawyer keeps 40%, you might assume that—at worst—you have \$600,000 of income. Actually, you have \$1 million of income even if you only net \$600,000! That means you need to worry how to deduct the \$400,000 of fees.

Fortunately, damages in personal physical injury cases are tax-free. So if you hire a contingent fee lawyer in a personal physical injury case (say an auto accident), your *entire* recovery is tax-free. It doesn't matter if you measure it before or after fees. Unfortunately, there is great confusion about what is tax-free. See [10 Things To Know About Taxes On Damages](#). Personal physical injury and physical sickness recoveries are tax-free, but punitive damages and interest are taxable.

If you hire a contingent fee lawyer in an employment case, the most you will be taxed on is your net after attorney's fees. Most employment lawsuit recoveries are income and don't qualify for the physical injury/sickness exclusion. A settlement may be wages (subject to withholding) or non-wage income (on an [IRS Form 1099](#)). For more regarding Forms 1099, see [Ten Things You Should Know About 1099s](#). 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.

Here are a few more lawyer's fee tax rules:

- **Capitalizing Fees**. Some business and investment legal expenses must be "capitalized." If you are trying to sell your business and spend \$50,000 in legal fees, you must add it to your basis. Ditto if you pay legal fees to resolve a lot line dispute with your neighbor (add the legal fees to your basis in your home).
- **Tax Advice**. Legal fees for tax advice are deductible, and any tax qualifies: income, estate, gift, property, excise or sales and use tax. The fees may involve tax planning or controversies, and even fees for purely personal tax advice qualify (as miscellaneous itemized deductions).

- **Beware Combined Cases.** If you receive tax-free and taxable damages (like punitive damages or interest), you'll need to apportion your attorney's fees.

Example: You're seriously injured in your car and recover \$500,000 in compensatory damages and \$500,000 in punitive damages from the other driver. Your lawyer gets 40%. Since punitive damages are taxable, half your lawyer's fees are income, and you can probably deduct them only as a miscellaneous itemized deduction.

For more about legal fees and tax deductions, see:

[Que Sera, Sera: Deducting Legal Fees](#), Vol. 125, No. 10, Tax Notes (Dec. 07, 2009), p. 1115.

[Top Ten Tenets for Trial Lawyers](#), Vol. 35, No. 4, Litigation, The Journal of the Section of Litigation, American Bar Association (Summer 2009), p. 38

[Attorney Fees: To Deduct or Not to Deduct](#), Vol. 123, No. 1, Tax Notes (Apr. 6, 2009), p. 65.

[Big Legal Fee Tax Trap](#), Vol. 27, No. 10, Tax Hotline (Oct. 2007), p. 12.

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