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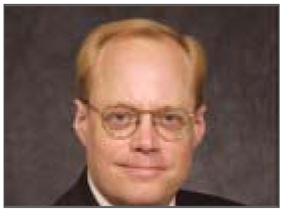

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THE TAX LAWYER

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What's The Unkindest Tax Of All?

"Boston Tea Party.", The History of North America. London: E. Newberry, 1789.Engraving. Plate opposite p. 58. Rare Book and Special Collections Division, Library of Congress (40) (Photo credit: Wikipedia)

Taxes are on everyone's mind right now. Much of the debate is about who pays, who doesn't and who should. But it's also about fairness. Is it fair for everyone to pay the same rate, or for those who earn more to pay more?

This isn't a new question. In 1953, two University of Chicago law professors, Walter J. Blum and Harry Kalven Jr. published The Uneasy Case for Progressive Taxation, an influential work addressing our tax system. With a flat tax, everyone pays the same percentage rate. Those with higher incomes simply pay larger amounts.

With progressive rates, additional dollars are subjected to higher marginal rates even though the first dollars qualify for lower rates. Progressivity has resulted in some bizarre history, including a time when U.S. taxpayers paid 70% on some income. Rates were even higher in England.

More than mere rates, what most people find inequitable is Byzantine complexity and endless special rules. Some seem arbitrary or flatly wrong. Like so much else in life, it hurts most in your backyard.

This article: The Most Outrageous Tax of the Year, notes that taxes on forgiven debt can be especially egregious. We know when a debt is forgiven you generally have income. See Ten Things To Know About COD Income. Because the exceptions to cancellation of debt income are narrow, Congress enacted the Mortgage Forgiveness Debt Relief Act in 2007.

Unfortunately, even these rules are limited. What's more, they expire at the end of 2012. That means you can be taxed when you have a debt forgiven and must dig in your pocket to pay the IRS.

What other tax rules seem especially unfair? If you've been a successful litigant you may feel skewered by paying tax on monies your lawyer receives. If you hire a lawyer on contingency and settle a lawsuit, a third or more of the money will be paid directly to your lawyer.

Even so, the IRS treats it as ***100% paid to you***. In two cases, you won't pay tax on the lawyer's fees. The first is if 100% of your damages aren't taxable (say an auto crash injury). The second is if your case is against your employer. See Six Tax-Wise Ways To Reduce Your Legal Bills.

But in other suits, attorney fees are income to you but your deduction for them is only a miscellaneous itemized deduction subject to strict limits and to the alternative minimum tax. Bottom line: you pay tax on money your attorney received. See Duke Lacrosse Tax Lien Highlights How Lawsuits Are Taxed.

What else is unfair? It depends on which tax rule hits you hardest. Apart from rate discussions, greater simplicity and transparency would be big improvements.

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