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THE TAX LAWYER

TAXES 12/21/2016

For Trump Tax Cuts, Pay Legal & Other Bills In 2016



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President Elect Trump has proposed big tax cuts. So defer income into next year if you can. Conversely, Trump's plans make paying expenses in 2016 especially attractive if you can deduct them. The deductions may be worth a lot less in 2017. One good example is legal fees. No one likes paying legal fees, but tax deductions can make them a lot less painful. If you pay a 40% tax rate, \$10,000 in deductible legal fees costs you only \$6,000. But not every legal bill is tax deductible.

For example, if your legal fees are to get divorced or because a family member sues you for slander, the legal fees are purely personal and non-deductible. Distinguish purely personal expenses from those for investment. The best kind of legal fees are business expenses. They are fully deductible by individuals, corporations, LLCs, and partnerships. Fully deductible means not subject to limitations or alternative minimum tax (AMT). For many individuals not regularly filing as proprietors, even business legal fees are generally treated as miscellaneous itemized deductions. That triggers limitations such as the 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.

Contingent lawyer fees can be tricky. Suppose you recover \$1 million in a lawsuit and your contingent fee lawyer keeps 40%. You might assume you have \$600,000 of income. Actually, you have \$1 million of income, and must consider how to deduct the \$400,000 of fees. Fortunately, if you hire a contingent fee lawyer in a personal physical injury case (say an auto accident), your entire recovery should be tax-free.

Still, there is great confusion about what is tax-free. Personal physical injury and physical sickness recoveries are tax-free, but punitive damages and interest are taxable. If you receive tax-free and taxable damages (punitive damages and interest are always taxable), 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.

In employment cases, a special rule allows you to deduct attorney's fees "above-the-line" so there's no AMT. A settlement may be wages (subject to withholding) or non-wage income (on an IRS Form 1099). 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 (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 no matter what. The fees may involve tax planning or controversies. Even fees for purely personal tax advice qualify.

Paying deductible items before year-end means you can deduct them now. In 2016, we pay tax on ordinary income tax at graduated rates stretching from 10% to 39.6%. But under Obamacare, high-income taxpayers pay an additional 3.8% surtax on net investment income. That means the top federal rate for individuals is really 43.4%. Qualified dividends and long-term capital gains are taxed at 15% or 20%, depending on your income. Yet, that rate too gets hit with the additional 3.8% for Obamacare's net investment income tax.

President Elect Trump proposed cutting the tax brackets to three: 12%, 25%, and 33%. He would eliminate Obamacare's 3.8% net investment income tax, too. As a result, the top rate would be 33%, with the top rate on capital gains and dividends a firm 20%. There are some drawbacks, though. Trump's tax plans call for slashing itemized deductions and eliminating personal exemptions. Itemized deductions would be capped at \$200,000 for married couples.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.