

Legal Fee Tax Rules Every Lawyer Faces

By Robert W. Wood

No one likes paying legal fees, but a client paying \$10,000 in fees who can deduct them at a combined 40 percent tax rate is actually paying only \$6,000. But clients cannot deduct all fees, and some deductions are better than others. Here are 10 rules every lawyer should know about taxes and legal fees.

Contingent attorney fees are income. Before addressing deductions, there's one big income worry. Legal fees paid by someone else can create income for your client. A plaintiff recovering \$1 million on a 40 percent contingency might assume he has only \$600,000 of income. However, the U.S. Supreme Court ruled in 2005 that "as a general rule" the client has income when his lawyer is paid, even by the defendant. (*Commissioner v. Banks*, 543 U.S. 426 (2005).) Clever lawyering may get around this general rule in some cases, but in most situations, with \$1 million in income, the plaintiff must consider deductions.



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Don't deduct personal legal fees. The least desirable legal expenses are personal and the best are business expenses. Legal fees to get divorced or to defend a family lawsuit are probably purely personal and therefore non-deductible (with a few exceptions). But distinguish between purely personal and investment. Even if legal fees arose out of the client's personal activity, the client may claim he had to incur it for his business and reputation. In some cases that can make it a business expense, or at least an investment expense.

Personal physical injury cases are tax-free. If a client hires a contingent fee lawyer in a physical injury case (say auto accident or slip-and-fall), both the legal fees and the net recovery are tax-free. If the recovery is tax-free, it doesn't matter whether one considers the gross recovery (including legal fees) or the net after legal fees.

Unfortunately, there is often confusion about what is not tax-free. Recoveries for physical injuries and sickness are tax-free, but exactly what is "physical" is not clear. Plus, punitive damages and interest are always taxable. A settlement or judgment may be part tax-free and part taxable. This can be especially messy in cases that settle while on appeal.

Fees in employment cases are fully deductible. Most employment recoveries are taxable. Monies may be wages (subject to withholding and employment taxes), or non-wage income (on an Internal Revenue Service Form 1099). Payment for physical injuries or sickness is tax-free, but most employment cases are simply split between wages and other income. Fortunately, due to a 2004 change, the client can deduct employment legal fees "above-the-line," so there's no regular tax and no alternative minimum tax.

Business legal fees are fully deductible. Legal fees in business are fully deductible by corporations, LLC, partnerships and even proprietorships. Proprietorships use Schedule C to IRS Form 1040, which arrives at net profit or loss. As a result, legal fees on Schedule C operate like an above-the-line deduction (no regular tax and no alternative minimum tax). But even in business, some legal fees have to be capitalized.

Investment legal fees are miscellaneous itemized deductions. If the lawsuit does not involve personal physical injuries, employment, or a trade or business, the client has a tax problem. The client can deduct the legal fees as a miscellaneous itemized deduction on Schedule A of the client's Form 1040, but that triggers numerous limitations. The legal fees are deductible only in excess of 2 percent of the client's adjusted gross income. For clients with high incomes, miscellaneous itemized deductions and personal exemptions will be phased out. Even worse, there's an alternative minimum tax.

Alternative minimum tax liabilities can be big. Legal fees deducted as miscellaneous itemized deductions are non-deductible under the alternative minimum tax, which applies at a 28 percent rate. When people complain of "paying tax on lawyer fees," this is invariably what they mean. To try to net their legal fees against their recovery, some clients file a Schedule C, claiming to be a proprietor. Unless the client is really in business, however, these claims usually fail.



Capitalize some legal fees. Some legal fees must be capitalized. If the client pays fees trying to sell his business, the client usually must capitalize them and add them to basis. Similarly, legal expenses to resolve a client's lot line dispute with a neighbor should be added to the client's basis in his home, just like the cost of the client's kitchen remodel. The lot line could be viewed as purely personal, but since the client's home is an investment, he should be able to capitalize it.

Fees for tax advice are deductible. Legal fees for tax advice covering income, estate, gift, property, even excise, sales or use tax, whether personal or business, are deductible. The legal fees may involve tax planning or controversies. However, an individual can only claim a miscellaneous itemized deduction triggering limitations.

If the tax advice relates to the client's business, treat the legal fees as business expenses (fully deductible). Note that some purely personal legal fees can be deducted as tax advice. Divorce is personal, but the portion of the client's divorce legal fees for tax advice is deductible.

Allocate fees in combined cases. If the client receives tax-free and taxable damages in a contingent fee case, he should also bifurcate the attorney fees, generally in the same proportion. Some of the legal fees in a contingent fee case will be income, so the client should try to find a way to deduct them. Punitive damages and interest often raise this problem.

Tax deductions alleviate some of the pain of paying legal bills. The facts are often ambiguous and the client may incur legal fees that fall into more than one category. The tax analysis can be sophisticated, and there are often several ways of allocating the fees. But planning pays off.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.