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Need A Tax Deduction? Pay Legal Fees By Year-End

No one likes paying legal fees, but tax deductions can make them a lot less painful. With a 40% tax rate, \$10,000 in deductible legal fees costs you only \$6,000. But 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. See [How To Make Divorce Less Taxing](#). Distinguish purely **personal** expenses from **investment** expenses.



Photo credit: walknboston

[Business](#) legal fees are fully deductible by individuals, corporations, LLCs, and partnerships. Fully deductible means not subject to limitations or alternative minimum tax (AMT). But 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.

Have a **contingent** fee lawyer? 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 is tax-free.

Still, 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 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](#)). See [Ten Things You Should Know About 1099s](#). However, most employment recoveries are income and don't qualify for the physical injury/sickness exclusion.

Capitalizing Fees. 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).

Tax Advice. 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.

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