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THE TAX LAWYER

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# Perfectly Legal Tax Write-off? Lawyer Fees -- Even \$1,200 An Hour

No one likes paying legal fees, but you can [reduce](#) your legal bills and your tax bills by asking the government to share the pain. Lawyers can be expensive. A controversial case in point is [Baltimore, which is paying outside lawyers up to \\$1,200 an hour](#) in its Justice Department probe. Many legal fees are legitimate to write off as long as you are careful and observe these rules:

**1. You Can't Deduct Personal Legal Bills.** In the tax system, personal usually means nondeductible. That's certainly true with legal fees. The least desirable legal expenses are those of a purely personal nature. Examples include divorce fees, or if a family member sues you for slander. But some legal matters of a personal nature can impact business or investment, making some deductible. It can be a confusingly slippery slope, and as you might expect, some people push the envelope. A good example is some [stars and their legal fees](#), since arguably everything is about image.



**2. Fees for Tax Advice Are Deductible.** Legal fees for tax advice are deductible, whether for tax planning or disputes. What's more, any tax qualifies, including income, estate, gift, property, sales, use and excise tax. Not how broad this rule is. In fact, despite the general rule that personal legal fees are non-deductible, tax fees are deductible even if the taxes are purely personal.

**3. Business Legal Fees Are Deductible.** Legal fees you pay in your trade or business are deductible. However, some fees must be capitalized and added to the basis of assets. For example, say you are trying to sell your business and spend \$50,000 in legal fees. Can you deduct it against your income or must you add it to your basis in your company? Usually the latter.

**4. Investment Legal Fees Are Miscellaneous Itemized Deductions.** If legal expenses don't relate to your business but only to investments, you can still deduct them but usually only as a miscellaneous itemized deduction. That means a 2% threshold, phase-outs and (worst of all) Alternative Minimum Tax (AMT). See [AMT Problems For Attorney Fees Remain](#). However, as with business legal fees, some investment legal fees must be capitalized to the basis of the assets (such as legal fees for the purchase of investment property).

**5. Contingent Lawyer's Fees Are Tricky.** If you recover \$1 million in a lawsuit and owe 40% to your contingent fee lawyer, you might assume you have \$600,000 of income. How could you **possibly** have to pay tax on the full \$1 million? Answer: In [Commissioner v. Banks](#), the U.S. Supreme Court ruled you've got income when your lawyer is paid. That means you need to worry about how to deduct the fees.

In a pure personal physical injury case (say an auto accident or slip-and-fall), the entire recovery is tax-free so it doesn't matter whether you consider the recovery including legal fees or the net. Unfortunately, there is often confusion about what is tax-free.

**6. Legal Fees in Employment Cases Are Fully Deductible.** Most employment settlements are either wages (on a Form [W-2](#)) or non-wage income (on a Form [1099](#)). If your lawyer takes 40%, you still must include 100% in your income. However, you can deduct the legal fees "above-the-line," before reaching adjusted gross income. That means you have no tax—no regular tax and no AMT—on the legal fees.

**7. What's Reasonable?** Nobody pays higher fees than they have to, so there is probably not much chance you will be denied a deduction for legal fees that are lavish or extravagant. Entertainment expenses are another matter. Over the top parties even in a business context may not be deductible. So how about high legal fees? Perhaps it is conceivable that you could lose out on a deduction for legal fees that are unreasonably high.

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