Seven Key Tax Rules About Legal Fees

By Robert W. Wood

Tax rules can make paying legal fees more or less painful. To make paying them less rather than more painful, here are seven rules you should know.

You can't deduct personal legal fees. The least desirable legal expenses are those of a purely personal nature. If you incur legal expenses to get divorced or because you insult a family member who sues you for slander, the legal fees are personal and therefore non-deductible. Sometimes personal activity legal fees can count as business or investment fees when you incur them to save your reputation or business. However, these issues are delicate and you may need professional help.

Legal fees for tax advice are deductible. This covers tax planning and tax controversies, including income, estate, gift, property, sales tax, and more — even if the taxes are personal rather than business. Everyone should like paying his or her tax lawyer!

Business legal fees are fully deductible. Legal fees incurred in running a business are fully deductible by corporations, limited liability companies, partnerships and proprietorships. However, the fees must relate to current business operations, not to something that might need to be capitalized.

For example, if you are selling your business and spend $50,000 in legal fees, can you deduct the fees against other income or must you add them to your basis in your company? Usually the latter. If you do sell, you can claim the fees now. But if your efforts are unsuccessful, you may be stuck with a basis addition and have to wait until you do sell to get a tax benefit.

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Investment legal fees are miscellaneous itemized deductions. Legal fees for investments are deductible but only as miscellaneous itemized deductions. They face limitations and phase-outs and the dreaded alternative minimum tax (AMT). Because legal fees claimed as miscellaneous itemized deductions are non-deductible for purposes of AMT, many find their legal fees are not deductible.

One big exception to AMT problems, which investors face on legal fees, relates to capital gains and losses. Suppose you pay $50,000 in legal fees to dispose of investment property? You can usually offset the fees against your gain on sale, thus avoiding AMT limitations.

Contingent attorney fees are income. If you recover $1 million in a lawsuit and your contingent fee lawyer keeps 40 percent, you might assume you have $600,000 of income. However, the U.S. Supreme Court ruled in 2005 that you have income of $1 million even if your lawyer is paid directly by a third-party. That means you need to try to deduct the fees so you (hopefully) pay tax on only $600,000.

If your case is a pure personal physical injury case (say an auto accident or slip-and-fall), it is all tax-free. It won't matter whether you are treated as receiving $600,000 or $1 million. Unfortunately, there is often confusion about what is tax-free.

The basic rule is that recoveries for personal physical injuries and physical sickness are tax-free. Emotional distress recoveries are taxed unless they arise out of (and are attributable to) physical injuries. Punitive damages and interest are always taxable, even in a personal physical injury case.

A settlement or judgment often involves multiple elements, part tax-free and part taxable. In many cases, the legal fees are completely or partially non-deductible because of the AMT. Get some professional advice and be careful.

Legal fees in employment cases are fully deductible. Most employment lawsuit recoveries are taxable income. They may be wages (withheld employment taxes, reported on Form W-2), or non-wage income (reported on Form 1099). Payments for physical injuries or sickness are tax-free, but in most employment cases, the monies are split between wages and other income.

If the client receives 60 percent and the lawyer receives 40 percent, the client is still treated as receiving 100 percent. But fortunately, there's a special deduction for legal fees in employment cases. The client can deduct them "above-the-line" so the client isn't paying any tax — no regular tax and no AMT — on the legal fees.

You should address taxes before you settle. We've only scratched the surface of the tax rules impacting legal fees. Yet even this short summary suggests the tax rules regarding legal fees are nuanced and contain traps. They often tie into the tax treatment of the legal matter.

Whether you represent plaintiffs, defendants, or are in either role yourself, get some advice early. Addressing these tax issues in the settlement agreement before it is signed is best. The tax savings from doing so can be dramatic. What's more, although such language doesn't bind the Internal Revenue Service, the agency often looks favorably on such language and may respect it.

Clients can be forgiven for not wanting to pay legal fees without deducting them, but the tax analysis can be sophisticated. The facts are often ambiguous and the legal fees may fall into more than one category. Fortunately, planning can pay off.

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