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BIG LEGAL FEE TAX TRAP

Before you start a lawsuit, consult with a tax lawyer as well as with your litigation lawyer to avoid a big potential tax trap—an award covering your legal fees that is provided by the court is taxable in your income, but the deduction for legal fees is restricted...

- Legal fees are deducted among “miscellaneous expenses,” the total of which is deductible only to the extent that it exceeds 2% of adjusted gross income (AGI).

So, if you don't itemize deductions, you get no deduction for your fees. If you do itemize, you may get a reduced deduction.

Example: If your AGI is \$50,000, you get no deduction for your first \$1,000 (2% of \$50,000) of miscellaneous expenses.

- There is no deduction for legal fees from alternative minimum tax (AMT). This is a big risk in cases where fees are large.

Example: In a contingency-fee arrangement, in which you pay your lawyer 30% (or more) of any award you win, you may owe income tax on the 30% (or more) even though it doesn't go to you.

Recent case: Marcia Green complained to her employer when she was passed over for promotion, and then was fired for doing so. She sued the employer and won a \$2.349 million jury award. She had a contingency-fee agreement with her lawyer under which he received 40% of any award she won—\$928,576. But she received a 1099 from the defendant

reporting its payment of the entire \$2.349 million judgment as income to her.

Ms. Green protested that this was wrong, saying that the fee going to her lawyer should have been taxed directly to him instead of to her.

(Although the court record does not say so, Ms. Green was a California resident, and state taxes on the award plus the size of it would surely have made her subject to the AMT, eliminating the legal fee deduction.)

Tax Court: Ms. Green is not entitled to exclude any of her lawyer's fee from her own income. It is all taxable to her, even though the amount paid to the lawyer is taxable to him as well (Marcia S. Green, TC Memo 2007-39).

Worst case: If you sue somebody and win, then receive only a small award of damages but also receive a large award of legal fees that you can't keep but must pay tax on, you may lose a large amount of money outright even though you won your case.

Employment case note: There is now a statutory above-the-line deduction for legal fees in employment cases (Internal Revenue Code Section 62), but if your case arises outside of the employment law field, beware! ■ ■

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