

## *Sy Accountancy Corporation*

Member, American Institute of CPAs

704 Mira Monte Place, Pasadena, California 91101

Tel (626) 744-0200 • Fax (626) 744-0300 • vsy@victorsycpa.com • www.victorsycpa.com

### HOW TO DEDUCT LEGAL FEES

By Victor Sy, CPA, MBA

We live in such a litigious environment that you are likely to incur some legal fees during your lifetime. When that happens, can you deduct legal fees? The proper tax treatment of legal fees is frequently an area of confusion. Read on and which legal fees can be deducted.

Fees paid to lawyers fall into four categories:

1. **Legal fees for income, taxes, or business activities:** Legal fees that you pay to produce or collect income as well as to manage, protect or maintain income-producing assets are deductible. Write them off as miscellaneous, itemized deductions on Schedule A of Form 1040. You may deduct legal expenses for tax advice, tax calculations, tax return preparation, contesting tax assessments, claiming refunds, fighting levies for income, estate, gift, property, sales or use tax.

Assuming then that such legal fees under this category are deductible, how much can you write off? Legal expenses just described would be deductible on Schedule A of your individual income tax 1040 and would only benefit you if they exceed 2% of your adjusted gross income (AGI).

On the other hand, legal expenses are fully deductible if they are ordinary and necessary in the conduct of your business. This would apply to sole proprietorships, partnerships, corporations, LLCs and LLPs. For example, legal fees to collect customer receivables are deductible as ordinary and necessary business expenses.

There are three exceptions to the current deductibility rule for legal expenses paid in the course of business:

- A. Legal costs incurred to enter a new line of business should be capitalized and amortized over 60 months.
  - B. Legal costs to set up a new business entity like a corporation or a partnership should be capitalized as organizational expenses and amortized over sixty months also.
  - C. Legal costs incurred to arrange debt financing for your business must be capitalized and amortized over the life of the loan.
2. **Fees related to personal matters:** Legal fees incurred with immigration, divorce proceedings, traffic tickets and other personal matters are not deductible. Even the costs of preparing a will or setting up a living trust to avoid probate are not deductible.

You may, however, deduct at least a part of such legal fees by seeking advice on tax implications of a divorce. Similarly, seek estate and gift-tax planning advice when drafting a will or a living trust. Ask your lawyer to clearly identify amounts charged for tax advice that then become deductible.

3. **Fees related to purchase or sale of assets:** Legal costs to acquire an asset are capitalized as part of the asset's tax basis. So are legal costs to prepare title to an asset, to perfect title, or to defend a title against a lawsuit. These legal expenses will form part of the basis and will reduce taxable gains when the asset is later sold. If the asset in question is also depreciable or amortizable, then they are also depreciated and amortized along with the rest of the asset costs.
4. **Fees related to civil or criminal charges from business or job:** Fines and penalties paid by a business to a governmental agency are not generally deductible. However, you may deduct legal costs to defend against civil and criminal charges or assessments of civil and criminal fines and penalties arising from business operations. Such legal costs can be deducted as ordinary and necessary business expenses. The same is true with costs to negotiate out-of-court settlements before a verdict is reached. You may also deduct legal costs if you hire an attorney to deal with governmental fines and penalties and other legal actions arising from your conduct as an employee. Such legal and defense costs qualify as business expenses.

The above guidelines of the four categories seem easy to understand in theory; however, they are complicated in real life. The idea is to take steps to get them out of the non-deductible nature and to characterize them as deductible expenses. It is not too bad if you end up capitalizing such costs since you can still amortize them over a certain period. The best treatment naturally would be to fully deduct them as business expenses. Discuss the deductibility of such expenses with your lawyer at the outset of your initial interview. To sue and get sued is bad enough. To incur major legal fees and not be able to deduct them is even worse. A little planning could help characterize your legal fees as deductible to ease the pain of litigation.

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## DEVELOPMENTS

There has been a lot of activity in the area of **contingent legal fees** on taxable settlement or awards. As you know, many lawsuits are handled on a contingency basis. In other words, your lawyer gets paid only if a judgment is won (typically 25 to 50%). If the case is lost, your lawyer gets nothing.

The IRS naturally wants you to report 100% of the award and take business-related legal fees as an itemized deduction (and therefore minus 2% of adjusted gross income). And naturally, you prefer to report only your share of the award, minus what was paid to your lawyer.

Tax courts and appellate courts have been split on this issue. In some cases, the full amount of judgment is income to the taxpayer even though part of the award is paid to the attorney. In one case, the taxpayer lost even when all settlement was deposited to a trust that then disbursed 60% to her and 40% to her lawyer. She lost and had to declare 100% of the income then took the \$40% - minus the 2% floor - as an itemized deduction. The court's rationale: she used her control over the money to assign it to her lawyer.

In another case, the taxpayer won and attorney's fees were not included in his income. The difference in this case was that the fee was **payable out of the judgment**. The court's rationale: the attorney had the same right as the client and that the lawyer's portion of the fee **never came under the control of the taxpayer**.

Good luck.