

February 1, 2003

To Our Clients and Friends:

In today's litigious society, many of you are likely to incur legal fees for any number of reasons. Naturally you would want a tax write-off to at least partially reduce this cost. As this letter explains, whether a current deduction is in the cards depends on the circumstances. In many situations, the charges will fall rather neatly into one of the four categories listed below, with the indicated tax outcomes. Then again, sometimes it's not so easy.

Fees Related to Income, Taxes, or Business Activities

Legal fees paid by an individual to produce or collect income or to manage, protect, or maintain income-producing assets can be written off as miscellaneous itemized deductions on Schedule A of Form 1040. For example, this rule covers hiring an attorney to collect alimony owed by an ex-spouse or to resolve a dispute regarding how much interest is due on an installment note receivable. However, you cannot deduct legal fees connected with the production or collection of income not subject to the federal income tax or for the management, protection, or maintenance of assets producing such income. Likewise, you cannot deduct legal expenses for the management, protection, or maintenance of a personal residence.

Back to the good news: Individuals are entitled to deduct legal expenses for tax advice, tax calculations, return preparation, contesting tax assessments, or claiming refunds. This is true for taxes levied by any and all jurisdictions and for any and all types of taxes (income, estate, gift, property, sales, use, etc).

Unfortunately, deductible legal expenses described in the preceding two paragraphs will actually generate a tax benefit only if—when combined with all your other miscellaneous itemized deductions—they exceed 2% of adjusted gross income (AGI). (Your AGI is the number at the bottom of page 1 of your return.) Even worse, if you are subject to the alternative minimum tax (AMT), miscellaneous itemized deductions do you no good because they are completely disallowed in calculating your AMT bill.

On the other hand, legal expenses are fully deductible—for both regular tax and AMT purposes—if they are necessary in the conduct of your business, including a sole proprietorship. For example, if you or your company is forced to take legal action to collect a customer receivable, the fees are deductible just like any other business expense.

Naturally, there are exceptions to the current deductibility rule for legal expenses paid in the course of business. If the costs are incurred to enter a new line of business, you may have to “capitalize” the expenses (along with other so-called startup costs) and amortize them over 60 months. For example, the capitalization rule applies to legal due diligence work performed in connection with acquiring the assets of a target business. However, if you are merely expanding your existing business, you should be able to deduct legal due diligence expenses currently as business expenses.

Capitalization is also required for legal charges necessary to set up a new business entity like a corporation, limited liability company, or family limited partnership. Such so-called organizational expenses can then be amortized over 60 months. Finally, legal costs incurred in connection with arranging debt-financing for your business must be capitalized and amortized over the life of the loan to which they relate.

Fees Related to Personal Matters

Legal fees incurred in connection with personal matters are a nondeductible personal expense. For example, you can't deduct the cost of hiring an attorney to fight a traffic ticket, defend you against a personal injury claim, or represent you in a divorce proceeding. Likewise for the cost of preparing a will, setting up a "living trust" to avoid probate, or setting up a trust for your child.

Remember, however, that tax-related fees and fees to generate or collect income or to manage, protect, or maintain income-producing assets generally qualify as miscellaneous itemized deductions. For example, a divorce attorney may (should) give advice about the tax implications of a marital split. In connection with drafting a will, an attorney may (should) give estate and gift tax planning advice. If so, the attorney's billing statement should identify the amount charged for delivering tax advice.

Fees Related to Purchase or Sale of Assets

Legal costs to acquire an asset are not currently deductible. Instead, they are capitalized as part of the asset's tax basis. The same is true for legal costs to prepare title to an asset or to defend or perfect title. When you later sell the asset, the taxable gain will be reduced (or your loss increased) by the capitalized fees. If the asset in question is depreciable or amortizable, the capitalized fees are depreciated or amortized along with the rest of the acquisition cost. However, if the asset is not depreciated or amortized and you end up leaving it to your heirs, the additional basis "falls through the cracks." This is because your heir's basis is adjusted to reflect the asset's date-of-death fair market value.

Legal fees to sell an asset are considered part of the selling expenses. As such they should be added to the basis of the asset being sold, which reduces the gain (or increases the loss) on the sale.

Fees Related to Civil/Criminal Charges from Business or Job

Fines and penalties paid by a business to governmental agencies are generally not deductible for federal income tax purposes. However, a business generally can 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 should be deductible as "ordinary and necessary" business expenses. The same is true for legal costs to negotiate out-of-court settlements in advance of charges being filed or during proceedings before a verdict is reached.

Deductions should also be allowable when an individual hires an attorney to deal with governmental fines and penalties or other legal actions arising from the individual's conduct as an employee. In other words, the legal defense costs should also qualify as business expenses. However, they fall into the category of unreimbursed employee business expenses and can therefore be written off only as miscellaneous itemized deductions subject to the 2% of AGI rule.

As we said earlier, the above guidelines seem easy enough to understand in theory. However, in real-life situations, it's not always a piece of cake to slot legal expenses into the proper category. The moral is this: Taxpayers can often take steps to make a better case for treating legal fees as fully deductible business expenses or at least as miscellaneous itemized deductions. We are available to help when and if the need arises. Of course, we can serve you best if we are contacted at the start of any significant legal maneuverings.

If you have any questions or want additional information, please do not hesitate to call.

Best Regards,

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