

Are Legal Expenses Tax Deductible?

Article Highlights:

- Legal Fees Associated with Personal, Living, or Family Issues
- Legal Fees Associated with Business and the Production of Taxable Income
- Examples of Legal Fees and Their Deductibility
- The Tax Benefit of Legal Fee Deductions

A frequent question that arises is whether legal expenses are deductible. The answer to that question can be both yes and no and can be complicated depending upon the nature of the legal expense. The Internal Revenue Code (IRC), which is the body of tax laws written by the United States (U.S.) Congress and approved by the president in office at the time the law is created, tells us that except as otherwise expressly provided, such as itemized deductions, no deduction shall be allowed for personal, living, or family expenses.

The IRC also says that, in the case of an individual, deductions are allowed for all of the ordinary and necessary expenses paid or incurred during the taxable year:

- For the production or collection of taxable income;
- For the management, conservation, or maintenance of property held for the production of income; or
- In connection with the determination, collection, or refund of any tax.

Applying those IRC provisions will allow you to determine whether a legal expense you've incurred is deductible or not, but the application can sometimes be complicated and also must take into account the Internal Revenue Service's (IRS's) interpretation of the law through rulings and regulations as well as the courts' opinions on all of the above. The following are some frequently encountered situations and how legal expenses paid in those situations should be handled:

- **Divorce** - Legal costs, such as attorney fees and court costs, connected with divorce, separation, or support are non-deductible personal expenses. Non-deductibility extends to legal fees incurred in disputes over money claims. However, legal and accounting fees paid for tax advice in connection with the divorce are deductible, provided the amounts for those services are delineated on the legal firm's billings.
- **Taxable Alimony** - The part of legal fees attributable to producing taxable alimony is deductible by the recipient of the alimony. The attorney's statement or invoice should stipulate what part of the fee relates to alimony to ensure a deduction for the alimony recipient. Legal fees paid by the payer of the alimony are not deductible. Because child support payments are not taxable, fees paid to obtain those payments are not deductible.
- **Conduct of a Business** - Legal fees incurred by a taxpayer in the course of a trade or business are generally deductible if they are ordinary and necessary expenses of the business.
- **Relating to Insurance Proceeds** - Legal fees to collect on a claim related to a taxpayer's business are currently deductible, but legal fees related to a personal loss are not deductible. However, where a loss is associated with a capital asset, such as a taxpayer's personal home, the related expenses can be added to the home's tax basis and be used to offset any taxable gain in the future.
- **Producing or Collecting Taxable Income:** Attorney fees, court costs, and similar expenses are deductible if incurred during the production or collection of taxable income. A reasonably close connection must exist between the legal expense and the production or collection of the taxable income.
- **Bankruptcy** - Legal fees connected with a business bankruptcy are deductible. If personal bankruptcy is primarily caused by the failure of a business activity, the legal fees related to the bankruptcy proceedings

are partially deductible as a business expense. The courts have used a proration of the fees based on the ratio of business creditor claims to total creditor claims.

- **Managing, Conserving, or Maintaining Income-Producing Property** – Legal fees related to managing, conserving, or maintaining income-producing property are generally deductible. However, just because a taxpayer may have to sell income-producing property to satisfy a possible adverse judgment doesn't mean he/she can deduct the cost of defending the suit under this provision.
- **Related to Title of Property** – Although legal expenses to acquire, perfect, defend, or clear title to property currently can't be deducted as business or investment expenses, they are capital expenditures whose cost may be recovered through depreciation, depletion, or cost recovery. Incurred legal expenses related to title of personal property, such as a principal residence, aren't deductible but can be added to the basis of the property.
- **Damage Suits** – Legal fees for defending and filing damage suits in a taxpayer's business or in employment are deductible. Examples include expenses paid for defending a suit for wrongfully taking property; settling a damage suit against a business, which could help to avoid adverse publicity and controversy; getting a judgment for damages to rental real estate; and a teacher's action of sex discrimination against a university.
- **Damages for Personal Injury or Sickness** – In some cases, damages for personal injury or sickness can be excluded from income. Thus, the legal fees paid to secure such income are not deductible if the damage award is not taxable. However, to the extent that the damage award is taxable or accrued interest is paid on the settlement funds, the legal fees are deductible. Where the funds are partially taxable and partially excludable, the legal expenses have to be prorated in the same ratio as the income is.
- **Will and Trust Document Preparation** – The cost of legal fees for preparing a will is considered a personal expense that is not deductible. In most cases, the legal cost of creating a living trust is similarly treated as a personal, nondeductible expense. However, if the attorney who prepares the trust indicates on the billing statement the amount of the fee that is for tax planning or tax advice, the tax-related portion of the fee is deductible.
- **Criminal Cases** - Legal fees incurred to defend against criminal charges related to a taxpayer's trade or business are deductible. This is true even if the taxpayer is convicted of the crime. However, legal defense expenses incurred by an individual charged with a crime are personal and generally not deductible.
- **Tax Issues** – Legal fees associated with obtaining tax advice, having tax returns prepared, and defending a taxpayer being audited are all specifically included as deductible legal expenses.

Just because legal fees are deductible doesn't necessarily mean you will receive any tax benefit from the deduction. While some legal fees can be deducted on business schedules and provide the maximum benefit, others have to be deducted as a miscellaneous itemized deductions, the total of which is subject to a 2% of AGI deduction floor. In addition, miscellaneous itemized deductions are not deductible for alternative minimum tax (AMT) purposes.

As you can see, determining which legal expenses are deductible is complicated, and even if allowed, a deduction may not provide any tax benefit. As every circumstance is unique, you are encouraged to call this office to determine if you will derive any tax benefit from your legal expenses.