

The Tax Verdict on Legal Fees

By Donna Laubscher, CPA
(480) 483-1170 ~ DonnaL@hhcpa.com



The new American Taxpayer Relief Act—officially signed on January 2, 2013— is there any justice when it comes to deducting legal expenses? It depends upon your point of view. Certain legal fees are currently deductible, others must be capitalized and still others provide no tax benefit whatsoever. Let's take a closer look at the tax treatment of the different types of legal expenses.

Is it business or personal? As a general rule, legal fees incurred by a business are currently deductible (assuming they are not capital expenditures). According to the applicable section of the tax law, you may deduct a legal expense that is "ordinary and necessary" to the conduct of your trade or business. However, the rules are considerably more complicated for nonbusiness expenses.

To be deductible, a nonbusiness legal expense must be incurred under one of the following circumstances:

- The collection or production of taxable income
- Managing, conserving or maintaining income-producing property
- The determination, collection or refund of any tax

While nonbusiness legal expenses incurred in connection with a rental property may be deducted from your annual gross income, other costs generally are deducted as miscellaneous expenses. Miscellaneous expenses are deductible only to the extent the total for the year exceeds 2% of your adjusted gross income (AGI). Therefore, you may not get the full tax benefit of these legal expenses.

Say that you have an annual AGI of \$100,000. You incur \$5,000 in legal expenses relating to personal stock investments in 2013. Assuming you have no other miscellaneous expenses during the year, your deduction for 2013 is limited to \$3,000 (\$5,000 less 2% of AGI).

As a general rule, legal expenses incurred to acquire property or defend or protect its ownership must be capitalized and added to the "basis" of the property. This may allow you to claim depreciation deductions over a period of time or cut your taxable gain when the property is sold. Similarly, legal fees incurred in connection with buying a personal residence are added to its basis. When the home is sold, the legal expenses may reduce the taxable gain.

On the other hand, legal costs related to personal or family matters generally do not provide any tax benefit. This includes fees paid in connection with a divorce or separation. The portion of the cost associated with determining the tax ramifications of alimony or other tax aspects may be deductible.

Ask your attorney for an itemized bill detailing the cost for various services rendered. It won't do you much good if your bill simply states that you paid for "legal services." At the very least, make sure your attorney specifies the amount of the fee (if any) that is tax deductible. This is particularly important in the estate-planning area, where taxes can be a significant factor.

These same basic principles also apply to the accounting profession. In other words, accounting fees incurred in connection with a business generally can be deducted currently, while some individual expenses are deductible.

Donna H. Laubscher, CPA, is a Partner at Henry & Horne, LLP. Her areas of expertise include individual taxation and accounting services for business entities. Contact Donna at (480) 483-1170 or DonnaL@hncpa.com.



HENRY & HORNE, LLP
Certified Public Accountants

Tempe
2055 E. Warner Road
Suite 101
Tempe, AZ 85284
(480) 839-4900

Scottsdale
7098 E. Cochise
Suite 100
Scottsdale, AZ 85253
(480) 483-1170

Casa Grande
1115 E. Cottonwood
Suite 100
Casa Grande, AZ 85122
(520) 836-8201