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Can your clients deduct their legal expenses? There's no cut-and-dried answer. Generally, it depends on the nature of the expense. As a new case shows, legal fees may be deductible under certain business provisions of the tax law or be recharacterized as other types of expenses (Sas, TC Sum. Op. 2017-2, 1/30/17).

For starters, legal expenses incurred for business purposes are generally deductible as "ordinary and necessary" expenses of the business. Conversely, most legal fees paid for personal reasons are not. However, the distinctions can get blurry, especially in matters contested in a divorce or in dealings relating to a business. For instance, under a special tax law provision, an individual may deduct expenses paid in connection with a claim of unlawful discrimination.

In the new case, a Seattle bank paid the taxpayer, its president and CEO, a bonus of \$612,000. Subsequently, she reported the bonus as taxable income on her 2010 return.

A few months after the bonus was paid, the bank terminated the taxpayer's employment. Then it filed a complaint against her, alleging breach of fiduciary duty, and attempted to recover the full bonus amount. The taxpayer counterclaimed under a charge of employment discrimination.

Eventually, both sides signed a settlement agreement and mutual releases, effective May 17, 2011. Under the settlement, neither party had to pay anything and all claims

against each other were dismissed. The taxpayer incurred \$25,000 in legal expenses

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allow them to be deducted as miscellaneous itemized deductions. However, only miscellaneous expenses in excess of 2 percent of adjusted gross income (AGI) are deductible. Because of the 2 percent-of-AGI floor, the IRS said that the deductible amounts should be limited to \$4,525 in 2010 and \$50,579 in 2011.

The taxpayer argued that the legal fees were deductible in full because they were paid in connection with an action involving a claim of unlawful discrimination. Alternatively, she said they constitute ordinary and necessary business expenses. And so she went to court.

The Tax Court disputed both of the taxpayer's arguments.

First, the Court considered whether the deductions qualified for the provision relating to as a claim of discrimination. But the Court said that the bonus could not reasonably be interpreted to include prevention of potential loss of income that would be included in the absence of any claim. Under the settlement agreement, neither party received any amount includible in gross income. Thus, it didn't buy this argument.

Second, the Court looked to the origin of the claim. Although it acknowledged that the results may have been damaging to the taxpayer's reputation — and, in turn, the couple's accounting business — the Court concluded that the claims arose from the taxpayer's status as a former bank employee. The legal action had nothing to with the accounting business. Therefore, the legal fees don't qualify as an ordinary and necessary business expenses. Case closed: The IRS wins.

The case indicates how the courts may rule in similar situations, but each case is decided on its own merits. Be prepared to represent your clients' best interests.

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