



March 31, 2022

Tax Write Off of Legal Fees Simplified

By Robert W. Wood

If you hope to write off your legal fees, there is some good news from the IRS. Before you rejoice, the bad news is that the complex and confusing rules governing when legal fees are deductible have not gotten any easier. There are still plenty of cases in which deducting legal fees is difficult or when the rules seem to say that you shouldn't be deducting them at all. Even so, there is some good news, because the mechanics for deducting employment, whistleblower, and civil rights legal fees have been improved, at long last: starting with 2021 tax returns, the IRS is implementing a new Form 1040 that has a line item for attorney fees.

DEDUCTIONS WERE PREVIOUSLY HARD TO CLAIM

The tax code was amended back in 2004 to allow legal fee deductions “above the line” in some cases, which is almost like not having the income in the first place. But the deduction has been quirky to claim ever since. Many taxpayers have trouble; so do accountants and some types of tax return preparation software. That is barely surprising. Since 2004 it has been a kind of write-in deduction, sort of like writing in a political candidate who isn't on the ballot.

Before and after 2004, the other kind of deduction was below the line. That meant subject to all sorts of limits and thresholds (including the dreaded alternative minimum tax (AMT)). The result was usually that you lost much or even all of your deduction. And starting in 2018, that below the line deduction went away entirely (until 2026, when it is supposed to come back). Talk about confusing. So this above the line deduction was and remains terribly important, which is one reason why *how* to claim it is so critical.

I have seen plenty of mechanical glitches with these deductions since 2004. I have seen some plaintiffs not properly claim the deductions they deserve and some plaintiffs and their return preparers not claim them at all—sometimes purely or largely because they cannot seem to manage the mechanics. In that sense, the easier mechanics created by the recent IRS update are a big win.

Because the previous versions of Form 1040 did not have a separate line to write in “other” above-the-line deductions, above-the-line deductions involving employment, whistleblower, and civil rights cases had to be written onto the dotted leader line next to the box where the total of the above-the-line deductions was to be calculated. This reporting not infrequently created confusion with the computer systems of state taxing agencies, because their algorithms often didn’t recognize the legal fee deduction reported on the leader line, or outside of any box of the form.

State agencies, like California’s Franchise Tax Board, would regularly send notices to taxpayers who followed the IRS’s instructions asserting that the taxpayers’ tax returns must contain a calculation error: The total of the above-the-line deductions reported in the boxes of the Form 1040 as calculated by the states’ computers simply did not match the taxpayer’s self-reported total on the tax form, they said. Of course, in these cases, the supposed calculation error was simply that the taxpayer’s calculated total correctly included the legal fee deduction written onto the leader line, whereas the state’s calculation did not. Even though these state notices are relatively easy to address, it was obviously frustrating to taxpayers to default into a state income tax examination over a poorly drafted tax form.

Not only was there no proper line for legal fee deductions on the IRS forms, but you had to include a particular code next to your write-in. If your case was an employment case, the code to enter was “UDC” for unlawful discrimination claim. The instructions said:

Write “UDC” and the amount of the attorney’s fees next to line 36 of Form 1040. For example, if you paid \$100,000 in attorney fees, write “UDC \$100,000” next to line 36.

If your case was a whistleblower case, you put in “WBF” for whistleblower. (I’m not sure what the F stood for, though “fees” seems the most likely candidate).

But at long last, starting with 2021 tax returns, the IRS is finally making it easier with a new Form 1040 that has a line item for attorney fees. For 2021, Schedule 1 to Form 1040 now gives you two lines. Line 24 of Part II, Adjustments to Income, allows for:

(h) Attorney fees and court costs for actions involving certain unlawful discrimination claims \$_____

(i) Attorney fees and court costs you paid in connection with an award from the IRS for information you provided that helped the IRS detect tax law violations \$_____

Notably, there is still not a separate line item specifically for “WBF” whistleblower fees under Section 62(a)(21). Perhaps that deduction is too rarely claimed to merit its own line. Still, the new form makes life a little better for those claiming “other”

above-the-line deductions that do not have their own line on the tax form. The IRS has finally included an “other adjustments” line, Line 24z, where other above-the-line deductions can be reported in an actual box on the form without having to write them onto any leader lines. Hopefully, the inclusion of this catchall line will fix the state “calculation error” notices issue created by the previous versions of the Form 1040.

When the IRS updated the Form 1040, it also updated its instructions for the Form 1040, which now make no mention of the codes (“UDC” and “WBF,” for example) that used to be necessary to identify the deduction on the old forms. That makes sense for UDC deductions under Section 62(a)(20), since they now have their own line and do not have to be identified by a code.

However, this is somewhat puzzling for the above-the-line deductions that have not been given their own lines, since taxpayers will still need to identify the type of “other” deduction claimed on the new catchall Line 24z. It will be interesting to see if tax preparers continue to use “WBF” to identify whistleblower fee deductions out of convention, even though that code is no longer required or mentioned in the form’s instructions.

PLAINTIFFS PAYING TAX ON LEGAL FEES

Why worry about deducting legal fees in the first place? Most plaintiffs would rather have the lawyer paid separately and avoid the need for the deduction. Unfortunately, it is not that simple. If the lawyer is entitled to 40 percent, the plaintiff generally will receive only the net recovery after the fees. Most plaintiffs therefore sensibly assume that the biggest tax they could face would be tax on their net recoveries.

However, regardless of how the checks are cut, the plaintiff must usually contend with 100 percent of the proceeds under *Commissioner v. Banks*, 543 U.S. 426 (2005). As a result of that seminal case, plaintiffs in contingent fee cases must generally recognize gross income equal to 100 percent of their recoveries, even if the lawyer is paid directly, and even if the plaintiff receives only a net settlement after fees. This harsh tax rule usually means plaintiffs must figure out a way to deduct their 40 percent (or other) fee.

Fortunately, in 2004 shortly before *Banks* was decided, Congress enacted an above-the-line deduction for employment claims, civil rights claims, and some whistleblower claims. Plaintiffs in employment and civil rights cases can use this deduction for contingent fees, generally ensuring that they are taxed on their net recoveries, not their gross. Even so, many taxpayers and return preparers have had trouble with the mechanics of claiming it, as discussed above. There are also technical limits because a plaintiff’s deduction for fees in employment, civil rights, and qualifying whistleblower cases cannot exceed the income the plaintiff received from the litigation in the same tax year.

If all the legal fees are paid in the same tax year as the recovery (such as in a typical contingent fee case), that limit causes no problem. But this is a problem if the plaintiff has been paying legal fees hourly over several years. In that event, there is no income to offset, so you cannot deduct the fees above the line. Paying back the prior fees and having the lawyer charge them again in the year of the settlement is sometimes suggested to bring the fee payment into the same tax year as the recovery. It is unclear if that kind of circular flow of funds would adequately address the issue, although perhaps it might give a potential return position.

WHO CAN CLAIM THE ABOVE-THE-LINE LEGAL FEE DEDUCTION?

The big question, of course, is what types of cases qualify for the above-the-line deduction? The answer is that only employment, civil rights, and some types of whistleblower claims qualify for it. Some people fear that employment cases based on contract disputes without discrimination might somehow not qualify. Perhaps that fear was fueled by the “UDC” notion that might seem to suggest that only unlawful discrimination claims (as opposed to *all employment claims*) qualify. However, there is a catchall provision, section 62(e)(18), that seems to cover the waterfront and make the long list of claims unnecessary. In the tax code itself, any claim about employment is actually defined as an unlawful discrimination claim.

Unlawful Discrimination

The above-the-line deduction applies to attorney fees paid because of claims of “unlawful discrimination.” The definition of such claims refers to claims for unlawful discrimination brought under these federal statutes:

- the Civil Rights Act of 1991;
- the Congressional Accountability Act of 1995;
- the National Labor Relations Act;
- the Fair Labor Standards Act of 1938;
- the Age Discrimination in Employment Act of 1967;
- the Rehabilitation Act of 1973;
- the Employee Retirement Income Security Act of 1974;
- the Education Amendments of 1972;
- the Employee Polygraph Protection Act of 1988;
- the Worker Adjustment and Retraining Notification Act;
- the Family and Medical Leave Act of 1993;
- chapter 43 of Title 38 (concerning employment rights of uniformed service personnel);
- Section 1981, Section 1983, and Section 1985;
- the Civil Rights Act of 1964;
- the Fair Housing Act; and
- the Americans with Disabilities Act of 1990.

It also refers to claims permitted under any provision of federal law (popularly known as whistleblower protection provisions) prohibiting discharge, discrimination,

retaliation, or reprisal, and under any provision of federal, state, local, or common law providing for the enforcement of civil rights or regulating any aspect of the employment relationship.

Catchall Employment Claims

Arguably the most important piece in all this is the section 62(e)(18) catchall provision, which makes a deduction available for claims alleged under:

Any provision of federal, state, or local law, or common law claims permitted under federal, state, or local law —

- i. providing for the enforcement of civil rights, or
- ii. regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

This language is very broad. Some people may argue that an employment contract between a company and an executive doesn't involve alleged discrimination and might not be covered. However, it seems hard to argue that an employment contract dispute does not amount to an employment matter within the meaning of this broad catchall statement. Many people claim these deductions and have been doing so since 2004. Yet so far, there is little guidance on this issue.

In LTR 200550004, however, the IRS ruled that attorney fees and costs rendered to obtain federal pension benefits fell within the catchall category. The case concerned a taxpayer who, after his retirement, discovered that he was being shortchanged on his pension. The IRS found unlawful discrimination. Interestingly, the IRS ruled that the case fell within the catchall category for unlawful discrimination even though the action was brought under ERISA (one of the enumerated types of unlawful discrimination).

Because only actions brought under section 510 of ERISA are expressly allowed under section 62(e), the catchall provision was needed to cover the taxpayer's case. This ruling suggests an expansive reading of the catchall category, and so does the plain language of the statute.

Whistleblower Recoveries

The "unlawful discrimination" deduction also creates an above-the-line deduction for whistleblowers who were fired from their employment or retaliated against at work. But what about whistleblowers who expended legal fees to obtain a qui tam award but were not fired? Separately from the unlawful discrimination deduction,

section 62 allows these qui tam plaintiffs to deduct their attorney fees above the line.

Several features about fees in non-employment whistleblower cases are noteworthy. Originally, the law for non-employment whistleblowers covered only federal False Claims Act cases. In 2006 the above-the-line attorney fees deduction was expanded to include attorney fees paid by tax whistleblowers in cases brought under section 7623 (regarding detection of underpayments of tax, fraud, etc.). In 2018 it was extended to SEC and Commodities Futures Trading Commission whistleblowers. Regarding False Claims Act recoveries, commencing with the 2018 tax year, the above-the-line deduction for attorney fees was extended to cover state whistleblower statutes as well.

Civil Rights Claims

The catchall language in section 62(e)(18) also provides for the deduction of legal fees to enforce civil rights. This unlawful discrimination deduction is arguably even more important than the deduction for fees concerning employment cases. What exactly are civil rights, anyway? You might think of civil rights cases as only those brought under 42 U.S.C. section 1983.

However, the above-the-line deduction extends to any claim for the enforcement of civil rights under federal, state, local, or common law. Section 62 of the Internal Revenue Code does not define “civil rights” for purposes of the above-the-line deduction, nor does the legislative history or committee reports. Some definitions are broad indeed, including:

. . . a privilege accorded to an individual, as well as a right due from one individual to another, the trespassing upon which is a civil injury for which redress may be sought in a civil action. . . . Thus, a civil right is a legally enforceable claim of one person against another. See Volume 15, American Jurisprudence, 2d at Page 281, quoted in *In re Colegrove*, 9 B.R. at 339 (emphasis added).

Moreover, in an admittedly different context (charitable organizations), the IRS itself has generally preferred a broad definition of civil rights. In one general counsel memorandum, the IRS stated: “We believe that the scope of the term ‘human and civil rights secured by law’ should be construed quite broadly.” Could invasion of privacy cases, defamation, debt collection, and other such cases be called civil rights cases? Possibly.

What about credit reporting cases? Don’t those laws arguably implicate civil rights as well? Might wrongful death, wrongful birth, or wrongful life cases also be viewed in this way? Of course, if all damages in any of these cases are compensatory damages for personal physical injuries, then the section 104 exclusion should protect them, making attorney fees deductions irrelevant.

However, what about punitive damages? In that context, plaintiffs may once again be on the hunt for an avenue to deduct their legal fees. Reconsidering civil rights broadly might be one way to consider fees in the new environment. In any event, the scope of the civil rights category for potential legal fee deductions seems broad.

CONCLUSION

The IRS gets big points for fixing what has been a tough deduction to claim since 2004. Personally, I'm still not used to the Schedule 1 idea for Form 1040, which may have been part of the effort to make tax returns more akin to postcards. Of course, we know how that turned out. But those issues aside, the IRS change for 2021 returns with the express line item for above-the-line attorney fees is a huge win.

Schedule 1 devotes two lines to these deductions: Line 24 of Part II, Adjustments to Income, for "(h) Attorney fees and court costs for actions involving certain unlawful discrimination claims" and "(i) Attorney fees and court costs you paid in connection with an award from the IRS for information you provided that helped the IRS detect tax law violations." Don't overlook them.