12 Ways to Deduct Legal Fees Under New Tax Laws

by Robert W. Wood


In this article, Wood details several options available to plaintiffs to avoid being taxed on their attorney fees despite the additional difficulties created by the Tax Cuts and Jobs Act.

This discussion is not intended as legal advice.

Copyright 2019 Robert W. Wood. All rights reserved.

You are a plaintiff in a lawsuit and just settled your case for $1 million. Your lawyer takes 40 percent, $400,000, leaving you the balance. You ask, what is your worst-case tax picture? Most plaintiffs would say worst case, they must pay tax on $600,000. But today you could pay tax on the full $1 million.

Ideally, of course, you pay tax on $600,000 or even less, but that depends on what kind of case you have. The above-the-line deduction for employment, civil rights, and whistleblower legal fees is still in the law and is more important than ever. Qualifying for it means that at most you are taxed on $600,000. But if you don’t qualify, is there any other way to deduct legal fees?

Possibly, but one must be creative. Miscellaneous itemized deductions, the category under which many plaintiffs historically deducted most legal fees, are disallowed for 2018 through 2025.¹ If you can’t wait to settle your case until 2026, is there any tax relief in the meantime? And what categories of plaintiffs and cases need to worry about these issues in the first place?

I. Huh? Legal Fees Are Income to Clients?

Why even worry about ways to deduct legal fees? Here is the background: Under Banks,² plaintiffs in contingent fee cases must generally recognize gross income equal to 100 percent of their recoveries. Yes, 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 a way to deduct their 40 percent (or other) fee.

Fortunately, 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 still use this deduction for contingent fees, generally ensuring that they are taxed on their net recoveries, not their gross. Even so, some taxpayers and return preparers have trouble with the mechanics of claiming the deduction. Moreover, 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 what if the plaintiff has been paying legal fees hourly over

several years? In that event, there is no case income to offset, so the plaintiff can’t deduct the fees above the line. Several possible workarounds have been suggested, such as paying back the prior fees and having the lawyer charge them again in the year of the settlement.

However, none of these workarounds is reliable, so even in cases in which the availability of a deduction would appear to be clear-cut, some plaintiffs can end up unable to deduct their legal fees. Moreover, only employment, civil rights, and some types of whistleblower claims qualify for the above-the-line deduction. Some people fear (incorrectly) that employment cases based on contract disputes without discrimination might somehow not qualify. In short, there is still considerable fear about who can deduct legal fees, and how.

II. Physical Injury Recoveries

Only relatively few plaintiffs are freed from worrying about deducting legal fees. One safe ground is when a recovery is 100 percent tax free — that is, in a pure physical injury case with no interest and no punitive damages. If the recovery is fully excludable from income, you cannot deduct attorney fees, but you don’t need to. But what if a case is partially taxable and partially tax free?

Example 1: You are injured in a car crash. Thereafter, you collect $50,000 in compensatory damages and $5 million in punitive damages. The $50,000 is tax free, but the $5 million is fully taxable. What’s more, you cannot deduct your attorney fees. If you pay a 40 percent contingent fee, $2 million of that $5 million goes to the lawyer, with the client netting $3 million. But the client must report the full $5 million. If the client cannot find a way to deduct the fees, any taxable money is 100 percent taxable, even if 40 percent goes to the lawyer.

Example 2: Your case settles for $2 million and is 50 percent compensatory for physical injuries. The other 50 percent is for punitive damages. There is a 40 percent contingent fee, and it should generally be allocated 50-50 to the taxable and nontaxable damages. That means the client actually nets $1.2 million. But the IRS divides the $2 million recovery in two, so the client is taxed on $1 million. The client cannot deduct any of the $800,000 in legal fees.

The same kind of attorney fee tax problems can occur when there is interest instead of punitive damages. You might receive a tax-free settlement or judgment, but pre- or post-judgment interest is taxable, and you may not be able to deduct the legal fees on that part of the case. Sometimes an allocation of legal fees that is not strictly pro rata can help, but you need to document it, and the IRS may not agree.

Despite the additional difficulties the 2017 tax reform legislation created for plaintiffs, there are still options for plaintiffs who would like to avoid being taxed on monies they didn’t actually receive.

1. Unlawful discrimination recoveries under some federal statutes.

The above-the-line deduction applies to attorney fees paid because of claims of unlawful discrimination. Unsurprisingly, the definition of an unlawful discrimination claim is complex. The first set of claims that qualify as claims for unlawful discrimination consists of claims brought under these specific 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;
- ERISA;
- 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);
- cases under sections 1981, 1983, and 1985 of title 42;
- the Civil Rights Act of 1964;
• the Fair Housing Act; and
• the Americans With Disabilities Act of 1990.3

2. 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 weren’t 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 fee deduction was expanded to include attorney fees paid by tax whistleblowers in cases brought under section 7623 (regarding the detection of underpayments of tax, fraud, etc.). In 2018 it was extended to SEC and Commodities Futures Trading Commission whistleblowers. For 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.

3. Catchall employment claims.

Arguably the most important item in this list is section 62(e)(18). This catchall provision 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, that provides for the enforcement of civil rights, or regulates any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, 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 seems quite broad but is arguably clear. So far, there is little authority on this important provision. However, in LTR 200550004, the IRS concluded 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 letter ruling suggests an expansive reading of the catchall category. So does the plain language of the statute.

4. Catchall 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 section 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.4 Section 62 doesn’t define civil rights for purposes of the above-the-line deduction, nor do the legislative history or the 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

---

3 Section 62(e).

4 See section 62(e)(18).
right is a legally enforceable claim of one person against another.5

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."6 Could invasion of privacy, 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, the section 104 exclusion should protect them, making attorney fee 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 merits separate treatment in a forthcoming article.

5. Legal fees as business expenses.

Employment and civil rights avenues are thus broader than they might appear. However, if section 62(a)(20) and (e) aren’t fertile grounds for legal fee deductions, is anything else available? Can legal fees be a business expense? Business expense deductions were largely unaffected by the 2017 tax changes, other than the so-called Weinstein provision restricting deductions in confidential sexual harassment cases.7

In a corporation, limited liability company, partnership, or sole proprietorship, business expenses are above-the-line deductions. However, one must ask, are your activities sufficient that you are really in business, and is the lawsuit really related to that business? If one can answer yes to both those questions, all is well. A plaintiff doing business as a proprietor (or through a single-member LLC that is a disregarded entity) and regularly filing Schedule C might claim a deduction there for legal fees related to the trade or business.

A plaintiff filing his first Schedule C as a proprietor for a lawsuit recovery probably won’t look very convincing. Before the above-the-line deduction was enacted in 2004, some plaintiffs argued that their lawsuits amounted to business ventures, so they could deduct legal fees. Plaintiffs usually lost those tax cases.8 The repeal of miscellaneous itemized deductions until 2026 may revive attempts by some plaintiffs to file Schedule C.

Some may push the envelope about what is a trade or business, and how their lawsuit is inextricably connected to it. Some plaintiffs may consider filing a Schedule C, even if they have never done so before. Schedule C is historically more likely to be audited, and it draws self-employment taxes. The extra tax hit can be 15.3 percent, although over the wage base the rate drops to 2.9 percent.

Even so, most plaintiffs don’t want to add self-employment tax to the taxes they are already paying. In any event, plaintiffs who have been regularly filing Schedule C for business activities in the past stand a better chance of prevailing with a Schedule C position for legal fees.

6. Capital gain recoveries.

If your recovery is capital gain, you arguably could capitalize your legal fees and offset them against your recovery. You might regard the legal fees as capitalized, or as a selling expense to produce the income. Either theory should result in you not having to pay tax on your attorney fees. Thus, the new “no deduction” rule for attorney fees may encourage some plaintiffs to claim that their recoveries are capital gain, just (or primarily) to deduct or offset their attorney fees.

III. Exceptions to Banks

The next entries on this list — the exceptions to Banks — are technically not ways to deduct legal

6 GCM 38468 (Aug. 12, 1980).
7 See TCJA section 13307; see also Wood, “Taxing Sexual Harassment Settlements and Legal Fees in a New Era,” Tax Notes, Jan. 22, 2018, p. 545.
8 See Alexander v. Commissioner, 72 F.3d 938 (1st Cir. 1995).
fees. Rather, falling into one of these exceptions keeps attorney fees out of the plaintiff’s income in the first place. In *Banks*, the Supreme Court laid down the general rule that plaintiffs have gross income on contingent legal fees. But general rules have exceptions, and the Court alluded to situations in which this general 100 percent gross income rule might not apply.

7. Separately paid lawyer fees.

Some defendants will agree to pay the lawyer and client separately. Do two checks obviate the income to the plaintiff? According to *Banks*, they do not. Still, separate payments can’t hurt, and perhaps Forms 1099 can be negated in the settlement agreement.

Of course, the Form 1099 regulations generally require defendants to issue a Form 1099 to the plaintiff for the full amount of a settlement, even if part of the money is paid to the plaintiff’s lawyer. Nevertheless, a defendant might agree to issue a Form 1099 to the plaintiff only for the net payment. In that case, despite *Banks* — which would seem to dictate that there is gross income anyway — the plaintiff may feel comfortable reporting only the net.

8. Injunctive relief.

Although there is not yet a hard and fast rule, the Supreme Court suggested that legal fees for injunctive relief may not be income to the client. The bounds of this exception to *Banks* are not clear, but it presumably offers a way out in some cases. If the plaintiff receives only injunctive relief, but the plaintiff’s counsel is awarded large fees, should the plaintiff be taxed on those fees? Arguably not. However, if there is a big damage award with small injunctive relief, will that take all the attorney fees from the client’s tax return? That seems unlikely. Tax opinions on this issue seem appropriate.

9. Court-awarded fees.

Court-awarded fees may also provide relief, depending on how the award is made and on the nature of the fee agreement. Suppose that a lawyer and client sign a 40 percent contingent fee agreement. It provides that the lawyer is also entitled to any court-awarded fees. A verdict for the plaintiff yields $500,000, split 60-40. The client has $500,000 in income and cannot deduct the $200,000 paid to his lawyer.

However, if the court separately awards another $300,000 to the lawyer alone, that shouldn’t have to go on the plaintiff’s tax return. What if the court sets aside the fee agreement and separately awards all fees to the lawyer? Does such a court order mean the IRS should be unable to tax the plaintiff on the fees?

10. Class action fees.

There has long been confusion about how legal fees in class actions should be taxed. Historically, there was a difference between the tax treatment of opt-in cases and opt-out cases. In more recent years, however, the trend appears to be away from taxing plaintiffs on legal fees in class actions of both types. That is fortunate because the legal fees in class actions generally dwarf the amounts plaintiffs take home. It is an overgeneralization, but most plaintiffs in most class actions generally assume that they won’t be taxed on the gross amount (or even their pro rata amount) of the legal fees paid to class counsel. Optimally, the lawyers will be paid separately under court order.

11. Statutory attorney fees.

If a statute provides for attorney fees, can this be income to the lawyer only, bypassing the client? Perhaps in some cases, although contingent fee agreements may have to be customized. In *Banks*, the Court reasoned that the attorney fees were generally taxable to the plaintiffs because the payment of the fees discharged a liability of the plaintiffs to pay their counsel under their fee agreements. However, in statutory fee cases, the fees aren’t necessarily being paid to satisfy a plaintiff’s liability.

Instead, a statute (rather than a fee agreement) creates an independent liability on the defendant to pay the attorney fees. If statutory fees are not awarded, the plaintiff may not be obligated to pay any additional amount to his attorney. Accordingly, some attorneys seem to assume that if a statute calls for attorney fees, the general rule of *Banks* can never apply. Arguably, however, more may be needed.
If the contingent fee agreement is plain vanilla, the fact that the fees can be awarded by statute may not be enough to distance the client from the fees. As the Banks decision notes, the relationship between lawyer and client is that of principal and agent. The fee agreement and the settlement agreement may need to address the payment of statutory fees.

12. Lawyer-client partnerships.

A partnership of lawyer and client arguably should allow each partner to pay tax only on that partner’s share of the profits. The tax theory of a lawyer-client joint venture was around long before the Supreme Court decided Banks in 2005. Despite numerous amicus briefs, the Supreme Court expressly declined to address this long-discussed topic and whether it would sidestep the holding of Banks.

A mere fee agreement is surely not enough to suggest a partnership. But with appropriate documentation, one can argue that the lawyer contributes legal acumen and services while the client contributes the legal claims. Legal purists will note the ethical rules that suggest this cannot be a true partnership because lawyers are generally not allowed to be partners with their clients. Yet tax law is unique and sometimes at odds with other areas of law.

Could a lawyer-client partnership agreement state that it is a partnership to the maximum extent permitted by law? It isn’t clear that ethics rules would control the tax treatment of the arrangement. One factor in how these partnerships will fare with the IRS will be optics and consistency.

Plainly, partnership nomenclature and formalities will matter. A partnership tax return with Schedules K-1 to lawyer and client might be hard for the IRS to ignore, but so far, lawyer-client partnerships may not look all that promising. At the very least, lawyer-client partnerships deserve to be discussed, even though they rarely seem to be attempted with any conviction.

IV. Conclusion

No plaintiff will think it’s fair to pay taxes on portions of their recovery paid directly to their lawyer that they never see. In the old days, alternative minimum tax and phased-out deductions often limited the efficacy of legal fee deductions. There was plenty of grousing about those rules, but it was relatively rare for them to result in truly catastrophic tax positions.

However, there were a few cases in which plaintiffs actually lost money after tax when the old miscellaneous deduction and AMT rules were taken into account. Even today, how serious the problem is will vary with the numbers involved and the percentage of contingent fees. Still, on any numbers — especially big ones — entirely disallowed legal fee deductions are less likely to be easily endured.

Some plaintiffs may aggressively try to plan or report their way around this unjust landmine. They may try to gerrymander their settlement agreements to avoid receiving gross income on their legal fees in the first place. If plaintiffs can’t credibly argue that they have somehow avoided the gross income, they may go to new lengths to try to deduct or offset the fees. The bigger the numbers and the higher the contingent fee percentage, the more creative and assertive the plaintiff may be. Good luck out there!

9 Allum v. Commissioner, T.C. Memo. 2005-177, aff’d, No. 06-70623 (9th Cir. 2007).