New Tax on Litigation Settlements, No Deduction for Legal Fees

by Robert W. Wood

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Wood writes that under tax reform, plaintiffs in many types of litigation will pay tax on 100 percent of their recoveries, including the shares to their contingent fee lawyers, with no deduction for legal fees. He explores who is affected and possible workarounds that litigants may now try.

Tax cuts are supposed to be good. Yet as everyone knows, there was both pain and pleasure in the big year-end tax law (Tax Cuts and Jobs Act, P.L. 115-97). For example, there is pain in the $10,000 cap on deducting state and local taxes. It is roiling high-tax states, and causing some residents to flee for no-tax states like Texas, Nevada, or Florida. Some states are proposing a workaround "donation" or are filing lawsuits to block the law.

A less obvious group hurt by the tax law is plaintiffs in lawsuits. For many plaintiffs, the results of the tax bill are surprisingly bad. By extension, it may affect their lawyers, too, including case resolution and lawyers' wallets. The biggest hit to many plaintiffs will be the new tax treatment of attorney fees.

Many plaintiffs will now be taxed on their gross recoveries, with no deduction for attorney fees. This bears repeating. Many plaintiffs who settle for $100,000 will be taxed on $100,000, even if they pay $40,000 or more to their lawyers. In bigger recoveries, the tax situation can become dire. This stark reality not only will affect plaintiffs and their lawyers, but may also affect defendants, who may have to pay more to resolve cases.

I. It's All Gross Income

Part of the problem triggered by the sweeping tax reform bill is historical. In 2005 in *Banks*,[1] the U.S. Supreme Court held that plaintiffs in contingent fee cases must generally recognize gross income equal to 100 percent of their recoveries. That means plaintiffs must figure out a way to deduct their 40 percent (or other) fee.

Months before *Banks*, Congress enacted an above-the-line deduction for employment claims and some whistleblower claims. An above-the-line deduction is almost like not having the income in the first place. It subtracts the qualifying fees before you reach page 2 of the tax return.

Under the new GOP tax law, plaintiffs in employment cases will remain unaffected, unless their case involves sexual harassment, because the above-the-line deduction for legal fees remains in the law. This generally ensures that employment claim plaintiffs are taxed on their net recoveries, not their gross.

But there are nagging problems even for employment plaintiffs. For example, a plaintiff's above-the-line deduction for fees in employment and qualifying whistleblower cases cannot exceed the income the plaintiff received from the litigation in the same tax year. As long as all the

[1] *Commissioner v. Banks*, 543 U.S. 426 (2005).

legal fees are paid in the same tax year as the recovery (as in a typical contingent fee case), that might not be an issue.

However, what if the plaintiff has been paying legal fees hourly over several years? There are possible workarounds, but none are foolproof. Some plaintiffs can end up unable to deduct their legal fees even in employment cases.

Also, only employment (and some types of whistleblower) claims qualify for the above-the-line deduction. There has always been concern that the IRS could limit deductions for legal fees by attributing them to particular claims. Will the IRS start allocating legal fees between employment claims and other claims? That danger seems enhanced now.

Moreover, plaintiffs in employment claims must now contend with the so-called Harvey Weinstein provision for sexual harassment claims and releases. Amazingly, it can disallow all settlement and legal fee deductions, potentially even plaintiffs' deductions.

II. Affected Plaintiffs

If you are not an employment plaintiff (or one of a few types of whistleblowers) and your claim did not involve your trade or business, you may not be able to deduct legal fees above the line. Until now, that meant deducting your legal fees below the line. A below-the-line (or miscellaneous itemized) deduction was more limited, but it was still a deduction.

It faced three limits: (1) Only fees greater than 2 percent of your adjusted gross income could be deducted, so there was a haircut on the first part of your fees; (2) depending on income, you could be subject to a phaseout of deductions; and (3) your legal fees were not deductible for purposes of the alternative minimum tax. Now there is no below-the-line deduction for legal fees for tax years 2018 through 2025. If you are not an employment plaintiff or qualified whistleblower, and you cannot find a way to position your claim as a trade or business expense or to capitalize your fees into the tax basis of a damaged asset, you get no deduction. Period. That means you are taxed on 100 percent of your recovery.

Examples of when you'll be affected as a plaintiff include recoveries from:

1. a website for invasion of privacy or defamation;
2. a stock broker or financial adviser for bad investment advice, unless you can capitalize your fees;
3. your ex-spouse for anything concerning your divorce or children;
4. a neighbor for trespassing, encroachment, or anything else;
5. the police for wrongful arrest or imprisonment;
6. anyone for intentional infliction of emotional distress;
7. your insurance company for bad faith;
8. your tax adviser for bad tax advice;
9. your lawyer for legal malpractice; and
10. a truck driver who injures you, if you recover punitive damages.

The list of lawsuits in which this will be a problem is almost endless. Conversely, the list of cases in which you should *not* face this double tax is much shorter:

1. Your recovery is 100 percent tax free, for example, in a pure physical injury case with no interest and no punitive damages. If the recovery is fully excludable from your income, you cannot deduct attorney fees, but you don't need to.

2. Your employment recovery qualifies for the above-the-line deduction (but watch out if it involves a sexual harassment claim).

3. Your recovery is in a federal False Claims Act case or IRS whistleblower case, qualifying for the above-the-line deduction.

4. Your recovery relates to your trade or business, and you can deduct your legal fees as a business expense.

5. Your recovery comes via a class action, in which the lawyers are paid separately under court order.

Eliminating miscellaneous itemized deductions means that many plaintiffs (outside employment and some whistleblower cases) will have no legal fee deduction at all. Plaintiffs in many types of litigation will feel the full force of paying taxes on their gross recoveries, with no deduction for their fees.

III. SEC Whistleblowers

SEC whistleblowers also did not fare well under the new law, at least initially. An amendment had proposed giving them an above-the-line deduction for legal fees. That would match the treatment IRS whistleblowers and Federal False Claims Act whistleblowers enjoy. But the amendment for SEC claimants was not included in the final tax law passed at Christmas.

However, the massive budget bill just passed in February of 2018 came to the rescue. It allows an above-the-line deduction of legal fees for whistleblower recoveries under section 21F of the Securities Exchange Act of 1934 (15 U.S.C. 78u-6), recoveries under state false claims acts, and those under section 23 of the Commodity Exchange Act (7 U.S.C. 26).[2] The new provision is effective for recoveries after December 31, 2017.

IV. Sexual Harassment

The new law includes the Weinstein tax. The idea is to deny tax deductions for settlement payments in sexual harassment or abuse cases if there is a nondisclosure agreement. Notably, this no-deduction rule applies to the lawyers' fees as well as the settlement payments.

Of course, most legal settlement agreements have some type of confidentiality or nondisclosure provision. And many employment cases have a mixture of facts and claims and a comprehensive settlement agreement. That means lawyers will worry about whether this no-deduction rule will apply.

If it applies, it may apply with a vengeance. Even legal fees paid by the plaintiff in a confidential sexual harassment settlement could be covered. The new provision was added into section 162, which addresses business expenses. The Congressional Research Service's official summary of the legislation says that the provision prohibits a tax deduction for trade or business expenses in some sexual harassment and sexual abuse cases.[3]

Arguably, Congress's intent was only to limit the defendant's trade or business deduction for settlement payments and related legal fees. Nevertheless, the language actually enacted into the tax code is much broader. It provides that "no deduction shall be allowed under this chapter." "This chapter" appears to include every section of the tax code between section 1 and section 1400Z-2, covering most sections a taxpayer uses for calculating taxes each year.

It therefore could also disallow the above-the-line deduction for a plaintiff's employment and qualifying whistleblower claims. Small allocations to the sexual harassment portion of settlement agreements might be one answer to preserve the availability of deductions for the other claims.[4] However, it is unclear whether the IRS would respect them.

V. What to Do Now

For many types of cases involving significant recoveries and attorney fees, the lack of deductions for attorney fees may seem downright confiscatory. Plaintiffs and their lawyers are unlikely to take the situation lying down. Here are potential ideas for addressing the new rules.

A. Separately Paid Lawyer Fees

Some defendants will agree to pay lawyer and client separately. Do two checks obviate the income to the plaintiff? According to *Banks*, not hardly. The Form 1099 regulations may not help. They 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. However, some taxpayers may still claim reporting positions on these facts.

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[2] *See* section 62(a)(21).

[3] Congressional Research Service, "The 2017 Tax Revision (P.L. 115-97): Comparison to 2017 Tax Law," CRS R45092 (Feb. 6, 2018).

[4] *See* Robert W. Wood, "Taxing Sexual Harassment Settlements and Legal Fees in a New Era," *Tax Notes*, Jan. 22, 2018, p. 545. *See* section 62(a)(21).

B. Business Expenses

One possible way of deducting legal fees could be a business expense deduction. Businesses did well in the tax bill, and business expense deductions remain unaffected (other than the Weinstein provision). But are your activities such that you are really in business, and is the lawsuit related to that business?

Alternatively, could your lawsuit itself be viewed as a business? A plaintiff filing his first Schedule C as a proprietor for a lawsuit recovery probably won't look convincing. Before the above-the-line deduction for employment claims was enacted in 2004, some plaintiffs argued that their lawsuits amounted to business ventures so they could deduct legal fees.

Plaintiffs usually lost these tax cases. After all, just suing your employer doesn't seem like a business. It might be regarded as investment or income-producing activity (which used to give rise to a below-the-line deduction), but not a business. And remember, under tax reform, investment expenses — whether legal fees or otherwise — do not qualify for a tax deduction.

However, a plaintiff doing business as a proprietor and regularly filing Schedule C might claim a deduction there for legal fees regarding the trade or business.[5] It seems inevitable that there'll be more arguments based on Schedule C from plaintiffs in the future.

C. Capital Gain Recoveries

One other possibility for legal fee deductions is capital recoveries. If your recovery is capital gain, you arguably can capitalize your legal fees and offset them. You might regard the legal fees as capitalized or as a selling expense to produce the income. But at least you should not have to pay tax on your attorney fees. Perversely, the new no-deduction rule for attorney fees may encourage some plaintiffs to claim that their recoveries are capital gain, just to "deduct" their attorney fees.

VI. Exceptions to *Banks*

There will be new efforts to explore the exceptions to the Supreme Court's 2005 holding 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 100 percent gross income rule might not apply.

A. Injunctive Relief

Legal fees for injunctive relief may not be income to the client. The bounds of this exception are unclear, but it may offer a way out on some facts. If there is a big damage award with small injunctive relief, will that take all the lawyer's fees from the client's tax return? That seems unlikely.

B. Court-Awarded Fees

Court-awarded fees may provide relief, depending on how the award is made and the nature of the fee agreement. Suppose 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 her lawyer.

However, if the court separately awards another $300,000 to the lawyer alone, that should not 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 not be able to tax the plaintiff on the fees? It is unclear, but the IRS has an incentive to scrutinize such attempts.

C. Statutory Attorney Fees

Statutory fees are another potential battleground. 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 particular ways. The relationship between lawyer and client is that of principal and agent. It may take considerable effort to distance a plaintiff from the fees his lawyer is due.

[5] *See Alexander v. Commissioner*, 72 F.3d. 938 (1st Cir. 1995).

D. Lawyer-Client Partnerships

How about a partnership of a lawyer and client? Partnerships fared well in the tax reform bill. Moreover, the tax theory of a lawyer-client joint venture (which is just another name for a partnership) was around long before the Supreme Court decided the *Banks* case in 2005. Despite numerous amicus briefs, the Supreme Court expressly declined to address it.

If a fee agreement says it is a 60/40 partnership, can't that partnership report 60/40? The lawyer contributes legal acumen and services. 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 supposed to be partners with their clients.

Yet tax law is unique and sometimes is at odds with other areas of law. Couldn't a lawyer-client partnership agreement state that it is a partnership to the maximum extent permitted by law? At the least, it is unclear that ethics rules will control the tax treatment of the arrangement.

To be sure, key factors in how such partnerships would fare with the IRS would be optics and consistency. Partnership nomenclature and formalities would matter. A partnership tax return with Schedules K-1 to lawyer and client might be hard for the IRS to ignore. At the very least, lawyer-client partnerships deserve to be resuscitated. There are surely some in the works at this very moment.

VII. Conclusion

For many types of cases involving significant recoveries and attorney fees, the lack of tax deductions for legal fees may be catastrophic. We should expect plaintiffs to more aggressively try to avoid receiving gross income on their legal fees in the first place. For plaintiffs who are stuck with the gross income, we should expect some to go to new lengths to try to deduct or offset the fees.

Some of these efforts may be sophisticated and well thought out. Others may be clumsy, if not downright desperate. But few plaintiffs receiving a $100,000 recovery will think it is fair to pay taxes on the full amount if legal fees have consumed a third or more of their recovery.

Multiply the figures into bigger numbers, and the situation will be worse. Add a higher contingent fee percentage and high case costs, and the situation will be worse still. Contingent fee lawyers may be sympathetic and may try to help plaintiffs where they can. All in all, settlement time for legal disputes may become more stressful in this troubling new tax world. Tax time will be, too. ■