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Legal Fee Tax Deductions for Plaintiffs Under Current Law

By Robert W. Wood

Most plaintiffs in lawsuits pay their lawyer via a contingent fee. If the case settles for $1,000,000, the lawyer is paid a percentage, say 40 percent. Checks can be cut in different ways, but in most cases, the lawyer receives the gross proceeds, deducts the fee and expenses, and sends the balance to the client. As a result of these mechanics, many plaintiffs assume that at most, their tax obligations apply to the amount they actually receive (in this example, $600,000).

However, under *Commissioner v. Banks*,[1] plaintiffs in contingent fee cases generally must report all the proceeds as gross income, even if the lawyer is paid directly out of the proceeds before the plaintiff receives anything. If the settlement is fully taxable (and defendants tend to assume that most settlements are taxable) the plaintiff is likely to receive an IRS Form 1099 for 100 percent of the settlement amount.

Some defendants will agree to pay lawyer and plaintiff separately. However, that does not obviate the income to plaintiff, as the Supreme Court made clear in *Banks*.

Moreover, the Form 1099 regulations generally require defendants to issue a Form 1099 to the plaintiff for the full amount of a settlement to the extent a recovery does not qualify for a tax exclusion, even if part of the money is paid to the plaintiff's lawyer. The plaintiff would need to use an available tax deduction for the legal fees if their recovery is taxable as ordinary income (including wages), in order to pay tax only on the reduced amount they actually received.

From 2018 through 2025, the Tax Cuts and Jobs Act suspended miscellaneous itemized deductions, which was how many plaintiffs historically deducted legal fees.[2] The One Big Beautiful Bill Act[3] made that suspension permanent, so plaintiffs can no longer deduct legal fees as miscellaneous itemized deductions. Is the elimination of miscellaneous itemized deductions a huge blow for plaintiffs?

In 2018, I was alarmed at the change, imagining that many plaintiffs could be saddled with paying taxes on money paid to their lawyer that they could not deduct. However, long before 2018, plaintiffs frequently were displeased with miscellaneous itemized deductions, even though they were legally available.

Miscellaneous itemized deductions faced three limitations: (1) Only fees greater than 2 percent of the plaintiff's adjusted gross income could be deducted; (2) higher incomes were subject to a phaseout of deductions; and (3) legal fees were not deductible for purposes of the alternative minimum tax.

Therefore, long before 2018, a plaintiff who could find a *better* tax deduction—ideally an above-the-line deduction—claimed it instead of a highly restrictive miscellaneous itemized deduction. The stakes grew larger in 2018 and continue today. A plaintiff whose above-the-line deduction is disallowed can no longer fall back on a miscellaneous itemized deduction as second choice. But I have come to believe that there are still ways for most plaintiffs to claim viable tax deductions despite the elimination of miscellaneous itemized deductions.

ABOVE-THE-LINE DEDUCTIONS

It has long been the rule that legal fees in cases involving a taxpayer's trade or business (other than the trade or business of being an employee) or involving a taxpayer's efforts to produce rental or royalty income can qualify as an above-the-line deduction. In 2004, shortly before the *Banks* case was decided by the Supreme Court, Congress enacted an above-the-line deduction for employment, civil rights, and whistleblower claims.[4] Congress expanded it over the years, and the IRS has made claiming it simpler.[5]

However, a plaintiff's deduction for fees cannot exceed the income the plaintiff received from the litigation in the same tax year. That same-year limit presents no problem in a typical contingent fee case since the contingency fee is paid out of the settlement payment nearly contemporaneously with the payment of the settlement. If the plaintiff is paying legal fees hourly over several years, some plaintiffs ask their lawyer to pay back prior fees and bill them again out of the settlement.

Other plaintiffs treat a portion of a current year settlement as a reimbursement of previously paid (and not deducted) legal fees. The latter is a kind of reverse tax benefit theory. Either approach could be attacked on audit, but either one may allow a plaintiff to take a reporting position that the net settlement is taxable, not the gross.

PHYSICAL INJURY RECOVERIES

Most physical injury settlements need not worry about the tax treatment of the legal fees. In a physical injury case with no interest and no punitive damages, the plaintiff's recovery should be fully excludable from income under section 104.[6] The related attorney fees are taxed only to the lawyer, not to the plaintiff, and the plaintiff does not need to deduct the legal fees. But what if a case is partially taxable and partially tax-free?

***Example*:** Sam is injured in an accident and collects $300,000 in compensatory damages and $5 million in punitive damages. The $300,000 is tax free, but the $5 million is taxable. If Sam pays a 40 percent contingent fee, $2 million of that $5 million in punitive damages goes to the lawyer, with Sam netting $3 million of the punitive damages. Sam must report the full $5 million of punitive damages as gross income and needs a way to deduct the $2 million in legal fees paid out of the punitive damages.

A similar situation arises with interest. Pre- or post-judgment interest is taxable even on physical injury damages. Sometimes, an allocation of legal fees that is not strictly pro rata can help, but this must be documented accordingly. The more conventional answer is to find a tax deduction for the legal fees attributable to the interest.

EMPLOYMENT AND DISCRIMINATION CLAIMS

Some of the confusion about the tax treatment of legal fees came from unfortunate drafting by Congress. An employment plaintiff can effectively claim a deduction in *any* kind of employment case, regardless of whether discrimination is alleged. Above-the-line treatment applies to legal fees in any case under any law "regulating any aspect of the employment relationship,"[7] which is a much broader scope than just employment cases involving discrimination.

Yet as written, the deduction is named by the tax code as a deduction in cases involving claims of "unlawful discrimination," which can imply to taxpayers that the deduction is narrower than it actually is. The statutory definition of an unlawful discrimination claim is a veritable kitchen sink; section 62(e) defines unlawful discrimination to include any claims brought under one or more of a specifically identified list of federal statutes:[8]

i. the Fair Labor Standards Act of 1938 (29 U.S.C. §§ 201 *et seq*.);
ii. sections 4 or 15 of the Age Discrimination in Employment Act of 1967 (29 U.S.C. §§ 623 or 633a);
iii. sections 501 or 504 of the Rehabilitation Act of 1973 (29 U.S.C. §§ 791 or 794);
iv. section 510 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. § 1140);
v. section 105 of the Family and Medical Leave Act of 1993 (29 U.S.C. § 2615);
vi. sections 1981, 1983, or 1985 of Title 42 of the United States Code;
vii. sections 703, 704, or 717 of the Civil Rights Act of 1964 (42 U.S.C. §§ 2000e–2, 2000e–3, or 2000e–16);
viii. section 102, 202, 302, or 503 of the Americans with Disabilities Act of 1990 (42 U.S.C. §§ 12112, 12132, 12182, or 12203); or
ix. any whistleblower protection provision of federal law prohibiting the "retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law."[9]

The unlawful discrimination deduction also covers whistleblowers who were fired or faced retaliation. Separately, section 62 allows whistleblowers to deduct fees in federal False Claims Act, state whistleblower cases, and IRS, SEC, and Commodity Futures Trading Commission claims.[10]

CATCHALL EMPLOYMENT CLAIMS

Critically, there is *also* a catchall that covers *any* kind of claim arising in or about employment, making the list illustrative, not finite. Section 62(e)(18) allows a deduction for claims alleged under

> [a]ny 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.[11]

This is an expansive description, and so far, there appears to be little authority. In Letter Ruling 200550004, the IRS ruled that attorney fees and costs to obtain federal pension benefits fell within the catchall category. The case concerned a taxpayer who, after his retirement, discovered that he was being short-changed on his pension. Notably, the IRS ruled that the case fell within the catchall for unlawful discrimination, even though the action was brought under ERISA. Since only actions brought under section 510 of ERISA are expressly allowed under section 62(e), the catchall was needed to cover the taxpayer's case. This ruling suggests an expansive reading of the catchall, as does its plain language.

CIVIL RIGHTS CLAIMS

Section 62(e)(18) *also* provides for deduction for legal fees to enforce civil rights, a term much broader than section 1983 of the Civil Rights Act.[12] The deduction applies to *any* claim for the enforcement of civil rights under federal, state, local or common law.[13] Section 62 does not define "civil rights" for this purpose, nor do the legislative history or committee reports. Yet some legal definitions are expansive:

> 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*. [14]

The IRS has used a very broad definition for civil rights in other contexts. For example, in a 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*."[15] Therefore, invasion of privacy, defamation, debt collection, credit reporting, and many other cases can fairly be classified as involving claims for civil

rights. Medical device case, consumer litigation, claims for wrongful death, wrongful birth, wrongful life, and many others could be considered as enforcing the civil rights of the plaintiffs.[16]

In my view, a path often exists to deduct legal fees in numerous contexts, where I believe it is defensible to characterize claims as involving civil rights, given IRS authorities that give this term a very broad interpretation. There is not 100 percent certainty, but I have written many tax opinions in support of a broad view of civil rights for purposes of legal fee deductions. So far, my IRS audit experience on this issue has been positive.

To be sure, it would be best if the tax law were amended to make it clear that no plaintiff should have to fear paying taxes on the portions of a settlement or judgment that is paid to their lawyer and does not end up in their pocket. However, until the tax law is clarified, there are viable workarounds for plaintiffs to avoid the topsy-turvy result of a plaintiff paying taxes on more money than they net out of a case.

BUSINESS EXPENSES

For a business, legal fees are a classic business expense. In addition to corporations, LLCs, and partnerships, a sole proprietor is entitled to claim business expenses on Schedule C if the legal fees relate to the business. Before the above-the-line deduction was enacted in 2004, some plaintiffs argued that a lawsuit itself amounts to a business venture so they should be able to deduct legal fees. Some plaintiffs consider filing a Schedule C, even if they have never done so in the past.

But without a Schedule C track record, it can be a tough argument.[17] Moreover, Schedule C is historically more likely to be audited and also 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. Still, in appropriate cases, a business expense deduction for legal fees is perfectly appropriate.

CAPITAL RECOVERIES

A plaintiff with a capital recovery does not need to, and technically should not, deduct related legal fees. If a recovery is capital in nature, you should capitalize the legal fees and offset them against the recovery. Whether you capitalize the legal fees or view them as a selling expense, either approach should avoid tax on the attorney fees.

EXCEPTIONS TO *BANKS*

Although we are focusing on attorney fee deductions, it is worth noting that some plaintiffs may have arguments that they should not be considered to have gross income on the legal fees in the first place. To my mind, it is generally safer to

assume that the legal fees will be gross income to the plaintiff, particularly compared with the strained approaches to avoid the income that are sometimes suggested. In *Banks*, the Supreme Court laid down the general rule that plaintiffs have gross income from contingent legal fees.

However, general rules have exceptions, and the Court alluded to situations in which this general 100 percent gross income rule might not apply. Falling within one of the exceptions to the *Banks* case is not a way of deducting legal fees, but should rather avoid the income in the first place.

INJUNCTIVE RELIEF

The Supreme Court suggested that legal fees for injunctive relief may not be income to the plaintiff. The bounds of this exception to *Banks* are still not clear, and in my experience, the issue comes up only rarely. If the plaintiff receives only injunctive relief, but plaintiffs' counsel is awarded large fees, should the plaintiff be taxed on those fees? Perhaps not, but tax advice and a tax opinion in such a case is appropriate.

COURT-AWARDED FEES

Court-awarded fees may not be income to the plaintiff, but much depends on how the award is made and 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 plaintiff yields $500,000, split 60/40. The plaintiff has $500,000 of gross income, and should look for a deduction.

However, if the court separately awards another $300,000 to the lawyer alone, that should not be gross income to the plaintiff. 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? The terms of the fee agreement will matter. In that case, the statutory fee effectively satisfied the plaintiff's obligation to pay the contingency fee that they otherwise would owe their counsel. Some private letter rulings suggest that an award of fees or costs that satisfies a plaintiff's separate obligation to pay a contingency fee is includible in the income of the plaintiff.

STATUTORY ATTORNEY FEES

This topic may be misunderstood more than many others. If a statute provides for attorney fees, can this be income to the lawyer only, bypassing the plaintiff? 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 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 are not necessarily 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 the statutory fees were not awarded, the plaintiff may not be obligated to pay any additional amount to their attorney. Accordingly, some attorneys seem to assume that if a statute calls for attorney fees, the general rule of *Banks* can never apply. However, the mere availability of attorney fees under a statute does not override the general rule of *Banks.*

If the contingent fee agreement is like most, the fact that the fees can be awarded by statute may not be enough to distance the plaintiff from the fees. As the *Banks* decision notes, the relationship between lawyer and client is principal and agent. The fee agreement and the settlement agreement may need to address the payment of statutory fees. On at least two occasions *after Banks* was decided, the IRS has issued private letter rulings concluding that a plaintiff was not taxable on statutory fees separately paid to and awarded to their counsel that did not substitute for or provide credit against any contingency fee obligation owed by the plaintiff to their counsel.[18]

LAWYER-CLIENT PARTNERSHIPS

This was a rather hot topic before and after *Banks,* but it seems to be only a footnote today. A partnership of lawyer and client arguably should allow each partner to pay tax only on that partner's share of the profits. However, despite numerous amicus briefs, the Supreme Court in *Banks* expressly declined to address this long-discussed topic. If ethics rules can be navigated, a partnership tax return with K-1s to lawyer and client could help. However, as a practical matter, lawyer-client partnerships have not been promising,[19] and they are very rarely discussed or implemented.

CONCLUSION

No plaintiff believes that it is fair to pay taxes on portions of their recovery paid directly to their lawyer that they never see. Before 2018, alternative minimum tax, the 2 percent AGI threshold, and the phase-out of deductions limited the efficacy of miscellaneous itemized deductions. There was frequent grousing about those rules, but it was relatively rare for them to result in catastrophic tax positions.[20] Since 2018, miscellaneous itemized deductions have been gone, and while it seemed for a time that they might come back in 2026, they are now gone for good.

As plaintiffs have been doing for years, planning with the existing deduction choices is needed. I may be more aggressive with attorney fee deductions than some other tax advisers, but so far, I have not seen a plaintiff with a contingent fee lawyer *actually* pay tax on their gross settlement with no deduction. If plaintiffs cannot credibly argue that they avoided the gross income, there is usually a reasonable tax position for them to take to declare the gross income but to only pay taxes on their net recovery.

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1. Commissioner of Internal Revenue v. Banks, 543 U.S. 426 (2005). ↥
2. Tax Cuts and Jobs Act, Pub. L. 115-97, § 11045 (2017). ↥
3. One Big Beautiful Bill Act, Pub. L. 119-21 (2025). ↥
4. The Civil Rights Tax Relief provision of the American Jobs Creation Act of 2004, H.R. 4520, § 703 (2004). ↥
5. *See* Robert W. Wood, *Tax Write Off of Legal Fees Simplified*, BUS. L. TODAY (Mar. 31, 2022). ↥
6. Internal Revenue Code, 26 U.S.C. § 104. ↥
7. I.R.C. § 62(e)(18). ↥
8. *See* I.R.C. §§ 62(e)(4)–(7), (11), (13), (14), (16), and (17). ↥
9. I.R.C. § 62(e). ↥
10. *See* I.R.C. § 62(a)(21). ↥
11. I.R.C. § 62(e)(18). ↥
12. 42 U.S.C. § 1983. ↥
13. *See* I.R.C. § 62(e)(18). ↥
14. 15 Am. Jur. 2d *Civil Rights* § 1. ↥
15. IRS Gen. Couns. Mem. 38468 (Aug. 12, 1980). ↥
16. *See* *Civil Rights Fee Deduction Cuts Tax on Settlements*, 166 TAX NOTES FED. 1481 (Mar. 2, 2020). ↥
17. *See* Alexander v. Comm'r, 72 F.3d 938 (1st Cir. 1995). ↥
18. *See* IRS Private Letter Ruling 201015016 (Jan. 5, 2010); IRS Private Letter Ruling 201552001 (Aug. 25, 2015). ↥

19. Allum v. Comm'r, T.C. Memo 2005-117, *aff'd*, 231 Fed. Appx. 550 (9th Cir. 2007), *cert. denied*, 128 S. Ct. 303 (2007). ↥

20. For a famous example, s*ee* Spina v. Forest Preserve District of Cook County, 207 F. Supp.2d 764 (N.D. Ill. 2002), as reported in 2002 National Taxpayer Advocate Report to Congress at 166; *see also* Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Case*, N.Y. TIMES, Aug. 11, 2002, at section 1, p. 18. ↥