

# Legal Fees in a Post-Tax-Reform World

New tax rules may impact legal fee deductions—  
here's what you need to know

BY ROBERT  
W. WOOD

For many, the Tax Cuts and Jobs Act of 2017 (TCJA) is regarded as a positive development. But for one group—plaintiffs involved in lawsuits—the opposite may actually be true. By establishing taxation on gross recovery amounts in certain

cases, without allowing any deduction for attorney fees, the new law could, in cases involving large recoveries, create a dire tax situation for plaintiffs, their lawyers, and even some defendants who could end up paying more to resolve cases.

Part of the problem triggered by the sweeping TCJA dates back to 2005, when the U.S. Supreme Court held, in *Commissioner v. Banks*,<sup>1</sup> 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 the 40 percent (or other amount) of their recovery paid to their attorneys under the contingency fee agreement.

Months before *Banks*, Congress enacted an above-the-line deduction for employment claims and certain 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 the second page of your tax return.

After the TCJA, plaintiffs in employment cases

are still mostly OK, unless those cases involve sexual harassment (more on that below). That is, the above-the-line deduction for legal fees remains in the law. This generally ensures that plaintiffs bringing employment claims are taxed on their net recoveries, not their gross.

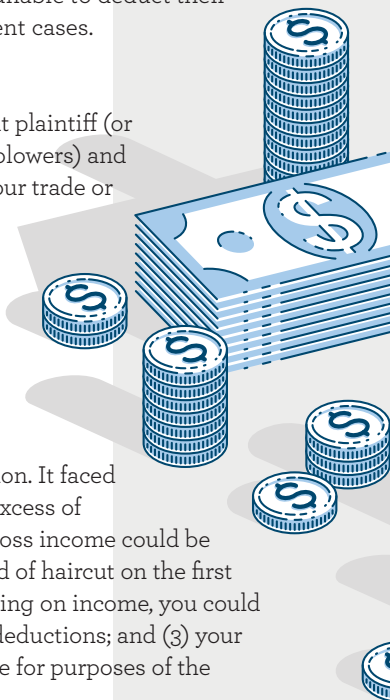
But there are nagging problems even for employment plaintiffs. For example, a plaintiff's above-the-line deduction for fees in employment and qualifying whistleblower cases cannot exceed the income the plaintiff received from the litigation in the same tax year. As long as all the legal fees are paid in the same tax year as the recovery (such 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 the course of several years? There are several possible workarounds, but none are foolproof. Some plaintiffs can end up unable to deduct their legal fees even in employment cases.

## IMPACTED 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 still counted as a deduction. It faced three limits: (1) only fees in excess of 2 percent of your adjusted gross income could be deducted (so there was a kind of haircut on the first part of your fees); (2) depending on income, you could be subject to a phase-out of deductions; and (3) your legal fees were not deductible for purposes of the



## Alternative Minimum Tax (AMT).

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 type of 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 impacted plaintiffs include those whose recoveries are:

- From a website for invasion of privacy or defamation;
- From a stockbroker or financial adviser for bad investment advice unless you can capitalize your fees;
- From your ex-spouse for anything related to your divorce or children;
- From a neighbor for trespassing, encroachment, or anything else;
- From the police for wrongful arrest or imprisonment;
- From anyone for intentional infliction of emotional distress;

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- From your insurance company for bad faith;
- From your tax adviser for bad tax advice;
- From your lawyer for legal malpractice; and
- From a truck driver who injures you if you recover punitive damages.

Conversely, the list of cases where you should not face this double tax is much shorter. For example:

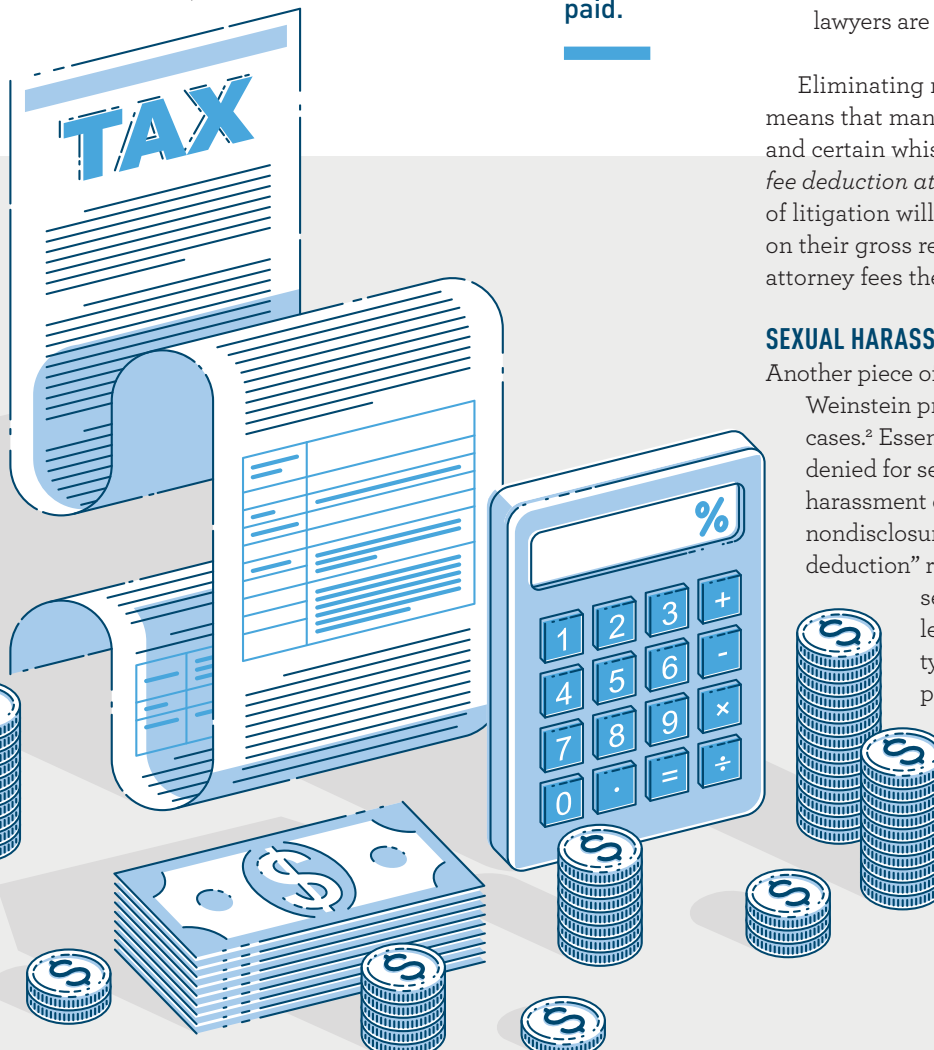
- Your recovery is 100 percent tax-free in a pure physical injury case with no interest and no punitive damages. If the recovery is fully excludable from your income, you cannot deduct attorney fees, but you do not need to;
- Your employment recovery qualifies for the above-the-line deduction (but watch out if it involves a sexual harassment claim);
- Your recovery is in a federal False Claims Act case or IRS whistleblower case, qualifying for the above-the-line deduction;
- Your recovery relates to your trade or business, and you can deduct your legal fees as a business expense; or
- Your recovery comes via a class action, where the lawyers are paid separately under court order.

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

## SEXUAL HARASSMENT

Another piece of the TCJA, known as the Harvey Weinstein provision, addresses sexual harassment cases.<sup>2</sup> Essentially, all tax deductions are now denied for settlement payments in sexual harassment or sex abuse cases if there is a nondisclosure agreement. Notably, this “no-deduction” rule applies to attorney fees as well as 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 settlement agreement that is comprehensive.

Arguably, Congress's intent with the Harvey Weinstein provision 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.<sup>3</sup> If it applies, even legal fees paid by the *plaintiff* in a confidential sexual harassment settlement could be covered.

The provision provides that “No deduction shall be allowed *under this chapter*.”<sup>4</sup> It therefore could disallow the above-the-line deduction for a plaintiff’s employment and qualifying whistleblower claims as well. So far, this evident error has not been corrected. Small allocations to sexual harassment in settlement agreements might be one answer, to preserve the availability of deductions for the other claims. However, it is not clear if the IRS will respect them.

So what to do? For many types of cases involving significant recoveries and significant 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.

#### Separately paid lawyer fees:

Some defendants will agree to pay lawyers and clients separately. But do two checks obviate the income to a plaintiff? According to *Banks*, no. The Form 1099 regulations may not help either. 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.

**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 (aside from the Weinstein provision). But are your activities sufficient to show that you are really in business, and is the lawsuit really related to that business?

Alternatively, could your lawsuit itself be viewed as a business? A plaintiff filing their first Schedule C as a proprietor for a lawsuit recovery probably will not look very 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. But plaintiffs usually lost those tax cases.<sup>5</sup> After all, just suing your employer doesn’t seem like a business. It might be regarded as an investment or income-producing activity (which used to give rise to a below-the-line deduction), but not as a business. And remember, after the 2017 tax reform, investment expenses—whether legal fees or otherwise—do not qualify for a tax deduction.

A plaintiff doing business as a proprietor and regularly filing Schedule C might claim a deduction there for legal fees related to that trade or business.<sup>6</sup> It seems inevitable that we should expect more arguments based on Schedule C from plaintiffs in the future.

**Capital gain 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. Ironically, the new “no-deduction” rule for attorney fees may encourage some plaintiffs to claim that their recoveries are capital gain, just to “deduct” those fees.

**Exceptions to *Banks*:** There will also 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 one might not apply, discussed below.

**Injunctive relief:** Legal fees for injunctive relief may not count as income to the client. The parameters of this exception are not clear, but it may offer a way out on some facts. If there is a big damage award with small injunctive relief, will that remove all the lawyer’s fees from the client’s tax return? This seems unlikely.

**Court-awarded fees:** Court-awarded fees may also 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. If 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 their lawyer.

#### NOTES:

1. 543 U.S. 426 (2005).
2. TCJA, Section 13307.
3. See I.R.C. Section 162(q).
4. TCJA, Section 13307(a)(emphasis added).
5. See, e.g., *Alexander v. Comm’r*, 72 F.3d 938 (1st Cir. 1995).
6. *Id.*

**ROBERT W. WOOD** practices law with Wood LLP and is the author of *Taxation of Damage Awards and Settlement Payments* and other books. He can be reached at wood@WoodLLP.com. This discussion is not intended as legal advice.



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's not clear, but the IRS has an incentive to scrutinize such attempts.

**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 unique 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 due to their lawyer.

## CONCLUSION

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

Few plaintiffs receiving a \$1 million recovery will think it is fair to pay taxes on the full amount, if legal fees have consumed 40 percent of their recovery. For cases with higher contingent fee percentages and costs, the situation will be worse still. It seems even more important now to engage in tax planning before a case is settled. Settlement time for legal disputes could become more stressful in this troubling new tax world. Tax time will be, too. 