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In this article, Wood examines tax issues facing plaintiffs in lemon law and other consumer actions, focusing on how legal fees could be reported and taxed.

This discussion is not intended as legal advice.

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Suppose you are a plaintiff in a lemon law or other consumer lawsuit. You recover $50,000 for your car, either as damages or for the repurchase of a car you hand in. Your lawyer ends up collecting $100,000. Consumer lawyers are often paid separately in those cases, negotiating fees with the manufacturer or fighting about them in court. Not infrequently, the plaintiff lawyers receive more than the client — think of it as a smaller version of the phenomenon in class actions.

In a lemon law case, automakers traditionally paid the $150,000 to the consumer lawyer, and reported the $150,000 to the lawyer. But today, some manufacturers issue Forms 1099 to the lawyer and to the plaintiff, each for $150,000. Plaintiffs might end up losing money after taxes. Welcome to the crazy way legal fees are taxed.

If the plaintiff receives a Form 1099 for $150,000, can't they just deduct the $100,000, so they pay tax only on their net? Not easily, and maybe not at all. Miscellaneous itemized deductions — how most people deducted those fees — were repealed by the Tax Cuts and Jobs Act for tax years 2018 through 2025.[1] They are scheduled to return in 2026. Can lemon law plaintiffs do anything until then?

An above-the-line tax deduction for employment, civil rights, and whistleblower legal fees is still in the law. But if you don't qualify, you can be taxed on 100 percent of the client and the lawyer money. Some defendants know this, so extra care is needed.

Legal Fees Are Income to Clients

In *Banks*,[2] the Supreme Court held that plaintiffs in contingent fee cases generally have income on 100 percent of their recoveries. That is so even if the lawyer is paid directly, and even if the plaintiff receives only a net settlement after legal fees. This harsh tax rule usually means plaintiffs must figure out a way to deduct those fees.

Plaintiffs in employment and civil rights cases can still use the above-the-line deduction for contingent fees. However, even if the plaintiff qualifies, many taxpayers and tax return preparers have trouble with the mechanics of claiming it. If a plaintiff receives a Form 1099, the entire amount of that Form 1099 must be reported on the return. Failing to report it, and to show it prominently on the return, will guarantee a notice from the IRS, usually asking for taxes on the full amount of the Form 1099.

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[1] P.L. 115-97, section 11045 (2017).

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

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Civil Rights Claims

Can lemon law plaintiffs claim the above-the-line deduction? It is not clear. The National Association of Consumer Advocates is supporting a tax bill, the End Double Taxation of Successful Civil Claims Act, introduced by Sen. Catherine Cortez Masto, D-Nev.[3] If passed, it would change the first sentence of section 62(a)(20) to cover *any* civil action. Currently, the above-the-line deduction applies to attorney fees paid on account of claims of "unlawful discrimination."

The definition of unlawful discrimination is a laundry list that includes race, age, gender, and many other types of discrimination.[4] 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 is broad, but there is little authority. In LTR 200550004, 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. So does the plain language of the statute.

The catchall language in section 62(e)(18) also provides for deductions for legal fees to enforce civil rights. What exactly are civil rights, anyway? You might think of civil rights cases as only those brought under section 1983.[5] However, the above-the-line deduction extends to any claim for the enforcement of civil rights under federal, state, local, or common law.[6]

Section 62 does not define civil rights for the purposes of the deduction, and neither do 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*.[7] [Emphasis added.]

Moreover, in another tax context (charitable organizations), the IRS has generally preferred a broad definition of civil rights. In one IRS 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."[8] Could invasion of privacy cases, defamation, debt collection, and other such cases be called civil rights cases? Arguably, yes. Many consumer cases such as lemon law cases might also be viewed in this light.

What about credit reporting cases? Don't those laws arguably implicate civil rights, too? 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[9] exclusion should protect them, making attorney fee deductions irrelevant.

[3] S. 2627, 116th Cong. (2019-2020).

[4] Section 62(e).

[5] 42 U.S.C. section 1983.

[6] *See* section 62(e)(18).

[7] 15 Am. Jur. 2d *Civil Rights* section 1.

[8] GCM 38468 (Aug. 12, 1980).

[9] Section 104(a).

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But 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. The scope of the civil rights category for potential legal fee deductions is well worth a close look.

Client Versus Lawyer Monies

Can consumer plaintiffs keep attorney fees out of their income in the first place? That would be best; the plaintiff would avoid having to deal with a Form 1099, which might vastly exceed their net recovery, and avoid worrying about claiming a tax deduction. In the past, lemon law plaintiffs rarely received Forms 1099. If they did, the forms usually matched the payment they received.

In litigation more generally, defendants usually want to issue a Form 1099 for any payment. And if a payment is going jointly to lawyer and client, defendants generally want to issue duplicate Forms 1099 to lawyer and client. After all, the defendant does not know who is receiving what. However, historically defendants in lemon law cases issued a Form 1099 only to the lawyer.

That was probably correct because the defendant usually did not know whether any of the payment was income to the plaintiff. If a defendant does not know how much of a payment (if any) is income, no Form 1099 is usually required.[10] But there is now intense scrutiny on these issues, with some auto manufacturers insisting on receiving Forms W-9 from plaintiffs.

That squarely raises the question whether all or any of the payments in a typical lemon law case *must* be reported to the plaintiff. Suppose that there are three elements to the recovery: $50,000 repurchase to the plaintiff; $80,000 in damages and penalties split 60/40 between lawyer and client; and $100,000 in separate lodestar fees to the lawyer in which the plaintiff does not share.

Let's suppose that each payment is separately made. Arguably, there should be no Form 1099 for the $50,000 repurchase. After all, the defendant cannot know the actual gain (if any) to the plaintiff.

What about the $80,000 paid by joint check? Unless the statutory fee issue changes it, this one falls under the general rule of *Banks*, gross income to the client, even if the client only receives 60 percent ($48,000). The plaintiff probably will receive a Form 1099 for the $80,000 even if the settlement agreement calls for the $80,000 to be divided into two checks, $48,000 to client and $32,000 to lawyer.

What about the reporting of the separate $100,000 paid to the lawyer in which the client does not share? This arguably could be either a court-awarded or a statutory fee, either one arguably being outside *Banks*. 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. Some defendants will agree to pay the lawyer and client separately.

In the real world, of course, a plaintiff may still bargain for no Form 1099, or a Form 1099 only on his net. And a defendant might agree to issue a Form 1099 to the plaintiff for only the net payment. In that case, a consumer plaintiff may feel comfortable reporting only the net, despite *Banks*.

Court-Awarded Fees

Although the *Banks* court mentioned that court-awarded fees should be different, there is not much guidance. The fee agreement seems key. 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. After a verdict, if the court separately awards another $300,000 to the lawyer alone, that presumably should not have to go on the plaintiff's tax return.

What if the court order says the plaintiff gets the fees? What if there is no court award, but the settlement agreement states that the fees are being paid by the defendant in lieu of court-awarded

[10] *See* reg. section 1.6041-1(f) ("The amount to be reported as paid to a payee is the amount includible in the gross income of the payee."); LTR 200442023 ("As used in Section 6041, 'gains, profits and income' means gross income, not the gross amount paid."); instructions to 2019 IRS Form 1099-MISC, at 6 ("However, do not report damages (other than punitive damages) . . . that are for a replacement of capital, such as damages paid to a buyer by a contractor who failed to complete construction of a building.").

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fees? These are good questions, and tax advisers might disagree about their answers.

Statutory Attorney Fees

If a statute provides for attorney fees, can this be income to the lawyer only, bypassing the client? Arguably yes, 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. But in statutory fee cases, the fees are not 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 the statutory fees were not awarded, the plaintiff may not be obligated to pay any additional amount to his attorney. Thus, some attorneys seem to assume that if a statute calls for attorney fees, the general rule of *Banks* can never apply. Arguably, more may be needed.

After all, 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 one of principal and agent. The fee agreement and the settlement agreement should probably specifically address the payment of statutory fees. The best case for avoiding income to the client would be if those fees go entirely to the lawyer, and if the fee agreement makes clear that the client has no right or obligation to pay fees.

The IRS has informally asserted that fees awarded to a prevailing plaintiff under federal and state fee-shifting statutes belong to the plaintiff and not the lawyer.[11] Some courts have seemingly agreed with the IRS's position.[12] But that does not mean that all cases involving fee-shifting awards are the same and therefore should result in the same conclusion. For example, the IRS has indicated in LTR 201015016 and LTR 201552001 that attorney awards under fee-shifting statutes were not taxable to the plaintiffs because neither had an obligation to pay for legal fees. Thus, each case must be analyzed on its own facts and circumstances.

Legal Fees as Business Expenses

Some consumer cases relate to a consumer's trade or business, which can provide another tax hook. Business expense deductions were largely unaffected by the 2017 tax changes, other than the Weinstein provision restricting deductions in confidential sexual harassment cases.[13] In a corporation, limited liability company, partnership, or sole proprietorship, business expenses are above-the-line deductions.

However, are your activities sufficient that you are really in business, and is the lawsuit really related to that business? If you can answer yes to both of these 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.

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 these tax cases.[14] Some plaintiffs may push the envelope about what is a trade or business, and how their lawsuit is inextricably connected to it. Of course, Schedule C is historically more likely to be audited, and draws self-employment taxes, too.

Capital Gain

If your recovery is capital gain, you can capitalize your legal fees and offset them against your recovery, or you might regard the legal fees as a selling expense to produce the income.[15] Either theory should result in you not having to

[11] PMTA 2009-035.

[12] *See, e.g.*, *Green v. Commissioner*, 312 F. App'x 929 (9th Cir. 2009), *aff'g in part*, *rem'g in part* T.C. Memo. 2007-39; and *Vincent v. Commissioner*, T.C. Memo. 2005-95.

[13] *See* TCJA section 13307; *see also* Robert W. Wood, "Taxing Sexual Harassment Settlements and Legal Fees in a New Era," *Tax Notes*, Jan. 22, 2018, p. 545.

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

[15] *Dye v. United States*, 121 F.3d 1399, 1405 (10th Cir. 1997); *Woodward v. Commissioner*, 397 U.S. 572, 576 (1970); and *Spangler v. Commissioner*, 323 F.2d 913, 919 (9th Cir. 1963).

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pay tax on your attorney fees. For some lemon law plaintiffs, this might be helpful.

However, if you turn in a car you purchased for $50,000 and get your $50,000 back, receiving a Form 1099 saying that you have $150,000 of income would be upsetting. Many plaintiffs, perhaps most of them, will not know how to address such issues on their tax returns. Even many tax professionals will not.

Conclusion

Since the TCJA, many litigants and their lawyers are surprised and outraged at the possibility that they may not be able to deduct legal fees. Some argue that the whole thing is unconstitutional. After all, they quip, how could the same money be taxed to a plaintiff and to a lawyer! Of course, our tax system is filled with similar examples.

Before the enactment of the above-the-line deduction in 2004, there were a few cases in which plaintiffs actually lost money after tax when the old miscellaneous deduction and alternative minimum tax rules were taken into account.[16] Perhaps there will be cases today that are even worse. Entirely disallowed legal fee deductions are less likely to be easily endured, especially when a very small net recovery is overshadowed by very large legal fees that are taxable.

Lemon law and other consumer cases are perfect examples, and negotiations over the tax language and reporting can become heated. Some plaintiffs will get what they want regarding Forms 1099, but some may have to be dogged in making sure their tax returns are carefully vetted. Understandably, they want to avoid paying taxes on money they did not get to keep, and may never have seen.

Some plaintiffs may be blindsided and may end up in tax disputes over these issues. We are likely to see many of these as tax audits and disputes involving 2018 and subsequent tax returns start to percolate through the system. Some of them won't be pretty. ■

[16] *See 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 (Dec. 31, 2002); *see also* Adam Liptak, "Tax Bill Exceeds Award to Officer in Sex Bias Case," *The New York Times*, Aug. 11, 2002, section 1, at 18.

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