

New Tax Law's Plaintiff Tax: No Deduction For Legal Fees

By Robert W. Wood

Many plaintiffs will face higher taxes on their lawsuit settlements under the recently passed tax reform law. Some will be taxed on their gross recoveries, with no deduction for their attorney fees, even if their lawyer takes 40 percent off the top. In a \$100,000 case, it can mean paying tax on \$100,000, even if \$40,000 goes to their lawyer.

The new law should generally not impact qualified personal physical injury cases, where the entire recovery is tax free. It also should generally not impact plaintiffs who bring claims against their employers. They are still allowed an above-the-line deduction for their legal fees (although there are new wrinkles in sexual harassment cases).

However, for many other types of claims, if you cannot find a way to position your claim as a trade or business expense, or to capitalize your legal fees into the tax basis of a damaged asset, you get no deduction for legal fees or costs. That means you are taxed on 100 percent of your recovery.

Examples of settlements that may face tax on 100 percent include recoveries:

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

In fact, the list of lawsuits where this will be a problem seems almost endless. The new tax law wiped away miscellaneous itemized deductions, and deductions for investment expenses (they return as deductions in 2026). But part of the tax problem is historical.

In 2005, the U.S. Supreme Court held that plaintiffs in contingent fee cases must generally recognize gross income equal to 100 percent of their recoveries. See *Commissioner v. Banks*, 543 U.S. 426 (2005). That means plaintiffs must figure out a way to deduct the fees paid to their lawyers. Fortunately, at about the same time, 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. For employment and some whistleblower claims, this deduction remains in the law, so those claimants will pay tax only on their net recoveries. Yet plaintiffs in employment claims that involve sexual harassment face new tax problems.

The new law denies tax deductions for legal fees and settlement payments in sexual harassment or abuse cases, if there is a nondisclosure agreement. Of course, virtually all settlement agreements include confidentiality/nondisclosure provisions. As worded, even legal fees paid by the plaintiff in a confidential sexual harassment settlement could be covered. Congress probably

intended only to deny defendant tax deductions, but it remains to be seen how this new law will be interpreted.

Up until now, if you could not deduct your legal fees above the line, at least you could deduct them below the line. A below-the-line (or miscellaneous itemized) deduction was more limited, but it was still a deduction. Now, there is no below the line deduction for legal fees (until 2026).

Do two checks (one to lawyer, one to plaintiff) obviate the income to plaintiff? Not according to *Banks*. 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.

One possible way of deducting legal fees could be a business expense if the plaintiff is in business, and the lawsuit relates to it. Some may claim that the lawsuit itself is a business. Some plaintiffs in tax cases have argued that their lawsuits amounted to business ventures, so they could deduct legal fees. Plaintiffs usually lost.

Suing someone might be regarded as income producing activity, but not a business itself. And remember, after tax reform, investment expenses—whether legal fees or otherwise—do not qualify for a tax deduction.

There will also be new efforts to explore potential 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 some in which this general 100 percent gross income rule might not apply.

For example, court awarded fees could provide relief, depending on how the award is made, and the nature of the fee agreement. Statutory fees are another potential battle ground. How about a partnership of lawyer and client?

If a fee agreement says it is a 60/40 partnership, can't that partnership report 60/40? Ethics rules may say that lawyers are not supposed to be partners with their clients, but it is not clear if this prohibits a tax partnership. One factor in how such partnerships will fare with the IRS will be documentation and consistency. A partnership tax return with K-1s to lawyer and client might be hard for the IRS to ignore.

For many types of cases, the lack of tax deductions for legal fees will come as a bizarre and unpleasant surprise. We should expect plaintiffs to aggressively try to avoid sidestep having to take the legal fees their lawyers receive as gross income in the first place. Plaintiffs who are stuck with the gross income may go to new lengths to try to somehow deduct or offset the fees.

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

Add higher contingent fees and high case costs, and the tax problem may get even worse. Contingent fee lawyers can be expected to try to help plaintiffs where they can. But how this tax mess will resolve in each case could be terribly important to plaintiff's after-tax recovery.

Robert W. Wood is a tax lawyer with www.WoodLLP.com, and the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This is not legal advice.