PERSPECTIVE

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Plaintiff Legal Fee Deductions Under 'Beautiful' Tax Law

By Robert W. Wood

Most plaintiffs in lawsuits pay their lawyer a contingent fee. If the case settles for $1,000,000, the lawyer is paid a percentage, say 40%. 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 $600,000, the amount they receive.

However, under *Commissioner v. Banks* (543 U.S. 426 (2005)),plaintiffs in contingent fee cases generally must report gross income on all the proceeds, even if the lawyer is paid directly. 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% of the settlement. Some defendants will agree to pay the lawyer and client separately. However, that does not obviate the income to the plaintiff, as the Supreme Court in *Banks* made clear.

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 needs an available tax deduction for the legal fees if their recovery is taxable as ordinary income (including wages), so they pay tax only on the 60% they collect.

From 2018 through 2025, the tax law suspended miscellaneous itemized deductions, which was how many plaintiffs historically deducted legal fees. The One Big Beautiful Bill Act made that suspension permanent, so you can no longer deduct legal fees as miscellaneous itemized deductions. Is the elimination of miscellaneous itemized deductions a huge blow for plaintiffs? It might seem to be but 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 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. The stakes grew larger in 2018 and continue today, but I believe there are still ways for most plaintiffs to claim viable tax deductions despite the elimination of miscellaneous itemized deductions. It has long been the rule that legal fees in cases involving a taxpayer's trade or business or involving a taxpayer's efforts to produce rental or royalty income can qualify as an above-the-line deduction.

Moreover, 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. Congress expanded it over the years, and the IRS has made claiming it simpler. 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. 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 you need to document it. 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," 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," But the statutory definition of an unlawful discrimination claim is a veritable kitchen sink of federal laws. Besides, there is *also* an expansive catcall 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:

"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."

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. The deduction applies to *any* claim for the enforcement of civil rights under federal, state, local or common law. 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*" (15 Am. Jur. 2d *Civil Rights* § 1).

The IRS has used a very broad definition for civil rights in other contexts. 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.

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% 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 100% 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 workarounds for plaintiffs that are often viable 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 can 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 (*See Alexander v. Comm'r*, 72 F.3d 938 (1st Cir. 1995)). 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.

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% 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. 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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