

Tax Rules for Plaintiffs: When Legal Fees Can and Can't Be Deducted

By Robert W. Wood

Paying legal fees is a classic business expense for anyone in business. Lawyers and businesses of all shapes and sizes have relied on this basic tax rule for generations. But what about legal fees in other contexts? If you hire a lawyer to write a will and trust, the expense is not tax deductible.

Similarly, if you hire a lawyer to sue your neighbor over a tree that blocks your view, you cannot deduct the expense. However, you may be able to capitalize it into the basis of your home, rather like a kitchen remodel. There are many circumstances in which legal fees and taxes are considered together, and that is especially true with legal settlements.

Many plaintiffs in lawsuits worry that they will be taxed on their *gross* lawsuit settlement—including the portion of the settlement paid to their contingent fee lawyer-- not on their net settlement *after* legal fees. The current situation started in 2018, when the tax law was changed to eliminate miscellaneous itemized deductions through the end of 2025. The recently passed Big Beautiful Bill made that elimination permanent.

Miscellaneous itemized deductions were never the optimal way of deducting fees, since they faced various limitations, phase-outs, and alternative minimum tax. But they did provide a kind of universal legal fee deduction when something better was not available. As a result, since 2018, there has been more concern to make sure a tax deduction for fees is available.

Fortunately, if you are a plaintiff with a contingent fee lawyer, there are still ways to deduct your legal fees. The deduction for legal fees in employment, whistleblower and civil rights cases has been in the tax code since 2004, allowing legal fee deductions "above the line," almost like not having the income in the first place.

How are legal fees income to plaintiffs, and why would they worry about deducting legal fees? Most plaintiffs would rather have the lawyer paid separately and avoid the need for the deduction. Unfortunately, it is not that simple. If the lawyer is entitled to 40 percent, the plaintiff generally will receive only the net recovery after the 40 percent fee. Most plaintiffs assume that the biggest tax they could face would be tax on their *net* recoveries.

But under a U.S. Supreme Court tax cases, *Commissioner v. Banks*, 543 U.S. 426 (2005), plaintiffs in contingent fee cases must generally include *100 percent* in income, even if the lawyer is paid directly, and even if the plaintiff receives only a net settlement. It's just one of many odd rules how legal settlements are taxed. This harsh tax rule usually means plaintiffs must figure a way to *deduct* their 40 percent fee. Fortunately, in 2004, shortly before *Banks* was decided, Congress enacted an above the line deduction for employment claims, civil rights claims, and certain whistleblower claims."

That means plaintiffs claiming a deduction are taxed on their net, not their gross. The deduction covers employment, civil rights, and whistleblower claims. For employment claims, the tax code confusingly says the deduction applies to attorney fees in claims of "unlawful discrimination." The definition of what is a claim of unlawful discrimination refers to claims under a long list of laws, including the Civil Rights Act of 1964, ERISA, ADA, ADEA, Title VII, Title IX, NLRA, FLSA, WARN, FMLA, 1983, 1981, and any whistleblower protection or civil rights law.

Yet after quite a long list of laws, the tax code adds a catchall that swallows up much more:

"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." IRC section 62(e)(18).

This catchall *also* covers legal fees to enforce civil rights. You might think of civil rights cases as only those brought under section 1983. But the deduction extends to *any* claim for the enforcement of civil rights under federal, state, local or common law.

The tax code does not define "civil rights," nor does the legislative history or committee reports. But some authorities suggest they are quite broad, that a civil right is a legally enforceable claim of one person against another. In the context of charitable organizations, the IRS even said that, "We believe that the scope of the term 'human and *civil* rights secured by law' should be construed *quite broadly*."

It is not a stretch to suggest that privacy cases, defamation, debt collection and other such cases are civil rights cases. What about credit reporting cases? Those laws arguably implicate civil rights as well. Wrongful death, wrongful birth, or wrongful life cases can likely be brought within the broad scope of civil rights for this purpose to make sure plaintiffs don't pay tax on their legal fees. Of course, if all damages in any of these cases are compensatory damages for personal physical injuries, then the section 104 exclusion should protect them, making attorney fee deductions irrelevant.

However, if plaintiffs receive *punitive* damages, or interest as occurs when a judgement is paid, they need a way to deduct their legal fees. Fortunately, in my view, a defensible tax path often exists to deduct the fees. I believe it is defensible to characterize it as a *civil rights case*, 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.

And so far, my IRS audit experience on this issue has been positive, too. 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. Even so, 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.

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