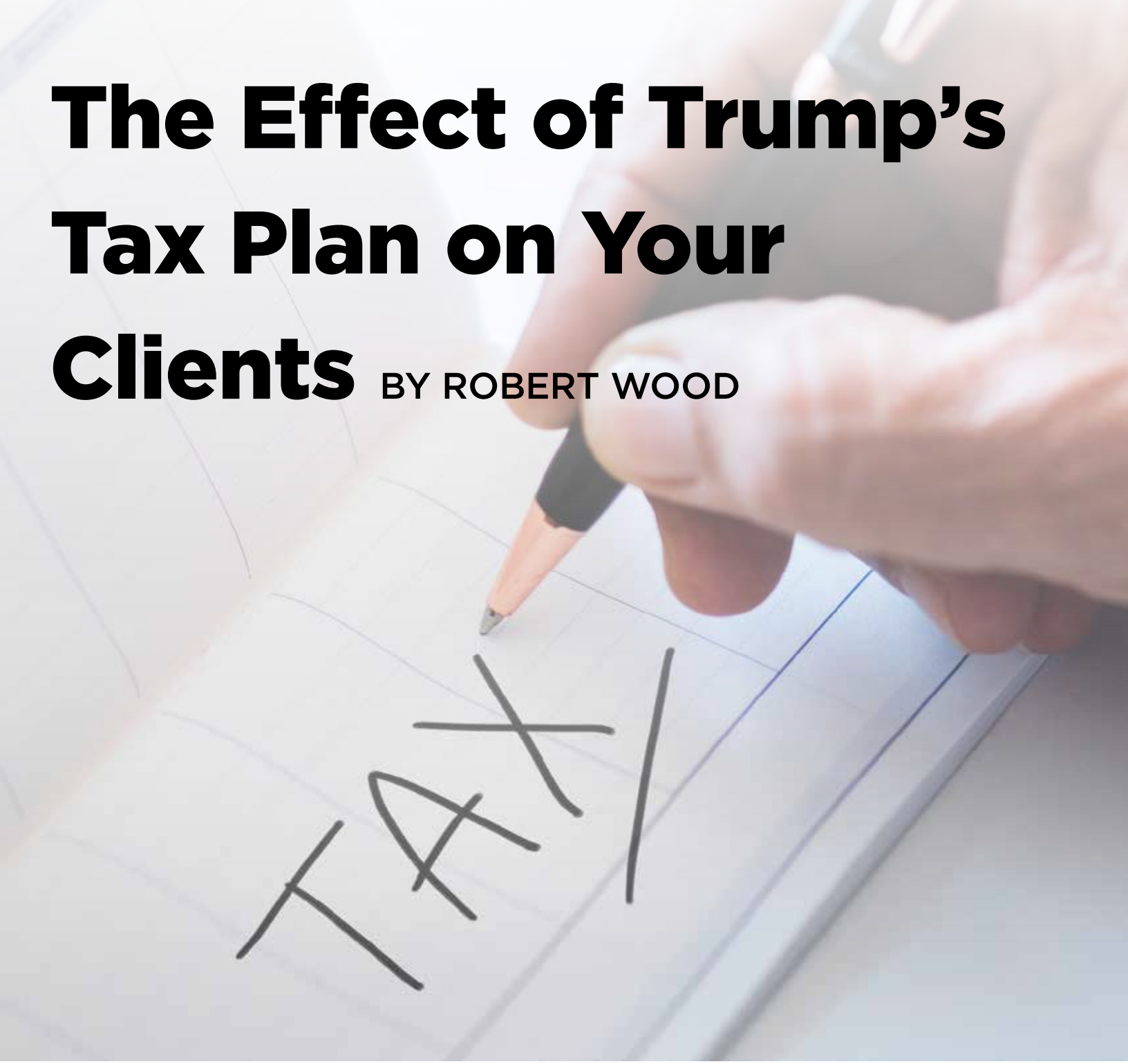
The Effect of Trump's Tax Plan on Your Clients

BY ROBERT WOOD



Many plaintiffs face higher taxes under Trump's recently passed tax reform law. Some plaintiffs will now pay tax on their gross recoveries, with no deduction for attorney fees. In a $100,000 case, it means paying tax on $100,000, even if $40,000 goes to the plaintiff's lawyer.

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). Even if the contingent fee lawyer takes 40% off the top, the plaintiff has that income even if he owes his lawyer 40%. That means plaintiffs must figure out a way to deduct the fees paid to their lawyers.

Fortunately, a few months before the Supreme Court's *Banks* case, 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 the new statute is worded, even legal fees paid by the *plaintiff* in a confidential sexual harassment settlement could be covered. That could mean that plaintiffs in sexual harassment cases might have to pay tax on 100% of their recoveries, with no deduction for their legal fees. Presumably, Congress's intent was only to limit the defendant's tax deductions for settlement payments and related legal fees.

However, it remains to be seen how this new law will be interpreted, or whether its language may be corrected.

What about plaintiffs who do not qualify for the above the line deduction of legal fees? If you are not an employment plaintiff (or a qualified whistleblower) 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 it was still a deduction. It faced three limits: (1) only fees in excess of 2 percent of your adjusted gross income could be deducted; (2) higher incomes faced a phase-out of deductions; and (3) your legal fees were not deductible for purposes of alternative minimum tax (AMT). Under the new law, 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. That means you are taxed on 100 percent of your recovery. Examples of impacted plaintiffs 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.

The list of lawsuits where this will be a problem is almost endless. Conversely, the list of cases where you should not face this double tax is much shorter:

1. Your recovery is 100 percent tax free, for example, 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;
2. Your employment recovery qualifies for the above the line deduction (but watch out if it involves a sex harassment claim);
3. Your recovery is in a federal False Claims Act case or IRS whistleblower case, qualifying for the above the line deduction;
4. Your recovery relates to your trade or business, and you can deduct your legal fees as a business expense; or
5. Your recovery comes via a class action, where the lawyers are paid separately under court order.

Plaintiffs and their lawyers may look for work-arounds. Some defendants will agree to pay lawyer and client separately. Do two checks obviate the income to plaintiff? According to the Supreme Court in *Banks*, not hardly. And the IRS Form 1099 regulations do not help either.

The IRS regulations generally require defendants to issue a Form 1099 to the plaintiff for 100% of a settlement. This is so even if part of the money is paid to the plaintiff's lawyer. However, some taxpayers may still try to report only their net settlements on their taxes.

One possible way of deducting legal fees could be as a *business* expense. But are the plaintiff's activities sufficient to really be in business, and is the lawsuit really related to that business? In many cases, the answer may be no. Alternatively, could the lawsuit *itself* be viewed as a business?

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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. Plaintiffs usually lost these tax cases. Some of it may depend on the optics. A plaintiff filing his first proprietorship tax schedule (Schedule C to Form 1040) for a lawsuit recovery probably will not look very convincing.

After all, just suing your employer doesn't seem like a business. It might be regarded as investment or income producing activity, but not a business. And remember, after tax reform, investment expenses—whether legal fees or otherwise—no longer qualify for a tax deduction.

However, a plaintiff doing business as a proprietor and regularly filing Schedule C might claim a deduction there for legal fees related to the trade or business. We should expect more arguments based on Schedule C from plaintiffs in the future. There will also be new efforts to explore potential exceptions to the Supreme Court's 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 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? Some lawyers will note that ethical rules suggest that lawyers are not supposed to be partners with their clients.

Yet, tax law is unique, and it is not clear that ethics rules will control the tax treatment of this kind of tax arrangement. One factor in how such partnerships will fare with the IRS will be documentation and consistency. A partnership tax return with Forms K-1 distributed to lawyer and client on each of their shares might be hard for the IRS to ignore.

Conclusion

For many types of cases involving significant recoveries and significant attorney fees, the lack of tax deductions for legal fees may be catastrophic. We should expect plaintiffs to aggressively try to sidestep receiving gross income on their legal fees in the first place. For plaintiffs who are stuck with the gross income, we should expect some to 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 if they have to pay taxes on 100% of their recoveries, when legal fees have consumed a third or more.

Multiply the figures into bigger numbers, and the situation may seem even worse. Add higher contingent fees and high case costs, and the taxes may get worse still. Contingent fee lawyers can be expected to try to help plaintiffs out of this tax trap where they can. But how this tax mess will resolve in each case could be terribly important to plaintiff's after-tax recovery. TL