

## Can Employment Plaintiffs Deduct Legal Fees Paid in Prior Years?

by Robert W. Wood



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In this article, Wood examines the uncertainty surrounding whether plaintiffs in employment cases can deduct legal fees paid in prior years.

This discussion is not legal advice.

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Can you ever be taxed on more money than you receive? To anyone but a tax lawyer it sounds like a crazy question, something that anyone on the street could answer. Surely the answer would have to be no. Suppose that you collect \$1,000 but it costs you \$400 in commission or fees to collect it. The most you have to pay would be taxes on the \$600 you got to keep, right?

Ideally you could just report your net income of \$600. But even if you had to report the gross income of \$1,000, you can surely deduct the \$400 as an expense. Under traditional tax principles for many decades, you might even have a choice of deductions. If you were in business, the \$400 was likely a trade or business expense.

Even if you were not in business, the \$400 was surely an expense for the production of income. The standards were low for claiming those deductions. All you really had to show was that you somehow made \$1,000, whether you intended

to or not, even if it was a complete windfall. If the \$400 in expenses was somehow connected to getting paid, *voila*, you could deduct it.

It is true that those deductions faced various limitations. There was a 2 percent income threshold, and there were phaseouts if your income was too high. Finally, hardest to explain was the alternative minimum tax, which could whittle down your deduction if you had too many deductions of a specific kind. Still, even with all these technical rules, in rough justice, you could claim a deduction for the expense.

Thus, in most cases you could say you were really not being taxed on more money than you received. Critically, however, this type of deduction was a miscellaneous itemized deduction. Taxpayers are disallowed from claiming these deductions in any tax year from 2018 through 2025 courtesy of the Tax Cuts and Jobs Act and section 67(g). Thus, many plaintiffs who would otherwise have deducted their fees under this provision are now looking elsewhere for an equitable result.

For plaintiffs in some types of lawsuits, there is a kind of hybrid deduction for some types of legal expenses. You get something akin to the better trade or business deduction, even though you are not in a trade or business. These so-called above-the-line deductions are essentially a complete offset against income and not subject to the limitations of the investment expense deductions.

And that is where our story begins. Suppose that you are a plaintiff in an employment lawsuit. Employment cases still qualify for this gold-plated above-the-line deduction. As a result, everyone — plaintiffs, lawyers, and even defendants — seems to assume that there is never a tax problem. That is, if the case settles for \$1 million with a 40 percent

fee, the most the plaintiff could be taxed on is \$600,000.

It's true that some lawyers, even some tax lawyers, argue about whether the employment matter must really involve some type of discrimination to qualify for this deduction, as opposed to, say, a simple employment contract dispute. I believe it is clear, however, that *any* employment case qualifies for the deduction. I will try to lay that debate to rest in a future article. For now, I want to focus on timing issues. Does it matter when the legal fees are paid?

### Gross Versus Net Settlements

Let's assume that your lawyer charges you 40 percent, \$400,000. For ease of reference, we will ignore costs, although there are always some, for depositions, travel, filing fees, FedEx, and so on. Most lawyers take the costs out of the client's share, although some take the costs off the \$1 million top before applying the 60/40 split.

Any way you slice it, though, even if you think you are getting \$600,000, it will probably be less. Normally, if you are the plaintiff, you don't even see the \$400,000. Usually when the money hits your bank account, your lawyer has already deducted the costs and his legal fees. Most plaintiffs' lawyers are uncomfortable having the client collect the full \$1 million and then writing the lawyer a check for \$400,000.

For tax purposes, what does the IRS say happened when the lawyer receives the gross settlement proceeds and deducts the legal fees and costs? The IRS — with the backing of the Supreme Court<sup>1</sup> — says that the plaintiff received the *full* \$1 million. Most plaintiffs know instinctively that they can just deduct the fees. It all happens in one year so what's the harm? However, what if you have been paying your lawyer hourly for a few years?

### Hourly Fees

Just to make the math easy, let's say that you actually paid out \$400,000 in legal fees during the two years before the settlement. The good news, of course, is that you do not owe additional legal fees because you have already paid them. But can

you claim the same above-the-line deduction for your legal fees as the plaintiff who uses a contingent fee lawyer? No, not really. The problem is timing.

Section 62(a)(20) provides for the above-the-line deduction for legal fees in employment, discrimination, and civil rights litigation. But there is a dollar limit. The section provides that the deduction "shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement . . . resulting from such claim." (Emphasis added.)

As a result, a plaintiff's above-the-line deduction is capped by the amount of income they receive from the same litigation in the same tax year. Thus, if you paid legal fees in 2018 for a recovery that did not settle until 2020, you cannot deduct the fees above the line when you paid them in 2018. Surely, you could save them up, carry them forward, and deduct them when you settle?

No, there is no provision in section 62(a)(20) to allow you to roll over or carry forward disallowed section 62(a)(20) deductions into the future year when you finally receive your recovery. Somehow capitalizing the fees seems logical, but the wording suggests that a disallowed section 62(a)(20) deduction is disallowed indefinitely.

If you pay hourly and you pay all the legal fees in the same year as your recovery, the deduction is still available and works fine. Those all-in-one-year hourly fees are treated in the same way as contingent fees, and the deduction works fine. But if — as is vastly more likely — you were paying hourly legal fees for a year, two years, or three, what then?

First let's consider the possibility that you deducted the legal fees in the past. Tax deduction rules for legal fees changed in a big way starting in 2018. For 2017 you could have deducted legal fees for the production of income as miscellaneous itemized deductions. If you did, you claimed a tax benefit, and you cannot expect to get any tax benefit out of them later. However, let's assume that you did not deduct the fees in 2017, and you could not in 2018.

Suppose that you paid legal fees of \$50,000 in 2018, \$50,000 in 2019, and another \$50,000 in 2020, when many legal-fee deductions were suspended

<sup>1</sup>*Commissioner v. Banks*, 543 U.S. 426, 430 (2005).

under section 67(g). You settle your case for \$600,000 in 2020.

You can clearly deduct the \$50,000 of fees you paid in 2020 because they occur in the same tax year as your recovery, and they are obviously less than the \$600,000 of gross income you are recognizing. But how about the \$100,000 you paid in the past? There is no easy path. Because you could not deduct either of those \$50,000 amounts when you paid them, can't you claim them in 2020?

Understandably, many people may want to argue that you sort of "capitalized" them, holding them like you would if they were fees relating to a capital transaction. This doesn't seem abusive, but the tax code appears to say no. You must pay the fees in the same year as your recovery. You aren't claiming a double tax benefit.

In fact, you are just trying to save up your previously paid fees and deduct them when you have the offsetting income from settling your case. In effect, you want to capitalize them and hold them to deduct later when your case resolves. However, the language of section 62(a)(20) suggests that you actually must pay the fees in the year you settle to be able to deduct them.

### Refund, Then Repay?

What if your lawyer repays you the fees you paid in the past, and then you pay your lawyer again? This may sound flaky, but some plaintiffs' lawyers may do this as a way to at least give their client an argument. The flow of funds might work something like this: Lawyer and client amend their fee agreement to call for a kind of hybrid fee arrangement. The amendment is signed now, but probably says it is clarifying their original fee agreement, effective as of the date of the original agreement.

As amended, it calls for hourly fees converting to contingent fees, which just happens to work out mathematically the way the hourly fees did. As part of the amendment, the lawyer agrees to rebate the \$100,000 paid in the past and to charge all fees at settlement time, a total of \$150,000. Based on the amendment, the lawyer hands back a check for \$100,000 to the client. Then, when the case settles, the attorney retains all \$150,000 from the settlement payment, like a plain vanilla contingent fee.

On the surface, the client has "paid" the full amount in 2020, right? So shouldn't that offset the \$600,000 settlement, leaving the net taxable at about \$450,000? There is certainly an argument, and given the not-very-good choices in this dilemma, perhaps it is the best the client can do. Properly documented, and not missing any of the steps or formality, the client might even have a decent case.

The client in some sense did pay the fees in 2020, so might feel good claiming the above-the-line deduction. Even in an audit, the client might be able to show the settlement document and even show the 2020 legal fee payment. If the IRS asks for more, of course, the argument may not look so appealing.

Indeed, if you think too hard about both sides of the transaction, you might be more skeptical. After all, it is a circular transaction that is fairly transparent in its motive and intended effect. It can be artfully or clumsily documented, but even in a good version, it is unlikely to be perfect. Besides, what about the lawyer?

The lawyer surely took the fees into income when they were actually paid in past years. Thus, on the lawyer's side of the ledger, the lawyer is probably not going to be amending his tax return and reversing that out. Deducting the \$100,000 payment as a business refund may also be unpopular. For the lawyer, it is just a kind of check-swapping in the year of the settlement to accommodate the plaintiff and a seemingly unfair tax result.

That does not necessarily mean the plan is doomed to fail, but it isn't exactly a strong tax position either. This treatment also assumes that the refund or rebate of the \$100,000 to the plaintiff is a tax nothing, merely a tax-free refund that is not an accession to wealth by the plaintiff. However, the IRS view of rescission is that all events must occur in the same tax year to be effective.<sup>2</sup>

That arguably is not happening here, when the original contract and the steps to unwind it occur in different tax years. A modification of the fee agreement and rebate to the plaintiff seems pretty innocuous, but it might not negate the

<sup>2</sup> See Rev. Rul. 80-58, 1980-1 C.B. 181.

original fee agreement and the previous payments by the plaintiff. Is there a downside to this exercise for a plaintiff who otherwise has no way to deduct the fees? Well, it seems hard to see it as fraudulent, and in that sense, perhaps there is no downside to giving it a try. If equity matters, many plaintiffs might believe that there is little more inequitable than paying tax on a gross recovery with no deduction for legal fees.

### Above-the-Line Deduction

The above-the-line deduction for legal fees has been in the law since 2004, and it has not been controversial. The law seems clear (at least through the end of 2017, a point noted later), and many such deductions are claimed. Yet taxpayers and even CPAs can have trouble with the mechanics of claiming the deduction, which is more than a little quirky. There is that odd unlawful discrimination claim write-in for line 22 of Schedule 1.

At least that is the placement for 2019. The IRS has been reorganizing Form 1040 over the last several years, which has resulted in the place for claiming the above-the-line deduction changing for each of the last two years. It is currently line 22 of Schedule 1. In 2018 it was line 36 of Schedule 1, and for years before that it was line 36 of Form 1040 itself.

Hopefully, the place for the deduction has finally found a home, but we will not know about 2020 until the 2020 Form 1040 and Schedule 1 are published. There really ought to be a better place for this important deduction. There is not really a proper line for claiming it, and the unlawful discrimination claim write-in causes no end of problems for accounting software.

Some plaintiffs end up filing their tax returns on paper rather than electronically because of those glitches. It is frustrating, particularly because it has been that same strange reporting since 2004, and yet the audit activity appears to be extremely low. Despite seeing very large numbers of employment case legal-fee deductions claimed every year since 2004, I have personally seen almost no audits or even IRS queries on the legal-fee issue. One wonders if that will change with the TCJA elimination of miscellaneous itemized

deductions. It seems likely that an expanded reading of the above-the-line deduction may have caused many more such deductions to be claimed on 2018 and 2019 tax returns.<sup>3</sup>

Concerning the paucity of audits of legal-fee deductions I have experienced, I should be quick to point out that the vast, vast majority of these deductions have involved no timing issues, and they have been straight employment cases, or whistleblower cases in which the deduction clearly applies. The deduction works as it is supposed to in contingent fee cases. The money comes in in one year, and the legal fees are paid at the same time.

### Rebate Reporting?

I have seen only a very few taxpayers try the rebate procedure described here as a way of attempting to leverage previously paid (but not deducted) legal fees into the current tax year. Of course, no tax practitioner can give tax advice based on audit rates. But clients all think about this, perhaps every taxpayer does. And the lack of audit activity on employment case legal fees might still hold some allure in the back of taxpayers' minds.

Tax lawyers cannot say "go ahead and claim this, as audit rates are low." Indeed, Treasury actually has rules on this. Tax advisers must determine that there is at least a reasonable basis for a tax position before telling the client that he can try claiming the deduction. There is no precise percentage or set of odds to say what reasonable basis means.

Some say a reasonable basis might be as high as a 1 in 3 chance of success. However, most people (including the American Institute of CPAs) seem to peg a reasonable basis at about 20 percent, or a 1 in 5 chance of success. Put differently, you might be able to claim something even if the IRS is likely to win 80 percent of the time. Of course, bear in mind that these percentages are assuming that there is actually an audit so the tax position is actually examined. You cannot take audit rates into account in reaching these percentage figures.

<sup>3</sup> See Robert W. Wood, "Civil Rights Fee Deduction Cuts Tax on Settlements," *Tax Notes Federal*, Mar. 2, 2020, p. 1481. See also Wood, "12 Ways to Deduct Legal Fees Under New Tax Laws," *Tax Notes Federal*, Oct. 7, 2019, p. 111.

So how does our circular repayment-payment of legal fees stand up to this test, assuming it is well documented? There is no direct authority on the legal-fee issue of which I am aware. But the IRS could certainly trot out a number of cases and tax doctrines regarding circular transactions that the IRS might label as a sham. We will see whether this is ever tested.

In the meantime, it would certainly be nice to have an easy way to deduct legal fees in all cases. A pending bill, the End Double Taxation of Successful Consumer Claims Act (S. 3913), would expand the above-the-line deduction for legal fees to any civil case. But even it would not address the timing question. ■

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