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THE TAX LAWYER

TAXES 02/17/22

## How To Write Off Legal Fees On Your Taxes

Since 2018, it's been tougher to deduct legal fees, and some plaintiffs in contingent fee cases are taxed on their gross recoveries, not net after legal fees. Some call it a [new tax on legal settlements](#). Being creative is needed in this new age, since sometimes the rules seem to say you shouldn't be deducting them at all. Checklists of [ways to deduct legal fees](#) can help. Fortunately, though, the *mechanics* of deducting legal fees in employment, whistleblower and civil rights cases have been improved, at long last. The tax code was amended in 2004 to allow legal fee deductions "above the line," almost like not having the income in the first place. But the deduction has been quirky to claim ever since, so many taxpayers and accountants have trouble. Not only was there no proper line for it on the IRS forms, but you had to include a particular code next to your write-in, entering "UDC" for unlawful discrimination claim. But at long last, starting with 2021 tax returns, the IRS is made it easier with a new Form 1040 with a line item for attorneys' fees. For 2021, Schedule 1 to Form 1040 gives you two lines. Line 24(h) and 24(i) of Part II, Adjustments to Income.



Why worry about deducting legal fees in the first place? 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 fees. Most plaintiffs therefore assume that the biggest tax they could face would be tax on their *net* recoveries.

But under *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 [settlement 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 should mean those plaintiffs are taxed on

their net recoveries, not their gross. Even so, many taxpayers and return preparers have had trouble claiming it.

Even for contingent fees, the deduction only covers employment, civil rights, and certain types of whistleblower claims. For employment claims, the tax code 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).

The catchall in Section 62(e)(18) *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 itself once said, “We believe that the scope of the term ‘human and *civil rights* secured by law’ should be construed *quite broadly*.” Could invasion of privacy cases, defamation, debt collection and other such

cases be called civil rights cases? What about credit reporting cases? Don't those laws arguably implicate civil rights as well? Arguably, [civil rights are broad and could provide legal fee deductions to cut the tax on some settlements.](#)

Might wrongful death, wrongful birth, or wrongful life cases also be viewed in this way? 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, they may need an avenue to deduct their legal fees. Reconsidering civil rights broadly may be one way to consider fees in the new environment. The IRS deserves credit for fixing a deduction that's been tough to claim since 2004. Personally, I'm still not used to the Schedule 1 idea for Form 1040, part of the failed effort to make tax returns like postcards. But those issues aside, the IRS change for 2021 returns with a place for attorney fees is a big win. Don't overlook it.

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