Workarounds for Plaintiffs & Lawyers Under New Tax Law

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You are a plaintiff in a lawsuit and just settled your case for $1,000,000. Your lawyer takes 40%, $400,000, leaving you the balance. Most plaintiffs assume their worst-case tax exposure would be paying tax on $600,000. But today, you could pay taxes on the full $1,000,000. Welcome to the crazy way legal fees are taxed.

In *Commissioner v. Banks,*[1] the Supreme Court held that plaintiffs in contingent fee cases must *generally* recognize income equal to *100%* of their recoveries. This is so even if the lawyer is paid directly by the defendant, and even if the plaintiff receives only a net settlement after fees. This harsh tax rule usually means plaintiffs must figure a way to *deduct* those fees.[2]

Until 2018, there were two ways to deduct legal fees: above the line or below the line.[3] Under the new tax law, however (which took effect January 1, 2018), below-the-line (also called miscellaneous itemized) deductions, where plaintiffs historically deducted most legal fees, have been disallowed for 2018 through 2025.[4]

Starting in 2018, therefore, above-the-line became the only remaining choice—for those who qualify.[5] The above-the-line tax deduction, which is the topic of this article, is for employment, civil rights, and whistleblower legal fees, and is more important than ever. Qualifying for it means, at most, you are taxed on $600,000 of the hypothetical settlement above.

Physical Injury Recoveries?

You might think there would be no tax issues in physical injury cases, where damages should be tax-free. But section 104 (the tax exclusion section for physical injury recoveries) applies only to compensatory damages, not to punitive damages or interest.[6]

What if a case has some of each?

Example: You are injured in a car crash, and sue the other driver. Your case settles for $2 million; 50 percent is awarded as compensatory damages for physical injuries, and 50 percent for punitive damages. There is a 40 percent contingent fee. That means you net $1.2 million. But the IRS divides the $2 million recovery in two, and allocates legal fees pro rata. You claim $600,000 as tax-free for physical injuries. But you are taxed on $1 million, and cannot deduct *any* of your $800,000 in legal fees.

1. "Unlawful Discrimination" Recoveries

The above-the-line deduction applies to attorney fees paid in "unlawful discrimination" cases. The tax code defines a claim of unlawful discrimination as one arising out of any of a long list of claims brought under:

1. The Civil Rights Act of 1991;
2. The Congressional Accountability Act of 1995;
3. The National Labor Relations Act;
4. The Fair Labor Standards Act of 1938;
5. The Age Discrimination in Employment Act of 1967;
6. The Rehabilitation Act of 1973;
7. The Employee Retirement Income Security Act of 1974;

8. The Education Amendments of 1972;
9. The Employee Polygraph Protection Act of 1988;
10. The Worker Adjustment and Retraining Notification Act;
11. The Family and Medical Leave Act of 1993;
12. The Chapter 43 of Title 38 (relating to employment rights of uniformed service personnel);
13. Section 1981, 1983, and 1985 cases;
14. The Civil Rights Act of 1964;
15. The Fair Housing Act; and
16. The Americans With Disabilities Act of 1990.[7]

2. Whistleblower Cases

The above-the-line deduction applies to whistleblowers who were fired or retaliated against at work.[8] But what about whistleblowers who obtain awards outside this context? The deduction applies to federal False Claims Act cases, and was later amended to cover state whistleblower statutes, as well.[9] It also applies to IRS tax whistleblowers, and in 2018 was extended to SEC and Commodities Futures Trading Commission whistleblowers.[10]

3. Catchall Employment Claims

Arguably the most important item in this list is the catchall provision for claims under section 62(e)(18):

> 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.[11]

This is a broad provision, and should cover employment contract disputes even where no discrimination is alleged.

4. Civil Rights Claims

The catchall language in section 62(e)(18) *also* provides a deduction for legal fees to enforce civil rights. This unlawful discrimination deduction is arguably even more important than the deduction for fees relating to employment cases.

What exactly are civil rights, anyway, though? You might think of civil rights cases as *only* those brought under section 1983, which provides a right of action to victims of discrimination under color of law.[12] However, the above-the-line deduction extends to *any* claim for the enforcement of civil rights under federal, state, local, or common law,[13] and "civil rights" is not defined for purposes of the above-the-line deduction. Neither the legislative history nor the committee reports addressing section 62(e)(18) help.

Some general definitions of the term are broad, indeed, including:

> [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*.[14]

In an admittedly different context (charitable organizations), the IRS itself has generally preferred a broad definition of civil rights. In a General Counsel Memorandum, the IRS stated, "[w]e believe that the scope of the term 'human and *civil rights* secured by law' should be construed *quite broadly.*"[15] Could invasion of privacy, defamation, debt collection, and other similar cases therefore be called "civil rights" cases? Possibly.

What about credit reporting cases? Don't those laws arguably implicate civil rights as well? 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.

What about punitive damages, however? In that context, plaintiffs may once again be on the hunt for an avenue to deduct their legal fees. Construing "civil rights" broadly might be one way to deal with fees in the new environment. In any event, the scope of the civil rights

category for potential legal fee deductions merits separate treatment that is beyond the scope of this article.

5. Business Expenses

If sections 62(a)(20) and 62(e) prove not to be fertile grounds for legal fee deductions, however, is anything else available? Can legal fees be a business expense? Of course they can. Business expense deductions were largely unaffected by the 2017 tax changes, other than the Weinstein provision, which restricts deductions in confidential sexual harassment cases.[16]

In a corporation, LLC, partnership, or sole proprietorship, business expenses are above-the-line deductions.[17] Of course, one must ask, are your activities sufficient that you are really in *business,* and is the lawsuit really *related* to that business? If one can answer both of these questions yes, then all is well.

However, a plaintiff filing his first Schedule C as a proprietor to report a lawsuit recovery may not be convincing. Before the above-the-line deduction was enacted in 2004, some plaintiffs did institute cases arguing that their lawsuits were business ventures.[18] They usually lost those cases.[19] Nevertheless, the repeal of miscellaneous itemized deductions until 2026 may revive such attempts.[20]

Some claimants may push the envelope regarding what constitutes a trade or business—and how their lawsuit is inextricably connected to it. Some plaintiffs may consider filing a Schedule C, even if they have never done so before. Historically, however, filing a Schedule C increases the likelihood that a tax return will be audited, and draws self-employment taxes.[21]

6. Capital Gain Recoveries

If your recovery is capital gain, you could, arguably, capitalize your legal fees and offset them against your recovery under section 263A. You might regard the legal fees as capitalized, or as a selling expense to produce the income. Thus, the new "no deduction" rule for attorney fees may encourage some plaintiffs to claim that their recoveries are capital gain, just (or primarily) to deduct or offset their attorney fees.

Exceptions to *Banks*

Other approaches to minimizing or avoiding the taxation of attorney fees try to keep them out of the plaintiff's income in the first place. Technically, falling within one of the exceptions to the *Banks* case is not a way of *deducting* legal fees, but of avoiding having to recognize those fees as income. In *Banks*, the Supreme Court laid down the *general* rule that plaintiffs have gross income on contingent legal fees.[22] But general rules have exceptions, and the Court alluded to situations in which this general 100 percent gross income rule might not apply.[23]

7. Separately Paying Lawyer Fees

Some defendants agree to pay the plaintiff's attorney and the plaintiff separately. Do two checks obviate the income to plaintiff? According to *Banks*, they do not. Still, separate payments cannot hurt, and perhaps the issuance of Forms 1099 can be negated in the settlement agreement. (The Form 1099 regulations generally require defendants to issue a Form 1099 to the plaintiff for the full amount of a settlement, even if part of the money is paid to the plaintiff's attorney.[24] Even so, a defendant *might* agree to issue a Form 1099 to the plaintiff alone, and only for the net payment.) *Banks* seems to dictate that there would be gross income anyway, but some plaintiffs might feel comfortable reporting only the net.

8. Fees for Injunctive Relief

The Supreme Court suggested that legal fees for injunctive relief may not be income to the client.[25] If the plaintiff receives only injunctive relief but plaintiffs' counsel is awarded large fees, should the plaintiff be taxed on those fees? Arguably not. However, if there is a big damage award coupled with relatively minor injunctive relief, will that allow a client to exclude *all* the attorney's fees from their tax return? That seems unlikely, though properly drafted settlement documents might help finesse the issue.

9. Court-Awarded Fees

Court-awarded fees may also provide relief, depending on how the award is made and the nature of the fee agreement. Suppose that a lawyer and client sign a 40% contingent fee agreement. It provides that the lawyer is also entitled to any court-awarded fees. A verdict for plaintiff yields $500,000, split 60/40. The client has $500,000 in income and cannot deduct the $200,000 paid to his lawyer.[26] However, if the court separately awards another $300,000 to the lawyer *alone*, that should not have to go on the plaintiff's tax return. What if the court

sets aside the fee agreement and separately awards *all* fees to the lawyer?

10. Class Action Fees

There has long been confusion about how legal fees in class actions should be taxed. Historically, there was a difference between the tax treatment of opt-in cases and opt-out cases. In more recent years, however, the trend appears to be away from taxing plaintiffs on legal fees in class actions of both types.[27]

That is fortunate, since the legal fees in class actions generally dwarf the amounts plaintiffs take home. It is an over-generalization, but most plaintiffs in most class actions generally assume that they will not be taxed on the gross amount (or even their pro rata amount) of the legal fees paid to class counsel. Optimally, the lawyers will be paid separately under court order.

11. Statutory Attorney Fees

If a statute provides for attorney fees, can this be income to the lawyer only, bypassing the client? Perhaps in some cases, although contingent fee agreements may have to be customized. In *Banks*, the Court reasoned that the attorney fees were generally taxable to plaintiffs because the payment of the fees discharged a liability of the plaintiffs to pay their counsel under their fee agreements.[28] In statutory fee cases, a statute (rather than a fee agreement) imposes an independent liability on the *defendant* to pay the attorney fees. If the statutory fees were not awarded, the plaintiff may not be obligated to pay any additional amount to their attorney.

Accordingly, some attorneys seem to assume that if a statute calls for attorney fees, the general rule of *Banks* can never apply. Arguably, though, more may be needed. If the contingent fee agreement is plain vanilla, the fact that the fees *can* be awarded by statute may not be enough to protect the client from liability for the fees. As the *Banks* decision notes, the relationship between lawyer and client is that of principal and agent.[29] The fee agreement and the settlement agreement may need to address the payment of statutory fees.

12. Lawyer-Client Partnerships

A partnership of lawyer and client arguably should allow each partner to pay tax only on that partner's share of the profits.[30] The tax theory of a lawyer-client joint venture was around long before the Supreme Court decided *Banks* in 2005, but it was never fully developed. Moreover, despite the submission of amicus briefs filed in *Banks* asserting that lawyers and clients are partners for tax purposes, the Supreme Court expressly declined to address this topic. Thus, whether establishing the existence of such a partnership would allow a taxpayer to sidestep the holding in *Banks* remains unclear.

A mere fee agreement is surely not enough to create a partnership. But with appropriate documentation, one can argue that the lawyer contributes legal acumen and services, while the client contributes the legal claims. Lawyer purists will take note of the ethical rules that suggest this cannot be a true partnership, because lawyers are generally not allowed to be partners with their clients. Yet, tax law is unique, and is sometimes at odds with other areas of law.

Could a lawyer-client partnership agreement state that it is a partnership to the maximum extent permitted by law? Partnership nomenclature and formalities matter, and lawyer-client partnerships rarely seem to be attempted with conviction. A partnership tax return with Forms K-1 to lawyer and client might be hard for the IRS to ignore. However, so far, lawyer-client partnerships do not look terribly promising.[31]

Conclusion

To return to our $1,000,000 recovery with $400,000 in fees: no plaintiff will think it is fair to pay taxes on $400,000, paid directly to their lawyer, which they never see. Increase those amounts, and emotions may run higher still. In the old days, alternative minimum tax and phased-out deductions often limited the efficacy of legal fee deductions,[32] and there was plenty of grousing about those rules, but it was relatively rare for them to result in clients taking truly catastrophic tax positions.

Even so, there were a few cases in which plaintiffs actually *lost* money after-tax by "winning" their case.[33] Today, entirely *disallowed* legal fee deductions increase the likelihood of such an occurrence, and are less likely to be easily endured. Some plaintiffs may aggressively plan or report around what they consider to be this unjust landmine. They may try to gerrymander their settlement agreements to avoid having their legal fees treated as gross income. If plaintiffs cannot credibly argue that they have achieved that goal, they may go to new lengths to try to deduct or offset those fees. The bigger the numbers

and the higher the contingent fee percentage, the more creative and assertive plaintiffs may be. Good luck out there!

Endnotes

1 Comm'r v. Banks, 543 U.S. 426 (2005).

2 For taxpayers whose recoveries are capital in nature, they may be able to capitalize their legal fees to be taxed only on their net recoveries. *See* I.R.C. § 263A. However, many recoveries are taxed as ordinary income, and taxpayers who receive ordinary recoveries generally must deduct their fees to be taxed only on their net recoveries.

3 *See* I.R.C. §§ 62(a)(20) (providing for an above-the-line deduction for certain legal expenses), 63(d) (providing that any deduction not qualifying as an above-the-line deduction would be deductible only as an itemized deduction below-the-line.)

4 *See* I.R.C. § 67(g); Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 11045 (2017).

5 I.R.C. §§ 62(a)(20), 63(d).

6 *See* I.R.C. § 104(a)(2) (punitive damages); regarding interest, *see* Kovacs v. Comm'r, 100 T.C. 124 (1993), *aff'd* 25 F.3d 1048 (6th Cir. 1994).

7 I.R.C. § 62(e).

8 § 62(e)(18)(ii).

9 § 62(a)(20), (a)(21).

10 § 62(a)(21).

11 § 62(e)(18).

12 *See* 42 U.S.C. § 1983.

13 *See* I.R.C. § 62(e)(18).

14 15 Am. Jur. 2D *Civil Rights* § 1.

15 I.R.S. Gen. Counsel Mem. 38468 (Aug. 12, 1980).

16 *See* Tax Cuts and Jobs Act, Pub. L. No. 115-97, § 13307 (2017); *see also* Robert W. Wood, *Taxing Sexual Harassment Settlements and Legal Fees in a New Era*, 158 TAX NOTES No. 4, at 545 (Jan. 22, 2018).

17 I.R.C. § 62(a)(1).

18 *See* Alexander v. Comm'r, 72 F.3d 938 (1st Cir. 1995).

19 *Id.*

20 *See* Publication 529 (12/2019), Miscellaneous Deductions, I.R.S. (Revised Dec. 2019), https://www.irs.gov/publications/p529.

21 I.R.C. § 6017.

22 *See* Comm'r v. Banks, 543 U.S. 426 (2005).

23 *Id*.

24 Treas. Reg. § 1.6045-5.

25 *See Banks,* 543 U.S. at 438–39 ("Sometimes, as when the plaintiff seeks only injunctive relief . . . court-awarded attorney's fees can exceed a plaintiff's monetary recovery. . . . We need not address these claims.").

26 *See* I.R.C. § 67(g).

27 *See* Wood, *Tax Treatment of Class Action Attorneys' Fees: After Banks*, J. TAX PRAC. & PROC. 37 (Apr.-May 2005).

28 *See Banks,* 543 U.S. 426.

29 *See Id.* at 436 ("The relationship between client and attorney, regardless of the variations in particular compensation agreements or the amount of skill and effort the attorney contributes, is a quintessential principal-agent relationship.").

30 *See* I.R.C. § 702.

31 *Allum v. Comm'r*, T.C. Memo 2005-117, *aff'd*, 231 Fed. Appx. 550 (9th Cir. 2007), *cert. denied*, 128 S. Ct. 303 (2007).

32 *See, e.g.,* I.R.C. §§ 67, 68; *see also* Spina v. Forest Preserve Dist. of Cook Cty., 207 F. Supp. 2d 764 (N.D. Ill. 2002).

33 *See Spina*, 207 F. Supp. 2d 764, as reported in 2002 National Taxpayer Advocate Report to Congress at 166; *see also* Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Case*, N.Y. TIMES, Aug. 11, 2002, at A18.