‘TAX CUTS’ MEAN PLAINTIFFS PAY TAX ON 100%, EVEN LAWYER FEES

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Tax cuts are supposed to be good. Yet as everyone knows, there was both pain and pleasure in the big year-end tax law. For example, there is pain in the $10,000 cap on deducting state and local taxes. It is roiling high-state tax states, and causing some residents to flee for no-tax states like Texas, Nevada or Florida. Some states are proposing a workaround ‘donation’ or filing lawsuits to block the law.

A less obvious group adversely impacted by the tax law is plaintiffs in lawsuits. For many plaintiffs in lawsuits, the results of the tax bill are surprisingly bad. By extension, it may impact their lawyers too, impacting case resolution and lawyers’ wallets. The biggest hit to many plaintiffs will be the new tax treatment of attorneys’ fees.

Many plaintiffs will now be taxed on their gross recoveries, with no deduction for attorney fees. This bears repeating. Many plaintiffs who settle for $100,000 will be taxed on $100,000 even if they pay $40,000 or more to their lawyer. In bigger recoveries, the tax situation can become dire. This stark reality is going to impact plaintiffs and their lawyers. It may also impact defendants, who conceivably may have to pay more to resolve cases.

IT’S ALL GROSS INCOME

Part of the tax problem triggered by the sweeping tax bill is historical. In 2005, in Commissioner v. Banks, the U.S. Supreme Court held that plaintiffs in contingent fee cases must generally recognize gross income equal to 100 percent of their recoveries. That means plaintiffs must figure a way to deduct their 40 percent (or other) fee.

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. An above-the-line deduction subtracts the qualifying fees before you reach page 2 of the tax return.

After the new GOP tax bill, plaintiffs in employment cases are still mostly OK, unless their case involves sexual harassment, a topic considered below. That is, the above-the-line deduction for legal fees remains in the law. This generally ensures that employment claim plaintiffs are taxed on their net recoveries, not their gross.

But there are nagging problems even for employment plaintiffs. For example, a plaintiff’s above-the-line deduction for fees in employment and qualifying whistleblower cases cannot exceed the income the plaintiff received from the litigation in the same tax year. As long as all the legal fees are paid in the s ame tax year as the recovery (such as in a typical contingent fee case), that might not be an issue. However, what if the plaintiff has been paying legal fees hourly over several years? There are several possible work-arounds, but none is foolproof. Some plaintiffs can end up unable to deduct their legal fees even in employment cases.

In addition, only employment (and certain types of whistleblower) claims qualify for the above-the-line deduction. There has always been concern that the IRS could limit deductions for legal fees based on attributing legal fees to particular claims. Will the IRS start allocating legal fees between employment claims and other claims? That danger seems enhanced now.

Moreover, plaintiffs in employment claims must now contend with the Harvey Weinstein provision for sexual harassment claims and releases. Amazingly, it can disallow all settlement and legal fee deductions, potentially even plaintiffs' deductions, We'll return to this provision after addressing other plaintiffs impacted by the law.

IMPACTED PLAINTIFFS

If you are not an employment plaintiff (or one of a few types of whistleblowers) 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 first part of your fees); (2) depending on income, you could be subject to a phase-out of deductions; and (3) your legal fees were not deductible for purposes of the alternative minimum tax (AMT).

Now, 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. Period. That means you are taxed on 100 percent of your recovery.

Examples of impacted plaintiffs include recoveries:

- from a website for invasion of privacy or defamation;
- from a stock broker or financial adviser for bad investment advice, unless you can capitalize your fees;
- from your ex-spouse for anything related to your divorce or children;
- from a neighbor for trespassing, encroachment, or anything else;
- from the police for wrongful arrest or imprisonment;
- from anyone for intentional infliction of emotional distress;
- from your insurance company for bad faith;
- from your tax adviser for bad tax advice;
- from your lawyer for legal malpractice; and
- 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:

- 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;
- Your employment recovery qualifies for the above-the-line deduction (but watch out if it involves a sex harassment claim);

- If the recovery is fully excludable from your income, you cannot deduct attorney fees, but you do not need to;
- Your recovery is in a federal False Claims Act case or IRS whistleblower case, qualifying for the above-the-line deduction;
- Your recovery relates to your trade or business, and you can deduct your legal fees as a business expense; or
- Your recovery comes via a class action, where the lawyers are paid separately under court order.

Eliminating miscellaneous itemized deductions means that many plaintiffs (outside employment and certain whistleblower cases) will have *no legal fee deduction at all*. Vast numbers of plaintiffs in many types of litigation will feel the full force of paying taxes on their gross recoveries, with no deduction for their fees.

SEC WHISTLEBLOWERS

SEC whistleblowers also do not fare well under the new law. An amendment had proposed giving them *an above-the-line deduction for legal fees*. That would match the treatment IRS whistleblowers and Federal False Claims Act whistleblowers enjoy. But the amendment for SEC claimants was not included in the final law. That means SEC whistleblowers may pay taxes on their gross recoveries, with no deduction for legal fees.

Again, there is *no longer* a below-the-line deduction for legal fees, at least not until 2026. None. The only hope for an SEC whistleblower is to argue that the legal fees relate to employment. Since whistleblowers often face retaliation, that argument should work in some cases. But the IRS can argue that the SEC award was made in consideration for information and blowing the whistle, not for any retaliation the whistleblower experienced.

If there is a separate employment settlement, the IRS argument becomes stronger. Moreover, the failure of the proposed amendment to add an SEC whistleblower deduction may also affect future IRS examinations. It remains to be seen whether the IRS will trumpet the failed legislative proposal in trying to deny tax deductions to SEC whistleblowers who claim that their fees arose out of employment.

SEXUAL HARASSMENT

The new law includes what some call a Harvey Weinstein tax. The idea is to deny tax deductions for settlement payments in sexual harassment or abuse cases, if there is a nondisclosure agreement. Notably, this "no deduction" rule applies to the lawyers' fees, *as well* as the settlement payments.

Of course, most legal settlement agreements have some type of confidentiality or nondisclosure provision. And many employment cases have a mixture of facts and claims, and a settlement agreement that is comprehensive. That means lawyers will worry whether this no-deduction rule will apply.

If it applies, it may apply with a vengeance. Even legal fees paid by the *plaintiff* in a confidential sexual harassment settlement could be covered. The new provision was added into Section 162 of the tax code, which addresses business expenses. Indeed, the Congressional Research Service official summary of the legislation says that the

provision "prohibits a tax deduction for trade or business expenses" in certain sexual harassment and sexual abuse cases.

Arguably, Congress' intent was only to limit the defendant's trade or business deduction for settlement payments and related legal fees. Nevertheless, the language actually enacted into the tax code is much broader. It provides that "No deduction shall be allowed *under this chapter*." "This chapter" appears to include every section of the tax code between Section 1 and Section 1400Z-2, covering most that a taxpayer uses for calculating taxes each year.

It therefore could also disallow the above-the-line deduction for a *plaintiff*'s employment and qualifying whistleblower claims. Small allocations to sexual harassment in settlement agreements might be one answer, to preserve the availability of deductions for the other claims. However, it is not clear if the IRS will respect them.

WHAT TO DO NOW

For many types of cases involving significant recoveries and significant attorney fees, the lack of deductions for attorney fees may seem downright confiscatory. Plaintiffs and their lawyers are unlikely to take the situation lying down. Here are potential ideas for addressing the new rules.

SEPARATELY PAID LAWYER FEES.

Some defendants will agree to pay lawyer and client separately. Do two checks obviate the income to plaintiff? According to Banks, not hardly. The Form 1099 regulations may not help. They 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 lawyer. However, some taxpayers may still claim reporting positions on these facts.

BUSINESS EXPENSES.

One possible way of deducting legal fees could be a business expense deduction. Businesses did well in the tax bill, and business expense deductions remain unaffected (other than the Weinstein provision). But are your activities sufficient that you are really in business, and is the lawsuit really related to that business?

Alternatively, could your lawsuit itself be viewed as a business? It will probably not look very convincing for a plaintiff's first Schedule C to be filed as the proprietor for a lawsuit recovery. 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. After all, just suing your employer doesn't seem like a business. It might be regarded as investment or income producing activity (which used to give rise to a below-theline deduction), but not a business. And remember, after tax reform, investment expenses — whether legal fees or otherwise — do not 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. It seems inevitable that we should expect more arguments based on Schedule C from plaintiffs *in the future*.

CAPITAL GAIN RECOVERIES.

One other possibility for legal fee deductions might be capital recoveries. If your recovery is capital gain, you arguably can capitalize your legal fees and offset them.

You might regard the legal fees as capitalized, or as a selling expense to produce the income. But at least you should not have to pay tax on your attorney fees. Perversely, the new 'no deduction' rule for attorney fees may encourage some plaintiffs to claim that their recoveries are capital gain, just to 'deduct' their attorney fees!

EXCEPTIONS TO BANKS

There will also be new efforts to explore the exceptions to the Supreme Court's 2005 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.

INJUNCTIVE RELIEF.

Legal fees for injunctive relief may not be income to the client. The bounds of this exception are not clear, but it may offer a way out on some facts. If there is a big damage award with small injunctive relief, will that take all the lawyer's fees from the client's tax return? That seems unlikely.

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 percent 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. Client has $500,000 in income, and cannot deduct the $200,000 paid to his lawyer.

However, if the court separately awards another $300,000 to 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? Does such a court order mean the IRS should not be able to tax the plaintiff on the fees? It is not clear, but the IRS has an incentive to scrutinize such attempts.

STATUTORY ATTORNEY FEES.

Statutory fees are another potential battleground. 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 unique ways. The relationship between lawyer and client is that of principal and agent. It may take considerable effort to distance a plaintiff from the fees 'his' lawyer is due.

LAWYER-CLIENT PARTNERSHIPS.

How about a partnership of lawyer and client? Partnerships fared very well in the tax reform bill. Moreover, the tax theory of a lawyer-client joint venture (which is just another name for a partnership) was around long before the Supreme Court decided the Banks case in 2005. Despite numerous amicus briefs, the Supreme Court expressly declined to address it.

If a fee agreement says it is a 60/40 partnership, can't that partnership report 60/40? The lawyer contributes legal acumen and services. The client contributes the legal claims. Lawyer purists will note the ethical rules that suggest this cannot be a true partnership, because lawyers are generally not supposed to be partners with their clients.

Yet, tax law is unique, and sometimes is at odds with other areas of law. Could not a lawyer-client partnership agreement state that it is a partnership to the maximum extent permitted by law? At the least, it is not clear that ethics rules will control the tax treatment of the arrangement.

To be sure, one factor in how such partnerships will fare with the IRS will be optics and consistency. Partnership nomenclature and formalities will matter.

A partnership tax return with K-1s to lawyer and client might be hard for the IRS to ignore. At the very least, lawyer-client partnerships deserve to be resuscitated. There are surely some in the works at this very minute.

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 more aggressively try to avoid 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 deduct or offset the fees somehow.

Some of these efforts may be sophisticated and well thought out. Others may be clumsy, if not downright desperate. But few plaintiffs receiving a $100,000 recovery will think it is fair to pay taxes on the full amount if legal fees have consumed a third or more of their recovery.

Multiply the figures into bigger numbers, and the situation will be worse. Add a higher contingent fee percentage and high case costs, and again, the situation will be worse. Contingent fee lawyers can be expected to be sympathetic, and to try to help plaintiffs where they can. All in all, settlement time for legal disputes looks likely to get more stressful in this troubling new tax world. Tax time will be too.

ABOUT ROBERT W. WOOD

Robert W. Wood is a tax lawyer with www.WoodLLP.com, and the author of numerous tax books including "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This discussion is not intended as legal advice.

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