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Tax Treatment of Legal Fees Under 2017 Tax Cuts and Jobs Act

BY FRED B. BROWN

This past tax return filing season has been the first for the years affected by most of the changes made by the 2017 Tax Cuts and Jobs Act, and some taxpayers who have paid legal expenses may have been shocked and dismayed to discover that they were taxed on the funds used to pay these legal fees.

To illustrate, assume that in 2018 a woman with a modest salary as an employee recovers $100,000 in damages in a lawsuit from a claim against another person for defamation, with 40 percent of the recovery, or $40,000, going to her lawyer to pay legal fees. She will not receive a tax deduction for the legal fees, and thus will be taxed on the full $100,000, even though she is only collecting a net $60,000 in damages.

Assuming that she is subject to an average federal income tax rate of 20 percent, she would pay $20,000 in federal taxes on the net recovery of $60,000, which amounts to an effective tax rate of 33 percent. After legal fees and federal taxes, she walks away with only $40,000. This hardly seems fair.

Prior to the 2017 tax law changes, legal fees incurred to produce income were generally deductible for regular federal income tax purposes. However, many types of legal expenses incurred by individuals are classified as “miscellaneous itemized deductions,” and therefore were deductible only if the taxpayer is one of the minority of Americans who itemize their deductions and then, only to the extent that these legal fees, plus other miscellaneous itemized deductions, exceeded two percent of the taxpayer’s adjusted gross income (the so-called two percent floor). In addition, the types of legal expenses treated as miscellaneous itemized deductions are completely nondeductible for purposes of the alternative minimum tax, or AMT.

The total disallowance of deductions for many types of legal fees violates traditional norms of tax policy that allow deductions for expenses incurred to produce income. Both before and after the 2017 tax act, legal fees incurred in lawsuits involving business matters, unlawful discrimination claims (which includes employment claims), and some whistleblower claims are fully deductible. In 2018, Congress expanded the types of whistleblower lawsuits that allow for the full deductibility of legal fees. And for legal fees related to the recovery of compensatory damages for personal physical injuries or physical sickness, no deduction is permitted, but then these damages are not taxable, either. This means that before the 2017 changes, individuals who were not subject to the AMT – typically those with modest income

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– could usually deduct a substantial portion of the legal expenses incurred in prosecuting or settling claims where the recoveries were taxable.

Starting in 2018, this has changed. The law enacted in 2017 completely disallows deductions for miscellaneous itemized deductions, which includes many types of legal expenses; this will continue until 2026, when the two percent floor rule is restored. Consequently, for 2018–2025, all individual taxpayers will be denied deductions for many types of legal expenses, including legal fees incurred in claims involving defamation; malpractice by investment advisers, lawyers or accountants; trespass; infliction of emotional distress; and false imprisonment.

The total disallowance of deductions for many types of legal fees violates traditional norms of tax policy that allow deductions for expenses incurred to produce income. While the two percent floor for miscellaneous itemized deductions has the effect of disallowing or reducing deductions incurred for producing income, its arguable justification is that it reduces the burdens on taxpayers to keep records for small expenditures as well as the IRS to monitor compliance in deducting such expenditures. For legal fees relating to litigation, which tend to be significant in amount, this policy is misplaced. It is also wrong to disallow deductions for these legal expenses for purposes of the AMT, which was enacted to prevent taxpayers from using tax preferences to avoid their fair share of federal income taxes. This is not the case where taxpayers are incurring significant legal expenses to secure damage awards.

Going forward, Congress should rectify the situation by permitting taxpayers an “above-the-line” (not itemized) deduction for legal fees incurred in connection with all types of civil damage claims where the recoveries would be taxable. This would amount to a broadening of rules that Congress has created that permit claimants in unlawful discrimination, employment and whistleblower suits above-the-line deductions for legal fees. By treating such legal expenses as above-the-line deductions, taxpayers could fully deduct legal fees incurred to prosecute or settle litigation where the recoveries would be taxable, without regard to a two percent floor for miscellaneous itemized deductions (when restored) or AMT consequences. Such an approach would promote equity, by treating legal expenses incurred by taxpayers in order to make themselves financially whole after suffering a legal harm like most other expenses related to the production of taxable income.

FRED B. BROWN is a Professor of Law at the University of Baltimore School of Law. Brown teaches in the area of federal income taxation and directs the University’s Graduate Tax Program. He has published articles on matters concerning international taxation as well as articles addressing fundamental income tax features such as realization and nonrecognition, and has co-authored a book on the taxation of business entities. In 2000–01, Brown served as an academic adviser to the staff of the Joint Committee on Taxation in connection with the Joint Committee staff study of the overall state of the federal tax system. In 2007, he was awarded the Saul Ewing Award for Excellence in Teaching in the Area of Transactional Law. In 2011, Brown was awarded the Tax Excellence Award by the Taxation Section of the Maryland State Bar Association. In 2019, he received the award for Outstanding Teaching by a Full Time Faculty Member of the University of Baltimore School of Law.

1 Internal Revenue Code sections 162, 212
2 Internal Revenue Code sections 67(b), 63(b), 62(a)
3 https://taxfoundation.org/90-percent-taxpayers-projected-lci-a-expanded-standard-deduction/
4 Internal Revenue Code section 67(a)
5 Internal Revenue Code section 56(a)(1)(A)(ii)
7 Internal Revenue Code section 62(a)
8 Internal Revenue Code section 62(a)(21)
9 Internal Revenue Code section 104(a)(2)
10 Internal Revenue Code section 67(g)
11 Internal Revenue Code sections 162, 212
12 Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System, 119
13 Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendations of the Staff of the Joint Committee on Taxation to Simplify the Federal Tax System, 2–6

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