

# DEDUCTING ATTORNEY FEES AFTER THE 2017 TAX ACT

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In the entire spirit of the #Metoo movement a client sues her employer and receives a \$1,000,000 judgment. Her attorneys take a customary 33% of the judgment (\$300,000) after also deducting case costs. Unfortunately, taxes will take a further bite from this award.

Many people do not realize that even under current law the client likely pays federal and state taxes on the full \$1,000,000. Taking out \$500,000 (50%) of the total award in taxes, the \$100,000 case costs, and the \$300,000 attorney fees leaves the client with only \$100,000 from such a large award. On top of that, the attorney also must pay tax on the money received from the client. In effect, the federal and state governments would actually receive \$650,000, or 65% of the total judgment, while the client only receives 10%.

The new Tax Cuts and Jobs Act of 2017 (“2017 Tax Act”) does not change this result. In fact, the Act now makes the outcome the same for smaller cases. Before this year, the client might have deducted some attorney fees as miscellaneous itemized deductions, unless a large award would have pushed the client into the Alternative Minimum Tax (AMT) regime. The 2017 Tax Act completely eliminates miscellaneous itemized deductions for all matters no matter how small, so the client would not be able to deduct her attorney fees or case costs even if the award were only \$100,000.

Generally, attorney fees used to be possibly deductible as a miscellaneous itemized deduction if they produce or result in the collection of taxable income or are in any way related to taxes. Such a deduction also had to exceed 2% of the client’s adjusted gross income to be deducted. Clients receiving tax advice, clients consulting an attorney regarding alimony, or clients with an emotional distress or harassment case might have been able to deduct their attorney fees if they were not subject to AMT. Those deductions have largely been eliminated under the new Tax Act.

## Some Deductions Still Available

Fortunately, for businesses the law is unchanged. A sole proprietorship can still fully deduct attorneys’ fees for business matters on Schedule C of the individual’s tax return. Partnerships, limited liability companies and corporations also may deduct attorney fees for matters related to the business.

Although technically not a deduction, real estate costs reduce the sales price of real property and are subtracted from the capital gain received from the property. Further, employment discrimination fees and costs are taken out “above-the-line,” meaning that neither AMT nor the 2017 Tax Act affect the tax-free attorney fees for those cases.

Finally, attorney fees for personal injury matters involving physical harm are not taxable, since the awards in those cases are not subject to any income tax. This tax-free treatment likely encompasses most fire-related litigation matters where there is some physical injury, such as smoke inhalation.

## Summary

Overall, attorney fees and costs are less deductible than under the previous tax law, but the change mostly affects smaller cases. Some larger cases were already not deductible for other reasons. Payments from some cases were always and remain fully deductible. For any specific matter, a client should consult a tax professional before jumping into litigation and again before signing any settlement agreement.