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IMPACT OF TAX REFORM ACT ON PARTIES TO LITIGATION

April 1, 2018

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As a result of the new tax reform act (H.R. 1), signed into law by President Trump on December 22, 2017, a below-the-line deduction[1] for legal fees incurred in litigation is no longer available for tax years 2018 through 2025. Thus, plaintiffs in numerous categories of litigation could end up paying taxes on one hundred percent (100%) of the gross amount recovered in their cases, with no offsetting tax deduction for the legal fees incurred in pursuit of the recovery. By way of example, a plaintiff in a contingency fee case where the gross amount recovered is $1,000,000 could be required to pay tax on the $1,000,000 recovery even if such plaintiff's counsel receives the standard one-third contingency legal fee totaling $330,000 from such recovery.[2] In addition, H.R. 1 precludes any tax deductions attributable to any settlement, payout, or legal fees related to sexual harassment or sexual abuse claims in litigation if the payments are subject to a nondisclosure agreement, and this preclusion may apply to both defendants and plaintiffs. Thus, if parties are engaged in litigation where sexual harassment and/or sexual abuse claims are implicated, and if the parties enter into a non-disclosure agreement, then the plaintiff may not be able to deduct its legal fees and the defendant may not be able to deduct its settlement payments or legal fees (even if the settlement payment or legal fees would otherwise be deductible above-the-line as a matter of legislative grace or as business expenses).

However, H.R. 1 generally should not generally affect (i) plaintiffs in 'qualified whistleblower' cases, *e.g.*, cases arising under the qui tam (whistleblower) provisions of the federal False Claims Act; or (ii) plaintiffs engaged in employment litigation (except cases where sexual harassment and/or sexual abuse claims are implicated, and where the parties enter into a non-disclosure agreement) because the legislatively enacted above-the-line deduction for legal fees incurred in these two categories of litigation survives the enactment of H.R. 1. By virtue of such above-the-line deduction, the incidence of taxation relating to these categories of cases should generally be limited to the net amount recovered in the litigation, *i.e.*, the gross amount recovered *minus* the legal fees incurred should be subject to tax. But not so fast, there is a caveat: if parties are engaged in employment litigation where sexual harassment and/or sexual abuse claims are implicated, and if the parties enter into a non-disclosure agreement, then the plaintiff may not be able to deduct its legal fees and the defendant may not be able to deduct its settlement payments or legal fees (even if such legal fees would otherwise be deductible above-the-line as a matter of legislative grace or as business expenses).

In respect to most other categories of litigation, if the lawsuit does not arise out of the plaintiff's trade or business, there may be no deduction available for legal fees incurred in pursuing the plaintiff's claim. If that is the case, then one hundred percent (100%) of the gross amount recovered in such a plaintiff's case may be subject to tax.

The takeaways from this blog are two-fold: (i) H.R. 1's suspension for tax years 2018 through 2025 of below-the-line deductions for legal fees means that a multitude of plaintiffs may not be able to take any deductions for legal fees incurred in litigation and, as a result, such plaintiffs may be subject to tax on one hundred percent (100%) of the gross amount of their recoveries; and (ii) H.R. 1 precludes any tax deductions attributable to any settlement, payout, or legal fees related to sexual harassment or sexual abuse in litigation if the payments are subject to a nondisclosure agreement, and this preclusion may apply to both defendants and plaintiffs.

Consideration should be given to engaging appropriate tax advisors to assist with understanding these new rules and planning to mitigate (if possible) the impact of these new rules.

For more information, please contact authors, Mark Wisniewski or Nick Jovanovich, on our Business, Finance and Tax Team.

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[1] There are two types of tax deductions. "***Above-the-line***" deductions are claimed on Page 1 of Form 1040 and *reduce Adjusted Gross Income*. "***Below-the-line***" deductions are claimed on Page 2 of the Form 1040 and *reduce Taxable Income*.

[2] See *Comm'r v. Banks*, 543 U.S. 426 (2005)(providing generally that the portion of the amount recovered in litigation by a plaintiff that is paid to such plaintiff's lawyer in the form of legal fees is includible in the plaintiff's gross income, regardless of whether such legal fees are paid directly by the defendant to the plaintiff's lawyer). Thus, the potential ability to deduct the legal fees can be of paramount import in attempting to mitigate the incidence of taxation on the gross amount recovered in the subject litigation.

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