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Legal Settlement Tax Myths Debunked

by Robert W. Wood

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In this article, Wood examines common mistakes and half-truths about the tax treatment of legal settlements.

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Everyone faces tax issues: litigation lawyers, corporate lawyers, real estate brokers, bankers, butchers, bakers, and candlestick makers. We all pay taxes, and we all talk about them, especially how we wish they were lower. Since we all pay them, naturally enough, we all know *something* about taxes. A surprising number of people also express tax opinions to others.

I'm not sure if lawyers are worse than most people on this issue. Perhaps a cross-section of society makes plenty of tax gaffes when it comes to describing or explaining the tax law. But in my experience, so do many lawyers, and sometimes their tax gaffes are whoppers. Lawyers often speak with authority, and sometimes clients believe them.

In fact, the tax gaffes might even be bad enough to trigger potential malpractice liability. Here are some of the most common tax myths I've heard from well-meaning lawyers.

1. "Putting the money in our lawyer client trust account isn't taxable. It can't be taxed until we take it out of our trust account."

Actually, when settlement moneys go into a lawyer's trust account, it is treated for tax purposes as received by the lawyer and received by the client. It is actual receipt of fees to the lawyer and constructive receipt of the client's share to the client. If a case settles and funds are paid to the plaintiff's lawyer trust account, both the client and the lawyer can be taxed.

2. "My client can't be taxed on money in our trust account. It isn't received by the client until I pay the client."

This is a variation of myth number 1. Often, taxes can precede actual physical receipt. The IRS says a lawyer is the agent of his client, so, absent exceptional circumstances, the client is treated as receiving funds when the lawyer does. It can create problems when settlement funds arrive in late December, but the client's check isn't dispatched until January. It may be possible to treat it as January income, and documentation can help. But if push comes to shove, the IRS can say it was payment in December.

3. "If a settlement agreement calls for payment in the future, the client has constructive receipt now."

Actually, you *can* call for payment in the future in many common circumstances without triggering taxes before the payment is made. Suppose that a client verbally agrees to settle a case in December but specifies in the settlement agreement that the money will be paid in January. Is the amount taxable in December or January? The answer is January.

The mere fact that the client *could* have agreed to take the settlement in December doesn't mean the client has constructive receipt. The client is free to condition the execution of a settlement agreement on the payment later. The key will be what the settlement says *before* it is signed. But if you sign the settlement agreement first and *then*

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ask for a delay in payment, you have constructive receipt.

4. "Don't worry; the defendant won't issue a Form 1099 for this."

Be careful — you never *really* know what IRS Forms 1099 will be issued unless the settlement agreement makes it clear. Do you know if the defendant has your law firm's or your client's tax ID number? If a Form 1099 is issued in January, you usually won't be able to persuade the defendant to undo it without express tax language in the settlement agreement that negates a Form 1099.

If the settlement agreement is clear and negates a Form 1099, you can say that the Form 1099 *breaches* the settlement agreement. In my experience, defendants always fix this quickly, issuing a corrected Form 1099. In contrast, if the settlement agreement isn't clear, you're out of luck. Forms 1099 are issued for most legal settlements except payments for personal physical injuries and for capital recoveries.

5. "I have to pay tax on the lawyer's fees I receive, so the IRS can't possibly tax the plaintiff on the same legal fees. That would be unconstitutional."

Both the client and the lawyer must take the legal fees into income, and that is not unconstitutional. In *Banks*,[1] the U.S. Supreme Court held that plaintiffs in contingent fee cases generally must recognize gross income equal to 100 percent of their recoveries. Even if the lawyer is paid separately by the defendant, and even if the plaintiff receives only the net settlement after legal fees, 100 percent of the money is *treated as* received by the plaintiff.

This harsh tax rule usually means that plaintiffs must figure out a way to deduct their legal fees. Of course, the legal fees are gross income to the lawyer too. It may seem unfair, but it isn't double taxation, and it isn't unconstitutional.

6. "The defendant can't issue a Form 1099 to the plaintiff for 100 percent of the settlement and issue *another* Form 1099 to the plaintiff *lawyer* for 100 percent. That would be double reporting of income."

Wrong again. In fact, the IRS regulations on Forms 1099 expressly say that defendants should usually issue *two* Forms 1099 each for 100 percent of the money when the defendant doesn't know exactly how much each is receiving. If the defendant issues a joint check to the lawyer and the client, the plaintiff will usually receive a Form 1099 for 100 percent, and so will the lawyer.

7. "Your damages are for pain and suffering, so they are tax free."

The phrase "pain and suffering" may mean something under state tort law. But this well-worn phrase doesn't mean much in the tax law. In fact, far from being a helpful phrase for tax purposes, the IRS generally treats it as code for emotional distress, and that isn't enough for tax-free treatment. To be tax free, compensatory damages must be for personal physical injuries or physical sickness.

They are tax free only under section 104 of the tax code. But exactly what injuries are "physical" turns out to be messy. Stay away from ambiguous "pain and suffering" language in settlement agreements. Ideally, you want the defendant to pay on account of personal physical injuries, physical sickness and emotional distress therefrom.

8. "Emotional distress damages are not taxable."

This myth remains surprisingly prevalent, even though Congress amended section 104 of the tax code back in 1996 to state that emotional distress damages are taxable. That's right: Emotional distress damages are usually fully taxable. Only if the emotional distress emanates from *physical* injuries or *physical* sickness are the damages tax free. That's why you might commonly see the phrase "physical injuries, physical sickness and emotional distress therefrom" in settlement agreements.

That sounds simple, but exactly what injuries are "physical" turns out to be messy. If you make claims for emotional distress, your damages are taxable. If you claim that the defendant caused you to become physically sick, those damages should be tax free. Yet if *emotional distress causes* you to be physically sick, even that physical sickness won't spell tax-free damages — that is, because the emotional distress came first, the sickness is a byproduct of the emotional distress.

[1] *Commissioner v. Banks*, 543 U.S. 426 (2005).

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In contrast, if you are physically sick or physically injured and your sickness or injury itself *produces* emotional distress, those emotional distress damages should be tax free. It is a confusing and nuanced subject. It also seems highly artificial and can depend on which words someone might use. In the real world, of course, these lines are hard to draw and can seem contrived.

In fact, of all the tax issues facing litigants, this one is probably the thorniest. Plaintiffs often think that their headaches and insomnia should lead to tax-free dollars. But you need to have something more serious that is a real, physical sickness. Post-traumatic stress disorder is probably enough to be physical, although there is no tax case yet that expressly so holds.

9. "If you lose money or property and sue to recover it but don't have a net gain, you can't be taxed."

This myth sounds perfectly logical. If you lost something worth $1 million and get back only $500,000, how could you possibly be taxed? Unfortunately, you can still be taxed, even if you don't break even in the case. It seems counterintuitive, but you can be taxed even when you have not gotten back all your losses. "How can that be?" you might ask.

In investment loss and property damage or destruction cases, taxpayers need to consider their tax basis in the property as well as its fair market value. For example, suppose that you had a million-dollar stock portfolio that was churned by your investment adviser, dropping its value to $200,000. That sounds like an $800,000 loss, right? If you recover, say, $500,000, isn't it clear that you can't be taxed?

Before you give a knee-jerk answer, we need to know your *tax basis* in the property. You had a $1 million stock portfolio, and let's say that you previously paid $1 million for these investments. Thus, that was your tax basis *and* the FMV of the investments. In that event, you still lost money, so you would probably use the $500,000 to reduce your tax basis in the assets. However, what if your tax basis in the $1 million portfolio was only $100,000?

In other words, you had $900,000 in untaxed capital gain before the mismanagement. You lost money when your investment adviser misstepped, but if you get back $500,000, with only a $100,000 tax basis, you have a big gain and taxes to pay. That is true even though you had a mismanaged portfolio with a market value of $1 million and even though you got only a *portion* of your money back.

The same kind of thing happens with other property cases, such as wildfire cases and many others. When there are taxes to pay, there is the possibility of section 1033 involuntary conversion benefits.

10. "If a plaintiff law firm receives an IRS Form 1099 for 100 percent of a settlement, the law firm must pay tax on 100 percent, even if it immediately pays out 60 percent to the plaintiff."

No, the plaintiff law firm merely pays tax on its fee, 40 percent in this example. The confusion often centers on IRS Form 1099. Generally, amounts paid to a plaintiff's attorney as legal fees are includable in the plaintiff's income, even if they are paid directly to the plaintiff's attorney by the defendant. For tax purposes, the plaintiff is considered to receive the gross award, including any portion that goes to pay legal fees and costs.[2]

The IRS rules for Form 1099 reporting bear that out. Under current Form 1099 reporting regulations, a defendant or other payer that issues a payment to a plaintiff and a lawyer must issue two Forms 1099. The lawyer should receive one Form 1099 for 100 percent of the money, and the client should receive a Form 1099 for 100 percent also.

The lawyer's Form 1099 will usually be a gross proceeds Form 1099 with the amount included in box 10 of Form 1099-MISC. Gross proceeds paid to an attorney are now reported in box 10 of Form 1099-MISC. However, until 2020, they were reported in box 14 of Form 1099-MISC; the change came when new Form 1099-NEC was created for independent contractors.

Lawyers should take note that gross proceeds reporting (box 10 of Form 1099-MISC) is the best reporting for a lawyer. Money reported as gross proceeds paid to a lawyer isn't classified as income by the IRS. That is, unlike Form 1099-MISC box 3 (other income) or Form 1099-NEC, the

[2] *See id.*

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IRS doesn't match the taxpayer ID number for gross proceeds paid to an attorney and match with the lawyer's tax return to be sure it is income.

A portion of the payment reported to the lawyer may be income to the lawyer. However, the amount could also be for a real estate closing or some other client purpose. The IRS doesn't track amounts reported as gross proceeds paid to an attorney on Form 1099 in the way it treats, say, "other income" on Form 1099-MISC box 3. Therefore, the lawyer should simply report whatever portion of the reported payment (if any) is income to the lawyer.

Conclusion

Talking about taxes is second nature, but be careful what you say and how you express it. Especially in a field as complex as our tax law, mistakes and half-truths can take on a life of their own. It can be surprisingly difficult for tax advisers to disabuse listeners of these comments once they are uttered. Sometimes the more blatantly incorrect the statement is, the more difficult it is to rebut.

Disclaimers like, "I'm not a tax lawyer" preceding tax comments may conceivably provide some shelter if they are given effect as some type of disclaimer. However, they might not provide complete insulation. In any event, it seems prudent not to rely too heavily on disclaimers. Some remarks may even bring liability to the lawyer who utters them.

For example, suppose a real estate lawyer is hired by a client to handle real estate deals. He says to his client, "I'm not a tax lawyer, but I know we can do a section 1031 exchange of your personal residence for a small office building." Let's assume that, from time to time, this real estate lawyer has advised on such tax topics. Could there be liability?

The tax advice is plainly wrong, and the disclaimer seems not to be intended as a *disclaimer,* but rather to show off the special knowledge of the speaker. "I'm not a tax lawyer, but . . ." sounds as if the tax advice is that much *more certain* because it is so obviously true.

As long as our tax laws are complicated and in the daily news, we'll keep hearing comments about taxes. For some, talking about taxes and figuring out how to reduce or avoid them seem like American pastimes. Many lawyers venture into other areas of law, including taxes. Consider whether you should give tax advice, how you can limit your liability, and how you can improve the odds that your client is getting competent advice. In the meantime, be careful out there. ■

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