



**Robert W. Wood**  
THE TAX LAWYER

---

TAXES 04/19/21

## Tax Rules Your Lawyer Might Not Know

Many lawyers are asked about tax issues, at least in a general way. For example, clients may ask whether legal fees they pay are tax deductible. Unfortunately, many tax issues are complex, even tax deductions for legal fees. Except for tax lawyers, many lawyers try to steer clear of tax questions. Still, many lawyers want to have some tax knowledge, so they know when there are tax dangers, and when to suggest that clients should get some tax advice of their own. For lawyers that handle disputes and litigation, any time money changes hands there are bound to be tax issues on some level. The overwhelming majority of disputes settle, and the tax planning opportunities are better with settlements than with cases that go to judgment. A judgment is absolute, and if you've gone to trial, you usually don't have the time or the opportunity to try to shape any tax wording in a judgment.

With a settlement, your shot at cooperation is while you are hammering out a settlement agreement. So, if you want to say anything in a settlement agreement about taxes, ask for it as part of your other comments. Once a settlement agreement is signed, there is no incentive for the parties to cooperate. If you have ever tried to go back to a defendant *after* a settlement

agreement is signed to say “hey, we were not expecting a Form 1099 for that payment,” you know this. If the settlement agreement is silent about Forms 1099, arguments that the defendant handled it differently than you expected will usually fall on deaf ears. In fact, that is the case even if you can prove that how the defendant issued the Forms 1099 conflicts with the tax law.



There are many judgment calls about Forms 1099 and there are hundreds of pages of tax regulations about these little forms. As a result, it is often possible for defendants to defend whatever they have done in reporting to the IRS. However, if the settlement agreement has express instructions about Forms 1099, you can almost always get a defendant to abide by that document. Moreover, if the defendant makes a mistake with the Forms 1099, which can happen (the accounting department may never see the settlement agreement), you can almost always get a defendant to fix it. But if you have no written

commitment in the settlement agreement, getting a defendant to undo a Form 1099 is usually impossible.

Apart from thinking about tax reporting, what provisions do you ask for? Tax language in the settlement agreement will not bind the IRS or the courts in any subsequent tax dispute. However, it is often respected by the IRS. Since recoveries in disputes are generally taxed based on the claims made and the origin of the dispute, you may want to say what the payment is for. And you can say something about the tax reporting on Forms W-2 and 1099. Section 104 of the tax code excludes from taxes recoveries for personal physical injuries. It also excludes damages for physical *sickness*. Emotional distress damages flowing from that injury or sickness are excludable. In contrast, emotional distress damages that occur outside the context of physical injuries or physical sickness, are taxable.

In a contingent fee case, no matter how checks are cut, the client is usually treated as receiving 100%, and then paying his or her lawyer, even though most lawyers handle the funds. In some cases (like employment) the client can deduct the fees. There is income to the client, and then an offsetting deduction, so the employment plaintiff doesn't have to pay tax on the legal fees. Even so, claiming the deduction can be tricky, and many people have trouble with the mechanics. Outside of employment cases, many clients have trouble deducting their legal fees. Be careful, since tax changes in effect since 2018 can make fees nondeductible.

Many lawyers are sensitive to tax issues, since paying or receiving money nearly always raises tax issues of some kind. Lawyers understandably do not want to go outside their comfort zone. At the same time, lawyers want to help their clients, and to flag tax issues if they see them. After all, you can often do a good deal of tax planning as a case is winding up. In fact, you can sometimes

use tax rules to bring the parties together, settling a case that might not otherwise seem resolvable.

*Check out my [website](#).*