

Tax rules that every lawyer in California should know

By Robert W. Wood

Money usually triggers taxes, and that is true for lawyers too. When the client pays you, you have income. Retainers you are holding in trust that are really client monies are not income, until you invoice the client and pay yourself from the retainer. Inevitably, many lawyers need to know something about client tax issues too, at least in a general way. Some clients may even ask you whether the legal fees they pay you are tax deductible. Tax deductions for legal fees are surprisingly complex, so you may want to be careful how much tax advice you provide.

In fact, unless you are a tax lawyer, you probably want to steer clear of most specific tax questions. Still, you probably want to have some tax knowledge, so you know what points might involve tax dangers, and when to suggest to your client that he or she should get some tax advice of their own. If you are a litigator, you certainly know that most disputes involve tax issues on some level.

The overwhelming majority of disputes settle, and the tax planning opportunities with settlements are better than with cases that go to judgment. After all, 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. Settlements are different, but even there it can be tough to get cooperation.

Even so, 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, my client was 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 or your client 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 usually 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 happens fairly frequently (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 often respected by the IRS and the California Franchise Tax Board. 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 recoveries for personal physical injuries from income. 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.

Clients ask about legal fees too, and how they are treated. In a contingent case, no matter how checks are cut, the client is usually treated as receiving 100%. 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 even accountants often have trouble with the mechanics.

You should not worry about attorneys' fee deductibility in a pure physical injury case where there are only compensatory damages. But in many other cases clients may have trouble deducting their legal fees. Be careful, since tax changes in effect since 2018 make fees nondeductible in many cases.

It's also worth knowing something about Qualified Settlement Funds (QSFs). These trusts enable defendants to claim tax deductions for settlement payments currently, even though amounts might be tied up for months or even years with plaintiffs and their lawyers. The defendants get a complete release, and the QSF gets the settlement money, which will be paid out to clients and lawyers later.

A court takes jurisdiction over the QSF, but it need not be the court with jurisdiction over the legal dispute being resolved. A QSF can give you more time to determine exact numbers, to fix final attorneys' fees and costs, and to facilitate structured settlements and structured legal fees. In fact, a desire to implement structured settlements or structured legal fees is a common reason for setting up a QSF.

The plaintiffs or lawyers may need time to determine the form of a structure, the exact payout, family needs, etc. The QSF operates as a tax-free holding pattern. Monies are not treated as received by the plaintiffs or their lawyers until they are paid out of the QSF. Yet, the defendant is entitled to a tax deduction as soon as the money is put into the QSF.

No one said our tax system was easy. In fact, our federal income tax system is by far the most complicated tax system in the world. Even so, lawyers should be 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. And lawyers can be sued for trying to address topics they are not competent to address. At the same time, lawyers instinctively want to help their clients, and to provide at least some high-level advice to their clients. There is probably no perfect answer to this situation.

Recommending that your client get some tax advice is rarely an overreaction and is frequently appreciated. After all, you can often do a good deal of tax planning as a case is winding up. In fact, you can sometimes even use the tax rules to bring the parties together to settle a case that might not otherwise seem resolvable.

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