Guest blog: Three tax tips for every lawyer

By Guest Blogger Robert Wood on March 27, 2017

1. Constructive Receipt and Lawyer Trust Accounts

Lawyers often face constructive receipt tax issues, whether they know it or not. Constructive receipt—a tax term used to determine when a taxpayer has received gross income—is one of those subjects that many people think they understand in part because it comes up frequently.

Around year-end, chances are, you’ve heard someone say: “Pay me next year.” Many of these transactions escape the IRS and get paid and reported later. And the federal W-2 or 1099 forms reporting of transactions is likely to carry weight.

Nevertheless, you might be surprised at how many times the IRS does catch constructive receipt issues. They can spoil an otherwise good legal settlement or transaction.

The IRS says you have income when you have an unqualified right to receive it. Asking for payment later doesn’t change that. (Childs v. Comm’r, 103 T.C. 634, 654 (1994), aff’d, 89 F.3d 856 (11th Cir. 1996).) The tax regulations say that a taxpayer has constructive receipt when income is credited to the taxpayer’s account, set apart, or otherwise made available to be drawn upon. (See Treas. Reg. § 1.451-2.)

On the other hand, there is no constructive receipt if your control is subject to substantial limitations or restrictions. For example, suppose that your client agrees orally to settle a case in December but specifies that the money is to be paid in January. In which year is the amount taxable? The mere fact that the client could have agreed to take the settlement in Year 1 does not mean the client has constructive receipt. The client is free to condition his agreement (and the execution of a settlement agreement) on the payment in Year 2.

Until the client signs the agreement, he or she does not have a right to the money. The key will be what the settlement says before it is signed. If you sign the settlement agreement, and condition the settlement on
payment next year, there is no constructive receipt.

But if funds are paid to the plaintiff’s lawyer trust account, be careful. The IRS treats the lawyer’s receipt also as receipt by the client. Many lawyers and clients find this surprising.

Say a lawyer receives settlement proceeds in December and holds the client’s money until January. The IRS says the client is taxed in December. For the same reason, if a lawyer receives settlement money in his or her trust account, it is usually too late to structure the plaintiff’s payments.

Even though the plaintiff may not have actually received the money, his or her lawyer has. For tax purposes, a lawyer is the agent of the client. If the lawyer and client will split settlement proceeds 60/40, they each have income then even if the lawyer does not disburse funds until the next year.

If the lawyer wants to structure his or her legal fees, it is also too late if the money is in the trust account. The lawyer is deemed to have receipt of his or her fees too, even though they remain in the account.

2. Tax Indemnity Provisions

Tax indemnity provisions are common in settlement agreements, corporate agreements, and real estate deals. They generally state that one party will cover tax problems if they arise and they commonly occur in legal settlement agreements.

When parties are settling a dispute, the first mention of tax issues may be in a draft settlement agreement. Some lawyers will insist that their client hire a tax adviser. Others try to muddle through themselves. But be careful about relying too heavily on the idea of a tax indemnity provision fixing all the tax issues.

For example, the settlement agreement may say that the plaintiff agrees to pay his or her own taxes, and that the defendant will issue a federal 1099 form. The settlement agreement might go on to say that if the defendant incurs any tax problem on these funds, the plaintiff will indemnify the defendant.

This kind of provision rarely hurts anything, but it may not solve much either. It seems to put the issue back on the plaintiff, so many lawyers for defendants may have the (false) sense that their client cannot have a tax problem.

Will the defendant ever go after the plaintiff if there is a tax problem in the future? It is not likely. In most cases, the prospect that the defendant will actually pursue the plaintiff on the tax indemnity is remote. There is usually little for the defendant to benefit, and there are usually reasons not to try.

It is also clear that the indemnity provision may not accomplish what the defendant thinks it does. For example, what if some or all of the settlement payment to the plaintiff is really wages? Issuing a federal 1099 form is not enough. The employer (or former employer) is required to withhold taxes on the wages.
All liability for failure to withhold income and employment taxes resides squarely with the defendant employer. The IRS will pursue the defendant for all the withholding money and penalties. The defendant can demand indemnity and try to go after the plaintiff.

But unless the indemnification agreement is explicit that it covers failure to withhold liability, it may be hard to enforce. Besides, the IRS certainly will not release its hold on the defendant employer, whatever the indemnity provision may say. And then there is the enormous practical barrier.

Trying to enforce an indemnity provision (at least against a former employee) is almost always a mistake. Most lawyers will advise the defendant not to even try to pursue the plaintiff since the litigation is likely to backfire. If the defendant thinks that some or all of the settlement money is wages, the defendant should withhold.

Indeed, a tax indemnity provision often may seem to offer the promise that the tax risk is obviated. However, whenever possible, get some tax advice too, and try not to rely too heavily on a tax indemnity provision as a substitute for analysis. It can be pretty upsetting to have your client complain several years later that the indemnity provision you recommended did not protect them after all.

3. Legal Fees

No one likes paying legal fees, but a tax deduction makes them less painful. Yet not all legal expenses are equal. The least desirable are those of a purely personal nature. Examples include divorce fees or if a family member sues you for slander.

However, legal fees for tax advice are deductible, whether for tax planning or disputes. What’s more, any tax qualifies, including income, estate, gift, property, sales, use, and excise tax. And despite the general rule that personal legal fees are nondeductible, tax fees are deductible even if they are purely personal.

The best legal fees are those in your trade or business, as they are generally fully deductible. Though, some fees must be capitalized and added to the basis of assets. For example, say you are trying to sell your business and spend $50,000 in legal fees. Can you deduct it against your income or must you add it to your basis in your company? Usually the latter.

If legal expenses don’t relate to your business but only to investments, you can still deduct them though usually only as a miscellaneous itemized deduction. That means a 2 percent threshold, phase-outs, and Alternative Minimum Tax.

If your client recovers $1 million in a lawsuit, and 40 percent is your contingent fee, the client might assume he or she has $600,000 of income. But could the client have to pay tax on the full $1 million? Yes. In Commissioner v. Banks, the U.S. Supreme Court ruled you have received gross income when your lawyer is paid. That means you need to worry about how to deduct the fees.
In a pure personal physical-injury case (say an auto accident or slip-and-fall), the entire recovery is tax-free, so it doesn’t matter whether you consider the recovery including legal fees or just the net. Another big context where the legal fee deduction issue is not a problem is employment cases. In an employment case, if the lawyer takes 40 percent, the client still must include 100 percent in gross income.

However, there is now an “above-the-line,” for employment legal fees in employment and certain whistleblower cases. That means the plaintiff has no tax—no regular tax and no AMT—on the legal fees.

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