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10 Legal Settlement Tax Myths Debunked (Part One)

Robert W. Wood *February 18, 2022*

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* 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 *Commissioner v. Banks* (2005) 543 U.S. 426, 430, 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 resulting from personal physical injuries or physical sickness.

This is Part One of a two-part article. It was originally published in its entirety in Vol. 173, No. 5, Tax Notes Federal (November 1, 2021), p. 673.

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