10 Legal Settlement Tax Myths Debunked (Part Two)

Robert W. Wood March 07, 2022

This article is Part Two of a two-part series. Part One covers the first seven tax myths relating to legal settlements.

Talking about taxes is second nature, but lawyers should beware of making tax gaffes when it comes to describing or explaining the tax law. 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 other common tax myths I've heard from well-meaning lawyers.

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.

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. (*Commissioner v. Banks* (2005) 543 U.S. 426.).

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 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. The lawyer says to the 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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