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How Legal Fees In Lawsuit Settlements Are Taxed To Plaintiffs

Legal settlements invariably involve taxes. Money is paid by someone and received by someone else. Defendants want to deduct whatever they pay, and plaintiffs hope the money they receive is tax free. If they cannot have tax-free money, they may want the settlement to be taxed as long term capital gain, not ordinary income. But there are also tax issues with legal fees.

Tax On Legal Fees?

The tax law says contingent legal fees are treated as paid to the plaintiff, even if fees go directly to their lawyer and bypass the plaintiff completely. That's why the tax issues for plaintiffs are not limited to their net settlements after legal fees and costs. Plaintiffs need to consider the gross settlements, including legal fees. Under a U.S. Supreme Court tax case, *Commissioner v. Banks,* 543 U.S. 426 (2005), plaintiffs in contingent fee cases must generally include *100 percent* in income, even if the lawyer is paid directly and even if the plaintiff receives only a net settlement.

It's one of many ways taxes on lawsuit settlements are tricky. No plaintiff wants to end up paying taxes on money that goes to their lawyer, and there is a lot of confusion about tax deductions for legal fees. But despite all the hype to the contrary, there are still ways to deduct your legal fees. In most cases, plaintiffs you can still write off legal fees.

Tax Free Damages

What about taxes on the net amount the plaintiff collects? Compensatory damages for personal physical injuries are not taxable. Therefore, if the case is solely about personal physical injuries and settles before trial, it is usually safe to assume the damages are all compensatory in nature, with no punitive damages or interest. Punitive damages and interest are always taxable.

But not all cases are about physical injuries. Most kinds of lawsuit damages are taxable, including employment cases, property loss or damage, defamation, emotional distress, invasion of privacy, credit reporting and consumer cases, and many others. Most settlements are taxed by the IRS, and plaintiffs need to consider their gross settlements including legal fees, not just their net recovery.

What's A Qualified Settlement Fund?

How does a qualified settlement fund fit into this equation? When a lawsuit settles, the money can be sent to the plaintiff or his lawyer. Usually, it goes to the lawyer, who subtracts legal fees and sends the balance to the client. Alternatively, the funds can be sent to a qualified settlement fund (QSF). QSFs receive special tax treatment so claimants are not taxed until the QSF distributes funds to them.

QSFs were added to the tax law in 1993 so that defendants could deduct settlements *immediately* upon payment to the QSF, even though it might take years for disputes among plaintiffs and lawyers to be resolved and amounts to be paid out. But QSFs also help plaintiffs and their lawyers too with navigating settlement tax rules. But QSFs generally do not impact the tax treatment of legal fees.

When a defendant settles a case and sends money to a QSF instead of to the plaintiff or plaintiff's lawyer, the QSF takes over the defendant's tax reporting. The QSF may send out the lawyer money separately, and may not even issue a Form 1099 to the plaintiff. But the IRS says that it is *still* a payment to the plaintiff for tax purposes. The fact that the QSF may not issue a Form 1099 or that the plaintiff may not be aware of how legal fees are taxed, does not change the way the IRS looks at this.

Legal Fees Are Still An Issue

Plaintiffs may be pleased if they do not receive a Form 1099 for the legal fees, and they may think this gets them off the hook on reporting the legal fees. However, the tax rules are clear that the U.S. Supreme Court *Banks* decision on legal fees still applies. That means it is safer to report the gross amount including the legal fees. The tax law is clear that if a payment is income to you, even if you don't receive a Form 1099, you still must report the income. Failing to report the legal fees can even lengthen the period the IRS can audit you, from three years to six years.

In short, even when funds are paid from a defendant to a QSF, and from a QSF to a plaintiff and lawyer, the tax treatment of legal fees is the same as if the defendant paid it directly. Besides, the hype on deducting legal fees is not as bad as you think. There are still viable ways to do it, and so far, my IRS audit experience on this issue has been positive. It would be best if the tax law were amended to make it 100% clear that no plaintiff should have to fear paying taxes on legal fees. However, until the tax law is clarified, there are workarounds for plaintiffs to avoid paying taxes on more money than they net out of a case.