

Navigating lemon law and consumer settlement tax issues

By Robert W. Wood
and Ira Rheingold

Should successful plaintiffs pay taxes on legal fees they never receive? It sounds like a silly question, especially in consumer cases where consumer protection statutes give extra protection to plaintiffs, calling for defendants to pay legal fees. Like nearly any other plaintiff who recovers money in any variety of cases, plaintiffs who sue auto manufacturers to enforce their consumer rights under California's Song-Beverly Consumer Warranty Act (Civil Code Sections 1790-1795.8) or other state lemon laws should pay attention to their taxes. The same is true in many other kinds of consumer cases, including fair credit reporting cases, fair debt collection cases and many others.

Tax law changes in 2018 made deducting legal fees challenging, but not impossible in all circumstances (*see* Tax Cuts and Jobs Act of 2017, P.L. 115-97), and some, but not all, companies have taken to issuing more IRS Forms 1099 than in the past. But for plaintiffs who pay attention, the tax issues are eminently resolvable. The risk that plaintiffs will actually "lose money by winning their case" (an undercurrent that may cause some defendant companies to smile) is greatly exaggerated, if not a downright unicorn. Of course, being careful with your taxes is important.

As with anything having to do with taxes, you need to handle your tax return with care. Let's start with the basic principle that the tax treatment of litigation recoveries is tricky. Make no mistake, that applies to most any civil litigation recovery, not just lemon law or other consumer cases. The way contingent attorney fees are taxed and reported is part of the problem. In most cases of any type — even personal injury cases — a plaintiff who ends up with his net settlement after legal fees is treated as receiving 100%, even though his or her lawyer collects a contingency of 40% or more off the top.

There is even a U.S. Supreme

Court case that says this is the basic tax rule. *See Banks v. Comm'r*, 543 U.S. 426 (2005). Thus, plaintiffs often receive an IRS Form 1099 for 100%, even if the plaintiff only sees 60%. Before we address how to fix this on a plaintiff's tax return, it is worth noting that this rule does not apply in all cases. The U.S. Supreme Court case that addresses the tax treatment of contingent fees declined to address the tax treatment of statutory fees. *Id.* at 427-28 ("This Court need not address Banks' contention that application of the anticipatory assignment principle would be inconsistent with the purpose of statutory fee-shifting provisions He settled his case, and the fee paid to his attorney was calculated based solely on the contingent-fee contract."). There are strong public policy arguments that the blanket 100% rule should not apply to statutory fees, and where the fees are for injunctive relief, since the reason for statutory fees in the first place is to make litigation affordable to people with little financial means but whose important rights may have been violated.

But where the rubber meets the road in most of these cases is with IRS Form 1099. Forms 1099 are tax forms that stubbornly arrive in mailboxes in late January every year reporting the prior year's payments. Independent contractors receive them for their pay, while employees get a Form W-2. Banks issue Forms 1099 for interest, and most payments settling litigation are reported on a Form 1099 too. *See* Treas. Reg. Sections 1.6041-1(e)(5), Ex. 7; 1.6045-5(f).

There are hundreds of pages of Form 1099 regulations detailing who issues the forms and for what amounts. The fact that there are hundreds of pages of regulations should tell you that there are often differences of opinion, even among tax professionals. Most auto makers do not issue Form 1099s in lemon law cases. That makes sense, since the auto companies do not always know how much of the settlement constitute basis recovery (cost of the vehicle), and so on.

The Form 1099 rules say that

when you are unsure what part of a payment, if any, is income, you should not issue a 1099. *See* IRS Revenue Ruling 88-22, 1980-1 C.B. 286; IRS Priv. Ltr. Rul. 9451052 (Dec. 23, 1994); IRS Priv. Ltr. Rul. 9623025 (June 7, 1996); IRS Priv. Ltr. Rul. 200046014 (Nov. 14, 2000). The companies still correctly issue the forms to the lawyers, as gross proceeds paid to an attorney on Form 1099-MISC. *See* I.R.C. Section 6045(f); Treas. Reg. Section 1.6045-5. Of course, some auto makers believe that if there is any doubt at all, issue the form. Until recently, most auto makers settled many thousands of lemon law cases over many years without issuing Forms 1099. That remains true today for most auto companies.

There has been no change in the Form 1099 rules, but a few automakers now issue Forms 1099 with a vengeance, perhaps hoping to chill lawsuits. Some Forms 1099 appear to report portions of the recovery that are traditionally not reportable. Examples include a refund of the plaintiff's purchase price for their vehicle, and statutory fees separately awarded to the plaintiffs' counsel.

An automaker that issues Forms 1099 to plaintiffs for virtually all payments might assume that the plaintiff has no way out, but there is an answer. Plaintiffs should be careful to report each Form 1099 and deduct or offset the fees and costs. There is no universal way to do this, but there is usually a path so at most, the plaintiff pays tax on any net dollars received over the vehicle purchase price.

Example. You bought a lemon for \$60,000, and you later sue and collect \$50,000 for your car. You also get \$30,000 as civil penalties or punitive damages. Your lawyer ends up collecting \$40,000 for statutory fees. Let's say the automaker does issue you a 1099 for the whole \$120,000. What do you do?

First, you need to report any Form 1099 on your taxes, treating it as income, explaining that it is not, etc. Deducting or explaining legal fees is harder since 2018 when certain corporate tax cuts were made, while certain personal tax deduc-

tions were temporarily suspended through 2025. *See* I.R.C. Section 67(g). However, there are still options many plaintiffs use to end up paying tax only on their \$30,000 of additional damages.

The legal fees may be deductible, may be considered part of the cost basis of the car itself, or could be an offset on the later sale of the car (in circumstances that do not involve a full repurchase). Any of these approaches may result in you not paying tax on your attorney fees. The terms of the settlement and the way it is structured could also have an effect, as do the terms of a consumer's retainer agreement or the nature of the allegations in the complaint itself.

Legislation would also help. A tax bill called the 'End Double Taxation of Successful Consumer Claims Act' was introduced in Congress in 2020 to make clear that plaintiffs can deduct legal fees above-the-line in any consumer-protection case (*see* H.R. 7171, S.3913, 116th Congress (2019-2020)), just like plaintiffs can in employment, discrimination and civil rights cases thanks to a 2004 amendment to the tax code. The legislation did not pass in 2020, but it has already been reintroduced in the new session. S.766, 117th Congress (2021-2022). With a new Democratic Senate, House and President, prospects seem brighter, although some polling suggests support for deducting legal fees in successful consumer suits is bipartisan.

Plainly, getting a Form 1099 reporting that you received more than you did would be upsetting to anyone. This frustration is not unique to plaintiffs in consumer rights' cases. It is also experienced by plaintiffs in employment cases, and most other kinds of cases. Employment plaintiffs typically receive a Form 1099 for legal fees as well as their net recoveries, but at least it is clear that they can deduct the legal fees.

Plaintiffs in consumer rights cases may need more help addressing the Forms 1099 on their tax returns. For many years, lemon law plaintiffs may not have needed to worry, and most auto makers still do not issue

IRS Forms 1099 in these situations. However, if you do receive a Form 1099, don't throw it away. Get some tax advice to fix it on your tax return — so you can make lemonade out of the lemons. ■

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