# Tax Mistakes in Legal Settlements

By Robert W. Wood

We all pay taxes, and we all talk about them, especially how we wish they were lower. A surprising number of people also express tax opinions to others. Lawyers often speak with authority, but sometimes, they make tax comments that turn out to be less than accurate. Here are some of the more common tax mistakes I've heard:

### 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 monies 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 #1. Taxes can often 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 agrees orally 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 does not 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 clients tax ID number? If a Form 1099 is issued in January, you usually will not be able to convince the defendant to undue it without express tax language in the settlement agreement that negates a Form 1099.

If the settlement agreement is explicit 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 is not explicit, you are 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 have to take the legal fees into income, and that is not unconstitutional. In *Commissioner v. Banks,* 543 U.S. 426 (2005), the U.S. Supreme Court held that plaintiffs in contingent fee cases generally must recognize gross income equal to 100% 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% 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 not seem fair, but this isn't double taxation, and it isn't unconstitutional.

### 6. "The defendant can't issue a Form 1099 to the plaintiff for 100% of the settlement, and issue another Form 1099 to the plaintiff lawyer for 100%. 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% of the money when the defendant does not 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%, 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 is code for emotional distress, and that is not enough for tax-free treatment. To be tax-free, compensatory damages must be for personal physical injuries or physical sickness.

Only they are tax free 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 therefrom.

### 8. "Emotional distress damages are not taxable."

This mistake 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 will not 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 sometimes 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, sue to recover it but don't have a net gain, you can't be taxed."

This mistake sounds perfectly logical. If you lost something worth $1M and only get back $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 $1M stock portfolio, and let's say that you previously paid $1M for these investments. Thus, that was your tax basis *and also* the fair market value 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 $1M 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 portfolio with a market value of $1M that was mismanaged, and even though you only got a *portion* of your money back.

The same kind of thing happens with other property cases, such as wildfire cases and many others. Where there are taxes to pay, in some cases there may be section 1033 involuntary conversion benefits possible.

### 10. "If a plaintiff law firm receives an IRS Form 1099 for 100% of a settlement, the law firm must pay tax on 100%, even if it immediately pays out 60% to the plaintiff."

No, the plaintiff law firm merely pays tax on its fee, 40% 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 income of the plaintiff, even if 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.[1]

The IRS rules for Form 1099 reporting bear this 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% of the money. The client should also receive a Form 1099, also for 100%.

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 currently 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 were 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 is not classified as income by the IRS. That is, unlike Form 1099-MISC box 3 (other income) or Form 1099-NEC, the IRS does not 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 does not track amounts reported as gross proceeds paid to an attorney on Form 1099 in the way it treats say "other income" on from 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 natural, but be careful. There are many elements involved in resolving lawsuits and pre-litigation disputes. For lawyers and especially for clients, the situation can be difficult and emotionally charged. Extra tax uncertainties can add to the pressure, especially when they turn out to be big and unpleasant surprises later. Be careful out there.

## Endnote

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

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