PERSPECTIVE

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Top five tax problems for lawyers

By Robert W. Wood

Whether you've just filed your tax return or filed an automatic extension giving you a reprieve until October 15, don't let taxes get too far from your mind. We all pay them. Likewise, we should all consider the tax impact of business and personal decisions. Lawyers in particular have a smattering of tax concerns and their issues can be individualized.

Some tax issues impact lawyers' own pocketbooks and some impact their clients'. However, in over 30 years of practicing tax law, I've seen five tax issues occur for lawyers most repetitively.

Attorney Fees Pay AMT. Lawyers must pay tax on the fees they earn. I hope that's no surprise. Yet how fees are taxed to clients should be a huge concern for lawyers too. Bad tax consequences related to your fees can make the client unhappy with you *and* with the IRS.

The primary tax problem concerns contingent fees. If your client wins or settles a lawsuit and recovers damages, the IRS and the California FTB treat it as *100 percent paid to the client* even if the defendant issues a separate check to the lawyer for his cut. If the case is an employment case, a special 2004 tax law gives the client an "above-the-line" deduction so the legal fees won't affect the client's tax bill.

Of course, if 100 percent of the damages aren't taxable (as in an auto crash injury), there's no tax on the fees. But in other non-business suits, attorney fees are considered income to the client, and the client can usually only claim them as a miscellaneous itemized deduction. That tax mismatch is usually painful.

The alternative minimum tax applies, so your client often pays tax on the fees the lawyer receives, even though the lawyer must *also* pay tax on them. Sometimes this can be avoided. Talk to a tax expert before the client signs any settlement.

Personal Injury Exclusion. If your client is physically injured in an accident and receives damages, they are tax free under Section 104 of the tax code. Only punitive damages and interest are taxed. Up until 1996, just about any claim qualified, including emotional distress, defamation and invasion of privacy. But in 1996, the tax code was changed to say only recoveries for physical injuries or physical sickness are tax free.

Since then, there's been no end of litigation about the scope of this tax exclusion and the question of just how "physical" an injury must be in order to count. Headaches and insomnia? Not enough. Ditto for stomachaches. The IRS hasn't issued a formal interpretation of the "physical" modifier but routinely argues in audits and tax cases that there must be "observable bodily harm" like bruises or broken bones.

However, many injuries are internal and much physical sickness can't be observed with the naked eye. Frustrated tax lawyers and accountants have repeatedly asked for regulatory guidance. Meanwhile, the U.S. Tax Court is clogged with taxpayer cases trying to determine what's taxed. Lawyers and their clients can still influence these rules significantly with the wording of settlement agreements. Get some advice or ask your client to.

Legal Fee Structures. Contingent fee lawyers may complain about the economics of practice and fluctuating income, but there's an upside too. Amazingly, the tax law allows them to "structure" their fees. What does that mean?

It means that instead of taking their 40 percent (or other) share of a settlement in cash, these lawyers elect to receive installment payments of their fees over time. They can do so even if the defendant is paying cash and even if the client is uninterested in structuring and wants a cash settlement. What's more, the investment return element (in effect, the interest on the deferred money) can also be deferred — the lawyer pays tax only as payments are received.

However, such structuring must be done with precision, and timing is critical. The documents must be prepared before the settlement agreement is signed and before the monies hit the lawyer's trust account. Lawyers often wait too long and then try to set up a structure when it is too late.

Deduction for Costs. One more feature of contingent fee practice relates to the costs and disbursements of a case. They can be large and funding them can be painful. Most contingent fee lawyers must pay costs — most use the word "advance" — or the client will go to another lawyer who will. Costs can balloon and can span a number of years before there's a recovery (if there is *ever* a recovery).

Can't lawyers deduct these costs as business expenses? Generally not until the conclusion of the case. Most lawyer fee agreements say the lawyer will "advance" costs. Then, when and if there's a recovery from the defendant, the costs are first reimbursed to the lawyer. Then lawyer and client split (in specified percentages) the balance. This is a "net" fee agreement, and the lawyer cannot deduct the costs until the conclusion of the case.

However, if you are careful and do it just so, you can deduct costs earlier but only if you're in the 9th Circuit. Tax cases in the 9th Circuit hold that the lawyer can deduct costs under a "gross" contingent fee agreement that does not account for costs (so the lawyer is never reimbursed for the costs he's covering). A gross fee contract says the lawyer "pays" the costs and is never reimbursed.

The client and lawyer split the recovery according to whatever percentage split suits them. The lawyer can factor in the likely costs in determining whether to charge 33 percent, 40 percent or more, but costs are not *separately* accounted for. Under such a "gross" fee agreement, a lawyer in the 9th Circuit can deduct the costs as they are incurred.

Foreign Accounts and FATCA. This tax landmine is an equal opportunity problem that affects both lawyers and their clients. As a by-product of the requirement to report worldwide income to the IRS, you'll find that the IRS wants to know what you have and where it is. The first step in this direction occurred when the IRS and Treasury Department dusted off a 1970 money-laundering law requiring annual FBAR reports for those keeping more than $10,000 overseas at any time during the year. If so, one must file a Report of Foreign Bank and Financial Accounts.

FBARs are filed separately from tax forms (by June 30 each year), and the penalties for failure to file them are Draconian. But this year, for the first time, there's another wave of disclosure required. Under FATCA, if your foreign assets exceed $50,000 you must file an IRS Form 8938, Statement of Specified Foreign Financial Assets. Although higher thresholds apply to some expatriates living long-term outside the U.S., the record-keeping and disclosure requirements are onerous.

The new Form 8938 must be filed *with* your tax return, and covers securities accounts, custodial accounts and more. There's another raft of penalties too: up to a $10,000 penalty for failure to disclose and an additional $10,000 for each 30 days of non-filing after the IRS notifies you. Criminal penalties may also apply.

Conclusion. Whether these are your tax concerns or you have others, pay attention to them year round, not just at tax time.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.

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