Be ready for post-settlement tax issues

Once a case is settled, what are the tax implications for your clients, and for you? You don't need to delve deeply into all the complications of tax law, but you do need to know some basics to ensure fair treatment for everyone.

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Many trial lawyers cringe when discussing taxes, and they are not alone. Few people like paying taxes, much less talking about them. And tax law is complicated and full of pitfalls.

But understanding some tax basics related to settlement is important because often, a small change in a settlement agreement can make a big difference in the size of the tax bite you or your clients face. And an open discussion of a settlement's tax implications can often serve to smooth out a contentious issue that may be getting in the way of the parties' reaching an agreement.

As a trial lawyer, you need to know some tax law—even if you routinely rely on experts, and even if your engagement letter includes a blanket disclaimer that you provide no tax advice. At a minimum, you need to be able to identify potential tax issues when discussing settlement. As you know, the overwhelming majority of cases are settled, and tax-planning opportunities are far more significant when cases are settled than when they go to judgment.

As a tax lawyer, I spend much of my time with trial lawyers and their clients. I believe that every trial lawyer should know a few tax basics:

- how to address tax issues in a settlement agreement
- how attorney fees are treated for tax purposes
- how tax issues affect confidentiality provisions
- how to use qualified settlement funds

■ how tax reporting and filing obligations affect the attorney and client

Settlement agreement

The agreement itself can have a big impact on how taxes are handled. Of course, you will want to seek to include tax provisions in the agreement that could help your client. Ask a tax lawyer to provide you with the tax comments, so you can transmit all your comments to opposing counsel (on taxes and other issues) at the same time.

For example, suppose you are going to ask defense counsel for payment within five days, and for a tougher confidentiality clause than the one contained in the draft settlement agreement. Ask for any desired tax provisions to be included in the settlement agreement at the same time, which may give you a better chance of getting them accepted.

What tax provisions should you ask for? Litigation recoveries—whether from settlement or judgment—take their tax character from the origin and nature of the claim. If your client is suing for lost wages, the recovery will probably be treated as wages for tax purposes. If your client is suing for lost profits, lost-profits tax treatment will apply. If your client is suing for diminution in the value of his or her stock portfolio, capital gains treatment (or even recovery-of-basis treatment) may be appropriate. Ask for tax language in the agreement that is consistent with your theory of the case. This can help secure—or even improve—your client's tax result.

One critical statutory exclusion confuses many trial lawyers. Section 104 of the Internal Revenue Code excludes from taxation recoveries for personal physical injuries. The confusion arises because until 1996, this exclusion applied to any personal injury recovery, including recoveries for nonphysical injuries like defamation, emotional distress, and many others.

In 1996, Congress amended §104 to limit the tax exclusion to damages arising from physical injuries or physical sickness. Although this statutory change is now 13 years old, there are no regulations explaining what "physical" means. To be excludable, the IRS says a recovery must be for physical injuries you can see, such as broken bones or bruises. But if you have a legitimate physical injury or physical sickness, emotional distress damages flowing from that injury or sickness are also excludable. In contrast, emotional distress damages outside the context of physical injuries or sickness are taxable.

Here's an example. Your client, Mary, sues for intentional infliction of emotional distress, and you settle the case. Her recovery is taxable because there is no claim for physical injury or sickness. Another client, Sam, sues for battery, a black eye, and a torn ear he received in a bar fight, as well as for emotional distress. This case gets settled for the same amount as Mary's. Under §104, the entire amount of Sam's settlement is tax free, including the portion attributable to emotional distress.

You and your client may need a tax specialist's help before you finalize the settlement agreement. Once you decide what tax provisions are appropriate, document them in the agreement. In addition, keep a binder of backup documents. That way, in the event of a later tax dispute, you'll be able to readily locate key documents.

Although tax language in a settlement agreement will not bind the IRS or the courts in any subsequent tax dispute, they often will respect these terms. If the settlement agreement is silent on taxes, the IRS will often interpret that silence to your client's detriment.

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Attorney fees

The tax treatment of attorney fees is complex. Let's start with the question of how much income the client is considered to have received when a case is resolved and a contingent fee lawyer is paid.

For example, let's say your client, Terry, receives $100,000 to settle an employment discrimination case. As her lawyer, you receive 40 percent of that amount. Does Terry have $100,000 of income or only $60,000?

The IRS will probably treat Terry as having received the full $100,000 as income, even if the defendant paid your fee directly to you. In a 2005 decision, the U.S. Supreme Court held that the client generally has gross income for the full amount of a recovery, including attorney fees.[1]

You might think Terry can simply deduct the contingent fee, so the tax result would be the same as it would have been if she had had only $60,000 of income in the first place. But this is where it gets complicated.

The deductibility of the legal fee depends on the type of case. In employment cases, the client can claim an above-the-line deduction. "Above-the-line" means an adjustment to income before you reach adjusted gross income. An above-the-line deduction is always better from a tax viewpoint.

"Below-the-line" means itemized, going from adjusted gross income to taxable income. A plaintiff in an employment case can deduct the $40,000 in fees above the line, so will only have to pay tax on $60,000. But in other litigation, most clients can deduct the legal fees only as a miscellaneous itemized deduction. Such deductions are subject to various

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limitations and phase-outs, and they tend to run afoul of the alternative minimum tax (AMT). The result is that, frequently, the client cannot deduct all—or sometimes any—of the attorney fee.

Apart from employment cases, there is one other type of case where attorney fees should not be a tax worry: the pure physical injury case. If your client is injured in a catastrophic accident, the entire recovery is excludable from his or her income under §104. Whether the client is treated as having received 100 percent of the recovery or only 60 percent, it is all excludable from his or her income, so there won't be a need to deduct the attorney fees.

Many clients think all legal fees they pay are tax deductible. Not true. If the fees relate to their trade or business, they do get a deduction. If the fees are personal, they don't.

But there's a caveat: Before you can conclude that attorney fees won't cause any tax problems in a personal physical injury case, consider whether interest or punitive damages are being paid. These are taxable income to the client even in a physical injury case. Plus, the portion of the attorney fees attributable to those items generally is also taxable.

The client may be able to deduct this amount, but that deduction may be subject to the limitations applicable to miscellaneous itemized deductions, including the AMT. Where punitive damages and interest are involved, you probably need the help of a tax specialist.

Here's an example. Ernie is seriously injured in an auto accident and awarded a verdict of $2 million in compensatory damages and $2 million in punitive damages. His lawyer receives $1.6 million (40 percent of the $4 million total). Ernie has $2 million of gross income from the punitive damages award, and he can deduct half of the legal fee (the half related to the punitive award) as a miscellaneous itemized deduction.

Many clients think all legal fees they pay are tax deductible. Not true. If the fees relate to their trade or business, they do get a deduction—although even in those cases, some legal expenses must be capitalized and written off over time. But if the legal fees are personal, they cannot be deducted. Personal legal expenses would include, for example, expenses of a divorce or the expenses of a fence dispute with your neighbor.

Often, though, a legal expense that is arguably "personal" may still produce income (a recovery in a personal defamation suit, for example). In such cases, you can usually claim a deduction for your legal fees against your recovery. So the mere fact that a legal matter is nonbusiness doesn't necessarily mean it is personal for tax purposes.

Indeed, you could consider a car accident case to be personal. Yet as noted above, to the extent your recovery in an auto accident case is taxable, your legal fees would be deductible. The legal fees in such a case are treated as an expense for the production of income. In general, though, such legal fee deductions would be miscellaneous itemized deductions, subject to various limitations.

Similarly, legal fees relating to investments are usually deductible, but only as miscellaneous itemized deductions, which means they are subject to limitations.

Confidentiality provisions

Another possible question you will have to face at settlement concerns confidentiality provisions. Much of the confusion about the tax aspects of confidentiality clauses started with the famous 2003 case *Amos v. Commissioner*. No, this case didn't involve chocolate chip cookies; it involved Dennis Rodman.[2]

In 1997, Rodman was a famous (and famously colorful) forward with the Chicago Bulls. During a basketball game, Rodman kicked a cameraman named Eugene Amos in the groin. Hoping to settle quickly and quietly, Rodman paid Amos $200,000 within a few days. When Amos failed to pay tax on the settlement, the major tax issue was whether the photographer could treat the recovery as tax free for personal physical injuries.

The Tax Court said that Rodman and Amos had failed to include explicit tax provisions in the settlement agreement, so the court had to examine it carefully. The court ruled that $120,000 of the settlement was for Amos's injuries and was tax free, but the other $80,000 was a taxable payment for confidentiality. There was evidence that confidentiality was one of Rodman's primary concerns in settling.

Amos went mostly unnoticed in the tax world. (Frankly, Amos got a good deal, since there was little evidence that the groin kick did any real injury.) But many trial lawyers were puzzled by the ruling on confidentiality. There was widespread concern that confidentiality provisions in otherwise tax-free settlements (in a catastrophic injury case, for example) could make some amount taxable.[3]

That concern has caused attorneys to do one or more of the following: (a) omit confidentiality clauses in settlement agreements; (b) include a confidentiality provision, but expressly allocate a specific dollar amount to it; (c) include a confidentiality provision, but expressly say that no portion of the settlement amount is attributed to it; (d) include a confidentiality provision, but underscore in the settlement agreement that all of the monies are paid for personal physical injuries and are therefore excludable under §104; or (e) include reciprocal confidentiality provisions.

There is no universally right answer here, and all these solutions have their downsides. Omitting confidentiality clauses because of tax fears might be an overreaction. Expressly allocating a small dollar amount to a confidentiality clause may invite a plaintiff to violate it. Allocating no amount to confidentiality, and being explicit in the settlement agreement that all of the money is being paid on account of personal physical injuries, is probably the best approach. Another good approach is to include reciprocal confidentiality provisions.

But what is the best lesson from *Amos*? It may simply be that where some or all of the proceeds can fairly be attributed to personal physical injuries, you should expressly and carefully address tax issues in the settlement agreement. Usually, that means you or your client should seek the help of a full-time tax adviser.

Qualified settlement funds

Qualified settlement funds (QSFs), also known as 468B funds, provide some important tax benefits that can encourage settlement. In litigation today, the topic of QSFs may be broached by a lawyer, client, mediator, judge, or structured settlement broker. Usually it comes up during settlement negotiations. To avoid getting caught flat-footed, you should have a sense of how these funds work, when they are appropriate, and what limitations apply. If you haven't seen one yet, don't worry—you will.

Authorized by §468B of the Internal Revenue Code, these are trusts set up to resolve claims, enabling defendants to claim a tax deduction currently for the full amount of the settlement in the year the case is settled, even though the plaintiffs may not receive their money for months or even years. Generally, a defendant cannot claim a tax deduction until the plaintiff actually receives funds.

There are three straightforward requirements for forming a QSF. First, the trust must be subject to court supervision—a judge must approve the trust document and take jurisdiction over the funds. Any court—state, federal, or even probate—will do. It need not be the court with jurisdiction over the case.

Second, the trust must exist to resolve or satisfy claims—to receive money from defendants and pay plaintiffs.

Third, the QSF must qualify as a trust under state law. This is easy; a simple trust agreement will ensure that this requirement is met. There is great flexibility as to who can be a trustee, and lawyers and accountants often fill this role.

A QSF makes sense in many situations. The most common is a class action, where some plaintiffs are not yet identified or where, even if all plaintiffs are known, you need to establish a claims procedure to determine exactly who gets what.

But QSFs are useful in individual cases, too. For example, the plaintiff and the defendant may be negotiating a settlement but find themselves unable to agree on the tax language for the agreement. A QSF can bridge these difficulties, allowing the defendant to pay the money to a QSF so the plaintiffs can later sign releases with the trust. The settlement agreement between the defendant and the QSF might say nothing at all about taxes, only specifying that the defendant will pay over all amounts to the trust. Each individual plaintiff can then sign a settlement agreement with the QSF. It is usually far easier to include favorable tax provisions in those settlement agreements.

A desire to implement structured settlements is another common reason for setting up a QSF. The plaintiffs may need time to determine the form of a structure and the exact annuity payout, assess changing family needs, and address other issues. Quite simply, a QSF is an ideal place to park the money after a settlement amount has been agreed to, but before the details of a structure are worked out.

QSFs are immensely flexible. They can be short term, lasting only a few weeks to a few months. In complex and large class actions, QSFs may exist for several years while payments are disbursed over time. The defendant is entitled to a tax deduction as soon as it deposits funds into the QSF, but the money is not treated as received by the plaintiffs or their lawyers until it is paid out—a great deal for both parties.

About the only time you probably should not use a QSF is in a case with only one plaintiff. Although the jury is still out on the question of whether it is permissible to have a QSF in such a case, the IRS says it is studying the matter.[4]

A 'qualified settlement fund' is an ideal place to park the money after a settlement amount has been agreed to, but before the details of a structure are worked out.

Reporting rules

Tax reporting and withholding seem like accounting drudgery, but if you think you can avoid dealing with them, you're mistaken. Congress and the IRS have increased the penalties that apply if you fail to observe them.

When a settlement is reached, the defendant must file Form 1099-MISC to report to the IRS the payment it makes to resolve the case.[5] You and your client, as payees, are responsible for accurately reporting your income from the settlement on your tax returns.

If the defendant makes payment by a traditional joint check payable to you and your client, IRS regulations require the defendant to issue one Form 1099 to you and one to your client, each for the *full* amount of the settlement.[6] This does not mean that you both are liable for taxes on the full amount. But it does mean you must deal with it on your respective tax returns.

Thus, if you receive a $1 million settlement (including a legal fee of $400,000) and you disburse $600,000 to your client, you should show all of that on your tax return. You will pay tax only on your $400,000 fee. If your client also receives a Form 1099 for the full $1 million, your client will need to find a way to deduct the $400,000 fee. As discussed above, if the fee deduction is above the line, your client pays tax only on the $600,000 net recovery. If your client can only claim a below-the-line deduction, the numbers can get complex, but usually your client ends up paying tax on considerably more than his or her $600,000 net recovery.

This mode of reporting can be confusing at tax time, so I generally ask the defendant to issue two checks—one to the lawyer for the lawyer's share, and the other to the client for the client's share. I've heard plaintiff lawyers voice two objections to this idea: one, the defendant will know what the lawyer's fee is, and two, the lawyer has to figure out and assemble the aggregate costs of the litigation (to be paid by the client) rapidly.

To the former objection, I usually note that the defendant probably can guess the lawyer's fee anyway based on the fairly standard nature of most contingent fee agreements. To the latter, I suggest that the lawyer can make a good estimate of the costs and can send a check to the client later if it turns out the costs are less than estimated.

The advantage of having two separate payments is that you will receive a Form 1099 only for your fee. The client may still receive a Form 1099 for 100 percent of the settlement, but use this bifurcated check procedure unless there is a good reason not to.

Another concern is what Form 1099s the plaintiff lawyer must issue to others. The penalties are severe if you intentionally fail to file a required Form 1099 (10 percent of the payment you fail to report), so you should make a practice of issuing these forms when required.

One of the big places the IRS looks for compliance is in payments to cocounsel. Although most payments to corporations are exempt from Form 1099 rules, that's not the case for payments to lawyers, including incorporated lawyers and law firms.

Here's an example. You're the lead counsel in a case and receive a $1 million fee but are entitled to keep only $400,000, paying the other $600,000 to other lawyers and law firms. You will have to issue Form 1099s to each of your cocounsel. If you don't, you may have trouble deducting the $600,000 you paid out.

One question that frequently stumps lawyers is when to issue Form 1099s to their clients. Suppose you receive a $1 million settlement by check, payable solely to your trust account. You cut a check to your client for your client's share of $600,000. Your share of $400,000 represents your fee. Should you issue a Form 1099 to your client showing your $600,000 payment?

Tax advisers give varying answers to this question. Certainly, if the case involved a personal physical injury (unless there is interest or punitive damages), you should not issue a Form 1099 to your client for the $600,000. The instructions to Form 1099-MISC expressly state that an excludable damages payment is not one of the types of payments to be reported on the form.[7]

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What's less clear is whether you should issue a Form 1099 to your client in other kinds of cases. For example, it is clear that punitive damages and interest are taxable income to plaintiffs, and that a defendant issuing such a payment to a plaintiff should issue a Form 1099 for that amount. However, whether or not the defendant issues a Form 1099 to the plaintiff in such a case, if you as plaintiff counsel are disbursing the money to your client and you know it is punitive damages or interest, should you issue a Form 1099 to your client?

Most lawyers do not issue these forms to clients in such cases, on the theory that they are merely intermediaries, and that as lawyers they are not the "payer." The U.S. Department of the Treasury has promulgated some highly complex regulations applying to lawyers and other intermediaries. In general, these regulations require that you issue a Form 1099 to your client only if you exercised significant management and oversight of the funds before paying them out.[8] Most lawyers, in most cases, do not.

Finally, a word about tax withholding: It doesn't apply to every case. Typically, withholding issues arise when you are settling an employment lawsuit and the settlement includes back pay or other wages. In such a case, the client will receive a net check after payroll tax withholding, and the withheld taxes will be sent to the federal and state governments. In addition to wage withholding, you may face withholding issues when making disbursements to certain foreign persons. In most other types of cases, you probably will not face withholding issues.

Last word

Our federal income tax system is, hands down, the most complicated in the world, and some lawyers throw up their hands without even trying to understand the basics. That's understandable, but it's a mistake. As a trial lawyer, you need to be sensitive to tax issues, and you need to know when it's time to turn to a tax adviser for guidance.

You can do some tax planning as a case winds down to settlement. In fact, you can sometimes use the tax rules to bring parties together, helping to settle a case that doesn't seem resolvable. If you know some basic tax concepts, you can help your client materially, keep yourself out of trouble, and create benefits for yourself and your law firm. ■

Notes

1. *Commr. v. Banks*, 543 U.S. 426 (2005).
2. 86 T.C.M. (CCH) 663 (2003).
3. *See* Randall O. Sorrels & Neel Choudhury, *Avoiding the Confidentiality Tax Bite*, TRIAL 56 (June 2006), www.justice.org/cps/rde/xchg/justice/hs.xsl/4790.htm.
4. Robert W. Wood, *Single-Claimant Qualified (468B) Settlement Funds?*, 122 Tax Notes 71 (Jan. 5, 2009).
5. For general information about Form 1099, see IRS, *A Guide to Information Returns*, www.irs.gov/efile/article/0,,id=98114,00.html.
6. *See* Treas. Reg. §1.6041-1(f) (2008).
7. *See* IRS, *Form 1009-MISC Instructions*, at 4, www.irs.gov/pub/irs-pdf/i1099msc.pdf.
8. *See* Treas. Reg. §1.6041 (2008).