Ten Tax Rules Litigators Should Know

Familiarity with basic tax concepts can help your clients and achieve tax planning benefits for your firm

By ROBERT W. WOOD

Most trial lawyers cringe when discussing taxes, and they are not alone. Even if Joe Biden thinks paying taxes is patriotic, most of us (including tax lawyers) don't particularly like paying them. But we must, or society grinds to a halt.

Taxes are central to our system, and even non-tax lawyers need basic grounding in the tax system. Tax law is formalistic. Often, doing something one way triggers a big tax bill, while doing it only slightly differently does not. Lawyers may bristle at the thought they have to jump through hoops to do something that ought to be simple, just to comply with the tax law.

Nevertheless, every lawyer should know some tax law, even if only to be able to identify tax issues to refer them out. Here are 10 tax rules every litigator should observe.

1. Taxes matter in drafting settlement agreements

Once a settlement agreement is signed, there is little incentive for the parties to cooperate. So, ask for tax provisions in a settlement agreement. But what tax provisions do you request?

Litigation recoveries 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. If your client is suing for lost profits, lost profit tax treatment will apply. If your client is suing for diminution in value to his stock portfolio, capital gain treatment (or even recovery of basis tax treatment) may be appropriate. Ask for tax language in the settlement agreement that is consistent with your theory of the case.

Tax language in the settlement agreement will not bind the IRS or the courts in any subsequent tax dispute. However, such language is often respected by the IRS and the courts. Besides, if you don't even attempt to provide tax language in a settlement agreement, the IRS may use that silence as a weapon against your client in a subsequent tax dispute.

2. Beware the personal physical injury exclusion

One critical exclusion from income that confuses many lawyers relates to personal physical injuries. Section 104 of the Internal Revenue Code excludes from income recoveries for personal physical injuries. Until 1996, this exclusion applied to *any* personal injury recovery, including defamation, intentional or negligent infliction of emotional distress, and many others.

In 1996, Congress amended Section 104 to require *physical* injuries. Although this statutory change is now 13 years old, there are no regulations explaining what "physical" means. The IRS says a recovery must be for physical injuries you can see (such as broken bones or bruises). The statute also excludes damages for physical *sickness*, but there is virtually no authority on what physical sickness means.

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However, 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 physical sickness are taxable. If you find this confusing, you are not alone. You may need a tax specialist to help you and your client before the settlement agreement is finalized.

3. Interest and punitive damages are always taxable

When a defendant pays interest or punitive damages, it will always be income to the recipient. For example, even though a settlement may be excludable as attributable to personal physical injuries, if pre-judgment or post-judgment interest or punitive damages are paid, they will be taxable. Be especially careful when cases are settling on appeal and punitive damages and/or interest elements are being compromised.

Incidentally, even though punitive damages are always income to the recipient, they are deductible by the payor as business expenses if the conduct relates to the defendant's business.

4. Clients usually have income when their contingent fee lawyer is paid

To untangle the mess of attorneys' fees tax rules, let's start with the question whether the client has gross income when the lawyer is paid. For example, assume a client receives $100,000 to settle an employment discrimination case. The lawyer receives 40 percent of that $100,000. Does the client have $100,000 of income or only $60,000?

You may think it doesn't matter, since even if the client is considered as receiving $100,000, the client can surely deduct the $40,000 paid to his lawyer. Yet it's not that simple. The IRS will generally treat the client as having the full $100,000 of income, whether or not the lawyer receives the money directly from the court or the defendant. In *Comm'r v. Banks,* 543 U.S. 426 (2005), the U.S. Supreme Court held the client generally has gross income measured by the full amount of the recovery. You might think the client could simply deduct the contingent fee, so the tax treatment would be the same as only having $60,000 of income in the first place.

5. Legal fee tax deductions vary

The client can usually deduct the legal fee in one of several ways. In employment cases, the client gets an above-the-line deduction, so the client will only have to pay tax on $60,000. But in non-employment litigation, most clients will be able to deduct the legal fees only as a miscellaneous itemized deduction. Such deductions are subject to limitations and phase outs, and do not apply for purposes of the alternative minimum tax. The result is that frequently the client will not be able to deduct all (or sometimes any) of the attorneys' fees.

Apart from employment cases, there is one more type of case where you should not worry about attorneys' fee deductibility: the pure physical injury case. If your client is injured in a catastrophic accident, the entire recovery ought to be excludible from the client's income under Section 104. Whether the client is treated as receiving 100 percent or only 60 percent, it should all be excludible. The client won't need to deduct the attorneys' fees. However, where punitive damages and interest are involved, you probably need a tax specialist to assist.

6. Know qualified settlement fund requirements

Every trial lawyer should be conversant with Qualified Settlement Funds (QSFs or 468B Funds), a topic that may be broached by a lawyer, client, mediator, judge or structured settlement broker. You should have a sense how these funds work, when they are appropriate, and what limitations apply. Enabled by section 468B of the Internal Revenue Code, they are trusts to resolve claims. They enable defendants to claim tax deductions for settlement payments *currently*, even though amounts might be tied up among squabbling plaintiffs for months or even years.

There are three requirements to form a QSF. First and foremost, the trust must be subject to court supervision. That means you ask a judge to approve a QSF trust document and take jurisdiction over the assets. Second, the trust must exist to resolve or satisfy legal claims. Third, the trust must qualify as a trust under state law.

Lawyers and accountants often act as trustees. A court must take jurisdiction over the QSF, but any state, federal or even probate court will do. It may be most logical to consider the court and judge most familiar with the case, but it need not be that court. Traditionally, QSFs were used mostly for class actions, but you don't have to have a class action to have a QSF.

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A QSF can give you more time to determine exact numbers, to fix final attorneys' fees and costs, and to facilitate structured settlements.

7. Consider IRS Form 1099 and withholding rules

Tax reporting rules may seem like accounting drudgery. Yet if you think you don't need to know anything about this, you're mistaken. The IRS has an enormous interest in the tax reporting and withholding regimen, and they've increased the rules — and the penalties — that apply if you fail to observe them.

First and foremost, let's talk about withholding. The main category of payments subject to withholding is wages in employment cases. If you are handling employee lawsuits you will be familiar with the notion that the employer must withhold on wage payments. Withholding means the client will receive a net check after payroll tax withholding, and all of the withheld tax will be sent to the federal and state governments.

If your case is outside the employment context, you may not have withholding issues, but you will face Form 1099 reports. You need to be aware what tax forms you and your client will receive when a case settles. You may be surprised to learn that how checks are cut can dramatically influence what Forms 1099 you and your client receive.

8. Beware of duplicate Form 1099 reporting

If you settle a case for a traditional joint check (payable to you and your client), the IRS regulations require the defendant to issue one Form 1099 to you and one Form 1099 to your client, each for the *full* amount! If that sounds like duplicate reporting and potential double taxation, that's just the way the rules work. I generally prefer to ask a 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.

The advantage of having two separate checks is that the lawyer will receive a Form 1099 *only* for the lawyer's fee. The client is probably still going to receive a Form 1099 for 100 percent of the fee, but not always. If you want to have any ability to argue about the client's Form 1099, use this bifurcated check procedure unless there is a good reason not to.

9. Lawyers need to *send* Forms 1099, too

Another concern is what Forms 1099 you as a lawyer must *send*. In general, anyone making payments in connection with a business must issue IRS Forms 1099 for payments of $600 or more. The penalties are not too severe for failing to do so (generally $50 for each Form you fail to file) but they are quite severe if you *intentionally* fail to do so. You should make a practice of issuing 1099s when required.

For example, suppose you are lead counsel in a case and receive a $1 million fee, but only keep $400,000, paying the other $600,000 to other lawyers or law firms. You must issue Forms 1099s to all of your co-counsel. If you don't, you may have trouble deducting the $600,000 you paid, and you may be subject to penalties.

Incidentally, although most payments to corporations are exempt from Form 1099 rules, this is not true for payments to lawyers. Incorporated lawyers and law firms must still be issued Form 1099 for legal fees.

10. Usually you need not send Form 1099 to clients

An area of confusion for lawyers is under what circumstances to issue Forms 1099 to their own clients. For example, suppose you receive a $1 million settlement, by a check that is payable solely to your trust account. Suppose you cut a check to your client for your client's share, $600,000. Your share of $400,000 represents your fee. Should you issue a Form 1099 to your client for $600,000?

Tax advisors vary in their answers to this question. If it is a personal physical injury case (unless interest or punitive damages are being paid), you *should not* issue a Form 1099 to your client for the $600,000. The instructions to Form 1099-MISC expressly state that an excludible damage payment is not to be the subject of a Form 1099.

It is less clear whether you should issue a Form 1099 in other kinds of cases. The rules are complex and practice varies. However, most lawyers do not issue Forms 1099 to clients, on the theory that they are merely acting as an intermediary.

The Treasury Department has promulgated some highly complex regulations applying to lawyers and other intermediaries. In general, these regulations require you to issue a Form 1099 to your client if you exercised significant management and oversight of the funds before paying them out. Most lawyers in most cases probably do not.

Conclusion

No one said our tax system was easy. In fact, our federal income tax system is (by far) the most complicated tax system in the world. Even so, trial lawyers need to be sensitive to tax issues to know when to call upon tax advisors for guidance. Frequently, you can do a good deal of tax planning as a case is winding up.

In fact, you can sometimes use the tax rules to bring the parties together to settle a case that might not otherwise seem resolvable. If you know these basic concepts, you can help your client materially, help keep yourself out of trouble, and achieve tax planning benefits for yourself and your law firm.

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1. Tax provisions in a settlement agreement are binding on the IRS.

2. In a settlement agreement, it is a good idea for both plaintiff and defendant to agree on tax characterization and tax reporting.

3. Damages for emotional distress are tax-free.

4. The IRS generally expects there to be observable bodily harm in order to treat a recovery for that harm as tax-free.

5. Generally speaking, when a client receives a recovery and a share of the recovery goes directly to the client's contingent fee lawyer, the client nevertheless has income.

6. Clients in employment cases are entitled to an above the line deduction for their contingent legal fees, which effectively means the same as netting the legal fees against their gross recovery.

7. A client who deducts legal fees as a miscellaneous itemized deduction may run into problems under the alternative minimum tax.

8. If a defendant makes a settlement payment to a qualified settlement fund, the defendant can deduct the payment currently (assuming it is otherwise deductible), and is not required to wait for settlement monies to be paid from the qualified settlement fund to plaintiffs.

9. To set up a qualified settlement fund, the court with jurisdiction over the case must also take jurisdiction over the qualified settlement fund.

10. Qualified settlement funds are used only for class actions.

11. There are penalties on taxpayers who fail to issue 1099s when required.

12. If a case is settled via a joint check to lawyer and client, the IRS regulations require the defendant to issue duplicate Forms 1099 for the full amount to plaintiff and lawyer.

13. If a settlement agreement contemplates a payment of wages, wage withholding is required.

14. In general, if a lawyer receives a fee, part of which the lawyer then pays to co-counsel, the lawyer must issue Forms 1099 to the co-counsel.

15. If you practice in an incorporated law firm, the law firm is exempt from 1099 requirements along with other corporations.

16. If a plaintiff receives a settlement of an auto accident case for personal physical injuries, the payor should issue a Form 1099 for that payment.

17. If you are in doubt whether you should issue a 1099 or not, it is probably safest to issue it.

18. Under the origin of the claim doctrine, punitive damages received for personal physical injuries are tax free.

19. A qualified settlement fund must have a trust company as its trustee.

20. Punitive damages are generally deductible by the payor.

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