Top 10 Tax Mistakes Made by Contingent Fee Lawyers

By Robert W. Wood

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Contingent fee lawyers inevitably confront — or fail to confront — tax issues as they resolve cases. They need to understand the pivotal tax issues their clients face and when to prompt clients to obtain tax advice. If they don't, they may make one of the 10 big mistakes identified in this column.

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

Many tax problems are common to contingent fee litigation, and it's understandable that many plaintiff lawyers don't venture into the tax rules for fear of missteps. As tempting as it may be for lawyers to say they don't practice tax law and aren't accountable for *any* of this, that stance can also cause problems. There are a surprising number of times the clients or the lawyers themselves are sorely disadvantaged. Even seemingly innocent missteps may cause tax liability.

By the time the tax problems are identified, it's often too late to get effective tax advice — no matter how skilled the tax adviser may be. Lawyers who hope to prevent tax disasters need to know when and where to reach out for help or know when to insist that their clients do so. One can't put spilled milk back in a bottle.

Put another way, there are some things lawyers *need* to know even if only to be able to identify a tax problem, not to solve it. As in the medical field, a triage can sometimes be more important than any other function. Here, then, are the top 10 tax mistakes made by (even very good) plaintiff lawyers.

1. Don't overlook the bottom line. This is basic, even obvious. It subsumes many of the other points below, because how you get to a bottom line after taxes inevitably involves many of my other points. Yet it is actually distinct and merits separate discussion, tying into the delicate subject of lawyer liability.

Axiomatically, every client in a contingent fee case wants to know how much money he will net. The contingent lawyer's percentage fee may be well known to all parties. Yet the matter of costs inevitably comes up and will need to be factored in. So there is already a bottom-line computation of sorts in the works.

Pre-tax and post-tax computations may be surprisingly different and counterintuitive. Suppose a plaintiff is receiving a $1 million recovery with a 40 percent attorney fee and costs that total 10 percent. Simple math might suggest that $500,000 is taxable to the plaintiff. Yet, as we shall see, the tax treatment may be $1 million of income followed by a miscellaneous itemized deduction for $500,000. The result may be vastly greater than $500,000 being taxed.

In all cases, therefore, it pays to have a tax professional run computations for the after-tax result of the case. How else can one say what a "net" recovery is going to be? When there is doubt about the application of the tax rules to a particular case, those variables can be built into a model to produce a range of net recoveries from best- to worst-case scenarios, taking into account tax possibilities and risk profiles. But failing to at least attempt to come up with some figures seems careless.

2. Don't fail to consider interest. In these days of low interest rates, it may seem understandable for lawyers and clients not to focus on how much interest is accruing on a judgment. Conversely, some statutory rates of interest on judgments are relatively high compared with market rates. That can make interest an even more important component of the recovery.

Whether the judgment is ultimately paid as such or compromised during appeal, interest is a tax trap waiting to be sprung. The reason is simple: Interest is always taxable no matter the kind of underlying case.[1] Even in a personal physical injury case in

[1]*See Wheeler v. Commissioner*, 58 T.C. 459 (1972).

which there is no doubt that the compensatory damages are tax free, interest is taxable.[2]

This can be particularly confusing in settlements. Suppose a judgment for $5 million has accrued $500,000 of interest but the case is settled on appeal for $5 million. Is there any interest? None? $500,000? The fraction derived by dividing $5 million by $5.5 million? The answer may be any one of those choices or even another figure.

Another problem is presented when the parties think of the issue in advance but simply state that everyone agrees there will be *no* interest paid. Is this effective for tax purposes? If not, is it worth doing? How do these variables change if the same case is settled for $5.1 million?

As simple as those questions may sound, it is something not to try at home if you aren't a tax specialist. The tax case law is nuanced. Sometimes the IRS or the courts will respect your tax planning. Other times, it won't.

''No interest'' provisions are generally disregarded.[3] However, rather dramatic interest compromises have often been upheld. Care and judgment are needed.

3. Don't forget the tax treatment of punitive damages. The tax treatment of punitive damages is similar in some respects to the tax treatment of interest. Yet it is also different and represents a much bigger tax trap. As with interest, punitive damages are always taxable, regardless of the kind of recovery or case.[4]

Suppose a plaintiff is terribly injured and there is no question that all compensatory damages should be tax free. Even then, any punitive damages will be taxed. This can raise interesting allocation questions in cases that settle on appeal. Because of the potential magnitude of punitive damage recoveries compared with interest, the tax problems can be more severe.

Suppose a catastrophic injury case goes to verdict, yielding $1 million in compensatory damages and $10 million in punitive damages. On appeal the case settles for $2 million. Is any amount taxable as punitive damages? $1 million? The figure derived by subtracting from $2 million the fraction represented by multiplying $2 million by 1 million over 11 million? Some other number?

In evaluating alternatives, could one ever argue that the entire $2 million settlement is tax free? (Hint: Yes, even that home run may be possible, at least if the appeal involves not merely the appropriateness of the punitive damages award but also the plaintiff's cross-appeal for additional compensatory damages.)

In all this, the stakes are large, and the nature and scope of the tax language to be inserted should be considered carefully. It may seem pointless to request language in a settlement agreement to specifically address punitive damages if the defendant is difficult and uncooperative. If you think this way, think again.

Consider that especially on punitive damages issues, the defendant may have its own (nontax) reasons for preferring to characterize a settlement as not involving wrongdoing or any punitive element. Insurance and public relations issues may be major motivators. Finally, there can be worrisome issues even in cases that don't resolve on appeal.

In a handful of cases, the IRS has tried — and succeeded — in importing punitive damage treatment even when a case has never gone to the jury. When punitive damages were requested in the complaint, the IRS has occasionally argued that it is reasonable to treat some amount of the settlement as punitive in nature and therefore taxable.[5] This appalling tax trend can be countered, but not by amateur tax sleuths.

4. Don't forget the tax treatment of attorney fees. This mistake may sound exaggerated. After all, one might assume that even the most tax-naïve plaintiff lawyer is likely to know *something* about the bad tax treatment to which attorney fees are subject. The lawyer may simply know that there is some kind of tax problem or that the plaintiff may be unable to deduct the fees and could end up actually paying tax on monies the lawyer receives.

Whatever the lawyer knows about the tax treatment of attorney fees, it is unlikely to be enough or to be the right information. Even if the lawyer is quite tax savvy and knows the tax rules applicable to attorney fees, applying those rules to a given fact pattern can be difficult. It is precisely because most lawyers think they know *something* about this set of nettlesome issues that it is one of the most dangerous.

If a case is truly a personal physical injury case and 100 percent of the recovery will be tax free, there will be no problem with the tax treatment of the attorney fees. But note the terribly qualified nature of this rule. The case must be a *true* personal physical injury case (a wrongful death case for this purpose will qualify), and *100 percent* of the recovery must be tax free.

[2]*Kovacs v. Commissioner*, 100 T.C. 124 (1993), *Doc 93-2636*, *93 TNT 45-22*, *aff'd*, 25 F.3d 1048 (6th Cir. 1994), *Doc 94-6133*, *94 TNT 126-16*.

[3]*Rozpad v. Commissioner*, 154 F.3d 1 (1st Cir. 1998), *Doc 98-26496*, *98 TNT 166-4*.

[4]Rev. Rul. 85-98, 1985-2 C.B. 51.

[5]*See Barnes v. Commissioner*, T.C. Memo. 1997-25, *Doc 97-1505*, *97 TNT 11-13*.

That eliminates most cases. In fact, if some of the recovery is treated as interest (see Mistake 2) or if some of the recovery is treated as punitive damages (see Mistake 3), some of the attorney fees also will be taxable. Exactly how one deals with this varies.

The IRS's presumption is that everything should be done pro rata.[6] Thus, if 50 percent of the recovery is tax free and 50 percent is punitive and therefore taxable, the IRS would expect to see the attorney fees similarly allocated. That would generally mean the client would have to include in income 50 percent of the attorney fees and claim them as a miscellaneous itemized deduction.

Miscellaneous itemized deductions receive unfavorable treatment. They endure a 2 percent haircut and complete nondeductibility for purposes of the dreaded (and increasingly ubiquitous) alternative minimum tax. It is the AMT that causes many taxpayers to pay tax on their attorney's fees.

Yet it is possible to have another (non-pro rata) fee allocation.[7] One may be able to demonstrate (with attorney timesheets or declarations) that a smaller portion of the attorney fees was allocable to the punitive phase of the case. The tax picture from an 80/20 allocation of fees may be vastly more favorable from a tax viewpoint than one under the presumptive pro rata approach. But timing and details are important.

5. Don't forget the unclear scope of section 104. Virtually every plaintiff lawyer knows something about the section 104 exclusion. For more than 80 years, our tax system has exempted from taxation recoveries in personal injury cases. But it was only in 1996 that this timeworn rule was cut back to exempt only damages for personal physical injuries and physical sickness.[8]

Over the last 15 years, the IRS has not been exactly forthcoming in describing what is and is not physical. Even so, many things are clear. The IRS generally requires observable bodily harm.[9]

Damages for physical manifestations of emotional distress are not tax free. Headaches, stomachaches, and insomnia are in this category. However, if there is a physical injury as a catalyst, emotional distress damages are also tax free, carried along by the physical act.

That means damages for sexual harassment are typically taxable. But if the first event is a physical assault with bruises or broken bones, all the compensatory damages thereafter should be entirely tax free. Moreover, several recent Tax Court cases suggest that even without a physical catalyst, the onset or exacerbation of physical sickness can produce damages that are also excludable under section 104.[10]

In all this, timing and details matter a great deal. Taxpayer victories have been decided in some areas. In a 2008 legal memorandum, the IRS concluded that a sexual abuse recovery was entitled to tax-free treatment despite the lack of any physical mark from the abuse.[11] Similarly, a private letter ruling accorded tax-free treatment to a bad-faith insurance recovery arising from a personal physical injury.[12]

However, there also have been many tax disasters. A common but potentially ruinous tax problem occurs when the parties think a recovery will be tax free but it turns out not to be. Not only is the net amount the plaintiff receives taxable but so too are the attorney fees (see Mistake 4).

This problem is quite common because many people — even tax advisers — seem to misread some of the authorities. For example, a 2010 IRS legal memorandum on wrongful imprisonment led many to conclude that all those recoveries are now tax free, which is surely an exaggeration.[13] In short, don't assume the section 104 exclusion applies. Also, don't assume it *doesn't* apply. Get some advice or strongly urge the client to do so.

6. Don't ignore constructive receipt. Constructive receipt concerns go to the very underpinnings of our tax system. Taxpayers can report on the cash or accrual basis, but accrual basis taxpayers tend to be big companies. Individuals and small law firms are invariably on the cash method.

To a cash basis taxpayer, something is income when one receives it or when one has an unrestricted right to receive it, even though it is not collected until later.[14] The latter is known as constructive receipt, and it is a confusing but pervasive concept. When you have an unfettered right to receive something, its actual receipt will be assumed. Constructive receipt trumps actual receipt.

The classic example is a bonus check that an employer makes available in December but the employee asks to have held until January 1. Normal cash accounting would suggest that the bonus is not income until actually paid in January. However,

[6] *Metzger v. Commissioner*, 88 T.C. 834, 860 (1987).

[7] *Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995), *Doc 96-602*, *96 TNT 1-74*.

[8] H.R. Conf. Rep. No. 104-737, at 301 (1996).

[9] LTR 200041022, *Doc 2000-26382*, *2000 TNT 201-10*.

[10] *Parkinson v. Commissioner*, T.C. Memo. 2010-142, *Doc 2010-14364*, *2010 TNT 124-12*; *Domeny v. Commissioner*, T.C. Memo. 2010-9, *Doc 2010-787*, *2010 TNT 9-9*.

[11] ILM 200809001, *Doc 2008-4372*, *2008 TNT 42-21*.

[12] LTR 200903073, *Doc 2009-1070*, *2009 TNT 11-27*.

[13] ILM 201045023, *Doc 2010-24317*, *2010 TNT 219-20*.

[14] Reg. section 1.451-2(a).

because the check was available in December, constructive receipt makes it income to the employee in December.

In resolving litigation, lawyers and structured settlement brokers commonly must address constructive receipt concerns. If you are settling litigation and have already signed the settlement agreement, it's generally too late to change terms, including terms of payment. That seems obvious.

Yet lawyers often think they can ask for periodic payments even though the parties have already executed a binding document that calls for cash. Because of the constructive receipt doctrine, it's usually too late. As for trust accounts, a lawyer is the agent of his client. If the lawyer receives settlement money in his trust account, the client usually has income, even if the lawyer does not disburse it until the following year.

7. Don't assume wages are terrible. In employment disputes, some amount of the settlement is almost always intended as wages. That would make them subject to withholding and employment taxes. Many plaintiff lawyers seem to think wage treatment is terrible and try to avoid it. This can be shortsighted for several reasons.

With wages, the employer and the employee each pay half of the Social Security tax. In contrast, if the damages are treated as self-employment income, the former employee must pay the entire tax, equal to both the employee and employer portions of Social Security. That can make wage treatment better for the plaintiff.

An arguably more important point is a practical one. If there's no or little wage withholding, the former employee will have little or no tax withholding. For the first time, the plaintiff may have to budget for paying taxes himself. That can lead to a rude awakening at filing time the following April.

For that reason, consider whether and how much withholding is appropriate, and plan ahead. The IRS generally expects a portion of a settlement in any employment case to be wages. The only question is how much.

In that sense, arguing for no wage treatment seems odd or even flatly incorrect. It may even invite the IRS to inquire further and to reallocate the payments. In general, try to come up with a figure for wages that's fair and reasonable based on the facts of the case and the risk profiles of the plaintiff and the defendant.

8. Don't ignore the breadth of the above-the-line fee deduction. I've noted the tax problems associated with attorney fees (Mistake 4), but there's one big exception. Plaintiffs in taxable damage cases are generally treated as receiving the fees paid to their contingent fee lawyer.[15] However, an above-the-line deduction (rather than a miscellaneous itemized deduction) is available in some cases.

The shorthand version of this 2004 statutory change is that an above-the-line deduction applies to employment cases and Federal False Claims Act cases.[16] But many non-employee claims, notably whistleblower and federal civil rights cases, also are entitled to this favorable deduction.[17] Even though one must be vigilant about attorney fee tax problems, make sure you investigate the tax treatment of your specific case (or engage someone else to do it).

The IRS seems to be interpreting the above-the-line deduction broadly. You might be surprised by the circumstances under which this tax relief for litigants can apply.

9. Don't forget about Forms 1099. Many lawyers are now familiar with the notion that they should try to insert tax language into a settlement agreement, even if it may later be viewed as self-serving. Ideally, they should get tax advice from a professional about what to say and how to say it, but most now know that they should try.

Yet the import of Forms 1099 seems to elude many lawyers. This is odd, because lawyers themselves also receive Forms 1099. If you are settling a case and believe the entire recovery to your client is tax free, hopefully your client will not receive a Form 1099. In fact, the IRS instructions to Form 1099-MISC say that a personal physical injury settlement should not be the subject of a Form 1099.

Yet many defendants and insurance companies still issue the ubiquitous forms. The only reliable way to ensure that no such form is issued is to expressly so provide in the settlement agreement. If the client does receive one, he'll need to report the amount on his tax return even if you're both still convinced the recovery is tax free.

There are ways to back out the payment on the client's Form 1040 so the client isn't taxed on the amount reported on the Form 1099. However, those methods aren't foolproof and can be higher profile than the client may like. Whatever the desired tax treatment, and the amount reported on and number of Forms 1099, discuss this issue. Come to an explicit agreement in the settlement agreement whenever possible.

10. Don't fail to consider structures. Structured settlements provide tax efficiency, level out income, and protect assets from creditors. A plaintiff injured

[15]*See Commissioner v. Banks*, 543 U.S. 426 (2005), *Doc 2005-1418*, *2005 TNT 15-10*.

[16]Section 703 of the American Jobs Creation Act of 2004 (P.L. 108-357).

[17]*See generally* section 62(e).

in a car accident might receive a lump sum settlement tax free, but his investment earnings thereafter are taxable. If he receives a structured settlement instead, he'll receive payments over a term of years or over his lifetime (however he chooses), and each payment will be fully tax free.

Thus, a structure converts after-tax earnings into a tax-free return. A plaintiff can structure as much or as little as he wants and take the rest in cash. This doesn't violate the constructive receipt doctrine (Mistake 6), because the settlement agreement itself will call for the structure. However, the mechanics are important.

The plaintiff can't own the annuity policy. The defendant will send the money for the structure to a life insurance company's subsidiary (an assignment company). The assignment company will buy the annuity from its parent life insurance company and will hold the policy and pay the plaintiff each month as the annuity contract requires.

There are also taxable structures under which each payment is taxable when received, but the earnings grow on a tax-deferred basis. Taxable structures have become popular to resolve employment suits and many other non-personal physical injury cases. The same idea is used for lawyers who want to structure their fees. Contingent fee lawyers can elect to receive (and pay tax on) monies paid over time rather than in one lump sum.[18]

Once again, this doesn't violate the constructive receipt doctrine (Mistake 6). In all this, though, timing is important. Obviously, these issues must be addressed before signing a settlement agreement. In fact, it's rarely too early to start discussing it. Don't leave it for the last minute, or there may not be time to set it up properly.

Conclusion

Increasingly, the tax problems associated with litigation recoveries are nuanced and not suited to cookie-cutter solutions. Lawyers, structured settlement brokers, accountants, financial advisers, and others are likely to encounter these issues. They often arise in ways that combine multiple rules applying across a mix of confusing facts and documents.

Learning when, where, and how to address these problems can be challenging. Even identifying the issues requires attention to detail. Whatever your role in these situations, address the tax issues early, often, and thoughtfully.

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[18]*See Childs v. Commissioner*, 103 T.C. 634 (1994), *Doc 94-10228*, *94 TNT 223-15*, *aff'd without opinion*, 89 F.3d 856 (11th Cir. 1996), *Doc 96-19540*, *96 TNT 133-7*.