TACKLING POST-SETTLEMENT TAX ISSUES
SOME BASICS YOU NEED TO KNOW
By Robert W. Wood*

Many trial lawyers cringe when discussing taxes, and they are not alone. But understanding some tax basics related to settlement is important. 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.

The settlement agreement itself can have a big impact on how taxes are handled. 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. Ask for tax language in the settlement 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 or personal physical sickness. In 1996, Congress amended §104 to limit the tax exclusion to damages arising from physical injuries or physical sickness (it previously just said “personal”). 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.

I believe explicit tax language belongs in virtually every settlement agreement in every kind of litigation. Yet arguably the greatest need for clarity in tax language comes in employment litigation. The IRS has an incentive to view all payments in this context as wages, and employees often regard their settlements as either non-wage income, or even as excludable recoveries. Because there are very serious penalties imposed on an employer who fails to withhold on wages, there’s also a big reason for the defendant in such cases to be very clear. It serves no one to have a dispute about the appropriateness of withholding and reporting after the settlement agreement is signed.

In general, therefore, it’s appropriate for the settlement agreement to specifically set forth: (1) what amount of money will be treated by the parties as wages subject to withholding and a Form W-2; (2) what portion will be

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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.

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. Yet 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 legal expenses of a divorce or the legal 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. Thus, the mere fact that a legal matter is non-business doesn’t necessarily mean it is personal for tax purposes. Legal fees relating to investments are usually deductible, but only as miscellaneous itemized deductions, which means they are subject to limitations.

Qualified Settlement Funds

Qualified settlement funds (QSFs), also known as 468B funds, provide important tax benefits that can en-
Courage settlement. Authorized by §468B of the Internal Revenue Code, these are trusts set up to resolve claims. Generally, a defendant cannot claim a tax deduction until the plaintiff actually receives funds. Yet QSFs allow 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.

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. 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 is most classically used in class actions, but QSFs are useful in individual cases too. The plaintiff and 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 each party to get what they want because there can be two settlement agreements.

A desire to implement structured settlements is another common reason for setting up a QSF. A QSF is an ideal place to park the money while the details of structures are worked out. QSFs are immensely flexible. They can be short term, lasting only a few weeks or 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.

Reporting Rules

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. 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. Thus, if you receive a $1 million settlement (including a legal fee of $400,000) and you disburse $600,000 to your client, you will pay tax only on your $400,000 fee. If your client also receives a Form 1099 for $400,000 and the deduction is above-the-line, your client pays tax only on the $600,000 net recovery. If your client can claim only a below-the-line deduction, the numbers can get complex, but usually your client ends up paying tax on considerably more than his $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. The advantage of 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 co-counsel. 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.

Most lawyers do not issue these forms to clients, on the theory that they are merely intermediaries, and that as lawyers they are not the “payor.” The Treasury Department 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. Most lawyers in most cases do not.

Final Word

Our federal income tax system is the most complicated in the world, and some lawyers throw up their hands without even trying to understand the basics. That’s a mistake. As a litigator, you should be sensitive to tax issues, and know when it’s time to turn to a tax adviser for guidance. Often, you can do some tax planning as a case winds down to settlement. If you know some tax basics, you can help your client materially, keep yourself out of trouble, and create benefits for yourself and your firm.

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