Ten Tax Rules To Keep In Mind

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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, and even non–tax lawyers need basic grounding in the tax system. Tax law is arcane and formalistic, so paying attention to form is quite important.

Often, doing something one way can trigger a big tax bill, while doing it only slightly differently has no adverse tax result. Trial 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 trial lawyer should know some tax law, even if only to be able to identify the tax issues to refer them out. The overwhelming majority of cases settle, and the tax planning opportunities with settlements are far more significant than with cases that go to judgment.

10 Rules Every Litigator Should Observe About Tax Issues

1. Taxes Matter In Drafting Settlement Agreements

Most lawyers know the maxim that once a settlement agreement is signed, there is no incentive for the parties to cooperate. So, if you want tax provisions in a settlement agreement, ask for them as part of your other comments. The first draft of a settlement agreement is typically drafted by the defendant. If you are plaintiff's counsel, ask tax counsel to provide tax comments to you, so you can transmit all of the comments (tax and non–tax points) at once. This can be effective in slipping tax provisions into a settlement agreement that could materially help your client.

But what tax provisions do you ask for? Litigation recoveries (whether by settlement or judgment) take their tax character from the origin and nature of the claim. This tax rule seems more logical than most of the rest of the tax code. 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 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.

Including tax provisions in the settlement agreement can go a long way toward helping your clients achieve their tax goals. 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, you may miss out entirely. If the settlement agreement is silent, the IRS will often use that silence as a weapon against your client in a subsequent tax dispute. That means the best time to consider tax issues is before the settlement agreement is signed.

2. Beware Of The Personal Physical Injury Exclusion

One critical statutory exclusion that confuses many lawyers relates to personal physical injuries. Section 104 of the Internal Revenue Code excludes from income recoveries (by settlement or judgment) for personal physical injuries. Up 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 just 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.

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 that occur 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. 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% 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.

4. Legal Fee Tax Deductions Vary

The client can usually deduct the legal fee in one of several ways. We must distinguish between employment lawsuits (and federal False Claims Act suits) and virtually all others. 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 attorney's fees.

Apart from employment cases, there is one more type of case where you should not worry about attorney's 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% or only 60%, should all be excludible from the client's income. The client won't need to deduct the attorney's fees.

But as you consider such personal physical injury cases, be careful if interest or punitive damages are awarded. If interest or punitive damages are paid, then that interest or punitive damages will be taxable income to the client even in a physical injury case. That means a portion of the attorney's fees attributable to those taxable items would generally also be taxable to the client.

The client may be able to deduct the attorney's fees attributable to the punitive damages and interest. However, that deduction may be subject to the limitations applicable to miscellaneous itemized deductions (including alternative minimum tax). Where punitive damages and interest are involved, you probably need a tax specialist to assist.

5. 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. Under general tax rules, a defendant cannot claim a deduction until the plaintiff receives the funds. QSFs provide a big exception to the normal reciprocity in the tax law between payor and payee.

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.

There is great flexibility as to who can be a trustee. Lawyers and accountants often act as trustees. A court must take jurisdiction over the QSF, but it need not be the court with jurisdiction over the legal dispute being resolved. Any court—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.

A QSF is taxed as a separate entity, but only on the income it earns on contributed funds. Usually, that means it is only taxed on interest and dividends.

6. Be Creative When You Use Qualified Settlement Funds

There are many circumstances in which a QSF makes sense. Plaintiff and defendant may be negotiating a settlement, but may not agree on tax language for the settlement agreement. A QSF can bridge such difficulties, allowing the defendant to simply pay over the money, and plaintiffs to later sign releases with the QSF. Another circumstance ripe for a QSF is a class action, where all the plaintiffs haven't been identified. Even if they have been identified, you may need to establish a claims procedure to determine exactly who gets what.

Traditionally, QSFs were used mostly for class actions, but you don't have to have a class action to have a QSF. You may employ a QSF to give you more time to determine exact numbers, to fix final attorney's fees and costs, and to facilitate structured settlements. Structured settlements involve the purchase of annuities that provide regular payments to plaintiffs for a term of years or life. A desire to implement structured settlements is a common reason for setting up a QSF. The plaintiffs may need time to determine the form of a structure, the exact annuity payout, family needs, etc. Structures can be purchased for attorney's fees too.

QSFs are flexible, and while QSFs usually exist for a short time, often a few weeks or a few months, there is no express time limit on their duration. In complex and large class actions, however, QSFs may exist for several years. The QSF truly operates as a tax free holding pattern. Monies are not treated as received by the plaintiff(s)—or the plaintiff lawyers—until they are paid out of the QSF. Yet, the defendant is entitled to a tax deduction as soon as the money is put into the QSF.

QSFs are tremendously flexible, and their uses are increasing. Many lawyers (both plaintiff and defense) are surprised when they hear the fundamental benefits of a QSF. Both plaintiffs and defense counsel can use a QSF to make the settlement process smoother, more efficient, and more closely tailored to what the plaintiffs (and their counsel) need and want. Remarkably, monies can sit in a QSF after the defendant(s) pay, but before the plaintiffs and their counsel have to report the money for tax purposes!

7. Beware Of 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 your client and you will both receive when a case settles. You may be surprised to learn that how you ask for checks to be 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 jointly), 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.

In fact, I generally prefer to ask a defendant to issue two checks, one to the attorney for the lawyer's share, and the other to the client for the client's share. The only objections I've heard plaintiff attorneys voice is that everyone will then know what the attorney's fee is, and that it requires the attorney to get costs together rapidly. To the former objection, I say that everyone can probably guess the attorney's fees. To the latter objection, I answer that you can always estimate total costs and build in a cushion. You can later remit a small check from attorney to client if it turns out the costs are less than you estimated.

The advantage of having two separate checks is that the attorney will then receive a Form 1099 only for the attorney's fee. The client is probably still going to receive a Form 1099 for 100% 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 Form 1099 Too

Another concern is what Form 1099 you as an attorney must send. In general, anyone making payments in connection with a business must issue IRS Form 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.

One of the big places the IRS looks for compliance concerns payments to co–counsel. Suppose you are the lead counsel in a case and receive a $1 million fee, but are only entitled to keep $400,000, paying the other $600,000 to other attorneys and 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 out, and you may be subject to penalties. That should be reason enough for you to comply with the rules.

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

10. Usually You Need Not Send Form 1099 To Clients

One of the great areas 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. It is quite clear that 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 if it is another kind of case. The rules are complex and practice varies. However, most lawyers do not issue Form 1099 to clients, on the theory that they are acting merely as an intermediary. The Treasury Department has promulgated some highly complex regulations applying to attorneys 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 attorneys 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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