

TAX

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HOTLINE

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TAX TRAP

Lawsuit Plaintiffs Can Lose Big Even When They Win Big

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A big tax trap for winning lawsuit plaintiffs can cause them to keep much less from a court award, after taxes, than they ever expected. In fact, this trap can even cause plaintiffs to owe the IRS more in taxes than they win in damages—so they literally lose by winning. Plus, this pitfall has just been upheld by the US Supreme Court. *What you need to know to be alert to this danger...*

cruel twist

Damages won in lawsuits in most kinds of cases are taxable income

(though there are exceptions, such as damages meant to compensate for physical injury). A plaintiff who brings such a case and wins might naturally assume that his/her taxable income will be the amount he keeps after his lawyer's fee.

Example: A plaintiff who sues for \$100,000 and agrees to pay his

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lawyer a 40% contingency fee might expect to have taxable income of \$60,000 if the suit is fully won.

But the IRS says that this is incorrect. Since the entire award is paid to the plaintiff, the entire \$100,000 is taxable to the plaintiff, who then can deduct the legal fees paid to the lawyer.

Snag: Under normal tax rules, legal fees are deductible only as miscellaneous expenses, and these are deductible only to the extent that they exceed 2% of adjusted gross income (AGI). Moreover, itemized deductions generally are disallowed by 3% of the amount by which AGI exceeds \$145,950 (in 2005).

Combined, these two rules can cause an award of \$100,000, all of which is included in AGI, to reduce itemized deductions by \$5,000 (2% + 3%), effectively making \$5,000 of the related legal fees nondeductible. (Other deductions, such as medical expenses and casualty losses that are allowed only to the extent that they exceed a percentage of AGI, will be reduced, too.)

Big trap: If the plaintiff is subject to the alternative minimum tax (AMT)—and a large lawsuit award can cause this—the plaintiff will get no deduction at all, because legal

fees are not deductible under the AMT.

Example: With a \$100,000 award and \$40,000 legal fee, the 28% tax rate of the AMT can cause \$28,000 of tax to be due on the entire award, even though only \$60,000 of it is kept—an effective 46.7% tax rate (not including state and local taxes). This is the case even though the top regular federal tax rate is only 35%.

But it can be much worse. Legal fees won in a court award or settlement agreement may be larger than the amount of damages. Then the plaintiff may wind up owing the IRS more than the amount won in the case. *True-life examples...*

- A woman won a court award of \$300,000 in damages plus \$1 million to cover her legal fees—and wound up owing the IRS almost \$400,000 in tax, thus losing nearly \$100,000 from the case by winning! [*Spina v. Forest Preserve District of Cook County*, 207 F. Supp. 2d 764.]

- Paula Jones, in her case against former president Bill Clinton, reportedly obtained a settlement of \$850,000 and incurred attorney fees of \$650,000. Although the full details of her tax situation aren't public, experts have noted that these facts could have caused her to lose \$38,000 net due to the AMT. (A 28% tax rate \times \$850,000 = \$238,000, when her recovery after her legal fees was only \$200,000).

Congress and the Court

The fact that deserving plaintiffs can lose by winning due to the AMT has created much consternation in the legal system. As a result, both Congress and the Supreme Court have acted on the problem during the past year—but largely without eliminating it. *What they've done...*

- In the *American Jobs Creation Act of 2004*, Congress made legal fees fully deductible notwithstanding the AMT—but only in a limited set of cases. These are cases “for the enforcement of civil rights,” or regulating “any aspect of the employment situation, including claims for wages, benefits, prohib-

iting discharge of an employee, and discrimination against an employee.”

This is helpful for civil rights and employment cases—but still leaves the majority of cases not covered.

Examples of cases not included under the new law include those for libel and defamation, contract violations, investment losses, and infliction of emotional distress, among many others.

Moreover, a single lawsuit may have several causes of action—so even in a civil rights or employment lawsuit, if there are other causes as well, not all legal fees may be deductible.

- In a January 2005 opinion, the Supreme Court generally upheld the IRS's position on legal fees (in cases not covered by Congress's new law) ruling, “We hold that, as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee,” so AMT rules do apply. [*Banks and Banaitis*, US Supreme Court, 125 S.Ct. 826.]

But in upholding the IRS position only “generally,” the Court left open the possibility of making legal fees deductible through exceptions to the general rule.

planning strategies

The case considered by the Supreme Court involved only a straight contingency fee—where the lawyer received a percentage of the plaintiff's award.

There are other kinds of fee agreements (and even other arguments regarding contingency fees) that the Court specifically said it did not consider—and which thus still provide the possibility of making fees deductible.

Example: Statutory fee shifting is a possibility in many cases under

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FILING Hotline

May Tax Calendar

Sunday 5/1

- Due date for filing **Form 941, Employer's Quarterly Federal Tax Return**, for the second quarter of 2005, in order to report income tax withholding and Social Security and Medicare taxes. If taxes were deposited in full and on time, the return can be filed up to May 10.

Monday 5/16

- Partnerships and S corporations that made a Section 444 election to use a fiscal year must make any required payment (a tax prepayment of sorts that is the price of the election) and file **Form 8752, Required Payment or Refund Under Section 7519** even if no payment is due.

both federal and state law. With this, instead of the plaintiff receiving a general award from which he pays his lawyer, the judge assesses the cost of legal fees directly against the losing defendant and directs their payment to the plaintiff's lawyer. Because they are not awarded to the plaintiff personally, they very arguably are not taxable to him.

It's also possible to write a settlement agreement to reflect terms of statutory fee shifting. The Supreme Court stated that its ruling did not consider this option—so the question of whether this will work is still open.

Another strategy is to design a negotiated settlement as a *structured settlement*. In simplest terms, this spreads the receipt of the settlement amount over a period of years. This may prevent it from *piling up* sufficiently in any one year to result in AMT applying and legal fees becoming nondeductible.

the right help

A full discussion of all strategies that might be tried to get around the Supreme Court's decision is beyond the scope of a short article.

But if you are a plaintiff in a lawsuit, or planning to be one, it is important that you—and your lawyer—know the tax risks imposed by the AMT. A lawyer who is a litigation expert may not be a tax expert who is up on the AMT, the new tax law, and the new Supreme Court decision. So be sure you consult with a litigation tax expert, too, and plan your strategies accordingly. **TH**