



Avoiding Tax Surprises on Settlements/Judgments

By Richard Warner, CPA and Deborah Dickson, CPA, CFF, MAFF

Scenario: You successfully negotiated a settlement for your individual plaintiff client in the amount of \$1,000,000 due to claims of emotional distress from non-physical injuries at work. This total includes attorney fees of \$400,000. You call it a “win” and are certain that your client will be happy with the \$600,000 net result – until you receive a phone call from the client, complaining that her CPA has informed her that she has to pay taxes on the entire \$1,000,000 of proceeds, including your \$400,000 fees, so her net after tax result is only \$200,000! Your client goes away unhappy and you wonder what went wrong.

Deductibility of Legal Fees for Individual Plaintiffs

In this scenario, a partial culprit is the Tax Cuts and Jobs Act of 2017 (TCJA). One of the commonly overlooked changes of the TCJA is the effect on taxable settlement or judgment recipients. This has occurred through the elimination of miscellaneous itemized deductions subject to two percent of adjusted gross income, meaning your legal fees may not be deductible. In many cases, this change has dramatically increased the tax burden on settlements or judgments received by individual plaintiffs.

An individual taxpayer under the old law could deduct miscellaneous itemized deductions to the extent they exceeded two percent of adjusted gross income. Expenses that qualified were certain legal fees, unreimbursed employee expenses, investment expenses, and tax preparation fees.

Under the old tax law, the plaintiff in the above scenario would pay tax on the net amount received of \$600,000 since she could deduct the legal fees of \$400,000 on her tax return. However, since the TCJA has eliminated miscellaneous itemized deductions, no deduction for legal fees is allowed and the plaintiff is required to pay tax on the gross award of \$1,000,000 even though she only received \$600,000. Depending on her tax bracket, she may put in her pocket as little as \$200,000 on a \$1,000,000 gross settlement.

Sexual Harassment Settlements

Another major tax change was enacted regarding settlements that involved sexual harassment. The TCJA denies any deduction to the defendant for legal fees and settlement payments made in connection with sexual harassment or abuse cases if there is a nondisclosure agreement. In contrast, the IRS has issued informal guidance indicating that recipients of settlements related to sexual harassment are not precluded from deducting attorney fees related to the settlement when there is a nondisclosure agreement.

Avoid Tax Surprises

It is tempting to bring a dispute to an end without giving adequate consideration to tax consequences, whether one is a plaintiff, a defendant, or counsel. Before you resolve the case and sign, consider working with a CPA who specializes in the taxation of litigation awards to discuss how your firm should negotiate settlements.



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