

AVOIDING TAX SURPRISES ON SETTLEMENTS OR JUDGMENTS AND 1099 FORMS: EFFECTS ON YOUR FIRM AND CLIENTS

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Imagine 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 would be only \$200,000! Your client goes away unhappy and you wonder what went wrong.



Deductibility of Legal Fees for Individual Plaintiffs

In the above scenario, a partial culprit is the Tax Cuts and Jobs Act of 2017 (TCJA). The TCJA is the most sweeping tax legislation passed since the Tax Reform Act of 1986. The central focus of the new law is how it has impacted both small and large businesses; however, one of the commonly overlooked changes is the effect on taxable settlement or judgment recipients. This impact 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. The elimination of legal fees as a miscellaneous itemized deduction has come as an unwelcome surprise to many individual plaintiffs who are on the receiving end of a taxable settlement or judgment.

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 tax reform 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.

No wonder your client would be disillusioned, and even wondering if you were somehow to blame. You might even ask yourself, “Could I have done more? Was there a different way to structure the settlement to minimize taxes for my client?”

But Wait, There’s More! Sexual Harassment Settlements

If that were not enough, there was another major tax change regarding settlements that involved sexual harassment. The TCJA precludes 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.

Deductibility of Legal Fees for Individual Plaintiffs

Fortunately, there were some areas of tax law related to settlements and judgments that the new law did not affect. Legal fees for plaintiffs and defendants related to discrimination suits, whistleblower suits, and those incurred during the ordinary course of business all remain fully deductible above-the-line, meaning these fees can be deducted from the gross award amount.

Settlement awards for physical injury and wrongful death continue to be non-taxable to the recipient. However, attorney fees related to these types of physical personal injury/wrongful death cases are correspondingly not deductible by the awarded plaintiff.

Under current tax law, individual plaintiffs receiving all other types of settlements will now face higher taxes based on their inability to deduct the associated legal fees.

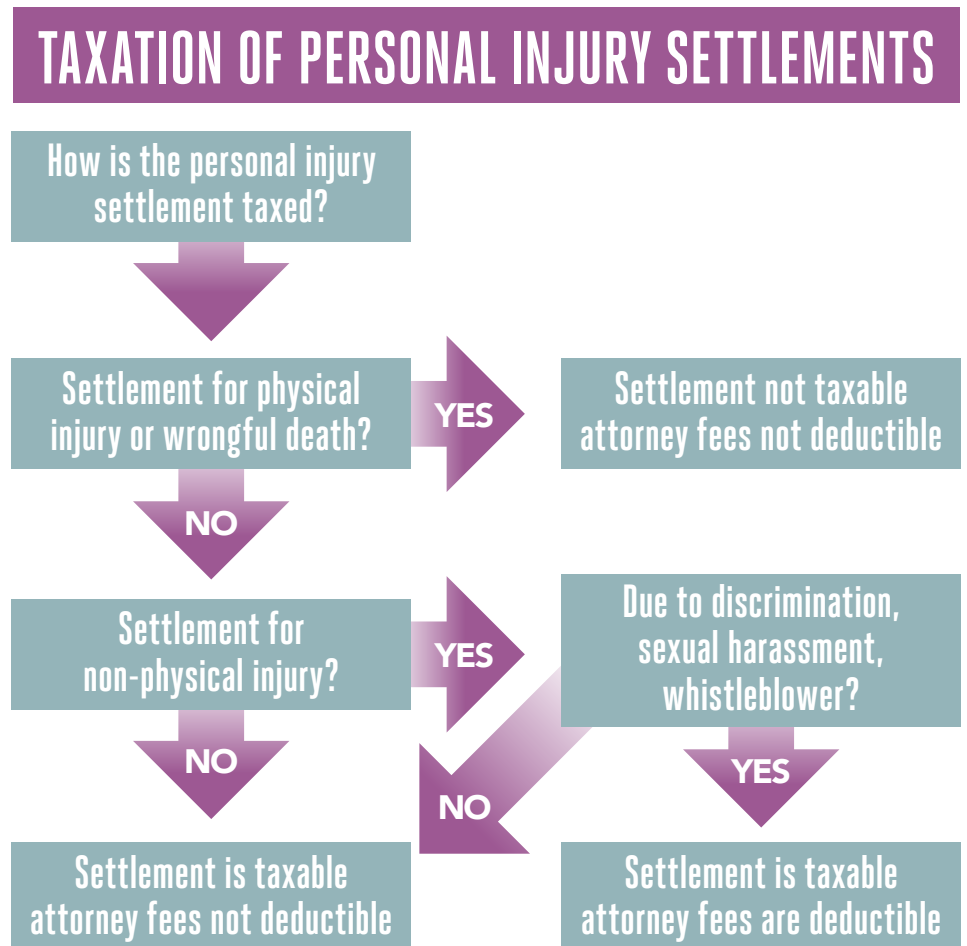
Taking Taxation Into Account in Litigation

Nearly every piece of litigation eventually sprouts tax issues although the courts do not always take those into account. It is tempting to bring a dispute to an end without giving adequate consideration to the tax consequences. Whether one is a plaintiff, a defendant, or counsel, it can be a costly mistake to disregard the ultimate tax consequences of a settlement. The changes described in this article relate to federal taxation only; some states have conformed to these new rules, and some states—including California—retain the prior tax law. Before you resolve the case and sign, consider the tax aspects to prevent a rude awakening later (see the below chart).

Should You Issue 1099 Forms?

When settlements are completed, law firms may be unclear as to whether 1099 Forms should be issued, to whom, and if so, in what amounts.

Many lawyers receive settlement funds which they pass along to their clients. There is rarely a Form 1099 obligation for such payments to clients. Most lawyers receive





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to write two checks, one payable to AP in the amount of \$100,000 as compensation for legal services and the other payable to P, in the amount of \$200,000. D writes the checks in accordance with AP's instructions and delivers both checks to AP. D must file a Form 1099 with respect to AP for \$100,000 under IRC

Example 1. In addition, assume that after paying the service providers and deducting his legal fee, AP pays P the remaining funds that AP had received from the settlement with D. With respect to the payment to P, AP is not performing management or oversight functions, does not have a significant economic interest in the payment, and is not subject to the information reporting requirements of IRC Sec. 6041.

ing a joint settlement or a separate check to resolve a client lawsuit are not considered payors. The settling defendant is considered the payor, so that person has the obligation to issue the 1099 forms, not the lawyer. However, the amount on the Form 1099 received by the law firm will differ based on whether a joint check or separate checks are issued by the defendant. The following examples help to clarify when Forms 1099 should be issued and the amounts to declare.

Form 1099: Issued by Defendants

Example 1: One Check/Joint Payees: Employee P, who sues employer for emotional distress, is represented by attorney AP. D settles the suit for \$300,000 and writes a settlement check payable jointly to P and AP in the amount of \$300,000. D delivers the check to AP. AP retains \$100,000 of the payment as compensation for legal services, and disburses the remaining \$200,000 to P. D must file a Form 1099 with respect to AP for \$300,000 under Internal Revenue Code Section 6045. D also must file a Form 1099 with respect to P under IRC Sec. 6041 and 6051, in the amount of \$300,000. See Internal Revenue Code §§ 1.6041-1(f), 1.6041-2.

Example 2: Separate Checks: P, an individual plaintiff in a suit for lost profits against corporation D, is represented by attorney AP. D settles the suit for \$300,000 but AP requests D

Sec. 6045. Pursuant to Internal Revenue Code § 1.6041-1(a) and (f), D must file Form 1099 with respect to P for the \$300,000.


Form 1099: Issued by Attorneys

The primary circumstance in which lawyers must issue 1099 Forms is when the lawyer exercises significant oversight and management instead of merely receiving the money and dividing up the lawyer's and client's shares. The IRS regulations stipulate that if lawyers exercise management and oversight of client monies or have a significant economic interest in the payment, they become the payors and are required to issue 1099 Forms when they disburse the funds.

Example 1: Attorney AP deposits into a client trust fund a settlement payment from D, the defendant in a breach of contract action for lost profits in which AP represented plaintiff P. AP makes payments from the client trust fund to service providers such as expert witnesses and private investigators for expenses incurred in the litigation. AP decides whom to hire, negotiates the amount of payment, and determines that the services have been satisfactorily performed. With respect to payments to the service providers, AP is performing management or oversight functions, and is subject to the information reporting requirements of IRC Sec. 6041.

Example 2: Assume the same facts as in

Avoid Tax Surprises

Tax issues may not be the most dazzling and intriguing aspect of your engagements. However, the consequences of not effectively planning for them can be substantial. Consider working with a CPA who specializes in the taxation of litigation awards to discuss how your firm should negotiate settlements and prepare Forms 1099. 

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