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# Personal Injury Settlements: Anticipating Impact of Tax Reform on Settlement Proceeds

Strategies to Manage Tax Impact on Lost Wages, Punitive Damages and Interest

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TUESDAY, MAY 7, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

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# Personal Injury Settlements: Anticipating Impact of Tax Reform on Settlement Proceeds?

**Strafford Webinars**  
**May 7, 2019**

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# Tax Cuts and Jobs Act

- In large part, the tax rules for legal settlements and judgments remains the same. However, there are very large changes impacting tax deductions for legal fees and the treatment of confidential sexual harassment cases.

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# Tax Exclusion for Physical Injuries

- The law on this—Section 104 of the tax code—is unchanged.
- It applies to physical injuries and physical sickness, and covers only compensatory damages, not punitive damages or interest.
- Does it cover lost wages?

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# Tax Exclusion for Physical Injuries (cont.)

- If the recovery is 100% tax-free, the attorney fees are also tax free. Otherwise, the plaintiff may have tax deduction problems with those legal fees.
- If a case is 50% compensatory damages for physical injury, 50% punitives, half of the attorney fees can't be deducted.

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# Non-Physical Injury Cases

- In employment cases, there is still an above-the-line deduction for legal fees. It generally works well, and the IRS has generally interpreted it broadly.
- In non-employment cases, in the past, plaintiffs could at least deduct their fees below the line. Now, the lack of miscellaneous itemized deductions means some plaintiffs will pay tax on 100% of their recoveries, with no deduction for legal fees.

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# Non-Physical Injury Cases (cont.)

- Examples of impacted plaintiffs include recoveries:
  - From a website for invasion of privacy or defamation;
  - From a stock broker or financial adviser for bad investment advice, unless you can capitalize your fees; and
  - From your ex-spouse for anything related to your divorce or children.
- The list of lawsuits where this will be a problem is almost endless.

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## Non-Physical Injury Cases (cont.)

- Conversely, the list of cases where you should *not* face this double tax is much shorter:
    - Your recovery is 100 percent tax free, for example, in a pure physical injury case with no interest, and no punitive damages. If the recovery is fully excludable from your income, you cannot deduct attorney fees, but you do not need to;
    - Your employment recovery qualifies for the above the line deduction (but watch out if it involves a sex harassment claim);
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# Non-Physical Injury Cases (cont.)

- ❑ Your recovery is in a federal False Claims Act case, IRS or SEC whistleblower case, qualifying for the above the line deduction;
- ❑ Your recovery relates to your trade or business, and you can deduct your legal fees as a business expense; or
- ❑ Your recovery comes via a class action, where the lawyers are paid separately under court order.

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## Non-Physical Injury Cases (cont.)

- For many types of cases involving significant recoveries and attorney fees, the lack of a miscellaneous itemized deduction could be catastrophic.
- There may therefore be new efforts to explore the exceptions to the Supreme Court's 2005 holding in *Banks*.

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## Non-Physical Injury Cases (cont.)

- The Supreme Court in *Banks* laid down the rule that plaintiffs generally have gross income on contingent legal fees. But the Court alluded to various contexts in which this general rule might not apply.
- We should expect taxpayers to more aggressively try to avoid being tagged with gross income on their legal fees.

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# Punitive Damages

- Always taxable
- Punitive damages before trial?
- Punitive damages on appeal

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# Interest

- Always taxable
- Pre-judgment v. post-judgment
- Settlements that obviate interest
- Settlements that compromise interest
- Structured settlements

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# Structuring Punitive Damages and Interest

- New incentives to structure
- Does it obviate the gross income issue under *Banks*, and the legal fee deduction issue?
- At least the mechanics should be fixed

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# Qualified Settlement Funds

- Possible uses for QSFs.
- If the QSF separately pays clients and lawyers, will QSF issue 1099 to clients for legal fees?

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# Exceptions to *Banks*

- Statutory Fees
- Court Awarded Fees
- Fees for injunctive relief
- Lawyer-Client Partnerships

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# Mechanics

- Amending legal fee agreements?
- Separate check and Form 1099 for legal fees?

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# Sexual Harassment: Employment Case Legal Fees

- The above-the-line deduction for legal fees still applies to employment cases. However, the above-the-line deduction may be eliminated in the case of confidential sexual harassment settlements.
  - It is not yet clear if the law applies only to defendant legal fees and settlement payments, or *also* to plaintiff legal fees. As written, the law seems to apply to both defendant and plaintiff, although that was probably not its intent.
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# Sexual Harassment Settlements

- Defendant legal fees and settlement payments in sexual harassment cases usually are deductible business expenses.
- The new "Harvey Weinstein" rule is that damages and attorney fees paid for sexual harassment in a confidential agreement are not deductible. This "no deduction" rule applies to the lawyer fees as well as the settlement payments. See New IRC Section 162(q).

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# Sexual Harassment: Conference Committee Report

- The conference committee report describes new Section 162(q) as disallowing a deduction “for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement.”
  - Congress intended for the new provision to apply only to legal fees paid for sexual harassment or sexual abuse settlements that are subject to a nondisclosure agreement.
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# Sexual Harassment: Conference Committee Report (cont.)

- However, there may still be debates over whether the wording of the statute prohibits legal fee deductions, even when there is no express confidentiality clause.
- Defendants will surely claim the deductions unless there is a confidentiality provision.

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# Sexual Harassment: Plaintiff Legal Fees

- The target of the new law is the alleged harasser and the defendant company. But what about legal fees paid by the plaintiff in a sexual harassment case in which a confidential settlement is reached?
- The wording of the new law seems to prevent any deduction for legal fees in this context. Even the conference committee report is not particularly helpful to plaintiffs trying to deduct their fees.

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# Sexual Harassment: Confidentiality Provisions

- The nondisclosure is clearly the trigger for the denial of the deduction for the settlement monies.
- The legal fees are not so clear. It is possible — although I would hope unlikely — that the IRS or the courts might read the law as a denial of a tax deduction for legal fees regarding sexual harassment or abuse, even *without* a nondisclosure agreement.

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# Express Allocations

- Most legal releases cover a wide range of known and unknown claims. Defendants want to know that any and all claims will be barred.
- In an employment case, even if race, gender, or age discrimination claims were not explicitly made, they will be covered by the settlement agreement. Sexual harassment is likely to be covered too.

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## Express Allocations (cont.)

- Will any mention of such claims trigger the Weinstein provision?
- If it does, will it bar any tax deduction, even if the sexual harassment part of the case is minor?
- Could plaintiff and defendant expressly agree on a particular tax allocation to avoid the Weinstein tax?

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# Possible Solutions

- Allocate small amount to sexual harassment?
- Allocate nothing to sexual harassment?
- Plaintiff requires indemnity from defendant?

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# Settlement Language, Mechanics, and Forms 1099

- Settlement language, mechanics, and Forms 1099
- Don't assume that tax language in a settlement agreement and explicit handling of Forms 1099 solve everything.
- Tax indemnity provisions

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# Consider Two-Step Tax Advice

- Tax language for settlement
  - ❑ Stress physical injury claims?
  - ❑ Stress compensatory damages?
  - ❑ Negate punitives and interest?
  - ❑ Warn that settlement language is not binding on IRS

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# Tax Advice and Structures are More Important Than Ever

- Consider taxes early
- Consider structures early
- Be reasonable
- Ask questions