Contingency Fee Trap Under Tax Reform: Avoiding Hidden Settlement Obstacles and Malpractice Issues

WEDNESDAY, AUGUST 8, 2018
1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today’s faculty features:

Glen Armand, Chief Executive Officer, Chief Compliance Officer, Eastern Point Trust, Warrenton, Va.
Lawrence J. Eisenberg, Attorney, Lawrence J. Eisenberg, P.C., Bethesda, Md.
Phillip M. Krause, CSSC, CLMP, Managing Director of Strategic Planning, Ringler Associates, Ft. Lauderdale, Fla.

The audio portion of the conference may be accessed via the telephone or by using your computer’s speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact Customer Service at 1-800-926-7926 ext. 1.
The Contingency Fee Tax Trap and a Solution

By Lawrence J. Eisenberg, Esq.*

INTRODUCTION

Under the 2017 tax act, it is possible that a plaintiff who prevails in litigation or receives settlement proceeds might receive less than 20% of the recovery, depending on the contingency fee rate and the applicable federal and state income tax rates.

Successful plaintiffs must pay both their attorneys and the Internal Revenue Service. However, as a result of a 2005 Supreme Court decision, these plaintiffs must report as taxable income (where the recovery is taxable) their entire recovery, including the attorneys’ fees. In the past, plaintiffs could deduct the attorneys’ fees, subject to a number of limitations, that prevented a full income tax deduction on their Form 1040. The inability to fully deduct attorneys’ fees already was seen as unfair. Now, after enactment of the 2017 Tax Cut and Jobs Act (2017 tax act), the situation is even worse because now attorneys’ fees are not deductible at all, including attorneys’ fees that were previously deductible “above the line.” This means that a successful plaintiff pays income taxes on amounts he or she never sees. This is the “Contingency Fee Tax Trap.” 1

Fortunately, for contingency fee cases, there is now a solution.

BACKGROUND

In Commissioner v. Banks, the Supreme Court addressed whether the portion of a money judgment or settlement paid to a taxpayer’s attorney under a contingency fee agreement is income to the taxpayer for federal income tax purposes. 2 The Supreme Court held that when a taxpayer’s recovery constitutes taxable income, the taxpayer’s income includes the portion of the recovery paid to the attorney as a contingency fee. 3 That is, a plaintiff may not report his recovery “net” of the attorneys’ fees.

As a very simple example, where a plaintiff receives a taxable money judgment for $100,000, and there is a 40% contingent attorney fee, the plaintiff must report $100,000 of taxable income, even though she actually received only $60,000.

Until 2018, the plaintiff could deduct the attorneys’ fees portion of the recovery. However, there were a “trifecta” of limitations that prevented the plaintiff from being able to fully deduct the cost of the attorneys’ fees. First, only “miscellaneous itemized deductions” in excess of 2% of the plaintiff’s adjusted gross income could be deducted. 4 Litigation attorneys’ fees count as a miscellaneous itemized deduction. Second, there was an overall phase-out limitation on itemized deductions, including miscellaneous itemized deductions. 5 Finally, when determining the plaintiff’s alternative minimum tax, miscellaneous itemized deductions were not permitted. 6 As a result, much of attorneys’ fees were not deductible. Thus, even prior to 2018, the Contingency Fee Tax Trap was a problem.

But the situation got much worse beginning in 2018. This is because under the 2017 tax act, miscellaneous itemized deductions are not deductible at all.

---

* Lawrence J. Eisenberg, Esquire is principal and founder of Lawrence J. Eisenberg, P.C. He was materially involved with the development of the Contingency Fee Tax Trap solution described in this Article.

1 A similar legal fee tax trap applies to plaintiffs who pay hourly fees, but this article focuses on plaintiffs who are in contingency fee arrangements. Note that the formula for determining a contingency fee can be determined partially by reference to the hourly fees incurred in connection with the litigation.

3 Id. at 430.
4 §67. All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.
5 §68.
6 §56(b)(1)(A)(i).
for the 2018 through 2025 tax years. At the time this article was written, there are discussions about making the 2017 tax act changes permanent, including the full disallowance of miscellaneous itemized deductions.

Take the example above. Assuming the plaintiff had a combined 40% federal and state income tax rate, her income taxes on the recovery would be $40,000. The result would be that this participant would net only $20,000 from her $100,000 recovery ($100,000 less $40,000 in attorneys’ fees, less $40,000 in federal and state income taxes). In effect, the plaintiff’s income tax rate on his or her actual recovery is 66.66% ($40,000 taxes divided by $60,000 in actual income).

The combination of the Banks Supreme Court ruling and the tax law, including the 2017 tax act changes, is very adverse for plaintiffs. By having to include the attorney portion of the recovery in gross income without any corresponding deduction, the result to a successful plaintiff is substantially higher federal and state income taxes, because the attorneys’ fees portion of the settlement cannot be “written off.” In short, for plaintiffs who must pay contingency fees, this is not only a Contingency Fee Tax Trap — it can be a Contingency Fee Tax Trap disaster.8

**CASES IMPACTED**

Now that attorneys’ fees are entirely nondeductible, many contingency fee cases involving a taxable recovery are affected by the Contingency Fee Tax Trap. These include — but are not limited to — cases involving:

- payments of punitive damages and interest;
- another’s fraud, negligence, or breach of contract (e.g., by insurance companies or finance companies);
- intentional infliction of emotional distress;
- interference with property or contract rights;
- employment issues;
- amounts recoverable from an ex-spouse regarding alimony or child support;
- wrongful arrest or imprisonment;
- reputational damage or defamation;
- privacy matters;
- incorrect tax return preparation or advice;
- investor fraud;
- whistleblowers, other than certain whistleblower cases involving the Internal Revenue Service, the Securities Exchange Commission (SEC), the False Claims Act, and the Commodity Exchange Act, §23;
- legal malpractice;
- “opt-in” class action cases. (These are class action cases where the plaintiff affirmatively elects to be included in the class of litigants and agrees to be bound by the resulting settlement or judgment. Because a class action plaintiff’s share of a contingency fee can exceed the amount that the plaintiff is entitled to as a share of the recovery, the need for a solution to the Contingency Fee Tax Trap is particularly necessary for opt-in class actions.)

Also, through 2017, employment discrimination, False Claim Act, and IRS whistleblower cases were not subject to the deduction limitations that give rise to the Contingency Fee Tax Trap. This is because the attorneys’ fees related to those types of litigation were treated as an “above the line” deduction, i.e., not a miscellaneous itemized deduction to which the limitations apply. However, in 2018, after the 2017 tax act, is it quite possible, based on the literal language in the Code, that attorneys’ fees related to these cases are also not deductible, including contingent fee cases.10 This would subject those plaintiffs to the Contingency Fee Tax Trap as well.

Some contingency fee cases are not subject to the Contingency Fee Tax Trap. These include:

- Section 104(a)(2) physical injury cases, which are income tax-free (except for the punitive damage award portion of the recovery, and interest, which is taxable income).
- Where the plaintiff’s legal fees may be capitalized under §263.
- Where the plaintiff’s legal fees may be treated as a §162 trade or business expense.
- “Opt-out” class actions. These are class action cases where an individual is not required to take

---

7 §67(g), as added by Pub. L. No. 115-97 (2017 tax act), §11045(a).
8 It does not matter if the recovery comes from a judgment or a settlement — the Contingency Fee Tax Trap still applies.
9 §62(a)(20), §62(a)(21).
10 The reason for this result is that the statutory language that authorizes these “above the line” deductions starts with the phrase “any deduction allowable under this chapter.” Because attorneys’ fees are fundamentally miscellaneous itemized deductions under §212, which are no longer tax deductible as a result of the 2017 tax act, it is possible that the required condition for the above the line deduction no longer exists, resulting in no deductible attorneys’ fees. It is not clear whether this result was intended.
any action to be included in the class and where the attorneys are paid separately under a court order.

It is important to note that structuring the attorneys’ fees or the plaintiff portion does not eliminate the requirement to include the attorneys’ fees in the plaintiff’s taxable income.

**Purported Solutions — No Go**

Various solutions have been presented to address the Contingency Fee Tax Trap. There are three approaches that are frequently suggested (there are others as well). None of them work, as explained below. In our view, a plaintiff that seeks to avoid reporting the attorneys’ fees portion of the recovery on any of these bases runs a significant risk of tax penalties, which of course would make the Contingency Fee Tax Trap outcome even worse.

**Separate Checks to Plaintiff and the Attorney**

This approach does not work because it runs right into the “**Banks Buzzsaw**.” The Supreme Court is explicit that the attorneys’ fees portion of the recovery is includible in the plaintiff’s income. This tax result cannot be avoided simply by paying part of the plaintiff’s recovery to someone else (the attorney). Just as having part of a parent’s wages paid to a child would not avoid the parent having to include the diverted wages in his or her income, the result is the same if part of a plaintiff’s income is diverted to the attorney. That dodge is too easy for the IRS to overcome.

Also, as a practical matter, when the defendant sends a Form 1099 with respect to the payment, the Form 1099 will usually report the entire amount of the recovery (including the attorneys’ fees portion) as income. The IRS would immediately identify and challenge any discrepancy between what is reported on a Form 1099 and what is reported on the tax return.

**Forming a Partnership Between the Plaintiff and the Attorney**

Some have suggested that a partnership may be formed between the plaintiff and the attorney, where the plaintiff receives his or her share of the recovery, and the attorney receives the contingency fee, each in their capacity as a partner.

The theory is that the plaintiff contributes the case to the partnership, and the attorney brings the skill and expertise necessary to generate a recovery. Unfortunately, this approach will not work for three reasons. First, it fails to recognize that there is a principal-agent relationship between the plaintiff and the attorney. That is, the attorney acts for and represents the plaintiff. As a result, there is no separate identity between the plaintiff and the attorney as relates to the claim. Second, lawyer ethics requirements generally preclude an attorney from acting as a partner with a plaintiff. Third, the **Banks** case specifically rejected this argument.

**Treating the Lawsuit as a Trade or Business**

It also has been asserted that a plaintiff may be able to treat a lawsuit as a trade or business, so that the attorneys’ fees may be treated as an offsetting business expense. This approach will most likely fail, because the plaintiff would somehow have to be in the business of bringing litigation. There is a difference between a lawsuit arising in connection with a trade or business (where the attorneys’ fees may be a deductible expense), and a lawsuit being the trade or business, which the IRS is most likely to view as not legitimate.

Of course, it is always worthwhile to try to allocate a recovery between the non-taxable portion (e.g., physical injuries) and the taxable portion (e.g., punitive damages) in order to minimize the effects of the Contingency Fee Tax Trap. In addition, where the litigation involves capital assets, consider whether the recovery may be taxed as a long-term capital gain (which, under current tax law would result in a lower tax rate on the income).

**A NEW SOLUTION**

There is a solution to the Contingency Fee Tax Trap. But to understand the solution, some more background is necessary.

In the **Banks** case, the Supreme Court explained that a litigation claim is an asset, which may be income generating only if there is a successful judgment or recovery. This is in contrast to the litigation being considered a right to receive income, with the amount not yet known (which, under **Banks**, it is not). This is an important distinction, because assets may be assigned without generating current taxable income. In contrast, the assignment of income that is certain to be paid results in current taxation to the person assigning the income.

---

11 Other approaches include recharacterizing the attorneys’ contingent fees into court-awarded fees, applying the attorneys’ fees into injunctive relief, or treating the lawsuit as a capital asset for which the legal fee might be viewed as a capital expense. The best that could be said for any of these approaches is that it would take a very unusual fact pattern for them to apply. The more reasonable response is that none of these approaches should work.

12 “The relationship between client and attorney, regardless of the variations in particular compensation agreements or the amount of skill and effort the attorney contributes, is a quintessential principal-agent relationship. Restatement (Second) of Agency §1, Comment e (1957) (hereinafter Restatement); ABA Model Rules of Professional Conduct Rule 1.3, and Comments 1; Rule 1.7, and Comment 1 (2002).” **Banks**, 543 U.S. at 436.
It follows that because the litigation claim is an asset, it can be given away. For instance, it is possible to donate the litigation claim to charity. While uncommon, this does occur. Such donations are uncommon because most public charities are unwilling or unable to accept an asset that is unusual or which has a complex structure or mechanics (such as a litigation claim). Also, most plaintiffs would like to derive some personal benefit from the litigation, which is difficult when the claim is fully donated to a charity. Although there are practical aspects to consider, such as how to value the litigation claim for income tax deduction purposes, these do not change the fundamental point that there is an asset to give away.

Accordingly, the solution is for the plaintiff to transfer his or her litigation claim to a specially designed split-interest charitable trust that has a separate legal identity from the plaintiff. The plaintiff (or someone the plaintiff designates) will be one of the beneficiaries of this split-interest trust. Properly structured, the plaintiff no longer owns or controls the litigation claim. That ownership and control is now with the trust. As a result, the trust would receive any recovery that becomes due, and is formally obligated to pay any attorney’s fees that are owed in connection with a successful outcome. The trust would then allocate the net recovery between the trust beneficiaries, including the charity and the original plaintiff, in the manner specified in the trust. Because the plaintiff gave away his or her interest in the litigation, his or her only entitlement is that of a trust beneficiary, and his or her taxable income will reflect only what is received in that capacity, i.e., not including the amount payable to the attorney (and as such a “net” recovery). As the example below will demonstrate, this can substantially increase the plaintiff’s after-tax settlement proceeds.

The principal reason this solution works is because the miscellaneous itemized deduction prohibition applies to individuals, and a properly structured trust is not an individual.

For this solution to work, there are several important conditions that must be satisfied:

- The plaintiff must fully relinquish his or her ownership of the litigation claim in favor of the trust.14

- The transfer must occur before it is certain that the litigation would result in a recovery, i.e., before there is a definitely determinable settlement. This is to avoid the assignment of income doctrine, which would result in the plaintiff being taxed on the recovery (including on the attorney fee portion). It therefore is critical to transfer the litigation claim to the trust as early in the litigation process as possible, while the outcome of the litigation and the recovery is still in doubt.

- The attorneys representing the original plaintiff should transfer their representation to the trust that receives the litigation claim. This is to avoid an assertion by the IRS that the trust assumed a liability of the plaintiff (which at the time the claim was donated was only a contingent liability), which assumption may be taxable income to the donating plaintiff.

An Example

The following contains a simple example showing the effect of the Contingency Fee Trap and the suggested solution. In this example, the recovery is $400,000 and the contingent attorney fee rate is 40%.

---

13 There are some fees and other expenditures that apply in connection with the solution, but the result is nevertheless much better than would apply if the solution is not implemented. These costs also would be an obligation of the trust.

14 Because of the way the trust is structured, even though a charity is a beneficiary of the trust, there would be no charitable deduction associated with the transfer.
As the example demonstrates, the suggested solution is highly advantageous to the plaintiff and imposes no restrictions or adverse economic effect on the attorney.

CONCLUSION

The combination of the *Banks* Supreme Court case and onerous tax law provisions results in the Contingency Fee Tax Trap. This can have a devastating effect on a successful plaintiff’s net recovery. Fortunately, there is a solution. Contingent fee attorneys who already achieve extraordinary results for their clients can take their efforts one step further by helping clients understand that the tax law will significantly and adversely affect their recovery, and letting them know that a solution exists.