Strafford

Presenting a live 90-minute webinar with interactive Q&A

Tax Traps in Class Action Settlements: Avoiding Overtaxation of Plaintiffs and Nondeductibiliy for Defendants

WEDNESDAY, AUGUST 26, 2020

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

Today's faculty features:

Phillip M. Krause, CSSC, CLMP, Managing Director of Strategic Planning, **Ringler Assoc.**, Ft. Lauderdale, Fla.

Robert W. (Rob) Wood, Managing Partner, **Wood LLP**, San Francisco

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**.

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-877-447-0294** and enter your **Conference ID and PIN** when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the 'Full Screen' symbol located on the bottom right of the slides. To exit full screen, press the Esc button.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

Program Materials

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the link to the PDF of the slides for today’s program, which is located to the right of the slides, just above the Q&A box.
- The PDF will open a separate tab/window. Print the slides by clicking on the printer icon.

Tax Traps in Class Action Settlements: Avoiding Overtaxation of Plaintiffs and Nondeductibiliy for Defendants

Strafford Webinars
Wednesday, August 26, 2020

by Robert W. Wood

Wood LLP

www.WoodLLP.com

wood@WoodLLP.com

(415) 834-0113

Tax Treatment of Legal Settlements and Judgments

- Settlements and judgments are taxed the same, but there is almost always more flexibility with settlements.

- Most payments are taxable, and how legal fees are treated is really important.

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.
- *See* Wood, "Settlement Awards Post-TCJA," Vol. 159. No. 12, Tax Notes (June 18, 2018), p. 1771.

Banks Case = 100% to Client

- 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.

Exceptions to *Banks*

- Statutory Fees
- Court Awarded Fees
- Fees for injunctive relief
- Lawyer-Client Partnerships
- *See* Wood, "12 Ways to Deduct Legal Fees Under New Tax Laws" Tax Notes (October 7, 2019), p. 111.
- *See* Wood, "Civil Rights Fee Deduction Cuts Tax on Settlements" Tax Notes (Mar. 2, 2020), p. 1481.

Opt-Out vs. Opt-In

- A class action can be either opt-out or opt-in.
- In an opt-out case, no class member (other than the class representative) will generally execute a fee agreement with class counsel.
- Potential class members need take no action to be considered part of the class.
- See Wood, "Opt-In, Opt-Out Hopscotch Over Taxes in Class Actions" Tax Notes (Nov. 13, 2006), p. 655.

Opt-Out vs. Opt-In

- In opt-in cases, class members could be tagged with income in the amount of the attorney fees.
- There is little tax risk in opt-out cases. The theory for excluding attorney fees is that ‘as of the time fees are awarded, not all members of a class have become identified or contractually obligated to compensate class counsel.
- See Wood, “Opt-In, Opt-Out Hopscotch Over Taxes in Class Actions” Tax Notes (Nov. 13, 2006), p. 655.

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.

- *See* Wood, "Emotional Distress Damages Are Taxable, Physical Sickness Damages Are Not, How Come?" Forbes (June 25, 2018)

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.

- *See* Wood, "Roundup Weedkiller Verdicts Draw IRS Taxes, Here's Why," Forbes.com (Mar. 25, 2019).

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.

Whistleblower + Civil Rights Fees

- FCA (Federal + State)
- SEC
- IRS
- CFTC
- Civil Rights
  - §1983
  - Other

Fee Deduction Problems

- Examples of 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.
  - a neighbor for trespassing, encroachment, or anything else;
  - the police for wrongful arrest or imprisonment;
  - anyone for intentional infliction of emotional distress;
  - your insurance company for bad faith;
  - your tax adviser for bad tax advice;
  - your lawyer for legal malpractice; and
  - a truck driver who injures you, if you recover punitive damages.

Fee Deduction Problems (cont.)

- The list of lawsuits where this will be a problem is almost endless.

- *See* Wood, "New Tax on Litigation Settlements, No Deduction for Legal Fees," Vol. 158, No. 10, Tax Notes (Mar. 5, 2018), p. 1387.

Deductible Legal Fees

- Conversely, the list of cases where you should *not* face this double tax is short:
  - Your recovery is 100% 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.

Deductible Legal Fees (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 <u>business</u> expense; or
- Your recovery comes via a class action, where the lawyers are paid separately under court order.
- *See* Wood, "New Tax on Litigation Settlements, No Deduction for Legal Fees," Vol. 158, No. 10, Tax Notes (Mar. 5, 2018), p. 1387.
- *See also* Wood, "New Tax On Lawsuit Settlements — Legal Fees Can't Be Deducted," Forbes. (03/12/2018)

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.

- *See* New IRC Section 162(q); Wood, "Taxing Sexual Harassment Settlements And Legal Fees in a New Era, Vol. 158, No. 4, *Tax Notes,* January 22, 2018, p. 545.

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 IRS recently confirmed plaintiff fees can still be deducted. *See* Wood, "IRS Gives Tax Break To Sexual Harassment Victims," *Forbes*, Mar. 4, 2019.

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

Qualified Settlement Funds

- Possible uses for QSFs.
- If the QSF separately pays clients and lawyers, will QSF issue 1099 to clients for legal fees?
- *See* Wood, "Ten Reasons Not to Form a Qualified Settlement Fund" *Tax Notes,* (May 17, 2010) p. 823

Mechanics

- Amending legal fee agreements?
- Separate check and Form 1099 for legal fees?
- *See* Wood, "Lawyers, Clients Dance The 'Taxes Two-Step'" Los Angeles Daily Journal, May 26, 2017.

Tax Indemnities

- Almost always appropriate
- Careful with Scope of Indemnity
  - *See* Wood, "Legal Settlements With Tax Indemnities Are on the Rise" *Tax Notes,* July 30, 2019.
  - *See* Wood, "Tax Indemnity Provisions: Important Considerations for Clients" *NWLawyer Magazine,* Feb 2017.
  - *See* Wood, "Tax Indemnity Provisions In Settlement Agreements" Tax Notes, October 3, 2016.

Tax Reporting on Forms 1099

- §104 Payments = No Reporting
- Most payments reported
- Box 3, Box 7, Box 14 of Form 1099-MISC
  - *See* Wood, "A Lawyer's Guide To Navigating 1099s" *Los Angeles Daily Journal,* January 27, 2016.
  - *See* Wood, "IRS Form 1099: Ten Things Every Lawyer Should Know" Montana Bar Magazine, February 2012.
  - *See* Wood, "IRS Forms 1099 Come Soon: Taxing Investors, Sharing Economy & Everyone Else" *Forbes*, January 1, 2019.

Settlement Language, Mechanics, and Forms 1099

- Settlement language, mechanics, and Forms 1099.
- Don't assume that tax language or Forms 1099 solve everything.

Robert W. Wood

Wood LLP

www.WoodLLP.com

wood@WoodLLP.com
(415) 834-0113

Tax Traps in Class Action Settlements: Avoiding Overtaxation of Plaintiffs and Nondeductibility for Defendants

Strafford Webinars
Wednesday, August 26, 2020 • 1:00 pm EDT

by Phillip M. Krause, CSSC, CLMP
Managing Director, RINGLER
www.RinglerAssociates.com
Pkrause@RinglerAssociates.com
(954) 372-1071

Partial Solutions to the Problem

Review "missed" planning opportunities that may enable both you and your client(s) to reduce your respective tax liabilities resulting from a taxable claim.

IRC § 104(a)(2) was amended to exclude from gross income "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or <u>physical sickness</u>."

Although the origin of a claim may be taxable, the "life" of a claim may impact multiple parties and present derivative claims over time that present themselves as qualified under IRC § 104(a)(2)

Tax Exclusion for Physical Injuries

The law on this - Section 104 of the tax code - is unchanged, and therefore is it important to fully understand the circumstances of the plaintiff, and any others named in the Complaint (spouse or family members) throughout the progression of the claim.

Section 104 applies to physical injuries and <u>physical sickness</u>, which can often include <u>derivative claims</u> that present themselves over time or are directly correlated to how the taxable claim may have had a physical (sickness) impact to the claimant.

Tax Traps Under Tax Reform

Complaint – Make sure to describe accurately the physical components that may have derived from the claim's origin, or are evidenced over time.

Evidence – It is important to be able to tie the physical component of the claim to evidence, and present that data.

Ex: Receipts for therapy and prescription medication with a timeline that corresponds to the origin of the claim.

Tax Traps Under Tax Reform

Mediation – At this point, there should be sufficient evidence both describing the physical component (Complaint) and evidencing it with proper documentation (i.e. medical bills, therapy bills, prescribed anti-depressant medication or other anti-anxiety medication, etc...)

Allocation – Consider what is appropriate and what is expected when allocating the physical component. If necessary, seek assistance from an expert, such as a tax attorney or settlement consultant.

Tax Traps Under Tax Reform

Example of an Allocation:

Taxable Claim: $2,000,000.00

Physical Component: Medically Diagnosed Anxiety & Depression

Evidenced by Suicidal Attempts, Doctors Visits, Therapy & Anti-Depressant Medications

Tax Traps Under Tax Reform

Example of an Allocation:

Taxable Claim: $2,000,000.00

Future or Projected Physical Allocation of Damages:

Continued Doctors Visits, Therapy & Anti-Depressant Medications

Projected Future Medical Cost: $460,000.00

Tax Traps Under Tax Reform

Example of an Allocation:

Taxable Claim: $2,000,000.00

Future Physical Allocation of Damages:

Projected Future Medical Costs: $460,000.00

Tax Traps Under Tax Reform

In the prior example, 23% of the taxable claim was successfully allocated to a tax-free, Qualified Assignment, also referred to as a "structured settlement annuity."

Due to the nature of the "derivative physical sickness claim," and the on-going projected future needs of the individual, the Defendant was wiling to allocate and fund a benefit stream via a structured settlement annuity, that would support the future physical sickness/medical needs of the Plaintiff.

This portion of the settlement proceeds was then allocated to a Qualified Assignment, and therefore excluded from the taxable claim and 1099.

Tax Traps Under Tax Reform

Example of an Allocation:

Taxable claim reduced to: $1,540,000.00

1099 was issued only for taxable portion

23% of the Taxable claim was successfully allocated to Tax-Free via a Qualified Assignment, structured settlement annuity

Resulted in significant tax savings to the Plaintiff and a reduction in the reported 1099

Fee Deduction Problems

Examples of 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.
- a neighbor for trespassing, encroachment, or anything else;
- the police for wrongful arrest or imprisonment;
- anyone for intentional infliction of emotional distress;
- your insurance company for bad faith;
- your tax adviser for bad tax advice;
- your lawyer for legal malpractice; and
- a truck driver who injures you, if you recover punitive damages.

Qualified Settlement Funds

Understand how a Qualified Settlement Fund is properly used to provide post-settlement planning and what impacts a QSF can have on a claimant's post-settlement planning options if established improperly or without the input of the Defendant.

Communicate with the Plaintiff(s) and understand their needs prior to making this decision.

- Existing or future creditor issues
- Incapacity or guardianship issues
- Government benefits eligibility
- Other personal financial circumstances impacted by constructive receipt or economic benefit

Qualified Settlement Funds

If the Plaintiff(s) circumstances warrant a Qualified Settlement Fund, then make sure to ask the right questions regarding tax reporting and the QSF administrators knowledge and ability to provide a Qualified Assignment.

Next, be sure to verify available Qualified Assignment options, typically by providing a copy of the proposed QSF, a copy of the Complaint and/or the proposed Settlement and Release documents.

Timing is important, as in most cases, this must be done prior to establishing and funding the QSF.

Qualified Settlement Funds

Revenue Procedure 93-34

This revenue procedure provides rules under which a designated settlement fund described in section 468B(d)(2)of the Internal Revenue Code or a qualified settlement fund described in section 1.468B-1 of the Income Tax Regulations will be considered "a party to the suit or agreement" for purposes of section 130.

(2) it is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or a related series of events) that has occurred and that has given rise to at least one claim asserting liability

Qualified Settlement Funds

Reg. 1.468B-1 establishes that you may not create a QSF for claims that have not yet occurred.

Single Master Pooled QSFs:

Reg. 1.468B-1 requires that a QSF must only contain "claims that have resulted or may have resulted from an event (or related series of events) that <u>has occurred</u> and that has given rise to at least one claim asserting liability."

Consequences of Rejected QSF Status:

- a defendant's ability to deduct transfers to the QSF
- the claimants' ability to avoid taxation of funds received by the QSF.

Qualified Settlement Funds

Reg. 1.468B-1 establishes that you may not create a QSF for claims that have not yet occurred.

Single Claimant QSFs:

Reg. 1.468B-1 requires that a QSF must only contain "claims that have resulted or may have resulted from an event (or related series of events) that <u>has occurred</u> and that has given rise to at least one claim asserting liability."

Consequences of Single Claimant QSF Status:

- Inability to utilize highly rated life markets via a Qualified Assignment, structured settlement annuity
- Possible constructive receipt and economic benefit issues

Qualified Settlement Funds

Adversely, Misinterpreted QSF Language:

Section 30.1 No Assignment of Claims. Neither the Settlement Class nor any Class or Subclass Representative or Settlement Class Member has assigned, will assign, or will attempt to assign, to any person or entity other than the NFL Parties any rights or claims relating to the subject matter of the Class Action Complaint. Any such assignment, or attempt to assign, to any person or entity other than the NFL Parties any rights or claims relating to the subject matter of the Class Action Complaint will be void, invalid, and of no force and effect and the Claims Administrator shall not recognize any such action.

Qualified Settlement Funds

Adversely, Misinterpreted QSF Language Can Create “Traps”:

The parties intended to prohibit someone from buying, for example, a player’s rights at a discount and pursuing those rights to make a profit.

Interpretation: the clause would prohibit assignments (including Qualified Assignments) in the structured settlement annuity context indicates a failure to understand the distinction between “rights” and “responsibilities”.

Qualified Settlement Funds

Adversely, Misinterpreted QSF Language Can Create "Traps":

When an assignment company takes an assignment, they are taking on the "responsibility" to make certain payments as provided for in the settlement agreement.

The assignment company is being paid to take that responsibility from someone who has it but doesn't want to continue to have it for years into the future. With this, the responsible parties can offer the flexibility of taking a lump sum, or flexible payments over time without having to take responsibility for making those payments years into the future.

2018 Tax Year Changes – How Are You Impacted

SALT Deduction - state, local, or foreign jurisdiction

Post 2018 Tax Year Changes – this deduction is no longer unlimited.

Tax Cuts and Jobs Act (TCJA) now limits the SALT deduction to $10,000.00

A comparison of 2019 tax rates compiled by the Federation of Tax Administrators ranks California as the top taxer with a 12.3 percent rate, unless you make more than $1 million and have to pay 13.3 percent.

How Are You Impacted

Each of these states has a personal income tax floor, deductions, exemptions, credits and varying definitions of taxable income that determine what a citizen actually pays. The 10 highest income tax states for high net worth earners in 2019 are:

- California 13.3%
- Hawaii 11%
- Oregon 9.9%
- Minnesota 9.85%
- Iowa 8.98%
- New Jersey 8.97%
- Vermont 8.95%
- District of Columbia 8.95%
- New York 8.82%
- Wisconsin 7.65%

Year-End Tax Planning

Consider how deferring your contingency fees could help to reduce your tax liability and how the deferral of your income may impact the way in which the claim is reported via a 1099 to the claimant.

Traditional, Qualified Plans - 401(k)s, SIMPLE IRA, SEP IRA

Contingent Fee Deferral Options **PRIOR** to Settlement:

Non-Qualified Deferred Compensation Plan - IRC Section 409A

Periodic Payments in the form of a Non-Qualified Assignment