

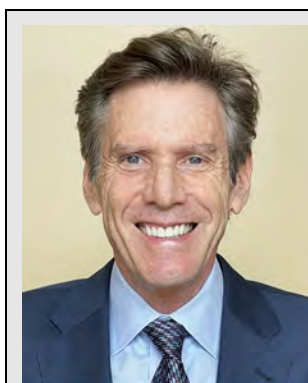
The Individual Plaintiff Tax Trap — A Conundrum and a Solution

by Lawrence J. Eisenberg

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In this article, Eisenberg examines the disparate tax treatment of various plaintiff recoveries and the deductibility of attorney fees, and he offers a trust-based solution for individuals caught in a costly tax trap.

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Background

As tax professionals know, the Internal Revenue Code is replete with quirky provisions. Some are meant to raise revenue — for example, an annual \$3,000 limitation on capital losses, which has not increased since 1977.¹ Some are meant to achieve social objectives, like the complete tax exemption for sales of startup businesses.² Some curb perceived unfair tax benefits (for example, the rule that imposes double tax on a section 401(k) contribution over

the annual dollar limit that is not removed in time³). Occasionally, the tax rules are just strange, and the taxation of individual plaintiff litigation recoveries is just that — strange.⁴

Obviously, an individual plaintiff whose litigation efforts result in a successful verdict or settlement must pay their attorneys — and their taxes.⁵ For a long time, however, it was unclear whether the plaintiff had to pay taxes on the portion of the recovery that was owed to their attorney. The courts were split on the issue, but in 2005 the Supreme Court cleared up the uncertainty in *Banks*,⁶ holding that plaintiffs must report the entire recovery as taxable income — unless the recovery is not taxed, such as with damages resulting from physical injuries.⁷ That includes the portion used to pay attorneys' fees and costs.⁸ The opinion does not distinguish between cases in which the attorney is paid on a contingency basis and cases in which they're paid hourly. However, because contingency fees almost always involve a much larger portion of the recovery — typically 33 percent to 40 percent, sometimes more — the effect of this decision is clearly more pronounced for contingency fee cases.

³ Section 402(g)(2).

⁴ The taxation of litigation recoveries received by entities (including sole proprietorships) is much more straightforward. In almost all cases, the entire recovery is taxable income (the concept of physical damages does not exist in the case of a trade or business), and the attorney fee expense is either deductible as a trade or business expense under section 162 or capitalized into the value of an asset, depending on the nature of the recovery. Thus, litigation recoveries by entities do not involve the same tax conundrums as individual recoveries.

⁵ From here on, this article will refer only to "plaintiffs," which should be understood to mean individual plaintiffs and not business entities.

⁶ *Commissioner v. Banks*, 543 U.S. 426 (2005).

⁷ Section 104(a)(2).

⁸ Future references in this article to "attorney fees" should be understood to also include attorney costs, since the tax treatment is the same.

¹ Section 1211(b).

² Section 1202.

Now that it has been clear for almost 20 years that the entire taxable recovery is reportable, can the plaintiff be confident in deducting the attorney fee portion of the recovery so that they pay taxes only on the net amount? Unfortunately — and strangely — no. This area of the tax law remains confusing, inconsistent, and often unknown.

The ability of a plaintiff to deduct their attorneys' fees is summarized by the following questions:

- Is the recovery tax free by statute? (This would mean that it falls under the section 104(a)(2) exclusion for recoveries attributable to physical injuries.)
- If the recovery is not tax free by statute, is there an above-the-line deduction for the attorney fee? (As seen in some employment discrimination and whistleblower cases.)⁹
- If the recovery is taxable and there is no above-the-line deduction for the attorney fees — meaning the attorney fee becomes a miscellaneous itemized deduction (MID) — can it be deducted, and if so, to what extent?

As in many tax matters, the resolution of the above questions has its complications. For instance, is a recovery attributable to a physical injury? But in a logical tax world, the treatment of attorney fees should be consistent: When the recovery is taxable, there should be an offsetting deduction for the attorney fee portion of the recovery because that is the “expenditure” needed to produce the income. But, of course, that is not how it works.

It is beyond the scope of this article to address the appropriateness of treating one type of recovery as taxable but not another. It is also beyond the scope of this article to address the appropriateness of some types of attorney fees receiving better (above-the-line) tax treatment than others. Both are decisions for Congress. Instead, we are left trying to explain the disparate tax treatment related to various plaintiff recoveries, the effect of the deduction tax treatment, and the proposed solutions.

⁹ See sections 62(a)(20) and 62(a)(21). See also section 62(e) for a description of the discrimination events that would result in an above-the-line attorney fee deduction.

The Individual Plaintiff Tax Trap Issue

As noted, attorney fees attributable to individual plaintiff taxable litigation recoveries that cannot be deducted above the line are treated as MIDs. Before the Tax Cuts and Jobs Act was enacted in 2017, MIDs were deductible for regular income tax purposes. However, there was also the alternative minimum tax treatment to consider. For AMT purposes, MIDs are “preference items” that cannot be deducted when calculating the AMT.¹⁰ This subjected the attorney fee portion of the recovery to the AMT, resulting in a “partial double tax.” The AMT traps probably surprised many individual plaintiffs, who couldn't be blamed for considering that to be sneaky and unfair tax treatment.

The double tax situation worsened under the TCJA because MIDs (including individual plaintiff attorneys' fees) are not deductible at all. Thus, a successful individual plaintiff pays income taxes on the entire attorney fee portion of their recovery, even though they will never actually see that amount. Also, the attorney receiving the fee pays taxes on that fee. In effect, taxes are paid on the attorney fee twice, once by the plaintiff and once by the attorney — hence a “complete double tax.” Thus, the “individual plaintiff tax trap,” which individual plaintiffs may view as even sneakier and more unfair (and strange) than pre-TCJA law (assuming they were aware of the issue).

The TCJA remains in effect through 2025. After that, the tax law is supposed to revert to pre-TCJA status. It is anticipated, however, that the TCJA tax rules pertaining to MIDs will not revert to pre-TCJA status for several reasons, including the government's need for revenue. And even if the law does revert to pre-TCJA status, the continued application of the AMT rules would still provide an unfair double tax result.

Individual Plaintiff Tax Trap Example

Depending on the plaintiff's federal and state tax rates as well as the contingency fee rate, the individual plaintiff tax trap can cause the plaintiff to end up with a tiny portion of the gross recovery,

¹⁰ Section 56(b)(1)(E).

often 20 percent or less — sometimes less than 10 percent and occasionally approaching zero. Below is a simple, not uncommon, but nonetheless egregious example. Assume the plaintiff (1) lives in California and (2) receives a \$2 million taxable litigation recovery; (3) the nature of the claim (for example, defamation) does not allow an above-the-line deduction, and (4) the contingency fee rate is 40 percent. Under those facts, the plaintiff's net recovery would be less than 10 percent, calculated as shown in Table 1.

Table 1. Individual Plaintiff Tax Trap, Example 1

Taxable Recovery	\$2,000,000
Federal Tax Rate	37%
State Tax Rate (maximum)	13.38%
Combined Tax Rate	50.38%
Amount Due Attorney	(\$800,000) (\$2,000,000 * 40%)
Taxes	(\$1,007,600) (\$2,000,000 * 50.38%)
Net Amount to Plaintiff	\$192,400 (9.62% of the recovery)

Note in this example the following interesting facts:

- The federal and state governments receive more than five times as much as the plaintiff.
- The attorney receives four times as much as the plaintiff (and still two times as much once the attorney pays their taxes).
- If the attorney fee could have been fully deducted (or not included in income — same thing), the net amount the plaintiff would have received would be almost \$600,000 — about three times what was actually received (and even more if the deduction placed the plaintiff in a lower tax bracket).

When the Individual Plaintiff Tax Trap Kicks In (and When It Doesn't)

Many types of cases are significantly and adversely affected by the individual plaintiff tax trap, especially in high contingency fee rate situations. These include cases involving:

- Punitive damages and interest. Note that the individual plaintiff tax trap applies to these damages even when the basis of the claim is tax free, for example, recoveries related to a wrongful death case. If punitive damages are awarded, the punitive damages would be subject to the tax trap, even though the damages attributed to the wrongful death are not.
- Nonphysical injuries, such as mental health issues.
- Defamation and reputational injury.
- Intentional infliction of emotional distress.
- Employment situations that do not involve discrimination, such as breach of an employment contract.¹¹ To be more precise, the individual plaintiff tax trap applies when an employment-based claim does not include a situation involving a federal, state, or local law or a common law claim permitted under federal, state, or local law addressing civil rights or aspects of the employment relationship such as claims for wages or benefits.¹²
- Fraud, negligence, or breach of contract (including by insurance companies).
- Interference with property or contract rights.
- Wrongful arrest or imprisonment.
- Privacy matters.
- Amounts recoverable from an ex-spouse regarding alimony or child support.
- Incorrect tax return preparation or advice.
- Injuries/damages related to pets.
- Breaches of consumer protection laws.
- Investor fraud.
- Professional (for example, legal) malpractice.
- Whistleblowers (other than some whistleblower cases involving the IRS, the SEC, the federal False Claims Act, and section 23 of the Commodity Exchange Act).

¹¹ Section 62(e)(18).

¹² Some have argued that general employment cases involve civil rights, which allows the claim to be based on discrimination, which in turn allows the attorney fee to be claimed as an above-the-line deduction. We note that the IRS has not included support for such treatment in its field audit guidance to examiners. Thus, that treatment is an untested position that may subject the plaintiff to significant increases in taxes as well as substantial penalties and interest should the IRS examine the matter and conclude otherwise.

- Opt-in class action cases. These are class action cases in which the plaintiff affirmatively elects to be included in the class of litigants and agrees to be bound by the resulting settlement or judgement. (In these types of cases, a plaintiff's share of a contingency fee can exceed the amount that the plaintiff is entitled to as a share of the recovery. Hence an acute need for a solution to the tax trap.)

On the other hand, some contingency fee cases are not subject to the individual plaintiff tax trap. These include:

- Section 104(a)(2) physical injury cases (for the physical injury damage itself or related emotional distress, but not punitives and interest, when the tax trap does apply).
- Employment cases involving a violation of a specified discrimination law or federal, state, or local law involving civil rights or an aspect of the employment relationship — when the discrimination involves a law (or laws) described in section 62(e).
- When legal fees may be capitalized under section 263.
- When the fees may be treated as a section 162 trade or business expense.
- Opt-out class actions. These are cases in which an individual is not required to take any action to be included in the class, and the attorneys are paid separately under a court order.

Tip: It is often difficult to know whether a claim is subject to the individual plaintiff tax trap. Reference to the pleadings/settlement agreement can help, as can discussions with the plaintiff's attorney. There may be instances in which language in the pleading or settlement agreements may be stated or revised to achieve a more favorable tax outcome, including by reducing the individual plaintiff tax trap. It would be helpful to work with tax professionals who understand this area of the law because so much depends on the right answer. In uncertain situations that could be individual plaintiff tax traps, given the potential increased taxes, the best approach is to implement an effective solution as soon as possible because doing so can only help and will not make the tax situation worse.

Goal: The tax issues associated with plaintiff recoveries are often unknown or unappreciated by litigation attorneys, who naturally are focused on winning the case.¹³ (But why win to give so much of it back in taxes?) Unfortunately, that also tends to be true for the plaintiff's accountants, who often are unaware of the issue — or spot it after it is too late. The same may be true for persons involved in the structured settlement industry, who are closely involved with plaintiffs and their attorneys and have opportunities and incentives to address tax issues with plaintiffs. The sooner the plaintiff's team can be educated about the individual plaintiff tax trap, the better for the plaintiff. (An incentive for the structured settlement team to familiarize themselves with the issue: The less the plaintiff's income taxes, the more there is to structure.)

Commonly Proposed Solutions

Even when there is awareness of the individual plaintiff tax trap issue, reliable solutions are scarce. Below is a summary of common solutions:

- *Effective pleading and settlement agreements (this works).* The most effective approach is to have the pleadings and the settlement describe the claims and the nature of the damages in the most tax-friendly way possible. For instance, when a claim involves both physical and nonphysical injuries, and there is emotional distress, it is much preferable (when the facts support it) that the emotional distress damages relate to the physical injury, which are tax free, rather than relating to the nonphysical injury, when the emotional distress recovery is taxable.
- *Separate checks to the plaintiff and the attorney (this doesn't work).* This is frequently suggested — when the plaintiff is paid their share in one check, and the attorney is paid theirs in a separate check. Unfortunately, that is not legally valid because the Supreme

¹³ American Bar Association materials advise that “competent representation” of plaintiffs requires “considering the tax implications of the settlement.” ABA, “Ethical Guidelines for Settlement Negotiations” (Aug. 2002). Ethics rules require that personal injury lawyers tell clients the consequences of not addressing taxes or seeking competent tax advice.

Court in *Banks* made it clear that the entire amount of the plaintiff's taxable recovery is reportable as income. That applies regardless of how the recovery is actually paid.

- *Separate Form 1099s reporting only part of the settlement to the plaintiff and the attorney (this doesn't work).* While frequently suggested, this also does not work for the same reasons that apply to separate checks; that is, the entire recovery is reportable no matter how it is reported to the IRS. (Note also that there are significant penalties for reporting incorrect amounts on a Form 1099 in the case of intentional disregard — 10 percent of the amount that should have been reported, with no cap.¹⁴ And the IRS position is that there is no statute of limitations for such incorrect reporting.)
- *The plaintiff and attorney partnership gambit (this doesn't work).* This is a more sophisticated argument that reflects that neither the plaintiff nor the attorney can benefit without the other. The plaintiff cannot prevail unless the attorney successfully pursues the case. And the attorney cannot get paid unless there is a case to pursue. Thus, under this theory, the plaintiff and attorney are partners and should only be taxed only on their respective "share" of the partnership, as they determine (for example, 60/40). There is logic and appeal to this argument, and it reflects a sense of economic reality. However, this argument was overtly nixed in *Banks* because the Supreme Court view (and the better view) is that the attorney is an agent of the plaintiff (their alter ego) — not a partner. That's because the attorney acts for and represents the plaintiff. The attorney does not have their own identity in the matter. Further, lawyer ethics requirements do not allow an attorney to act

in partnership with the plaintiff. So the partnership argument is a "no go."¹⁵

- *The lawsuit as a trade or business (this doesn't work).* Some contend that the plaintiff should be able to treat the lawsuit as a trade or business, which would allow the attorney fee to be deductible as an ordinary trade or business expense. After all, in almost all cases, the plaintiff could not receive a recovery without the skill and expertise of their attorney. Unfortunately, this argument also does not fly, because plaintiffs are not (usually) in the trade or business of bringing litigation — certainly the case if only the single litigation is involved.

Does a structured settlement help? Some may think that structuring a plaintiff's recovery (by purchasing an annuity that pays the settlement over time) solves the individual plaintiff tax trap issue. It does not. While a structured settlement may lower taxes by spreading the payments over time so that each payment is taxed at a lower rate, it does not avoid taxation on the attorney fee portion of the recovery. Another answer is needed.

A Trust-Based Solution (the Plaintiff Recovery Trust)

Ordinary trust law principles provide the basis of a solution that has been developed to deal with the individual plaintiff tax trap. Some background is necessary to understand and appreciate this new approach.

First, it is necessary to understand what is being dealt with when a litigation claim is involved. As explained in *Banks*, the litigation claim is an asset.¹⁶ That contrasts with a mere right to receive income. While the purpose of the litigation claim is to eventually generate income (the recovery), until that occurs, if it ever does, the claim merely represents the potential for income. From a tax perspective, the difference between an

¹⁴Section 6722(e). Although we understand this penalty is rarely imposed, the consequences are severe if it is, especially in large recovery cases. For example, in a \$20 million recovery involving a 40 percent contingency fee in which only what the plaintiff receives is reported, the penalty exposure would be \$800,000 (\$20 million * (1 - 60 percent) * 10 percent). That's a pretty large hammer the IRS has, should it choose to use it or make an example of someone.

¹⁵See Second Restatement of Agency, section 1. See also ABA Model of Professional Conduct, rule 1.3 and rule 1.7.

¹⁶See *Logan v. Zimmerman Brush Co.*, 455 U.S. 422 (1982). See also *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306 (1950); *Tulsa Professional Collection Services v. Pope*, 485 U.S. 478 (1988) (there is little doubt that an unsecured claim was a property interest). LTR 200534015 (transfer of wrongful death claim to an irrevocable trust). LTR 200107019 (transfer of punitive damages portion of claim to a charity).

asset and a right to income is crucial. That is because an asset can be assigned (sold or given away) before there is a tax event. In contrast, income that is certain to be paid cannot be given away for tax purposes — rather, the income is taxed to the person who owns it even if the income recipient wishes to assign it.¹⁷ This is the “assignment of income” principle.

Because a litigation claim is an asset, it can be given away. For example, a litigation claim can be donated to charity. While this rarely happens — because most charities are unwilling or unable to accept unusual or hard to value assets — the impracticalities of a gift do not preclude its possibility. Another reason that a charitable gift is rare is because plaintiffs typically want to get at least something from the litigation claim, which can be difficult if not impossible to do by a charitable donation of the entire claim.¹⁸ There are also practical considerations, including how to value the litigation claim for income tax deduction purposes (and the cost of the appraisal). However, none of that changes the essential point that the litigation claim is an asset that can be given away.

Because the litigation claim can be given away, the solution is for the plaintiff to transfer the litigation claim to a specially designed split-interest charitable trust that has a separate legal identity from the plaintiff. The charitable trust is conceptually like a charitable remainder trust (CRT), which is permitted under the code,¹⁹ but it is not intended to be a CRT as such. (Perhaps think of this solution as involving a “nonqualified CRT.”) Thus, none of the traditional CRT benefits are available through this solution, such as a charitable contribution tax deduction or the avoidance and deferral of capital gains, but those are not the intended purpose of the solution.

Under this trust-based solution — known as a plaintiff recovery trust — the litigation claim is

¹⁷ *Lucas v. Earl*, 281 U.S. 111 (1930). The crux of the assignment of income principle is that one cannot give away income one has a right to after it has been earned and avoid the taxes on that income.

¹⁸ The plaintiff receiving something back from the charity after a litigation claim is successfully pursued raises inurement issues. While it might be possible for a plaintiff to donate a fraction of the claim, it probably is simpler for all concerned to simply donate part of any litigation recovery proceeds that are received. This should be permissible.

¹⁹ Section 664.

contributed to a CRT-like trust. The plaintiff is one of the beneficiaries of this split-interest trust, the other is a charity.²⁰ After the donation, if the trust is properly structured, the plaintiff will no longer own or control the litigation claim; ownership and control are now with the trust. Thus, the trust receives any recovery that becomes due, the attorney fees owed in connection with a successful outcome are paid, and the trust beneficiaries are allocated the net recovery in proportion to their respective interests, as specified in the trust.²¹

Because the plaintiff gave away their interest in the litigation, the only entitlement the participant has is that of a trust beneficiary, and their taxable income will reflect only what is received in that capacity, that is, it will not include the amount payable to the attorney (and thus, a “net” recovery).²² As the example below demonstrates, this can substantially increase the plaintiff’s after-tax settlement proceeds.²³

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

Important Conditions for the Trust-Based Solution to Work

Several important conditions must be satisfied for the trust-based solution to work:

- Condition 1: The plaintiff must fully relinquish ownership of the litigation claim in favor of the trust.²⁴
- Condition 2: The assignment must be valid under state law.

²⁰ Others may be designated to receive any recovery, instead of the plaintiff. This may have gift or estate tax implications that are beyond the scope of this article.

²¹ The trust has been structured so that the MID deduction limits that apply to a grantor trust, and that might apply to a non-grantor trust, do not apply. Reg. sections 1.67-2T and 1.67-4.

²² Some fees and other expenditures apply in connection with the solution, but the result is nevertheless much better than if the solution is not implemented. The costs would also be an obligation of the trust.

²³ Another nontax benefit of the trust-based solution is that the trust assets would be protected from the plaintiff’s creditors while held in the trust.

²⁴ The trust is structured so that, even though a charity is a beneficiary of the trust, there is no charitable deduction associated with the transfer because the CRT requirements of section 664 are not satisfied (and are not intended to be).

- Condition 3: The transfer must occur before it is certain that the litigation would result in a recovery, that is, before there is a definitely determinable settlement (that is, the recovery is contingent and doubtful). That avoids the assignment of income doctrine, which would result in the plaintiff being taxed on the recovery (including on the attorney fee portion). Whether that condition is met depends on the circumstances. Thus, it 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 trust-based solution does not prevent or avoid this requirement.
- Condition 4: The attorneys representing the original plaintiff should also represent the trust that receives the litigation claim. That is to avoid an assertion by the IRS that the trust assumed a liability of the plaintiff (which was only a contingent liability when the claim was donated) because that might be taxable income to the donating plaintiff.

How the Trust-Based Solution Saves Taxes – The Earlier Example Revisited

The trust-based solution saves taxes by subjecting only what the plaintiff receives to taxes rather than the entire recovery. Using the earlier example, we can see how the trust-based solution solves the individual plaintiff tax trap. Restating the facts: The plaintiff (1) lives in California and (2) receives a \$2 million taxable litigation recovery, (3) the nature of the claim (for example, defamation) does not allow an above-the-line deduction, and (4) the contingency fee rate is 40 percent. (See Table 2.)

Table 2. Individual Plaintiff Tax Trap, Example 2

Taxable Recovery	\$2,000,000
Federal Tax Rate	37%
State Tax Rate (maximum)	13.38%
Combined Tax Rate	50.38%
Amount Due Attorney	(\$800,000) (\$2,000,000 * 40%)

Table 2. Individual Plaintiff Tax Trap, Example 2 (Continued)

Taxes	(\$574,332) (based on plaintiff's allocable share of the trust income) ^a
Net Amount to Plaintiff	\$625,668 (31.29% of the recovery)
Increase in Net Recovery (\$)	\$433,268 (compared with not using the trust-based solution)
Increase in Net Recovery (%)	225% (compared with not using the trust-based solution)
^a The taxes may be even lower if the reduced taxable income places the plaintiff in a lower tax bracket.	

Conclusion

The taxation of individual plaintiff recoveries is peculiar, resulting in the individual plaintiff tax trap. The results — and the existence of the tax trap — depend on the nature of the claim and not the economic income to the plaintiff-taxpayer, the latter of which should be the appropriate basis for taxation. Thus, the individual plaintiff tax trap results in unfair and punitive outcomes, especially when the plaintiff lives in a high-tax state, the contingency fee rate (or attorney costs) are high, or both.

Awareness of plaintiff tax issues and the individual plaintiff tax trap is essential but far from typical. Understanding it and solving for it is crucial to the well-being of plaintiffs, who benefit from a maximized recovery to make them whole from their injuries. And even when there is an awareness of the issue, a legally valid solution must be used. The trust-based solution described in this article is one solution. ■