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## Guest Article

# Taxation Of Personal Injury Settlements: Trap For The Unwary

By Jeffrey A. Baskies

A recent decision by the California Court of Appeal, *Jalali v. Root*, highlights a serious problem for employment and personal injury lawyers. (See "Attorney Not Liable For Advice On Tax Consequences Of Settlement," Lawyers Weekly USA, June 23, 2003. Search words for LWUSA Archives: Jalali and bifurcated.)

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While ultimately the attorney prevailed in this case, there is nevertheless an important lesson in this case for every employment litigator and personal injury lawyer and for any tax lawyer working with one.

### The Facts

In *Jalali*, a woman settled a suit for racial discrimination against her former employer for \$2.75 million. However, after attorney fees and taxes, she was left with only

\$700,000. She felt cheated by the amount she paid in taxes, and sued her attorney, Walter Root III. She claimed that Root advised that she'd only be subject to income tax on her share of the settlement after deducting his contingent fee. The IRS, however, taxed the entire settlement amount and phased out her deductions for the fees that she paid as a result of the "alternative minimum tax" ("AMT").

The 4th District Court of Appeal in California overruled a trial court victory for Jalali and ordered judgment in attorney Root's favor, basically stating that the plaintiff failed to show she could have done any better by way of a trial. The court found that Root's work in the underlying employment discrimination case to have been exemplary. The opinion stated that had Jalali refused the settlement (claiming that as a result of the taxes it wasn't enough to settle), then she could not prove she would have received more money at trial.

So, in this case, the attorney was not held liable. But he had to endure a malpractice suit, a trial (including a judgment against him) and an appeal. The case shows lessons that can be learned and ways in which others can avoid those problems.

## The Problems

The problems highlighted in the *Jalali* case relate to the taxation of personal injury settlements (which for purposes of this article include settlements in employment discrimination cases, as well). The taxation of personal injury settlements generally creates two types of problems. On the one hand, there is an issue of what portion - if any - of a settlement should be subject to tax. On the other hand, there is the issue of how the attorney fees will be treated for federal income taxation.

### 1. Taxation Of Settlements

Generally, recoveries for physical harm are not taxable while recoveries for non-physical injuries - lost wages, emotional damages, punitive damages, etc. - are taxable. And in many cases this means a portion (and sometimes all) of the damages recovered in personal injury suits are subject to federal income taxation.

While the merits of that policy may be debated, it has been well-settled law for some time. Unfortunately, too often the taxation of settlements is not adequately considered.

In order to adequately address the tax consequences of damages, the primary issue for lawyers to consider is what portion of a settlement can and should be attributed to non-taxable theories of recovery and what portion should be attributed to taxable theories of recovery. The allocation of damages can be a difficult and contentious issue. There is a strong incentive (currently there is potentially a 35 percent differential - the maximum income tax rate) to categorize as much of a settlement as untaxable as possible.

Attorneys representing their personal injury clients can sometimes get caught up in these issues. As you are drafting settlement agreements, you (or your clients) may push to categorize damages as non-taxable in the agreement. That leads to clients taking positions on income tax returns. And sometimes filing those returns leads to defending those positions in IRS audits or in Tax Court proceedings.

It is important to note the potential liability pitfalls that can trap personal injury attorneys when they are asked to advise clients in this area. To be blunt: Get too aggressive and your client may get burned. If you "promised" too much, the client may then sue you for giving bad tax advice. While you may have innocently tried to help your client take the "strongest" position possible, if you didn't explain the risks (audit risks, interest and penalty risks, Tax Court litigation risks, etc.), your client may claim you malpracticed. And you will be forced to defend yourself - all for something that makes you no additional revenue and does you no particular good.

### 2. Deducting Attorney Fees

The second problem - the one highlighted in *Jalali* - relates to the deductibility of attorney fees.

As *Jalali* involved a civil rights claim, the damages were all subject to income tax either as non-physical damages or punitive damages. So that was not the issue. Instead, the issue was how the attorney fees would be handled.

In general, the income tax laws subject all forms of income to taxation. Taxpayers are then allowed to deduct certain expenses against the income when calculating their taxes. One important item of deduction is the legal fees incurred in the production of the income. As a result, in general, civil rights settlements (like the \$2.75 million one in *Jalali*) are taxable and the attorney fees incurred to generate the income are deductible on the litigant's Form 1040.

If that were the whole taxation story, there would have been no case.

What's missing is the impact of the "alternative minimum tax." The AMT was designed to

disallow certain deductions and recalculate a taxpayer's return to "insure that millionaires (back when millionaires were *really* millionaires) couldn't use itemized deductions and tax credits to shield themselves entirely from federal taxes."

The AMT was created more than three decades ago and developed under a tax code that had a high rate of income tax and permitted a huge amount of deductions and credits. However, since 1981, there has been a steady movement in the tax code to reduce the marginal rates and eliminate many of the deductions. Thus, the tax environment, which gave birth to the AMT, does not exist today.

Further undermining the AMT is the fact that it was designed to only impact wealthy taxpayers but has grown to impact many in the "middle class." Finally, and most importantly to this case, the AMT has "metamorphosed into a terror for civil rights plaintiffs," as Judge David G. Sills found in his opinion for the California Court of Appeal.

The terror in this case came from the AMT reducing the amount of attorney fees that could be deducted by the client. As a result, the amount of income tax she owed turned out to be more than she claimed she anticipated (by more than \$300,000). Further, as a result of the higher tax, the client claimed the amount of the net settlement she received (after taxes and fees) was less than her bottom line acceptable amount to settle. Had she properly understood the amount she'd be left after fees and taxes, she claimed, she would not have accepted the settlement.

Thus, based on the facts reported in this case, it appears her attorney misunderstood the impact of the ATM when advising her client about the settlement. However, the attorney argued, the ATM is hard to understand and there is a split of authority on the issue of how to handle attorney fees. It is true, the federal circuits are split on whether a plaintiff should report the full settlement as income and then deduct attorney fees, or should report only the net amount (settlement minus fees) as income and don't bother with the deduction.

As Judge Sills wrote: "The whole area is tailor-made for a national moot court competition, since it involves a substantial split in the federal appellate courts, and ultimately turns on a common law doctrine (the 'assignment of income' doctrine) on which reasonable minds could differ."

Having said all of that, the real problem for personal injury and employment attorneys is not misunderstanding the AMT. Most citizens do not understand the AMT. The trap for employment and PI attorneys, instead, stems from holding themselves out as tax experts. By giving tax advice to their clients concerning the settlement of personal injury and employment cases, many lawyers unwittingly are holding themselves out as experts. And many litigants are relying on their tax advice when deciding whether or not to accept settlement offers. That's where the trouble lies and the liability begins.

What caused the problem for Walter Root - the attorney/defendant in the *Jalali* case - was the following assertion (according to testimony quoted by the appellate court): "This is my field. I know what taxes are for discrimination cases." By trying to explain the taxation to his client and not directing her to seek expert assistance to consider the impact of the AMT on the settlement, the attorney exposed himself to this suit.

But how many attorneys are immune? How often do personal injury attorneys counsel clients on matters just like this one? How often are employment attorneys asked to help clients in settlements by explaining the taxation of the settlement and/or the attorney's fees?

This situation - or others like it - probably comes up often in the careers of litigators. To avoid problems or future malpractice claims, there are basically two choices: (1) personal injury and employment attorneys can become true tax experts and dive into the AMT regulations with gusto, or (2) they can adopt the lessons explained below.

### The Lessons

The lessons in this case are actually fairly simple. Unless attorneys are prepared to become truly an expert on the issues of taxation of damages, then they should adopt a simple technique taken from television.

We all learned from the cops on "Hill Street Blues" (and other TV shows) that the only way to ensure *Miranda* rights were properly administered was to write them down on a piece of paper and read them to suspects. Similarly, lawyers opining on the tax consequences of settlements should write this down and read it to their clients prior to accepting any settlement offers:

"While I am an experienced personal injury lawyer, and I am generally familiar with the tax consequences of settlements of personal injury lawsuits, you should know your rights:

"1. You have the right to an attorney (or accountant) from whom you may seek expert opinions on the taxation of your settlement.

"2. You are generally obligated to include damages from personal injury suits (other than those compensating physical injury) in your ordinary income and report them on your form 1040.

"3. You generally have the right to deduct attorneys fees on your federal income tax return (form 1040) to help offset the income - if any - generated by your personal injury settlement.

"4. You have the right to pull your hair out trying to understand the 'alternative minimum tax' (the 'AMT'); however, at the least, you should know that the AMT may cause you to lose the benefit of any or all of your deductions.

These simple "settlement taxation warnings" may save you from years of future litigation troubles. Indeed, these simple warnings may have helped attorney Walter Root avoid a time consuming and obviously worrisome trial and appeal.

In this case, the court went out of its way to congratulate Root on a job well done in the underlying discrimination case, and noted it was a shame the client litigated against him. But that just goes to show you that even a job well-done can lead to future headaches.

So let's be careful out there.

*Jeffrey A. Baskies, Esq., who practiced estate planning in Florida for many years, is currently the CEO of Lawyers Weekly Inc. in Boston. Board certified as a specialist in wills, estates and trusts law by the Florida Bar, his column runs regularly in Lawyers Weekly USA, the national newspaper for small law firms. If you have questions or issues relating to estate planning, please feel free to e-mail Jeff at [jbaskies@lawyersweekly.com](mailto:jbaskies@lawyersweekly.com). All questions are*

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