

# Contingency Fee Trap

## Issue

The U.S. Supreme Court ruling in *Commissioner V. Banks*<sup>1</sup> conclusively established that in certain types of contingency fee arrangement cases the attorney fee portion of the recovery must be included in the Plaintiff's gross income and reported as income on the Plaintiff's Form 1040. That is, a plaintiff may not report his recovery "net" of the attorney fee. Further, under the 2017 Tax Cuts and Jobs Act, there is no longer any available corresponding, separate deduction for the attorney fee (except for certain types of litigation).<sup>2</sup>

The combination of the Supreme Court ruling and the changes to the tax law is very adverse for Plaintiffs. By having to include the attorney portion of the recovery in gross income without a corresponding deduction, the result is substantially higher federal and state income taxes on the Plaintiff, because the attorney fee portion of the settlement cannot be "written off." This "tax trap" is the "Contingency Fee Trap."

As a result of the Contingency Fee Trap, Plaintiffs may end up with much less of a "net" recovery. In fact, Plaintiffs may see 80% or more of their recovery go to taxes and attorney fees, particularly in states with high-income taxes.

## Types of Cases Impacted

Since attorney fees are now entirely nondeductible, **ALL** contingency fee cases are affected, **except for:**

- "opt-out" class action, or
- Internal Revenue Code (IRC) Section 104(A)(2) physical injury, or  
(Note: the punitive damage award portion of the recovery is taxable)
- Where the plaintiff's legal fees are capitalized under IRC Section 263.

*Note: Structuring the attorney fee or the plaintiff portion does not eliminate the requirement to include the attorney fee in the Gross Income of the plaintiff.*

## Solution

The National Coalition for Equitable Settlements, Inc. (a 501(c)(3) not-for-profit entity) has designed a simple and easy solution to avoid the Contingency Fee Trap<sup>3</sup>. This solution effectively results in the Plaintiff including as taxable income only an amount equal to the "net" recovery – the recovery reduced by the attorney fee. **NCES's solution can substantially increase the Plaintiff's after-tax settlement proceeds!**

The following contains a simple example showing the effect of the Contingency Fee Trap and the NCES Solution. (over)

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<sup>1</sup> *Commissioner V. Banks*, 543 U.S. 426 (2005).

<sup>2</sup> Prior law allowed attorney fees to be deducted as a "miscellaneous itemized deduction". Even then, these deductions had limited usefulness for many taxpayers on account of various rules that limited the use of these types of deductions.

<sup>3</sup> Cases which have reached a definitely determinable settlement do not qualify.

## HYPOTHETICAL INCOME TAX COMPARISON OF SETTLEMENT

	Settlement Including Attorney Fee and Federal and State Income Tax	CONTINGENCY FEE TRAP SOLUTION (Attorney Fee Portion of Recovery Not Included in Income)
TAXABLE SETTLEMENT AMOUNT	\$400,000	\$240,000
FEDERAL INCOME TAXES ON SETTLEMENT PORTION	-\$129,630	-\$73,630
STATE INCOME TAXES ON SETTLEMENT PORTION	-\$24,000	-\$14,400
<b>TOTAL INCOME TAXES</b>	<b>-\$153,630</b>	<b>-\$88,030</b>
ATTORNEY FEE	-\$160,000	-\$160,000
DONATION/TRUSTEE FEE (15% of ATTORNEY FEE PORTION)	\$0	-\$24,000
<b>TOTAL TAXES AND ATTORNEY FEES PAID ON SETTLEMENT</b>	<b>-\$313,630</b>	<b>-\$272,030</b>
<b>NET AFTER TAX PROCEEDS TO PLAINTIFF</b>	<b>\$86,370</b>	<b>\$127,970</b>
<b>INCREASED NET PROCEEDS TO PLAINTIFF</b>	<b>-</b>	<b>\$41,600</b>
<b>PERCENTAGE OF NET PROCEEDS INCREASE</b>	<b>-</b>	<b>48.16%</b>
<b>SAVINGS OPPORTUNITY VALUE (@ 6% OVER 10 YRS)</b>		<b>\$74,499</b>

ASSUMPTION VARIABLES INPUT	
GROSS SETTLEMENT AMOUNT	\$400,000
CONTINGENT ATTORNEY FEE	40%
ESTIMATED TAXABLE HOUSEHOLD INCOME (before standard deductions)	\$100,000
FILING STATUS	Single
STATE INCOME TAX RATE	6.00%

**IMPORTANT: Taxable Household Income is adjusted with standard deductions internally by system.**

**IMPORTANT: The values and tax calculations contained herein are HYPOTHETICAL ESTIMATES ONLY and may not reflect your full and specific tax circumstances - seek professional advice before proceeding.**

## Features

The Contingency Fee Trap solution:

1. Avoids the attorney fee portion of the recovery from being included in the Plaintiff's income and thereby increases the Plaintiff's net recovery.
2. Provides up to \$25 Million in FDIC coverage per Plaintiff prior to disbursement.
3. Offers the ability to obtain an individual legal opinion.
4. Is quick and easy with no ongoing administration or expense required.
5. Is available in all 50 states and the U.S. Territories.
6. Imposes no intermediate administrative burdens on the Plaintiff.
7. Retains ability to structure the settlement or utilize a Settlement Trust or SNT.
8. Does NOT require using any insurance contract or a particular type of investment.
9. Does NOT require extended payouts of a structured settlement.
10. Protects a pending settlement from the claims arising from ex-spouses and creditors.
11. Has no secondary bankruptcy risk exposure.

## Information

For more information, please dial (406)761-4957 to contact:

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