How Personal Injury Attorneys Can Benefit from the Tax Cuts and Jobs Act

by Greg Maxwell, Esq., CFP®, Esq., Joseph Tombs, Esq., MBA, RSP, CFP®, Larry Peterson, MS, RSP, CFP®

How would you like to pay a lot less in taxes on the income from your personal injury practice? The Tax Cuts and Jobs Act ("TCJA") was enacted in late 2017 and became effective in 2018. Although the TCJA was sold to the public as an almost universal tax cut, there are definitely winners and losers under the Act. Taxpayers are still waking up to some of the less obvious tax-planning implications of this sweeping reform. Much of the media's attention was immediately drawn to the benefits of the reduction of tax rates and the overall simplification of reporting for most individual taxpayers due to the doubling of the standard deduction and the elimination or reduction of certain itemized deductions. The fact that a disproportionate share of the tax reductions went to corporations instead of the middle-class was also covered extensively. The primary message of this article is that there are opportunities in the TCJA for most personal injury attorneys if they are willing to make some minor adjustments in their practices and perhaps in their personal lives.

§199A was added to the Internal Revenue Code to allow owners of pass-through business entities to deduct up to 20% of "Qualified Business Income" ("QBI"). QBI is the net profits from businesses that pass through any income tax obligation to the owners. Since the TCJA gave corporations a massive tax reduction, the QBI deduction was intended to ensure that owners of small businesses (which are much more likely to use pass-through business structures) also got a reduction.

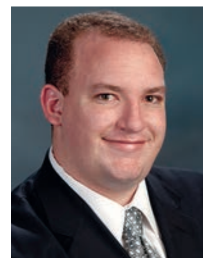
This time of year, most attorneys' tax preparers already either took the QBI deduction or did not take it based on whether the practice presently qualifies for it. What the attorneys who did not qualify for the deduction may not have been told as they stroked and handed over their tax checks is that if they did not presently qualify for the QBI deduction, they may easily be able to qualify next year with some adjustments.

Most personal injury lawyers own an interest in their law practices and most law practices are set up as pass-through entities (partnerships, sole proprietorships, or PCs, PLLCs, or LLCs that have elected to be taxed as

Greg Maxwell, Esq., CFP® *is a partner in the law firm of Tombs Maxwell LLP, and a founder of Amicus Settlement Planners. He specializes in helping contingency-fee attorneys across the country minimize their income tax liability by taking advantage of legal fee deferral strategies. He also specializes in the legal and financial needs of settling plaintiffs – structured settlement annuities, investment management, special needs trusts, and government benefit planning.*

Joseph Tombs, Esq., MBA, RSP, CFP® *is a partner in the law firm of Tombs Maxwell LLP, and a founder of Amicus Settlement Planners. He specializes in the legal and financial needs of settling plaintiffs and their attorneys.*

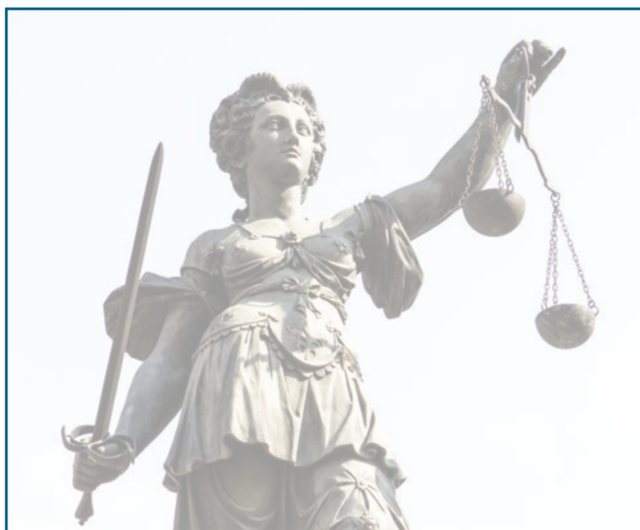
Larry Peterson, MS, RSP, CFP® *is a Partner in Amicus Settlement Planners. He focuses on helping plaintiffs and attorneys maximize the benefits they receive from their settlements. He cheerfully serves as a nerd in each client's corner.*



S-corporations or partnerships). The question many personal injury lawyers have is, "Does my ownership interest in my law business qualify for a QBI deduction?" The answer is most often, "Maybe." Lawyers' practices and many other professional practices are callously dubbed, "Specified Service Trades or Businesses" ("SSTBs") and that's not a good thing. In 2019, owners of SSTBs may only take the QBI deduction if their taxable income before the QBI deduction is less than the specified thresholds of $160,700 of taxable income for single owners and $321,400 if married and filing jointly. A partial QBI deduction is available for those with taxable incomes slightly higher than those thresholds, but the deduction is completely phased out over the next $50,000 for single taxpayers and $100,000 for those who are married filing jointly.

In summary, personal injury lawyers with ownership in their practices can take a full QBI deduction if their taxable incomes fall below $160,700 for single taxpayers and $321,400 for those who are married filing jointly. If you make less than the applicable threshold, take the deduction. Many personal injury lawyers make a taxable income below these thresholds in most years. If an attorney expects to make more than that, he or she can probably still take the deduction with some planning and perhaps a little sacrifice. There are many ways to reduce income without reducing overall wealth. For example, a personal injury attorney may be able to make deductible contributions to a qualified retirement plan or invest in deductible capital equipment or an advertising campaign.

One simple and often overlooked way to reduce a personal injury attorney's taxable income is by entering into a contingency fee deferral agreement with the clients whose cases generate the largest fees. Over the years, several mechanisms to accomplish this deferral have been devised including the use of structured settlement annuities, assignment of an obligation to pay future sums to an offshore company located in a tax-haven country, and non-qualified deferred compensation based solutions such as rabbi trusts. Each



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of tax-deferral concepts follows the same basic structure; the client who hires the attorney agrees to defer payment of a specified portion of the fee to a time in the future and then delivers that portion of the fee to a third-party company that takes over the obligation to make the future payment. As long as the attorney avoids taking actual or constructive receipt of the funds and the funds are not set aside for the attorney's exclusive economic benefit, the income tax on the fees is delayed until the attorney receives them.

This may be best illustrated with an example. Sam is a personal injury attorney who owns a solo practice organized as a Professional Corporation and he has filed an S-election. Sam is married to Julie who is disabled and does not currently make an income. Sam and Julie file jointly and have a very simple return, taking only the standard deduction. Sam expects to make $550,000 in net profits from his practice this year and $50,000 in ordinary income from investments held with his broker. He and his wife spend about $400,000 each year. If Sam does no tax planning, they will owe approximately $152,000 in federal income taxes on their $600,000 in income. As discussed above, since practicing law is an "SSTB", Sam and Julie cannot take the QBI deduction because their taxable income exceeds the threshold. Fortunately, they made $448,000 after taxes and since they only spend $400,000, they'll be able to add $48,000 to their investments.

Sam is "living the dream" even without any planning: he enjoys his practice, lives a great lifestyle, and added $48,000 to the couple's investment stash. Why should he care about QBIs or attorney fee deferrals? Although he audibly groans every year when the tax preparer reveals the number, Sam feels successful and perhaps feels a little pride that he makes enough to not have to worry about careful tax planning.

But let's take a moment and reevaluate Sam's year assuming he had spent a few minutes with a tax planner who convinced him to arrange to defer $256,000 of his legal fees from his biggest one or two cases during the year. To acknowledge the fact that this approach is wiser than the previous more carefree approach, we'll refer to this tax-planning Sam as "Wise Sam." Wise Sam's income from his law practice would have been $294,000 ($550,000 net practice income – $256,000 deferred). Adding the couple's investment income would result in $344,000 in income less a $24,400 standard deduction which would result in taxable income of $319,600. Wise Sam's law practice income now qualifies for a QBI deduction because their joint taxable income is below the threshold. Wise Sam's QBI deduction would be $58,800 (20% of $294,000 QBI). Wise Sam would pay about $51,000 in taxes (instead of $152,000). In summary, he would have received $344,000 in income and paid $51,000 in taxes, so he would need to take $107,000 from his brokerage account to spend the $400,000 he and his wife are used to spending each year.

At the end of the year, Wise Sam would have $155,000 less in his brokerage account than his unplanned self but would have $256,000 growing for his benefit in a tax-deferred account that will pay him sometime in the future. The extra $101,000 that is now growing for Wise Sam's future came from this year's reduction in taxes ($152,000 – $51,000). Obviously, if Wise Sam repeats this in future years for as long as his investment account holds up, the tax savings will start to pile up. If we then add to our analysis a decade or two of tax-deferred, compounded growth, Wise Sam will likely be millions of dollars ahead due to this exercise.

Of course, when dealing with tax law, there are always intricacies that could affect the results. However, contingency-fee based attorneys are in a unique position to be able to control the amount of income tax they pay from year to year by taking advantage of the legal fee deferral options available to them. So, assuming you don't like paying more in taxes than you need to, don't be normal Sam. Be Wise Sam. Make time to consult with a specialized tax-planning advisor about whether the techniques discussed in this article are suited to you.

Sam v. Wise Sam

	Sam	Wise Sam
Attorney Income	$ 550,000	$ 550,000
Attorney Fee Deferred Amount	$ -	$ (256,000)
Attorney Net Taxable Income	$ 550,000	$ 294,000
Ordinary Income from Investments	$ 50,000	$ 50,000
Gross Income	$ 600,000	$ 344,000
Standard/Itemized Deductions	$ (24,400)	$ (24,400)
Taxable Income before QBI Deduction	$ 575,600	$ 319,600
QBI Deduction	$ -	$ (58,800)
Taxable Income after QBI	$ 575,600	$ 260,800
Tax Due	$ 152,000	$ 51,000
Tax Savings - QBI		**$ 14,112**
Tax Savings - Fee Deferral		**$ 86,888**
Projected Tax Savings		**$ 101,000**

*This simplified scenario assumes taxes are filed as married filing joinly. Your individual circumstances will vary.

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