

# IRS Tax Treatment of Legal Settlements

BY JEREMY BABENER

Rob Wood's treatise has long been the go-to guide for tax issues surrounding settlement and recovery. He is also the author of the Bloomberg portfolio on this topic, but his new bigger treatise is more extensive, comprising a sizable 942 pages. This fifth edition (2021) of *Taxation of Damage Awards and Settlement Payments* continues that tradition and expands on subjects and strategies critical to plaintiffs and defendants. For the first time, this new edition is in electronic form, delivered in a cased flash drive. That makes the book more usable and accessible.

Readers will find guidance on compliance and, more important, paths to increase plaintiffs' after-tax recoveries and decrease defendants' after-tax costs. It also brings us up to date on analysis and approaches necessitated by recent decisions by the IRS, federal courts and Congress. If you regularly work in the litigation context, this book belongs in your library.

The fifth edition dedicates a whole chapter to the treatment of attorney fees, and with good reason. Whether parties can deduct or capitalize legal costs, and how much they can, changes the cost of settlement. Wood walks us through the litany of cases considering the "origin of the claim," and more recent decisions affecting the analysis. The 2017 Tax Cuts and Jobs Act may have had the biggest impact on the tax treatment of legal fees in this space. It disallowed miscellaneous itemized deductions through 2025, and in doing so, disallowed most individual plaintiffs' deductions of their legal fees.

Many plaintiffs used to take for granted the deductibility of their fees, believing that at

worst they would pay tax on their net recoveries after deducting legal fees. But the 2017 law creates the seemingly confiscatory rule that taxes some plaintiffs on their gross recoveries despite paying substantial legal fees. Wood addresses this concern and some of the more popular ways to address it.

In the same 2017 legislation Congress limited defendants' ability to deduct expenses in sexual harassment and sexual abuse cases. Of critical note is the impact of confidentiality in these settlements, which triggers defendants' inability to deduct their expenses. Wood addresses the defendants'

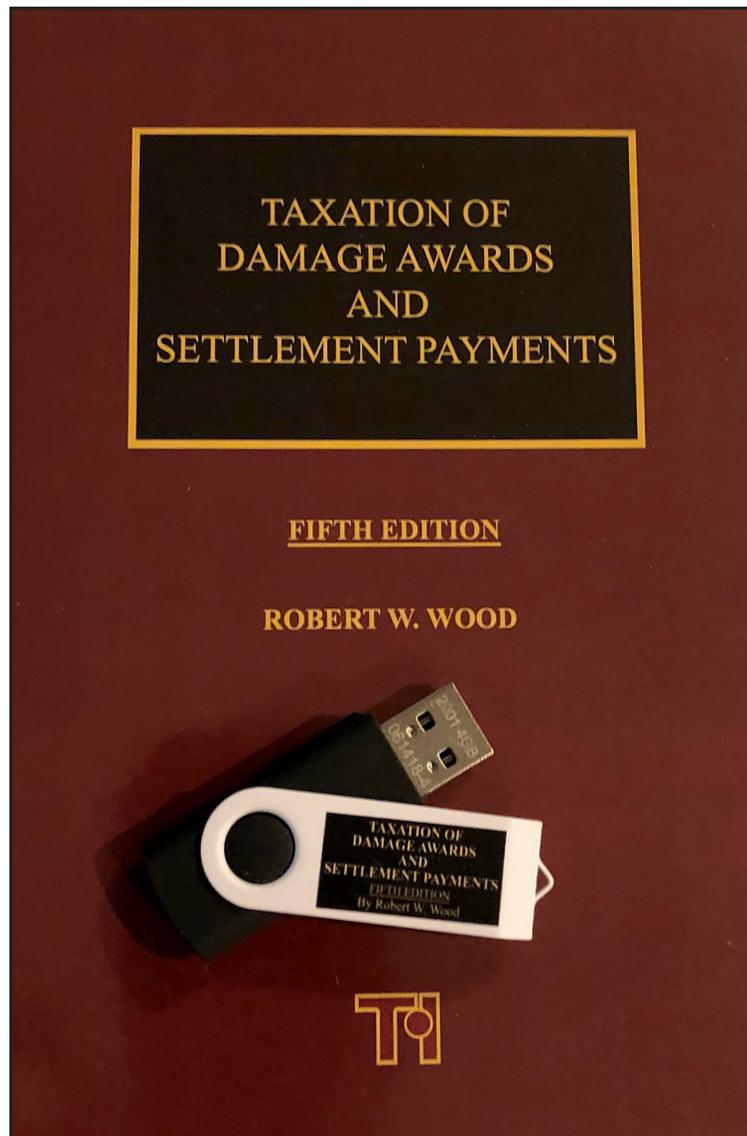
perspective, then discusses how plaintiffs could have been, but will not be impacted. At least, not directly.

The taxation of recoveries for physical symptoms and physical sickness has developed significantly since the fourth edition. In 1996, Congress limited Section 104(a)(2)'s general income exclusion for personal injury recoveries to "physical injuries" and "physical sickness." The fourth edition looked at legislative history, which called for the taxation of recoveries for "physical symptoms" of emotional distress.

In this fifth edition, Wood considers the application of recent federal court decisions discussing that history. For example, the U.S. Tax Court distinguished "physical signs" from "physical symptoms." This leaves open the possibility of better treatment of compensation for physical ailments resulting from emotional distress when the ailments are objectively verified by a physician.

Injured businesses continue to allocate recoveries to a "loss of goodwill" rather than "lost profits," hoping to benefit from basis recovery and capital gain rates. Wood recounts recent caselaw, describing the narrow circumstances when the IRS and courts will side with businesses.

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In the same chapter on business recoveries, he summarizes the tax treatment of recoveries in shareholder derivative suits, patent infringement cases, and will contests.

Of paramount importance to tax treatment in any case is the nature of the claims and the language used in the settlement agreement. Indeed, the IRS and courts regularly look to the settling parties' allocation of proceeds. Wood recounts how and why a defendant's intent generally dictates the character of the settlement payment.

The question then remains, "How can the parties allocate to minimize taxation?" Each chapter in this volume describes different types of recoveries and their varying

tax treatment. In discussing how to allocate, Wood emphasizes when the IRS will respect such allocations—key to anyone drafting settlement language.

Each edition of this treatise makes the job easier for those regularly working on and near the frontline of litigation. Know how your recovery and expenses should be treated. Identify when and how you can improve that treatment. Identify when you can help the other side do the same. This treatise is organized and full of planning tips to help you do so. The fifth edition of *Taxation of Damage Awards and Settlement Payments* is available at [www.TaxInstitute.com](http://www.TaxInstitute.com) for \$395, including shipping. California orders add \$33.58 for sales tax. 