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THE TAX LAWYER

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In Tesla's \$137M Race Verdict, Big Winner Is IRS

A San Francisco jury ruled that Tesla [TSLA -1%](#) must pay [\\$137 million in a workplace racism case](#) in which a Black man alleged that he endured racist abuse while working at Tesla's Fremont California plant. Owen Diaz alleged that he suffered racist remarks and abuse causing him sleepless nights, weight loss, and loss of appetite. The jury awarded him \$6.9M in compensatory emotional distress damages, and a whopping \$130M in punitive damages. The verdict may be appealed, but even if it stands up, taxes will slash the award because of how the IRS taxes legal settlements and judgments. Many plaintiffs win or settle a lawsuit only to be surprised that they have to pay taxes. Some don't realize it until tax time the following year when IRS Forms 1099 arrive in the mail. In fact, under the [2018 tax "reform" law](#), many plaintiffs are even taxed on their attorney fees too, even if their lawyer takes 40% off the top. In a \$100,000 case, that means paying tax on \$100,000, even if \$40,000 goes to the lawyer.

In Mr. Diaz' case, he should at least be able to deduct his legal fees, since his case arose out of employment. But most of his award is punitive damages, and punitive damages are always taxed. Taxes are based on the origin of

your claim. If you get laid off at work and sue seeking wages, you'll be taxed as wages, and probably some pay on a Form 1099 for emotional distress. The rules are full of exceptions and nuances, so be careful, how [settlement awards are taxed, especially post-tax reform](#). One big surprise for plaintiffs is that emotional distress damages are taxed, meaning that Mr. Diaz probably has to pay tax on his entire award, even the \$6.9M. Before 1996, all "personal" damages were tax-free, so emotional distress and defamation produced tax-free recoveries. But since 1996, your injury must be "physical."



It is not clear if what happened to Mr. Diaz is enough. If you sue for intentional infliction of emotional distress, your recovery is taxed. Physical symptoms of emotional distress (like headaches and stomachaches) are taxed, but physical injuries or sickness are not. The rules can [make some tax cases chicken or egg](#), with many judgment calls. If in an employment dispute you receive \$50,000 extra because your employer gave you an ulcer, is an ulcer

physical, or merely a symptom of emotional distress? Many plaintiffs take aggressive positions on their tax returns, but that can be a losing battle if the defendant issues an IRS Form 1099 for the entire settlement. Haggling over tax details before you sign and settle is best.

Most legal disputes involve multiple issues. You might claim that the defendant kept your laptop, frittered away your trust fund, underpaid you, failed to reimburse you for a business trip, or other items. Even if your dispute relates to one course of conduct, there's a good chance the total settlement involves several types of consideration. It is best for plaintiff and defendant to agree on tax treatment. Such agreements aren't binding on the IRS or the courts in later tax disputes, but they are usually not ignored by the IRS.

If you are the plaintiff and use a contingent fee lawyer, you'll usually be treated (for tax purposes) as receiving 100% of the money recovered by you and your attorney, even if the defendant pays your lawyer directly his contingent fee cut. If your case is fully nontaxable (say an auto accident in which you're injured), that shouldn't cause any tax problems. But if your recovery is taxable, watch out. Say you settle a suit for intentional infliction of emotional distress against your neighbor for \$100,000, and your lawyer keeps \$40,000. You might think you'd have \$60,000 of income. Instead, you'll have \$100,000 of income. In 2005, the U.S. Supreme Court held in [*Commissioner v. Banks*](#), that plaintiffs generally have income equal to 100% of their recoveries. even if their lawyers take a share.

How about deducting the legal fees? In 2004, Congress enacted an above the line deduction for legal fees in employment claims and certain whistleblower claims. That deduction still remains, but outside these two areas, there's big trouble. in the big tax bill passed at the end of 2017, there's a [new tax on litigation settlements, no deduction for legal fees](#). No tax deduction for legal

fees comes as a bizarre and unpleasant surprise. Tax advice early, before the case settles and the settlement agreement is signed, is essential.

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