Post Trump Tax Reform, How Legal Settlements are Taxed

Robert W. Wood

Robert W. Wood is a tax lawyer with www.WoodLLP.com, and the author of numerous tax books, including *Taxation of Damage Awards & Settlement Payments* (www.TaxInstitute.com). This discussion is not intended as legal advice.

Lawyers and clients resolve disputes all the time, usually with an exchange of money and a release. One of the first questions plaintiffs ask their attorneys is whether the payments they receive will be taxable. The answer to that question can vary enormously, depending on how you were damaged, how the case was resolved, how the checks and IRS Forms 1099 were issued, and other variables.

Last year, the *Business Law News* published an article by the author summarizing the tax rules that applied in this common situation.[1] Some of those tax rules changed with the major tax bill passed in December 2017,[2] however. This article updates that earlier article to reflect the changes, which impact the tax treatment of attorney fees in a variety of cases and add special rules for sexual harassment and abuse cases.

In 2017, the author identified ten rules that lawyers and their clients should know about the taxation of settlements. This update restates the first seven rules, which were not affected by the changes, both to provide context and for ease of reference. Original rules eight through ten have been rewritten in their entirety, and a new rule has been added to address the special treatment accorded to sexual harassment and abuse awards by the 2017 Tax Act.

1. Settlements and judgments are taxed the same.

The same tax rules apply whether you are paid to settle a case or win a lawsuit judgment, or even if your dispute only reached the letter-writing phase. Despite the similarities, though, you'll almost always have more flexibility to reduce taxes if a case settles rather than goes to judgment.

If you are audited, you'll need to show what the case was about and what you were seeking in your claims. Consider the settlement agreement, the complaint, the checks issued to resolve the case, IRS Forms 1099 (or W-2), etc. You can influence how your recovery is taxed by how you deal with these issues.

2. Taxes depend on the "origin of the claim."

Settlements and judgments are taxed according to the item for which the plaintiff was seeking recovery (the "origin of the claim").[3] If you're suing a competing business for lost profits, a settlement will be lost profits, taxed as ordinary income. If you get laid off at work and sue for discrimination seeking wages and severance, you'll be taxed as receiving wages.

In fact, your former employer will probably withhold income and employment taxes on all (or part of) your settlement. That is so even if you no longer work there, even if you quit or were fired years ago. On the other hand, if you sue for damage to your condominium by a negligent building contractor, your damages usually will not be income.

Instead, the recovery may be treated as a reduction in your purchase price of the condominium. That favorable rule means you might have no tax to pay on the money you collect. However, these rules are full of exceptions and nuances, so be careful. Perhaps the biggest exception of all applies to recoveries for personal physical injuries (see point three following).

3. Compensatory recoveries for personal physical injuries and physical sickness are tax-free.

This is a really important rule, and one that causes almost unending confusion with lawyers and their clients. If you sue for personal physical injuries like a slip and fall or car accident, your compensatory damages should be tax-free. That may seem odd, since you may be seeking lost wages because you couldn't work after your injuries.

But a specific section of the tax code—§ 104 (26 U.S.C. § 104)—shields damages for personal physical injuries and physical sickness. Note the "physical" requirement. Before 1996, "personal" injury damages were tax-free. That meant emotional distress, defamation, and many other legal injuries also produced tax-free recoveries. That changed with the 1996 amendments to the key tax code provision.[4]

Since then, your injury must be "physical" to give rise to tax-free money. Unfortunately, neither the IRS nor Congress has made clear what that means. The IRS has generally said that you must have visible harm (cuts or bruises) for your injuries to be "physical."[5] This observable bodily harm standard generally means that if you sue for intentional infliction of emotional distress, your recovery is taxed.

If you sue your employer for sexual harassment involving rude comments or even fondling, that is not physical enough for the IRS. But some courts have disagreed. The Tax Court, in particular, has allowed some employment lawsuits complete or partial tax-free treatment, where the employee had physical sickness from the employer's conduct or the exacerbation of a pre-existing illness.[6]

Thus, standards are getting a little easier. However, taxpayers routinely argue in U.S. Tax Court that their damages are sufficiently physical to be tax-free. Unfortunately, the IRS usually wins these cases.[7] In many cases, a tax-savvy settlement agreement could have improved the plaintiff's tax chances.

4. Symptoms of emotional distress are not "physical."

The tax law draws a distinction between the money you receive for physical symptoms of emotional distress (like headaches and stomachaches) and personal physical injuries or physical sickness.[8] Here again, these lines are not clear. For example, if in settling an employment dispute you receive $50,000 extra because your employer gave you an ulcer, is an ulcer physical or is it merely a symptom of your emotional distress?

Many plaintiffs end up taking aggressive positions on their tax returns, claiming that damages of this nature are tax-free. But that can be a losing battle if the defendant issues an IRS Form 1099 for the entire settlement. That means it can behoove you to try to get an agreement with the defendant about the tax issues. There is nothing improper about doing this.

There are wide variations in tax reporting and multiple players often involved in litigation (parties, their insurance companies, and their attorneys). Thus, not trying to nail all this down in the settlement agreement can be foolish. You may have to pay for outside tax experts, but you'll almost always save considerable money later by spending a little at this critical moment.

Otherwise, you might end up surprised with Forms 1099 you receive the year after your case settles. At that point, you will not have a choice about reporting the payments on your tax return.

5. Medical expenses are tax-free.

Even if your injuries are purely emotional, payments for medical expenses are tax-free, and what constitutes "medical expenses" is surprisingly liberal.[9] For example, payments to a psychiatrist or counselor qualify, as do payments to a chiropractor or physical therapist. Many nontraditional treatments count too.

However, if you have previously deducted the medical expenses and are reimbursed when your suit settles in a subsequent year, you may have to pay tax on these items. Blame the "tax benefit" rule.[10] It says that if you previously claimed a deduction for an amount that produced a tax benefit to you (meaning it reduced the amount of tax you paid), you must pay tax on that amount if you recover it in a subsequent year.

The opposite is also true. If you deducted an amount in a previous year, and that deduction produced no tax benefit to you, then you can exclude the recovery of that amount in a later year from your gross income.[11]

6. Allocating damages can save taxes.

Most legal disputes involve multiple issues. You might claim that the defendant kept your laptop, frittered away your trust fund, undercompensated you, failed to reimburse you for a business trip, or other items. In fact, even if your dispute relates to one course of conduct, there is a good chance the total settlement amount will involve several types of consideration.

It is usually best for plaintiff and defendant to try to agree on what is being paid and its tax treatment. Such agreements are not binding on the IRS or the courts in later tax disputes, but they are rarely ignored. As a practical matter, what the parties put down in the agreement is often followed. And in the real world, there are usually multiple categories of damages.

For all of these reasons, it is more realistic—and more likely to be respected by the IRS and other taxing authorities—if you divide up the total and allocate it across multiple categories. If you are settling an employment suit, there might be some wages (with withholding of taxes and reported on a Form W-2); some nonwage emotional distress damages (taxable, but not wages, so reported on a Form 1099); some reimbursed business expenses (usually nontaxable, unless the employee deducted them); some pension or fringe benefit payments (usually nontaxable); and so on. There may even be some payment allocable to personal physical injuries or physical sickness (nontaxable, so no Form 1099), although this subject is controversial (see points three and four above).

7. You may have capital gain instead of ordinary income.

Outside the realm of suits for physical injuries or physical sickness, just about everything is income. However, that does not answer the question of *how* it will be taxed. If your suit is about damage to your house or your factory, the resulting settlement may be treated as capital gain. Long term capital gain is taxed at a lower rate (15 percent or 20 percent, not 39.6 percent), so is much better than ordinary income.

Apart from the tax rate preference, your tax basis may be relevant too. This is generally your original purchase price, increased by any improvements you have made, and decreased by depreciation, if any. In some cases, your settlement may be treated as a recovery of basis, not income.

A good example would be harm to a capital asset, such as your house or your factory. If the defendant damaged it and you collect damages, you may be able to simply reduce your basis rather than reporting gain. Some settlements are treated like sales, so again, you may be able to claim your basis.[12] In fact, there are many circumstances in which the ordinary income versus capital distinction can be raised, so be sensitive to it. For example, some patent cases can produce capital gain, not ordinary income.[13] The tax rate spread can be nearly 20 percent.

8. Attorney fees can be a trap.

This area was changed materially by the 2017 Tax Act. Whether you pay your attorney hourly or on a contingent fee basis, legal fees will impact your net recovery and your taxes. If you are the plaintiff and use a contingent fee lawyer, you usually will be treated (for tax purposes) as receiving 100 percent of the money recovered by you and your attorney. This is so even if the defendant pays your lawyer the contingent fee *directly*.

If your case is fully nontaxable (say an auto accident in which you are physically injured and you receive compensatory damages), that should cause no tax problems. But if your recovery is taxable, the type of deduction you can claim for the legal fees can vary materially. This trap occurs frequently.

Say you settle a suit for intentional infliction of emotional distress against your neighbor for $100,000, and your lawyer keeps 40 percent, or $40,000. You might think that you would report $60,000 of income. Instead, you will have to report $100,000 of income. For payments received up until the end of 2017, you could claim a $40,000 miscellaneous itemized deduction for legal fees.[14] That meant you faced numerous limitations (including having to deal with alternative minimum tax ("AMT")), but at least you could claim the deduction. For 2018 and thereafter, however, there will be no deduction for these legal fees. Yes, that means that a plaintiff may keep only collect 60 percent of an award, but be taxed on 100 percent.

Notably, not all lawyers' fees face this draconian tax treatment. If the lawsuit concerns the plaintiffs' trade or business, the legal fees are a business expense. Those legal fees can be deducted above the line, the best kind of deduction.[15] And if your case involves claims against your employer, or involves certain whistleblower claims, there is also an "above-the-line" deduction for legal fees.[16] That means you can deduct those legal fees before you reach the adjusted gross income ("AGI") line on the first page of your Form 1040.

Outside of trade or business or employment (and certain whistleblower) claims, however, be careful. There are sometimes ways of circumventing these attorney fee tax rules, but you'll need sophisticated tax help—before your case settles—to do it.

9. Punitive damages and interest are always taxable.

Punitive damages and interest are always taxable, even if your injuries are 100 percent physical. Say you are injured in a car crash and get $50,000 in compensatory damages and $5 million in punitive damages. The $50,000 is tax-free, but the $5 million is fully taxable. What's more, you may be unable to deduct your attorney fees (on this point, see rule eight above). Because the case does not arise out of employment or a trade or business, any taxable payment can be 100 percent taxable, even though 40 percent may go to the lawyer. The lack of a tax deduction for legal fees commencing in 2018 is likely to catch many people by surprise come tax return time in 2019.

The same can occur with interest. You might receive a tax-free settlement or judgment, but pre- or post-judgment interest is always taxable.[17] As with punitive damages, taxable interest can produce attorney fee deduction problems. These rules can make it more attractive (from a tax viewpoint) to settle your case rather than have it go to judgment.

10. Sex harassment and abuse.

Under the 2017 Tax Act, confidential sexual harassment or abuse settlements face special tax rules.[18] If the settlement is confidential, the defendant cannot deduct the settlement payment or the legal fees.[19] As written, this "no deduction" rule for legal fees seems to apply to plaintiffs' legal fees, as well.

Most sexual harassment cases occur in the context of employment, where an above-the-line deduction for plaintiffs' legal fees has applied up to now.[20] But the wording of the 2017 Tax Act now calls this deduction into question. That (surely, it is to be hoped) unintended result for plaintiffs may be corrected by a subsequent tax bill, but for now the issue is not clear.

No plaintiff wants to pay tax on 100 percent of an award when they will be receiving only 60 percent for themselves. Some plaintiffs, therefore, may insist on omitting the nondisclosure provision in an agreement settling a sexual harassment or abuse case, or may demand a tax indemnity if their tax deduction for legal fees is denied. Others might agree to allocate only a portion (usually small) of the settlement to the sexual harassment or abuse component of a broader set of claims. But this may be unrealistic where the whole case is about sexual harassment, and there is no guarantee the IRS will accede to such an allocation of damages.

11. It pays to consider the defense.

Plaintiffs are generally much more worried about tax planning than defendants. Still, a defendant paying a settlement or judgment always wants to deduct it. Although some defendants face questions whether an amount can be immediately deducted (e.g., expensed) or must instead be capitalized, most defendants engaged in a trade or business can expense litigation as a cost of doing business. Even punitive damages are tax deductible by businesses. Only certain government fines cannot be deducted. And even then defendants can sometimes find a way if the fine is in some way compensatory.

As noted above, however, a notable new exception to that general rule applies to confidential sexual harassment or abuse settlements and related legal fees. In addition, if a suit is related to investment activity, there may be no (or only a limited) deduction, and, if the suit is purely personal, the defendant may get no deduction at all. In some cases, that can extend to attorney fees, too.

Conclusion

Nearly every piece of litigation eventually involves tax issues. For many, those issues are tougher and more important for cases resolving in 2018 and thereafter. Where possible, urge clients to get tax help early.

Endnotes

1 Robert W. Wood, *How Legal Settlements and Judgments re Taxed*, Bus. L. News, no. 1, 2017, at 21.

2 Pub. L. No. 115-97 (the "2017 Tax Act").

3 *See, e.g.,* United States v. Gilmore, 372 U.S. 39, 49 (1963); Hort v. Comm'r, 313 U.S. 28 (1941); Arrowsmith v. Comm'r, 344 U.S. 6 (1952).

4 *See* § 1605(a) and (b) of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1838. The legislative history of the 1996 amendments to I.R.C. § 104(a)(2) provides that the reason for the change is because

> [t]he confusion as to the tax treatment of damages received in cases not involving physical injury or physical sickness has led to substantial litigation, including two Supreme Court cases within the last four years. The taxation of damages received in cases not involving a physical injury or physical sickness should not depend on the type of claim made.

H.R. Rep. No. 104-586, at 143 (1996) (Conf. Rep.).

5 *See* I.R.S. Ltr. Rul. 200041022 (July 17, 2000) ("We believe that direct unwanted or uninvited physical contacts resulting

in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under section 104(a)(2).”).

6 *See, e.g.,* Domeny v. Comm’r, T.C.M. 2010-9 (exacerbation of multiple sclerosis symptoms); Parkinson v. Comm’r, T.C.M. 2010-142 (heart attack from job stress).

7 *See, e.g.,* Sharp v. Comm’r, T.C.M. 2013-290; Molina *et ux.* v. Comm’r, T.C.M. 2013-226.

8 *See* I.R.C. § 104.

9 *See* I.R.C. § 213.

10 *See* I.R.C. § 111(a); Hornberger v. Comm’r, 4 Fed. App’x. 174 (4th Cir. 2001).

11 *See* Hillsboro Nat’l Bank v. Comm’r, 460 U.S. 370, 377 (1983).

12 *See* Doud v. Comm’r, T.C.M. 1982-158 (1982) (recovery for a stamp collection was not taxable income where Doud’s basis in his collection was less than he recovered).

13 *See, e.g.,* Kucera v. Comm’r, 1951 T.C.M. LEXIS 269; E.I. du Pont de Nemours and Co. v. U.S., 432 F.2d 1052, 1055 (3d Cir. 1970).

14 *See* Comm’r v. Banks, 543 U.S. 426 (2005).

15 I.R.C. § 162.

16 *See* I.R.C. § 62(a)(20).

17 *See* Kovacs v. Comm’r, 100 T.C. 124 (1993), *aff’d*, 25 F.3d 1048 (6th Cir. 1994) (holding that despite a lump-sum payment for wrongful death damages, the interest portion of the award simply did not constitute excludable damages under § 104); I.R.S. Ltr. Rul. 199952080 (Sept. 30, 1999) (This letter ruling involved the application of § 104(a)(2) prior to its amendment by the 1996 Act. For amounts to be excludable under § 104(a)(2) after the 1996 Act, they must be paid on account of personal physical injury or physical sickness.).

18 Pub. L. No. 115-97, § 13307.

19 I.R.C. § 162(q) provides:

> (q) PAYMENTS RELATED TO SEXUAL HARASSMENT AND SEXUAL ABUSE. — No deduction shall be allowed under this chapter for —
>
> > (1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or
> >
> > (2) attorney’s fees related to such a settlement or payment.

20 *See* I.R.C. § 62(a)(20).