

## Settlement Awards Post-TCJA

by Robert W. Wood



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intended as legal advice.

In this article, Wood updates an earlier summary of the tax rules for settlement awards, noting several changes under the Tax Cuts and Jobs Act (involving tax deductions for legal fees and the treatment of confidential sexual harassment cases).

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Lawyers and clients resolve disputes all the time, usually with an exchange of money and a release. Last year I wrote a summary of the tax rules that apply in this common situation.<sup>1</sup> Because some of those rules changed with the passage of the Tax Cuts and Jobs Act (P.L. 115-97) in December 2017 (items 8-11 below), this is an update. The tax changes affect the treatment of attorney fees in a variety of cases, as well as sexual harassment and abuse cases.

The first question most plaintiffs ask is whether their settlement is taxable. The tax treatment 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. Here are 11 rules lawyers and clients should know about the taxation of settlements.

### 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 reached only the letter-writing phase. Despite the similarities, however, you'll almost always have more flexibility to reduce taxes if a case settles rather than goes to judgment.

If you are audited, you must 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, 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").<sup>2</sup> 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

<sup>1</sup>Robert W. Wood, "10 Tax Rules All Lawyers and Clients Should Know," *Tax Notes*, Feb. 6, 2017, p. 755.

<sup>2</sup>See, e.g., *United States v. Gilmore*, 372 U.S. 39, 49 (1963); *Hort v. Commissioner*, 313 U.S. 28 (1941); *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

building contractor, your damages usually won't 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 3 following).

### 3. Some recoveries are tax free.

This is an 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 — section 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.<sup>3</sup>

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.<sup>4</sup> This observable bodily harm standard generally means that if you sue for intentional infliction of emotional distress, your recovery is taxed.

<sup>3</sup> See section 1605(a) and (b) of the Small Business Job Protection Act of 1996, P.L. 104-188, 110 Stat. 1838. The legislative history of the 1996 amendments to section 104(a)(2) says the reason for the change is that “the 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) (conference report).

<sup>4</sup> See LTR 200041022: “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).”

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 when the employee had physical sickness from the employer's conduct or the exacerbation of a preexisting illness.<sup>5</sup>

Thus, standards are getting a little looser. However, taxpayers routinely argue in Tax Court that their damages are sufficiently physical to be tax free. Unfortunately, the IRS usually wins these cases.<sup>6</sup> In many cases, a tax-savvy settlement agreement could have improved the plaintiff's chances.

### 4. Emotional distress symptoms 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.<sup>7</sup> Here again, these lines are unclear. 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 a 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

<sup>5</sup> See, e.g., *Domeny v. Commissioner*, T.C. Memo. 2010-9 (exacerbation of multiple sclerosis symptoms); *Parkinson v. Commissioner*, T.C. Memo. 2010-142 (heart attack from job stress).

<sup>6</sup> See, e.g., *Sharp v. Commissioner*, T.C. Memo. 2013-290; *Molina v. Commissioner*, T.C. Memo. 2013-226.

<sup>7</sup> See section 104.

almost always save considerable money later by spending a little at this critical moment.

Otherwise, you might be surprised by the Forms 1099 you receive the year after your case settles. At that point, you won't 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.<sup>8</sup> 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."<sup>9</sup> 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.<sup>10</sup>

### 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's 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 aren't binding on the IRS or the courts in later tax disputes, but they're 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 these reasons, it is more realistic — and more likely to be respected by the IRS and other tax authorities — to 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 had 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 3 and 4 above).

### 7. Capital gain instead of ordinary income.

Outside the realm of suits for personal physical injuries or physical sickness, just about everything is income. However, that doesn't answer the question of how it will be taxed. If your suit is about damage to your house or 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 it is 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've made and decreased by any depreciation. 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 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.<sup>11</sup> 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

<sup>8</sup> See section 213.

<sup>9</sup> See section 111(a); *Hornberger v. Commissioner*, 4 Fed. Appx. 174 (4th Cir. 2001).

<sup>10</sup> See *Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 377 (1983).

<sup>11</sup> See *Doud v. Commissioner*, T.C. Memo. 1982-158 (recovery for a stamp collection was not taxable income when Doud's basis in his collection was less than he recovered).

produce capital gain, not ordinary income.<sup>12</sup> The tax rate spread can be nearly 20 percent.

### 8. Attorney fees can be a trap.

This area has major changes under the Trump tax law. Whether you pay your attorney hourly or on a contingent fee basis, legal fees will affect 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 have \$60,000 of income. Instead, you will have \$100,000 of income. Up until the end of 2017, you could claim a \$40,000 miscellaneous itemized deduction for legal fees.<sup>13</sup>

That meant you faced numerous limitations (including alternative minimum tax), but at least it was a deduction. In 2018 and thereafter, there is no deduction for these legal fees. Yes, that means you collect 60 percent but are 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.<sup>14</sup> If your case involves claims against your employer, or involves specific whistleblower claims, there is also an above-the-

line deduction for legal fees.<sup>15</sup> But see the caution below.

That means you can deduct those legal fees before you reach the adjusted gross income line on the first page of your Form 1040. But outside of employment and specific whistleblower claims or your trade or business, 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. Caution. There is one unsettling issue about the above-the-line deduction for legal fees. Some advisers are worried that the above-the-line deduction is in jeopardy too. Section 62 allows an above-the-line deduction for a "deduction allowable under this chapter." Technically, it does not create a new deduction. Instead it promotes an existing below-the-line deduction, to make it a (better) above-the-line deduction. The below-the-line deduction has been suspended between 2018 and 2025.

Thus, there is at least an argument that this is a problem Congress or the IRS should clarify. But it is hopefully a glitch that will either be ignored or corrected. Congress surely did not mean to impact the above-the-line deduction. Moreover, after the Tax Cuts and Jobs Act, Congress extended the above-the-line deduction to SEC whistleblower claims. And finally, in the pending Repeal the Trump Tax Hike on Victims of Sexual Harassment Act of 2018, Congress would make clear that plaintiffs in sexual harassment cases (which are nearly all employment claims) can still deduct their fees.

### 9. Punitive damages and interest 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 item 8 above). Because the case doesn't arise out of employment or a trade or business, any taxable money can be 100 percent taxable even if 40 percent goes to the lawyer. The lack of tax deduction for legal fees commencing in

<sup>12</sup> See, e.g., *Kucera v. Commissioner*, T.C. Memo. 1951-090; *E.I. du Pont de Nemours and Co. v. United States*, 432 F.2d 1052, 1055 (3d Cir. 1970).

<sup>13</sup> See *Commissioner v. Banks*, 543 U.S. 426 (2005).

<sup>14</sup> Section 162.

<sup>15</sup> See section 62(a)(20).

2018 is likely to catch many people by surprise in 2019 at tax return time.

The same can occur with interest. You might receive a tax-free settlement or judgment, but pre- or post-judgment interest is always taxable.<sup>16</sup> 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. Sexual harassment and abuse.

Under the new tax law, confidential sexual harassment or abuse settlements face special tax rules.<sup>17</sup> If the settlement is confidential, the defendant cannot deduct the settlement payment or the legal fees.<sup>18</sup> As written, this no-deduction rule seems to apply to plaintiff legal fees too.

Most sexual harassment cases arise in the employment context, in which an above-the-line deduction for plaintiff legal fees applies. But this deduction is now called into question. That surely unintended result for plaintiffs may be corrected. The pending “Repeal Trump Tax Hike on Victims of Sexual Harassment Act of 2018” would do so.

No plaintiff wants to pay tax on 100 percent of his or her recovery and receive only 40 percent of it. Some plaintiffs insist on omitting the nondisclosure provision or a tax indemnity if they have their tax deduction for legal fees denied. Others agree to a set (usually small) amount of the settlement being allocated to sexual harassment. But this may be unrealistic when the whole case is about sexual harassment, and there is no guarantee the IRS will agree.

## 11. It pays to consider the defense.

Plaintiffs are generally more worried about tax planning than defendants. A defendant paying a settlement or judgment always wants to deduct it. Although some defendants face questions whether an amount can be immediately deducted or must be capitalized, most defendants engaged in a trade or business can expense litigation as a cost of doing business.

A notable new exception applies to confidential sexual harassment or abuse settlements, and related legal fees. Outside this context, even punitive damages are tax deductible by businesses. Only some government fines cannot be deducted. And even then, defendants can sometimes find a way if the fine is in some way compensatory.

However, if the suit is related to investments, there may be no (or a limited) deduction. 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, they are tougher and more important for cases being resolved in 2018 and thereafter. When possible, urge clients to get some tax help early. ■

<sup>16</sup> See *Kovacs v. Commissioner*, 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 didn't constitute excludable damages under section 104); LTR 199952080. This letter ruling involved the application of section 104(a)(2) before its amendment by the 1996 act. For amounts to be excludable under section 104(a)(2) after the 1996 act, they must be paid on account of personal physical injury or physical sickness.

<sup>17</sup> TCJA, section 13307.

<sup>18</sup> Section 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.