Forbes

Robert W. Wood
THE TAX LAWYER

Most Lawsuit Settlements Are Taxed By IRS, But Some Are Capital Gain

Robert W. Wood
Senior Contributor
Robert W. Wood is a tax lawyer focusing on taxes and litigation.

March 26, 2025

The IRS taxes most lawsuit settlements, and exact wording matters if you are trying to avoid that grim result. However, some settlements can be positioned as capital gain. Here are a few examples:

- A suit about intellectual property;
- A founder dispute about shares in a company;
- A landlord tenant dispute with a lease buyout;
- A suit about damage to or conversion of property;
- A suit about construction defects, harm to property or diminution in its value;
- A suit against an investment adviser for losing your money;
- A lemon law suit about a defective vehicle.

Lower Tax Rates And Recouping Your Basis

Ordinary income is taxed at up to 37%, while capital gain can be taxed as low as 0% and as high as 23.8%. Apart from lower tax rates, capital gain can involve recouping basis too. If you spent $1 million in costs that you have not deducted, that is basis that can be repaid without tax before you start reporting gain. The IRS can push back and tends to argue for ordinary income, it is one of the IRS rules about legal settlements and legal fees.

In an audit, you might convince the IRS you are right, and you can even go to court. That is what happened in NCA Argyle LP, Newport Capital Advisors, LLC, where the IRS and the taxpayer faced off over the treatment of a $23 million legal settlement. The taxpayer claimed that the money was capital gain for its interests in the failed joint ventures. The IRS said the money was really future fees the joint ventures would reap, plus punitive damages, both of which are clearly taxed as ordinary income. You can read more about the case here.

The dispute started when Newport Capital Advisors, LLC entered into several real estate joint ventures with Commonfund Realty. When disputes developed, Commonfund disavowed the joint ventures and walked away. When the dispute reached trial, the jury agreed with NCA, awarding more than $16 million in compensatory damages, and twice that in punitive damages. After an agreement to halve the punitive damages award, like any good commercial litigant, Commonfund appealed the verdict.

Settlement Agreement Wording Can Help

While the case was on appeal, the parties settled for a lump-sum $23 million payment. The deal called for Commonfund to pay NCA in exchange for NCA's relinquishing whatever rights it had in the joint ventures. A simple sale, right? NCA reported it as capital gain on its taxes, but the IRS pushed back hard. By the time the tax dispute got to Tax Court, the IRS was willing to treat $5 million as capital gain for the joint venture interests, but the rest, said the IRS, was ordinary income.

Settlement agreement wording is helpful, but it does not bind the IRS. The settlement agreement between NCA and Commonfund stated that NCA received all $23 million in exchange for its interests in the joint ventures. The Tax Court relied heavily on the express allocation in the settlement agreement, and was inclined to agree with the taxpayer that these were sale proceeds and capital gain.

However, the IRS had plenty of other arguments why the settlement was ordinary income. For example, the IRS claimed that the settlement did not comport with economic reality, noting that the stream of payments NCA would have collected if the deals had survived would all have been ordinary. The IRS also took aim at the punitive damages award at trial, since punitive damages are always ordinary income.

But the taxpayer still persuaded the Tax Court. In rejecting the IRS' barrage of ordinary income arguments, the Tax Court thought the way damages were *calculated* in the case was important. The damages analysis at trial projected future fees only to *value* the interests, the court said. Indeed, a jury eventually awarded NCA damages for the *value* of the joint venture interests plus punitive damages. That value was estimated, in part, based on the anticipated revenue stream the joint ventures were expected to produce.

The IRS harped on that, saying that it showed that what the litigation produced was all ordinary income. But the Tax Court ruled solidly for the taxpayer and rejected all the IRS arguments. The settlement agreement wording had a lot to do with that. So did what the Tax Court called the adverse tax interests of the parties, noting that they had bargained over the wording.

Consider Taxes At Settlement Time

No one wants to go through a protracted legal dispute. After enduring that process, no one wants to go through *another* dispute about taxes on the money they recovered, or the money they had to pay. Despite these truths, many people don't focus on taxes when they write up a legal settlement. What does it matter what we call it in a settlement agreement? The answer is that it matters a lot.

Most plaintiffs about to receive money usually have a big interest in any taxes they will pay. Defendants seem less likely to focus on taxes at settlement time, but even they are much more likely to make sure taxes are addressed. In any but the most pedestrian and tiny of legal disputes, it seems foolish to sign a settlement agreement without considering taxes, and asking for the wording you want. But as *NCA Argyle* illustrates, it pays to get tax advisers involved well before any documents are signed. Don't miss out on a chance to help shape the tax result.