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THE TAX LAWYER

Unlike Trump's $25 Million Meta Deal, Most Legal Settlements Are Taxed

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When the news broke that Meta agreed to pay $25 million to settle President Donald Trump's lawsuit over his suspended accounts, not many people focused on taxes. But since most settlements are taxable income, it is worth noting that Trump was able to sidestep taxes. Reports said that most of the money — $22 million to be exact — would fund Trump's presidential library, with the remainder going to legal fees and other litigants. That suggests the settlement avoids taxes.

Most Settlements Are Taxable

Can other plaintiffs follow the President's lead and avoid taxes by directing money to someone else like a charity? Directing settlement money to charity can work in some cases, but even that is not foolproof. And having the settlement agreement direct the money to someone else — say a friend or relative — usually does not avoid taxes to the plaintiff. The IRS taxes the person who had a legal right to payment. 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.

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, usually with a portion on a Form 1099 for emotional distress. If you sue for damage to your condo by a negligent building contractor, you may be able to treat the recovery as a reduction in your purchase price of the condo. The rules are full of exceptions and nuances, so be careful, how settlement awards are taxed, especially post-tax reform.

Physical Injury Damages

If you sue for physical injuries, your damages should be tax-free. 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." Physical symptoms of emotional distress (like headaches and stomachaches) is taxed, but physical injuries or sickness is not. There are many chicken or egg tax cases. 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.

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. 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.

How Legal Fees Are Taxed

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. But outside these two areas, in some cases it is very difficult to find a deduction for legal fees. Tax advice early before the case settles and the settlement agreement is signed is best. Fortunately, there are often ways to deduct legal fees even under the new law.

Punitive Damages And Interest

Punitive damages and interest are always taxable. If you are injured in a car crash and collect $50,000 in compensatory damages and $5 million in punitive damages, the former is tax-free. But the $5 million is fully taxable, and you can have trouble deducting your attorney fees. The same occurs with interest. You might receive a tax-free settlement or judgment, but pre-judgment or post-judgment interest is always taxable (and can produce attorney fee problems). Sometimes, that can make it attractive to settle your case rather than going to judgment.