Tax Implications of Settlements and Judgments

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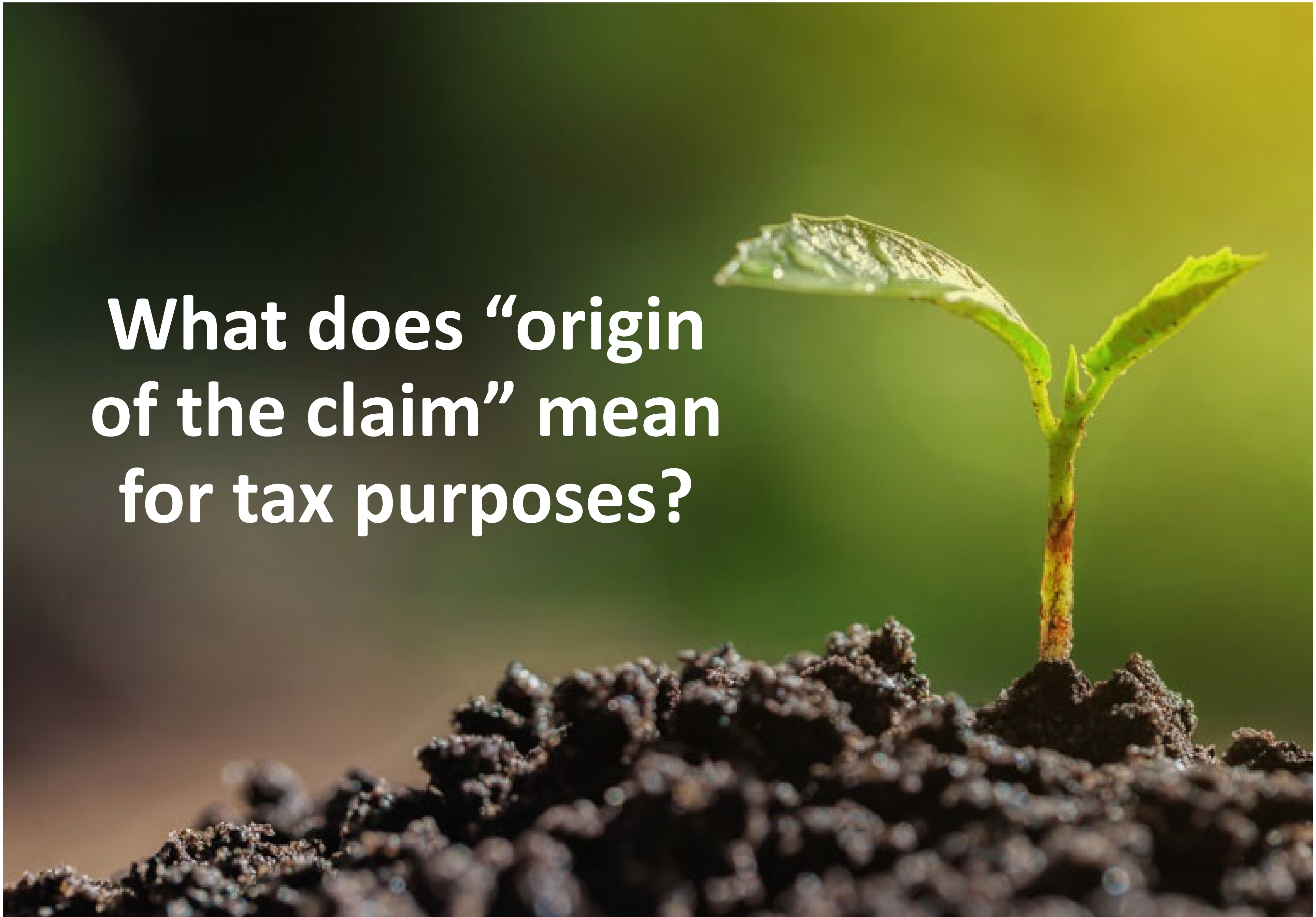
What should all attorneys know about the taxation of settlements and judgments?

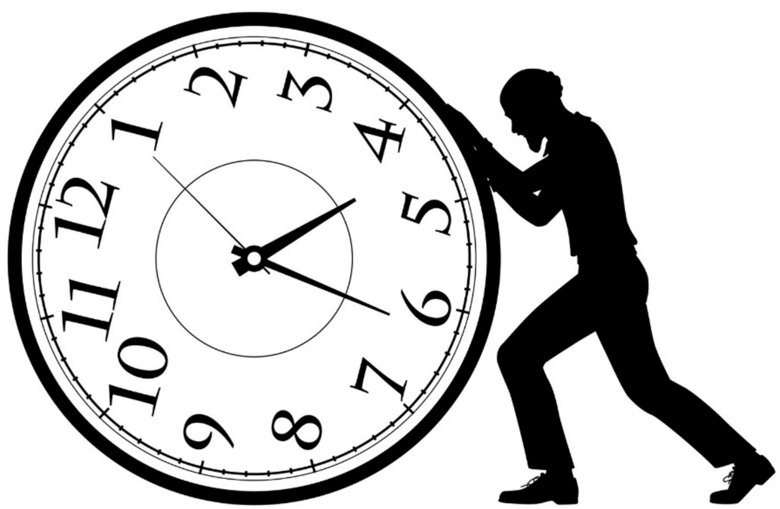
- A settlement and judgment are treated the same for tax purposes.
- Taxation is based on the "origin of the claim."
- Apportioning damages in a settlement agreement can save taxes.
- Certain recoveries are excluded from income taxation, but not all.
- Punitive damages and judgment interest are always taxable.
- Attorneys fees are usually taxable to the client unless a specific deduction applies.

What does "origin of the claim" mean for tax purposes?



"Origin of the Claim"

- *Back to the Future* – Resolution by settlement or judgment occurs at the end of litigation, but the taxation of that amount is determined by what happened at the beginning of the litigation.



“Origin of the Claim”

- *What is the nature and basis of the action settled?* - Amounts received in compromise of a claim have the same nature as the rights being compromised.
- Essentially, the IRS and the courts ask what is the payment being paid “in lieu of”?

“Origin of the Claim”

- *How the lawsuit is framed is important, for tax purposes* – The IRS considers the initial pleading to be the most persuasive evidence of the tax treatment of amounts eventually recovered.
- The IRS treats the settlement agreement as the best indication of what the amounts were given “in lieu of.”
- Consider the strongest theory for your client’s claim, but also think about potentially favorable or unfavorable tax results.

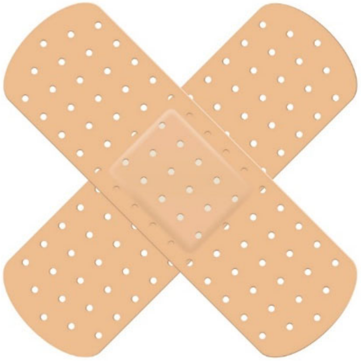
Exclusion for Physical Injuries or Sickness (26 USC §104)

Exclusion for Physical Injuries or Sickness

- Reimbursement for actual medical expenses are excluded from taxable income unless they were previously deducted (i.e. Tax Benefit Rule).

Exclusion for Physical Injuries or Sickness

- *What constitutes a "physical" injury or sickness*?
  - The word "physical" was added to the exclusion in the internal revenue code in 1996 requiring a "physical" component before it can be excluded.
  - Small scrapes and bruises may count.
  - Inappropriate touching in sexual harassment case may not.



Exclusion for Physical Injuries or Sickness

- *Emotional distress usually not excluded* – if the claim is for purely emotional distress then amounts are not excluded. However, if the emotional distress is the result of physical injury and sickness then it can be excluded.
    - *Symptoms of emotional distress* – Generally, the symptoms of emotional distress (e.g. headaches, insomnia, etc.) are not considered physical and so amounts paid for those injuries are taxable.

Exclusion for Physical Injuries or Sickness

- *Mixed Claims* – drafting of both the complaint and the settlement agreement is paramount.

    - Consider including a specific tax provision in the settlement agreement. Both the IRS and the courts have indicated that a tax provision in the settlement agreement characterizing the recovery can result in exclusion. The IRS and the courts are reluctant to override the clear intent of the parties.

Exclusion in Estate Cases (26 USC §102)

Exclusion in Estate Cases

- Section 102 of the internal revenue code excludes “the value of property acquired by gift, bequest, devise, or inheritance.” But it also says that income received on inherited property is subject to income tax (e.g. income distributions from the trust are taxable but value of trust’s principal is not). Litigation, however, can make things confusing.

Exclusion in Estate Cases

- *Language is important –*
  - Settlement agreements indicating that payments from the sale of property are a substitute for a bequest of property or specifically stating that amounts are "in lieu and instead of any inherited interest" can prevent an unwanted tax result.
  - Claims pled as compensation for services to a decedent can be found, instead, as taxable income to the recipient.

Exclusion in Estate Cases

- *Mixed Claims* – Just like with Section 104 exclusions, if the claims are mixed, clearly associating the recoveries with the asserted claims avoids confusion that can result in unwanted tax results.

Certain Items are Never Excluded from Income

Certain Items are Never Excluded

- *Punitive Damages* – almost always included gross income and taxable.
  - This includes any portion received by or paid to an attorney as a contingent fee. Only one unique exception applies (i.e. state law prohibits any recovery other than punitive damages in a wrongful death claim.)

Certain Items are Never Excluded

- *Judgment Interest* – Interest on a judgment is also fully taxable, even if the rest of the settlement or judgment is tax-free. This includes both pre and post judgment interest.
  - Be careful with the term “interest.” Especially when unnecessary such as in periodic payment arrangements.

Attorney Fees are Sometimes a Tax Trap

Attorney Fees

- Businesses can usually deduct legal fees as a trade or business expense. However, some expenses cannot be deducted.
  - *Sexual Harassment Claims Exception*. 26 U.S.C. §162(q) removes any deduction for settlement or payment related to sexual abuse or sexual harassment if such settlement or payment is subject to a nondisclosure agreement. (i.e. the Harvey Weinstein Rule).
  - *Unrelated to Trade or Business*. Also must consider the claims involved and if they are truly related to the trade or business or personal to the owners. If personal, they may not be deductible.

Attorney Fees

- For individuals the default is that the entire recovery (even contingent fees paid to lawyers) is gross income. *Comm'r v. Banks*, 543 U.S. 426 (2005).
  - Certain "above the line" deductions (e.g. employment claims, specific whistleblower claims) are allowed. Perhaps "civil rights" claims, but there is little case law interpreting those claims.
  - Itemized Deductions (below the line) eliminated by the TCJA. Therefore, no deduction if not employment or specific whistleblower claims for 2018 through 2025.

Options for Clients with Tax Questions About Settlements or Judgments

Options for Clients

- Be careful with "I'm not a tax attorney…but" advice.
- Formal tax opinions (provides both guidance and potential penalty protection).
- Practical tips to prepare if audited by IRS.
- When in doubt, get professional tax help.