TAXATION OF DAMAGES: A PRIMER FOR LITIGATORS

by DAVID L. KELIGIAN

It's never too early for litigation counsel to think about how a successful verdict or settlement they achieve for their client will be treated for tax purposes. This is because of the interplay between (1) the different characterizations of income that may be realized from a recovery, and (2) the impact that restrictions may have on the deductibility of legal fees.

As an example of the potential economic loss by taxation, assume your client recovers $1,000,000 in lost wages, and your contingent fee is $400,000. Under *Commissioner v. Banks*, 543 U.S. 426 (2005), your client must recognize $1,000,000 in gross income, even though their net recovery was only $600,000. That means that if they are unable to deduct their $400,000 of legal fees, their net after-tax recovery on their $1,000,000 gross recovery may be less than $200,000.

The deductibility of legal fees is an issue because of the Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (the "Act"), which makes some legal fees nondeductible from 2018 through 2025. Certain legal fees that are categorized as "miscellaneous itemized deductions" are now suspended under the Act, leading to the unhappy result above.

The good news is that with some attention to tax rules early enough in the process, litigators can help their clients achieve much better after-tax results. The first part of this article explains the various tax characterizations of recoveries, and the rest of the article provides guidance on how settlements can be structured for the best tax result.

The starting point in analyzing how settlements and judgments will be taxed is the "origin of the claim" standard, which looks to the underlying claim for which damages were awarded. *See United States v. Gilmore*, 372 U.S. 39 (1963). When evaluating this issue, the Internal Revenue Service (IRS) will look at the entire record, not just what the parties may document in a settlement agreement. *See* Revenue Ruling 85-98, 1985-2 C.B. 51. For example, if a plaintiff's lawyer tries to document a settlement as being on account of physical injuries—non-taxable income under Internal Revenue Code Section 104 (a) —but the pleadings and record reveal no claims for physical injury, the provisions of the settlement agreement will be given no effect for tax purposes.

The tax treatment of litigation recoveries can range from completely non-taxable income, income that is treated as a recovery of tax basis (resulting in no current tax to the extent of available basis), income that is taxed as capital gains, and income that is taxed as ordinary income. Similarly, legal fees can sometimes be deducted against ordinary income, but must be "capitalized" in some circumstances, which is much less favorable. Worse, legal fees may be treated as non-deductible personal expenses, or suspended (i.e., lost) under the Act, or completely disallowed (as in the case of legal fees attributable to the defense of sexual harassment settlements, which contain prohibited non-disclosure provisions). Taking these variations into account in the complaint and subsequent pleadings may lead to a much better tax result.

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In the case of compensation for physical injuries or sickness, you can expect close scrutiny by the IRS. This is because there is confusion about how the Code Section 104 exclusion applies. The IRS maintains that one must have visible harm, such as cuts or bruises, for injuries to be "physical." For example, if a defendant punches a plaintiff and breaks their nose, the exclusion would apply to the recovery, even if damages are also awarded for lost wages due to the injury. According to IRS Publication 4345, if someone receives a settlement for personal physical injuries or physical sickness, and they did not take an itemized deduction for medical expenses related to that event, the full recovery is non-taxable. That publication goes on to state that proceeds from emotional distress or mental anguish attributable to the same physical injury also qualify for the exclusion.

But the converse is not true. Suppose your client files a lawsuit against their employer for a stressful work environment. The stress triggers emotional distress, and that distress results in physical symptoms such as headaches. Even though there is a physical symptom, the entire award becomes taxable because it did not have its genesis in a physical injury or illness.

Damages for a loss in value of property can also escape current taxation. If the recovery is less than the recipient's adjusted basis in their property, there is no reportable income. The recipient must reduce their basis in the property by the amount of the recovery. But if the recovery exceeds the recipient's adjusted basis, any excess is income. Depending on the holding period and nature of the property, the income may be reportable as capital gain.

Given the pervasiveness of intellectual property litigation, the ability to claim capital gains treatment on recoveries is a significant opportunity in intellectual property litigation. For example, if your client sues for lost royalties from a patent, that income will be treated as taxable ordinary income since the underlying royalties would be taxed as such. However, Code Section 1235 permits capital gains treatment if a "holder" of a patent transfers "all substantial rights" thereto. This treatment even applies if the payment is contingent on the productivity or use of the property—i.e., a royalty.

This means that in the case of a patent, litigation counsel should be alert to the possibility of transferring "all substantial rights" to a patent, or an undivided interest therein, as part of a settlement. As an example, if the party violating the patent wants the right to continue to exploit it, the same recovery can be structured to yield capital gains, not ordinary income, to your client. The keys are having a client who qualifies as a "holder" of the patent, and the transfer of "all substantial rights" thereto. *See* Treas. Reg. Section 1.1235-2(b) for examples of when "all substantial rights" are not transferred.

Another example of a planning opportunity for either non-recognition, or at least capital gain treatment, involves disputes relating to

stock. Corporate stock is typically property that qualifies as capital gain property, but in certain circumstances, "qualified small business stock," as defined in Code Section 1202, enjoys up to a 100% exclusion from taxable income.

Since most lawsuits involve a number of claims, it is easy to see that steering recoveries and settlements to income categories that receive the most favorable tax treatment can be important to your client. From the defendant's point of view, there is typically much less tax sensitivity—as long as the legal expenses have their origin in a trade or business or other non-personal activity of the payer, the legal expenses will generally be deductible, or in some cases capitalized (i.e., added to the cost basis of property that is acquired pursuant to the settlement).

The balance of this article discusses specific guidance about how litigators can be mindful about possible tax advantages to their clients, depending on how litigation claims are resolved. For this purpose, there can be more flexibility in settlements achieved in mediations and prior to judgment because there may be more flexibility in allocating recovery amounts to different causes of action.

First, any recovery should always be allocated between different causes of action involved in the case. Attention should be given to the claims raised in the initial complaint and all pleadings. An attempt to allocate amounts to excludable physical injuries or illness when that cause of action was not part of the complaint will not hold up in an audit.

Next, even though a settlement agreement is not necessarily binding on the IRS (*see Basle v. Commissioner*, T.C. Memo 1957-169), typically settlement agreements are not completely ignored by the IRS. That is especially true if the record shows claims supporting the allocations to the different income categories mentioned in the settlement agreement. Counsel should carefully negotiate not only amounts that are to be allocated to each category of damages, but also how they are to be reported.

Even in a relatively straightforward action, there is a good chance any recovery will involve more than one category of damages. Taking a typical employment-related suit as an example, damages might be split between wages (which must be reported, including tax withholdings, on Form W-2) and other categories of recovery. Those other recovery categories might include the reimbursement of business expenses (generally non-taxable unless your client has previously deducted them), non-taxable or tax-deferred pensions and fringe benefits, and emotional distress damages (which are taxable, but reportable on Form 1099 as non-wage income). Be sensitive to the opportunity to categorize settlement amounts as either the recovery of basis (non-taxable to the extent your client has basis in an affected asset) or capital gain. Again, if attention is paid to such possible claims in the complaint, it is much easier to justify allocating settlement amounts to causes of action that provide your client with more favorable tax consequences.

Counsel should also be mindful of the objectives of settling defendants. For example, most settlements paid by corporate defendants (with the notable exception of sexual harassment settlements where the settlement is confidential) are deductible as business expenses under Code Section 162. *See* Revenue Ruling 79-208, 1979-2 C.B. 79. In some circumstances, the IRS may attack a settlement paid by a corporate defendant if the lawsuit is deemed to involve primarily non-business claims.

Just because a corporation is named as a defendant does not automatically mean the settlement payment will be deductible to the corporation. For example, in *Cavanaugh v. Commissioner, T.C. Memo 2021-324, aff'd per curiam*, 5th Cir. 2019, a settlement deduction was denied even though a corporate defendant was sued, because the main cause of action—wrongful death—was attributed to the individual, non-business related actions of the CEO. But in *Dolese v. United States*, 605 F.2d 1146 (10th Cir. 1979), the court held divorce costs—typically a personal expense—were partially deductible because a spouse obtained a court order prohibiting the distribution of assets of a liquidating corporation. To the extent the legal expenses were incurred to allow the corporation to continue its business activities, they were deductible. It is interesting to note that the main "origin of the claim" case—*Gilmore*—involved the denial of deductions because the *Gilmore* claim arose out of a divorce.

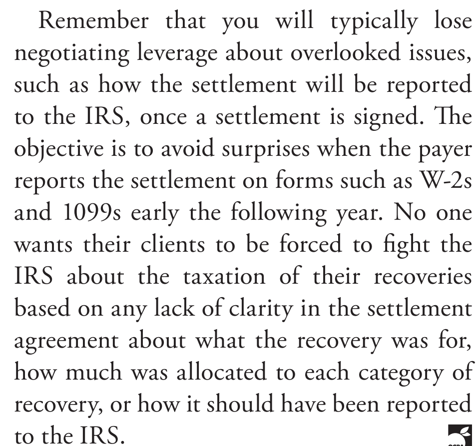
When representing defendants, the morale is the same—careful drafting of settlement agreements to make it clear that the amounts being paid are clearly related to the trade or business of the defendant—is critical. Showing the litigation will have an adverse impact on the defendant's ability to earn income provides strong support for deductibility.

Even punitive damages paid by a business defendant may be tax deductible to them. As to the plaintiff, punitive damages (even in cases involving physical injury or sickness) are always taxable, as is interest.

At the end of litigation, the parties and their counsel may drop their guard, feeling they have reached a deal and so nit-picking over issues such as exactly how much will be allocated to various types of income and how everything will be reported to the IRS is not worth it. However, sloppy settlement language has resulted in horrible results for clients, especially when it would have been possible to completely avoid taxation.

In *Blum v. Commissioner*, T.C. Memo 2021-18, a client sued their lawyer, claiming malpractice in a personal injury case. Because the settlement agreement stated the client's settlement was for malpractice, and not to compensate them for the damages they should have received due to their physical injuries, the Tax Court held the settlement to be fully taxable. It appears that, in *Blum*, had the settlement agreement clearly stated that the recovery was to compensate the plaintiff for the physical injury they suffered instead of for the attorney's malpractice, the tax result would have been different.

Remember that you will typically lose negotiating leverage about overlooked issues, such as how the settlement will be reported to the IRS, once a settlement is signed. The objective is to avoid surprises when the payer reports the settlement on forms such as W-2s and 1099s early the following year. No one wants their clients to be forced to fight the IRS about the taxation of their recoveries based on any lack of clarity in the settlement agreement about what the recovery was for, how much was allocated to each category of recovery, or how it should have been reported to the IRS.



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