Forbes

Robert W. Wood
THE TAX LAWYER

TAXES 01/29/24

Trump Can Write Off $83.3 Million Verdict, Carroll Pays Tax On 100%

The latest Donald Trump court episode was a NY jury verdict saying that Trump must pay $83.3 million in damages to E. Jean Carroll for defamation. The case includes a whopping $65 million award for punitive damages, and a sizable $18.3 million award in compensatory damages for injury to Carroll's reputation. As he did with the previous verdict, Trump has vowed to appeal this one. However, it appears that he may be required to pay the funds in a court-controlled account while the case is being appealed. Paying into a court controlled account could put the tax issues on hold for Trump and for Carroll until it is clear who ends up with the money.

Yet the tax rules at play are significant. First, is there a case that the former president can deduct most or all of his payment on his taxes? Probably. After all, even though the defamation accusations are arguably of a personal nature, Carroll alleged that Trump used his office to defame her, so there may be a business hook for the debacle sufficient for Trump to argue it is a business expense. After all, Trump is famously aggressive about his taxes, and even proud of that fact, and for Trump, perhaps most things are about business. Even the punitive damages—designed to punish the defendant—are fair game.

In contrast, the Carroll will have to pay tax on all of it, possibly even the funds going to their lawyers. Does that mismatch seem fair? All punitive damages are taxable ordinary income, even for death or serious injury. That is why even Roundup Weed Killer cancer victims can face IRS taxes when they sue. The IRS even taxes fire victims. Even worse, there is a tax on litigation settlements, with no deduction for legal fees in some cases.

Amazingly, many legal fees can't be deducted, so plaintiffs may pay tax on monies their attorney collects, even though the attorney must *also* pay tax on the same money. If you are a plaintiff with a contingent fee lawyer, the IRS treats you as receiving 100% of the money, even if the defendant pays your lawyer *directly*. Plaintiffs have to get creative to deduct their legal fees under a 2018 tax law just to get back to even.

But why is E. Jean Carroll taxable even on the compensatory damages? Carroll's suit against Trump was a defamation case, where the injuries are in the nature of emotional distress, not physical injuries. It sounds like hairsplitting, but recoveries for physical injuries and physical sickness are tax-free, but symptoms of emotional distress are taxed. Since 1996, the tax code says your injury must be "physical" to be tax free. If you sue for intentional infliction of emotional distress, your recovery is taxed, and even physical symptoms of emotional distress (like headaches and stomachaches) are taxed.

The rules can make some tax cases involve chicken or egg issues, with many judgment calls. 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.

How about Trump's tax write off? How damages are taxed is a complex subject, but business expenses are less so. Even President John F. Kennedy said, "The slogan — 'It's deductible' — should pass from our scene." JFK made the comment in 1961 about expense accounts and business entertainment, but it has broader application and still seems relevant more than 60 years later. Compensatory settlements by businesses are clearly deductible, and even *punitive* damages are too. That surprises most people.

Tax bills have been introduced in Congress over the years to make punitive damages, but the bills never gained traction. Sometimes, even amounts paid to the government are deductible, despite corporate wrongdoing. For decades, Section 162(f) of the tax code prohibited deducting any fine or similar penalty paid to a government for the violation of any law. That includes criminal and civil penalties, as well as sums paid to settle potential liability for a fine.

This sounds absolute, but the law is riddled with exceptions. To begin with, the rules cover only government payments, and some companies find ways to write off even the biggest payments. For example, BP probably wrote off a majority of its $20.8 billion out-of-court settlement for the Gulf of Mexico oil spill. The deal designated only about one quarter, $5.5 billion, as a non-tax-deductible Clean Water Act penalty.

Congress has pushed back on such practices. In 2017, the tax rules were tightened, but even under the new ones, it is permissible to write off certain payments of restitution or amounts paid to come into compliance with law. Some settlement agreements contain an explicit no-deduction provision. For example, when Tesla and Elon Musk settled with the SEC for $20 million each, a court filing said Tesla expressly agreed not to claim a tax deduction for its $20 million. Had it not been for that agreement, the tax write-offs don't seem to have been prohibited. After all, the SEC said the $40 million in penalties will be distributed to harmed investors under a court-approved process, and that sounds like restitution.

If Trump's temporary payment into court ends up going to Carroll in the end, there may be a good chance that he gets a fat tax deduction. And Carroll clearly will have lots of taxable income.

Check out my website.