



Robert W. Wood

THE TAX LAWYER

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Trump Tax Law Hurts Personal Injury Suit Settlements

Serious accident cases can produce tax-free money to clients. The injuries might be from an auto accident, slip and fall, medical malpractice, industrial accident, or drug or medical device case. If the plaintiff suffers physical injuries or physical sickness, compensatory damages should be tax free. But this tax-free treatment only applies to *compensatory* damages. Punitive damages and interest are taxable, and there are key changes under the [Trump tax law](#). To qualify for tax-free treatment, the injuries must be *physical*. Emotional distress is not enough, and physical symptoms such as insomnia, headaches and stomachaches are normal byproducts of emotional distress, says the IRS.

Exactly what injuries are “physical” is confusing. If you make claims for emotional distress, your damages are taxable. In contrast, if you claim that the defendant caused you to become physically sick, those damages should be tax free. Yet, if it is emotional distress that *causes* you to become physically sick, even that physical sickness will not spell tax-free damages. However, if you are physically sick or physically injured, and your sickness or injury produces emotional distress *too*, those emotional distress damages should be tax free.



If you are confused, you are not alone. The [chicken or egg](#) distinction can hinge on which words you use. Plus, this area has seen major changes under the Trump tax law. If you are the plaintiff with a contingent fee lawyer, you usually will be treated (for tax purposes) as receiving 100% of the money recovered by you *and* your attorney. This is so even if the defendant pays your lawyer directly. If your case is fully nontaxable (say, an auto accident in which you are physically injured, where you receive only compensatory damages), that should cause no tax problems.

But if your recovery is taxable, all *or in part*, you could be in tax trouble. Let's start with a fully taxable recovery, since the math there is easier to follow. Say you settle a suit for intentional infliction of emotional distress you brought against your neighbor for \$100,000. Your lawyer keeps 40%, or \$40,000. You might think that you would have \$60,000 of income at most. Instead, you will have \$100,000 of income. Up until the end of 2017, you could claim a \$40,000 miscellaneous itemized tax deduction for your legal fees. You faced limitations on your deduction, but at least it was a deduction.

In 2018 and thereafter, there is *no* deduction for these legal fees. Yes, that means you collect 60%, but are taxed on 100%. Notably, not all lawyers' fees face this terrible tax treatment. If the lawsuit concerns the plaintiffs' trade or business, the legal fees are a business expense. Those legal fees can be deducted 'above the line,' the best kind of deduction. Mathematically, it is like not having the income in the first place.

If your case involves claims against your employer, or certain whistleblower claims, there is *also* an above-the-line deduction for legal fees. That means you can deduct those legal fees on the first page of your [IRS Form 1040](#). It is essentially like not having the lawyer fee income in the first place. But outside of employment, specific whistleblower claims, and your trade or business, be careful. You get no tax deduction at all for the legal fees, unless you are awfully creative. There are sometimes ways to circumvent these attorney fee tax rules, but you'll need sophisticated tax help to do it, and nothing is foolproof.

What about a case that is *partially* taxable and partially tax-free? Remember, punitive damages and interest are always taxable, even if your injuries are 100% physical. Suppose you are injured in a car crash. Thereafter, you collect \$50,000 in compensatory damages and \$5 million in punitive damages. The \$50,000 is tax free, but the \$5 million is fully taxable. What's more, you can't deduct your attorney fees. If you pay a 40% contingent fee, \$2 million of that \$5 million goes to the lawyer, with the client netting \$3 million. But the tax law says the client receives (and must report) the *full* \$5 million.

Because the case does not arise out of employment or a trade or business, any taxable money is 100% taxable, even if 40% goes to the lawyer. This no deduction rule is catching many people by surprise. There are sometimes ways to address it, but it requires tax help, preferably before the case settles.

Here's another example. Suppose a case settles for \$2 million, and is 50% compensatory for physical injuries. The other 50% is for punitive damages or interest. There is a 40% contingent fee, and it is divided 50/50 too. That means the client nets \$1.2 million in cash out of the case. But the IRS divides the \$2 million case recovery in two, so the client is taxed on \$1 million. And the client cannot deduct any of the \$800,000 in legal fees. Sometimes, one can justify an allocation of legal fees that is not strictly pro rata, but you need to document it. And the IRS may not agree.

The same kind of attorney fee tax problems occur where there are interest payments, instead of punitive damages. You might receive a tax-free settlement or judgment, but interest is always taxable. For tax purposes, whether you collect pre-or post-judgment interest isn't important. It is taxable, and the legal fees on that part of the case cannot be deducted. There are no easy answers to these problems, but sometimes you can improve on these dire tax results. Settlements are usually better for taxes and tax planning than judgments. And getting tax advice before a case settles is a good place to start. You don't want to end up like the [plaintiff in the \\$289M Monsanto weedkiller verdict, who may lose 90%](#).

This is not legal advice. For tax alerts or tax advice, email me at Wood@WoodLLP.com.