Robert W. Wood

THE TAX LAWYER

United Settles With Passenger Dragged Off Plane, But Can IRS Tax It?

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After a public relations scandal that was truly one for the record books, United Airlines has reached a settlement with the passenger who was roughed up and dragged off a plane. The friendly skies slogan seems a distant memory as United has tried to fix this appalling mess quickly. The settlement figure is confidential, but the speed of the settlement could mean it was sizable. And that was not the only quick action.

United also announced several steps to prevent similar episodes. The airline now says that passengers who have arrived on an aircraft should not have to give up their seats. United said it would create a new check-in process that would allow passengers to *volunteer* to give up their seats for compensation. What's more, the price tag for a seat give-up has gone way up, from the old limit of $1,350 to a new ceiling of $10,000.

As for Dr. David Dao, the physician who lost his seat and in the process suffered not inconsequential physical injuries, how much of his settlement will he get to keep after taxes? Hopefully, he won't have to pay *any* of it to the IRS. In fact, as an update to this post, one source now says that he won't have to pay taxes. Yet some of that is likely to turn on how the deal was written, and tax reporting forms like IRS Form 1099. Just about everything is viewed as income by the IRS. However, one big exception is for compensatory lawsuit recoveries for personal physical injuries and physical sickness. That money is tax-free. The rule used to be more liberal.

Before 1996, all “personal” damages were tax-free, so emotional distress, defamation, etc. *also* produced tax-free recoveries. But since 1996, your injury must be “physical.” Taxpayers routinely argue in U.S. Tax Court that their damages are sufficiently physical to be tax-free; the IRS usually wins these cases, but not always. Dr. Dao’s case seems pretty clear, considering how badly he was roughed up. But often, the IRS draws a line between some physical injuries and some that are merely emotional.

The IRS says symptoms of emotional distress are not physical. Money you receive for physical symptoms of emotional distress (say headaches and stomachaches) is taxed, while physical injuries or sickness is not. Many legal disputes involve multiple issues, so there’s a good chance the total settlement may involve several types of consideration. It is almost always best for plaintiff and defendant to try to agree on what is being paid and its tax treatment. Such agreements aren’t binding on the IRS or the courts in later tax disputes, but they are rarely ignored.

Dr. Dao settled so quickly that there are clearly no punitive damages or interest in his settlement. But often there are, and punitive damages and interest are *always* taxable. If you are injured in a car crash and get $50,000 in compensatory damages and $5 million in punitive damages, the former is tax-free. The $5 million is fully taxable, and you can have trouble even deducting your attorney fees. Whether you pay your attorney hourly or a contingent fee, factor in the cost of your attorney when you address taxes. If you are the plaintiff and use a contingent fee lawyer, you will 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 30% to 40% contingent fee cut.

If a case is fully nontaxable (say an auto accident in which you’re injured), it should not cause tax problems. But if your recovery is taxable, lawyers’ fees are likely to be hard to deduct. The legal fees are usually subject to numerous limitations, including the alternative minimum tax or AMT. That is one reason among many that settling a case before trial–and hopefully avoiding the taint of punitive damages–can pay off. It is worth running some numbers and considering how IRS Forms 1099 will prepared in advance. You will almost always have to consider such points at tax return time the next year. It is better to consider taxes earlier when you can often improve the result. As for Dr. Dao, he should have a strong case not to pay taxes. But if he receives a Form 1099 for the money–and he may not know that until January of 2018, he will need to report and explain it on his return.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.