Association of Corporate Counsel

# Tax Consequences of Litigation Damages and Settlements

Jun 07, 2016 QuickCounsel

By Yan-Xin Li, 3L, University of Maryland Francis King Carey School of Law

## Overview

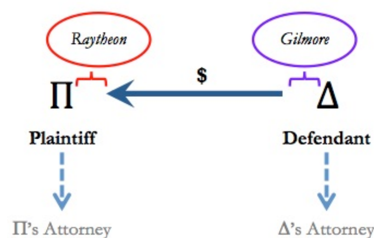
In litigation, attention is often focused solely on the amount of the awarded damages. The tax treatment of such damages (whether by judgment or settlement) is frequently overlooked, though it should feature prominently in resolving the litigation, and in determining how much a party ultimately owes or receives—and the payment structure. Advance planning techniques may improve one or both parties' tax posture, meaning a defendant could pay less and/or a plaintiff could receive more on an after-tax basis. This article briefly examines the tax consequences of payments from litigation and settlements, such as the character and inclusion of these payments as income, as well as their deductibility and reporting.

As to terminology, judgment refers to a formal court resolution of a dispute, where a party is ordered to pay money damages to another. Settlement refers to a mutual agreement between litigants that results from a process other than formal adjudication by a court, binding conclusion via arbitration, or other administrative hearing. For tax purposes, judgments and settlements are treated the same. Although paying damages or settling a lawsuit has tax consequences to both the payor-defendant and payee-plaintiff, the disposition depends on the nature of the suit. The analysis differs if the lawsuit is a personal physical injury case compared to, for instance, an employment-related claim, business liability, antitrust recovery, or structured settlement.

## Income

26 U.S.C. § 61(a) provides that, unless excepted by other provisions of the Internal Revenue Code ("the Code"), gross income includes "all income from whatever source derived." Gross income sets the ceiling from which adjusted gross income and taxable income can be calculated, after accounting for the relevant and allowable exclusions, deductions, and/or exemptions.

## A Typical Litigation




In a typical litigation, whether the plaintiff is awarded damages by an adjudicatory body or settles with the defendant, the tax treatment of plaintiff's incoming receipt of money is examined under the *Raytheon* "in lieu of" general rule. Conversely, the tax treatment of an outgoing payment of money—whether from defendant to the plaintiff or from either party to its attorney—is analyzed under the *Gilmore* "original of the claim" doctrine. Layered on top of *Raytheon and Gilmore* are, of course, exceptions and special provisions allowed by the Code.

*Raytheon's "In Lieu of" Test for Damages or Settlements Received*

When analyzing the appropriate tax treatment for the plaintiff-recipient of litigation damages or settlement, the question to ask is, "In lieu of what were the damages awarded?" In the originating dispute, the plaintiff-corporate taxpayer, Raytheon, settled its antitrust suit against its defendant-competitor, Radio Corporation of America (RCA), over rectifying tubes for radio receiving sets. Raytheon then claimed it was entitled to exclude from income $350,000 of the total $410,000 settlement amount as a nontaxable return of capital. The Commissioner of Internal Revenue determined that the entire $350,000 constituted taxable income and

assessed a deficiency against Raytheon. After the United States Tax Court found for the Internal Revenue Service (IRS), Raytheon appealed.

In Raytheon Production Corporation v. Commissioner, 144 F.2d 110 (1st Cir. 1944), the First Circuit clarified that "recoveries which represent a reimbursement for lost profits are income." Since normal profits would be taxable income, then proceeds of litigation which are their substitute are also taxable. Therefore, damages for violations of antitrust acts are treated as ordinary income where they represent compensation for—are in lieu of—lost profits.

However, Raytheon argued that the illegal conduct of RCA completely and totally destroyed its rectifying tube business and goodwill; therefore the suit was not to recover lost profits. In circumstances where a suit is for destruction of a business and injury to goodwill, recovery represents a return of capital, and with certain limitations, is not taxable. Nevertheless, the First Circuit explained that even if recovery represents a return of capital in that it takes the place of business goodwill, some or all of the recovery could still be taxable. Thus, although an injured party may not be deriving a profit as a result of the damage suit itself, the conversion of his property into cash is realization of any gain made over the cost or other basis of the goodwill prior to the illegal interference.

As illustration, suppose X buys Blackacre for $5,000. Blackacre appreciates in value to $50,000 before Y tortiously destroys it by fire. X sues and recovers $50,000 in tort damages from Y. While no gain was derived by X from the suit, X's prior gain due to the appreciation in value of Blackacre is realized when it is turned into cash by the money damages. X must include this prior gain of $45,000 in its gross income. Here, compensation for loss of Raytheon's goodwill in excess of its original basis, prior to RCA's illegal antitrust conduct, is gross income. But the record was devoid of evidence as to Raytheon's original basis for its business and goodwill, so the amount of any nontaxable capital recovery could not be ascertained, i.e., the original basis of Raytheon's goodwill was $0. Therefore, the entire settlement amount was taxable income, and the $350,000 must accordingly be included in Raytheon's gross income.

The holding in *Raytheon* gives the general rule that to determine the tax consequences of damages or settlements received by a plaintiff, one must ask in lieu of what was the amount awarded?

*Section 104: A Substantial Exception to Raytheon*

Of particular note in the litigation damages and settlement context is Code section 104, which provides a limited exclusion from gross income for amounts received as compensation for injuries or sickness. While *Raytheon's* "in lieu of" test is the general rule, section 104 is a substantial exception. For example, per section 104, gross income does not include amounts received from sources such as workmen's compensation, damages (other than punitive damages) received on account of personal physical injuries or physical sickness, or certain accident or health insurance not provided by an employer.

Under section 104(a)(2), emotional distress is not treated as a physical injury or physical illness. Thus, damages for emotional distress itself, like punitive damages, are included in gross income. But those damages for medical care attributable to emotional distress remain excluded from gross income. So in general, amounts received under a judgment or settlement outside of personal physical injuries or physical sickness are includible in gross income. Punitive damages are always gross income.

Because punitive damages are not excludable, one must be cognizant of this fact when negotiating a settlement of a case involving physical person injury or physical illness. It may be tempting to allocate the entire or a disproportionately large percentage of the settlement to physical injury (which would be excluded from gross income) even though the plaintiff's pleadings requested both compensatory and punitive damages. The IRS will likely scrutinize settlements carefully and challenge allocations it does not consider to be arms-length.

In addition, periodic payments are excludable from gross income per section 104(a)(2). For example, Plaintiff sues Defendant in a personal physical injury action. The parties come to a settlement agreement, where Plaintiff will pay Defendant $1,000 per month for the next five years (for a total payout of $60,000). Under section 104(a)(2), Plaintiff is entitled to exclude the entire amount received over the five-year period, even though a portion of the payments in effect constitutes interest income. Because of the statute's "generosity," it is highly encouraged for injured plaintiffs to structure their settlement awards so as to use periodic payments.

*Gilmore's "Origin of the Claim" Test for Damages or Settlements Paid*

The "origin of the claim" test was articulated in United States v. Gilmore, 372 U.S. 39 (1963), and addresses tax consequences—deductibility, capitalization, or no tax benefit—to the payor of damages, settlements, or other fees. In a prolonged divorce proceeding, Gilmore's wife claimed that Gilmore's controlling stock interests in three companies were community property, which would entitle her to a one-half interest. Gilmore spent approximately $40,000 successfully defending against his wife's claim. He subsequently sought to deduct the litigation expenses from his federal income taxes as ordinary and necessary expenses incurred for the conservation of property held for the production of income (formerly 26 U.S.C. § 23(a)(2) and currently Code section 212). The IRS found Gilmore's expenditures to be of a "personal" or "family" nature, and thus not deductible.

The Supreme Court of the United States sustained the Government's position, holding that litigation costs are deductible only if the claim arises in connection with the taxpayer's profit-seeking activities. The test for deductibility turns upon "the origin and nature of

the claims" themselves, and not upon the consequences of a successful legal claim. Gilmore's legal expenses did not become deductible merely because they were made to relieve him of a liability; otherwise, the expense of defending almost any claim would be deductible by a taxpayer on the ground that such defense was made to clear liens on any income-producing property the taxpayer might have. Rather, the legal claim must arise in connection with the business or profit-seeking activity at issue. Gilmore was defending against claims originating from a personal matter—the divorce proceedings had no connection with his income-producing activities other than the consequences. The fact that the claim would affect his income-producing property was irrelevant.

Thus, *Gilmore's* origin of the claim doctrine assesses the tax consequence of a damage or settlement payout based on the origin and character of the claim with respect to which such an expense was incurred, and not the potential resulting consequences. One can usually determine the origin or nature of the claim by examining the complaint, history of negotiations, and settlement agreement, if applicable.

---

## Tax Treatment in Practice

The following examples illustrate application of *Raytheon and Gilmore*, and highlight some of the exceptions provided under section 104. Example 1 is from Tax Aspects of Settlements and Judgments (Portfolio 522), which is part of the U.S. Income Portfolios Library. Examples 2 and 3 are based on problems in the eleventh edition of the Taxation of Individual Income casebook by J. Martin Burke and Michael K Friel.

*Example 1*

Corporation terminates Employee. Employee then files a suit claiming breach of her employment contract and requests two types of relief: (i) reinstatement and (ii) lost wages from the date of termination to date of reinstatement. Corporation and Employee come to a settlement where Corporation will (i) rehire Employee and (ii) provide $10,000 in back pay.

For Employee, under *Raytheon*, the $10,000 back pay received is for lost wages, i.e., in lieu of her salary. It is not a personal physical injury to Employee (so section 104(a)(2) does not apply). Thus, the $10,000 is included in Employee's gross income and taxed accordingly as it does not qualify for any exclusion.

From Corporation's point of view, under *Gilmore*, the origin of the claim stems from a breach of an employment contract. This is related to Corporation's carrying on of a business or trade, specifically paying employee salaries. Corporation may therefore deduct $10,000 on its federal tax return as an expense arising from trade or business per section 162.

*Example 2*

Plaintiff was injured last year when Defendant drunk driver struck him as she was swerving home from a bachelorette party. Plaintiff filed a negligence suit against Defendant, seeking over $2 million in both compensatory and punitive damages. This year, the parties to the action settled the suit out of court for $900,000. The allocation of the award is as follows: (i) $500,000 for pain and suffering; (ii) $65,000 for future medical expenses; (iii) $185,000 for lost income; and (iv) $150,000 for punitive damages.

For Plaintiff, since this is a personal physical injury, section 104 will apply to grant exceptions to *Raytheon* and the premise that all income from whatever source derived is included in gross income. The $500,000 for pain and suffering, $65,000 for future medical expenses, and $185,000 for lost income (for a total of $750,000) are all excluded from gross income because they are all compensation for Plaintiff's physical injury. In this case, even though *Raytheon* would dictate that an award for lost income would be in lieu of Plaintiff's normal salary, section 104 supersedes the general rule. However, the $150,000 for punitive damages is included in gross income, and Plaintiff must accordingly declare and pay federal taxes on that amount.

For Defendant, the origin of the claim is the personal activity of getting drunk, and per section 262, no deduction is allowed for personal, living, or family expenses. There will be no tax benefit for the entire $900,000 paid by Defendant to Plaintiff.

*Example 3*

Plaintiff began work at an advertising firm. Shortly after starting, she began to be sexually harassed by her supervisor, which was not limited to verbal statements and gestures, but also unwelcome physical contact, including bruising her arm when he grabbed her during one altercation. A few months after Plaintiff complained to the managing partner, she was fired. The advertising agency indicated in their dismissal notice that Plaintiff was terminated for incompetence. Plaintiff suffered emotional distress that exacerbated a preexisting ulcer, which led to brief hospitalization. She also experienced depression and sought treatment with a psychologist. Plaintiff sued for wrongful discharge and sexual harassment, and the ad agency offered to settle for $1 million. What are the tax consequences of this settlement?

As Plaintiff's attorney, in structuring this settlement payout, one must keep in mind that damages allocated to lost wages, hurt reputation, and even Plaintiff's depression will all be included in gross income. This is because while Plaintiff did suffer a bruise,

which may or may not arise to the level of personal physical injury, the bruise was not a direct cause to Plaintiff's lost wages or termination. Thus section 104 does not apply. Damages for depression would qualify as emotional distress, and are also included in gross income. However, amounts paid and reimbursed for Plaintiff's visits to the psychologist, prescription drugs, and medical expenses related to the ulcer, hospitalization, and possible future medical expenses would be excluded from gross income. It would also be beneficial to Plaintiff if future medical expenses could be paid periodically.

The origin of the claim of Plaintiff's wrongful discharge suit, regardless of whether the complaint specifically alleges violation of a discrimination statute, breach of contract, or tort, is related to the Defendant ad agency's trade or business. The $1 million payout is likely fully deductible to Defendant under section 162.

## Conclusion

There are usually greater tax planning opportunities available when litigation is concluded by settlement rather than judgment. In these instances, the parties may attempt to allocate precise amounts to various claims in dispute, though settlements are always subject to challenge by the IRS. Nevertheless, knowing the potential tax treatment of damages or settlements allows one to better advise respective parties to craft their complaint and request for relief.

## Additional Resources


1. *Articles*, Wood LLP (last visited Apr. 8, 2016).
2. Robert W. Wood, *Perfectly Legal Tax Write-Off? Lawyer Fees – Even $1,200 an Hour,* Forbes (Feb. 6, 2016, 8:35 AM).
3. Internal Revenue Serv., Publ'n 4345, Settlements – Taxability (2015).
4. *Lawsuits, Awards, and Settlements Audit Techniques Guide*, Internal Revenue Serv. (last updated Sept. 1, 2015).
5. Brennan Black, *Closing the Open Door: Using "True Economic Realities" to Determine the Tax Deductibility of False Claims Act Settlements*, 50 Gonz. L. Rev. 349 (2015).
6. Phyllis Horn Epstein, *Intricacies of Taxation of Damage Awards and Settlements*, 36 Penn. Law. 40 (Nov./Dec. 2014).
7. Jonathan H. Krol, *Tax Considerations When Settling Employment Cases*, Reminger (Oct. 28, 2014), http://www.reminger.com/insights-reports-408.html.
8. Elizabeth Erickson & Ira B. Mirsky, *The Tax Consequences of Settlement Agreements*, 42 Comp. & Benefits Rev. 426 (Sept./Oct. 2010).
9. Robert W. Wood, *10 Things to Know About Taxes on Damages*, Forbes (Apr. 29, 2010, 3:13 PM).