Tax Basics for Personal Injury Cases

By || Robert W. Wood

Personal injury lawyers aren't tax specialists, but a little tax knowledge comes in handy when working with clients and trying to settle cases. Wording in settlement agreements influences taxes to a surprising degree. Plaintiffs want to know whether their settlement is taxable and may ask their lawyer about this. Even if your engagement letter says you don't advise about taxes, what do you say when a client asks, "Is this taxable or not?"

Answering can be harder than you might think—tax law is full of shades of gray. The tax treatment of settlements and judgments depends on the type of claims, whether the case is settled or goes to judgment, how checks and IRS 1099 forms are issued, and more. The same tax rules apply to settlements and judgments, but you have more predictability and more flexibility to reduce taxes when a case is settled. Here are some tax tips for trial lawyers in this surprisingly thorny area.

Physical Injury Damages

If your client is suing for personal physical injuries, the compensatory damages should be tax free. Section 104 of the Tax Code shields damages for compensatory personal physical injuries and physical sickness.[1] This is true whether the case involves a car crash, medical negligence, a defective medical device, sexual assault, or most any kind of personal (and physical) injury.

Before 1996, "personal" injury damages were tax free. That meant emotional distress, defamation, and many other kinds of legal injuries *also* produced tax-free recoveries. But that changed in a fundamental way when §104 of the Tax Code was amended in 1996.[2] Since then, your injury must be "physical" to give rise to tax-free damages.

Unfortunately, neither Congress nor the IRS has clarified exactly what is physical and what is not. The IRS has generally said that you must have visible harm (cuts or bruises) for your injuries to be physical.[3] This observable bodily

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harm standard generally means that if your clients bring claims for intentional infliction of emotional distress, their recovery is taxed.

Lost wages. In many personal injury cases, plaintiffs are seeking lost wages because they couldn't work after their injuries. That raises a question: Is there a danger that those lost wages claims will make the case taxable? You might think so, since wages are always taxable, and wage claims in employment lawsuits are taxed. But with a personal physical injury case, even lost wages aren't taxed.[4] The reason for the payment is the physical injury itself, so that makes the compensatory damages tax free, even if you are using wage loss as a measure of damages. But use caution because this tax-free treatment does not extend to interest or punitive damages.

Loss of consortium. What if your client is not physically injured but has a loss of consortium claim related to a loved one? Loss of consortium damages related to an underlying physical injury or wrongful death of someone else can also qualify for tax-free treatment.[5] In effect, loss of consortium damages qualify for a kind of piggy-back tax status, on top of someone *else's* physical injury or wrongful death.

Gray areas. There are still vast gray areas in what qualifies as physical. For example, is PTSD taxable like emotional distress damages? Or is PTSD itself a physical sickness or injury and therefore tax free? There are good arguments that PTSD damages shouldn't be taxed, but the tax law is not yet clear.

Former President Barack Obama referred to PTSD as physical.[6] And the Social Security Administration also classifies some PTSD sufferers as disabled.[7] However, the tax cases have not yet confronted whether PTSD damages are excludable from income under §104 of the Tax Code. Specifying in a settlement agreement that the damages are paid on account of personal physical injuries and physical sickness within the meaning of §104 of the Tax Code can be helpful.

Sadly, plaintiffs often end up in tax audits and disputes later, often over tax wording in settlement agreements and whether the defendant intended the payments for physical injuries.[8] Former U.S. Taxpayer Advocate Nina Olson often lamented the numerous tax cases in U.S. Tax Court on this issue and called on Congress to clarify and expand the tax exclusion to cover emotional injuries and their physical effects.[9]

The U.S. Tax Court hears many cases on the question of whether damages are tax free—and it is an inherently factual area. But the IRS often takes a harsh view in audits, and the Tax Court tends to back up the IRS in most cases. So unless it is obvious that your client has physical injuries, it is a good idea to recommend to your client to get some tax advice.

Taxable Damages

Apart from the question of what is "physical" enough, there are also some other big qualifiers of the tax-free damages category. For example, punitive damages and interest are always taxable, even if your client's injuries are 100% physical.[10] Suppose that your client is injured in a car crash, and you get a verdict for $50,000 in compensatory damages and $5 million in punitive damages. The $50,000 is tax free, but the $5 million is fully taxable.

Attorney fees. What's more, your client may be unable to deduct your attorney fees.[11] The bizarre math works like this: First, in any contingent fee case, for tax purposes, the plaintiff is treated as receiving 100% of the money, even your fees. This is the tax rule even if your fees are separately paid and don't pass through the plaintiff's hands. The U.S. Supreme Court reached this pivotal tax decision in 2005 in *Commissioner v. Banks*.[12]

But note that in employment and whistleblower cases, plaintiffs are not hurt by the *Banks* case—the Tax Code provides an above-the-line deduction for legal fees for these types of claims.[13] That means the legal fees are gross income to the plaintiff, but immediately (and fully) deductible, so the plaintiff doesn't end up paying taxes on the legal fees.

But what about in other types of cases? Even if you've asked for punitive damages in a personal physical injury case, if the case is settled before trial, it's likely all compensatory damages.

For tax-free recoveries from physical injury suits, the *Banks* decision also does not present much of a hurdle. Since the recovery is excludable from income, the contingent legal fees represent additional *excludable* recovery, essentially a tax nothing for the plaintiff. There is no

PREVIOUS SPREAD: POH SMITH/SHUTTERSTOCK; THIS PAGE: UTAMARU KIDO/GETTY IMAGES need to deduct the contingent fees from the tax-free recovery to avoid paying tax on the recovery. In fact, taxpayers are disallowed from deducting legal fees that produce excludable recoveries by §265 of the Tax Code.

If a recovery is partially tax free and partially taxable—for example, a physical injury case with a punitive damages award—the legal fees are typically allocated pro rata between the excludable and taxable portions. The legal fees allocable to the tax-free portion are of no real concern to plaintiffs, but your clients will need to find a way to deduct the legal fees allocable to the taxable portion to avoid paying tax on contingent fees they never actually received.

However, in a case that goes to verdict with punitive damages, there's no easy way to deduct the contingent legal fees attributed to the punitive part of the case. Up until the end of 2017, you could claim a tax deduction for your legal fees. But starting in 2018, there is often no deduction for these legal fees since miscellaneous itemized

Structured Legal Fees

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In December 2022, the IRS released Generic Legal Advice Memorandum (GLAM) AM 2022-007 on structured legal fees.[1] The GLAM is 25 single-spaced pages and attacks an IRS hypothetical fee structure in which the settlement agreement calls for a lump-sum fee that the plaintiff attorney instructs to pay to an assignment company. In the hypothetical, deferral of the fee is an arrangement between the attorney and the assignment company, which does not necessarily include the agreement or participation of the defendant or the attorney's client. The GLAM claims that this violates the anticipatory assignment of income doctrine, the economic benefit doctrine, §83 of the Tax Code, and §409A of the Tax Code.

In my experience, most structured fees are never audited, and most are not disclosed on tax returns. If a fee has been deferred, it is usually not reported on a tax return until the periodic payments are reported and taxed. Even so, most lawyers who structure fees should pay attention to this GLAM.

The only prior attack on structured legal fees came in 1994, but the Tax Court and Eleventh Circuit approved of them in *Childs v. Commissioner*.[2] That case involved a fee deferral agreed to by the attorney, their clients, and the defendants, as specified in the settlement agreement signed by all parties. *Childs* addressed two fee structures: one in which a defendant acquired funding assets itself to pay for the periodic payments owed to the attorney, and one in which the defendant assigned the obligation to make the periodic payments to an assignment company and paid the assignment company a lump-sum payment in connection with the assignment. *Childs* approved both forms of structures. Since then, the IRS has left structured legal fees alone for nearly 30 years. So, although it is based on facts that differ from those in *Childs*, the GLAM was a surprise.

The IRS's broad arguments in the GLAM could surface in audits of structures mirroring that in *Childs*. And while the IRS does not have the power to outvote the Tax Court or Eleventh Circuit, it has the power to audit.

The biggest surprise in the GLAM is the IRS's claim about §409A, which was enacted in 2004, years after *Childs*. At its root, §409A provides that some deferred compensation is taxed—and is subject to large penalties—if it fails to comply with multiple rules. Fortunately, the Treasury Regulations under §409A say that the *entire provision* does not apply to independent contractors who have two or more customers or clients.[3] Since these regulations were released in 2007, they have been widely understood to *exempt* structured legal fees. Most lawyers have two or more clients and are exempt. Nevertheless, the GLAM argues that legal fee structures are subject to §409A because adding a third party makes it no longer an amount deferred between client and lawyer.

In the GLAM, the IRS tries to distinguish the facts and law in *Childs* from those in its hypothetical. But it may face bigger challenges attacking facts that squarely line up with *Childs*. So for attorneys facing an audit, the closer the fee structure conforms to the *Childs* facts, the better.

It is not clear that the IRS wants to relitigate *Childs*. It seems more likely that if the IRS wants to litigate structured fees again, it will pick facts more like those in the GLAM hypothetical. However, it could take years for a decision to emerge.

Given the number of stakeholders impacted by the IRS's arguments in the GLAM, some industry pushback is also possible. In the meantime, it likely is still safe for attorneys to structure their fees. But the surprise IRS announcement makes it doubly important for lawyers to consider and document their fee structures carefully.

NOTES

1. I.R.S. Generic Legal Advice Memo. AM 2022-007 (Dec. 16, 2022), https://www.irs.gov/pub/lanoa/am-2022-007-508v.pdf.
2. 103 T.C. 634 (1994), *aff'd without opinion*, 89 F.3d 856 (Table) (11th Cir. 1996).
3. *See* 26 C.F.Rø. §1.409A-1(f)(2). This is one among other requirements usually easily satisfied for structured fees.

deductions were eliminated (until 2026).[14] Punitive damages awards can easily dwarf the compensatory portion of a recovery, so finding an avenue to deduct legal fees paid out of punitive damages is particularly important—you want to avoid clients paying taxes on the portion of their punitive damages award they never received.

Some creative solutions to this dilemma are possible, but clients will need tax help to navigate them. For example, there is still an above-the-line deduction for legal fees relating to claims under any federal, state, local, or common law providing for the enforcement of civil rights.[15] However, the lack of a tax deduction for certain legal fees still catches many plaintiffs by surprise at tax return time.

Interest. You might receive a tax-free settlement or judgment, but pre- or post-judgment interest is always taxable.[16] As with punitive damages, taxable interest can produce attorney fee deduction problems. Legal fees are allocated pro rata by the IRS,[17] so if your case is 20% compensatory and 80% punitive, that could mean no tax deduction for 80% of the legal fees.

Benefits of Settlement

From a tax viewpoint for your client, these rules can make it more attractive to settle their case rather than have it go to judgment. Settling before trial allows you to shape the tax treatment your client can expect and help avoid surprises with IRS W-2 and 1099 forms. Settling after a verdict while a case is on appeal also can often be a smart move taxwise. The economics should control, of course, and you don't want to give up too much of a hard-earned verdict to settle for tax reasons. Besides, the verdict numbers can't be entirely ignored.

For example, suppose that the case with the $50,000 in compensatory damages and $5 million in punitive damages is settled on appeal. It may not be credible to say that a $2 million settlement is all compensatory. However, if you've cross-appealed for additional compensatory damages, that might give you more flexibility.

If your case is fully nontaxable—for example, if it's a personal physical injury case that is settled before trial—that causes no tax problems. But your client's injuries must qualify as "physical"—and be extra careful with the tax treatment of punitive damages and interest. In fact, when a verdict is rendered with punitive damages or interest, the plaintiff should get tax advice regardless of whether the case is settled or the verdict is paid. And how the legal fees should be handled from a tax viewpoint is worth addressing in all cases.

Words matter. Finally, be aware that it never hurts to specify in the settlement agreement that the damages are for compensatory physical injury damages, even if you think that is obvious. Plaintiff lawsuit settlements are frequently the subject of IRS and state income tax audits—and the IRS usually asks for the settlement agreement. If the settlement agreement states that the settlement was paid on account of personal physical injuries, that may end the audit.

In fact, including in the settlement agreement that the settlement payment is "excludable from income under §104 of the Internal Revenue Code" is helpful too. Going the extra mile and specifying that your client will not be issued an IRS Form 1099 can help your client avoid an unpleasant surprise in January of the year after settlement.

According to the IRS, settlement proceeds for compensatory personal physical injuries are not supposed to be the subject of an IRS Form 1099 *to the plaintiff*.[18] Even so, unwelcome 1099 forms are issued a lot more than you might think. When they are, plaintiffs need to explain them on their tax return.

The tax law is complex and full of shades of gray. However, it's helpful for trial lawyers to have a basic understanding of tax laws relevant to personal injury cases—both when working with clients and when trying to settle cases.

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Notes

1. 26 U.S.C. §104.
2. Pub. L. No. 104-188, Sec. 1605 (1996).
3. I.R.S. Priv. Ltr. Rul. 2000-41-022 (Oct. 13, 2000).
4. *See* 26 U.S.C. §104(a)(1).
5. *See* I.R.S. Priv. Ltr. Rul. 2001-21-031 (May 25, 2001).
6. *See CNN Presidential Town Hall: America's Military and The Commander and Chief* (CNN Sept. 28, 2016).
7. *See Laskowski v. Dep't of Veterans Affairs*, 918 F. Supp. 2d 301, 313 (M.D. Pa. 2013).
8. *See, e.g., Holliday v. Comm'r*, T.C.M. (RIA) 69 (2021).
9. *See National Taxpayer Advocate 2009 Annual Report to Congress* 355–56 (2009); *see also National Taxpayer Advocate 2013 Annual Report to Congress* 2 (2013).
10. *See* 26 U.S.C. §104(a)(2); *O'Gilvie v. United States*, 519 U.S. 79, 83 (1996); *Kovacs v. Comm'r*, 100 T.C. 124, 145 (1993), *aff'd*, 25 F.3d 1048 (6th Cir. 1994).
11. Regarding attorney fees, plaintiff attorneys should be award of I.R.S. Generic Legal Advice Memo. AM-2022-007 (Dec. 16, 2022), attacking certain structured legal fees. For more, see p. 44.
12. *Comm'r of Internal Revenue v. Banks*, 543 U.S. 426, 430 (2005).
13. *See* 26 U.S.C. §62(a)(21) (2020) (whistleblower claims) and 26 U.S.C. §62(a)(20) (employment claims).
14. *See* Tax Cuts and Jobs Act, Pub. L. No. 115-97, Sec. 11045 (2017). This eliminated miscellaneous itemized deductions for 2018 through 2025 tax years. The deduction is set to return in 2026.
15. *See* 26 U.S.C. §62(e)(18), discussed in Robert W. Wood, *Civil Rights Fee Deduction Cuts Tax on Settlements*, 166 Tax Notes Fed. 1481 (Mar. 2, 2020).
16. *See Kovacs*, 100 T.C. at 133.
17. *See* I.R.S. Pub. No. 4345 (Nov. 2022).
18. *See* I.R.S. Instructions for Form 1099-MISC.