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Charity or Tax Trap? Navigating the Hidden Pitfalls of Legal Settlements

By Robert W. Wood

The money goes to pay Trump's legal fees, and to his presidential library. Trump used the same technique in his $15 million settlement with ABC News over alleged defamation by George Stephanopoulos. Meta also settled with Trump, paying $25 million over suspending his social media accounts, and the funds once again were for legal fees and his presidential library. The widespread assumption is that this avoids taxes.

In general, though, the IRS view is that settling a lawsuit by having the money paid to charity may not always be a 100% tax solution. In some cases, a plaintiff's request to have settlement funds paid to charity are viewed by the IRS as a payment first to the plaintiff, and then a contribution by him to charity. That may be subject to percentage income limits, which in some cases means that the whole charitable contribution deduction may not be available in the year of the settlement.

If the settlement pays legal bills that Trump would otherwise owe, the IRS could call that taxable income. When someone discharges your liability, the IRS often views that as income, even if you never handle the cash. Similarly, if Trump receives a reimbursement out of the Paramount settlement for legal fees that he has already paid, is that income?

It depends on whether Trump has deducted the legal fees on his taxes that are later reimbursed. If he has deducted the fees, the IRS usually requires reimbursed amounts to be treated as income. The IRS calls it the tax benefit rule. Since you got a tax benefit from a deduction, if you are later reimbursed you can be required to take the reimbursement into income.

In my experience, most settlements involving payment to charity involve only a small part of a settlement, something like this. Sally has negotiated a sexual harassment settlement with her former employer, and part of the deal is that 10% of the funds will go to a designated charity. Will Sally be taxed on that? Some defendants would agree not to issue a Form 1099 to Sally for that 10%. But in my experience, most companies will treat that payment as made to Sally, even if the payment goes directly to the charity.

This is because Sally is viewed as the one requesting and directing the payment. Sally can still claim a charitable contribution deduction on her tax return, even if she does not write the check to the charity. There can be some difficult tax problems in the case of large payments to charity, such as 50% or 100% of the funds going to charity. In that case, extra caution is needed before the deal is signed. There are annual limits on charitable contributions, and since the IRS may view the settlement as paid to the plaintiff who then is deemed to make the donation, you don't want to have trouble with the size of your charitable contribution deduction.

Directing settlement money to charity can work in some cases, but even that is not foolproof, as noted above. And having the settlement agreement direct the money to someone else — say a friend or relative — usually does not avoid taxes to the plaintiff either. The IRS taxes the person who had a legal right to payment. Many plaintiffs win or settle a lawsuit only to be surprised that they have to pay taxes. Some plaintiffs don't realize it until tax time the following year when IRS Forms 1099 arrive in the mail.

That is one of many reasons that plaintiffs should consider their likely tax burden before they sign a settlement agreement. Considering it as soon in the settlement process as you can is usually best, not when you are expected to sign asap. A good time is before a case mediates, so you are not caught by surprise.

In my experience, plaintiffs are more likely to think about donating to charity if their settlement is mostly or entirely taxable to them. Taxes on legal settlements are based on the origin of your claim. If you get laid off at work and sue for wages, you'll be taxed as wages, usually with a portion on a Form 1099 for emotional distress. But the rules are full of exceptions and nuances, so be careful, how settlement awards are taxed.

One important exclusion from taxes applies to physical injury damages. Before 1996, all personal damages were tax-free, so emotional distress and defamation produced tax-free recoveries. But since 1996, your injury must be "physical." Trump alleged that the "60 Minutes" edits caused him mental anguish, but that would not qualify for a tax exclusion.

The IRS treats mental anguish, as well as physical symptoms of emotional distress (like headaches and stomachaches) as taxable. Haggling over tax details before you sign and settle is best. Such agreements aren't binding on the IRS or the courts in later tax disputes, but they can be enormously helpful in an audit, and the IRS rarely ignore them.

How legal fees are taxed is tricky. If you are the plaintiff and use a contingent fee lawyer, you'll 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. If your case is fully nontaxable (say an auto accident in which you are injured), that shouldn't cause any tax problems. But what if some or all of your recovery is taxable?

Say you settle a suit for intentional infliction of emotional distress against your neighbor for $100,000, and your lawyer keeps $40,000. You might think you'd have $60,000 of income. Instead, you'll have $100,000 of income. In 2005, the U.S. Supreme Court held in *Commissioner v. Banks*, that plaintiffs generally have income equal to 100% of their recoveries. even if their lawyers take a share. Fortunately, in 2004, Congress enacted an above the line deduction for legal fees, and in most cases there are still ways to deduct legal fees.

Punitive damages and interest are always taxable. If you are injured in a car crash and collect $50,000 in compensatory damages and $5 million in punitive damages, the former is tax-free. But the $5 million is fully taxable, and deducting your attorney fees may be tricky. The same occurs with interest. You might receive a tax-free settlement or judgment, but pre-judgment or post-judgment interest is always taxable (and can produce attorney fee problems). Sometimes, that can make it attractive to settle your case rather than going to judgment.

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