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How Lawsuits Over Cuba Confiscation Will Be Taxed By IRS



The Supreme Court appears to be easing the way for people and companies to make claims over the confiscation of Cuban property when Fidel Castro seized power in 1959. Recently, the [U.S. Supreme Court revived claims](#) filed by a U.S. company, Havana Docks, that operated docks in the Cuban capital. The suit targets four cruise lines that brought tourists to Cuba during a brief reopening of Cuban relations that occurred during the Obama administration, using confiscated property claimed by Havana Docks.

The pivotal law is the Helms-Burton Act, which Congress passed in 1996. Among other things, it allows Americans to sue almost any company that engages in commercial activity or that benefits from property confiscated by Cuba's government. The law allows U.S. nationals with claims to confiscated property to file suit in U.S. courts. But for decades, every U.S. president since 1996 suspended the law in view of broader international implications.

Then, in 2019, President Trump [reactivated the law to allow lawsuits](#). He also imposed travel restrictions that stopped the cruise ships that were in issue in the Havana Docks case. The trial court in the case awarded Havana Docks more than \$400 million in damages, but a federal appeals court reversed. The Supreme Court has sent the case back for further argument.

Taxing Damages For Confiscation

Numerous law firms have filed lawsuits under the law and some plaintiffs are collecting. When plaintiffs collect damages for property that was confiscated many years ago, it is often the descendants of property owners who are the recipients. And while it might seem that they are just getting back something that was taken from them, they are paid in cash, not with actual property. To the IRS, that means taxes, as the [IRS taxes most lawsuit settlements](#).

However, some settlements can be positioned as capital gain. A suit about damage to or conversion of property is a prime example.

Lower Tax Rates, Recovering Basis

Ordinary income is taxed at up to 37%, while capital gain can be taxed as low as 0% and as high as 23.8%. Apart from lower tax rates, capital gain can involve recouping basis too. If you spent \$1 million in costs that you have not deducted, that is basis that can be repaid without tax before you start reporting gain. The IRS can push back and tends to argue for ordinary income, it is [one of the IRS rules about legal settlements](#).

However, a successful Helms-Burton Act plaintiff is likely to have a good argument that settlement proceeds should qualify for long term capital gain treatment. After all, having property confiscated should mean that a later settlement is effectively paying you for your property. Selective settlement agreement wording could make that argument even better.

But will a taxpayer have a significant tax basis? Probably not after a 1959 confiscation. But there is one other significant tax impact of reporting as capital gain. Nearly all Helms-Burton Act plaintiffs use contingent fee lawyers. When their ship comes in, the IRS will treat them as receiving not only their net recovery, but the share of the funds that goes to their contingent fee lawyers as well. That means most plaintiffs must look for a way to claim a [legal fee tax deduction](#).

That can be tricky in some cases. However, if you recover capital gain, the tax case law says you can capitalize your legal fees and offset them to reduce your gain. That is an added benefit of lawsuit [settlements that are taxed as capital](#)

[gain](#). Still, not every plaintiff who reports capital gain for a legal settlement has an easy time convincing the IRS.

Settlement Agreement Wording Can Help

In [NCA Argyle LP, Newport Capital Advisors, LLC](#), the IRS and the taxpayer faced off over the treatment of a \$23 million legal settlement. The taxpayer claimed that the money was capital gain for its interests in the failed joint ventures. The IRS said the money was really future fees the joint ventures would reap, plus punitive damages, both of which are clearly taxed as ordinary income. You can read more [about the case here](#).

While the case was on appeal, the parties settled for \$23 million. The settlement agreement stated that NCA received all \$23 million in exchange for its interests in the joint ventures. Although settlement agreement wording does not bind the IRS, the Tax Court relied heavily on the express allocation in the settlement agreement, and was inclined to agree with the taxpayer that these were sale proceeds and capital gain.

Deferring Taxes Under Section 1033

Is there any other tax benefit for Cuban confiscation damages? Arguably yes, for the plaintiffs who want to take advantage of it. Section 1033 applies to [involuntary conversions](#), such as where your property is condemned by the government or damaged or destroyed by a fire, storm or defendant. Section 1033 can also apply to damage or destruction from defective construction. It is also used frequently by [victims of natural disasters who collect insurance or lawsuit money](#), but it also applies to lawsuit damages, and this is a prime example. Section 1033 allows you to put your gain into repairing or replacing

the damaged or destroyed property. There are time limits and requirements, but it is used frequently in property damage and construction defect cases.

Consider Taxes At Settlement Time

No one wants to go through a protracted legal dispute. After enduring that process, no one wants to go through *another* dispute about taxes on the money they recovered, or the money they had to pay. Plaintiffs receiving money usually have a big interest in any taxes they will pay. Often, it pays to get tax advisers involved before signing a settlement agreement, since one can often help to shape the tax result.