



Robert W. Wood

THE TAX LAWYER

Feb. 28 2011 — 11:17 am

Duke Lacrosse Tax Lien Highlights How Lawsuits Are Taxed

If you're like me, you were shocked to learn that [exonerated](#) Duke Lacrosse player Reade Seligmann—falsely accused of rape—got a whopping \$20 million settlement. That's the calculation by which some explain an IRS tax lien claiming he owes nearly \$6.5 million in tax. See [Ex-Duke Lacrosse Star Insists Tax Bill a 'Mistake'](#). An IRS [tax lien filed Feb. 17 in New York City](#) claims \$6,492,377 in tax from 2007, the year Seligmann and two others settled with Duke. While the settlement was never disclosed, some have speculated:

- Daily Mail: [Were the Duke Lacrosse Players Wrongly Accused of Rape Paid \\$20 Million Each in Secret Settlement?](#)
- New York Daily News: [IRS Claims Former Duke Lacrosse Player Reade Seligmann Owes Millions, Lawyer Says Bill Is Mistake](#)

Even if accurate, I can't say whether that's a reasonable sum for having your life upended. Still, I can't help but compare it to far smaller amounts received by innocent victims locked in prison for decades for crimes they too didn't commit. Just one example: Robert Lee Stinson was awarded **\$25,000 for 24 years** of wrongful imprisonment, and there was some question whether he **might** get an additional \$90,000. See [Justice Denied: The Journal for the Wrongly Convicted](#).

But while I'm not qualified to judge the *size* of awards, I *am* qualified to talk about taxes. As a tax lawyer for [30-years](#), I routinely see successful plaintiffs shocked by the size of their tax bills. You'd think it would be easy to explain what is taxable and what isn't, but there's a weird aura surrounding taxes and lawsuit recoveries. The palpable confusion is not only about what cases generate tax bills, but extends to how your income is measured, whether on your net share *after* lawyer fees, or on the gross *including lawyer fees!*

Tax-Free? If you sue for personal physical injuries like a car accident, your damages are tax-free. [Section 104](#) of the tax code shields damages for personal physical injuries and physical sickness. Before 1996 “personal” damages were tax-free, meaning emotional distress, defamation and many other legal injuries. But since 1996 your injury must be “physical” to be tax-free, and the IRS says your injuries must be visible. See [Tax-Free Physical Sickness Recoveries in 2010 and Beyond](#).

This “observable bodily harm” standard generally means that if you sue your employer for sexual harassment involving rude comments or even fondling, that's *not* physical enough for the IRS. Taxpayers routinely argue in U.S. Tax Court that their damages are sufficiently physical to be tax-free; the IRS usually wins these cases. See [Bruises, Settlements, and the Proposed 104 Regs.](#)

Distinguish between money you receive for physical symptoms of emotional distress (like headaches and stomachaches) and physical injuries or sickness. Still, these lines are not clear. See [Symptoms of Emotional Distress vs. Sickness: Sheep From Goats](#). For example, if in settling an employment dispute you receive \$50,000 extra because your employer gave you an ulcer, is an ulcer *physical* or is it merely a *symptom of your emotional distress*? Many plaintiffs end up taking aggressive positions on their tax returns, claiming damages of this nature as tax-free.

Beware Attorney Fees! If you use a contingent fee lawyer, you'll usually be treated (for tax purposes) as receiving 100% of the recovery even if the defendant pays your lawyer his contingent fee directly. If your case is fully nontaxable (say an auto accident in which you're injured),

that won't cause any tax problems. But if your recovery is taxable, beware.

Example: Suppose 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, followed by a \$40,000 miscellaneous itemized deduction. You'll be subject to numerous limitations, including the alternative minimum tax (AMT) that can whittle your deduction down to nothing.

That's why many clients say they are paying tax on lawyer's fees they never received. See [Attorney Fee Deduction Problems Remain](#). With high legal fees and costs and the AMT, some clients actually *lose* money after tax by winning a lawsuit. See [Spina v. Forest Preserve Dist. of Cook County](#). There are some routes out of this mess, but get some professional help and be careful. See [AMT Problems For Attorney Fees Remain](#).

Wrongful Imprisonment? Let's return to the Duke stars and more serious cases of long term wrongful conviction and imprisonment. What is the tax treatment of those awards? Unclear, and that's a real travesty. See [Tax-Free Wrongful Imprisonment Recoveries](#) and [Wrongful Imprisonment Tax Ruling Stirs Controversy](#).

For more, see:

[10 Things To Know About Taxes On Damages](#)

[AMT Problems For Attorney Fees Remain](#)

[Tax On Wrongful Imprisonment Needs Reform](#)

[Tax-Free Wrongful Imprisonment Recoveries](#)

Robert W. Wood practices law with Wood & Porter, in San Francisco. The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009, Tax Institute), he can be reached at wood@woodporter.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.