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How IRS Taxes Defamation Legal Settlements



The tax rules for how legal settlements are taxed are complicated.

Most [settlements for emotional distress](#) are taxed, and legal fees are taxed to the plaintiff, even if paid directly to the lawyer. Plus, if you settle [after the case goes to verdict, the taxes are even trickier](#). The type of legal claim matters, as taxes are based on the origin of your claim.

Physical Injury Damages

If you sue for physical injuries, your damages should be tax-free. 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.” Physical symptoms of emotional distress (like headaches and stomachaches) is taxed, but physical injuries or sickness is not. There are many [chicken or egg tax cases](#), so determining what is tax free can be difficult.

How Legal Fees Are Taxed

If you are the plaintiff and use a contingent fee lawyer, you’ll usually be treated 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’re injured), that shouldn’t cause any tax problems. But if your recovery is taxable, it means extra income.

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. But 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. How about deducting the legal fees? In 2004, Congress

enacted an above the line tax [deduction for legal fees](#). It is not universal, but there are often still [ways to deduct legal fees](#).

Defamation Damages Are Taxable

How is defamation treated for tax purposes? The damages are taxable, and the IRS generally assume ordinary income treatment. However, some cases can represent legitimate opportunities for capital gain tax treatment. The top federal tax rate on ordinary income is 37%. The capital gain rate depends on income level and the size of the gain. Depending on your income, the capital gain rate can be as low as 0% and as high as 23.8%, including the 3.8% Net Investment Income Tax. But even at the highest rate, 23.8% is better than 37%.

Moreover, this is not only about tax rates. Capital gain reporting can also involve recouping basis. If you owned a home worth \$1M that the defendant destroyed, suppose that you recover \$1M. If you paid \$1M for the home, you may be able to simply reduce your tax basis from \$1M to zero. No gain, and no tax. But if you basis in your home was only \$100k and it is now worth \$1M, you have \$900k of gain to consider.

Goodwill

For a business, goodwill is an asset that can grow in value and be damaged. When a business is compensated for damage to its goodwill, the business can recover its tax basis in its goodwill tax-free and owe capital gain tax to the extent the damages exceed the business's adjusted tax basis in its goodwill. In a professional context, an *individual* can also have goodwill that can be damaged by a defendant. Employees and professionals invest time, money,

and effort in developing their professional reputation with employers, colleagues, and clients.

However, the tax law has been unclear about the idea that individuals have goodwill as an asset that can be damaged in the way a business does. At one time, the question of the nature of an individual's reputation for tax purposes regularly arose in the context of section 104(a)(2) of the tax code. Until 1996, that tax law made "personal" injuries tax free. But since 1996, the exclusion has been limited to personal *physical* injuries or *physical* sickness.

In the decades before the 1996 revisions, tax cases distinguished between defamatory statements that damaged a taxpayer's *personal* reputation and those of a *non-personal* nature. In general, defamatory statements regarding a taxpayer's business or professional reputation were *non-personal*, and therefore taxable. But there was a second level of analysis. Were the damages taxable as ordinary income or as a capital recovery for damage to the individual's professional goodwill?

If the underlying *damages* were for income the individual lost rather than for the value of the damage done to their professional reputation, that made it easy for the courts to say the recovery was ordinary income. Compensation for lost business income or lost profits is typically taxed as ordinary income.

Professional Reputation

When damages are to an individual's *professional* reputation, there are stronger arguments for capital gain. The Tax Court has acknowledged that individuals and employees possess professional goodwill (which can include their relationships with key clients) as an asset that can be separately sold and is separate from the business goodwill of their employer. When a recovery is

attributable to both lost profits and harm to capital assets, the taxpayer is required to allocate the amounts received to lost profits and damage to capital assets.

Many claims about damages to a capital asset include references to the income the asset was expected to produce. However, the fact that the value of the asset was measured by reference to its anticipated income does not necessarily mean the recovery is ordinary. The recognition of an individual's professional goodwill as an asset that can be sold or damaged may be strongest when the individual is a "key person" for a business, someone who draws in clients and customers. However, being an employee can itself be a trade or business for tax purposes.

There are also cases where courts have determined that a legal recovery should be taxed as a capital recovery for damage to an individual's professional goodwill. These cases generally involve sole proprietors whose businesses are clearly tied to their individual professional reputations.

Settlement Agreement

The IRS and the courts have often scrutinized business taxpayers who attempted to categorize their recoveries as being for damage to goodwill. Often, these cases have been doomed by complaints and other litigation documents about lost profits that did not clearly say that the lost profits were being used solely to *value* the damage done to the business goodwill.

The causes of action under which the dispute is brought are important too. California has a cause of action for defamation that has been interpreted to provide relief for intentional misstatements regarding personal matters, and a cause of action for "disparagement," which has been interpreted to provide

relief for intentional misstatements regarding a plaintiff's business (or "goods").

Conclusion

Defamation claims involving only *personal* reputation are taxable as ordinary income. Even before the tax law changed in 1996, there were cases confirming that damages for harm to a taxpayer's *professional* reputation or goodwill can qualify for capital gain treatment. For businesses, there is a long body of case law differentiating between legitimate claims for damage to goodwill and claims that are in substance claims for lost income. Given the stakes, the prospect of capital gain in harm to professional reputation cases is worth considering. The tax rules about damages are full of exceptions and nuances, so it pays to be careful how [settlement awards are taxed](#).