

## How taxes can apply to Roundup verdicts might surprise you

By Robert W. Wood

**T**he manufacturers of Roundup weed killer have faced an avalanche of lawsuits from gardeners, farmers and homeowners claiming that their use of the product gave them cancer.

Roundup, manufactured by Monsanto, is owned by Bayer. Many of the lawsuits have gone to trial, and many have also been settled. The way taxes can apply to Roundup and similar legal recoveries may not be as straightforward as you think.

If a plaintiff is being awarded damages for a serious illness like cancer, how could the IRS consider it to be taxable income? After all, the tax code is clear that compensatory damages for personal physical injuries or physical sickness are free of tax. This rule is codified in section 104 of the tax code. There's significant money, and potential tax revenue on the line, with the size of the payouts and remaining lawsuits nothing short of staggering.

Bayer has reportedly paid nearly \$10 billion in settlement proceeds, and there are more than 60,000 additional cases pending. Yet the tax rules could swallow up some of the verdicts plaintiffs might be hoping to collect. The latest big verdict came in Georgia, where a jury awarded John Barnes approximately \$2.1 billion. The verdict included \$65 million in compensatory damages and \$2 billion in punitive damages. Isn't all this tax-free to the plaintiff?

Hardly. The compensatory damages should be tax-free, but punitive damages and interest are always taxable. Bayer will appeal Mr. Barnes' case, but if the big verdict is eventually paid, most of the money is taxable. In percentages, nearly 97% of the verdict was for punitive damages, with only about 3% being compensatory. That means most of it will be taxed. What's more, one tricky part relates to how legal fees are taxed.

Under a tax change that took effect starting in 2018, there is no longer a universal deduction for legal fees. Some legal fees can no longer be deducted, forcing some plaintiffs to fear that they may have to pay tax even on monies their attorneys collect. Of course, the lawyer must clearly pay tax on any legal fees paid to the lawyer. Some people say that having the lawyer and the plaintiff treated as receiving the same amounts for tax purposes is double taxation.

Perhaps it is, but the U.S. Supreme Court has made it clear that if you are a plaintiff with a contingent fee lawyer, the IRS is correct in treating you as receiving 100% of the money, even if the defendant pays your lawyer directly. If your case is fully nontaxable--say, all compensatory damages for personal physical injuries, that causes no tax problems. However, if some are taxable and some are not, it is not so simple.

Suppose that you sue over Roundup, claiming that the weed killer gave you cancer. Let's say you collect compensatory damages in the amount of \$10 million. Let's assume your lawyer charges a fee of 40%. That means you end up with \$6 million. Whether you view the total recovery as \$10

million or \$6 million doesn't really matter. With only compensatory damages, the whole \$6 million should be tax free. IRS rules clearly say that you can't deduct the \$4 million in legal fees to produce tax-free recoveries, but you don't need to, since the whole thing should be nontaxable.

However, what happens to this equation if punitive damages or interest are awarded? On top of \$10 million in compensatory damages, suppose that you are awarded \$40 million in punitive damages? Let's assume the same 40% legal fee. That means you should net \$30 million, and your lawyer should take home \$20 million. For what is taxable, you must separate the two categories of damage. It would be reasonable to assume that your \$10 million in compensatory damages can be treated as tax free. You get \$6 million of that amount, and your lawyer collects \$4 million.

For the \$40 million in punitive damages, after you pay your lawyer 40%, you should net \$24 million of those punitive damages. If you can claim a tax deduction for your legal fees on the punitive damages, there should be no problem. After all, suppose that this was a big employment case with compensatory damages, rather than a Roundup case. What would happen there?

In an employment case, whether any of the compensatory damages can be excluded would depend on whether the plaintiff was claiming any personal physical injuries or physical sickness. Of course, most employment cases are fully taxable. But contingent legal fees, including the fees on punitive damages and interest, would clearly be tax-deductible in an employment case. How is our Roundup example different?

The so-called Trump tax law that was passed in 2017 took effect in 2018. Whether to extend and modify that tax law is currently being debated in Congress. Unless it is extended, it is scheduled to expire at the end of 2025. One of its changes that is in effect for 2018 through 2025 (unless extended) is to eliminate tax deductions for many legal fees. It did not change the full above-the-line deductibility of legal fees paid in employment, whistleblower, and civil rights cases, as long as the fees and the settlement or judgment are paid in the same tax year, as happens with contingent fees. Please note especially that the deduction also applies to civil rights cases, as I will come back to that point.

However, the more garden-variety miscellaneous itemized tax deductions that were universal avenues for deducting fees were suspended for 2018 through 2025. Regardless of the fate of the big tax bill currently in Congress, does our Roundup plaintiff have a tax problem if a verdict with punitive damages or interest is paid in 2025? Many tax advisers say yes, there's a big problem, but I see a light at the end of the tunnel. That is, in my example, the plaintiff gets to keep \$24 million of the punitive damages, but should report the whole \$40 million as gross income. After all, the U.S. Supreme Court has ruled that in a contingent fee case, the plaintiff is treated as receiving 100% of the proceeds for tax purposes, and then paying their counsel.

But gross income is not the same thing as taxable income, and that's why tax deductions for legal fees are so important. Between the compensatory and punitive damages, the plaintiff will collect \$30 million, but has a gross income of \$40 million. Fortunately, there are workarounds for plaintiffs despite the current tax law. In my view, a defensible tax path often exists in the form of a deduction for legal fees. Plainly, this is not an employment or whistleblower case, but I believe it is defensible to characterize it as a civil rights case, given some IRS authorities that give this term a very broad interpretation, far beyond section 1983 and its ilk.

It would be an overstatement to say that there is 100% certainty on this point. However, I have written many tax opinions in support of a broad view of civil rights for purposes of legal fee deductions. And so far, my IRS audit experience on this issue has been positive, too. To be sure, it would be best if the tax law were amended to make it 100% clear that no plaintiff should have to fear paying taxes on the portions of a settlement or judgment that is paid to their lawyer and does not end up in their pocket.

However, until the tax law is clarified, there is often a viable avenue to avoid the topsy-turvy result of a plaintiff paying taxes on more money than they net out of a case. Be careful out there.

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