Forbes

Robert W. Wood

THE TAX LAWYER

TAXES 07/15/21

Kardashians Win $13.5M Beauty Lawsuit, IRS Collects Taxes

The Kardashians are becoming wealthier still. Sisters Kourtney, Kim and Khloe Kardashian won their suit for royalties from the makeup line Kardashian Beauty. After a five-year legal battle, a California State Appeals Court judge agreed that the Kardashians were owed $11.5 million in royalties from Haven Beauty and subsidiary Hillair Capital, who had licensed the beauty line that included various beauty items sold in stores. The award adds $2 million in post-judgment interest and costs. The Kardashians were owed a $1 million advance plus ongoing fees, but when they were shorted millions they sued. The trial court ruled for the Kardashians in 2018, and the Appeals court upheld it. The IRS will collect a share, and that share will be sizable. This was a royalty dispute, and royalties are taxed as ordinary income. In contrast, a sale of intellectual property can sometimes be entitled to more favorable capital gain rates. Under current rates, capital gain tops out a 23.8%, while ordinary income taxes are 37%. Both ordinary income tax rates and capital gain are slated to go up under President Biden's proposals. In fact, Biden would retroactively double capital gain tax. Paying up to 43.4% in capital gain tax sounds crushing.

Most legal settlements are taxed, but the treatment varies depending on how you were damaged, how the case was resolved, how checks and IRS Forms 1099 were issued and more. Suits for the infringement of patents or other intellectual property usually ask for lost royalties, a stream of payments that the holder would have collected but for the infringement. Most people are likely to say that a stream of royalties is taxed as ordinary income. Amazing, though, some patent infringement damages can be taxed as capital gain. Although capital gain usually means selling something, it is sometimes possible for inventors to treat patent litigation settlement proceeds as capital gain. It's just one of many of the quirky tax rules surrounding how lawsuit recoveries are taxed. Whether you settle or win a judgment, taxes apply in most cases. You can influence how your recovery is taxed by how you deal with these issues, and jockeying at lawsuit settlement time is common.

Fortunately, if you sue for personal physical injuries like a slip and fall or car accident, compensatory damages should be tax-free even if you were seeking lost wages because you couldn't work after your injuries. Section 104 of the tax code shields compensatory damages for personal physical injuries and physical sickness. However, your injury must be "physical," and it's not clear exactly what that means. The tax law draws a distinction between money for physical symptoms of emotional distress (like headaches and stomachaches) and physical injuries or sickness. The issue come up in employment cases where plaintiffs claim their employer made their medical condition worse or gave them PTSD. The tax law is uncertain, but one can argue that PTSD itself is a physical sickness. An agreement between plaintiff and defendant is not binding on the IRS, but what the parties say in the agreement is often followed in an audit. Thus, it is wise to try to get agreement with the defendant about the tax issues. A key issue is tax reporting. If you don't say anything about taxes in a settlement agreement, you will almost variably receive IRS Form W-2 or Form 1099.

The tax treatment of legal fees can be particularly alarming. In most cases, a Form 1099 will say you got 100% of the money, even if 40% went directly to your lawyer. Since 2018, many legal fees can no longer be deducted, so plaintiffs can be taxed on 100% with no tax deduction for their legal fees. The math came be bizarre, as where taxes slash a $2 billion Roundup weedkiller verdict. 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, watch out. 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, and you may not be able to deduct the $40,000 at all. That's why many clients say they are paying tax on money (the lawyer's fees) they never received. It can leave you scrounging for ways to deduct legal fees even under the new tax law.

But if your case involves claims against your employer or for other defined forms of unlawful discrimination, there's an "above the line" deduction for legal fees. But outside of employment or other unlawful discrimination litigation, watch out. There are sometimes ways of circumventing these rules, but you'll need sophisticated tax help before your case settles to do it.

Check out my website.