Forbes

Robert W. Wood

THE TAX LAWYER

TAXES 11/18/2015

Man Gets $21.5M Verdict For Door Injury, But IRS Is Biggest Winner

When you think of a sliding-glass door accident, you probably think of walking into one. But some doors are automatic, like the doors at some stores. Some cruise ships have them too, keeping the cool air inside and the hot tropical air outside. And if the settings are too fast, you might get hit.

That's what happened to James R. Hausman of Springfield, Illinois, who suffered a minor brain injury when he was struck in the head by a door on a Holland America cruise. After being injured, he was awarded $21.5 million by a jury. It is one of the largest verdicts in a Washington State federal court according to the Seattle Times. Mr. Hausman was able to finish out his 280-day world cruise, but his brain injury left him prone to vertigo and small seizures. Holland America accused Mr. Hausman of carelessly "walking into" the door and claimed that the incident was anomalous. The company has already filed an appeal, but there are other documented cases of sliding-glass door injuries.

Holland America Line's new 99,500-ton cruise ship, ms Koningsdam, is slated for delivery in February 2016. The 2,650-passenger ship is the largest ever built for the premium line. (Photo credit: PRNewsFoto/Holland America Line)

In fact, $16.5 million of the verdict was for punitive damages. That means the IRS will win big, even though recoveries for personal physical injuries and physical sickness are tax-free. Before 1996, all "personal" damages were tax-free, so emotional distress, defamation, etc. also produced tax-free recoveries.

But since 1996, your injury must be "physical." Taxpayers routinely argue in U.S. Tax Court that their damages are sufficiently physical to be tax-free; the IRS usually wins these cases, but not always.

Symptoms of emotional distress are not "physical." Money you receive for physical symptoms of emotional distress (like headaches and stomachaches) is taxed, while physical injuries or sickness is not. Of course, many legal disputes involve multiple issues, so there's a good chance the total settlement may involve several types of consideration. It is almost always best for plaintiff and defendant to try to agree on what is being paid and its tax treatment. Such agreements aren't binding on the IRS or the courts in later tax disputes, but they are rarely ignored.

Punitive damages and interest are always taxable. If you are injured in a car crash and get $50,000 in compensatory damages and $5 million in punitive damages, the former is tax-free. The $5 million is fully taxable, and you can have trouble deducting your attorney fees! Whether you pay your attorney hourly or on a contingent fee basis, factor in the cost of your attorney when you're addressing taxes. If you are the plaintiff and use a contingent fee lawyer, you'll usually be treated (for tax purposes) as receiving 100% of the money recovered by you and your attorney, even if the defendant pays your lawyer directly his 30% to 40% contingent fee cut.

If your case is fully nontaxable (say an auto accident in which you're injured), that should not cause tax problems. But if your recovery is taxable, watch out. With a $21.5 million recovery and $16.5 million being punitive, the IRS will get the biggest share of the award. And lawyers' fees are likely to take a cut and be hard to deduct. The legal fees are usually subject to numerous limitations, including the alternative minimum tax or AMT.

In that sense, settling–and hopefully avoiding the taint of punitive damages–can pay off. With any legal dispute, don't just let the tax chips fall where they may. Before you resolve the case, consider the tax aspects. You'll almost always have to consider them at tax return time the next year. You'll be better off considering taxes earlier, and may save yourself serious money.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not intended as legal advice.