Forbes

Robert W. Wood
THE TAX LAWYER

TAXES 12/18/23

Rudy Giuliani Can Write Off $148 Million Verdict While Plaintiffs Pay Tax On 100%

Rudy Giuliani was ordered to pay nearly $150 million in damages for defamation to former Georgia election workers Ruby Freeman and Shaye Moss. Guiliani says he will appeal, and even if he loses the appeal, collecting from him may be tough. The verdict is big by any standards: $16.171 million to Freeman for defamation, $16.998 million to Moss for defamation, $20 million to each for emotional distress, and $75 million total in punitive damages. The punitive damage portion of the verdict is the most likely to be attacked.

But if Giuliani ever pays, many Americans might be surprised at the tax rules at play. Was Giuliani engaged in his business of being a lawyer for former President Trump at the time, or acting in some other business pursuit? Maybe, and that suggests he may have a good chance of viewing a verdict or settlement he might pay to the election workers as business expenses. In contrast, the plaintiffs have to pay tax on all of it, maybe even the funds going to their lawyers.

Does that mismatch seem fair? All punitive damages are taxable ordinary income, even for death or serious injury. That is why even Roundup Weed Killer cancer victims can face IRS taxes when they sue. The IRS even taxes fire victims. Even worse, there is a tax on litigation settlements, with no deduction for legal fees in some cases.

Amazingly, many legal fees can't be deducted, so plaintiffs may pay tax on monies their attorney collects, even though the attorney must *also* pay tax on the same money. If you are a plaintiff with a contingent fee lawyer, the IRS treats you as receiving 100% of the money, even if the defendant pays your lawyer *directly*. Plaintiffs have to get creative to deduct their legal fees under a 2018 tax law just to get back to even.

Why are the plaintiffs taxable here even on the compensatory damages? Their suit against Giuliani was a defamation case, where the injuries are in the nature of emotional distress, not physical injuries. It sounds like hair-splitting, but recoveries for physical injuries and physical sickness are tax-free, but symptoms of emotional distress are taxed. Since 1996, the tax code says your injury must be "physical" to be tax free. If you sue for intentional infliction of emotional distress, your recovery is taxed, and even physical symptoms of emotional distress (like headaches and stomachaches) are taxed.

The rules can make some tax cases involve chicken or egg issues, with many judgment calls. Many plaintiffs take aggressive positions on their tax returns, but that can be a losing battle if the defendant issues an IRS Form 1099 for the entire settlement. Haggling over tax details before you sign and settle is best.

How about Giuliani's tax write off? How damages are taxed is a complex subject, but business expenses are less so. Even President John F. Kennedy said, "The slogan — 'It's deductible' — should pass from our scene." JFK made the comment in 1961 about expense accounts and business entertainment, but it has broader application and still seems relevant more than 60 years later. Compensatory settlements by businesses are clearly deductible, and even *punitive* damages are too. That surprises most people.

Tax bills have been introduced in Congress over the years to make punitive damages, but the bills never gained traction. Sometimes, even amounts paid to the government are deductible, despite corporate wrongdoing. For decades, Section 162(f) of the tax code prohibited deducting any fine or similar penalty paid to a government for the violation of any law. That includes criminal and civil penalties, as well as sums paid to settle potential liability for a fine.

This sounds absolute, but the law is riddled with exceptions. To begin with, the rules cover only government payments, and some companies find ways to write off even the biggest payments. For example, BP probably wrote off a majority of its $20.8 billion out-of-court settlement for the Gulf of Mexico oil spill. The deal designated only about one quarter, $5.5 billion, as a non-tax-deductible Clean Water Act penalty.

Congress has pushed back on such practices. In 2017, the tax rules were tightened, but even under the new ones, it is permissible to write off certain payments of restitution or amounts paid to come into compliance with law. Some settlement agreements contain an explicit no-deduction provision. For example, when Tesla and Elon Musk settled with the SEC for $20 million each, a court filing said Tesla expressly agreed not to claim a tax deduction for its $20 million. Had it not been for that agreement, the tax write-offs don't seem to have been prohibited. After all, the SEC said the $40 million in penalties will be distributed to harmed investors under a court-approved process, and that sounds like restitution.

If Giuliani pays, there's a good chance he gets a fat tax deduction, and the election worker plaintiffs have taxable income. Whether Giuliani has income to offset the payments is another question.

Check out my website.