PERSPECTIVE

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Tax Issues in Cases Settling on Appeal

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Under Section 104 of the tax code, compensatory damages for personal physical injuries or physical sickness are free of tax. For generations, "personal injuries" were enough for an exclusion, but since 1996, the injury must be "physical." Lawyers and clients in serious physical injury and wrongful death cases are used to counting on the section 104 exclusion. However, interest and punitive damages are always fully taxable, even in cases of wrongful death or serious bodily injury.

The tax rules can be surprising once a case goes to verdict. The elation over a big verdict can soon give way to worry about taxes, particularly where punitive damages and interest eclipse the size of an award for compensatory damages. In cases that settle before trial, there is generally little danger that the IRS or the state will try to import punitive damage or interest characterization to settlement proceeds in a physical injury or wrongful death case.

That is, in a case that is settling before trial, the fact that you are *asking* for punitive damages in your complaint should not morph some of your pretrial settlement proceeds into punitive damages. But what about cases that settle *after* a verdict in which punitive damages are awarded, or on which interest is running? It should be no surprise that the IRS and state tax authorities generally want to tax these amounts.
As a result, a plaintiff settling a case post-verdict is likely to need tax advice. Despite the rule that interest and punitive damages are taxable, there are often avenues to reduce or perhaps even eliminate the taxes. But as we will see, a great deal can depend on the verdict itself, what is being appealed, the amount of the settlement in relation to the verdict, and how the settlement agreement is written.

Language and Comprises on Appeal

In a case settling after a verdict with punitive damages and interest, can you steer settlement money away from punitive damages and interest? Can you just say that the parties agree that all damages being paid are compensatory, and that no punitive damages or interest are being paid? You can include such a provision in the settlement agreement if the defendant agrees, but would the IRS buy it?

Much depends on the verdict, the appeal, and the settlement agreement. Consider this example:

Example 1: Tom is seriously injured and sues an automobile manufacturer. He receives a jury verdict for $1 million in compensatory damages and $3 million in punitive damages. The manufacturer appeals, and after sparring in the appellate court but in advance of a final decision, Tom and the manufacturer settle for $2 million. How should the $2 million be treated?

Tom only received $1 million in compensatory damages according to the verdict, so is the other $1 million punitive damages? Tax consequences aside, the defendant will likely contend that it did no wrong, and that no punitive damages are payable. The defendant may have public relations concerns, insurance law restrictions, shareholder relations problems, and other reasons to take this position.

The IRS, in contrast, is likely to argue that the extra million dollars is punitive, even if the settlement agreement negates punitive status. But what if on appeal, Tom argued that he *should* have been awarded additional compensatory damages beyond the $1 million verdict? Tom's tax arguments for excluding a larger amount would improve materially if he had cross-appealed for additional compensatory damages, and if he succeeds with good settlement agreement wording.

Frequently, the plaintiff does not ask for additional compensatory damages on appeal. The plaintiff may instead be defending the punitive damage award that defendants hope to reduce or eliminate. In that sense, Tom's $1 million in compensatory damages may seem like an outer limit for tax free damages when the case settles on appeal. Suppose that Tom settles on appeal for only $750,000? Here, Tom can persuasively argue that it should all be tax-free, for it is less than the $1 million verdict.

In an audit, the IRS might try to *pro rate* the settlement, treating a portion as attributable to punitive damages. 75% of the jury verdict was for punitive damages, so the IRS could argue that 75% of Tom's settlement of $750,000, or $562,500, is taxable. But with decent wording in the settlement agreement, it should not be difficult to support Tom in treating his $750,000 settlement as tax-free.

As this example shows, the verdict amounts, the issues on appeal and the settlement agreement wording are all important. The example above involves punitive damages, but the issues are equally important with interest. There are numerous tax cases where a plaintiff is receiving damages for compensatory personal physical injuries post-verdict, in which there is pre-trial or post-trial interest. Consider the following:

Example 2: Sallie is seriously injured in a slip and fall case and sues the business where her accident occurred. She receives a jury verdict for $1 million in compensatory damages, and the defendant appeals. The verdict is affirmed, and under state law, Sallie is entitled to pre and/or post judgment interest that is running at a high interest rate. For tax purposes, pre-judgment and post judgment interest are treated the same, both are fully taxable.

If the interest is $1 million but Sallie settles for $1.5 million, is it clear that the extra $500,000 is interest? Again, the parties could agree that all the amounts are for physical injuries, and that may help Sallie. It would also help if she has cross appealed for additional compensatory damages, or if she alleged other post-verdict physical injuries or damages on top of the $1 million verdict. Finally, it would help if the parties compromised the interest and expressly stated the amount of the interest payment.

There are many tax cases in which the IRS is successful in striking down a "no interest" provision as ineffective for tax purpose, especially when it is clear on the facts that the settlement amount adds up to the compensatory verdict plus the statutory interest. On the other hand, there are tax cases in which plaintiffs have won their tax case against the IRS if the settlement agreement reflects a *compromised* interest amount. It is no surprise that plaintiffs would always rather compromise on taxable amounts like interest and punitive damages than compromising on compensatory damages.

Example 3: Jim is badly insured by a medical device, sues the manufacturer, and is awarded compensatory damages at trial of $5 million. He has also asked for $25 million in punitive damages, but before the jury considers punitive damages, Jim and the manufacturer settle for $10 million. How is Jim taxed?

There has been no punitive verdict yet, so Jim should be able to argue that the entire $10 million should be compensatory. There has not been time to appeal yet, and Jim and his lawyer may say that on appeal, they would have been asking for *additional* compensatory damages. Settlement agreement wording would be helpful. Of course, it is always possible for the IRS to disagree in an audit and to argue that the amount over $5 million should be viewed as punitive in nature. But this is an easier case than the prior examples.

Example 4: Sarah is injured in the operating room, and she sues her doctor and the hospital. She receives a compensatory verdict of $3 million, and a punitive verdict of $10 million, plus statutory interest that amounts to another 4 million. Everything is upheld on appeal, and efforts to settle the case fail. The defendants pay the verdict, and Sarah needs to attend to her tax responsibilities. Does she have any tax arguments to say that the $14 million of punitive damages and interest are not taxable? Unfortunately, when a verdict is paid, you are stuck with the amounts and the character of those amounts. That is one reason that settling is always better from a tax perspective.

<u>Treatment of Attorney Fees</u>

In Sarah's case, or indeed in any case where punitive damages or interest are awarded, the most surprising element for plaintiffs and their lawyers is how attorneys' fees are treated. It is easiest to see the issues when a judgment is being paid, and the amounts are set in concrete. However, the same issues can arise with settlements.

As discussed, settlement agreement language and compromises can reduce the tax bite of punitive damages and interest. However, whether the case settles or the defendant decides to pay the judgment, how legal fees are treated on each part of the case will play a part. Under a U.S. Supreme Court tax case decided in 2005, *Commissioner v. Banks*, 543 U.S. 426 (2005), if you are a plaintiff with a contingent fee lawyer, the IRS will treat you as receiving 100% of the money, even if the defendant pays your lawyer directly.

Understandably, many plaintiffs assume that the *most* they can ever be taxed on is the net amount that their lawyer sends them. Most plaintiff lawyers receive all settlement or judgment proceeds, subtract their fees and costs, and send the balance to their client. But under the *Banks* case (and related IRS Form 1099 rules which follow *Banks*), the IRS sees this as a 100% payment to the client, who then pays their lawyer.

This tax rule applies to every kind of case, employment, personal injury, property damage, you name it. If your case is fully taxable, say a former employee suing for back wages, that means that 100% of the settlement is gross income to the plaintiff, even though his lawyer may take 40%. This extra gross income causes no problems in such a case, because there is a statutory tax deduction for legal fees in employment, whistleblower and civil rights cases. A plaintiff is not hurt by the Supreme Court's *Banks* case because it is a wash, with the tax deduction fully offsetting the income on the lawyers' fees.

There are some requirements, most notably that the legal fees are only deductible against the settlement or judgment. In effect, this means that with hourly legal fees paid over several years, they would not qualify. There are sometimes ways to help that hourly plaintiff too, but it is not easy.

<u>Attorney Fees and Physical Injury Cases</u>

Do plaintiffs in personal physical injury cases need to worry about the tax treatment of legal fees? It depends. If your case is fully *nontaxable* because it is 100% compensatory damages for physical injuries, there is no tax problem. It does not matter if you consider 100% of the money paid to the plaintiff or 60%, since it is nontaxable. There's no need for the plaintiff to worry about a tax deduction for the legal fees. However, what if the case is a mixture of nontaxable (compensatory) and taxable (punitive damages and interest)?

Suppose that only 10% of a settlement or judgment is compensatory damages for personal physical injuries. 90% is punitive damages and interest. The compensatory damages should be tax free, but not the punitive damages or interest. The tricky part relates to how legal fees are taxed. The Supreme Court's *Banks* case says 100% of the funds belong to the plaintiff for tax purposes.

If the plaintiff can *deduct* the legal fees, that means the plaintiff is only paying tax on the *net* amount of punitive damages and interest. But does the fee deduction apply here? As mentioned, there is a tax deduction for employment, whistleblower and civil rights cases, and it has been in the tax law since 2004. More generally, for generations, with any case that produced taxable income, plaintiffs could deduct their legal fees as miscellaneous itemized deductions if they did not qualify for the better above-the-line tax deduction.

But under a tax code change that took effect in 2018, miscellaneous itemized deductions were *suspended* until January 1, 2026. And in the current One Big Beautiful Tax Bill being negotiated in Congress, it looks as if miscellaneous itemized deductions will permanently be repealed. That suggests that whether a case is resolving in 2025, 2026, or later, focusing on making sure that the plaintiff can deduct legal fees is appropriate. No plaintiff wants to pay taxes on money that they do not get to keep.

Example 5: Bill sues for a bad injury caused by a toxic produce that he alleges gave him cancer. Let's say he collects compensatory damages in the amount of $10 million and his lawyer takes 40%. That means Bill ends up with $6 million. Whether you view the total recovery as $10 million or $6 million doesn't matter tax-wise. 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. But Bill doesn't need to, since the whole thing should be nontaxable.

But what if punitive damages or interest are awarded in Bill's case? On top of $10 million in compensatory damages, suppose that he is awarded $40 million in punitive damages? Let's assume the same 40% legal fee. That means Bill nets $30 million, and his lawyer takes home $20 million.

For what is taxable, you must separate the two categories of damages. Bill's $10 million in compensatory damages is tax free. He collects $6 million, and his lawyer collects $4 million. For the punitive part, Bill will net $24 million after legal fees. Unless Bill can find a way to deduct his legal fees, although he only gets to keep $24 million of his punitive damages, he could be taxed on the entire $40 million.

In short, if a recovery is taxable, in whole or in part, the plaintiff can conceivably be taxed on more money than he collects, *unless* the plaintiff can claim a tax deduction for the legal fees. The path to a deduction is not entirely free of risk as it would be in an employment case. However, so far, despite the elimination of miscellaneous itemized deductions, I have generally been able to support a tax deduction for the legal fees.

This was true for many years before 2018 too. It was always preferable to claim the above-the-line deduction where possible, rather a miscellaneous itemized deduction that would face various haircuts and limits. The stakes have grown larger since 2018, but a preference for an above-the-line deduction for legal fees is nothing new. Notably, in addition to fee deductions in employment cases, the tax law still allows a deduction for legal fees in any case involving "civil rights."

That is a term that the IRS has interpreted expansively, and I believe it is broad enough for the legal claims in many kinds of cases. Some tax advisers may not share my opinion and may suggest various complex structures to try to avoid the client receiving gross income from the legal fees in the first place. However, I believe it is safer to follow the Supreme Court's *Banks* case, and to recognize that the *taxable* portions of the case proceeds *are* gross income to the plaintiff, including the pro rata share of the legal fees. Then, assuming it can be supported, the plaintiff claims a tax deduction for the legal fees. This deduction has been part of the tax law since 2004, I and I see large numbers of cases each year that claim it, with some each year that involve enormous figures. Most, the vast majority, are never audited. And so far, in the few audits that I have seen, they have gone smoothly.

Conclusion

Tax issues are worrisome to plaintiffs in myriad cases, and for good reason. There are especially good reasons for this when punitive damages or interest are involved. Plaintiffs who have been injured understandably want to minimize the amount of taxable damages. Tax language in settlement agreements, including addressing any Form 1099 issues, is arguably wise in any kind of settlement.

But it is especially needed in cases that are resolved after a verdict where interest or punitive damages complicates the analysis and may limit the options available. Perhaps most of all, no plaintiff wants to pay taxes on money that goes to attorney fees and costs rather than going into their pocket. Despite the hyperbole from some advisors, paying tax on fees and costs can usually be avoided. But precisely how one gets to that position varies, and it is best to get tax advice as cases are concluding rather than waiting until tax return time.

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