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Taxes On Lawsuit Settlements Are Tricky, Even More So After Verdict

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 and emotional distress is not enough. Lawyers and clients in physical injury and wrongful death cases count on this exclusion for how lawsuits are taxed. However, interest and punitive damages are always taxable, even in wrongful death or serious bodily injury cases. The tax rules can be especially surprising once a case goes to verdict where punitive damages and interest are awarded.

Compromise 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.

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? The IRS 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 $1M verdict?

In an audit, the IRS could *pro rate* the settlement. 75% of the 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, Tom could say his $750,000 settlement should be tax-free.

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.

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.

When a verdict is paid, the amounts and character of the items in the verdict may limit your choices. And from a tax viewpoint, settling may be worth considering.

Tax on Attorney Fees

The most surprising thing for plaintiffs may be how legal fees are treated. Under a U.S. Supreme Court tax case, *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. 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.

Attorney Fees in Physical Injury Cases

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 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 plaintiff needs to *deduct* the legal fees, so only the *net* amount of punitive damages and interest are taxed. But does the fee deduction apply here?

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 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. The path to a deduction is not entirely free of risk as it would be in an employment case. However, I believe a tax deduction for the legal fees can usually be supported. Even before 2018 it was preferable to claim the above-the-line deduction rather a miscellaneous itemized deduction that would face various limits. The stakes are larger since 2018, but a preference for an above-the-line deduction for legal fees is nothing new.

The tax law still allows an above the line deduction for legal fees in any case involving “civil rights.” The IRS has interpreted this term expansively, so that it cuts taxes on settlements for many kinds of cases. Some tax advisers suggest complex structures to attempt to avoid the client receiving gross income from the legal fees in the first place. However, it is safer to follow the Supreme Court’s *Banks* case and to recognize that the *taxable* portions of the case *are* gross income to the plaintiff, including the 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. The few audits I have seen have gone smoothly.

Tax issues are worrisome to plaintiffs in myriad cases, and there are especially good reasons for this when punitive damages or interest are involved. Even so, paying tax on legal 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.