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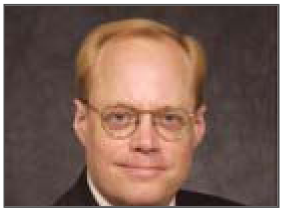

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THE TAX LAWYER

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Woman Billed $1,000 For Credit Card Error Gets $83 Million Verdict, But IRS Gets Last Laugh

Juries sometimes do strange things, and one in Missouri has ordered a company that buys up consumer debts to pay an astounding $83 million to Maria Guadalupe Mejia of Kansas City. Why, you may ask? The jury said the credit company *wrongly* tried to collect an erroneous $1,000 credit card bill. Credit.com has an extensive story about this shocker, the woman who sues a debt collector, and then wins $83 million. KCUR reported the verdict and the jury finding that the defendant–Portfolio Recovery Associates LLC–was guilty of violating the Fair Debt Collection Practices Act.

That law contains many safeguards for borrowers. With the small $1,000 disputed debt, as you might imagine, most of the verdict was for allegedly bad conduct, The verdict called for $250,000 in damages plus a few dollars shy of $83 million in punitive damages. The verdict calls it malicious prosecution, the debt not being hers to begin with.

PRA Group Inc., which owns Portfolio Recovery Associates, sent an email statement to Credit.com: "This outlandish verdict defies all common sense," wrote spokesman Michael McKeon. "We hope and expect the judge will set aside this inappropriate award, and we plan to file motions to make that request formally in the near term. Any fair reading of the facts of this case makes plain that a verdict of this size is not justice by any means, and cannot stand."

Cash (Photo credit: bfishadow)

Whose $1,000 card debt was it? The real debtor was a man in Kansas City, Kansas, who had a similar name. Debt collection suits have become common, and some aggrieved parties strike back. You might think that if a lawsuit succeeds, you will be on easy street. Not always. In fact, since punitive damages are always income, this woman could end up paying huge taxes, even on her attorneys' fees. Start with the rule that settlements and judgments are taxed based on the origin of your claim. So, if you're suing for lost profits, a settlement is lost profits, taxed as ordinary income. Punitive damages and interest are always taxed regardless of the type of case.

But the biggest exclusion from income is for personal physical injury recoveries. In that case, your damages are tax-free. Conversely, damages for emotional distress are taxed unless the emotional distress is *triggered* by the physical injury. Clearly, that's confusing. The IRS and courts frequently have to address the point, since exactly what constitutes personal physical injuries or sickness isn't defined. The IRS normally wants to see "observable bodily harm" such as bruises or broken bones before it excludes damages from income.

If the case arises out of employment, the IRS knee-jerk reaction is that recoveries are wage loss or otherwise taxable. However, an employee suit may be partially tax-free if the employee has physical sickness from working conditions. Many tax disputes involve employment cases, where stress or work injuries may be cause physical injuries or physical sickness.

And if there is related emotional distress, those damages should be tax-free as well. Thus, in one case, stress at work produced a heart attack. In another, stressful conditions exacerbated the worker's pre-existing multiple sclerosis. The Tax Court in both cases sided with the plaintiff, calling them tax-free physical sickness recoveries.

If you can, get tax advice *before* your settlement agreement is drafted and signed. The IRS isn't bound by the parties' tax characterization, but the IRS will frequently respect it if it is reasonable. Allocations between categories of damages, with the tax treatment of each part specified in the settlement agreement, can make your taxes simpler and more certain.

The tax treatment of lawyers' fees is confusing and leads to tax traps. If a contingent fee lawyer is to receive 40%, the IRS treats the *client* as receiving 100% and *then* paying the lawyer. If the case is an employment dispute, involves your trade or business, or is 100% for physical injuries, you won't pay tax on the legal fees.

In most other cases, though, you will probably have to include the legal fees in your income, and then try to deduct them. That would apply to the debt collection suit and the punitive damages. For many people, the attorney fees can only be claimed as a miscellaneous itemized deduction. And that means you lose part of your deduction and face Alternative Minimum Tax treatment. It is even possible for you to *lose* money by winning a suit once you pay your taxes.

Whatever you do, don't wait until tax return time to consider these issues. Get some advice *before* you settle. A little planning and some tax language in your settlement agreement can make a big difference.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.