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IRS Loses (A Little) on Taxation of Damages

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The taxation of damages is a nightmare for taxpayers.

The law is slanted in favor of both taxing the taxpayer on all recoveries and preventing the taxpayer from deducting the legal fees incurred in recovering the damages. Assume Joe recovers $100,000 of damages, of which $40,000 goes to the lawyer who handled the matter on a contingency basis. If Joe is in a combined 40 percent state and federal tax bracket, he pockets $100,000 minus $40,000 in taxes, minus $40,000 in legal fees equals $20,000. So, in terms of recovery, Joe ranks third behind the government and his lawyer.

It gets worse if Joe wins his case after an appeal. The legal fees can be 70 percent or more, in which case Joe the taxpayer will be in the following position: $100,000 minus $40,000 in taxes minus $70,000 in legal fees meaning Joe has to dig into his pocket for $10,000. And it gets worse if Joe the taxpayer is liable for costs. Is it surprising that Joe is in favor of tort reform?

The nature of the damages is based on the origin of the claim, according to ***United States v. Gilmore***, 372 U.S. 39 (1963). The best evidence is the judgment issued by the court. However, 99 percent of all lawsuits are settled, as a result of which the best item of evidence is the settlement agreement.

Unsurprisingly, virtually all settlement agreements are not written with a tax professional's help and do not specify how the damages are to be characterized for tax purposes. In that case, the court—if the dispute about the taxation of the damages goes to trial—tries to determine the payor's intent.

In ***Simpson v. Commissioner***, 141 T.C. No. 10 (October 28, 2010), Ms. Simpson made four claims against Sears, including employment discrimination. The court dismissed the first three claims. However, the parties agreed on the payment of $12,500 for lost wages; $98,000 for "emotional distress, physical and mental disability"; and $152,000 in legal fees and costs. Although the Internal Revenue Service generally prevailed in this case, Tax Court Judge Laro offered the taxpayer two small bones (which were certainly not worth the cost of trying the case in Tax Court).

On her tax return Ms. Simpson paid tax on the $12,500 but excluded the $250,000, even though it was reported by Sears on a 1099-MISC. To support her claim that the $250,000 was not taxable, Ms. Simpson's lawyer (who was not a tax lawyer) wrote, "The settlement was entirely based upon the claim that Ms. Simpson became ill due to work, became disabled due to the severity of that illness, and Ms. Simpson should have been accommodated by being provided Workers' Compensation or Short Term Disability Leave, but was not. It is our understanding that a lawsuit settlement based on illness and disability from work are non-taxable settlement proceeds to the injured taxpayer."

Tax Court Judge Laro had little problem finding both the taxpayer and her counsel to be credible in testifying that "the settlement agreement was made to settle her...workers' compensation claims....and that a portion of the settlement was made to compensate her for work-related personal physical injuries and sickness." However, the parties' intent did not automatically result in exclusion from tax under Internal Revenue Code Section 104(a)(1): "Section 104. Compensation for injuries of sickness. (a) In General. Except in the case of amounts attributable to (and not in excess of) deductions allowed under §213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include – (1) amount received under workmen's compensation acts as compensation for personal injuries or sickness...." Ms. Simpson and her lawyer failed to submit the settlement agreement to the California Workers' Compensation Appeals Board for the approval required under California law. As a result, the payments did not qualify for the exclusion from income.

However, Ms. Simpson also claimed that "10% to 20% of the $98,000 received under the settlement agreement is excludible under §104(a)(2) as an amount received `on account of personal physical injuries or physical sickness.'"

Section 104(a) excludes from gross income "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums, or as periodic payments) on account of personal physical injuries or physical sickness...." In a pleasant surprise for the taxpayer, the court held that 10 percent of the $98,000 workers' compensation award, though ineligible for exclusion under §104(a)(1), was eligible for exclusion as compensation for personal physical injuries and sickness.

Finally, the legal fees were generally deductible under Internal Revenue Code §62(a)(20), which allows an above-the-line deduction for attorney's fees and court costs paid by, or on behalf of, a taxpayer in connection with any action involving an unlawful discrimination claim. See also §62(e), defining "unlawful discrimination." However, the IRS refused to allow a deduction for the $38,014.40 that Ms. Simpson's lawyer said were used to reimburse her for court costs. Judge Laro accepted the lawyer's testimony as credible and ruled against the IRS.

Some estimates suggest that the number of lawsuits filed each year in the U.S. is as high as 16 million. The taxation of damages is a difficult area. The collision of the two—a massive amount of lawsuits and a tricky area of the law—suggests that all tax advisors must become conversant with the rules and be on the lookout for the situations in which the problems arise. As Ms. Simpson learned, trying a case in Tax Court is not a profitable way to work out the taxation of damages.

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