

Planning for Taxes on Personal Injury Judgments

Dentons Federal Tax Controversy Insights

Grow | Protect | Operate | Finance

KEY CONTACTS

Stephanie Bruns
Collier Clay
Helen Cooper
Mark Loyd
Lucy McAfee

Taxes almost always come into play in personal injury cases for all parties, including their attorneys. Even significant tax issues may be overlooked.

Plaintiffs, defendants and their attorneys can benefit from considering tax implications, especially at the outset of a claim and, of course, when settling claims.

After collecting a judgment, plaintiffs may be surprised to learn they have an associated tax bill. Defendants may wonder if their settlement payments are deductible. Even the attorneys themselves may wonder how different fee arrangements can impact their own federal income tax obligations.

Planning claims, settlements, judgments and financing arrangements can help minimize potential tax liability.

Judgments and settlements

Whether a personal injury dispute ends with a judgment or settlement, all or some of the awarded damages may be excludable from a plaintiff's income under Section 104(a) of the Internal Revenue Code of 1986, as amended.

Likewise, a defendant may be entitled to deductions for making such payments under Code Sections 162 and 212. For both parties, the tax treatment of money or property received or paid pursuant to the resolution of a dispute is the same regardless of whether the dispute is resolved through a judgment or a settlement. The appropriate tax treatment is determined by the origin and nature of the claim.

Origin of the claim: The tax treatment of a recovery or payment from a settlement or judgment is generally determined based on the origin of the claim. The treatment follows the origin and nature of the underlying claim rather than

the “potential consequences upon the fortunes of the taxpayer.” *United States v. Gilmore*, 372 U.S. 39, 50 (1963). So, whether the settlement payment is excludible from gross income, deductible as a business expense, ordinary or capital, is determined by the plaintiff’s original claim.

The IRS considers the complaint to be the most important document to establish the tax consequences of a recovery. See Rev. Rul. 85-98. However, language in a settlement agreement can offer probative evidence on the appropriate tax treatment. See *Bradley v. Comm’r*, 90 T.C.M. (CCH) 317 (2005) (citing *Bent v. Comm’r*, 87 T.C. 236, 246 (1986), *aff’d*, 835 F.2d 67 (3d Cir.1987)).

“Generally, the IRS will not disturb an allocation if it is consistent with the substance of the settled claims.” IRS Publication 4345 (Rev. 9-2023) (available at <https://www.irs.gov/pub/irs-pdf/p4345.pdf>). But, the IRS is not bound by the parties’ allocations if the facts and circumstances indicate otherwise. See *Bagley v. Comm’r*, 105 T.C. 396 (1995), *aff’d*, 121 F.3d 393 (8th Cir. 1997).

Exclusions: Damages received as a result of a settlement or judgment are generally taxable to the recipient. For personal injury plaintiffs, damages received are excludible from gross income if the personal injury or sickness is physical. IRC § 104(a)(2). However, no exclusion is permitted “to the extent that such amounts are attributable to (but not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year.” Treas. Reg. § 1.104-1(a). In other words, a plaintiff cannot “double dip” by deducting their medical expenses and excluding payments attributable to such expenses.

Emotional distress is not considered a physical injury or physical sickness, so any damages received for emotional distress are not excludable, except in specific instances. Treas. Reg. § 1.104-1(c)(1).

However, damages for emotional distress attributable to a physical injury or physical sickness are excludable. *Id.* The origin and nature of an emotional distress claim determines whether it is actually based in a physical injury or physical sickness. But even if the taxpayer “suffered from certain physical manifestations of emotional distress,” the damages are not excludable where the taxpayer’s “physical injuries themselves were not the reason for the award.” *Murphy v. I.R.S.*, 493 F.3d 170, 176 (D.C. Cir. 2007).

Deductions: Payments and expenses made or incurred in personal injury claims may be deductible if they are business expenses, rather than personal expenses. Ordinary and necessary expenses paid or incurred in carrying on a trade or business, or for the production or collection of income, are deductible under Section 162(a) and Section 212(1), respectively. But, Section 262(a) disallows a deduction for personal expenses.

The origin and nature of the expense determines whether it is deductible as a trade or business expense as opposed to a nondeductible personal expense. *Tarakci v. Comm’r*, 80 T.C.M. (CCH) 727 (2000). Legal expenses are deductible if the claim arises in connection with the taxpayer’s profit-seeking activities. See *Gilmore*, 372 U.S. at 48-49.

This determination requires reference to the nature of the plaintiff’s underlying claim. If the claim relates to the conduct of the defendant’s business, the settlement is deductible as a business expense. See *Maxwell v. Comm’r*, 95 T.C. 107 (1990) (damages paid by employer to employee who was injured on job).

Litigation financing arrangements

A common tax issue with litigation financing arrangements is whether the financing represents loans or advances of payments. Loans are not includible in gross income, but payments for legal services are taxable. In *Novoselsky v. Comm’r*, 119 T.C.M. (CCH) 1474 (2020), the taxpayer practiced as an attorney and was able to secure litigation financing agreements for clients in some of his cases.

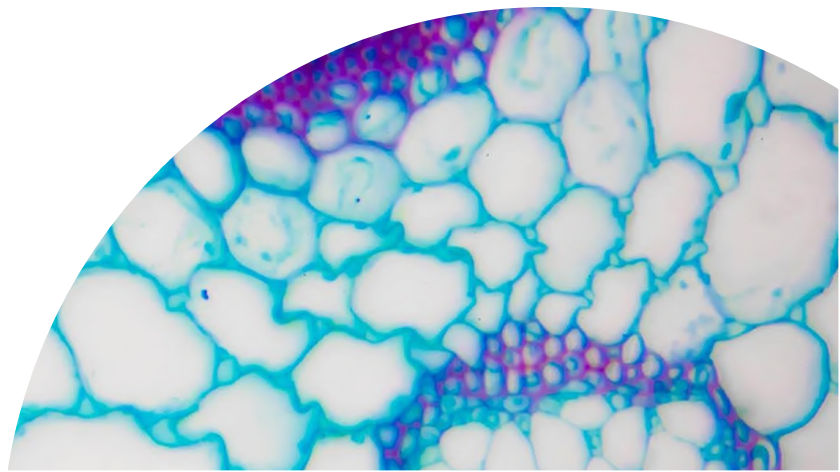
These agreements provided for support payments in advance of litigation that had to be repaid if the litigation was successful, but not if the case was unsuccessful. The U.S. Tax Court explained that for debt to be

respected, the debtor must have an unconditional obligation to pay the creditor. The court noted that it has consistently held that debt does not exist where an obligation to pay arises only upon the occurrence of a future event. The court found that the advances were not debt because the taxpayer had no obligation to repay unless the relevant litigation was successful. As such, the advances were includible in the attorney's [income](#).

Conclusion

“(W)hen a taxpayer has failed to arrange his affairs so as to minimize his taxes, he cannot expect the court to do it for him nunc pro tunc.” *Markham & Brown, Inc. v. United States*, 648 F.2d 1043, 1046 (5th Cir. 1981) (quoting *Balthrope v. Comm’r*, 356 F.2d 28, 34 (5th Cir. 1966)).

Significant tax implications can arise for plaintiffs, defendants and attorneys in personal injury cases. Litigators can bring additional value to their clients, and themselves, by considering these implications as soon as possible and ensuring that taxes are considered in settlements, judgments (if possible) and financing arrangements.



FEDERAL TAX CONTROVERSY TEAM

Alabama



Michelle Abrams Levin

Shareholder
Huntsville
michelle.levin@dentons.com



Ronald Levitt

Shareholder
Birmingham
ronald.levitt@dentons.com



Matthew A. Mantle

Shareholder
Birmingham
matthew.mantle@dentons.com



Gregory Rhodes

Shareholder
Birmingham
gregory.rhodes@dentons.com



Logan Chaney Abernathy

Senior Managing Associate
Huntsville
logan.abernathy@dentons.com



Sarah Green

Senior Managing Associate
Huntsville
sarah.green@dentons.com



Sidney W. Jackson, IV

Senior Managing Associate
Birmingham
sidney.jackson@dentons.com



Kristin Martin Centeno

Managing Associate
Birmingham
kristin.martin@dentons.com



Emily C. Ellis

Associate
Birmingham
emily.ellis@dentons.com



Olla Jaraysi*

Associate
Birmingham
olla.jaraysi@dentons.com
Licensed only in Illinois*



Benjamin Strong

Associate
Huntsville
benjamin.strong@dentons.com



Carneil Wilson

Associate
Huntsville
carneil.wilson@dentons.com



Ryder Winborn

Associate
Huntsville
ryder.winborn@dentons.com



Sarah Ray

Of Counsel
Huntsville
sarah.ray@dentons.com

Indiana



Stephanie Bruns

Of Counsel
Indianapolis
stephanie.bruns@dentons.com



Brett Miller

Counsel
Indianapolis
brett.miller@dentons.com

Iowa



Michael Gilmer

Special Counsel
Des Moines
michael.gilmer@dentons.com

Kentucky



Chaz Lavelle

Partner
Louisville
charles.lavelle@dentons.com



Mark A. Loyd

Partner & Co-Leader,
Tax National Practice Group
Louisville
mark.loyd@dentons.com



Bailey Roese

Partner
Louisville
bailey.roese@dentons.com



Helen Cooper

Partner
Louisville
helen.cooper@dentons.com



Collier Cooper

Managing Associate
Louisville
collier.cooper@dentons.com



Lucy McAfee

Associate
Louisville
lucy.mcafee@dentons.com

Pennsylvania



Frank Marano

Shareholder
Pittsburgh
frank.marano@dentons.com



Michael Silverman

Shareholder
Pittsburgh
michael.silverman@dentons.com

Utah



Gary Thorup

Shareholder
Salt Lake City
gary.thorup@dentons.com