

31st Annual  
*Tax Symposium*

**TAX TREATMENT OF LITIGATION  
WINDFALLS AND LOSSES:**

*“When the hurly-burly’s done,  
when the battle’s lost and won. . .”*

*--Macbeth, Act I Scene 1*

Jordan B. Segal, Esq.

**MH** Maddin Hauser  
Attorneys and Counselors

Maddin, Hauser, Roth & Heller, P.C.  
28400 Northwestern Hwy. Southfield, MI 48034  
p (248) 354-4030 f (248) 354-1422 maddinhauser.com



# AN OBSERVATION:

Attorneys defer tax questions to the Tax Professionals

BUT...

Tax Professionals defer litigation questions to the Attorneys

# THE BASIC RULE- ALL RECOVERIES ARE TAXABLE

- I. 26 USC 61: “Except as otherwise provided. . . all income from whatever source derived” is considered “Gross Income”

“Origin of the Claim” Doctrine: The tax consequences will be based upon the substance of the underlying claim.

# EXCEPT WHEN THE RECOVERY IS NOT TAXABLE

- I. 26 USC 104(a): the following is excluded from gross income (among other exceptions):
  - (1) Amounts received under workmen's compensation acts as compensation for personal injuries or sickness

# EXCEPT WHEN THE RECOVERY IS NOT TAXABLE

- (2) The amount of any damages (other than punitive damages) received (whether by suit or agreement) whether as lump sums or as periodic payments on account of personal physical injuries or physical sickness



# EXCEPT WHEN THE RECOVERY IS NOT TAXABLE

CRITICAL CONCEPT:

## “Physical Injuries”

Prior to August 21, 1996, IRC Section 104(a)(2) did not contain the word "physical" with regard to personal injuries or sickness. The Code was amended to exclude "personal physical injuries or physical sickness".

# EXCEPT WHEN THE RECOVERY IS NOT TAXABLE

CRITICAL CONCEPT:

“Physical Injuries”

Compensation received for emotional distress or mental anguish attributable to a personal physical injury or physical sickness is nontaxable if the compensation is attributable to an “observable bodily harm” which the IRS defines as “such as bruising, cuts, swelling and bleeding.”

*\*See IRS Private Letter Ruling 200041022.*

# EXCEPT WHEN THE RECOVERY IS NOT TAXABLE

CRITICAL CONCEPT:

“Physical Injuries”

Emotional distress recovery must be [attributed to] personal physical injuries or sickness unless the amount is for reimbursement of actual medical expenses related to emotional distress that was not previously deducted under IRC Section 213.

*See Emerson v. Comr.*, T.C. Memo 2003-82 & *Witcher v. Comr.*, T.C. Memo 2002-292.



# A FEW BRIGHT-LINE RULES

## Recovery is Taxable

- Plaintiff is a business entity (i.e. a “corporation” cannot suffer a physical injury)
- Punitive damages (except in some wrongful death cases)
- Lost wages and back pay
- Interest on judgments (even if the judgment, itself, is not included in gross income)
- Defamation suits and recovery for any other “reputational” harms

# A FEW BRIGHT-LINE RULES

## Recovery is NOT Taxable

- Torts that result in physical injuries, auto-accidents, slip-and-falls.
- Physical injuries in product liability.
- Worker's comp. recovery



# IT IS NOT ALWAYS CLEAR

- An employment suit results in an extra \$50,000 because the Employer's treatment caused the taxpayer to develop an ulcer.
- Is the ulcer a “physical injury” or is it a symptom of “emotional” distress?
- Origin of the Claim (how it was characterized in the pleadings and/or settlement) will control.

# ATTORNEYS FEES

- If the entire recovery is not taxable, then the attorney fee is not taxable.
- If the recovery is taxable, then attorneys fees (even the portion paid directly to the attorney) is taxable.

**Commissioner v. Banks, 543 U.S. 426 (2005)**

# ATTORNEYS FEES

- Might another deduction apply?
- Employment discrimination, (some) claims against the federal government, whistleblower claims, general business matters (like collection suits), suits to value property (not technically an award, but it will **change the basis** of the property)



# WHEN ARE LOSSES DEDUCTIBLE?

Payments made pursuant to a settlement agreement or court judgment will be characterized, from the payor's perspective as a capital expenditure, or a noncapital payment.

**“Origin of the Claim”** will control

# WHEN ARE LOSSES DEDUCTIBLE?

If a claim arises from acts performed by a taxpayer in the ordinary course of its business operations, settlement payments and payments made pursuant to court judgments related to the claim are deductible

# WHEN ARE LOSSES DEDUCTIBLE?

Fines and penalties are not deductible but expenditures to come into compliance with the law are deductible.

# SPECIAL RULE WITH REGARD TO HARASSMENT

As part of the Tax Cuts and Jobs Act, companies may not deduct litigation expenses incurred after December 22, 2017 if:

- The Origin of the Claim is a harassment or sexual abuse and
- The outcome is subject to a non-disclosure provision.

**This applies to any attorneys' fees, payment, or settlement related to the case.**



# *Tax Symposium*

# THANK YOU



**Jordan B. Segal, Esq.**

Attorney

(248) 359-7539

(248) 359-7579 fax

[jsegal@maddinhauser.com](mailto:jsegal@maddinhauser.com)



**Maddi Hauser**

Attorneys and Counselors

**Maddin, Hauser, Roth & Heller, P.C.**

28400 Northwestern Hwy. Southfield, MI 48034

p (248) 354-4030 f (248) 354-1422 [maddinhauser.com](http://maddinhauser.com)

