

31st Annual Tax Symposium

TAX TREATMENT OF LITIGATION WINDFALLS AND LOSSES

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I. AN OBSERVATION

- A. Neither attorneys nor tax professionals want to address this question: the attorneys defer to the accountants, and the accountants defer to the attorneys.
- B. The truth is that this involves a mixed question: the lawyers and tax professionals should be working together, and not throwing each other under the bus!

II. RECOVERIES: THE BASIC RULE AND ITS EXCEPTIONS

- A. The IRS will look to the “Origin of the Claim,” and will use the claim as described in the filed Complaint as a (nonbinding) guide.
- B. The Tax Code provides that **all income**, from whatever source, is “Gross Income,” unless an exception applies.
- C. Worker’s Compensation recoveries are an exception
- D. Damages (except for punitive damages) that are received on account of “Physical Injuries” or “Physical Sickness” are also exceptions
 - i. “Observable Bodily Harm” such as “bruising, cuts, swelling, and bleeding.
 - ii. Emotional Distress recoveries must be attributed to a physical injury or sickness, or be a reimbursement of an un-deducted medical expense.
- D. Attorney Fees awards are taxable if the underlying award is taxable (even if this portion is paid directly to the attorney)

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III. WHEN ARE LOSSES DEDUCTIBLE?

- A. Origin of the Claim controls (again)
- B. If the claim can be characterized as a “capital expenditure” it is deductible. In other words, the “ordinary course of business” deduction still applies to losses.
- C. Fines and penalties are **never** deductible, but expenditures to come into compliance with the law can be.
- D. Tax Cuts and Jobs Act: a litigation loss may not be deducted if:
 - i. The underlying claim is for harassment or sexual abuse, and
 - ii. the settlement contains a nondisclosure or confidentiality provision.