The Tax Ramifications of the Trump Tax Law on Personal Injury Settlements

Plaintiffs whose personal injury suits involve a major accident often expect a tax-free settlement. Settlements can be complex in any case, but the new Trump tax law further complicates the subject as it alters who, how and what is taxed in personal injury cases.

Personal injury attorneys need to understand the nuances of the newly revised U.S. tax code to properly advise and prepare clients on the realities of settlement dollars and taxation. Offering tax advice early in a case helps prepare plaintiffs for the tax ramifications of the potential settlement and can lead to much goodwill between you and your client. This article presents four reality checks which help demystify key changes in the new tax code related to personal injury settlements.

REALITY CHECK #1: ONLY COMPENSATORY DAMAGES INVOLVING INJURY ARE TAX FREE

Settlements normally involve compensatory (resulting injury) damages and often involve punitive (punishment-related) damages. Like under the prior code, only compensatory damages are tax free, but under the new tax code they must be proven to be physical—no emotion-related issues are permitted such as headaches and insomnia, even if emotional distress causes you to be physically sick. Punitive damages and interest are still taxable.

REALITY CHECK #2: TOTAL DOLLARS IN PUNITIVE REWARDS ARE TAXABLE

In a contingency fee arrangement, the attorney receives a fixed percentage of the recovery. If a plaintiff wins compensatory damages in a suit, no tax need be paid as it is tax free. If punitive damages are recovered, a percentage of the gross recovery is now taxed by the IRS. Exactly who is taxed, however, is a distinction worth clarifying.

For example, if a plaintiff receives $100,000 in punitive damages, an attorney might take 30 percent, or $30,000, based on the contingency fee arrangement. The plaintiff then receives the remaining $70,000. In this case, the plaintiff is taxed by the IRS on the entire $100,000, not just his/her take-home amount, even if the defendant pays the attorney fee directly as part of the settlement. If tax-free compensatory damages are also recovered in the same suit, the gross punitive amount is still taxable.

REALITY CHECK #3: ATTORNEY FEES ARE NO LONGER TAX DEDUCTIBLE

The new tax code states that contingency fees paid to attorneys as part of punitive or interest rewards are no longer permitted as an itemized miscellaneous tax deduction. In the above example, the $30,000 fee must be considered income and taxed appropriately. Not all attorney fees are taxed this way under the new code (i.e., employment, trade or business-related claims), but for personal injury cases in general, there is NO tax deduction for legal fees.

REALITY CHECK #4: INTEREST PAYMENTS ARE TAXABLE

If a plaintiff is awarded interest instead of punitive damages, the full reward amount is considered taxable. Even if an attorney is paid his/her contingency fee out of the reward, the total interest reward is viewed as taxable by the IRS. And like in punitive cases, attorney contingency fees are still not tax deductible.

The hard work involved in winning a personal injury suit can be overshadowed by a disgruntled client caught off guard by the unforeseen tax burden of a settlement. Consider enlightening your clients to these tax code changes and associated ramifications to their potential financial reward. And going one step further and getting the right tax experts involved early in a case can save you money in the long run.

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