Tax Trap for Civil Litigants: Recoveries and the Phantom Income Problem

by: R. Jeff Knight, Esq.

Introduction

Civil litigation attorneys routinely negotiate settlements and jury awards for clients who have suffered personal injuries, employment discrimination, civil rights violations, and other harms. While counsel naturally focus on maximizing recovery and protecting client interests in the underlying litigation, a recent U.S. Tax Court decision highlights a critical federal tax issue that can devastate clients: the taxation of attorney's fees as income to the plaintiff, even when those fees are paid directly to counsel and never touch the client's hands.

On July 14, 2026, the Tax Court issued *Eiler v. Commissioner*, 167 T.C. No. 3, Docket No. 16903-22, a fully-reviewed opinion that reaffirms the harsh tax consequences plaintiffs face when settlement proceeds are taxable. This article explains the key principles every civil litigation attorney must understand to counsel clients on tax risk—and to reduce malpractice exposure.

The Core Problem: Phantom Income

Under longstanding federal tax law, when a plaintiff recovers a taxable settlement or judgment, the plaintiff must include the entire recovery in gross income—including the portion paid to the plaintiff's attorney as a contingent fee or pursuant to a fee-shifting statute. *Mennemeyer v. Commissioner*, TC Memo 2025-80; *Commissioner v. Banks*, 543 U.S. 426 (2005). This rule flows from the anticipatory assignment of income doctrine articulated by the Supreme Court in *Commissioner v. Banks*, 543 U.S. 426 (2005), which held that a contingent-fee agreement is treated as an anticipatory assignment of a portion of the client's income to the attorney. *Commissioner v. Banks*, 543 U.S. 426, 430 (2005). The Supreme Court reasoned that the plaintiff retains dominion over the claim itself and therefore realizes income upon recovery before assigning a portion to counsel. *Id*. The result is "phantom income": the client is taxed on money the client never received.

The ***Eiler*** Case

In *Eiler*, plaintiffs sued credit reporting agencies under the Fair Credit Reporting Act (FCRA) and settled for $64,750. Under their contingent-fee agreements, the plaintiffs received only $4,700; their attorneys received $60,050. The defendants issued Forms 1099-MISC to the plaintiffs showing the full $64,750 as income. The plaintiffs reported only the $4,900[1] they actually received from their law firm, believing the attorney's fees were either excludible under the FCRA's fee-shifting provisions or deductible as an above-the-line deduction.

The Tax Court rejected both arguments. First, the Court held that the FCRA's fee-shifting provisions—15 U.S.C. §§ 1681n(a)(3) and 1681o(a)(2)—apply only to "successful action[s]" where fees are "determined by the court," not to settlements where defendants disclaim liability. Second, even if the fee-shifting statute had applied, Ninth Circuit precedent establishes that fee-shifting payments are still taxable income to the plaintiff. *Sinyard v. Commissioner*, 268 F.3d 756, 759 (9th Cir. 2001).

The plaintiffs also argued that their attorney's fees qualified for an above-the-line deduction under I.R.C. § 62(a)(20), which permits deductions for attorney fees paid "in connection with any action involving a claim of unlawful discrimination."[2] The Tax Court held that FCRA claims concerning fair and accurate credit reporting do not constitute claims "providing for the enforcement of civil rights" within the meaning of § 62(e)(18)(i). The Court noted that Congress enacted separate anti-discrimination credit legislation—the Equal Credit Opportunity Act—in 1974, but the FCRA contains no

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[1] The Court was unable to explain the discrepancy between the $4,700 received in the settlement and the $4,900 reported on the income tax return as being received. The case was submitted without trial under Tax Court Rule 122, and therefore the Court did not have the benefit of witness testimony.
[2] This above-the-line deduction was made available for the first time as part of the American Jobs Creation Act of 2004.

comparable anti-discrimination protections.

The bottom line: the plaintiffs were taxed on $64,750 in settlement proceeds but only received $4,700 net – resulting in an $11,423 tax bill on money they never saw.

When Is a Recovery Taxable?

We begin with the longstanding premise that gross income includes all income from whatever source derived, unless it is specifically excluded. I.R.C. § 61(a). That being said, not all litigation recoveries are taxable. A commonly seen exclusion for litigation proceeds stems from I.R.C. § 104(a)(2). Under that section, the critical threshold question is whether the receipt of litigation proceeds qualifies for exclusion from gross income as an "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." *Valia v. Commissioner*, T.C. Summ. 2005-17.

The Physical Injury/Physical Sickness Requirement

Section 104(a)(2) requires that damages be received "on account of personal physical injuries or physical sickness." Settlement proceeds for nonphysical injuries—such as employment discrimination, defamation, emotional distress (absent physical injury or sickness), civil rights violations, or violations of consumer protection statutes—do not qualify for exclusion and are fully taxable. *Id.*; *see also Murphy v. IRS*, 493 F.3d 170 (D.C. Cir. 2007). The scope of this exclusion has generated extensive litigation in the U.S. Tax Court, the Federal District Courts, and the Court of Federal Claims. The analysis is fact-intensive, and a civil litigation attorney should consider consulting a tax attorney before structuring a settlement agreement.

Key points for civil litigation attorneys:

- **Physical injury cases:** Settlements and judgments for automobile accidents, slip-and-falls, medical malpractice, assault and battery, and similar torts involving physical injury or physical sickness are generally excludible (except punitive damages, which are always taxable except with certain wrongful death statutes under I.R.C. § 104(c)).
- **Nonphysical injury cases:** Employment discrimination (Title VII, ADEA, ADA), civil rights (§ 1983), defamation, intentional infliction of emotional distress (without accompanying physical injury),[3] consumer fraud, and statutory violations like the FCRA produce taxable recoveries, although an above-the-line deduction may be available in certain discrimination cases.
- **Mixed claims:** If a settlement or judgment includes both physical injury and nonphysical injury components, the allocation matters. Absent a reasonable allocation supported by the underlying claims and facts, taxpayers may have difficulty proving that any portion of the recovery qualifies for exclusion under §104(a)(2).

The Attorney's Fee Problem in Taxable Cases

When a recovery is taxable, the plaintiff faces a brutal tax structure under current law:

1. **Gross income includes the full recovery.** The plaintiff must include 100% of the settlement or judgment in gross income, even though a

[3] The issue of emotional distress requires great care, and civil litigation attorneys should consult a tax attorney even before issuing a demand letter or filing a complaint or responsive pleading. Damages received for emotional distress *may be* excludable from gross income if the emotional distress stems from a physical injury or sickness. Further, damages received for medical care attributable to emotional distress are excludable from gross income to the extent they do not exceed the amount paid for such medical care. Symptoms such as headaches, insomnia, stomach disorders, or anxiety generally do not constitute physical injury for purposes of I.R.C. § 104(a)(2). These issues are fact-intensive and complex.

significant portion goes to the attorney. *Mennemeyer v. Commissioner*, T.C. Memo 2025-80; *Commissioner v. Banks*, 543 U.S. 426 (2005).

2. **Contingent fees are not excludible.** The fact that fees are paid pursuant to a contingent-fee agreement—or even directly by the defendant to plaintiff's counsel—does not exclude them from the plaintiff's income. *Commissioner v. Banks*, 543 U.S. 426, 430 (2005); *Coady v. Commissioner*, 213 F.3d 1187, 1191 (9th Cir. 2000).

3. **Fee-shifting does not help.** Even when attorney's fees are awarded under a fee-shifting statute (e.g., Title VII, § 1983, ADEA), those fees are income to the plaintiff if paid by the defendant. *Sinyard v. Commissioner*, 268 F.3d 756, 759 (9th Cir. 2001), *Eiler v. Commissioner*, 167 T.C. No. 3 (July 14, 2026), *Manning v. Astrue*, 510 F.3d 1246, 1250 (10th Cir. 2007).

4. **Limited deduction relief.** Before 2018, plaintiffs could deduct attorney's fees as miscellaneous itemized deductions subject to the 2% Adjusted Gross Income floor, providing some limited relief. The Tax Cuts and Jobs Act suspended miscellaneous itemized deductions for tax years 2018 through 2025. Beginning in 2026, the One Big Beautiful Bill Act (OBBBA) made permanent the suspension of miscellaneous itemized deductions that had been subject to the AGI floor, such as deductions of amounts expended for the production of income. I.R.C. § 67(h). For instance, un-reimbursed employee expenses and expenses related to investment activities are not allowable post-OBBBA. Deductions for certain expenses excluded from the definition of miscellaneous itemized deductions, such as charitable contributions, medical expenses, and state and local income taxes, are deductible. Notably, attorneys' fees remain non-deductible as itemized deductions. Itemized deductions will not offset phantom income.

5. **Above-the-line deduction under § 62(a)(20)—narrow scope.** Congress provided limited relief in the American Jobs Creation Act of

2004 by allowing an above-the-line deduction for attorney fees paid "in connection with any action involving a claim of unlawful discrimination" as defined in § 62(e). *Eiler v. Commissioner*, 167 T.C. No. 3 (July 14, 2026). However, as *Eiler* illustrates, this deduction is construed narrowly and does not apply to all statutory claims.

What Qualifies as "Unlawful Discrimination" Under § 62(a)(20)?

Section 62(e) defines "unlawful discrimination" to include claims under specific federal employment and civil rights statutes, as well as "[a]ny provision of Federal, State, or local law providing for the enforcement of civil rights" or "regulating any aspect of the employment relationship." *Mennemeyer v. Commissioner*, T.C. Memo 2025-80. Cases involving Title VII, the ADA, ADEA, § 1983 civil rights claims, and wage-and-hour claims generally qualify. But as *Eiler* makes clear, "civil rights" do not encompass all legally enforceable claims; they are limited to rights involving equal protection, due process, voting rights, and similar constitutional protections.

Practice point: Do not assume that a federal or state statutory cause of action automatically qualifies for the § 62(a)(20) deduction. Tort claims, consumer protection claims, and many statutory claims fall outside the definition.

Practical Guidance for Civil Litigation Attorneys:

1. Identify Whether the Recovery Is Taxable at the Outset

Before accepting a case or negotiating a settlement, determine whether the client's recovery will be taxable. Ask:

- Does the claim arise from personal physical injuries or physical sickness?
- If not, the recovery is generally taxable (although not always).

2. Discuss Tax Consequences With Clients Early

Clients must understand the tax impact of a recovery. A $100,000 settlement in a nonphysical injury case with a one-third contingent fee means the client receives approximately $66,667 but is taxed on the full $100,000. Depending on the client's tax bracket and state tax obligations, the client may owe $30,000 to $40,000 or more in taxes on funds the client never received—leaving the client with a net recovery of $26,667 to $36,667. That’s with no legal expenses factored in. The net recovery is probably much lower. As we saw in *Eiler*, the client may pay more in income tax than they received in the settlement, taking a net cash loss on the deal. In some cases, the tax cost of litigation may materially reduce—or even eliminate—the economic benefit of pursuing the claim. Counsel should evaluate the after-tax consequences before litigation strategy is finalized.

Malpractice risk: Because tax consequences can materially affect a client's net recovery, counsel should consider whether the circumstances warrant advising the client to consult qualified tax counsel. Failure to recognize significant tax issues or recommend appropriate tax advice may increase malpractice risk. Ensure clients know the after-tax value of settlement offers and judgments.

3. Be Careful When Drafting Pleadings or Demand Letters

The *Eiler* court specifically mentioned in its opinion that the court looked to the complaint from the underlying civil suit to help determine the nature of the claims for Federal income tax purposes. If a settlement agreement is drafted to support an argument that the award is compensation for a physical injury or sickness, and the complaint alleged merely emotional distress, the Tax Court is unlikely to buy the late recharacterization of the suit.

4. Negotiate Tax-Conscious Settlement Allocations

When drafting settlement agreements, always specify the allocation of proceeds to taxable and nontaxable components. If the case involves both physical and nonphysical injuries, allocate as much as reasonably supportable to the excludible physical injury claim.

Caution: The allocation must have a reasonable basis in the facts and claims. The IRS is not bound by self-serving allocations unsupported by the record. Where a settlement agreement is silent or ambiguous, courts will treat the entire amount as taxable if the plaintiff cannot show the portion allocable to excludible claims.

5. Understand Form 1099 Reporting

Defendants often issue Forms 1099-MISC to plaintiffs showing the full settlement amount, even when a portion is paid directly to the plaintiff's attorney. The *Eiler* case is a stark example: the defendants issued Forms 1099 to the plaintiffs for the full $64,750, triggering IRS scrutiny when the plaintiffs reported only the net amount received.

Practice point: Advise clients that they will receive a Form 1099 and must report the full amount as income if the recovery is taxable, even if they never touched the attorney's fees. Clients should consult a tax professional to determine available mitigation strategies.

6. Consider Structured Settlements and Other Tax Planning

Use tax consequences during settlement negotiations to structure the settlement in a manner that best protects your client's interests. Ask whether there is a more tax-efficient way to achieve the client's objectives. For example, compare the tax consequences of a lump-sum payment versus a structured settlement over a term of years; consider whether a qualified settlement fund may be appropriate; or negotiate a gross-up provision where feasible. Although none of these strategies eliminates the phantom income problem, they may reduce its practical impact or make the resulting tax burden more manageable for the client. Consulting a tax attorney early in the case may prove invaluable.

7. Advise Clients to Retain Tax Professionals

Tort attorneys are not tax advisors. When a recovery is taxable and significant, advise clients in writing to consult a certified public accountant or tax attorney to prepare their returns and evaluate available deductions.

Conclusion

The intersection of civil litigation and federal income tax law creates a hidden trap for plaintiffs: taxable litigation recoveries trigger income tax on the full amount, including attorney's fees the plaintiff never receives. The recent *Eiler* decision underscores that plaintiffs cannot rely on fee-shifting statutes or broad statutory claims to escape this result. Attorneys must identify tax risk early, discuss it candidly with clients, negotiate tax-conscious settlements, and recommend competent tax counsel. Failure to do so may harm clients and can increase counsel's exposure to malpractice claims.

In an era of limited deduction opportunities, the phantom income problem is more acute than ever. Every lawyer owes clients the duty to understand these rules and plan accordingly.

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