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February 2, 2009

Congressional Research Service

Report RL32253

Tax Issues in Litigation: Treatment of Judgment and Settlement Payments and Deductibility of Legal Expenses

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April 21, 2006

Abstract. When a party involved in a lawsuit makes a payment pursuant to a judgment or settlement agreement, the payment may be included in the recipient's income and may be deductible from the payor's income. A separate issue that also arises in litigation is whether either party may deduct the legal expenses incurred in the suit. The nature of the underlying claim is critical in determining the proper tax treatment of these payment and expenses. Portions of a payment may face different treatment depending on what each represents (e.g., replacement for lost wages, reimbursement of medical expenses, punitive damages, fines or penalties, or attorneys' fees). This report addresses the tax consequences of these payments and expenses to the payment recipient and the payor. It ends with a summary of the bills that have been introduced in the 109th Congress that would affect these consequences: H.R. 3 (Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2005), H.R. 1985 (Federal Whistleblower Protection Tax Act of 2005), H.R. 2755 (Victims Tax Fairness Act of 2005), H.R. 3076 (Freedom from Unnecessary Litigation Act of 2005), H.R. 4297 (Tax Relief Act of 2005), H.R. 4707 (Simplified USA Tax Act of 2006), S. 1565 (Tax Shelter and Tax Haven Reform Act of 2005), S. 1890 (Government Settlement Transparency Act of 2005), and S. 2020 (Tax Relief Act of 2005).

Order Code RL32253

CRS Report for Congress
Received through the CRS Web

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Summary

When a party involved in a lawsuit makes a payment pursuant to a judgment or settlement agreement, the payment may be included in the recipient's income and may be deductible from the payor's income. A separate issue that also arises in litigation is whether either party may deduct the legal expenses incurred in the suit. The nature of the underlying claim is critical in determining the proper tax treatment of these payment and expenses. Portions of a payment may face different treatment depending on what each represents (e.g., replacement for lost wages, reimbursement of medical expenses, punitive damages, fines or penalties, or attorneys' fees). This report addresses the tax consequences of these payments and expenses to the payment recipient and the payor. It ends with a summary of the bills that have been introduced in the 109th Congress that would affect these consequences: H.R. 3 (Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2005), H.R. 1985 (Federal Whistleblower Protection Tax Act of 2005), H.R. 2755 (Victims Tax Fairness Act of 2005), H.R. 3076 (Freedom from Unnecessary Litigation Act of 2005), H.R. 4297 (Tax Relief Act of 2005), H.R. 4707 (Simplified USA Tax Act of 2006), S. 1565 (Tax Shelter and Tax Haven Reform Act of 2005), S. 1890 (Government Settlement Transparency Act of 2005), and S. 2020 (Tax Relief Act of 2005).

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Tax Issues in Litigation: Treatment of Judgment and Settlement Payments and Deductibility of Legal Expenses

When a party involved in a lawsuit makes a payment pursuant to a judgment or binding settlement agreement, the payment may be included in the recipient's income and may be deductible from the payor's income. A separate issue that also arises in litigation is whether either party may deduct the legal expenses incurred in the suit. The nature of the underlying claim is critical in determining the proper tax treatment of these payments and expenses. This report examines the tax consequences of these payments and expenses. It ends with a summary of the legislation proposed in the 109th Congress that would affect these consequences.

For tax purposes, it does not matter whether the payment is made pursuant to a judgment or a binding settlement agreement. Furthermore, a payment made in a lump sum has the same consequences as a payment made in periodic installments, although the timing of the inclusion and/or deduction will differ. In this report, the terms "award" and "damages" are used interchangeably and intended to include all such payments.

Portions of a payment may face different treatment depending on what each represents (e.g., replacement for lost wages, reimbursement of medical expenses, or punitive damages). The different parts may be designated by the court in the judgment or by the parties in the settlement agreement. The parties must generally follow these allocations for tax purposes. If the judgment or agreement is silent, then the taxpayer must make the appropriate allocations. In any case, the Internal Revenue Service (IRS) or a judicial authority may reallocate the payment to properly reflect the actual substance of the award.[1] In order to determine the appropriate allocation, the IRS and reviewing authorities will look at such things as the complaint, other pleadings, evidence presented at trial, and a settlement agreement.

Tax Consequences to the Recipient

For awards received pursuant to a judgment or settlement for claims involving personal physical injury or sickness, the recipient's tax consequences are determined under section 104 of the Internal Revenue Code (IRC). For all other claims (i.e., non-personal injury and personal non-physical injury claims), general tax principles

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[1] For example, in *Robinson v. Comm'r*, 102 T.C. 116 (1994), the court held that the IRS could reallocate the award in a state court's order because the state court had not adequately reviewed the settlement agreement upon which the order was based.

include the award in the recipient's income unless an exclusion exists for the item of income that the payment is meant to replace.

Awards Received for Personal Physical Injury or Sickness

Under IRC § 104(a)(2), "the amount of any damages (other than punitive damages) received on account of personal physical injuries or physical sickness" is excluded from the recipient's gross income.[2] This includes all non-punitive damages, including economic ones (e.g., lost wages), that are received because of the personal physical injury or sickness. However, any amount that is attributable to medical expenses that have already been deducted may not be excluded.

Physical Injury and Sickness. IRC § 104(a)(2) does not define physical injury or sickness beyond excepting emotional distress. Congress did not intend the physical symptoms of emotional distress to be considered physical injury or sickness.[3] The IRS appears to take the position that physical injuries stem from "direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding" or causing pain.[4]

Prior to 1996, the injury or sickness did not have to be physical in order for the award to be excluded under IRC § 104(a)(2). When deciding if the exclusion applied, courts looked solely at whether (1) the injury or sickness was personal as opposed to professional[5] and (2) the claim was tort or tort-like as opposed to contractual.[6] This led to inconsistent results, particularly about whether damages received for various claims of discrimination qualified for exclusion.[7] In the Small Business Job Protection Act of 1996 (SBJPA), P.L. 104-188, Congress amended the

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[2] Section 104 also excludes amounts received as disability income by certain individuals injured as a result of terrorist or military action and amounts received for personal injury or sickness (1) under workmen's compensation acts, (2) through certain accident or health insurance, or (3) by certain federal employees, including members of the Armed Forces.

[3] *See* H.R. Conf. Rep. No. 104-737 at 301 (footnote 56).

[4] *See* Priv. Ltr. Rul. 200041022 (July 17, 2000).

[5] The line between personal and professional can be faint. For example, in *Roemer v. Comm'r*, 716 F.2d 693 (1983), damages for injury to professional reputation were excluded from income because the court found that such injuries were personal under state tort law.

[6] For example, the Supreme Court held that an employment discrimination claim arising under Title VII of the Civil Rights Act, which only allowed back pay as a remedy, was not tort-like because the legal basis for the claim did not allow the breadth of remedies available in tort actions. United States v. Burke, 504 U.S. 229 (1992).

[7] For example, prior to *Burke*, 504 U.S. 229, the Third and Sixth Circuits allowed awards of back pay for claims of employment discrimination to be excluded under IRC § 104, while the Tax Court and the Fourth, Fifth, Tenth and D.C. Circuits included such awards in income. *See* Rickel v. Comm'r, 900 F.2d 655 (3rd Cir. 1990); Burke v. United States, 929 F.2d 1119 (6th Cir. 1991), *rev'd by* 504 U.S. 229; Hodge v. Comm'r, 64 T.C. 616 (1975); Thompson v. Comm'r, 866 F.2d 709 (4th Cir. 1989); Johnston v. Harris County Flood Control Dist., 869 F.2d 1565 (5th Cir. 1989); Sears v. Atchison, Topeka & Santa Fe Ry., 749 F.2d 1451 (10th Cir. 1984); Sparrow v. Comm'r, 949 F.3d 434 (D.C. Cir. 1991).

statute to add the physical requirement. It is now clear that damages for discrimination claims are included in income since such claims do not involve physical injury or sickness.

Emotional Distress. Under IRC § 104(a)(2), awards for emotional distress are included in the recipient's income unless the emotional distress had its origin in physical injury or sickness.[8] Emotional distress is intended to include the "symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such distress."[9] If medical care for the emotional distress was sought, then damages equal to those medical costs may qualify for exclusion.[10]

Punitive Damages. Under IRC § 104(a)(2), as amended by SBJPA, punitive damages that are received on account of personal physical injury or sickness are included in the recipient's gross income. A limited exception exists under IRC § 104(c) for punitive damages awarded in a wrongful death action if state law, as existing on September 13, 1995, only allows the recovery of punitive damages.

Interest on Award. Courts have repeatedly held that if an award includes prejudgment interest, the interest may not be excluded from gross income under IRC § 104(a)(2).[11]

Legal Expenses. An award may include an explicit amount that represents the recipient's attorneys' fees and other legal costs. This may occur because the court awards the expenses under a fee-shifting statute, the settlement agreement includes the expenses, or there is a contingency fee agreement that grants a specified portion of any award to the attorney. If an award is excluded from the recipient's income under IRC § 104(a)(2), then any amount that represents attorneys' fees and other legal costs is also excluded from the recipient's income. The amount will be included as compensation in the attorney's income.

Deductibility. A plaintiff with a physical personal injury or sickness claim may not deduct the legal expenses incurred in the suit. This is because expenses incurred in the production of tax-exempt income are not deductible.[12]

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[8] *See* H.R. Conf. Rep. No. 104-737 at 301.

[9] *Id.*

[10] *See* IRC § 104(a), last sentence.

[11] *See* Rozpad v. Comm'r, 154 F.3d 1 (1st Cir. 1998); Francisco v. United States, 267 F.3d 303 (3rd Cir. 2001); Brabson v. United States 73 F.3d 1040 (10th Cir. 1996), *cert. denied,* 519 U.S. 1039 (1996); Kovacs v. Comm'r, 100 T.C. 124 (1993), *aff'd in unpublished opinion,* 74 A.F.T.R.2d 5001 (6th Cir. 1994), *cert. denied,* 513 U.S. 963 (1994).

[12] *See* IRC § 265.

Awards for Claims of Non-personal Injury and Non-physical Personal Injury

No statutory exclusion exists for payments received pursuant to a judgment or settlement in non-personal injury and non-physical personal injury cases. The treatment of an award is determined by general tax principles that include the award in the recipient's income unless it is properly designated as a return of capital or there is a statutory exclusion for the item of income that the payment is intended to replace. This is determined by the nature of the underlying claim. For example, an employment suit is a breach of contract claim and any award for back pay is meant to substitute for the payment of wages. Since there is not an exclusion for wages from gross income, the award is included in gross income.

If an award is included in the recipient's gross income, it must be characterized as ordinary income or capital gain. This is important because it determines such things as the appropriate tax rate. The characterization is made by looking at the nature of the underlying claim. For example, if a payment is meant to replace lost profits, then the award is treated as ordinary income. However, if the payment is to redress an injury to a capital asset, then the amount should be treated as capital gain.

Punitive Damages. Punitive damages that are awarded for a claim of non-personal injury or non-physical personal injury are included in the recipient's income.[13]

IRC § 186 Deduction. In suits claiming patent infringement, breach of contract, breach of fiduciary duty, or the violation of antitrust laws, the award recipient may be allowed a deduction under IRC § 186 if the compensatory portion of the award is included in income. The amount that may be deducted is the lesser of the compensatory payment less the costs of securing it or the amount of unrecovered net operating loss attributable to the injury.

Legal Expenses. As mentioned above, an award may include an explicit amount that represents the recipient's attorneys' fees and other legal costs. Prior to a Supreme Court decision in 2005 (discussed below),[14] it was unclear whether this amount was included in the recipient's income when it was received as part of an award in a non-personal injury or non-physical personal injury case with a contingency fee agreement. Courts generally required it be included in the recipient's income.[15] This approach was consistent with three fundamental tax principles: (1) payments are included in income unless specifically excluded by statute, (2) a

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[13] *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955); IRC § 104(a), as amended by P.L. 101-239.

[14] Comm'r v. Banks, 543 U.S. 426 (2005).

[15] *See* Freeman v. Comm'r, 82 T.C.Memo 643 (2001), O'Brien v. Comm'r, 319 F.2d 532 (3rd Cir. 1963); Young v. Comm'r, 240 F.3d 369 (4th Cir. 2001); Kenseth v. Comm'r, 259 F.3d 881 (7th Cir. 2001); Sinyard v. Comm'r, 268 F.3d 756 (9th Cir. 2001); Campbell v. Comm'r, 274 F.3d 1312 (10th Cir. 2001); Baylin v. United States, 43 F.3d 1451(Fed. Cir. 1995).

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taxpayer may not avoid taxation by assigning income to another party, and (3) a taxpayer receives a taxable benefit when another party pays his or her debt.

However, some courts allowed the amount to be excluded from the recipient's income.[16] This position had several bases: (1) the attorney's right to the income under state lien law, (2) the recognition that contingency fee agreements are not made with a tax-avoidance purpose and that inclusion of the fees in the client's income results in the amount being subject to double taxation, and (3) equitable reasons due to the fact that the recipient may not be able to fully deduct the legal expenses, as explained below.

In 2005, the Supreme Court resolved the conflict by holding that the recipient is required to include the amount representing attorneys' fees in income.[17] The Court appeared to answer the question with relative ease based on settled law. It began by stating that in situations involving anticipatory assignment of income, like contingency fee agreements, the test for determining if the assignor received the income for tax purpose is if he or she retains control over the income-generating asset.[18] The Court then reasoned that because the cause of action resulting from the injury is the income-generating asset and the injured party retains control over it throughout the litigation, the injured party receives all of the award for purposes of taxation.[19] The Court rejected the argument that the attorney had an ownership interest in the asset because he or she also contributed an income-generating asset (i.e., effort and expertise) or was granted it under state lien law.[20]

Deductibility. A plaintiff with a claim of non-personal injury or non-physical personal injury may be able to deduct the legal expenses incurred in the suit. Business plaintiffs may generally deduct the entire amount of attorneys' fees and other litigation costs as business expenses under IRC § 162. However, if the award was treated as capital gain, then the legal expenses should be capitalized rather than currently deducted.[21]

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[16] *See* Cotnam v. Comm'r, 263 F.2d 119 (5th Cir. 1959), *cited as controlling in* Srivastava v. Comm'r, 220 F.3d 353 (5th Cir. 2000); Banks v. Comm'r, 345 F.3d 373 (6th Cir. 2003); Banaitis v. Comm'r, 340 F.3d 1074 (9th Cir. 2003); Foster v. United States, 249 F.3d 1275 (11th Cir. 2001).

Furthermore, while courts generally hold that awards under fee-shifting statutes are income to the plaintiff, the California Supreme Court has held that attorneys' fees awarded under the state's Fair Employment and Housing Act "belong to the attorneys who labored to earn them" rather than to the plaintiff. Flannery v. Prentice, 28 P.3d 860 at 862 (Cal. 2001).

[17] Comm'r v. Banks, 543 U.S. 426 (2005). The case consolidated *Banks v. Comm'r*, 345 F.3d 373 (6th Cir. 2003) and *Banaitis v. Comm'r*, 340 F.3d 1074 (9th Cir. 2003).

[18] *See id.* at 434.

[19] *See id.* at 425.

[20] *See id.* at 435-37.

[21] Capital expenditures are not currently deductible. IRC § 263.

The deductibility of non-business plaintiffs' attorneys' fees will depend on the type of claim. Individuals with certain claims may deduct attorney fees and court costs as an above-the-line deduction.[22] This means that they will be able to deduct the entire amount so long as it does not exceed the amount of the judgment or settlement that was included in income. The claims to which this treatment applies are claims of unlawful discrimination, claims against the United States under chapter 37 of title 31, and claims made under section 1862(b)(3)(A) of the Social Security Act. Unlawful discrimination claims are those arising under:

- section 302 of the Civil Rights Act of 1991;
- section 201, 202, 203, 204, 205, 206, or 207 of the Congressional Accountability Act of 1995;
- the National Labor Relations Act;
- the Fair Labor Standards Act of 1938;
- section 4 or 15 of the Age Discrimination in Employment Act of 1967;
- section 501 or 504 of the Rehabilitation Act of 1973;
- section 510 of the Employee Retirement Income Security Act of 1974;
- Title IX of the Education Amendments of 1972;
- the Employee Polygraph Protection Act of 1988;
- the Worker Adjustment and Retraining Notification Act;
- section 105 of the Family and Medical Leave Act of 1993;
- chapter 43 of title 38 of the United States Code, which relates to employment and reemployment rights of members of the uniformed services;
- section 1977, 1979, or 1980 of the Revised Statutes (42 U.S.C. 1981, 1983, or 1985);
- section 703, 704, or 717 of the Civil Rights Act of 1964;
- section 804, 805, 806, 808, or 818 of the Fair Housing Act;
- section 102, 202, 302, or 503 of the Americans with Disabilities Act of 1990;
- federal whistleblower protection laws;
- any provision of federal, state, or local civil right law that provides for the enforcement of civil rights; and
- federal, state, or local employment and labor laws.[23]

Other individuals may deduct legal expenses as an income-production expense under IRC § 212. Income-production expenses are deducted as miscellaneous itemized deductions, which are subject to three limitations.[24] First, they are

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[22] *See* IRC § 62(a)(20). This provision was added by the American Jobs Creation Act of 2004 (P.L. 108-357). It is effective for fees and costs paid after October 22, 2004, for any judgment or settlement occurring after that date.

[23] *See* IRC § 162(e).

[24] Above-the-line deductions are not subject to these limitations. Plaintiffs in employment discrimination suits have tried to characterize awards of attorneys' fees as reimbursed employee business expenses, which give rise to an above-the-line deduction under IRC § 62.

(continued...)

deductible only to the extent that all miscellaneous itemized deductions exceed two percent of the taxpayer's adjusted gross income.[25] Thus, the legal expenses will not be fully deductible. Second, taxpayers who are subject to the alternative minimum tax may not deduct any expenses as miscellaneous itemized deductions.[26] Third, taxpayers with adjusted gross income in excess of $145,950 ($72,975 if married filing separately) are subject to an overall limitation on itemized deductions.[27]

Tax Consequences to the Payor

When a taxpayer makes a payment pursuant to a judgment or settlement, the payment may be deductible as a business expense under IRC § 162 or as an income-production expense under IRC § 212. This is generally true regardless of whether the payment represents compensatory or punitive damages. However, a deduction is not allowed to the extent that the taxpayer has been reimbursed for the expenses through insurance or other means. Additionally, fines and penalties paid to a government and payments in antitrust suits are subject to special rules.

IRC §§ 162 and 212. Under IRC § 162, taxpayers may deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." Under IRC § 212, taxpayers who are not carrying on a trade or business may deduct the "ordinary and necessary expenses" that are made pursuant to an income-producing activity. An expense is "ordinary" if it is not a capital expenditure. Whether a payment made pursuant to a judgment or settlement is a capital expenditure is determined by the nature of the underlying claim. In general, the payment is a capital expenditure if it is capital gain to the recipient. An expense is "necessary" if it is appropriate for carrying on a trade or business or in the production of income. Payments made pursuant to a judgment or settlement are generally considered to be appropriate.

If a payment is deducted as an income-production expense under IRC § 212, the payor will not be able to deduct the full amount. This is due to the limits on miscellaneous itemized deductions, which were discussed in the "Legal expenses" section under *Awards for Non-personal Injury and Non-physical Personal Injury Claims*.

Fines and penalties. IRC § 162(f) disallows a deduction "for any fine or similar penalty paid to a government for the violation of any law." Fines and penalties include (1) civil and criminal penalties imposed for the violation of any law after conviction or a plea of guilty or no contest and (2) payments for the settlement

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[24] (...continued)
It does not appear that any court has allowed this treatment.

[25] *See* IRC § 67.

[26] *See* IRC § 56(b)(1)(A).

[27] *See* IRC § 68. Beginning in 2006, the overall limitation is gradually phased out until it is repealed in 2010. *See* P.L. 107-16, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). EGTRRA's provisions expire on December 31, 2010.

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of the taxpayer's actual or potential liability for a criminal or civil fine or penalty.[28] Fines and penalties do not include compensatory damages or legal fees.[29]

Antitrust violations. In civil antitrust suits, the plaintiff is awarded damages that equal three times the actual damages. Under IRC § 162(g), the payor of such an award is not allowed to deduct two-thirds of it (i.e., the noncompensatory part of the award). For the section to apply, the taxpayer must have been convicted or pled guilty or no contest in a related criminal proceeding.

Legal expenses. The payor may be able to deduct the legal expenses incurred in the suit as a business expense under IRC § 162 or an income-production expense under IRC § 212. Expenses deducted under IRC § 212 will not be fully deductible due to the limits on miscellaneous itemized deductions that were discussed above. Legal expenses should not be deductible if the award payment was capitalized.

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Legislation in the 109th Congress

Bills Affecting the Recipient

H.R. 1985 (Federal Whistleblower Protection Tax Act of 2005) would exclude damages and the amounts awarded for attorneys' fees and costs from the recipient's income in claims brought under federal whistleblower protection laws. Punitive damages and damages on account of lost income would not be excluded from income. The bill would allow income-averaging on awards of lost income, so that the whistleblower would not be taxed on the entire award in the year it was received.

H.R. 2755 (Victims Tax Fairness Act of 2005) would explicitly state that the recipient's gross income includes awards representing attorneys' fees and costs in non-physical personal injury cases, and then would allow the recipient to deduct the full amount as an above-the-line deduction.

H.R. 3076 (Freedom from Unnecessary Litigation Act of 2005) would exclude all medical malpractice damages that were awarded in binding arbitration from the recipient's income.

H.R. 4707 (Simplified USA Tax Act of 2006) would return the law to how it was before SBJPA. Awards, other than punitive damages, for non-physical personal injury or sickness and punitive damages for physical personal injury or sickness would be eligible for the IRC § 104 exclusion. This is one provision in the bill, which is a fundamental tax reform bill.

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[28] *See* 26 CFR § 1.162-21(b)(1).

[29] *See* 26 CFR § 1.162-21(b)(2).

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Bills Affecting the Payor

Several bills contain a provision that would amend IRC § 162(f) to expand the disallowance of a deduction for the payment of fines and penalties to a government. Under the provision, only the portion of a payment paid to a government in relation to the violation of any law or the investigation or inquiry into the potential violation of any law that represents restitution would be deductible. Additionally, no deduction would be allowed for a payment to a nongovernmental regulatory agency if the payment would have been nondeductible if paid to a government. The provision would clarify that payments for fines and penalties are not deductible when made under the direction of, and not just to, a government or nongovernmental agency. It would also require the government or agency to report information on the payment to the IRS and all the parties in the suit. The provision is included in S. 1565 (Tax Shelter and Tax Haven Reform Act of 2005) and the Senate-passed version of H.R. 3 (Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2005). H.R. 3 was enacted into law as P.L. 109-59 with the provision stripped during conference. Additionally, two bills include similar provisions that would also allow a deduction for amounts paid to come into compliance with any law which was violated or involved in the investigation or inquiry. These are S. 1890 (Government Settlement Transparency Act of 2005) and the Senate-passed version of H.R. 4297 (Tax Relief Act of 2005).

A provision in several bills would prohibit a payor from deducting the payment of punitive damages. A limited exception would exist for punitive damages paid under a wrongful death statute described in IRC § 104(c). Also under the provision, if the punitive damages were paid by insurance, then the insured party would include the amount in income and the insurer would report the amount to the IRS. This provision has been introduced in S. 2020 (Tax Relief Act of 2005), the Senate-passed version of H.R. 4297 (Tax Relief Act of 2005), and the Senate-passed version of H.R. 3 (Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2005). H.R. 3 was enacted into law as P.L. 109-59 with the punitive damages provision stripped during conference.