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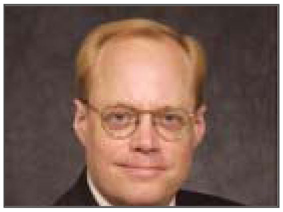

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THE TAX LAWYER

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10 Things To Know About Taxes On Legal Settlements

Your car got rear-ended at a red light. Your contractor did shoddy work on your condo. You were unfairly fired. If you're collecting a settlement or judgment, is it taxable income? Usually yes, but taxes vary enormously depending on how you were damaged, how the case was resolved, and even how checks and IRS Forms 1099 were issued. Here are 10 things you should know.

1. Settlements and judgments are taxed the same. The same tax rules apply whether you settle or win a judgment. Still, you have more flexibility to reduce taxes if a case settles. If you are audited, you'll need to show the settlement agreement, complaint, checks, IRS Forms 1099, W-2, etc. You can influence how your recovery is taxed by how you deal with them.

2. Taxes depend on the "origin of the claim." Settlements and judgments are taxed according to the origin of your claim. If you're suing a competing business for lost profits, a settlement will be lost profits, taxed as ordinary income. If you get laid off at work and sue for discrimination seeking wages, you'll be taxed on wages. Your former employer will probably withhold income and employment taxes even if you no longer work there.

But if you sue for damage to your condo by a negligent building contractor, your damages typically won't be income. Instead, the recovery will be treated as a reduction in your purchase price of the condo. These rules are full of exceptions and nuances, so be careful. Perhaps the biggest exception of all applies to recoveries for personal physical injuries.

3. Recoveries for personal physical injuries and physical sickness are tax-free. If you sue for personal physical injuries, your damages are tax-free. Section 104 of the tax code says so. Before 1996, all "personal" damages were tax-free, so emotional distress, defamation, etc. also produced tax-free recoveries. But since 1996, your injury must be "physical."

The IRS says your injuries must be visible. If you sue for intentional infliction of emotional distress, your recovery is taxed. If you sue your employer for sexual harassment involving rude comments or even fondling, that's not physical enough for the IRS. Taxpayers routinely argue in U.S. Tax Court that their damages are sufficiently physical to be tax-free; the IRS usually wins these cases, but not always.

4. Symptoms of emotional distress are not "physical." Money you receive for physical symptoms of emotional distress (like headaches and stomachaches) is taxed, while physical injuries or sickness is not. If in settling an employment dispute you receive $50,000 extra because your employer gave you an ulcer, is an ulcer physical, or merely a symptom of emotional distress? Many plaintiffs take aggressive positions on their tax returns, claiming that damages of this nature are tax-free. But that can be a losing battle if the defendant issues an IRS Form 1099 for the entire settlement. You may want to try to agree with the defendant about the tax issues.

5. Medical expenses are tax-free. Even if your injuries are purely emotional, payments for medical expenses are tax-free, and what constitutes "medical expenses" is surprisingly liberal. For example, payments to a psychiatrist or counselor qualify, as do payments to a chiropractor or physical therapist. Many nontraditional treatments count too.

6. Allocating damages can save taxes. Most legal disputes involve multiple issues. You might claim that the defendant kept your laptop, frittered away your trust fund, undercompensated you, failed to reimburse you for a business trip, or other items. In fact, even if your dispute relates to one course of conduct, there's a good chance the total settlement amount will involve several types of consideration. It is almost always best for plaintiff and defendant to try to agree on what is being paid and its tax treatment. Such agreements aren't binding on the IRS or the courts in later tax disputes, but they are rarely ignored.

7. You may have capital gain instead of ordinary income. Outside of accidents or injuries, just about everything is income. However, that doesn't answer the question of *how* it's taxed. If your suit is about damage to your house or your factory, a settlement may be treated as capital gain. Even better, depending on your tax basis (basically, your original purchase price, increased by any improvements you made, and decreased by depreciation), your settlement may be treated as a recovery of basis, not income.

8. Attorney fees can be a trap. Whether you pay your attorney hourly or on a contingent fee basis, factor in the cost of your attorney when you're addressing taxes. If you are the plaintiff and use a contingent fee lawyer, you'll usually be treated (for tax purposes) as receiving 100% of the money recovered by you and your attorney, even if the defendant pays your lawyer directly his 30% to 40% contingent fee cut. If your case is fully nontaxable (say an auto accident in which you're injured), that won't cause any tax problems. But if your recovery is taxable, watch out.

Say you settle a suit for intentional infliction of emotional distress against your neighbor for $100,000, and your lawyer keeps $40,000. You might think you'd have $60,000 of income. Instead, you'll have $100,000 of income, followed by a $40,000 miscellaneous itemized deduction. You'll be subject to numerous limitations–and to the alternative minimum tax or AMT–that can whittle your deduction down to nothing.

9. Punitive damages and interest are always taxable. If you are injured in a car crash and get $50,000 in compensatory damages and $5 million in punitive damages, the former is tax-free. The $5 million is fully taxable, and you can have trouble deducting your attorney fees! The same occurs with interest. You might receive a tax-free settlement or judgment, but pre-judgment or post-judgment interest is always taxable (and can produce attorney fee problems). That can make it attractive to settle your case rather than have it go to judgment.

10. It pays to consider the defense. A defendant paying a settlement or judgment will always want to deduct it. If the defendant is engaged in a trade or business, that will rarely be questioned, since litigation is a cost of doing business. But if the suit is related to investments, it may be deductible only against investment income or subject to limits. If the suit is purely personal, the defendant may get no deduction at all, and that can extend to attorney fees too.

Bottom line: It can be tempting to end your dispute and let the tax chips fall where they may. But before you resolve it, consider the tax aspects. You'll almost always have to consider them at tax return time the next year. You'll be better off considering taxes earlier, and may save yourself serious money.

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