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THE TAX LAWYER

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Don't Settle Legal Disputes Without Tax Advice

After a bitter dispute, you're collecting a legal settlement. Is it taxable and must you report it? Usually yes, but the tax treatment varies enormously. Consider how you were damaged, how the case was resolved, and how checks and IRS [Forms 1099](#) were issued. See [10 Things To Know About Taxes On Damages](#).

Settlements and judgments are taxed based on the origin of your claim. If you're suing a competing business for lost profits, a settlement is lost profits, taxed as ordinary income. If you get fired at work and sue for severance and discrimination, you'll be taxed as receiving wages. Usually, though, employment settlements are split between wages reported on a [Form W-2](#) and an amount reported on an IRS Form 1099.

These rules are full of exceptions, nuances and special rules. For example, punitive damages and interest are always taxed. But the biggest exclusion from income is for personal physical injury recoveries. Damages for personal physical injuries and physical sickness are tax-free.



Conversely, damages for emotional distress are taxed unless the emotional distress is **triggered** by the physical injury. Clearly, that's confusing, and the IRS and courts frequently have to address the point since exactly what constitutes personal physical injuries or sickness isn't clear. The IRS normally wants to see "observable bodily harm" such as bruises or broken bones before it excludes damages from income.

If the case arises out of employment, the IRS knee-jerk reaction is that such recoveries are wage loss or otherwise taxable. See [The IRS Speaks Out On Employment Lawsuit Settlements](#). However, an employee suit may be partially tax-free if the employee has physical sickness from working conditions. In one case, stress at work produced a heart attack. See [Is Physical Sickness the New Emotional Distress?](#) In another, stressful conditions exacerbated the worker's pre-existing multiple sclerosis. See [Tax-Free Physical Sickness Recoveries in 2010 and Beyond](#).

Whatever you do, get tax advice **before** your settlement is documented. See [Address Taxes When You Mediate Civil Disputes](#). The IRS isn't bound by the parties' tax characterization, but often the IRS will respect it if it is reasonable. Also note that lawyers' fees can cause tax trouble.

If a contingent fee lawyer is to receive 40%, the tax law assumes the client received 100% and then paid the lawyer. If the case is an employment dispute, involves your trade or business, or is 100% for physical injuries, you won't pay tax on the legal fees. In most other cases, though, you may have to include the legal fees in income but then be unable to fully deduct them. See [Need A Tax Deduction? Pay Legal Fees By Year-End](#).

Whatever you do, don't wait until tax return time to consider these issues. Get some advice **before** you settle if you can. A little planning and some good tax language in your settlement agreement can make all the difference.

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