PERSPECTIVE
Los Angeles | Daily Journal
OCTOBER 9, 2023

Even Landlord Tenant Settlements Have Tax Issues

By Robert W. Wood

Commercial disputes between landlord and tenant involve tax issues, and so do their legal settlements. However, these disputes are less likely to involve tax surprises. After all, commercial tenants and their landlords are both likely to have tax lawyers or accountants looking after them. Besides, commercial tenants and commercial landlords are used to profits being taxed, and to business expenses being deductible.

Some expenses need to be capitalized (basically written off over time), but even with those rules, there are few tax surprises. But how about residential disputes? There are plenty of tax issues there. If your apartment has defects or is uninhabitable, you might stop paying rent, and even sue to get rent money back. If you are forced out of your apartment, you might claim wrongful eviction.

And some cases involve tenant claims that they were injured or became sick from mold, water damage, or other uninhabitable conditions. Eventually, at settlement time, a settlement agreement will need to be hammered out. All too often, tenants focus only on the dollar amount of the settlement, not the tax issues. It might go something like this.

Suppose that you sue (or threaten to sue) your landlord and are about to collect a settlement.

But someone mentions taxes, so you ask the simple question, you won't pay taxes on this, right? Wrong. In fact, if you use a contingent fee lawyer as most tenants do, you might end up paying taxes not only on your net recovery after legal fees, but also on the lawyer's money too. This is so even though your lawyer will most likely receive 100% of the settlement proceeds, deduct their legal fees, and just send you the balance, say 60% or so.

How could you be taxed on a legal settlement, especially on the whole 100%, when your lawyer takes 40% off the top? If that sounds impossible, welcome to the arcane tax world of settlements and judgments. The IRS taxes most lawsuit settlements, and exact wording matters, particularly if you are trying to avoid that grim result, or even to lessen the tax impact. Landlord tenant legal disputes are nothing new, there have always been many of them.

But COVID seems to have increased that tendency, both for commercial and residential tenants. In the case of residential tenants, if they are not careful, the tax result can be bad indeed. They may not even realize it until early the following year when an IRS Form 1099 arrives, usually for 100% of the money, even though they only got 60% of their settlement.

They might go to their accountant and say, gee, at least I can deduct the 40% legal fees, right? Most accountants are likely to answer no. In 2018, the tax law was changed to disallow most legal fee deductions, except by businesses. Put differently, in many cases, there is a tax on lawsuit settlements, with legal fees that can't be deducted. That can mean paying tax on 100%, even if 40% off the top goes to your lawyer. For ideas how some can get around the tax treatment of attorney fees, check out 12 ways to deduct legal fees under new tax law.

Of the attorney fees aside, what kind of overall tax result can a settling tenant expect? It depends a lot on the facts. In some tenant cases, it is possible to see some or all of the settlement as a reimbursement of rent that is not taxable. In others, it is possible to view some or all the settlement as a lease buyout that is taxable as capital gain rather than ordinary income.

Fortunately, it is sometimes possible to treat the settlement as a lease buyout and therefore as capital gain (on general principles and/or under section 1234A of the tax code). In that event, one may be able to capitalize the legal fees, so they are an addition to basis or a selling expense. Of course, the tax rates spreads can be significant.

Ordinary income is taxed at 37%. But capital gain (depending on income level and the size of the gain) can be taxed as low as 0% and as high as 23.8%. Even if you are in the highest tax bracket, paying 23.8% is better than paying 37%. But it isn't entirely about tax rates, because capital gain reporting can involve recouping basis too. And that is where legal fees come in.

If you are able to treat your settlement as capital gain rather than income, you should also be able to offset your legal fees on your taxes. In effect, if you spent 40% of your settlement in legal fees to collect the other 60%, you can offset the 40%, treating it as your basis. It's important to establish that your settlement is capital gain, but settlement agreement wording can help on that point.

Tax reporting is also worth addressing in your settlement agreement. If you receive an IRS Form 1099 saying you received "other income," it is usually ordinary income. But a tax adviser may opine it is capital, and your tax return might sail through fine. Even in audit, you might convince the IRS it is capital. If you don't qualify for capital gain treatment, there is often still a way to deduct your legal fees, so at least you are only paying tax on 60%, not 100%.

Finally, if you suffered physical injuries or physical sickness, you might be able to treat a portion of your settlement as excludable from income (tax-free) under section 104 of the tax code (for mold, or other tenant sickness issues, PTSD, etc.). Section 104 of the tax code excludes from income damages for physical injuries and physical sickness. But if you make claims for emotional distress, your damages are taxable.

Robert W. Wood *is a tax lawyer with www.WoodLLP.com, and the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This is not legal advice.*