



Robert W. Wood

THE TAX LAWYER

Apr. 17 2012 — 10:18 am

Three Worst IRS Tax Traps

As you get ready to file or go on extension—see [Does Going on Return Filing Extension Increase IRS Audit Risk?](#)—there’s lots to fret about. Don’t forget that you sign returns under penalties of perjury. Opinions about tax traps vary widely, but I consider these the worst parts of the tax code.



Personal Injury Exclusion. If you’re physically injured in an accident and receive damages, they are tax free. So says [Section 104](#) of the tax code. Only punitive damages and interest are taxed. Up until 1996, just about anything qualified, including emotional distress, defamation or invasion of privacy. See [Don’t Fail To Consider Taxes When Settling Litigation](#). But in 1996, the tax code was changed to say only recoveries for physical injuries or physical sickness qualify.

Since then, there’s been no end of litigation about the scope of this tax exclusion and just how “physical” injuries must be to count. Headaches and insomnia? Not enough. Ditto for stomachaches. See [IRS To Collect on Italian Cruise Ship Settlements](#). The IRS hasn’t issued a formal interpretation of the “physical” modifier but routinely argues in audits and tax cases that there must be “observable bodily harm”—think bruises or broken bones.

But many injuries are internal and much physical sickness can’t be observed with the naked eye. See [Are PTSD Recoveries Tax Free?](#)

Frustrated tax lawyers and accountants have repeatedly asked for regulatory guidance. Meantime, the U.S. Tax Court is clogged with taxpayers trying to determine what's taxed. See [Damages Are Taxable. Even for "Political Discrimination" Says IRS.](#)

Attorney Fees Pay AMT. If you win or settle a lawsuit and get damages through a contingent fee lawyer, watch out. Even if a third or more is paid directly to your lawyer, the IRS treats it as **100% paid to you**. If your case is against your employer, a special 2004 law gives you an "above-the-line" deduction so the legal fees won't affect your tax bill. See [Six Tax-Wise Ways To Reduce Your Legal Bills.](#)

Likewise, if 100% of your damages aren't taxable (say an auto crash injury), there's no tax on the fees. But in other non-business suits, attorney fees are income to you but you can claim only a miscellaneous itemized deduction. The [alternative minimum tax](#) means you pay tax on money your attorney received. Talk to a tax expert before signing any settlement. See [Duke Lacrosse Tax Lien Highlights How Lawsuits Are Taxed.](#)

Foreign Accounts and FATCA. A by-product of being required to report worldwide income to the IRS is that they want to know what you have and where it is. First the IRS and Treasury Department dusted off a 1970 money-laundering law requiring annual [FBAR](#) reports if you have more than \$10,000 overseas at any time during the year. If so, you must file a Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts ([FBAR](#)). FBARs are filed separately from tax forms (by June 30 each year), and the penalties for failure to file them are Draconian. See [Despite FATCA, FBAR Penalties Still Under Fire.](#)

But this year for the first time there's another wave of disclosure required. Under FATCA, if your foreign assets exceed \$50,000 you must file a [Form 8938](#), Statement of Specified Foreign Financial Assets. Although higher thresholds apply to some expatriates living long-term outside the U.S., the record-keeping and disclosure requirements are onerous.

The new Form must be filed **with** your tax return, and covers securities accounts, custodial accounts and more. See [IRS Form 8938 Or FBAR?](#) There's another raft of penalties too: up to a \$10,000 penalty for failure

to disclose and an additional \$10,000 for each 30 days of non-filing after the IRS notifies you. Criminal penalties may also apply.

For more, see:

[Will BP Oil Spill Victims Pay Tax On \\$7.8B Settlement?](#)

[FATCA Makes Banks Shut Out Americans](#)

[Will IRS Get Fat Off FATCA?](#)

[Are Expats Derailing The FATCA Express?](#)

[Happy FATCA Filing Season](#)

[IRS Exempts Many Expats From FATCA](#)

[Please Sir, Can I Have Some More FATCA?](#)

[Damages Are Taxable, Even for “Political Discrimination” Says IRS](#)

*Robert W. Wood practices law with [Wood LLP](#), in San Francisco. The author of more than 30 books, including *Taxation of Damage Awards & Settlement Payments* (4th Ed. 2009 with 2012 Supplement, [Tax Institute](#)), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*