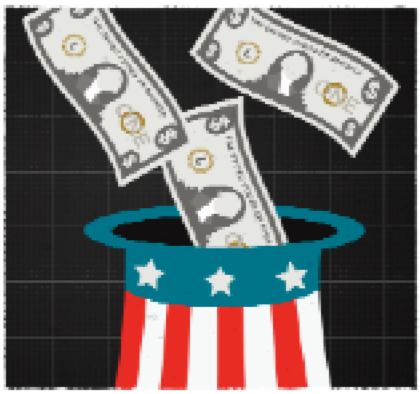
YOUR PAIN, THE IRS' GAIN

You've been done wrong. You win damages. Now Uncle Sam may want a cut.

BY ROBERT W. WOOD

Your car got rear-ended; you were fired unfairly; your contractor did shoddy work on your condo. Now you're due some money and wondering if Uncle Sam will demand a cut. The answer varies—depending on how you were damaged, how the case was resolved and more. So it pays to know a little about taxes on damages *before* you negotiate a settlement.



Physical injury awards are tax free
Damages for personal physical injuries (say, broken bones from an accident) are tax free, although punitive damages and interest paid on an injury award are taxable. Damages for emotional injuries are taxable. Physical symptoms caused by emotional distress—say, headaches—are generally taxable, but it's fuzzy and much litigated. Last year, for example, the U.S. Tax Court overruled an Internal Revenue Service decision to tax a $350,000 settlement a Maryland man received after suing his ex-employer for intentional infliction of emotional distress. Why? The distress arguably led to a real disease—a heart attack—the court said. Note, too, that payments for medical treatment, including counseling, aren't taxable.

How you settle can matter
You have more flexibility to reduce taxes if you settle, especially if you negotiate with an eye on the tax rules. So an agreement might say all the cash was for a (nontaxable) physical injury, while a court verdict might attribute some of it to taxable punitive damages or interest. (The IRS isn't bound by an agreement's wording, but it can help.)

Lose a job, pay the IRS
Severance pay is taxed and treated as wages, subject to tax withholding and payroll taxes (Social Security and Medicare), even though you no longer work at the company. Damages for discrimination are taxed as ordinary income, too, but not as wages—so you don't owe payroll tax. Emotional suffering from discrimination? Taxable—unless, for example, it gives you a heart attack. Outplacement and help with health insurance premiums (if paid directly to the insurer) aren't taxed.

Property damages can be tax free
If an auto crash payment or settlement from your contractor merely pays for the cost of fixing your car or condo, it's a "recovery of basis" and tax free, provided you don't get back more than you paid for the car or condo (and haven't claimed a casualty deduction for damage to the property). If the damage is to your business or factory, the same rules apply—although a recovery in excess of your basis might be taxed at the 15% capital gains rate.

Attorney fees can be a tax trap
Attorney fees in a business case are deductible as a business expense. In a personal case, watch out. The tax law treats you as receiving 100% of the settlement, even if the defendant issues a separate check to the lawyer for his cut. If your damages aren't taxable, that's no problem. Plus, a 2004 law makes attorney fees for discrimination awards deductible "above the line"—so they won't affect your tax bill. But in other nonbusiness suits, attorney fees count as a miscellaneous itemized deduction, meaning the alternative minimum tax and other gotcha tax provisions could leave you paying tax on money your attorney received. Another reason to talk to a tax expert before you sign any settlement.

Robert W. Wood is a San Francisco tax lawyer and Forbes.com tax columnist.