



The Tax Lawyer

10 Things To Know About Taxes On Damages

Robert W. Wood, 04.29.10, 3:13 PM ET

Your car got rear-ended while stopped at a red light. Your contractor did shoddy work on your condo. You were unfairly fired. Someone did you wrong and now you're collecting a settlement payment or judgment. Is it taxable income? Usually yes, but the tax treatment can vary enormously, depending on how you were damaged, how the case was resolved, how the checks and IRS Forms 1099 were issued and other variables.

Here are 10 things you should know about the taxation of settlements.

1. Settlements and judgments are taxed the same.

The same tax rules apply whether you are paid to settle a case or win a lawsuit judgment, or even if your dispute only reached the letter-writing phase. Despite the similarities, though, you'll almost always have more flexibility to reduce taxes if a case settles rather than goes to judgment.

If you are audited, you'll need to show what the case was about and what you were seeking in your claims. Consider the settlement agreement, the complaint, the checks issued to resolve the case, IRS Forms 1099 (or W-2), etc. You can influence how your recovery is taxed by how you deal with these issues.

2. Taxes depend on the "origin of the claim."

Settlements and judgments are taxed according to the item for which the plaintiff was seeking recovery (the "origin of the 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 and severance, you'll be taxed as receiving wages. In fact, your former employer will probably withhold income and employment taxes on all (or part of) your settlement even if you no longer work there.

But if you sue for damage to your condo by a negligent building contractor, your damages usually 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 (see point 3).

3. Recoveries for personal physical injuries and physical sickness are tax-free.

If you sue for personal physical injuries like a slip and fall or car accident, your damages are tax-free. That may seem odd, since you may be seeking lost wages because you couldn't work after your injuries. But a specific section of the tax code--Section 104--shields damages for personal physical injuries and physical sickness. Before 1996 "personal" damages were tax-free. That meant emotional distress, defamation and many other legal injuries also produced tax-free recoveries.

But since 1996 your injury must be "physical." Neither the IRS nor Congress has made clear what that means, but the IRS says your injuries must be visible to be "physical." This "observable bodily harm" standard generally means that 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.

4. Symptoms of emotional distress are not "physical."

The law draws a distinction between money you receive for physical symptoms of emotional distress (like headaches and stomachaches) and physical injuries or sickness. These lines are not clear. For example, if in settling an employment dispute you receive \$50,000 extra because your employer gave you an ulcer, is an ulcer physical or is it merely a symptom of your

emotional distress? Many plaintiffs end up taking 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. That means it can behoove you to try to get agreement with the defendant about the tax issues. There's nothing improper about doing this. In fact, given the great variation in tax reporting and the players in litigation (the parties, their insurance companies and their attorneys), it seems foolish not to try to nail all this down. You may have to pay for outside tax experts, but you'll almost always save considerable money later by spending a little at this critical moment.

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 more on medical expenses, [click here](#).) For example, payments to a psychiatrist or counselor qualify, as do payments to a chiropractor or physical therapist. Many nontraditional treatments count too.

However, if you have previously deducted the medical expenses and are reimbursed when your suit settles in a subsequent year, you may have to pay tax on these items. Under the "tax benefit" rule, if you previously claimed a deduction for an amount that produced a tax benefit to you (meaning it reduced the amount of tax you paid), you must pay tax on that amount if you recover it in a subsequent year. The opposite is also true. If you deducted an amount in a previous year, and that deduction produced no tax benefit to you, then you can exclude the recovery of that amount in a later year from your gross income.

You also can't generally claim future medical expenses. If you settle an employment discrimination case for \$500,000, and insist that \$100,000 is for your future psychiatric expenses, can you exclude that \$100,000 from income? Usually no, since you haven't yet incurred the expenses.

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. In fact, as a practical matter, what the parties put down in the agreement is often followed. And in the real world, there are usually multiple categories of damages.

For all of these reasons, it's more realistic--and more likely to be respected by the IRS and other taxing authorities--if you divide up the total and allocate it across a couple of categories. If you're settling an employment suit, there might be some wages (with withholding of taxes and reported on a Form W-2); some nonwage emotional distress damages (taxable, but not wages, so reported on a Form 1099); some reimbursed business expenses (usually nontaxable, unless the employee had deducted them); some pension or fringe benefit payments (usually nontaxable); and so on. There may even be some payment allocable to personal physical injuries or physical sickness (nontaxable, so no Form 1099), though this subject is controversial (see points 3 and 4 above).

7. You may have capital gain instead of ordinary income.

Outside the realm of suits for 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, the resulting settlement may be treated as capital gain, taxed at a current top rate of 15% instead of 35%.

Even better, depending on your tax "basis" (basically, your original purchase price, increased by any improvements you've made, and decreased by depreciation, if any), your settlement may be treated as a recovery of basis, not income. There are other circumstances where this ordinary versus capital distinction can be raised, so be sensitive to it.

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. That's why many clients say they are paying tax on money (the lawyer's fees) they never received.

If your case involves claims against your employer or for other defined forms of unlawful discrimination, there's an "above the line" deduction for legal fees. (That means you deduct those legal fees before you reach the adjusted gross income ("AGI") line on the front of your 1040, which prevents the problems related to miscellaneous itemized deductions taken after your AGI has been calculated.) But outside of employment or other unlawful discrimination litigation, watch out. There are sometimes ways of circumventing these rules, but you'll need sophisticated tax help before your case settles to do it.

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 (plus, you can have trouble deducting your attorney fees!--on this point, see item 8 above).

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. If you're in a car crash and about to receive \$50,000 in compensatory (tax-free) damages and \$5 million in punitive damages, can you settle for \$2 million that is all tax-free?

It depends. You'll need professional tax assistance, and the facts and procedural posture of your case are important. In some cases, though, you can be much better off, from a tax viewpoint, taking less money.

10. It pays to consider the defense.

We've focused on plaintiffs, since they generally are much more worried about tax planning than defendants. Nevertheless, consider the defense perspective too. 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. Defendants can also run up against questions about whether an amount can be immediately deducted or must be capitalized.

For example, if buyer and seller of real estate are embroiled in a dispute, any resulting settlement payment may need to be treated as part of the purchase price and capitalized, not deducted. The tax rules governing capitalization vary, but real estate usually must be capitalized over 31.5 years--a far cry from an immediate deduction!

The bottom line is this: It can be tempting to just bring your dispute to an end and to 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, and you'll be better off considering taxes earlier. Often, you can save yourself some serious money.

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