



A Lawyer's Guide to Tax Treatment of Settlement Payments

By Robert W. Wood

Every lawyer should know a few key tax rules that could influence what clients will take home when the smoke clears after a lawsuit is resolved. Wording in settlement agreements influences taxes to a surprising degree, and a little tax knowledge can come in handy when you are trying to settle cases. Plaintiffs want to know whether their settlement is taxable, and even if your engagement letter says you do not advise about taxes, it helps to know the basics.

Answering “is this taxable or not?” can be harder than you might think. The tax treatment depends on the claims, whether the case settles or goes to judgment, how checks and IRS Forms 1099 are issued, and more. Here are some tax tips about this surprisingly thorny area.

Settlement or Judgment

The same tax rules apply to settlements and judgments, but you have more predictability and more flexibility to reduce taxes when a case settles. If your client is suing for personal physical injuries, the compensatory damages should be tax free. The case may be about a slip-and-fall or car accident, medical malpractice, medical devices, sexual assault, or most any kind of personal (and physical) injury. In many of these cases, plaintiffs are seeking lost wages, because they couldn't work after their injuries.

Is there a danger that those lost wage claims will make the case taxable, since wages are always taxed? You might think so, since wages are always taxable, and wage claims in employment lawsuits are taxed. But with a personal physical injury case, even lost wages aren't taxed. The *reason* for the payment is the physical *injury*, making the compensatory damages tax-free, even if you use wage loss as a measure of the damages.

Physical Injuries

Section 104 of the tax code shields damages for compensatory personal physical injuries and physical sickness, but there are some important qualifiers. First, note the “physical” requirement. Lawyers may say “personal injury,” but it can be dangerous when you are talking taxes. Before 1996, “personal” injury damages were tax free. That meant emotional distress, defamation, and many other kinds of legal injuries *also* produced tax-free recoveries.

But that changed in a fundamental way in 1996 when Section 104 of the tax code was amended. Since then, your injury must be *physical* to give rise to tax-free money. Unfortunately, neither the IRS nor Congress has made clear exactly what is physical and what is not. The IRS has generally said that you must have visible harm (like cuts or bruises) for your injuries

to be physical. Damages for emotional distress are taxed, unless the emotional distress arises from physical injuries.

What if you are not injured yourself, but have loss of consortium claims related to a loved one? In general, loss of consortium damages related to an underlying physical injury or wrongful death of someone else can also qualify for tax-free treatment. In effect, the loss of consortium damages receives a kind of piggy-back tax status, on top of someone else's physical injury or wrongful death. But there are still vast gray areas in what qualifies as physical.

Settlement Agreement Wording

Many plaintiffs end up in tax audits and even litigation with the IRS. For example, is post-traumatic stress disorder taxable like emotional distress damages? Or is PTSD itself a physical sickness/physical injury and therefore tax free? There is no IRS ruling or tax court case yet about PTSD, but there are good arguments that PTSD damages shouldn't be taxed. In contrast, the tax cases so far say that damages for anxiety and depression are akin to emotional distress damages and are taxable.

Not surprisingly, settlement agreement wording matters. The U.S. Tax Court hears numerous cases on the question whether damages are tax-free, and it is an inherently factual area. But explicit settlement agreements can go a long way, even in an audit. Conversely, particularly where settlement agreements are not explicit, the IRS often takes a harsh view in audits, and the tax court tends to back up the IRS in most cases. Therefore, unless it is obvious that your client has physical injuries, and that the settlement agreement classifies the recovery in this way, it is a good idea to recommend that your client get tax advice.

Punitive Damages and Interest

Apart from the question of what is "physical" enough, there are also some other big qualifiers of the tax-free damage category. For example, punitive damages and interest are always taxable, even if your client's injuries are 100 percent physical. Suppose that your client is injured in a car crash, and you get a verdict for \$50,000 in compensatory damages and \$5 million in punitive damages. The \$50,000 is tax free, but the \$5 million is fully taxable.

What's more, your client may be unable to deduct your attorney fees. The bizarre math works like this. First, in any contingent fee case, *for tax purposes*, the plaintiff is treated as receiving 100% of the money, even your fees. This is the tax rule even if your fees are separately paid and don't pass through the plaintiff's hands. The U.S. Supreme Court reached this pivotal tax decision in 2005 in *Commissioner v. Banks*.¹

In employment and whistleblower cases, plaintiffs are not hurt by the *Banks* case, because the tax code provides an above-the-line deduction for legal fees. Above the line means the legal fees are a wash, gross income to the plaintiff, but immediately (and fully) tax deductible, so the plaintiff doesn't end up paying taxes on the legal fees. But how about in a non-employment and non-whistleblower case?

You might not think about taxes in most personal physical injury cases that settle before trial. Even if you've asked for punitive damages, if the case settles before trial, it's likely all compensatory damages. But in a case that goes to verdict with punitive damages, there's no easy way to deduct the legal fees on the contingent legal fees attributed to the punitive part of the case.

You might receive a tax-free settlement or judgment, but pre- or post-judgment interest is always taxable. As with punitive damages, taxable interest can produce attorney fee deduction problems. Legal fees are allocated pro rata by the IRS. Therefore, if your case is 20% compensatory and 80% punitive, that could mean no tax deduction for 80% of the legal fees. Up until the end of 2017, you could claim a tax deduction for your legal fees.

However, since 2018, when miscellaneous itemized deductions were eliminated, there was no longer a universal tax deduction for legal fees. There is a deduction for legal fees in employment, whistleblower and civil rights cases, and the latter is broader than you might think. Still, clients will need tax help to navigate them beyond their local accountant. The lack of a universal tax deduction for legal fees catches many plaintiffs by surprise at tax return time.

Settlements Improve Taxes

A settlement is always better than a judgment from a tax viewpoint, since a settlement affords you more ability to inject helpful tax allocation wording and Form 1099 reporting as you negotiate a settlement agreement. That means much more predictability for the plaintiff too. Unless the defendant demands an unacceptable discount off a verdict, settling after a verdict and while a case is on appeal can be a tax-smart move. Of course, you are unlikely to want to give up too much of a hard-won verdict to settle for tax reasons.

Even after a verdict, a settlement will typically save tax dollars over the verdict being paid, although the verdict numbers cannot be entirely ignored. For example, suppose that the case with the \$50,000 in compensatory damages and \$5M of punitive damages settles on appeal. It may not be credible to say that a \$2M settlement is all compensatory. However, the presence of a cross appeal for additional compensatory damages might give you a lot more flexibility. And remember, if you

are a plaintiff with a contingent fee lawyer, the IRS treats you as receiving 100% of the money, even if the defendant pays your lawyer directly.

If your case is fully nontaxable like a physical injury case that settles before trial, that should cause no tax problems, but it pays to make sure your client's injuries qualify as "physical." Also, where a verdict is rendered with punitive damages or interest, the plaintiff should get tax advice regardless of whether the case is settled or the verdict is paid. How the legal fees should be handled from a tax viewpoint is a big issue.

Tax Language in Settlement Agreements

Lawyers should be alert to how important it is to inject tax allocation and characterization language into a settlement agreement. It may be self-serving, but it never hurts to specify that the damages are for compensatory physical injury damages. In an IRS audit – plaintiff lawsuit settlements are frequent the subject of IRS and state income tax audits – the IRS usually asks for the settlement agreement first. If the settlement agreement seems to track what the plaintiff put on their tax return, that may end the audit.

IRS Form 1099 Issues

Specifying that your client will not be issued an IRS Form 1099 can help your client avoid an unpleasant surprise in January of the year after settlement. January is when most IRS Forms 1099 arrive, and most lawyers receive plenty of them. According to the IRS instructions for Form 1099-MISC, settlement proceeds for compensatory personal physical injuries should not be the subject of an IRS Form 1099 *to the plaintiff*.

Even so, unwelcome IRS Forms 1099 are issued a lot more than you might think. When they are, plaintiffs need to explain them on their tax return. Tax advice before the case settles can make a big difference.



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Endnote

1. *Commissioner v. Banks*, 543 U.S. 426 (2005).

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