

Another Settlement is Taxed Because of Poor Settlement Agreement

By Robert W. Wood

The tax treatment of lawsuit settlements can depend on the wording of the settlement agreement. For example, in *Blum v. Commissioner*, T.C. Memo. 2021-18. Debra Jean Blum received a \$125,000 settlement from a lawyer who botched her personal physical injury suit. Had she recovered in the original injury suit, that money would have been tax free. But she sued her lawyer for flubbing the suit, and she received an IRS Form 1099 for her settlement.

Unfortunately, she did not report it on her tax return. The lessons of the *Blum* case are not limited to the tax treatment of legal malpractice recoveries. It does not mean that legal malpractice recoveries for botched personal (physical) injury lawsuits cannot be tax-free, but in any settlement, care is needed. Ms. Blum was in the hospital for a knee replacement, but was injured in a wheelchair accident. She hired a lawyer and sued the hospital for negligence, but her case was dismissed. When she sued her lawyers for malpractice, she was trying to get the money that she would have collected in her hospital negligence case.

However, the settlement agreement said it was *only* for alleged legal malpractice, and explicitly was *not* for any personal physical injuries. In short, it did the exact *opposite* of what would have been helpful tax language. Settlement agreement wording is important. In fact, I would argue that it is *essential* if you want to avoid trouble. It does not bind the IRS or the states, but it can still go a long way. Quite apart from the truly terrible settlement agreement wording in *Blum*, there were other problems too.

What if the defendant or defendant's insurance carrier issues the plaintiff a Form 1099 for the settlement? It happens more frequently than you might think, even where the settlement agreement doesn't say anything about tax forms, or might even negate them. Does that flip the switch and always make a settlement taxable? Plainly no.

But unless you can get the defendant to undo the form (yes, there's a way to do that), the Form 1099 *must* be addressed on the tax return. Ms. Blum ignored the Form 1099, and that was the first domino to fall. A Form 1099 does not mean that a payment is always income, of course. But it usually does, and the IRS will rightly assume it is. It is a real killer if a Form 1099 is issued, but the taxpayer does not address it on her tax return.

Perhaps the form is lost in the mail, the taxpayer moves, or unwittingly ignores the form. In any event, if the IRS computer spits out a tax return that fails to account for a Form 1099, you should respond with care. I have resolved numerous cases of that sort where the facts and documents are strong. However, easy fixes are not always possible. Weak settlement agreement wording and failure to report a Form 1099 can be tall mountains to climb.

The result can depend on the facts, documents, handling, and even luck. Context matters too. You might not be claiming that a payment is excludable under section 104. You might be

saying that some or all of it is long-term capital gain. You might be claiming that it is basis recovery rather than income. All of these require facts, planning and thought. With a Form 1099, you do not have a choice about addressing it on your return in some fashion.

The definition of gross income is very broad, and exclusions from income are narrowly construed. In the case of Section 104, the Tax Court has said that "for a taxpayer to fall within this exclusion, he must show that there is a direct causal link between the damages and the personal injuries sustained." See *Doyle v. Commissioner*, T.C. Memo. 2019-8. The nature of the legal claim controls whether the damages are excludable from income under section 104(a)(2). The nature of the claim is typically determined by reference to the terms of the agreement.

This sentence in the *Blum* opinion says it all: "We need look no further than the parties' settlement agreement to conclude that the settlement payment is not excludable under section 104(a)(2)." The settlement agreement said the settlement was for malpractice and *expressly negated* any physical injury claim. Ms. Blum still tried to argue that the attorneys *intended* to compensate her for her physical injuries at the hospital, but court responded: "The settlement agreement dooms her contention."

Language matters. My guess is that the judge in *Blum* felt hamstrung by a settlement agreement that was hard to ignore. Ms. Blum was trying to get money from her lawyers that would have been tax-free had she collected from the hospital, but I think the extraordinarily bad settlement agreement was fatal. Of course, the case might not have become a case at all with better handling.

The settlement agreement could have been a lot better, and it could have negated a Form 1099. Forms 1099 are worth fighting about when negotiating a settlement agreement. The only bargaining power the plaintiff has is before it is signed, and you don't want to be surprised in January when Forms 1099 arrive.

In the end, this case had very little going for it, a kind of playbook for missed tax opportunities. Settlement agreement wording is *really* important and is an opportunity you should never let slip by. In IRS audits or queries, the IRS may be satisfied with the settlement agreement, and may not ask for further documents, so word it carefully.

Forms 1099 should be addressed explicitly whenever you can. And any Form 1099 that is issued should not be ignored. To be sure that you know about all Forms 1099, getting an IRS transcript can be a useful cross-check. The IRS system is often slow to be updated, so going on extension just to keep checking your transcript can be a useful precaution. These basic lessons apply across the board, to any kind of case.

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.