How Legal Settlements and Judgments are Taxed

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Lawyers and clients resolve disputes all the time, usually with an exchange of money and a release. Of course, almost any time money changes hands, there are tax issues, too, usually for both sides. Most lawyers rightly tell their clients that they are not tax advisers, and that it is worth seeing a tax lawyer or accountant to get straight on the tax implications.

Yet, after such a disclaimer, some lawyers do succumb to the temptation to offer some free tax advice. For example, the lawyer might say, 'I'm not a tax lawyer, but don't worry, all these damages are non-taxable.' But whether you are a lawyer or a client, a basic grounding in these issues will help you, not only with your own taxes, but possibly with colleagues' taxes too.

The tax issues come up in a surprising number of ways. Your car got rear-ended while stopped at a red light. Your contractor did shoddy work on your condominium. You were unfairly fired. Someone did you wrong, and now you're collecting a settlement payment or judgment. The first question in any of these situations is whether the settlement (or judgment) you get is taxable income. Usually, the answer is yes.

Of course, 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 ten rules lawyers and clients 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").[1] 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. That is so even if you no longer work there-- even if you quit or were fired years ago.

On the other hand, if you sue for damage to your condominium by a negligent building contractor, your damages usually will not be income. Instead, the recovery may be treated as a reduction in your purchase price of the condominium. That favorable rule means you might have no tax to pay on the money you collect.

However, these rules are full of exceptions and nuances, so be careful. Perhaps the biggest exception of all applies to recoveries for personal physical injuries.

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

This is a really important rule, and one that causes almost unending confusion with lawyers and their clients. If you sue for personal physical injuries, like a slip and fall or car accident, your compensatory damages should be 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.[2] Note the "physical" requirement. Before 1996, "personal" injury damages were tax-free. That meant emotional distress, defamation, and many other legal injuries also produced tax-free recoveries. That changed with the 1996 amendments to the key tax code provision.[3]

Since then, your injury must be "physical" to give rise to tax-free money. Unfortunately, neither the IRS nor Congress has made clear what that means. The IRS has generally said that you must have visible harm (cuts or bruises) for your injuries to be "physical."[4] 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 is not physical enough for the IRS. But some courts have disagreed. The tax court, in particular, has allowed some employment lawsuits complete or partial tax-free treatment, where the employee suffered physical sickness, or the exacerbation of a pre-existing illness, from the employer's conduct.[5]

Thus, standards are getting a little easier. However, taxpayers routinely argue in U.S. Tax Court that their damages are sufficiently physical to be tax-free. And the IRS usually contests those arguments successfully.[6] In many cases, a tax-savvy settlement agreement could have improved the plaintiff's tax chances.

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

The tax law draws a distinction between the money you receive for physical symptoms of emotional distress (like headaches and stomachaches) and the money you receive for personal physical injuries or physical sickness.[7] Here again, 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, should the ulcer be considered a physical injury, or 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 an agreement with the defendant about the tax issues. There is nothing improper about doing this.

There are wide variations in tax reporting, and multiple players often are involved in litigation (parties, their insurance companies, and their attorneys). Thus, not trying to nail all this down in the settlement agreement can be foolish. 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.

Otherwise, you might end up surprised with Forms 1099 you receive the year after your case settles. At that point, you will not have a choice about reporting the payments on your tax return.

5. Medical expenses are tax-free.

Even if your injuries are purely emotional, payments for medical expenses are tax-free, and the standard for what constitutes "medical expenses" is surprisingly liberal.[8] 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. Blame the "tax benefit" rule.[9] It says that 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.[10]

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 is a good chance the total settlement amount will involve several types of consideration.

It is usually best for plaintiff and defendant to try to agree on what is being paid and and how it should be treated for tax purposes. Such agreements are not binding on the IRS or the courts in later tax disputes, but they are rarely ignored. 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 is 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 multiple categories. If you are 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), although this subject is controversial.[11]

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

Outside the realm of suits for physical injuries or physical sickness, just about everything is income. However, that does not answer the question of *how* a recovery will be taxed. If your suit is about damage to your house or your factory, the resulting settlement may be treated as capital gain. Long-term capital gain is taxed at a lower rate than ordinary income (15 percent or 20 percent versus 39.6 percent), so is much better than ordinary income.

Apart from the tax rate preference, your tax basis may be relevant, too. This is generally your original purchase price, increased by the cost of any improvements you have made, and decreased by depreciation, if any. In some cases, your settlement may be treated as a recovery of basis, not income.

A good example would be harm to a capital asset, such as your house or your factory. If the defendant damaged it and you collect damages, you may be able to simply reduce your basis rather than reporting gain. Some settlements are treated like sales, so again, you may be able to claim your basis.[12] In fact, there are many circumstances in which the ordinary income versus capital gain distinction can be raised, so be sensitive to it. For example, some patent cases can produce capital gain instead of ordinary income.[13] The tax rate spread can be nearly 20 percent.

8. Attorney fees can be a trap.

Whether you pay your attorney on an hourly or a contingent fee basis, legal fees will impact your net recovery and your taxes. If you are the plaintiff and use a contingent fee lawyer, you usually will be treated (for tax purposes) as receiving 100 percent of the money recovered by you and your attorney. This is so even if the defendant pays your lawyer the contingent fee *directly*.

If your case is fully nontaxable (say, an auto accident in which you are physically injured, and you receive compensatory damages), that should cause no tax problems. But if your recovery is taxable, the type of deduction you can claim for the legal fees can vary materially. This trap occurs frequently.

Say you settle a suit against your neighbor for intentional infliction of emotional distress for $100,000, and your lawyer keeps 40 percent, or $40,000. You might think that you would have $60,000 of income. Instead, you will have $100,000 of income, followed by a $40,000 miscellaneous itemized deduction.[14]

That means you will be subject to numerous limitations that can whittle your deduction down to nothing. For alternative minimum tax (AMT) purposes, you get no tax deduction for the fees. That is why many clients say they are paying tax on money (the lawyer's fees) they never received. Notably, not all lawyers' fees face this harsh tax treatment.

If the lawsuit concerns the plaintiff's trade or business, the legal fees are a business expense. Those legal fees are above the line (a better deduction).[15] Moreover, if your case involves claims against your employer, or involves certain whistleblower claims, there is an "above-the-line" deduction for legal fees.[16]

That means you can deduct those legal fees before you reach the adjusted gross income ("AGI") line on the first page of your Form 1040. An above-the-line deduction prevents the problems related to miscellaneous itemized deductions taken after your AGI has been calculated. But outside of employment and certain whistleblower claims, or your trade or business, be careful. There are sometimes ways of circumventing these attorney fee tax rules, but you'll need sophisticated tax help before your case settles to do it.

9. Punitive damages and interest are always taxable.

Punitive damages and interest are always taxable, even if your injuries are 100 percent physical. Say you are injured in a car crash and get $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, you can have trouble deducting your attorney fees.[17]

The same occurs with interest. You might receive a tax-free settlement or judgment, but pre- or post-judgment interest is always taxable.[18] As with punitive damages, taxable interest can make it difficult to deduct attorneys' fees. These rules can make it more attractive (from a tax viewpoint) to settle your case rather than have it go to judgment.

Suppose that you were in a car crash and are about to receive $50,000 in compensatory (tax-free) damages, plus $5 million in punitive damages. Can you settle for $2 million that is all tax-free? It depends (among other things) on whether the judgment is final or on appeal.

If the case is on appeal, then the tax effect of your settlement payment also depends on what issues are up on appeal. 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.

Plaintiffs are generally 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.

Even punitive damages are tax deductible by businesses. Only certain government fines cannot be deducted. And even then defendants can sometimes find a way to deduct the payment, if the fine is in some way compensatory.

Despite these broad deduction rules for businesses, not everyone is so lucky. If the suit is related to investments, a defendant's payment may be deductible only against investment income, or the amount that can be deducted in respect of the payment may be subject to limits. If the suit is purely personal, the defendant may get no deduction at all. In some cases, 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 a buyer and a 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.

Conclusion

Nearly every piece of litigation eventually spouts tax issues. It can be tempting just to bring your dispute to an end, and to let the tax chips fall where they may. But whether you are a plaintiff, a defendant, or counsel for one or the other, that can be a mistake. Before you resolve the case and sign, consider the tax aspects. Tax withholding, tax reporting, and tax language that might help you are all worth addressing. You will almost always have to consider these issues at tax return time the following year; you can often save yourself money by considering taxes while your case is still pending.

Endnotes

1 *See, e.g., United States v. Gilmore*, 372 U.S. 39, 49 (1963); *Hort v. Commissioner*, 313 U.S. 28 (1941); *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952).

2 26 U.S.C. §104

3 *See* Section 1605(a) and (b) of the Small Business Job Protection Act of 1996, Public Law 104-188, 110 Stat. 1838. The legislative history of the 1996 amendments to IRC § 104(a)(2) provides that the reason for the change is because "[t]he confusion as to the tax treatment of damages received in cases not involving physical injury or physical sickness has led to substantial litigation, including two Supreme Court cases within the last four years. The taxation of damages received in cases not involving a physical injury or physical sickness should not depend on the type of claim made." H.R. Rep. No. 104-586, at 143 (1996) (Conf. Rep.).

4 *See* LTR 200041022 (July 17, 2000): "We believe that direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under section 104(a)(2)."

5 *See, e.g., Domeny v. Commissioner*, T.C. Memo. 2010-9 (exacerbation of multiple sclerosis symptoms); and *Parkinson v. Commissioner*, T.C. Memo. 2010-142 (heart attack from job stress).

6 *See, e.g., Sharp v. Commissioner*, T.C. Memo. 2013-290; *Molina et ux. v. Commissioner*, T.C. Memo. 2013-226.

7 *See* I.R.C. Section 104.

8 *See* I.R.C. Section 213.

9 *See* I.R.C. Section 111(a); *Hornberger v. Commissioner*, 4 Fed. Appx. 174 (4th Cir. 2001).

10 See *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 377 (1983).

11 *See* text at sections 3 and 4, *supra*.

12 See *Doud v. Commissioner*, 1982-158 (1982) (recovery for a stamp collection was not taxable income where Doud's basis in his collection was less than he recovered).

13 *See, e.g., Kucera v. Commissioner*, 1951 T.C. Memo LEXIS 269; E.*I. du Pont de Nemours and Co. v. U.S.*, 432 F.2d 1052, 1055 (3d Cir. 1970).

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

15 I.R.C. Section 162.

16 *See* I.R.C. Section 62(a)(20).

17 *See* text at section 8, *supra*.

18 *See Kovacs v. Commissioner*, 100 T.C. 124 (1993), *aff'd*, 25 F.3d 1048 (6th Cir. 1994) (holding that despite a lump-sum payment for wrongful death damages, the interest portion of the award simply did not constitute excludable damages under Section 104); Letter Ruling 199952080 (Sept. 30, 1999). This Letter Ruling involved the application of Section 104(a)(2) prior to its amendment by the 1996 Act. In order for amounts to be excludable under Section 104(a)(2) after the 1996 Act, they must be paid on account of personal physical injury or physical sickness.