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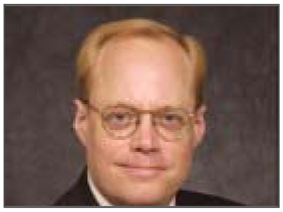

Robert W. Wood

THE TAX LAWYER

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IRS Gets A Share Of Most Legal Settlements

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After a bitter dispute, you're collecting a settlement or judgment. Is it taxable income and do you have to report it on your tax return? Usually yes, but the tax treatment can vary enormously. How you were damaged, how the case was resolved, and how the checks and IRS Forms 1099 were issued matter. See [10 Things To Know About Taxes On Damages].

Settlements and judgments are taxed based on the origin of your claim. If you're suing a competing business for lost profits, a settlement is lost profits, taxed as ordinary income. If you get fired at work and sue for severance and discrimination, you'll be taxed as receiving wages. Usually, though, employment settlements are split between wages reported on a [Form W-2] and an amount reported on an IRS Form 1099.

These rules are full of exceptions and nuances so be careful. The biggest exception is for personal physical injury recoveries. Damages for personal physical injuries and physical sickness are tax-free. Damages for emotional distress are taxed unless the emotional distress is triggered by the physical injury.

Unfortunately, that's confusing. Plus, exactly what constitutes personal physical injuries or sickness isn't clear. The IRS normally wants to see "observable bodily harm" such as bruises or broken bones. If the case arises out of employment, the IRS knee-jerk reaction is that such recoveries are wage loss or are otherwise taxable. See The IRS Speaks Out On Employment Lawsuit Settlements.

However, an employee suit may be partially tax free if the employee has physical sickness from working conditions. It must be much more than merely emotional distress. In one case, stress at work produced a heart attack. See Is Physical Sickness the New Emotional Distress?

In another, stressful conditions exacerbated the worker's pre-existing multiple sclerosis. See Tax-Free Physical Sickness Recoveries in 2010 and Beyond. Whatever you do, try to get tax advice ***before*** your settlement is documented. See Address Taxes When You Mediate Civil Disputes. The IRS isn't bound by the parties' tax characterization, but it is often respected if reasonable.

Punitive damages and interest are always taxed. Also note that lawyers' fees can cause tax trouble. If a contingent fee lawyer is to receive 40%, the tax law assumes the client received 100% and then paid the lawyer. But unless the case is 100% for physical injuries, an employment dispute or involves your trade or business, you may have no way to deduct the legal fees.

Whatever you do, don't wait until tax return time to consider these issues. Get some advice before you settle. A little planning and some good tax language in your settlement agreement can make all the difference.

Robert W. Wood practices law with Wood LLP, in San Francisco. The author of more than 30 books, including Taxation of Damage Awards & Settlement Payments (4th Ed. 2009 with 2012 Supplement, Tax Institute), he can be reached at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.