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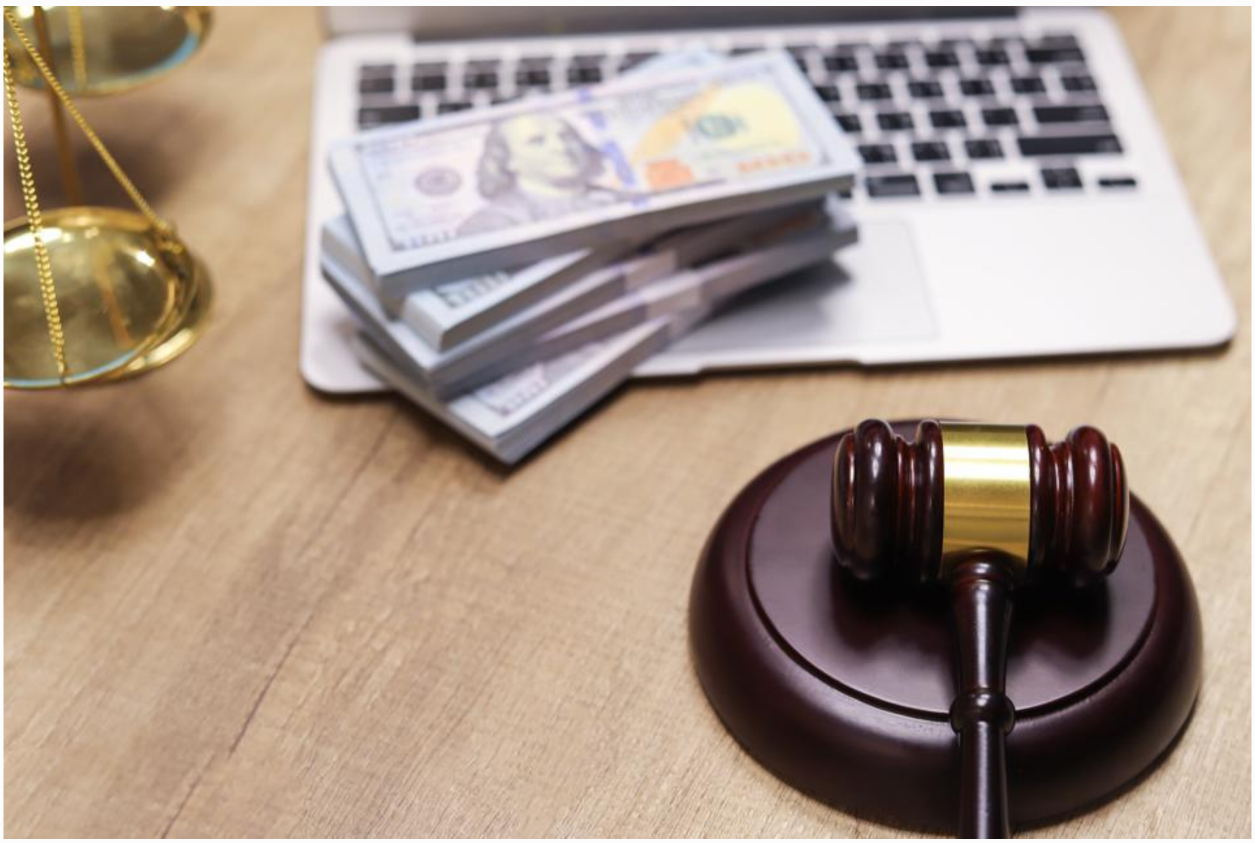
IRS Taxes Most Lawsuit Settlements And Exact Wording Matters

If you collect a legal settlement is it taxable? Usually yes, but the tax treatment varies depending on how you were damaged, how the case was resolved, how checks and IRS Forms 1099 were issued and more. Whether you settle your case, win a judgment, or even if your dispute only reached the letter-writing phase, taxes apply in most cases. Taxes depend on what the case was about, how the settlement agreement is worded, the complaint, how checks and IRS Forms 1099 are prepared and more. You can influence how your recovery is taxed by how you deal with these issues. Fortunately, if you sue for personal physical injuries like a slip and fall or car accident, compensatory damages should be tax-free even if you were seeking lost wages because you couldn't work after your injuries. Section 104 of the tax code shields compensatory damages for personal physical injuries and physical sickness.

However, your injury must be "physical," and it’s not clear exactly what that means. The tax law draws a distinction between money for physical symptoms of emotional distress (like headaches and stomachaches) and physical injuries or sickness. The issue come up in employment cases where plaintiffs claim their employer made their medical condition worse or gave them PTSD. The tax law is uncertain, but one can argue that PTSD itself is a physical sickness. An agreement between plaintiff and defendant is not binding on the IRS, but what the parties say in the agreement is often followed in an audit. Thus, it is wise to try to get agreement with the defendant about the tax issues. A key issue is tax reporting. If you don't say anything about taxes in a settlement agreement, you will almost variably receive IRS Form W-2 or Form 1099.



What's more, the tax treatment of legal fees can be particularly alarming. In most cases, a Form 1099 will say you got 100% of the money, even if 40% went directly to your lawyer. The tax rules on attorney fees are complex and difficult. So even if you aren't worried about the net money you receive, how legal fees are treated is a big deal. Since 2018 when the tax law changed, and many legal fees can no longer be deducted. That means plaintiffs are taxed on 100%—with no tax deduction for their legal fees. The math came be downright bizarre, as where taxes slashed a $2 billion Roundup weedkiller verdict. 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, and you may not be able to deduct the $40,000 at all. That's why many clients say they are paying tax on money (the lawyer's fees) they never received. It can leave you scrounging for ways to deduct legal fees even under the new tax law.

Fortunately, 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. 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. Even the math is tricky. 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, and you can have trouble deducting your attorney fees. 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. 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.

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