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IRS Taxes Personal Injury Settlements, Here's How

The tax treatment of legal settlements and judgments depends on the claims, whether the case settles or goes to judgment, how checks and IRS Forms 1099 are issued and more. The same tax rules apply to settlements and judgments, but you have more flexibility to reduce taxes when a case settles. If you sue for

personal physical injuries, the compensatory damages should be tax free under section 104 of the tax code.

The case may be about a slip-and-fall or car accident, medical malpractice, sexual assault, or most any kind of personal (and *physical*) injury. As part of the damages, the plaintiff may be seeking lost wages because they couldn't work after their injuries. Does that mean the lost wage claims are taxable? You might think so, since wages are always taxable.

But with a personal physical injury case, even lost wages aren't taxed. The reason for the payment is the physical injury itself, even if you are using wage loss as a measure of damages. Section 104 of the tax code shields damages for compensatory personal physical injuries and physical sickness. Yet there are some important qualifiers to this tax-free treatment.

First, note the "physical" requirement. 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 1996. 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.

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 are good arguments that PTSD damages shouldn't be taxed, but the tax law is not yet clear.

The IRS has generally said that you must have visible harm (cuts or bruises) for your injuries to be physical. But there are still vast gray areas in what qualifies as physical. Some plaintiffs end up in tax audits later. Settlement agreement wording matters too. The U.S. Tax Court hears numerous cases on the question whether damages are tax-free, and it is an inherently factual area.

But the IRS often takes a harsh view in audits, and the Tax Court tends to back up the IRS in most cases. So unless it is obvious that your client has physical injuries, it is a good idea to recommend that your client get some tax advice.

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 the plaintiff's injuries are 100 percent physical. Suppose that you are 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, you 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,* 543 U.S. 426 (2005).

In employment cases and whistleblower cases, plaintiffs are not hurt by the *Banks* case, because the tax code provides an above the line deduction for legal fees. That means the legal fees are a wash, gross income to the plaintiff, but immediately (and fully) 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, so 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.

But starting in 2018, there may be no deduction for these legal fees, since miscellaneous itemized deductions were eliminated (until 2026). Some creative solutions are possible, but clients will need tax help to navigate them beyond their local accountant. The lack of tax deduction for legal fees catches many plaintiffs by surprise at tax return time.

These rules can make it more attractive (from a tax viewpoint) to settle rather than have it go to judgment. Settling after a verdict while a case is on appeal can often be a tax smart move too. The economics should control, of course, and you don't want to give up too much of a hard-won verdict to settle for tax reasons. Besides, the verdict numbers can't be entirely ignored.

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 causes no tax problems. But it can pay to make sure your client's injuries qualify as "physical." And be extra careful with the tax treatment of punitive damages and interest. In fact, 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 does not bind the IRS, but it can be surprising how much wording in settlement agreements can matter. In an IRS audit—plaintiff lawsuit settlements are frequent the subject of IRS tax audits—the IRS usually asks for the settlement agreement. If the settlement agreement says that the settlement was paid on account of personal physical injuries, that may end the audit. In fact, having the settlement agreement go on to say that the settlement payment is "excludable from income under Section 104 of the Internal Revenue Code" is helpful too. Going the extra mile and 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. According to the IRS instructions for Form 1099-MISC, settlement proceeds for compensatory personal physical injuries are not supposed to be the subject of an IRS Form 1099 *to the plaintiff*. Even so, unwelcome 1099 forms are issued a lot more than you might think. When they are, plaintiffs need to explain them on their tax returns.

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