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Landlord-Tenant Settlements: Excludable, Ordinary, or Capital?

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In this article, Wood and Brown explore landlord-tenant legal settlements and how their tax treatment varies considerably.

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In a recent Tax Court case, tenants Luminita and Gabriel Roman settled litigation with their landlord and claimed that the $700,000 they received should not count as income.[1] Gabriel had a variety of medical problems and in several lawsuits, the couple alleged that the landlord harassed and discriminated against them because of those problems. To many, the Romans' assumption that the settlement was tax free might have seemed like a colorable tax claim. After all, section 104 says that damages on account of personal physical injuries and physical sickness are in most instances not taxable. But, as the Romans found out the hard way, the details of the legal claims and the documentation matter a good deal.

The Tax Court had an easy time agreeing with the IRS that the settlement paid to the Romans was fully taxable. Gabriel clearly had medical problems, including having to undergo spine surgery in 2010, and he was declared permanently disabled by the Social Security Administration. The Romans liked to litigate. They filed several state and federal discrimination, privacy, and fair housing suits against the owner and manager of the Los Angeles apartment building they lived in, so they were hardly the landlord's favorite tenants.

The landlord wanted to sell the building and to do that needed to get the Romans out of their apartment. In part, this allegedly resulted in a campaign of harassment and nuisance by the landlord and manager against the Romans to induce them to leave. Eventually, they worked out a $700,000 settlement that was paid in 2013. Neither Gabriel nor Luminita reported any of the settlement on their tax returns, even though it was reported as income on an IRS Form 1099. The Tax Court determined that this was not a settlement for personal physical injuries or physical sickness. Pure and simple, it was a payment to get them out of the apartment, and therefore fully taxable.

Failed Section 104(a)(2) Exclusion

The Romans' facts touch on a few oversights plaintiffs may make when trying to support an exclusion under section 104(a)(2). First, they failed

[1] *Roman v. Commissioner*, T.C. Memo. 2023-142.

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to allege that the landlord was responsible for any of Gabriel's physical injuries or physical sicknesses, or that the landlord's actions exacerbated Gabriel's preexisting physical injuries or physical sicknesses. Courts have repeatedly held that to be "on account of" a physical injury or physical sickness, the defendant must be credibly alleged to bear sufficient responsibility for causing or exacerbating the physical injury or physical sickness itself, not just the damage that may have some more indirect relationship to a physical injury or physical sickness.[2]

As the Tax Court noted, by failing to allege that the landlord's harassment caused any new physical injuries or exacerbated any of Gabriel's preexisting injuries or disabilities, the Romans "have not shown the nexus" between their physical injuries or physical sickness and the settlement payment. This requirement often causes failure to accommodate, wrongful termination, and disability discrimination cases to fail to qualify for exclusion. The landlord's harassment or failure to accommodate may in fact have been motivated by Gabriel's preexisting physical injury, sickness, or disability, as the Romans alleged in their litigation.

Even so, unless the plaintiff alleges that the defendant's actions caused or exacerbated the underlying physical injury or physical sickness, the causal relationship between the damages and the plaintiff's physical injuries, sickness, or disability is too attenuated to support exclusion under section 104(a)(2). Instead, the damage is considered to be "on account of" the defendant's harassment and other bad conduct, which is not itself a physical injury or sickness.

The Tax Court noted that the Romans argued that the landlord's actions exacerbated their physical injuries and physical sickness. But the court said the Romans "have not demonstrated that any claim for physical injuries against [the landlord] was considered when the Settlement Agreement was executed." Particularly when express allocation language is missing from the settlement agreement, the origin of the claim analysis is often based in significant part on the defendant's intent when agreeing to settle a claim.

A claim for physical injuries or physical sickness must generally be alleged to the defendant before settlement or judgment to support an allocation. Waiting until there is a tax dispute with the IRS to assert for the first time a connection between the defendant's actions and a physical injury is often too late. In *French*, the Tax Court denied an exclusion even though it was clear that the stress caused by a defendant's harassment caused the plaintiff to be hospitalized, suffering two pulmonary emboli that caused her to be medically dead — twice — before being resuscitated, and then placed in a medically induced coma for several days.[3]

Despite this, her complaint and litigation documents referred only to "emotional distress" and "inconvenience" and her clear physical injuries, including her coma and death, were never mentioned at trial. After the trial was over and she had received her recovery, her attorney testified in the tax dispute that the facts regarding her physical injuries were intentionally withheld from the defendant and jury to preserve her medical privacy. The Tax Court held that the jury and defendant could not have intended to compensate her for injuries intentionally kept from their knowledge.

In short, her exclusion was denied. The Romans also conflated physical symptoms of emotional distress (taxable), with physical injuries and physical sickness, which can qualify for exclusion. Mere physical "symptoms" of emotional distress, including insomnia, headaches, or stomach disorders, are not sufficient on their own to qualify for exclusion.[4]

The same symptom can be caused by several underlying conditions. For example, a headache can be caused by a virus, a tumor, a concussion, stress, an annoying companion, or an unpleasant smell. The list of possible causes may be longer for vague symptoms, such as fatigue or insomnia. For tax purposes, symptoms have no inherent tax

[2] *See, e.g.*, *Dern v. Commissioner*, T.C. Memo. 2022-90.

[3] *See French v. Commissioner*, T.C. Summ. Op. 2018-36.

[4] *See, e.g.*, H. Rep. No. 104-373, at 301, n.56 (1996) (Conf. Rep.); *Blackwood v. Commissioner*, T.C. Memo. 2012-190; *Wells v. Commissioner*, T.C. Memo. 2010-5.

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treatment, and damages received for symptoms follow the tax treatment of the underlying condition that created the symptoms.[5]

Luminita alleged experiencing panic attacks, depression, anxiety, and migraines on account of the landlord's harassment. However, she did not allege that these conditions were either physical injuries or physical sickness in their own right. She also did not allege that they were symptoms of any underlying physical injury or physical sickness. Therefore, the Tax Court viewed these claims as taxable emotional distress.

Landlord-Tenant Landscape

The Romans' landlord-tenant dispute aside, is every landlord-tenant dispute taxed in the same way? Far from it. Landlord-tenant disputes and settlements are common, and how they are taxed varies considerably according to the facts and the documents. Commercial disputes are less likely to involve tax surprises. After all, commercial tenants and their commercial landlords are both likely to have tax lawyers or accountants looking after them.

Commercial tenants and landlords are used to their profits being taxed and their business expenses being deductible. Some expenses may need to be capitalized (basically written off over time through depreciation deductions), but even with those rules, there are few tax surprises. But how about residential disputes? There are many variations, and there are plenty of messy tax issues in those cases.

If your apartment has defects or is uninhabitable, you might stop paying rent, and perhaps even sue to get your rent money back. If you are forced out of your apartment, you might claim wrongful or constructive eviction. Some cases involve tenant claims that they were injured or became sick from mold, water damage, or other uninhabitable conditions.

In the Romans' case, they believed they were being discriminated against because of Gabriel's disabilities. They alleged that they were subject to a retaliation and harassment campaign by the landlord that resulted in headaches, insomnia, and depression. However, this was insufficient to support an exclusion under section 104.

In assessing the tax treatment of any legal settlement, regardless of the type of case, the legal claims that are asserted matter. They can show up in a variety of documents, including demand letters, complaints, mediation briefs, damage reports, expert reports, and all manner of discovery documents. They may even show up in the settlement agreement itself, which is nearly always a critical document when considering the tax effect of a settlement.

Eventually, at settlement time, a settlement agreement will need to be hammered out. All too often, the parties focus only on the dollar amount of the settlement, not the tax issues. If they are not careful, the tax result can be bad indeed, particularly for the tenants. They may not even realize it until early the next year when a Form 1099 arrives.

Usually, Form 1099 will report 100 percent of the gross dollar amount awarded to plaintiffs, even though they may only collect 60 percent or so of their settlement after their attorneys retain their share. Tenants may go to their accountants assuming that they must only report their net recovery (the 60 percent), even if a Form 1099 reports 100 percent. But according to the Supreme Court in *Banks*,[6] the legal fees are gross income, too.

Deducting Legal Fees

In commercial disputes, most legal fees are deductible by both sides as business expenses. There may occasionally be questions about whether a particular legal expense must be capitalized, but by and large, deductions are the rule. The same applies to defendants in personal residential lease disputes, but how about the legal fees paid by the tenants or former tenants in these residential disputes?

They may not be so lucky. As noted, some tenants may be surprised the following year when they receive a Form 1099 for 100 percent of the proceeds — including the funds sent to their

[5]When a taxpayer's emotional distress was so severe that they experienced two heart attacks, the Tax Court reached the rather obvious conclusion that a heart attack is not a mere symptom of emotional distress and is its own physical injury sufficient to support exclusion under section 104(a)(2). *See Parkinson v. Commissioner*, T.C. Memo. 2010-142.

[6]*Commissioner v. Banks*, 543 U.S. 426 (2005).

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lawyer. Even if they realize that a Form 1099 must be fully accounted for on their tax return, they may assume that there can be no issue with deducting the 40 percent that was paid in legal fees. It can be a stark realization if their accountant tells them there is no way to deduct that 40 percent.

Section 212 allows a deduction of expenses to produce income. For decades, this deduction has allowed legal fees and expenses to be deducted in litigations that produced recoveries taxable as ordinary income. Formally, section 212 is still in the tax code. However, for most nonbusiness plaintiffs, the section 212 deduction is a "miscellaneous itemized" deduction for tax purposes.

In 2017, as part of the Tax Cuts and Jobs Act, miscellaneous itemized deductions were suspended for 2018 through 2025.[7] Although there is no indication that the ability of plaintiffs to deduct their legal fees was the target of this suspension, it is clear that they were caught in the wide net.[8] Unless a taxpayer can avoid the "miscellaneous itemized deduction" classification for their section 212 deductions, this can mean paying tax on 100 percent of the settlement, even if 40 percent off the top goes to the plaintiff's lawyer. Of course, the lawyer must also pay tax on their 40 percent.

The mechanics of distributing the settlement do not change the tax rules. In most cases, a plaintiff's lawyer will receive 100 percent of the settlement proceeds, deduct their legal fees, and send the plaintiff only the balance. But the *Banks* ruling makes clear that even then, for tax purposes, the plaintiff is treated as receiving 100 percent and then afterward paying their attorney their contingent fee and expense reimbursement. The plaintiff must report 100 percent and then try to support a deduction of the fees to avoid paying income tax on money they never actually received.

One promising path to avoid this result, and one attempted by the Romans, is to avoid the section 212 deduction being categorized as a miscellaneous itemized deduction in the first place.[9] In 2004, shortly before the Supreme Court decided *Banks*, Congress enacted an above-the-line deduction for employment claims, civil rights claims, and certain whistleblower claims. For employment claims, the deduction applies to attorney fees in claims of "unlawful discrimination."[10] Deductions that qualify as above-the-line deductions avoid classification as miscellaneous itemized deductions, and therefore avoid being suspended through 2025.

The definition of unlawful discrimination refers to claims under a long list of laws, including provisions of the Civil Rights Act of 1964, Title IX of the Education Amendments of 1972, ERISA, the Americans with Disabilities Act, the Age Discrimination in Employment Act, the National Labor Relations Act, the Fair Labor Standards Act, the Worker Adjustment and Retraining Notification Act, and the Family and Medical Leave Act.[11] Yet after quite a long list of laws, the tax code adds a catchall that swallows up much more:

> Any provision of federal, state or local law, or common law claims permitted under federal, state or local law, that provides for the enforcement of civil rights, or regulates any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.[12]

This catchall covers legal fees to enforce civil rights. This covers any claim for the enforcement of civil rights under federal, state, local, or common law. The code does not define "civil rights," but in the context of charitable organizations, the IRS itself once said, "We believe that the scope of the term 'human and civil rights

[7] Section 67(g).

[8] For discussion, see Robert W. Wood, "New Tax on Litigation Settlements, No Deduction for Legal Fees," *Tax Notes*, Mar. 5, 2018, p. 1387.

[9] For ideas on how to navigate the tax treatment of attorney fees, see Wood, "12 Ways to Deduct Legal Fees Under New Tax Laws," *Tax Notes Federal*, Oct. 7, 2019, p. 111.

[10] *See* section 62(a)(20) and (e).

[11] *See* section 62(e).

[12] Section 62(e)(18).

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secured by law' should be construed quite broadly."[13]

Invasion of privacy, defamation, debt collection, credit reporting, and other cases are arguably civil rights cases, and suits by tenants over their rights arguably are too. The above-the-line deduction for legal fees does not help with previously paid legal fees because the above-the-line treatment for the deduction is capped at the income produced by the same litigation in the same tax year.[14] But in a contingent fee case, which is what most tenants bring via their lawyers, deducting the fees in this way can rescue what would otherwise be the disaster of paying tax on 100 percent when the tenant only collected 60 percent.

The Romans were apparently well aware of section 62(a)(20)'s above-the-line deduction for legal fees. Luminita did not report any income related to the settlement on her return. However, the Tax Court noted that she deducted $20,000 of the legal fees and expenses related to the litigation on line 36 of her Form 1040. That was the line number on the relevant year's tax return used to claim above-the-line legal fee deductions under section 62(a)(20).[15]

By deducting the legal fees, while not reporting any income from the settlement, Luminita effectively tried to use the legal fee deduction to offset her $9,994 of wage income received from the state and $5,517 of taxable interest. Section 62(a)(20)'s above-the-line-treatment for legal fees is capped at the amount of taxable income included in the taxpayer's reporting for the same tax year from the case producing the income. However, the Tax Court did not need to address this obvious error head-on because it ruled that Luminita had $350,000 of taxable income that year from the litigation.

The $20,000 legal fee deduction was comfortably less than the $350,000 of gross income from the litigation, so the deduction limit in section 62(a)(20) was mooted. The Tax Court also did not devote time to considering whether the Romans' litigation qualified for above-the-line treatment under section 62(e)'s definition of unlawful discrimination.

The Romans alleged claims for discrimination based on Gabriel's disability status under the California Fair Employment and Housing Act, the California Unruh Civil Rights Act, and the California Disabled Persons Act, among several other laws. Without specifically discussing the issue, the Tax Court seemed not to contest whether claims under those statutes qualify under section 62(a)(20) and (e).

Nontaxable Reimbursements of Rent

Putting the tax treatment of attorney fees aside, what kind of overall tax result can settling tenants expect? It depends a great deal on the facts, and on how the claims and the settlement of the case are documented. In some tenant cases, it may be possible to characterize some or all of the settlement as a reimbursement of rent that is not taxable. Suppose that in a residential tenant dispute, tenants have been paying rent of $3,000 a month for the last year. In a dispute, they might claim that the space was not habitable and that they should get their money back. The tenants presumably would not have deducted any of the residential rent payments on their taxes,[16] so there should be no issue with the potential application of the tax benefit rule on the recapture of prior tax deductions.[17] If the settlement agreement says that the landlord is refunding the rent, is that a taxable accretion to the tenants' wealth? Arguably not.

It would help the tenants' position if the refund nature of the settlement was specifically earmarked in the settlement agreement. It may be self-serving, but the settlement agreement could even state expressly that the reimbursed rent is nontaxable (and should not be reported on a Form 1099). The rent reimbursement may be only a part of the settlement, as there may be other claims, possibly involving larger amounts than the rent. But the rent reimbursement idea can be worth considering when it seems to fit the facts. It can even tie into tax reporting too. In general, a

[13] GCM 38468 (Aug. 12, 1980).

[14] *See* section 62(a)(20).

[15] For 2023 reporting, unlawful discrimination claim deductions under section 62(a)(20) are now claimed on line 24h of Schedule 1.

[16] *See* section 262.

[17] *See* section 111.

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nontaxable reimbursement is not required to be the subject of a Form 1099.[18]

Lease Buyouts as Capital Gain

Payment for physical injury or physical sickness, and the possibility of rent refunds, are only several of the possibilities for landlord-tenant disputes. In many cases, neither may be available. Even if they are, the dollar figure may outpace the amount that can reasonably be allocated to these claims. The landlord and the tenant may primarily be settling to conclude the lease. In many landlord-tenant settlements, the tenant is out of the premises before the litigation commences or before it concludes.

However, some settlements between landlords and tenants end up with the tenant and landlord parting company at settlement time. Even if the tenant has moved out long before, the legal rights are often terminated in the settlement agreement. When there is a payment to terminate the lease, it may be possible to view some or all the settlement as a lease buyout that is taxable as capital gain rather than ordinary income. Section 1241 provides that amounts received by a tenant for the cancellation of a lease are generally considered as amounts received in exchange for the lease, that is, as sales proceeds. This should mean capital gain to the tenant, so long as the lease otherwise would qualify as a capital asset.

Section 1241 is consistent with the general rule for contract termination payments under section 1234A. That section also provides that amounts paid for the cancellation, lapse, expiration, or other termination of most contractual rights or obligations related to capital assets can be treated as the sale or exchange of the capital asset for tax purposes.

An obvious allure of capital gain reporting is tax rates. Ordinary income is taxed at 37 percent. Capital gain (depending on income level and the size of the gain) can be taxed as low as 0 percent and as high as 23.8 percent. Even if the taxpayer is in the highest tax bracket, paying 23.8 percent is better than paying 37 percent. Some states have preferred capital gain rates or even a capital gain exclusion.

However, the issue isn't entirely about tax rates because capital gain reporting can involve recouping basis too. And that is when legal fees come in. If the taxpayer pays legal fees to produce a capital recovery, the appropriate tax treatment of the legal fees is to capitalize them. One can view the legal fees as an addition to basis or as a selling expense. In either event, they offset the recovery, so the client is taxed on 60 percent, not 100 percent, of the settlement proceeds.

When legal fees are paid over several years, perhaps under an hourly fee agreement, capital gain treatment does not have the same timing issue that legal fee deductions, and in particular section 62(a)(20)'s above-the-line fee deduction, have. A section 62(a)(20) legal fee deduction is effectively lost if there is no income from the recovery in the same tax year, meaning hourly fees paid in the years before the case settles may not be able to be deducted. Still, in a capital recovery, legal fees paid in an earlier tax year can be added to the taxpayer's basis in the affected property even if there is no recovery in the same year.

The taxpayer's basis is cumulative, so legal fees and expenses capitalized into basis in a preceding year, unless otherwise recouped, should still be in the claimant's adjusted tax basis when they receive their recovery and need to calculate their gain. In effect, if the taxpayer spent 40 percent of their settlement in legal fees to collect the other 60 percent, they can offset the 40 percent, treating it as their basis. It is important to develop the position that the settlement is capital gain, but settlement agreement wording can help on that point.[19]

The lack of discussion about capital gain treatment in *Roman* is noteworthy. The Tax Court repeatedly emphasized that the settlement agreement was paid to persuade the Romans to leave their apartment. It quoted passages from the settlement agreement that required the Romans to agree to terminate their lease. Yet, capital gain treatment, or references to section 1241 or section 1234A, are all unmentioned in the opinion.

[18] *See* reg. section 1.6041-1(f) (providing that the amount to be reported on a Form 1099 is the amount that represents gross income to the payee).

[19] *See* Wood, *supra* note 9.

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Of course, this was the Romans' burden to raise, not the Tax Court's. Still, having rejected the section 104(a)(2) arguments for exclusion raised by the Romans, the Tax Court seems to assume by default that must mean the recovery is ordinary income. Perhaps the Romans could have considered capital gain as a backup position after their aggressive section 104(a)(2) exclusion argument failed. In failing to assert capital treatment, even as a fallback position, *Roman* is an important reminder not to let the perfect result (a complete exclusion from income) obscure a more supportable good result (capital gain treatment).

Form 1099 Reporting

If you are a plaintiff receiving money, tax reporting is always worth addressing in the settlement agreement. Otherwise, the plaintiff will likely receive a Form 1099 for the amount of the entire settlement. Because of the duplicate Form 1099 reporting that is generally required for legal settlements, the plaintiff's counsel will normally also receive a Form 1099 for the entire settlement amount.[20]

In most cases, a plaintiff will receive an IRS Form 1099-MISC, with the amount in box 3, as other income. In some cases, an unlucky tenant may receive a Form 1099-NEC, raising the specter of self-employment tax on top of ordinary income tax. Either way, the plaintiff's lawyer will nearly always receive a Form 1099-MISC, with the amount in box 10, as gross proceeds paid to an attorney. The gross proceeds reporting, which is special to attorneys, does not count as income to the lawyer, unlike box 3 reporting.

A defendant and the IRS will not know what portion of the settlement, if any, is actually income to the lawyer. There are ways to short-circuit and change some of the Form 1099 reporting, such as separate checks to the client and lawyer. But even if the lawyer is paid separately, the client will also be attributed the legal fees if the recovery is otherwise gross income to the client. *Banks* says that the client has income measured by the contingent fees, and the client's Form 1099 will include those fees.[21]

Form 1099 reporting issues should be worked out during settlement negotiations. If the landlord's counsel is briefed about the Form 1099 issue during negotiations and provided with the relevant tax authorities, these issues can often be resolved and documented so the tenant is not later surprised. A landlord who is approached after a settlement agreement is signed is highly unlikely to agree to change whatever reporting was initially provided for.

Arguing about what Forms 1099 should be issued after the settlement agreement is signed is rarely productive. A defendant may have expressly said in the settlement agreement that they are issuing the forms. Even if the settlement agreement is silent on the tax forms, defendants customarily do whatever tax reporting to the plaintiffs and the lawyers that they believe is correct. Complaints from plaintiffs after the forms are issued are unlikely to be successful. The Form 1099 regulations are voluminous and complicated enough that most defendants can support what they have done, even if the plaintiffs disagree.

One instance in which arguing about Forms 1099 after they are issued can be highly effective is if the settlement agreement was explicit about the forms to be issued and the defendant breached those commitments. In that case, the plaintiff can rightly say, "You breached the settlement agreement." In our experience, those errors or glitches get corrected virtually 100 percent of the time when there is language in the settlement agreement that has been violated. ■

[20] *See* section 6045(f) (requiring the reporting of all "gross proceeds" paid to an attorney, even if not includable in the taxable income of the attorney).

[21] *See* reg. section 1.6045-5(f), Example 1.

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