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Legal Settlements Without Tax Language Increase Your Taxes

Legal settlement agreements involve tax issues, and plaintiffs usually need help navigating settlement tax rules. Defendants understandably want to deduct whatever they have to pay. Plaintiffs hope the money they are receiving is tax free. If they cannot have tax-free money, they want the settlement to be taxed as long term capital gain rather than as ordinary income, and they certainly don't want to be taxed on money that that goes to their lawyer for legal fees.

The tax law says that contingent legal fees in lawsuit settlements are also taxed to plaintiffs, not just the net amount they receive after legal fees and costs. They need to consider the legal fees too. No plaintiff wants to pay taxes on their attorney fees.

Many Legal Fees Are Tax Deductible

Fortunately, despite all the hype to the contrary, it is often possible to deduct or offset the legal fees in a defensible way. Compensatory damages for personal physical injuries are not taxable, but the injury must be physical in nature. Damages for emotional distress are not considered physical. Plus, punitive damages and interest are taxable. That is one of the reasons why taxes on lawsuit settlements are tricky when a case settles on appeal. Most cases settle before trial, but even settling before trial, you may not have a completely free hand when it comes to taxes.

Consider How Your Claims Will Be Taxed

The IRS says you can only settle the claims that you made in your complaint. Suppose that you have a case about wrongful termination of employment, and that there are no allegations that the plaintiff was physically injured, became physically sick, or even had a pre-existing illness that grew worse as a result of alleged conduct of the employer. It is unlikely to be credible to say that 90% of the settlement is for physical injuries or physical sickness. Last-minute allegations may enter the negotiation process, but you may not be able to reshape what the case is about.

Settlement Agreement Wording

Settlement agreement wording is very important, and it is worth pausing settlement negotiations to negotiate tax allocations to make the most of the allegations you have. Otherwise, bad wording can doom your tax position, and it can be a costly mistake to sign a settlement agreement that says little or nothing about taxes or the nature of the payment. Take a wrongful termination case where the plaintiff asks for past and future wages loss, emotional dress, and damages for PTSD that allegedly occurred from a particularly stressful workplace. How will the settlement be taxed if the settlement agreement calls for the release of all claims for a lump sum of $1M? Given the employment context, the IRS is likely to say that the employer should have withheld taxes on at least some of the award.

Wage Withholding Issues

With no allocation, the employer may have a hard time saying that no wages were paid, when a significant part of the case was about past and future wage loss. The tax law is clear that wage loss, severance pay, and other wage-based damages are subject to withholding and employment taxes, even if paid years after the termination of employment. In that sense, the employer may face potential liability to the IRS for failing to withhold taxes on any portion of the settlement.

Even if only the plaintiff is worried about taxes, how will the plaintiff report the $1M when it comes tax time? The plaintiff may want to argue that most of the settlement should be tax-free for PTSD. There is no definitive tax case yet that says whether PTSD is a physical sickness qualifying for tax-free damages, but there are good arguments that it qualifies. Even so, the plaintiff will have a hard time convincing the IRS with a lump sum settlement agreement that contains no tax allocation.

Indeed, the conventional IRS answer is would be that everything is taxed in such a case. A general release that extinguishes all claims in return for a lump sum payment puts the plaintiff in a tough position when it comes tax return time, and later. Even if the plaintiff can show that she had, and alleged, physical injuries or physical sickness, if the settlement agreement does not earmark a particular dollar amount in payment of that claim, the IRS and the Tax Court are likely to say that the settlement is 100% taxable.

Volumes of tax cases can be cited for the proposition that the defendant's intent in making the settlement payment, as evidenced by the wording of the settlement agreement, is of supreme importance. If the settlement agreement releases all claims for a lump sum, the IRS and the Tax Court will not know what the defendant considered important.

Defendants Deduct Most Settlements on their Taxes

In most cases, business defendants should be able to claim a tax deduction for settlement payments, regardless of how the plaintiff will be taxed. It is the plaintiff who should be more worried about tax allocation language in a settlement agreement. Without it, how the plaintiff will be taxed will be up for grabs. The burden of proof in any tax audit or dispute is on the plaintiff to demonstrate that any portion of a settlement should not be taxed, or should be taxed as capital gain rather than ordinary income.

Courts frequently look at the complaint to see what the claims were about. However, in audits, the IRS often looks first and foremost at what the settlement agreement says. Plaintiffs are more likely to have tax trouble if the settlement agreement is silent about the specific claims the defendant is paying for and in what amounts.

When tax matters reach the courts, they often refer to the absence of specific language in settlement agreements in holding against the taxpayer's preferred tax treatment. Whenever possible, try to nail down the desired tax treatment in the settlement agreement, including the related tax reporting. If you are a plaintiff, you don't want to be surprised later when Forms 1099 arrive in the mail, when your tax preparer gives you bad news about your hoped-for tax filing position, or when the IRS disagrees with your tax return.