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By Robert W. Wood

Settling Lawsuits Or Disputes Usually Means Paying Taxes

Your car got rear-ended while stopped at a red light. Your contractor did shoddy work on your condo. You were unfairly fired. Someone did you wrong and now you're collecting a settlement or judgment.

Is it taxable income? Usually yes, but the tax treatment can vary enormously. There's an old adage about the taxman getting a piece of just about everything, and that is usually true in America. We have the most complex tax system in the world. The IRS can be unforgiving, and taxes impact nearly every type of transaction, including legal settlements.

Many plaintiffs who win or settle a lawsuit are surprised to find that they have to pay taxes. Some don't realize it until tax time the following year when IRS Forms 1099 arrive in the mail. A little tax planning, especially before you settle, goes a long way. It's especially important now with higher taxes on lawsuit settlements under the tax reform law that took effect in 2018.

Under the harsh new rules, many plaintiffs are taxed on their attorney fees too, even if their lawyer takes 40% off the top. In a $100,000 case, that means paying tax on $100,000, even if $40,000 goes to the lawyer. The new law generally does not impact physical injury cases with no punitive damages. It also should not impact plaintiffs suing their employers. But elsewhere, watch out.

Taxes are based on the origin of your claim. If you get laid off at work and sue seeking wages, you'll be taxed as wages, and probably some pay on a Form 1099 for emotional distress. But if you sue for damage to your condo by a negligent building contractor, you may be able to treat the recovery as a reduction in your purchase price of the condo. The rules are full of exceptions and nuances, so be careful, how settlement awards are taxed, especially post-tax reform.

If you sue for physical injuries, damages are tax-free. Before 1996, all "personal" damages were tax-free, so emotional distress and defamation produced tax-free recoveries. But since 1996, your injury must be "physical." If you sue for intentional infliction of emotional distress, your recovery is taxed. Physical symptoms of emotional distress (like headaches and stomachaches) is taxed, but physical injuries or sickness is not.

The rules can make some tax cases chicken or egg, with many judgment calls. If you receive $50,000 extra in an employment dispute because your employer gave you an ulcer, is an ulcer physical, or merely a symptom of emotional distress? Many plaintiffs take aggressive positions on their tax returns, but that can be a losing battle if the defendant issues an IRS Form 1099 for the entire settlement. Haggling over tax details before you sign and settle is best.

Most legal disputes involve multiple issues. You might claim that the defendant kept your laptop, frittered away your trust fund, underpaid you, failed to reimburse you for a business trip, or other items. Even if your dispute relates to one course of conduct, there’s a good chance the total settlement involves several types of consideration. It is best for the plaintiff and defendant to agree on tax treatment. These agreements aren’t binding on the IRS or the courts in later tax disputes, but they are usually not ignored by the IRS.

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 contingent fee cut. If your case is fully nontaxable (say an auto accident in which you’re injured), that shouldn't cause any tax problems. But if your recovery is taxable, beware. 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. In 2005, the U.S. Supreme Court held in *Commissioner v. Banks,* that plaintiffs generally have income equal to 100% of their recoveries. even if their lawyers take a share. But can’t you deduct the legal fees? In 2004, Congress enacted an above the line deduction for legal fees in employment claims and certain whistleblower claims. That deduction still remains, but outside these two areas, there's big trouble. In the big tax bill passed at the end of 2017, there's a new tax on litigation settlements, no deduction for legal fees.

The legal fee problem can arise with punitive damages too. 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, even if some of it goes to your lawyer. That can make it attractive to settle your case rather than have it go to judgment. At least in a settlement, you have more ability to shape the tax result in the documents. Tax advice early, before the case settles and the settlement agreement is signed, is essential.

Robert W. Wood is a tax lawyer and managing partner at Wood LLP. He can be reached at Wood@WoodLLP.com