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Tax Rules for Settlements and Judgments

Whenever you resolve a case, think about the tax implications. A little foresight can save a lot of money.

BY ROBERT W. WOOD

Lawyers and clients resolve disputes all the time, usually with an exchange of money and a release. Of course, almost any time money changes hands, there are tax issues too—usually for both sides. However, most lawyers take a hands-off approach: they simply tell their clients that they are not tax advisers and that it is worth seeing a tax lawyer or good accountant to get straight on the tax implications.

Yet after such a disclaimer, some lawyers succumb to the temptation to offer some free tax advice. For example, the lawyer might say, "I'm not a tax lawyer, but don't worry. All these damages are non-taxable." But whether you are a lawyer or a client, a basic grounding in settlement-related tax issues will help you and not only with respect to office matters, but also with respect to your own taxes.

The tax issues come up in a surprising number of ways. 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 payment or judgment. The first question in any of these situations always the same: is it taxable income? The first answer is usually the same too: yes.

Of course, the tax treatment can vary enormously, depending on how you were damaged, how the case was resolved, how the checks and IRS Forms 1099 were issued, and other variables.

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Here are 10 rules lawyers and clients should know about the taxation of settlements.

1. Settlements and judgments are taxed the same.

The same tax rules apply whether you are paid to settle a case or to satisfy a judgment obtained after a court or jury trial—indeed, even if the dispute resolved during the early letter-writing phase. Despite the similarities, though, you'll almost always have more flexibility to reduce taxes if a case settles rather than goes to judgment.

If you are audited, you'll need to show what the case was about and what you were seeking in your claims. Consider the settlement agreement, the complaint, the checks issued to resolve the case, IRS Forms 1099 (or W-2), etc. You can influence how your recovery is taxed by how you deal with these issues.

2. Taxes depend on the "origin of the claim."

Settlements and judgments are taxed according to the item for which the plaintiff was seeking recovery (the "origin of the claim"). If you're suing a competing business for lost profits, a settlement will be lost profits, taxed as ordinary income. If you get laid off at work and sue for discrimination seeking wages and severance, you'll generally be taxed as receiving wages.

In fact, your former employer will probably withhold income and employment taxes on all (or part) of your settlement. That is so even if you no longer work there, even if you quit or were fired years ago.

On the other hand, if you sue for damage to your condo by a negligent building contractor, your damages usually will not be income. Instead, the recovery may be treated as a reduction in your purchase price of the condo. That favorable rule

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means you might have no tax to pay on the money you collect. However, these rules are full of exceptions and nuances, so be careful. Perhaps the biggest exception of all applies to recoveries for personal physical injuries (see point 3, next).

3. Compensatory recoveries for personal physical injuries and physical sickness are tax-free.

This is a really important rule, and one that causes almost unending confusion with lawyers and their clients. If you sue for personal physical injuries (think: a slip and fall case or one stemming from a car accident), your compensatory damages should be tax-free. That may seem odd, since you may be seeking lost wages because you couldn't work after your injuries.

But a specific section of the tax code—I.R.C. Section 104 (26 U.S.C. §104)—shields damages for personal physical injuries and physical sickness. Note the "physical" requirement. Before 1996, "personal" injury damages were tax-free. That meant emotional distress, defamation and many other legal injuries also produced tax-free recoveries. That changed with the 1996 amendments to the key tax code provision.

Since then, your injury must be "physical" to give rise to tax-free money. Unfortunately, neither the IRS nor Congress has made clear what that means. The IRS has generally said that you must have visible harm (cuts or bruises) for your injuries to be "physical." This observable bodily harm standard generally means that if you sue for intentional infliction of emotional distress, your recovery will be taxed.

If you sue your employer for sexual harassment involving rude comments or even fondling, that is not physical enough for the IRS. But some courts have disagreed. The Tax Court in particular has allowed some employment lawsuits to enjoy complete or partial tax-free treatment. This has occurred where the employee had physical sickness from the employer's conduct, or the exacerbation of a pre-existing illness. See, e.g., *Domeny v. Commissioner*, T.C. Memo. 2010-9 (exacerbation of multiple sclerosis symptoms); and *Parkinson v. Commissioner*, T.C. Memo. 2010-142 (heart attack from job stress).

Thus, standards are getting a little easier. However, taxpayers routinely argue in U.S. Tax Court that their damages are sufficiently physical to be tax-free. Unfortunately, the IRS usually wins these cases. In many cases, a tax savvy settlement agreement could have improved the plaintiff's tax chances.

4. Symptoms of emotional distress are not "physical."

The tax law draws a distinction between money you receive for physical symptoms of emotional distress (like headaches and stomachaches) and personal physical injuries or physical sickness. Here again, these lines are not clear. For example, if in settling an employment dispute you receive $50,000 extra because your employer gave you an ulcer, is an ulcer physical or is it merely a symptom of your emotional distress?

Many plaintiffs end up taking aggressive positions on their tax returns, claiming that damages of this nature are tax-free. But that can be a losing battle if the defendant issues an IRS Form 1099 for the entire settlement. That means it can behoove you to try to get agreement with the defendant about the tax issues. There's nothing improper about doing this.

There are wide variations in tax reporting, and multiple players are often involved in litigation (parties, their insurance carriers, and their attorneys). Given the myriad interests, it is best to nail down the tax issues at the time the settlement papers are written. You may have to pay for outside tax experts, but you'll almost always save considerable money later by spending a little at this critical moment.

Otherwise, you might end up surprised with Forms 1099 you receive the year after your case settles. (IRS Forms 1099 usually arrive in January for payments made the prior tax year.) At that point, you will not have a choice about reporting the payments on your tax return.

5. Medical expenses are tax-free.

Even if your injuries are purely emotional, payments for medical expenses are tax-free, and what constitutes "medical expenses" is surprisingly liberal. For example, payments to a psychiatrist or counselor qualify, as do payments to a chiropractor or physical therapist. Many nontraditional treatments count too.

However, if you have previously deducted the medical expenses and are reimbursed when your suit settles in a subsequent year, you may have to pay tax on these items. Blame the "tax benefit" rule. It says that if you previously claimed a deduction for an amount that produced a tax benefit to you (meaning it reduced the amount of tax you paid), you must pay tax on that amount if you recover it in a subsequent year. *See* 26 U.S.C. § 111(a); and *Hornberger v. Commissioner*, 4 Fed. Appx. 174 (4th Cir. 2001).

The opposite is also true. If you deducted an amount in a previous year, and that deduction produced no tax benefit to you, then you can exclude the recovery of that amount in a later year from your gross income. See *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 377 (1983).

6. Allocating damages can save taxes.

Most legal disputes involve multiple issues. You might claim that the defendant kept your laptop, frittered away your trust fund, undercompensated you, failed to reimburse you for a business trip, or other items. In fact, even if your dispute relates to one course of conduct, there's a good chance the total settlement amount will involve several types of consideration.

It is usually best for plaintiff and defendant to try to agree on what is being paid and its tax treatment. Such agreements aren't binding on the IRS or the courts in later tax disputes, but they are rarely ignored. As a practical matter, what the parties put down in the agreement is often followed. And in the real world, there are usually multiple categories of damages.

For all of these reasons, it is more realistic—and more likely to be respected by the IRS and other taxing authorities—if you divide up the total and allocate it across multiple categories. If you are settling an employment suit, there might be some wages (with withholding of taxes and reported on a Form W-2); some nonwage emotional distress damages (taxable, but not wages, as reported on a Form 1099); some reimbursed business expenses (usually nontaxable, unless the employee had deducted them); some pension or fringe benefit payments (usually nontaxable); and so on. There may even be some payment allocable to personal physical injuries or physical sickness (nontaxable, so no Form 1099), although this subject is controversial (see points 3 and 4, above).

7. You may have capital gain instead of ordinary income.

Outside the realm of suits for personal physical injuries or physical sickness, just about everything is income. However, that does not answer the question of *how* it will be taxed. If your suit is about damage to your house or your factory, the resulting settlement may be treated as capital gain. Long term capital gain is taxed at a lower rate (15 percent or 20 percent, as opposed to 39.6 percent), so is much better than ordinary income.

Apart from the tax rate preference, your tax basis may be relevant too. This is generally your original purchase price, increased by any improvements you've made, and decreased by depreciation, if any. In some cases, your settlement may be treated as a recovery of basis, not income.

A good example would be harm to a capital asset, such as your house or your factory. If the defendant damaged it and you collect damages, you may be able to simply reduce your basis rather than reporting gain. Some settlements are treated like sales, so again, you may be able to claim your basis. See *Doud v. Commissioner*, 1982-158 (1982) (recovery for a stamp collection was not taxable income where Doud's basis in his collection was less than he recovered).

In fact, there are many circumstances in which the ordinary income versus capital distinction can be raised, so be sensitive to it. For example some patent cases can produce capital gain, not ordinary income. The tax rate spread can be nearly 20 percent.

8. Attorney fees can be a trap.

Whether you pay your attorney hourly or on a contingent fee basis, legal fees will impact your net recovery and your taxes. If you are the plaintiff and use a contingent fee lawyer, you usually will be treated (for tax purposes) as receiving 100 percent of the money recovered by you and your attorney. This is so even if the defendant pays your lawyer the contingent fee *directly*.

If your case is fully nontaxable (say an auto accident in which you are physically injured and you receive compensatory damages), that should cause no tax problems. But if your recovery is taxable, the type of deduction you can claim for the legal fees can vary materially. This trap occurs frequently.

Say you settle a suit for intentional infliction of emotional distress against your neighbor for $100,000, and your lawyer keeps 40 percent or $40,000. You might think that you would have $60,000 of income. Instead, you will have $100,000 of income, followed by a $40,000 miscellaneous itemized deduction. See *Commissioner v. Banks*, 543 U.S. 426 (2005).

That means you will be subject to numerous limitations that can whittle your deduction down to nothing. For alternative minimum tax (AMT) purposes, you get no tax deduction for the fees. That is why many clients say they are paying tax on money (the lawyer's fees) they never received. Notably, not all lawyers' fees face this harsh tax treatment.

If the lawsuit concerns the plaintiff's trade or business, the legal fees are a business expense. Those legal fees are above the line (a better deduction). See 26 U.S.C. § 162. Moreover, if your case involves claims against your employer, or involves certain whistleblower claims, there is an "above-the-line" deduction for legal fees (*see* 26 U.S.C. § 62(a)(20)), which means you can deduct those legal fees before you reach the adjusted gross income ("AGI") line on the first page of your From 1040. An above-the-line deduction prevents the problems related to miscellaneous itemized deductions taken after your AGI has been calculated. But outside of employment and certain whistleblower claims, or your trade or business, be careful. There are sometimes ways of circumventing these attorney fee tax rules, but you'll need sophisticated tax help before your case settles in order to do it properly.

9. Punitive damages and interest are always taxable.

Punitive damages and interest are always taxable, even if your injuries are 100 percent physical. See *O'Gilvie v. United States*, 519 U.S. 79 (1996); 26 U.S.C. §104. Say you are injured in a car crash and get $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 can have trouble deducting your attorney fees—on this point, see item 8 above).

The same occurs with interest. You might receive a tax-free settlement or judgment, but pre-judgment or post-judgment interest is always taxable. As with punitive damages, taxable interest can produce attorney fee deduction problems. These rules can make it more attractive (from a tax viewpoint) to settle your case rather than have it go to judgment.

Suppose that you were in a car crash and are about to receive $50,000 in compensatory (tax-free) damages, plus $5 million in punitive damages. Can you settle for $2 million that is all tax-free? It depends (among other things) on whether the judgment is final or on appeal.

It also depends on what issues are up on appeal. 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 and wrapping the settlement in a well-thought out agreement that takes into account the applicable tax rules.

10. It pays to consider the defense.

Plaintiffs are generally much more worried about tax planning than defendants. Nevertheless, consider the defense perspective, too. A defendant paying a settlement or judgment will always want to deduct it. If the defendant is engaged in a trade or business, such a deduction will rarely be questioned, since litigation is a cost of doing business.

Even punitive damages are tax-deductible by businesses. Only certain government fines cannot be deducted. And even then, defendants can sometimes find a way if the fine is in some way compensatory.

Despite these broad deduction rules for businesses, not everyone is so lucky. If the suit is related to investments, it may be deductible only against investment income or subject to limits. If the suit is purely personal, the defendant may get no deduction at all. In some cases, that can extend to attorney fees too.

Defendants can also run up against questions about whether an amount can be immediately deducted or must be capitalized. For example, if buyer and seller of real estate are embroiled in a dispute, any resulting settlement payment may need to be treated as part of the purchase price and capitalized, not deducted.

Conclusion

Nearly every piece of litigation eventually spouts tax issues. It can be tempting to just bring your dispute to an end, and to let the tax chips fall where they may at some later date. But whether you are a plaintiff, a defendant, or counsel for one of the parties, that can be a mistake.

But before you resolve the case and sign a settlement agreement, carefully consider the tax aspects. Tax withholding, reporting, and language that might help you in a subsequent dispute with the IRS, is worth addressing. You will almost always have to consider these issues at tax return time the following year. You can often save yourself money by considering them earlier, when the parties are hammering out their agreement to resolve their dispute.

MCLE – Tax Rules for Settlements and Judgments
True/False Test & Answer Key

1. The tax treatment of settlements and judgments is the same. TRUE. Fundamentally, the tax treatment of settlements and judgments is the same. However, there is almost always more flexibility in tax treatment with a settlement, particularly with tax language in a settlement agreement.

2. The tax treatment of litigation recoveries depends on the "origin of the claim." TRUE. The "origin of the claim" test asks: in lieu of what are damages being awarded? The IRS looks at the damages awarded and how the payment would have been taxed had there been no need for the litigation.

3. Section 104 of the Internal Revenue Code excludes from income compensatory damages for physical injuries and physical sickness. TRUE. The exclusion even applies to loss of income—even wages—as long as the suit is for physical injuries.

4. The "physical" requirement for tax-free treatment was added to Section 104 in 2008. FALSE. It was added to the law in 1996. Since then, the injury must be physical to produce a tax-free recovery.

5. Damages for symptoms of emotional distress are tax-free. FALSE. The IRS says that physical *symptoms* of emotional distress are taxable. Conversely, damages for physical *sickness* are tax-free. The line between them remains fuzzy.

6. Emotional distress damages are always taxable. FALSE. If the emotional distress is the result of physical injuries or physical sickness the emotional distress damages are also tax-free.

7. Punitive damages are always taxable income. TRUE. Punitive damages are taxable even when relating to physical injuries. The U.S. Supreme Court said as much in *O'Gilvie v. United States*, 519 U.S. 79 (1996), in 1996, and Congress made it doubly clear the same year. See 26 U.S.C. § 104.

8. Damages covering medical expenses are tax-free. TRUE. Payments for medical expenses are tax-free, and what constitute medical expenses is surprisingly liberal, including payments to a counselor, chiropractor, physical therapist, etc.

9. Even though reimbursed medical expenses are tax-free, they are not tax-free if you previously deducted them. TRUE. The tax benefit rule requires you to include in income a payment that you receive if you previously deducted it.

10. Under the tax benefit rule, if you received no benefit from deducting an item, you can exclude your later recovery. TRUE. The tax benefit rule has an income component and an exclusion component.

11. It is better not to address tax issues in a settlement agreement, since the payment must be reported to the IRS in any event. FALSE. It is almost always a good idea to try to address taxes in a settlement agreement. At a minimum, it is a chance to help shape the tax payment. It is also a good opportunity to try to nail down the Form W-2 and Form 1099 tax reporting. It is better not to be surprised the following January when Forms W-2 and 1099 arrive.

12. If a case involves multiple claims, it is usually best to allocate damages across several categories. TRUE. Most legal disputes involve multiple issues. It is often more realistic (and more likely to be respected by the IRS) if you allocate settlement monies across multiple categories.

13. Some lawsuit recoveries are taxed as capital gain rather than ordinary income. TRUE. The savings can be huge, from a 39.6% rate to 15% or 20%.

14. If damages relate to a capital asset such as a home or factory, it may be possible to treat some or all of a recovery as a non-taxable recovery of basis. TRUE. This is another big savings. For example, if your home was damaged and you receive damage for its reduced value, you may be able to reduce your tax basis in the home rather than reporting the settlement as income.

15. Contingent legal fees are generally treated as paid first to the client for tax purposes, even if they are paid directly to the plaintiff's attorney. TRUE. In *Commissioner v. Banks*, 543 U.S. 426 (2005), the Supreme Court held that plaintiffs generally must report their gross recoveries, even if the contingent fee lawyers are paid directly by the defendant.

16. A plaintiff with a lawyer on a 40 percent contingency can never be required to pay taxes on more than the 60 percent of the recovery the plaintiff receives. FALSE. Reporting the gross amount of a legal recovery as income (as required by *Commissioner v. Banks*, 543 U.S. 426 (2005)), means the plaintiff should consider whether, how, and where to deduct the legal fees and costs. Not being able to deduct them all can mean paying tax on amounts the plaintiff does not receive.

17. A plaintiff paying legal expenses relating to the plaintiff's business may not be able to deduct the legal fees and expenses associated with the case. FALSE. Businesses can almost always deduct the legal expenses. See 26 U.S.C. §162. Outside business though, a plaintiff may not be able to deduct all of the legal expenses.

18. A plaintiff's legal fees for an employment or whistleblower claim can be deducted "above the line," effectively obviating the rule in the Banks case. TRUE. An above the line deduction is a subtraction for all purposes, including alternative minimum tax. The result is that the plaintiff pays tax only on his or her net (post-attorney fee) recovery.

19. Whether interest received via settlement or judgment is taxable depends on the nature of the underlying claims. FALSE. Interest is always taxable, even in a wrongful death or physical injury suit.

20. In a case settling on appeal, how much a plaintiff can shape the tax treatment of a settlement may depend on the trial court verdict and which issues were being appealed. TRUE. If a verdict was $1M in compensatory physical injury damages and $5M in punitive damages, a $2M settlement may be partially taxable.

21. The tax treatment stated by the parties in their settlement agreement is binding on the IRS. FALSE. The IRS and the courts are free to disregard it. As a practical matter, though, it usually goes a long way toward securing the tax treatment you specify.

22. Business defendants can always deduct damages they pay. FALSE. Defendants can face questions whether an amount can be immediately deducted or must be capitalized. For example, if buyer and seller of real estate are embroiled in a dispute, any resulting settlement payment may need to be treated as part of the purchase price and capitalized, not deducted.