

Tax Traps in Construction Defect and Property Damage Settlements

By Robert W. Wood

Plaintiffs in lawsuits often ask if their settlement is going to be taxable. The answer varies, but in most cases, the safest answer is yes. Virtually any money changing hands in a lawsuit is taxable, or more exactly, it is includable in the plaintiff's income. The most common exception is compensatory damages for physical injuries. They are tax free by statute, but what qualifies as "physical" enough for an exclusion is famously cloudy. But outside of that exception, the plaintiff should count on reporting income.

However, as we will see, "includable in income" does not necessarily mean that you are paying tax on it. You may have offsetting deductions, or you may have basis that can reduce the resulting gain on the proceeds. We will come back to these topics, but let's start with the basic rule about legal settlements and income.

First, it is the *gross* settlement amount that is includable in the plaintiff's income, not the net after attorney fees. This surprises many plaintiffs, who understandably may think that, worst case, they will be taxed on the amount of settlement money their lawyer sends them, after deducting contingent fees and costs. But it's not that simple.

For example, if a case settles for \$1M, with a contingent legal fee of 40%, the client should collect \$600k, but must report the full \$1M as income. Therefore, many plaintiffs worry that they might end up paying taxes not only on their net recovery, but *also on the lawyer's money too*. How the checks are issued does not alter this rule. Thus, even if the lawyer is paid separately under the settlement agreement, the legal fees are attributed to the client for tax purposes.

There is often a way for the plaintiff to offset or deduct the \$400k of legal fees, but the plaintiff must report all the settlement. But even assuming that there is a deduction for the fees, will the plaintiff even be happy paying taxes on their net recovery? A plaintiff who does not expect to be taxed and who thinks they are just being made whole, or perhaps just *partially* whole at that, will be unhappy to see the settlement dollars whittled down by taxes.

Fortunately, it is often possible to reduce or in some cases even eliminate the taxes due. Consider construction defect cases. Suppose that you buy your dreamhouse, or commission it to be built from the ground up. To your dismay, you later discover defects and you sue (or threaten to sue) the seller or contractor for damages.

Suppose that you purchase a home or condo for \$1M. You discover defects, you sue, and you eventually recover \$500k from the seller or builder. Are you stuck with a tax bill on the \$500k? You might be, particularly if you receive a Form 1099 for the \$500k. However, if you play your cards right, you should be able to treat the \$500k as a reduction in your basis. That is, your basis started at \$1M when you bought it, and now it is \$500k, post recovery. You may have to pay taxes later if and when you sell it. But for now, you should not have to pay tax on your recovery.

Where a recovery compensates a plaintiff for injuries to a capital asset, the recovery should constitute a tax-free return of capital to the extent of the taxpayer's basis in the injured asset. The rationale for this principle is that no economic gain results from a basis recovery. Only amounts received that exceed the taxpayer's basis constitute income. An award may therefore produce capital gain (or reduce capital loss) depending on the taxpayer's basis in the asset.

Let's make the example more realistic with legal fees. Assume the same \$1M basis and \$500k settlement, but this time, you pay your lawyer a 40% contingent fee of \$200k from your \$500k settlement. Here, you can treat the full \$500k as a reduction in basis, and simultaneously treat the \$200k of legal fees as an addition to basis. When the smoke clears, you net \$300k in cash, and your basis in your condo is now \$700k.

What happens if you bought your property for only \$500k, it is now worth \$2M, and you collect \$1M from your contractor? You clearly do not have enough basis to absorb the full million-dollar settlement. So (ignoring legal fees), you have a \$500k gain. Do you have to pay tax on that?

It depends. First, let's note that this should be capital gain. Ordinary income is taxed at 37%. Capital gain (depending on income level and the size of the gain) can be taxed as low as 0% and as high as 23.8% federally. Even if you are in the highest tax bracket, paying 23.8% is better than paying 37%.

But capital treatment is not entirely about tax rates, because capital gain reporting can involve recouping basis too. And that is where legal fees come in.

If you are able to treat your settlement as capital gain rather than as ordinary income, you should *also* be able to offset your legal fees on your taxes. In effect, if you spent 40% of your settlement in legal fees to collect the other 60%, you can offset the 40%, treating it as your basis.

However, even if you have gain, do you have to pay tax on it? If the home is your principal residence, you can consider excluding some of the resulting gain under the principal residence gain exclusion rules of Section 121. Regardless of whether the home is your principal residence, you may also be able to elect to defer taxes on the gain under Section 1033 of the tax code.

This provision works a little like a 1031 exchange of real estate, which is something many people understand. Subject to requirements, Section 1031 allows you to defer taxes by rolling over sale proceeds into similar property. Section 1033 is different, and applies only to involuntary conversions, such as where your property is condemned by the government, or damaged or destroyed by a fire, storm or defendant.

Section 1033 also can apply to damage or destruction from defective construction. It allows you to put your gain into repairing or replacing the damaged or destroyed property. There are time limits and requirements, but it is used frequently in property damage and construction defect cases.

Of course, not all construction defect cases are solely about harm to the property. In some cases, the plaintiff is

claiming that the property is uninhabitable, so they need damages for alternative living arrangements. The plaintiff may also be claiming that the damage or defects caused the owner or inhabitants to become sick. The claim may be that the building materials have toxins, or that mold, water damage, sewage, *etc.*, made inhabitants sick or even caused or exacerbated an illness.

In cases like that, do you do the same basis, gain and section 1033 analysis? For the property damage claims yes, but a different tax treatment should apply to the sickness damages. Where there are bona fide physical injury or physical sickness claims, it is appropriate to allocate some of the settlement proceeds to those claims. Section 104 of the tax code treats such damages as tax free. But it is best to have a specific dollar amount allocated in the settlement agreement for physical injuries or physical sickness, and to make sure that the settlement agreement language is clear.

How about tax forms? The IRS Form 1099 instructions and the tax regulations state that no IRS Form 1099 should be issued for physical injury damages. Therefore, it is appropriate and safest to get a commitment from the defendant that it will not issue a Form 1099 for that amount. If you do not have such a commitment in the settlement agreement, it is likely that the defendant will issue the form.

Speaking of Form 1099, should a Form 1099 be issued to the plaintiff in a construction defect case without physical injuries? Not necessarily. Most defendants issue a Form 1099 to the plaintiff for 100% of the settlement. What's more, most companies will also issue a Form 1099 to the plaintiff lawyer, again, for 100% of the settlement. That may sound like double counting, but it is the usual duplicate Form 1099 reporting that is required by IRS regulations for most legal settlements, unless there is an exemption. Most defendants need an explanation for any payment that you are asking *not* to be reported on a Form 1099.

The most well-known exemption from Form 1099 reporting is for physical injury damages. But a less well-known exemption from Form 1099 reporting covers capital recoveries. That is, if a payor is making a payment for property damage—or a payment that is partially for property damage—which is common in construction defect cases, no Form 1099 should be required.

That is because only payments of income are to be reported on a Form 1099. In a payment for property damage, to know how much of the payment is income to the plaintiff, the payor would need to know the plaintiff's tax basis in the property. They are highly unlikely to know that, and the tax law does not require them to ask, or for the plaintiff to tell them. Consequently, because the defendant does not know how much of the settlement is gross income to the plaintiff, no Form 1099 is required.

Even so, in the hurly burly of settlement negotiations, it is very common for defendants to insist on Form 1099 reporting. A Form 1099 for property damage or for physical injuries does not guarantee that the plaintiff will be required to pay tax on that money. But it does mean that the plaintiff will need to report and explain the Form 1099 on their tax return when the time comes.

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