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Taxes On Legal Recoveries Hinge On Settlement Agreement



The tax rules governing lawsuit settlements are confusing. Some plaintiffs don't realize they have to pay taxes until tax time the year after they settle when IRS Forms 1099 arrive in the mail. Plaintiffs are treated as receiving the money paid to their attorney, even if the defendant pays the lawyer directly, since [legal fees in lawsuit settlements are taxed to plaintiffs](#). In a \$100,000 case, that could mean paying tax on \$100,000 even if \$40,000 goes to the lawyer unless the plaintiff can deduct it. There are often ways to do that, but it can be tricky and not all claims qualify.

How Taxes Apply

Taxes on lawsuit settlements are based on the origin of the claim. Thus, 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 the tax rules are full of exceptions and nuances. Recoveries for physical injuries and physical sickness are tax-free, but symptoms of emotional distress (like headaches and stomachaches) are not considered physical. Yet exactly what is physical enough is not clear.

If you receive \$100,000 extra in an employment dispute because your employer gave you an ulcer, is that physical sickness or merely a symptom of emotional distress? There's a good argument that an ulcer is not just a stomachache and is bona fide physical sickness. But whether it is taxed may depend on how the settlement agreement is written. 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.

Settlement Agreement or Release

Negotiating over the tax details before you sign a settlement agreement is best. The plaintiff will be required to sign a settlement agreement or release to be paid. It will be a complete release of claims, and it will include some other provisions, such as confidentiality. It may say something about taxes too, such as stating that the plaintiff must pay his own taxes. It might even require the plaintiff to indemnify the defendant if there is a tax claim against the defendant.

Whatever the agreement says, will it be a one-sided release in which the plaintiff signs to be paid? Or will it be a two-party settlement agreement that the plaintiff and defendant *both* sign? If you are the plaintiff and concerned about taxes, I strongly recommend a settlement agreement that the defendant *also* must sign. One of the most important tax rules impacting the tax treatment of settlements is that the defendant's intent in making the payment as reflected in the wording of the settlement agreement controls.

One Party Agreements

If the defendant does not sign the settlement agreement, how can the defendant be said to have agreed on the tax character of the payment? Perhaps there is an estoppel argument, and the fact that the defendant is paying the plaintiff must mean that the defendant agrees with all the wording in a release. However, the IRS is a stickler for settlement agreement wording and looks closely for an express agreement by the defendant what a settlement payment is for. If the defendant does not sign the settlement agreement, any "agreement" is not explicit.

Form 1099 Reporting

The same concerns apply to Form 1099 wording, and [IRS Forms 1099 for settlements often surprise plaintiffs](#). A release might say that the plaintiff is (or is not) going to receive a Form 1099. But if the defendant does not sign it, will the plaintiff have any recourse if the terms of the release are not followed? In contrast, if the same Form 1099 commitments are contained in a two-party settlement agreement, the plaintiff can feel more secure about what the settlement agreement says. If the defendant violates the Form 1099 provisions of the settlement agreement, the plaintiff can assert that the defendant has breached the settlement agreement.

Mistakes happen, and [IRS Forms 1099 can be wrong](#). If the settlement agreement is clear about the required tax reporting and the defendant has signed it, defendants are often cooperative about making corrections. But if the settlement agreement is not explicit about tax reporting, or if there is only a release signed by the plaintiff, it can be difficult to get any cooperation.

Settlement Agreement Wording and IRS Audits

Settlement agreement wording matters a great deal. In an audit, strong settlement agreement wording can be enough to convince the IRS to end the audit. The settlement agreement may be the first document the IRS asks for in an audit. And if the settlement agreement wording is strong and the tax return reports as the settlement agreement suggests, it may well end the audit. In contrast, if the settlement agreement wording is poor, the audit may become protracted, and poor wording can make it tough to win.

Consider Rebecca Tressler, who received a \$55,000 settlement from her former employer, Amtrak. She sued for workplace harassment and retaliation,

alleging a workplace sexual assault and physical injuries from a workplace stalking incident, physical manifestations of stress from a hostile work environment, and an injury to her ankle. The court agreed that there had been a sexual assault but dismissed her case, finding no evidence that Amtrak had been negligent concerning that assault.

Tressler appealed, at which point she settled with Amtrak for \$82,500, with \$27,500 in wages reported on Form W-2, and \$55,000 reported on Form 1099. The latter was for Tressler's claim for "emotional distress damages related to her allegations." But a later part of the settlement agreement said this was "inclusive of all claims by Tressler for any alleged damages against Amtrak, including, but not limited to, any alleged claims for physical injuries, emotional distress, attorneys' fees, and costs."

The wages were taxable, but Tressler argued that half the \$55,000 balance should be tax-free. But the Tax Court said that the settlement agreement wording said the \$55,000 was for emotional distress, and the other language did not change that. It was all taxable, ruled the court.

Most plaintiffs don't fully understand how important settlement agreement language can turn out to be. Many lawyers don't either. Be careful out there.