PERSPECTIVE

Los Angeles | Daily Journal

FRIDAY, NOVEMBER 26, 2021

Taxing Those Controversial Border Legal Settlements

By Robert W. Wood

Not long ago, reports about potential federal government legal settlements sparked outrage. The news broke that the Biden administration was considering payouts of approximately $450,000 to each illegal alien who was separated from their family at the southern border. The border and illegal immigration has long been a hotly debated issue, and the settlement money made it even more so. The President's mixed messages about the plan didn't help the debate.

First, the President said that the reports were wrong and the settlements were not going to happen, and then shortly thereafter he endorsed the plan. As the form and content of the settlements take shape and the settlements are eventually paid, the federal government would award money for claims that U.S. government policies left the border crossers with lasting psychological effects. The payment is meant to compensate them for the emotional distress or trauma caused by the separation.

The deal would be per person, and the illegal immigrants crossing the border generally included a parent and child. As a result, the total per family could approach $1 million. Approximately 940 families have reportedly filed claims, but how many people will be eligible is not yet clear. The ACLU and others filed lawsuits alleging that thousands of children and parents impacted by the Trump administration's zero-tolerance policy have mental health effects from the prolonged trauma.

If the money is awarded, it's worth asking whether the IRS will be able to collect any tax money. The first question you might ask is about the filing of tax returns. Surprisingly, our tax filing system is predominantly voluntary, meaning that you file a return and report your income. And although there is tax withholding on wages, other income needs to be reported on a return. Any U.S. source income needs to be reported even by non-.U.S. residents. That's why some foreigners have to file an IRS Form 1040NR (the NR is for nonresident).

As for U.S. residents, even if they are in the country illegally, they are supposed to file with the IRS. You don't have to be a U.S. citizen or even a green card holder to be required to file U.S. tax returns with the IRS. Undocumented immigrants are required to file tax returns with the IRS if they have income above the minimum level. However, overall compliance rates are hard to nail down.

Generally, only noncitizens authorized to work in the United States by the Department of Homeland Security can get a Social Security Number. For plaintiffs who do not have SSNs, they can request an Individual Tax ID number (commonly referred to as an ITIN or TIN) from the IRS. Undocumented immigrants may use ITINs for tax returns because a taxpayer doesn't need to provide immigrant status in order to obtain an ITIN. An ITIN can be used to complete an IRS Form W-9 and in most other instances where a SSN would be used for tax purposes.

But is this settlement money taxable in the first place? If you sue for physical injuries, compensatory damages are tax-free. But if you sue for emotional distress, your recovery is taxed. Physical symptoms of emotional distress (like headaches and stomachaches) are taxed, but physical injuries or sickness is not. The tax rules are confusing and often raise chicken or egg issues when it comes to taxes. Sometimes, what gets taxed may come down to settlement wording.

What constitutes personal physical injuries or sickness is not defined, but the IRS likes to see "observable bodily harm" such as bruises or broken bones. However, the interactions between physical and emotional injuries and sicknesses are starting to be explored. For plaintiffs claiming that their border separation caused them to have post-traumatic stress disorder, there is a good argument that PTSD is physical, although there is no definitive tax case on point.

Former President Obama intimated as much when discussing PTSD from military service. Physical confinement with emotional impacts may not actually be a physical injury, but plaintiffs and their lawyers in the border cases will probably argue that the damages are sufficiently physical not to be taxed. That seems especially likely if the plaintiffs have been diagnosed with PTSD.

How legal settlements are taxed can depend on how you were damaged, how the case was resolved, how checks and IRS Forms 1099 were issued and more. In trying to decipher what is physical and what is not, the tax law draws a distinction between money for physical symptoms of emotional distress (like headaches and stomachaches) and physical injuries or sickness. An agreement between plaintiff and defendant is not binding on the IRS, but what the parties say in the agreement is often followed in an audit.

The stakes can be big—taxable settlements are worth far less than non-taxable ones. In cases that are taxable, such as a conventional emotional distress claim, the tax issues are not only about the plaintiff's net recovery. If you are the plaintiff and use a contingent fee lawyer, you'll usually be treated as receiving 100% of the money recovered by you and your attorney, even if the defendant pays your lawyer directly his 30% to 40% contingent fee cut.

That is not a problem for plaintiffs who are able to deduct their legal fees, but that is not always possible. Plaintiffs may owe tax on a legal settlement and not be able to deduct the legal fees. And from a reporting perspective, if the settlement agreement does not prevent it, in most cases, a Form 1099 will say the plaintiff received 100% of the money, even if 40% went directly to the claimant's lawyer.

Since 2018 when the tax law changed, many legal fees can no longer be deducted. That means plaintiffs in some cases are taxed on 100%—with no tax deduction for their legal fees. Many plaintiffs take aggressive positions on their tax returns regarding the physical injury/sickness exclusion. But that can be a losing battle if the defendant issues an IRS Form 1099. You can disagree on your tax return, but the IRS may not agree.

Robert W. Wood *is a tax lawyer with www.WoodLLP.com, and the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This is not legal advice.*