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Ten Rules Every Lawyer—and Client—Should Know about Taxes on Legal Settlements

By Robert W. Wood

Lawyers and clients resolve disputes all the time, usually with an exchange of money and a release. Almost any time money changes hands, there are tax issues for both sides, coming up in a surprising number of ways. Perhaps your car was rear-ended while stopped at a red light, your contractor did shoddy work on your condo, you were unfairly fired, or someone did you wrong and, as a result, you are collecting a settlement payment or judgment. As it relates to taxes, the first question in any of these situations is whether the settlement payment or judgment is taxable income, and the answer usually is "yes." The tax treatment in these situations can vary enormously, however, depending on how you were damaged, how the case was resolved, how payment was made, how IRS Forms 1099 were issued, and other variables. 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 (even if your dispute only reached the letter-writing phase) or win a judgment. Despite this similarity, however, you will almost always have more flexibility to reduce taxes if a case settles rather than goes to judgment. If you are audited, you must show what the case was about, and what you were seeking in your claims. Consider the settlement agreement, the complaint, how payments were made 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 matter for which the plaintiff was seeking recovery (the origin of the claim). If you are suing a competing business for lost profits, a settlement or judgment will be considered lost profits taxed as ordinary income. If you are laid off at work and sue for discrimination seeking wages and severance, you will be taxed on your settlement or judgment as having received wages.

In fact, your former employer probably will withhold income and employment taxes on all (or part of) your settlement, even if you have not worked there for years. On the other hand, if you sue for damage to your condo by a negligent building contractor, your damages usually will not be considered income. Instead, the recovery may be treated as a reduction in the purchase price of the condo. That favorable rule means you might have no tax to pay on the money you collect. These rules are full of exceptions and nuances, however, so be careful. Perhaps the biggest exception of all applies to recoveries for personal physical injuries (see rule 3).

3. Recoveries for Personal Physical Injuries and Physical Sickness Are Tax-Free

This is a really important rule that causes almost unending confusion with lawyers and their clients. If you sue for personal physical injuries resulting from, for example, a slip and fall or car accident, your compensatory damages should be tax-free. That may seem odd if, because if you could not work after your injuries, you are seeking lost wages. However, a specific section of the tax code—section 104—shields damages for personal physical injuries and physical sickness.

Note the "physical" requirement. Before 1996, "personal" injury damages included emotional distress, defamation, and many other legal injuries and were tax-free. Since 1996, however, your injury also 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 determined generally 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 is taxed.

Likewise, if you sue your employer for sexual harassment involving rude comments or even fondling, that also is not physical enough for the IRS. Some courts have disagreed, however, and the U.S. Tax Court in particular has allowed some employment lawsuits complete or partial tax-free treatment where the employee developed a physical sickness from the employer's conduct or where a pre-existing illness was exacerbated. Taxpayers routinely argue in U.S. Tax Court that their damages are sufficiently physical to be tax-free, and although standards are getting a little easier, 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"

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

Many plaintiffs end up taking aggressive positions on their tax returns by claiming that damages of this nature are tax-free. Yet 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 come to an agreement with the defendant about the tax issues, and there is nothing improper about doing so. There are wide variations in tax reporting and multiple players are often involved in litigation (e.g., the parties, their insurance companies, and their attorneys); thus, neglecting to nail all this down in the settlement agreement can be foolish. You may have to pay for outside tax experts, but you will 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. 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 as well.

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 them. Blame the "tax benefit" rule, which provides 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. 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.

6. Allocating Damages Can Save Taxes

Most legal disputes involve multiple issues, but even if your dispute relates to one course of conduct, there is a good chance the total settlement amount will involve multiple categories of damages. It usually is best for the plaintiff and defendant to agree on what is paid and its tax treatment. Such agreements are not 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 often is followed.

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, so 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 rules 3 and 4).

7. Look for Capital Gain Instead of Ordinary Income

Outside the realm of suits for 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, plus the 3.8% Obamacare tax, not 39.6 percent) and is therefore much better than ordinary income.

Apart from the tax-rate preference, your tax basis may be relevant as well. This generally is your original purchase price, increased by any improvements you have 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 is 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 report gain. Some settlements are treated like sales; therefore, again, you may be able to claim your basis. In fact, there are many circumstances in which the ordinary income versus capital gain 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's 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 (e.g., an auto accident in which you are physically injured), that should cause no tax problems. Yet if your recovery is taxable, the type of deduction you can claim for the legal fees can vary materially. This trap occurs frequently. Suppose 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. 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 attorney's fees) they never received.

Notably, not all attorney's fees face such 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). Moreover, if your case involves claims against your employer, or involves certain whistleblower claims, there is an above-the-line deduction for legal fees. That means you deduct those legal fees *before* you reach the adjusted gross income (AGI) line on the front of your 1040. An above-the-line deduction prevents the problems related to miscellaneous itemized deductions taken after your AGI has been calculated. Outside of employment and certain whistleblower claims or claims involving your trade or business, however, be careful: there are sometimes ways of circumventing these attorney's fees rules, but you need sophisticated tax help before your case settles to do it.

9. Punitive Damages and Interest Are Always Taxable

Punitive damages and interest are always taxable, even if your injuries are 100 percent physical. Suppose you are injured in a car crash and receive $50,000 in compensatory damages and $5 million in punitive damages. The $50,000 is tax-free, but the $5 million is fully taxable. Moreover, you might have trouble deducting your attorney's fees (see rule 8).

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

Return to the situation above, in which you receive $50,000 in compensatory (tax-free) damages, plus $5 million in punitive damages. Can you settle instead 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, you can be much better off, from a tax viewpoint, taking less money.

10. It Pays to Consider the Defense

Plaintiffs generally are much more worried about tax planning than defendants. Nevertheless, consider the defendant's perspective as well. A defendant paying a settlement or judgment will always want to deduct it. If the defendant is engaged in a trade or business, doing so rarely will be questioned, given that 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, the deduction could be restricted to only investment income or face other limitations. If the suit is purely personal, the defendant may get no deduction at all. In some cases, that can extend to attorney's fees as well.

Defendants can also run up against questions about whether an amount can be immediately deducted or must be capitalized. For example, if a 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 sprouts tax issues. It is tempting to just bring your dispute to an end and let the tax chips fall where they may. Whether you are a plaintiff, a defendant, or counsel for one, that can be a mistake. Before you resolve the case and sign, consider the tax aspects. Tax withholding, reporting, and tax language that might help you are all worth addressing. You will almost always have to consider these issues at tax return time the following year. You often save yourself money by considering taxes earlier.

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