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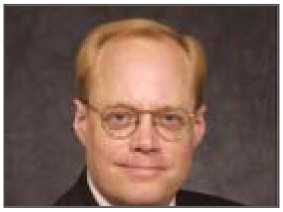

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THE TAX LAWYER

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Win A Lawsuit, Pay IRS---Even On Your Attorney's Fees

If after a bitter dispute, you're collecting a legal settlement or judgment, you might feel vindicated and relieved. But when you consider that you may need to report it to the IRS, less so. The tax treatment varies enormously. Consider how you were damaged, how the case was resolved, and how checks and IRS Forms 1099 were issued.

Settlements and judgments are taxed based on the origin of your claim. So, if you're suing for lost profits, a settlement is lost profits, taxed as ordinary income. If you get fired at work and sue for severance and discrimination, you'll be taxed as receiving wages. Usually, though, employment settlements are split between wages reported on a Form W-2 and an amount reported on an IRS Form 1099.

These rules are full of exceptions and nuances. Punitive damages and interest are always taxed regardless of the type of case. But the biggest exclusion from income is for personal physical injury recoveries. In that case, your damages are tax-free.

Cash (Photo credit: bfishadow)

Conversely, damages for emotional distress are taxed unless the emotional distress is ***triggered*** by the physical injury. Clearly, that's confusing. The IRS and courts frequently have to address the point, since exactly what constitutes personal physical injuries or sickness isn't defined. The IRS normally wants to see "observable bodily harm" such as bruises or broken bones before it excludes damages from income.

If the case arises out of employment, the IRS knee-jerk reaction is that recoveries are wage loss or otherwise taxable. However, an employee suit may be partially tax-free if the employee has physical sickness from working conditions. Many tax disputes involve employment cases, where stress or work injuries may be cause physical injuries or physical sickness.

And if there is related emotional distress, those damages should be tax-free as well. Thus, in one case, stress at work produced a heart attack. In another, stressful conditions exacerbated the worker's pre-existing multiple sclerosis. The Tax Court in both cases sided with the worker and against the IRS. See Tax-Free Physical Sickness Recoveries in 2010 and Beyond.

If you can, get tax advice ***before*** your settlement agreement is drafted and signed. The IRS isn't bound by the parties' tax characterization, but the IRS will frequently respect it if it is reasonable. Allocations between categories of damages, with the tax treatment of each part specified in the settlement agreement, can make your taxes simpler and more certain.

Finally, note that the tax treatment of lawyers' fees can catch you by surprise. If a contingent fee lawyer is to receive 40%, the IRS treats the client as receiving 100% and *then* paying the lawyer. If the case is an employment dispute, involves your trade or business, or is 100% for physical injuries, you won't pay tax on the legal fees.

In most other cases, though, you will probably have to include the legal fees in your income, and then try to deduct them. The trouble comes with just how you do the latter. For many, the fees can only be claimed as a miscellaneous itemized deduction. And that means you lose part of your deduction and face Alternative Minimum Tax (AMT) treatment. Yes, it is even possible for you to *lose* money by winning a suit once you pay your taxes.

Whatever you do, don't wait until tax return time to consider these issues. Get some advice *before* you settle. A little planning and some tax language in your settlement agreement can make all the difference.

You can reach me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.