

Settlements and Taxes: 5 IRS Rules to Remember

By Robert W. Wood

Many plaintiffs settle lawsuits or win judgments, but are later surprised that they have to pay taxes. Even those who know that most payments are taxable may be surprised at how the taxes are computed. Of course, some plaintiffs do not realize how big the tax issues are until tax time the following year, when IRS Forms 1099 arrive in the mail.

At that point, many plaintiffs suddenly worry about their tax returns and how to minimize the tax bite. The taxes will have to be reported, of course, and there are plenty of tax issues to be finessed after the case is resolved. However, a little advance tax planning, especially before you settle, can go a long way.

It's even more important now with higher taxes on lawsuit settlements under the tax reform law passed in late 2017. Many plaintiffs are taxed on their attorney fees too, even if their lawyer takes 40 percent off the top. In a \$1 million case, that can mean paying taxes on \$1 million even if \$400,000 goes to the plaintiff's lawyer.

The new law generally does not impact physical injury cases with no punitive damages. It also should not impact plaintiffs suing their employers, although there are new wrinkles in sexual harassment cases. Here are five rules to remember.

1. Taxes depend on the "origin of the claim." Taxes are based on the origin of your claim. 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 if you sue for damage to your condo by a negligent building contractor, your damages might not be income. You might be able to treat the recovery as a reduction in your purchase price of the condo. The rules are full of exceptions and nuances, so be careful with the tax treatment of any settlement, especially post-tax "reform."

2. Recoveries for physical injuries and physical sickness are tax-free, but symptoms of emotional distress are not physical. If you sue for physical injuries and collect only compensatory damages, that should be tax-free. Before 1996, all "personal" injury damages were tax-free, so emotional distress and defamation produced tax-free recoveries.

Since 1996, your injury must be "physical." If you sue for intentional infliction of emotional distress, your recovery is taxed. Physical symptoms of emotional distress (like headaches and stomachaches) are taxed, but physical injuries or sickness are not. The rules are confusing, with many judgment calls. Suppose that in an employment dispute, you receive an extra \$100,000 because your employer gave you an ulcer. Is an ulcer physical, or merely a symptom of emotional distress?

It sounds physical, but some of that may depend on settlement language, and whether the employer issues a Form 1099 for that payment. Many plaintiffs end up taking aggressive positions on their tax returns. But without support, that can be a losing battle if the defendant issues an IRS Form 1099 for the entire settlement. Haggling over tax details before the settlement agreement is signed is best.

3. Allocating damages can save taxes. Most legal disputes involve multiple issues. You might claim that the defendant kept your laptop, frittered away your trust fund, underpaid you, failed to reimburse you for a business trip, or other items. Maybe some of your claim relates to stock and can be viewed as a capital gain.

Even if your dispute relates to one course of conduct, there's a good chance the total settlement involves several types of consideration. It is best for plaintiff and defendant to agree on tax treatment. Such agreements are not binding on the IRS, the Franchise Tax Board or the courts in later tax disputes. However, they are usually not ignored.

4. Attorney fees are a tax trap. If you are the plaintiff and use a contingent fee lawyer, you will usually be treated (for tax purposes) as receiving 100 percent of the money recovered by you and your attorney, even if the defendant pays your lawyer directly the contingent fee. If your case is fully nontaxable (say an auto accident in which you're injured and receive only compensatory damages), that shouldn't cause any tax problems.

However, if your recovery is taxable, watch out. Say you settle a suit for intentional infliction of emotional distress against your neighbor for \$100,000, and your lawyer keeps \$40,000. You might think you'd have \$60,000 of income. Instead, you'll have \$100,000 of income. In 2005, the U.S. Supreme Court held in *Commissioner v. Banks*, 543 U.S. 426 (2005), that plaintiffs generally have income equal to 100 percent of their recoveries, even if their lawyers take a share.

How about deducting the legal fees? In 2004, Congress enacted an above the line deduction for legal fees in employment claims and certain whistleblower claims. That deduction still remains, but outside these two areas, there's big trouble. In the big tax bill passed at the end of 2017, there's a new tax on litigation settlements, no deduction for legal fees. No tax deduction for legal fees comes as a bizarre and unpleasant surprise. Tax advice early, before the case settles and the settlement agreement is signed, is essential.

5. Punitive damages and interest are always taxable. If you are injured in a car crash and receive \$50,000 in compensatory damages and \$5 million in punitive damages, the former is tax-free. The \$5 million is fully taxable, and you can have trouble deducting your attorney fees! The same occurs with interest. You might receive a tax-free settlement or judgment, but pre-judgment or post-judgment interest is always taxable, and can produce attorney fee problems. That can make it attractive to settle your case rather than have it go to judgment.

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