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THE TAX LAWYER

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When Settling Litigation ALWAYS Address Taxes

If you are involved in **any** kind of lawsuit, resolving it means you will probably pay or receive money. Either way, there will be tax issues. It's true across a wide array of cases: injuries, property damage, investment losses, contract claims, even patents and trademarks. In all of them, consider taxes. See [Don't Fail To Consider Taxes When Settling Litigation](#).



Your tax treatment hinges in part on how settlement documents are written, so consider taxes **before** you negotiate and sign a settlement. See [10 Things to Know About Taxes on Damages](#).

Physical injury awards are tax-free. Damages for personal physical injuries (say, broken bones from an accident) are tax-free, except for punitive damages and interest. See [Will BP Oil Spill Victims Pay Tax On \\$7.8B Settlement?](#) Damages for emotional injuries are taxable. Physical symptoms caused by emotional distress—such as headaches—are generally taxable. The line between what's physical injury/sickness (tax-free) and what's a mere symptom of emotional distress (taxable) is much litigated.

Lose a job, pay the IRS. Severance pay is subject to tax withholding and payroll taxes (Social Security and Medicare), even though you no longer work for the company. See [Tax Withholding on Family And Medical Leave Act Payments](#). Damages for discrimination are taxed as ordinary income but not as wages so you don't owe payroll tax. Emotional distress damages from discrimination are taxable.

But if bad treatment at work gives you serious physical sickness like a heart attack, your damages may be tax free. In [Parkinson v. Commissioner](#), that's what the [U.S. Tax Court](#) said about a man's \$350,000 settlement from his former employer. See [Tax-Free Physical Sickness Recoveries in 2010 and Beyond](#) and [Is Post-Traumatic Stress Disorder Physical Injury for Tax Purposes?](#)

Attorney fees can be a tax trap. If you hire a lawyer on a 40% contingency the tax law treats you as receiving 100% of a settlement even if the defendant issues a separate check to your lawyer for his 40%. If your damages aren't taxable (say an auto injury case), the suit relates to your business, or to your employment, there's no tax problem. See [Six Tax-Wise Ways To Reduce Your Legal Bills](#).

But elsewhere, attorney fees count only as a miscellaneous itemized deduction. That means the [alternative minimum tax](#) could leave you paying tax on money your attorney received. See [Three Worst IRS Tax Traps](#). Talk to a tax expert before you sign any settlement. See [Can Execs Deduct Legal Fees Above-The-Line?](#)

How you settle can matter. You have more tax flexibility if you settle, especially if you negotiate with an eye on the tax rules. The IRS isn't bound by an agreement's wording, but good wording can help ***enormously***. The biggest problems occur in employment litigation.

Take [Gutierrez v. Commissioner](#). Antonia Gutierrez was a vineyard worker subjected to gender discrimination, harassment, wage violations, lack of meal and break periods, exposure to pesticides, and more. When she settled for \$35,000, the settlement agreement said it was for emotional distress damages and attorney fees.

Gutierrez didn't speak English and there was some question as to who translated and precisely what they said. Despite the evidence that Gutierrez suffered respiratory damage, constant headaches, loss of vision and more—and that she hadn't even understood the settlement agreement's wording—the IRS said it was **all** taxable. Noting that the settlement agreement was general and just said “emotional distress,” the Tax Court agreed with the IRS.

The burden is on the taxpayer to show that the IRS determination is wrong. Here, that meant actually showing that the \$35,000 was for her physical sickness/injuries, not merely emotional distress. The best indication would be wording in the settlement agreement. Sadly, this one only said “emotional distress.”

For more, see:

[Duke Lacrosse Tax Lien Highlights How Lawsuits Are Taxed](#)

[Will BP Oil Spill Victims Pay Tax On \\$7.8B Settlement?](#)

[IRS To Collect on Italian Cruise Ship Settlements](#)

[Tax Issues in Employment Mediations](#)

[Six Tax-Wise Ways To Reduce Your Legal Bills](#)

[Tax-Free Physical Sickness Recoveries in 2010 and Beyond](#)

[Is Physical Sickness the New Emotional Distress?](#)

[Watch Your Mail For 1099s](#)

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