

Focus | Probate, Trusts & Estates/Tax Law

A Guideline for Taxation of Settlements and Judgments

BY JOSHUA D. SMELTZER

Nearly every time money changes hands there are tax issues, including when clients receive amounts resolving legal disputes. The specifics involved are paramount; however, knowing some basic guidelines will help attorneys guide their clients.

Settlements and Judgments are Taxed the Same

The same tax rules apply to amounts paid as part of a settlement or received as a judgment. The analysis of the tax treatment of these amounts, by the IRS or the courts, usually involves the normal documents used in litigation from the complaint to the final settlement agreement or judgment. If a settlement agreement is involved, the analysis of the agreement is particularly important. Both the IRS and the courts consider the settlement agreement the best evidence of the parties' intentions regarding why amounts were paid. Therefore, as a practical matter, a settlement agreement offers additional flexibility to explain unique facts and circumstances related to the recovery.

Tax Treatment is Determined by the "Origin of the Claim"

Taxation of settlements and judgments depends on the causes of action involved and the nature of the recovery sought. Lost-profits claims are generally

taxed as ordinary income. Lost wages are usually taxed as wages and subject to the normal withholding rules. Claims involving damage to property may not be treated as income at all and merely reduce the purchase price of the asset. The specific facts and circumstances of each cause of action are important and form the starting point for whether certain exceptions or distinctions to the tax treatment apply.

Recoveries for Injuries/Sickness are Excluded from Income

Internal Revenue Code Section 104 specifically excludes from taxable income damages for personal physical injuries and physical sickness. Therefore, a recovery for physical injuries or sickness is essentially tax free. Since 1996, the Internal Revenue Code added the "physical" requirement, and what is sufficiently "physical" is the primary cause of confusion among lawyers and their clients.

In general, the IRS requires some form of visible harm for an injury or illness to be "physical." This usually excludes all damages for infliction of emotional distress. In some cases, small scrapes and bruises are sufficient for exclusion. In contrast, sexual-harassment claims involving only verbal comments and inappropriate touching may not meet the necessary "physical" standard. The IRS wins a lot, but not all, of the close cases

on whether damages are physical enough to receive tax-free treatment.

Symptoms of Emotional Distress are Not Physical

Although things like headaches, stomach problems, and insomnia may seem "physical," they usually do not qualify for exclusion. The tax law distinguishes physical "symptoms" of emotional distress from actual physical injuries or sickness. However, if the emotional distress is a result of the physical injury, or exacerbates an existing injury, they can sometimes be excluded. The burden of proof is on the taxpayer to show entitlement to exclusion. Therefore, both documentation and the language in the settlement agreement are important to the analysis.

Punitive Damages are Always Taxable

The tax law clearly states that any portion of the recovery that is for punitive damages is taxable income—even if the other recovery involves a physical injury or sickness. As discussed below, this can cause problems when seeking to deduct attorney's fees.

Most Medical Expenses are Tax Free

Regardless of the physical or emotional injuries involved, payments for medical expenses are generally tax free. What is considered "medical expenses" is interpreted broadly and encompasses payments to both

traditional (e.g. psychiatrists, chiropractors, physical therapists, etc.) and even some non-traditional medical treatments. Remember, however, that there is a specific "tax benefit" rule that may prevent exclusion if a medical expense was previously reimbursed.

Some Recoveries are Entitled to Capital Gain Treatment

Aside from the exclusions for physical injuries and sickness, discussed above, the usual treatment for all other recoveries is taxable income. However, that still leaves the question of how that income will be taxed (i.e. ordinary income or capital gain). Again, the origin of the claim involved controls, and the specifics are important. The type of claim and assets involved are critical inquiries.

Attorney's Fees Must be Considered

In general, attorney's fees received as part of a settlement or judgment are included in income. For example, a plaintiff using a contingent-fee lawyer will be treated as receiving 100% of the recovery, even if the lawyer takes a percentage as their fee. Businesses can usually deduct attorney's fees as business expenses. Also, there are special rules allowing for deductibility when the suit involves the employment relationship or certain whistleblower claims. **HN**

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~ In Memoriam ~

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