



Settlement tax rules for lawyers

Getting tax advice before a settlement agreement is signed is best and can help to avoid surprises

By Robert W. Wood

As a case is being resolved, or soon thereafter, plaintiffs want to know whether some or all of their settlement is taxable, and whether they can deduct their legal fees. The tax treatment depends on the claims, whether the case settles or goes to judgment, how checks and IRS Forms 1099 are issued, and other factors. On the legal fee deduction point, you might think that is never an issue, yet even that can be a surprisingly nuanced tax question. Here are a few rules lawyers should know.

Settlements and judgments are taxed the same, but settlements are better taxwise

The same tax rules apply whether you are paid to settle a case, win a judgment, or even if your dispute only reached the letter-writing phase. Despite the similarities, you'll always have more flexibility to reduce taxes if a case settles rather than goes to judgment. A verdict or judgment can limit you. Cases settling during appeal are better than a verdict being paid, but amounts, the issues being appealed, etc., can all be relevant.

Settlements and judgments are taxed based on what the plaintiff was suing over, what the IRS calls the "origin of the claim." If you sue a competing business for lost profits, lost profits are ordinary income. If you get laid off at work and sue for discrimination, seeking wages and severance, you'll be taxed as receiving wages (on a Form W-2), and probably some emotional distress money reported on a Form 1099. If you sue for damage to your condo by a negligent building contractor, your damages may not be income. Instead, you may be able to treat them as a reduction in your purchase

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price of the condo. However, these rules are full of exceptions and nuances, so be careful.

Some recoveries are tax free

If you sue for personal physical injuries, like a slip-and-fall or car accident, your compensatory damages should be tax-free. That is true even if your damages include lost wages while you were injured. Section 104 of the tax code shields compensatory damages for personal physical injuries and physical sickness. Note the "physical" requirement. Before 1996, "personal" injury damages were tax-free, including emotional distress and defamation.

But since 1996, your injury must be "physical" for tax-free treatment. Unfortunately, the IRS and Congress have not made clear exactly what is physical and what is not. The IRS likes to see visible harm like cuts or bruises, so sexual harassment involving rude comments or even fondling may not be physical enough for the IRS.

But the U.S. Tax Court has allowed some employment suit recoveries tax-free treatment where the employee developed a physical sickness from the employer's conduct, or had a pre-existing illness that was exacerbated. Standards are getting a little easier, but taxpayers routinely argue in audits and tax court that their damages are sufficiently physical to be tax-free. The IRS wins many cases, but a nicely worded settlement agreement can materially improve the plaintiff's tax chances or even be dispositive. In short, it pays to get ahead of these tax issues at settlement time if you can.

Symptoms of emotional distress are not physical

The tax law distinguishes between damages for physical *symptoms* of emotional distress (like headaches and stomachaches) and physical injuries or sickness. Here again, the lines are not clear. In settling an employment dispute, if you receive $50,000 extra because your employer gave you an ulcer, it is not clear if the ulcer is physical or is merely a symptom of your emotional distress. There may be a good tax argument, but some of it can depend on wording in your settlement agreement.

Many tax concerns are not raised until the year *after* a settlement. In January, IRS Forms 1099 typically show up in the plaintiff's mailbox, which the IRS assumes should be taxed as income. Many plaintiffs end up taking aggressive positions on their tax returns, claiming that damages are tax-free. But that can be a losing battle if the pleadings are not clear, the settlement agreement is poorly worded, and the defendant issues an IRS Form 1099 for the entire settlement. Having good documentation is important.

Getting tax advice *before* the settlement agreement is signed is best and can help to avoid surprises. But it may still be possible post-settlement to justify an exclusion if there is enough support for the physical issues and claims (such as with PTSD, for which an exclusion seems to be increasingly common). 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 non-traditional treatments count, too. However, if you have previously *deducted* your medical expenses and are later reimbursed when your suit settles in a subsequent year, you may have to pay tax on these items under what's known as the "tax benefit rule."

Allocating damages can save taxes

Can you have several different tax treatments from a settlement? You bet. Many legal disputes involve multiple issues. You might claim that the defendant kept your laptop, frittered away your trust fund, undercompensated you, failed to reimburse you for a business trip, and so on. It is best if the plaintiff and defendant agree on what is being paid and its tax treatment. That will not bind the IRS, but it usually goes a long way in an audit, and as a practical matter, what the adverse parties agree in a settlement agreement is often followed by the IRS.

Suppose that you are settling an employment suit. There may be wages with withholding reported on a Form W-2, emotional distress damages reported on a Form 1099, reimbursed business expenses (usually nontaxable, unless the employee previously deducted them), 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). If you had equity in the company, there could be a payment for that too. If you made claims for defamation, it may be possible to view those damages as capital gain.

Attorney fees can be tricky

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, the IRS treats you as receiving 100 percent of the money, even if the defendant pays your lawyer a 40% or other fee *directly*. If your case is fully nontaxable (say, an auto accident in which you are physically injured), it doesn't matter if you are viewed as collecting 60% or 100%. Nontaxable is nontaxable.

But if your recovery *is* taxable, in whole or in part, whether and how you can claim a deduction for your legal fees can vary materially. This trap occurs frequently. Say that you settle a suit for intentional infliction of emotional distress against your neighbor for $100,000. Suppose that 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, hopefully, by a $40,000 deduction. But since 2018, many legal expenses are not deductible, at least not without some creativity. Legal-fee deductions are clear in employment and

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whistleblower cases, and in civil rights cases, an arguably broader category than you might think. If the lawsuit concerns the plaintiff's trade or business, the legal fees are a business expense, so there is also no problem with deducting the legal fees there. But in a physical injury case where punitive damages were *also* awarded, beware of legal-fee deduction issues, discussed below.

Punitive damages and interest are always taxable

Even if your injuries are 100 percent physical or your case is for wrongful death of a loved one, punitive damages and interest you may be awarded are taxed. Say you are injured in a car crash and are awarded $1 million in compensatory damages and $5 million in punitive damages. The $1 million is tax-free, but the $5 million is fully taxable. What's more, you can have trouble deducting your attorney fees attributable to the $5 million that is taxable.

The IRS allocates legal fees pro rata to the underlying damages. This means you need to consider if and how the legal fees you paid your lawyer on the punitive portion of your damages can be deducted. You may be able to view the legal fees as relating to a civil rights claim, but you will need professional tax advice, and how strong your tax deduction is likely to vary.

The same kind of legal fee tax issue occurs with interest. You might receive a tax-free settlement or judgment for physical injuries, but pre-judgment or post-judgment interest is always taxable. As with punitive damages, taxable interest can produce attorney fee deduction problems. These rules can make it more attractive (from a tax viewpoint) to settle your case rather than have it go to judgment.

Suppose that you were in a car crash and are about to receive $3 million in compensatory (tax-free) damages, plus $2 million in interest while the case has been on appeal. Post-verdict or while the case is on appeal, can you settle for $4 million and treat it all as tax-free? It can depend (among other things) on whether the judgment is final or on appeal, and on what issues are on appeal. The facts and procedural posture of your case are important, and so is the wording in the settlement agreement. In many cases, you may be better off from a tax viewpoint settling for less money than if you collect on your judgment.

Capital gain is better than ordinary income

Outside the realm of suits for physical injuries or physical sickness, just about everything is income, and that means paying tax. Paying tax on your net settlement means also worrying about making sure you don't have to pay tax on your legal fees. Then, there is the question of *how* your recovery will be taxed. Of course, the IRS assumes that everything is ordinary income, but your settlement might not be.

If your suit is about damage to your house or factory – or about a company of which you were a founder or had equity – your settlement might be capital in nature. The same can be true in some defamation cases. Long-term capital gain treatment would be better than ordinary income, so it is taxed at a lower rate (15% or 20%, not 37%). Apart from the lower tax rate, your tax basis may be relevant too. This is generally your original purchase price, increased by any improvements you've made, and decreased by depreciation, if any.

In some cases – say, a suit against a building for construction defects or a wildfire settlement against a utility company, some of your settlement may be treated as a recovery of your tax basis, not income. Suppose that you are suing for damage to your house or your factory. If you collect damages, you may be able to reduce your tax basis rather than reporting gain for some or all your settlement. Some settlements are treated like sales, so you may be able to claim your basis, or even to claim section 1033 involuntary conversion treatment.

Section 1033 allows some gains from involuntary conversions to be rolled over into new, repaired, or replacement property without paying tax, even though there is a gain. There are requirements and qualifications, of course, with more liberal tax rules in federally declared disaster areas. But as these examples show, there are many circumstances in which the ordinary income versus capital distinction can be raised, so be sensitive to it. Even some patent cases can also produce capital gain, not ordinary income.

Structured settlements

If a settlement agreement expressly calls for payment in January, or to be paid in several installments, that will be effective for tax purposes, so it will be taxed when and as you receive it. In contrast, if you sign a settlement agreement calling for immediate payment, but *later* ask the defendant to delay payment, you have constructive receipt when you *could* have gotten it. Of course, most plaintiffs do not want to trust a defendant to make a series of payments (and most defendants want to be done with the plaintiff too).

Since the 1980s, insurance companies have offered structured settlements to injured plaintiffs so that tax-free money can be paid over many years. Done properly, each payment – including all the payments that could be viewed as interest or investment return – is all fully tax-free. Although structured settlements for physical injury accidents are still the most popular kind, there are other types of structured settlements too. The same concept is now used with taxable settlements like contract disputes and employment settlements.

The idea is to stretch out the payments, and while each payment is taxable when received, the additional income tax and investment return features can be attractive. Finally, similar financial products are also available for lawyers' fees. That is, instead of a contingent-fee lawyer being paid contin-

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gent fees in cash when a case settles, it is possible for the lawyer to be paid in installments with investment return that is growing pre-tax.

All three of these types of structures must either be set up as part of the settlement agreement before it is signed, or via a qualified settlement fund. A qualified settlement fund (QSF) is a type of tax-neutral holding pattern between the time when a defendant pays money and when plaintiffs and lawyers receive it. Thirty years ago, QSFs were mostly used in class actions, but today, they are prevalent across many types of cases in which plaintiffs and lawyers need a little more time after the defendants are out of the picture to determine precisely who will get which amounts, to resolve liens, or to decide whether and how to structure payments.

Conclusion

Nearly every piece of litigation eventually triggers tax issues for plaintiffs, defendants or both. If you are slogging through a lawsuit, it may be tempting to simply bring your dispute to an end, and to let the tax chips fall where they may. But before you resolve the case and sign, consider the tax aspects. Tax characterization and reporting language that might help you is worth addressing. You will almost always have to consider these issues when IRS Forms 1099 arrive in January after the year of your settlement, and at tax return time a few months later. You can often save yourself money by considering taxes earlier.


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