# Are Lawsuit Settlements Taxable?

May 13, 2014 **|** by Timothy Ford

Do I have to pay taxes on money I receive in settling my claim? Is any of the settlement non-taxable? Plaintiffs frequently asked these questions when settling a personal injury, contract or employment case. Unfortunately, these questions are asked at the time the plaintiff is asked to sign the settlement agreement or even after he/she has executed the agreement. Instead, these issues should be addressed during the negotiation of the agreement so that you understand the tax implications of your settlement and the settlement can be structured to achieve the most favorable tax treatment. Of course, Uncle Sam is determined to get his share of the settlement proceeds, and there are certain rules and regulations that determine the taxability of settlement proceeds.

The first step in the analysis requires categorization of the purpose of the settlement proceeds. The proceeds may be for physical injuries, emotional distress, compensatory, lost wages, punitive in nature or attorney's fees. All of these categories are treated differently by the IRS. As a result, it is important that settlement agreements allocate the damages category with a dollar amount. Generally, the IRS will not disturb an allocation if it is consistent with the settled claims.

The following damages are considered income and therefore taxable:

1. Emotional distress/mental anguish proceeds that do not originate from a personal physical injury or sickness;
2. Lost wages/lost profits – this includes the portion of an employment settlement for severance, back pay, front pay;
3. Punitive damages;
4. Attorney's fees (with minor exceptions);
5. Compensatory damages – this includes causes of action for breach of contract;
6. Interest.

The following damages are not considered income and are generally non-taxable:

1. Personal physical injuries or sickness (only for those sums that you did not take an itemized deduction for medical expenses related the injury or sickness in prior years)
2. Emotional distress/mental anguish proceeds that originate from a personal physical injury or sickness.
3. Attorneys fees in limited circumstances

As you can see from the list above, nearly all proceeds from the settlement of an employment claim are taxable. The personal physical injury exception is very specific – the injury has to be "physical." That means observable or bodily harm such as bruising, swelling, cuts or bleeding. Of course, these types of injuries in employment cases are extremely rare. Similarly, the emotional distress/mental anguish exception only applies when the emotional distress or mental anguish arises from a physical injury. The exception from taxable income does not include physical symptoms arising solely from emotional distress. On the other hand, nearly all of the proceeds from the settlement of a personal injury case are non-taxable.

Attorney's fees – a common item of interest! – are generally included in the plaintiff's taxable income. This is the case even if the fees are paid directly to the plaintiff's attorney. There are, however, three limited exceptions. First, if the attorneys' fees were incurred with respect to a claim for physical injury or emotional distress that falls under one of the two exceptions discussed above, then those attorneys' fees are non-taxable. Second, in a class action lawsuit, attorneys' fees paid directly to class counsel are not included in a class member's gross income under certain circumstances. Third, expenses of another person or entity are not included in the plaintiff's taxable income.

Even if your attorneys' fees are included in your taxable income, it is important to discuss the attorneys' fees with your accountant when preparing your tax return. Often, attorneys' fees received in an employment or contract settlement can be included as a deduction on your return. The deduction can be taken if the employment claim was made under certain federal statutes or as miscellaneous itemized deduction if certain income requirements are met.

With these rules and exceptions in mind, it is important to understand the tax implications of your settlement agreement far in advance of signing your settlement. Understanding the tax implications in advance may impact your settlement negotiations. Avoiding the tax issues until after the agreement is signed could leave you with few options.

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