

Tax Consequences of Settlement and Litigation Award Payments

Determining the Correct Treatment

By Eric Smith

When an individual receives a settlement or litigation award payment, the likely first question is whether the payment is taxable. While CPAs may know that the answer will depend upon the claim underlying the lawsuit, several other questions can arise that will likewise depend on the facts and circumstances. These questions include: What about the treatment of attorney fees that will be paid out of the settlement or award payment? What if the individual's attorney represents multiple parties to the lawsuit? Will the settlement or award payment be subject to withholding for income and employment taxes if paid by the individual's employer?

Determining the correct treatment of settlement and litigation award payments is a multistep process requiring the determination of the character of the payment and the nature of the claim that gave rise to it; whether the payment constitutes an item of gross income; if the payment relates to an employment claim, whether the payment is wages for employment tax purposes; and the appropriate reporting for the payment of any attorney's fees.

Character of Settlement and Award Payments

The tax treatment of a settlement or award payment will be determined by the "origin of the claim" doctrine. Under this doctrine, if a settlement or award payment represents damages for lost profits, it is generally taxable as ordinary income. Similarly, a settlement or award payment received from an employer for lost wages and damages would likewise generally be ordinary income. On the other hand, if the payment represents a return of capital destroyed or injured, the money received, to the extent it does not exceed the basis of the property, is not taxable. This latter case could occur where the settlement or award payment was the result of damages to the individual's home or other property.

Item of Gross Income

The above rules are subject to certain exceptions, the most important of which is where the origin of the claim concerns a recovery for physical injuries and physical sickness. Under these circumstances, the Internal Revenue Code (IRC) section 104(a)(2) provides an exception from gross income for dam-

ages (other than punitive damages) received on account of such physical injuries or physical sickness. This is the case even where the settlement payment is based upon lost wages caused by the physical injury or sickness.

Physical injuries and physical sickness are not defined in the IRC or the legislative history of the Small Business Job Protection Action of 1996, which enacted IRC section 104(a)(2). The IRS has ruled that physical injuries must be observable bodily harms such as bruises, cuts, swelling, and bleeding. Emotional distress—even though it includes physical symptoms such as insomnia, headaches, and stomach disorders—is not considered a physical injury or physical sickness. Therefore, settlement and award payments arising from claims for emotional distress are generally taxable.

There are two notable times where settlement and award payments for emotional distress will be exempt from being treated as taxable income. First, because all damages received on account of physical injury or physical sickness are excludable from gross income, any damages received based on a claim of emotional distress that is attributable to physical injury or physical sickness would likewise be excluded from gross income. Second, settlement and award payments for medical expenses incurred to treat emotional distress are tax-free to the extent that such expenses were not previously deducted or resulted in a tax benefit to the recipient.

If a settlement agreement allocates payments between excludable and taxable amounts, an accountant can generally follow the allocation in reporting such payments on the individual's tax return as long as the allocation was made at arm's length and in good faith, and is consistent with the substance of the settled claims. If the settlement agreement does not provide any basis for allocation, however, the exclusion may be wholly lost on the grounds that the taxpayer cannot satisfy the burden of proving the excludable amount.

Including Attorney Fees

The Supreme Court has concluded that a recovering plaintiff must include in gross income the portion of the recovery payable to the attorney as a contingent fee. The same rule would apply to attorney fees arising from settlement payments.

Therefore, if an individual receives a settlement or award payment that is includible in income, any amounts allocated to attorney fees are also includible in the individual's income. This is the case even if the defendant pays the legal fees directly to the attorney.

When an attorney represents multiple plaintiffs receiving settlement or award payments, the attorney should be able to allocate the fees and costs equitably among those plaintiffs. It is likely that the default allocation would be pro rata unless another allocation can be supported. Each plaintiff would include only the portion of the attorney's fees allocable to that plaintiff in his tax return.

In certain circumstances, court-awarded attorney fees can exceed a plaintiff's monetary recovery, such as when a plaintiff seeks only injunctive relief or a statute caps plaintiffs' recoveries. This can lead to the perverse result that the plaintiff loses money by winning the suit. If the lawsuit relates to the plaintiff's business, she would be entitled to an above-the-line deduction for amounts paid the attorney and thus should be made whole. Similarly, plaintiffs who receive award payments for claims related to certain whistleblower claims or discrimination actions are also allowed an above-the-line deduction of attorney fees.

By contrast, if an individual receives a settlement or award payment that is not related to his business and does not fall within the specified list of whistleblower claims or discrimination actions, he would generally have been able to deduct his attorney fees only as a miscellaneous itemized deduction, which would have been allowed only to the extent that the aggregate amount of such deductions exceeds 2% of the person's adjusted gross income. Subsequent to the enactment of the Tax Cuts and Jobs Act of 2017 (TCJA), attorney fees are no longer deductible as a miscellaneous itemized deduction for the years 2018 to 2025, thus causing a plaintiff who is not entitled to an above-the-line deduction for attorney fees to bear the full brunt of such fees.

Income and Employment Tax Withholding

Wages generally encompass all remuneration for employment, regardless of the basis upon which the remuneration is paid or whether the employer/employee relationship exists at the time of payment. Payments constituting severance pay, back pay, and front pay will generally be treated as wages. As a result, an employer will generally withhold income taxes, FUTA taxes, and the employee's portion of FICA taxes on settlement and award payments arising from employment-related actions unless such payment is nontaxable (e.g., back wages being paid from actions arising from physical injuries).

Where attorney fees are clearly allocated as such by a court in a judgment awarding back pay or clearly

reflected in a settlement agreement, the attorney fees, while includable in income, are generally not wages for employment tax purposes. If a court order or settlement agreement does not distinctly allocate attorney fees and the claimant pays such fees out of the recovery, however, the entire recovery, including the amount paid to the attorney, is considered wages for employment tax purposes and therefore subject to withholding.

One Size Does Not Fit All

The tax consequences to an individual receiving a settlement or award payment can vary significantly depending on the type of the claim from which the payment arises. CPAs faced with individuals who have received such a payment will need to understand the specific facts of the underlying claim and, if taxable, whether attorney fees were included in the payment. □

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