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News & Insights

When are Legal Settlements Taxable?

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More often than not, the taxability of an award or legal settlement is not on the forefront of a person's mind when they are a party to a dispute or a lawsuit. Yet the tax implications of an award or legal settlement are important and should not be ignored, or there may be issues down the road.

For instance, certain awards of money or property as a result of a lawsuit or legal settlement are considered to be "taxable income" to the person who receives the award or legal settlement. If this is the case, the Internal Revenue Service (IRS), and even the state government, will expect to receive its "share" of the award or legal settlement—in the form of taxes. If the recipient of the award or legal settlement does not correctly report the award or legal settlement on his tax return and pay any tax thereon, he may soon find himself in the middle of an IRS or state audit and facing penalties and interest charges on top of any tax that might be owed.

Taxable Income

Section 61 of the Internal Revenue Code ("I.R.C." or the "Code") states that all income from whatever source derived is taxable, unless specifically excluded by another Code section. *See* I.R.C. § 61.

How does this rule affect awards in lawsuits and legal settlements? Under I.R.C. § 61, damages awarded as a result of a lawsuit or legal settlement are taxable unless specifically excluded by another section of the Code. Accordingly, a taxpayer must look to the Code in order to determine whether an award or legal settlement is taxable, under I.R.C. § 61, or is not taxable under another Code provision.

Tax Treatment of Awards and Legal Settlements

Generally, awards in lawsuits and legal settlements can be divided into two groups to determine whether they are taxable or not. One group includes claims arising from a physical injury. The second group includes claims arising from a non-physical injury. The claims in each of these groups usually fall into the following categories:

1. Actual damages resulting from the physical or non-physical injury;
2. Emotional distress damages arising from the actual physical or non-physical injury; and
3. Punitive damages.

In general, the issue of taxability of damages awarded as a result of a lawsuit or legal settlement is determined by focusing on how the Internal Revenue Code treats the money or other loss which the damages are intended to replace.

Physical Injuries or Physical Sickness

Under I.R.C. § 104(a)(2), damages received on account of personal physical injuries or physical sickness are excluded from gross income. I.R.C. § 104(a)(2) (excluding from gross income "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness."). This section provides the foundation for the view that most tort damages are not taxed.

The phrase "on account of" used in I.R.C. § 104(a)(2) is of particular importance to determining whether or not damages are includable in gross income. If damages received are not "on account of" a physical injury or physical sickness, then such damages are, with limited exceptions, includable in the recipient's gross income.

Damages that are "on account of" a physical injury or physical sickness, however, are excludable from the recipient's gross income—and thus are not taxed. Thus, if an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received "on account of personal physical injury or physical sickness" within the meaning of I.R.C. § 104(a)(2). For example, compensatory damages, including lost wages, received on account of a personal physical injury are excludable from gross income with the exception of punitive damages. *See* Rev. Rul. 85-97, 1985-2 C.B. 50, *amplifying* Rev. Rul. 61-1; *see also Commissioner v. Schleier*, 515 U.S. 323, 329-30 (1995) (Supreme Court held that medical expenses (not previously deducted), pain and suffering, and lost wages received by an accident victim are excludable from income as "on account of personal injuries").

The exclusion of damages from gross income is not limited only to those damages paid to the injured party. For instance, if the spouse of an injured party claims loss of consortium due to the physical injury or sickness of the injured party, damages paid to the spouse for the loss of consortium claim are considered to be "on account of personal physical injuries or physical sickness" within the meaning of I.R.C. § 104(a)(2).

The section 104(a)(2) exclusion applies whether recovery is realized through a court judgment or a settlement agreement, and even if the settlement was achieved without filing suit. *See* I.R.C. § 104(a)(2); *United States v. Burke*, 504 U.S. 229 (1992); *Paton v. Commissioner*, T.C. Memo. 1992–627 (exclusion from gross income applied where defendant settled as a result of implication in letter from plaintiff's counsel that lawsuit would be filed). Thus, voluntary settlements achieved or damages awarded as a result of claims based on personal physical injuries are generally excludable from gross income.

One exception to the general rule that damages received on account of personal physical injuries or physical sickness are excluded from gross income is when the recipient of the damages is compensated for medical expenses that the recipient previously deducted. If the recipient deducted medical expenses in a previous tax year and is later compensated for the medical expenses in an award or legal settlement, the recipient must include the award or legal settlement in his gross income to the extent that the previous deduction(s) provided a tax benefit to the recipient.

Emotional Distress

Damages for emotional distress *on account of* or *attributable to* physical injuries or sickness are excludable from gross income by I.R.C. § 104(a)(2). *See* Treas. Reg. § 1.104-1(c)(1).

In the absence of a physical injury or physical sickness that *causes* emotional distress, damages received for emotional distress are not considered to be damages received for a physical injury or physical sickness. This is because the terms "physical injury" and "physical sickness," as used in I.R.C. § 104(a)(2), do not include emotional distress, except to the extent of damages not in excess of the out-of-pocket amount paid for medical care attributable to emotional distress. *See* I.R.C. § 104(a) (flush language); *see also* H. Conf. Rept. 104-737, at 301 n.56 (1996), 1996-3 C.B. 741, 1041 n.56 (emotional distress, including symptoms such as insomnia, headaches, and stomach disorders, which may result from such emotional distress, is not considered a physical injury or physical sickness, except that an exclusion may be allowed to the amount paid for medical care attributable to the emotional distress).

Accordingly, if damages for emotional distress are not "on account of" a physical injury or physical sickness, such damages are includable in the recipient's gross income. However, the recipient does not have to include such damages in gross income to the extent of the recipient's actual out-of-pocket medical expenses attributable to emotional distress, provided the recipient did not previously deduct the out-of-pocket medical expenses.

Many cases have been litigated where taxpayers have attempted to exclude from their gross income awards of damages or settlements based on claims for emotional distress. Overwhelmingly, courts have held that in order for damage awards to be excluded from gross income they must have been received on account of personal physical injuries or physical sickness, and that "emotional distress, even when coupled with physical manifestations, is an insufficient basis on which a taxpayer may exclude settlement proceeds from gross income." *Sharp v. Commissioner*, T.C. Memo. 2013-290. Accordingly, "[m]oney paid for emotional distress not attributable to physical injury or physical sickness is includable in income, and any amounts paid in such circumstances for physical symptoms of emotional distress are similarly includable as income." *Wells v. Commissioner*, T.C. Memo 2010-5; *see also Murphy v. IRS*, 493 F.3d 170 (D.C. Circuit 2007) (holding that damages awarded in an administrative action against a former employer for "mental pain and anguish" and "injury to professional reputation" were not on account of physical injuries or physical sickness, even though the taxpayer suffered from physical manifestations of the emotional distress on which the award was based); *Sanford v. Commissioner*, T.C. Memo. 2008-158 (settlement award for emotional distress relating to sexual harassment and discrimination claims is not excludable, even where emotional distress symptoms included asthma, sleep deprivation, skin irritation, appetite loss, severe headaches and depression); *Shelton v. Commissioner*, T.C. Memo. 2009-116 (same); *Polone v. Commissioner*, T.C. Memo. 2003-339 (settlement award for defamation claim is not excludable), *aff'd*, 505 F.3d 966 (9th Cir. 2007); *Venable v. Commissioner*, T.C. Memo. 2003-240 (settlement payment for mental anguish and loss of reputation relating to malicious prosecution claim is not excludable), *aff'd*, 110 Fed.App'x 421 (5th Cir. 2004); *Stadnyk v. Commissioner*, T.C. Memo. 2008-289 (taxpayer's injuries included emotional distress, mortification, humiliation, mental anguish and damage to reputation), *aff'd*, 367 Fed.Appx. 586 (6th Cir. 2010).

Punitive Damages

Punitive damages are intended to punish the wrongdoer and do not compensate the claimant for lost wages or pain and suffering.

Punitive damages are not excludable from gross income under IRC § 104(a)(2), regardless of whether received in connection with a physical or non-physical injury or sickness. Indeed, punitive damages are taxable—with one exception. I.R.C. § 104(c) provides a limited exception to the taxability of punitive damages awarded in certain wrongful death cases, where under state law (such as Alabama), punitive damages are the only damages that may be awarded.

Non-Physical Injury

Damages received in an award or legal settlement are excludable under IRC § 104(a)(2) only if received on account of physical injury or physical sickness. Accordingly, amounts received to settle claims originating or arising from non-physical injuries are includable in the recipient's gross income. Such amounts include amounts from claims involving damage to the recipient's reputation (defamation), racial discrimination, wrongful discharge, breach of contract, fraud, lost wages and lost business profits.

As discussed above, a recipient of lawsuit proceeds from a non-physical injury claim cannot exclude any amount for payment to compensate for an intangible emotional distress value. If the emotional distress claim did not arise from a physical injury or sickness, the recipient can only exclude from gross income the amount the recipient paid for actual out-of-pocket medical costs, provided the recipient did not previously deduct the medical costs on his tax return. *See* I.R.C. §§ 111 and 213.

Amounts awarded or legal settlements for non-physical injuries are taxed at ordinary income tax rates.

Seek Professional Help for Settlements

Obviously, the tax law on damages awards and legal settlements is not only complex, it can be subjective. Each case is different, and has its own set of facts and circumstances.

If you expect to receive or have received an award or settlement, consult a tax attorney to determine the appropriate tax treatment for your specific situation. The tax attorneys at Hall Estill will be able to provide an in-depth analysis of the tax consequences of a specific legal settlement or damages award, and may be able to assist in negotiating more favorable terms.

Whatever you do, don't wait until tax return time to consider these issues. Get some advice *before* you settle. A little planning and some good tax language in your settlement agreement can make all the difference.

Attorneys

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