

## **Tax Treatments of Awards and Settlements**

**By Sheila May, CPA**

Settlements, whether the amounts received are included in your income, depends on the circumstances. A settlement agreement can have multiple elements such as amounts awarded for emotional distress, attorney's fees, punitive damages, or interest.

Are these amounts taxed?

TABLE 1: TAX TREATMENT OF SETTLEMENTS PAID TO RECIPIENT

<b>Type of settlement</b>	<b>Taxable or Exempt</b>	
Actual damages from physical injury or illness including lost wages	Exempt	Full amount is exempt if no itemized deductions were taken for medical expenses relating to the injury or sickness in prior years. If deduction was taken AND it resulted in a tax benefit, that portion of the settlement must be included in income. *See below. The tax benefit generated from the deduction must be included in "Other Income" on line 21 of Form 1040.
Emotional distress damages from physical injury or illness	Exempt	If emotional distress does NOT originate from physical injury or illness, the amount must be included in income less 1. Amounts previously deducted for medical expenses relating to physical injury or illness and 2. Amounts not previously deducted and paid for medical expenses relating to physical injury or illness. The net amount must be included in "Other Income" on line 21 of Form 1040.
Punitive damages from physical injury or illness	Taxable	"Other Income" on line 21 of Form 1040.
Actual damages from non-physical injury	Taxable	*See below.
Emotional distress damages from non-physical injury	Taxable	*See below.
Punitive damages from non-physical injury	Taxable	"Other Income" on line 21 of Form 1040.
Interest on settlement	Taxable	Line 8 Form 1040.
Canceled or reduced debt	Taxable	Exceptions/Exclusions: 1. Gifts or bequests 2. Certain student loans 3. If paid, would be deductible by taxpayer 4. Qualified purchase price reduction 5. Pay per performance success payments

**Tax Treatments of Awards and Settlements**

**By Sheila May, CPA**

		<p>reducing the principal balance of your home mortgage under the Home Affordable Modification Program (Mortgage Forgiveness Debt Relief Act of 2007)</p> <p>6. Debt canceled by Title 11 bankruptcy</p> <p>7. Debt canceled during insolvency (File Form 982)</p> <p>8. Cancellation of qualified farm indebtedness</p> <p>9. Cancellation of real property business indebtedness</p> <p>10. Cancellation of qualified principal residence indebtedness</p> <p>If not any of the above, include in "Other Income" on line 21 of Form 1040.</p>
--	--	---

Just because amounts collected are described in the agreement to be of a certain nature (i.e. settlement for emotional distress due to physical injury) does not mean the IRS will agree with the characterization and therefore the resulting tax treatment. The IRS looks to see if the allocation is consistent with the settled claim's substance. In addition, the IRS considers whether the settlement is reached at arm's length. As a result, the IRS is more likely to examine the characterization of funds from a settlement reached between parties or a settlement simply ratified by the court than it is an agreement reached after an adversarial proceeding tried before and decided by a judge or a jury.

If debt is secured by property and the property is taken in exchange for full or partial payment of debt, the property is considered sold for tax purposes. In other words, the exchange for reduction of debt may result in a gain or loss (and therefore tax consequences) completely separate from the issue of cancellation or reduction of debt.

Should the amounts paid to attorneys be included in the recipient's income?

Court decisions have varied on this topic. The IRS and the US Tax Courts argue contingent fees are paid after the settlement and therefore all amounts are to be first included in income. It is advisable to see a tax professional about the particular case.

TABLE 2: ARE ATTORNEY FEES PAID INCLUDED IN RECEPIENT'S INCOME?

	<b>ACCORDING TO IRS</b>
Exempt settlement amounts (Table1 #'s 1 and 2)contingent attorney fees	Yes

## **Tax Treatments of Awards and Settlements**

**By Sheila May, CPA**

Non-exempt settlement contingency attorney fees	Yes
Exempt settlement attorney fees paid prior to resolution	See a tax professional
Non-exempt settlement attorney fees paid prior to resolution	See a tax professional

\*If taxed, how are the amounts taxed?

The IRS looks to the origin of the claim to determine how the amount will be taxed. For example, if the settlement is an amount paid for lost wages (severance, back pay, front pay), they are subject to social security and Medicare taxes in effect the year paid. The amounts should be reported on line 7 of Form 1040. Lost profits should be included on line 2 of Schedule SE and the relevant forms and lines for business income.

Can amounts paid to attorneys be deducted?

Attorney's fees can be paid prior to resolution or on a contingency basis. The recipient of the settlement must report the amounts paid to attorneys, even payments distributed directly to attorneys.

How can the attorney fees be deducted?

The underlying reason for the lawsuit must be examined and the appropriate portion of IRC code considered.

TABLE 3: A PARTIAL LIST OF IRC CODES GOVERNING DEDUCTIONS FOR LEGAL FEES

62(a)	Adjustments to gross income
162	Relating to trade or business
212	Relating to expenses for production of income
262	Non deductibility of personal, living and family expenses
263	Relating to capital expenditures