

TAX CONSEQUENCES ASSOCIATED WITH SETTLEMENT

Many parties are of the belief that settlements have no tax consequences. That is not always the case and lawyers should be able to spot tax ramification issues in their cases and advise the parties before finalizing any settlement.

Section 104 of the Internal Revenue Code excludes from income recoveries for personal physical injuries and excludes from income damages for physical sickness. If your client's damages are solely for emotional distress and do not stem from physical injury or sickness, the settlement is probably taxable. You are advised to consult with a tax attorney before you finalize settlement of the case.

Recoveries in employment lawsuits and in False Claim Actions are taxed, at least to some degree. Interest and punitive damages awards in personal injury cases are taxed. You should consult a tax attorney regarding how the recovery affects your client's tax liability and itemized deductions (including Alternative Minimum Tax).

Most settlements result in the recipient and her attorney being listed on the check. The company issuing the check will send a 1099 form to the IRS reporting the settlement to the lawyer and the client, each for the full amount. When the lawyer does his year end tax accounting and tax reporting, the lawyer will, of course, only report the income that he earned on the case. This frequently results in an inquiry from the IRS and a necessary response from the attorney. The way to prevent this is to have the issuer issue two checks, one to the client and one to the attorney [though most attorneys do not know the exact net settlement to the client or to the firm at the time the check is written].

1099 forms must be filed by attorneys who pay other lawyers out of the settlement proceeds. If you pay a referral fee, you must report it to the IRS by way of Form 1099.

These are but a few of the examples of the tax consequences you might encounter in mediated settlements.

Parties settling large commercial litigation cases and parties settling class actions and other complicated cases should consult with a tax attorney prior to finalizing settlement, even before mediation, so the settlement does not unduly impact the attorneys' or parties' obligation of reporting and paying taxes.