

Tax Credits for 2011 • 2012–2013 NAEA Nomination Slate • Income Tax-Based Financial Statements

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YOUR QUESTIONS ANSWERED

Compiled by Gil Charney, CPA, CFP

LAWSUITS CAN BE BROUGHT FOR A VARIETY OF REASONS—physical injury, breach of contract, employment-related disputes, discrimination suits, and much more. Moreover, successful plaintiffs may receive a monetary award based on a court decision or an out-of-court settlement. The award may be paid in a lump sum, as an annuity, or in a structured settlement. The settlement or award amount itself may be a combination of damages for physical injuries, reimbursement of legal costs, emotional distress, punitive damages, and interest. Whether the settlement or award is excludible from income depends on whether the source of the claim was due to physical injury or physical sickness. However, non-excludible income from a lawsuit must be reported on an information document (generally, Form 1099-MISC) sent to the plaintiff and/or the plaintiff's attorney as well as to the IRS.

REPORTING A SETTLEMENT

Q: My client was awarded a \$300,000 settlement because of a car wreck in which he was involved. The amount withheld for medical expenses and attorney fees was about \$80,000. He received a 1099-MISC for \$220,000. Is the settlement taxable? How is it reported? What about the attorney fees?

A: **Nature of the Claim**
To understand how the settlement is taxed (and reported), you will need to examine the nature of the claim giving rise to the settlement and how the \$300,000 is to be applied. You did state that \$80,000 was withheld for medical expenses and attorney fees, but those two expenses need further analysis. Even if a portion of the settlement is for physical injuries sustained by your client, and therefore excludible from income, amounts paid to your client for medical expenses that he previously deducted would need to be included in income. Attorney fees are treated separately and may be partly excludible (see below).

The first step is to examine the settlement agreement and confirm what portion of the settlement was injury-related, the amount of attorney fees, and the reason for the rest of the settlement. If the settlement document does not provide a breakdown of the settlement, then you may need to dig a little deeper regarding the claim itself. Your

client's attorney may need to be contacted if the terms of the complaint or settlement statement are not entirely clear.

Physical Injury

As mentioned above, if a portion of the settlement amount was due to physical injury, it is excludible under IRC Sec. 104(a)(2). This includes not only medical expense reimbursement for the injury (assuming no prior medical deduction), but also any damages for lost wages or earnings, sickness due to complications from the physical injury, or emotional distress caused by the injury.

Attorney Fees

Attorney fees allocated to any portion of the settlement that is not taxable are not deductible.

However, if any portion of the settlement is taxable, the attorney fees allocated to the taxable portion of the settlement are includible in income, regardless of whether the fee was withheld from the

gross settlement and issued directly to the attorney or whether the settlement stipulated that part of the fee was to be paid by your client out of the net settlement. For example, suppose that half the gross settlement (\$150,000) is taxable. In that case, half the attorney fees must be included in income. The fees that are allocable to the taxable portion of the settlement may be deducted as a miscellaneous itemized deduction subject to the two-percent-of-AGI floor.

Settlement Balance

Aside from compensation for physical injuries and attorney fees, it is necessary to find out the nature of the claim and breakdown of the settlement in order to determine what part of the settlement balance is taxable. For example, punitive damages or even interest on the settlement amount, are taxable to your client. Compensation for damage to the client's vehicle (including allocated attorney fees) is non-taxable. (*Continued on Page 9*)

REPORTING BACK PAY

Q. My client sued her former employer for incorrect payment of overtime and will be receiving a settlement covering several years. The settlement required that the employer pay the additional overtime that should have been paid, as well as punitive damages in an amount equal to the additional overtime, plus interest. In what year will this be reported on the taxpayer's W-2? Where are the compensatory damages reported on the W-2?

A. Reporting by the Company

Although your client is no longer an employee of the company, the company should report back pay on Form W-2 (in boxes 1, 3, and 5) for the year payment is made. The punitive damages should be reported by the company on Form 1099-MISC because they are not payment for actual wages. Moreover, if the settlement included attorney fees, they are also reported on Form 1099-MISC, whether they were paid directly to the attorney or paid to your client. Interest associated with either the wages or the punitive damages is reported on Form 1099-INT.

Tax Consequences

Your client must report the wage portion of the settlement on the tax return for the

year in which the back pay is received. Note that only the part of the settlement that relates to the back pay is subject to payroll taxes. Interest paid on the settlement is taxable and likewise reported on the return for the year it is received. Punitive damages are reported as "other income" on line 21. Finally, note that any attorney fees associated with the lawsuit may be deducted by your client as a miscellaneous itemized deduction subject to the two-percent-of-AGI threshold.

About the Author:

Gil Charney, CPA, CFP®, MBA is a principal tax analyst at The Tax Institute at H&R Block, where he conducts research into complex tax problems and analyzes tax legislation. He also leads a team of EAs, CPAs, and tax attorneys in maintaining The Tax Institute's Tax Research Center. He has extensive experience in consulting, research, and corporate financial management. He also has taught graduate-level courses in accounting and finance and directed H&R Block's tax training department.

(Continued from Page 8)

Reporting the Settlement

Generally, the taxable portion of the settlement is reported on line 21 of Form 1040 as "other income." As explained above, deductible attorney fees are reported as a miscellaneous itemized deduction, subject to the two-percent-of-AGI limitation.

If the accident involved an automobile used for your client's business, any taxable settlement income and associated deductible fees should be reported on Schedule C or on a corporate tax return if appropriate.

If the taxable portion of the settlement does not match up to the net amount shown on Form 1099-MISC, it is likely that IRS' automated underreporter (AUR) program will pick up the discrepancy. To avoid a CP-2000 letter, it is helpful to attach a statement and appropriate portions of the settlement explaining the nature of the claim and settlement and how these items were reported.

REFERENCES

IRC Sec. 104, Compensation for injuries or sickness
Reg. Sec. 1.6045-5, Information reporting on payments to attorneys
IRS Pub. 525, Taxable and Nontaxable Income
IRS Lawsuits Awards and Settlements,
<http://www.irs.gov/businesses/page/0,,id=7050,00.html>,
IRS Office of Chief Counsel memorandum PMTA 2009-035,
<http://www.irs.gov/pub/lanoa/pmta2009-035.pdf>

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