

How to avoid a high bill

 finance.yahoo.com/personal-finance/taxes/article/taxes-on-settlements-how-to-avoid-a-high-bill-212054671.html

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We all see the ads for personal injury lawyers wanting to represent you when you've been hurt. They promise big wins and showcase happy clients.

What they don't mention is that you'll owe federal taxes on those settlement funds.

You might get an income tax bill for a lawsuit settlement from a slip-and-fall or car accident, other personal injury lawsuits, or if you get money from an insurance company. There are also settlements from situations that do not end up in court, like termination agreements.

Legal settlement awards often have several parts, which can include actual damages, emotional distress damages, and attorney's fees.

Some of these things are taxable federally, while others are not. It depends on how the settlement is written, and even then, it's subject to interpretation about whether it is taxable income.

A tax attorney and a tax accountant can help you sort things out. You might want to consult both before accepting any settlement because how it's written could have tax implications. Planning for this could save you money on future tax payments.

The IRS code about taxes on settlements

The Internal Revenue Service talks about the tax implications of settlements and judgments in Internal Revenue Code (IRC) Section 61. It says that all income is taxable unless it is exempted by another section of IRS tax code.

This means some settlements and parts of settlements are taxable.

The most common exemptions are for settlements paid for some discrimination claims and for some physical injuries, including in personal injury cases.

The IRS groups payments relating to physical injuries and non-physical injuries into three categories:

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

IRC Section 104(a)(2) says compensatory damages like lost wages due to a physical injury are not taxable.

Punitive damages are usually taxable income.

Types of settlements exempt from tax liability

The facts and circumstances of your case make a difference in whether the proceeds are taxed as income or are exempt.

According to IRC Section 104, a few main types of settlements are generally tax-free:

- Money received under workers' compensation for personal injuries or sickness
- Damages received by lawsuit or agreement because of personal physical injuries or physical sickness
- Amounts paid for certain discrimination claims

The code defines damages as an amount received “through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution.”

It doesn't matter if the compensation comes in a lump sum or periodic payments.

Diving in a bit deeper, if you receive a settlement for personal injuries from an accident, including lost wages, the amount is most likely not taxable.

If you receive a settlement for emotional distress, in order for it to be nontaxable, it must be directly because of personal physical injuries or sickness. You must also have not deducted actual medical expenses, medical costs, or medical bills related to the emotional distress on your taxes before. Basically, you can't get the same tax benefit twice.

Types of settlements that are taxable as income

These settlement amounts are taxable federally:

- Punitive damages, under most circumstances
- Back pay and damages for emotional distress that come in a settlement for employment discrimination

- Damages from employment-related lawsuits from wrongful discharge or failure to honor contract obligations — this means things like lost wages and business income are taxable unless a personal physical injury caused the losses
- Contractual and punitive awards from discrimination suits for age, race, gender, religion, or disability
- Dismissal pay, severance pay, or other payments for involuntary termination of employment are considered wages and are taxable

Some money from settlements is taxable as wages, and those wages are subject to employment taxes like FICA. Other money is taxable as ordinary income but is not subject to employment tax.

Attorney's fees are another complex issue. If an attorney's fee is included as part of an award settlement, the payer must report those fees. That means filing Forms 1099-MISC and Forms W-2 if appropriate.

These filings can help separate the money you actually keep from the money you paid someone else.

How to avoid paying taxes on settlement money

There's no easy answer to avoid paying taxes on settlement proceeds other than to consult a tax attorney and an accountant before accepting any settlement.

There are ways to structure the settlement and payout that might be more beneficial to you at tax time.

Personal injury attorneys and law firms specialize in this kind of case and can help make sure any settlement amount and settlement payment you receive is structured in a way to help you save on taxes or stay tax-free on your tax return.