

Income Tax Treatment of Awards and Settlements

A legal settlement can provide needed financial relief, but many settlement recipients overlook the tax consequences of a legal settlement or court award. Since the government's cut can approach ½ of the net proceeds, we prepare our clients by addressing the expected tax consequences of a legal settlement or award early in the process. The default assumption on court awards and settlements are that they are taxable unless the recipient meets a specific exemption.

Awards and settlements can be divided into two distinct groups:

1. Claims arising from physical injury, and
2. Those arising from non-physical injury.

The tax treatment of any award or settlement depends on which group it relates to. The following are key points in determining if an award or settlement is nontaxable:

Physical Injury or Sickness

- According to IRC section 104(a)(2), an “award or settlement received on account of physical injury or sickness is nontaxable.” The nontaxable treatment is allowed to whoever receives the award, whether or not the recipient is the injured party.
- Compensatory damages received because of emotional distress attributable to a physical injury or sickness are also nontaxable. Examples of emotional distress include headaches, insomnia, and stomach disorders.
- Punitive damages due to physical injuries or sickness are generally taxable with very limited exceptions.

Non-physical Injury

- Examples of non-physical injuries include breach of contract, employment wrongful discharge, discrimination, and libel.
- Damages received on account of non-physical injuries are taxable.
- Compensatory damages received because of emotional distress that arose from non-physical injuries are taxable as well. The taxable portion of the damages may be reduced by the amount of medical expenses paid to treat the emotional distress, unless the amount of medical expenses was deducted on the individual's tax return.
- Punitive damages due to non-physical injuries are taxable.

There are some physical injury cases in which both compensatory damages and punitive damages are awarded. Examples include wrongful death and product liability claims. In these cases, the total amount awarded must be allocated between compensatory and punitive damages because the compensatory damages are nontaxable and the punitive damages are taxable.

If you expect to receive or have received an award or settlement, consult your legal counsel and tax advisor to determine the appropriate tax treatment for your specific situation.

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