



**Tax Exempt &
Government Entities**

Federal, State, & Local Governments

Taxability of Lawsuit Judgments and Settlements



Presenters

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Ask Us Questions!

- Ask a Question” link
- Past presentations at the IRS Video

Portal - www.IRSvideos.gov/governments



Proper Tax Treatment



Considerations

- What is the character of the payment and the nature of the claim?
- Is any part of the payment considered gross income or wages?
- What is the appropriate reporting of the payment and any attorney's fees (Form 1099 or Form W-2)?



Taxability of Payments

- IRC Section 61
 - Income is taxable, unless excluded
- IRC Section 104(a)(2)
 - Exclusion from income
 - Personal physical injuries
 - Physical sickness



Taxability of Payments

- Group Types
 - Physical injury
 - Non-physical injury
- Claim Categories
 - Actual damages
 - Emotional distress damages
 - Punitive damages



- Bodily harm
 - Medical Treatment
 - Bruising
 - Bleeding
 - Swelling



Physical (Actual)

In 1996, IRC section 104(a)(2) amended to exclude from gross income “any amount of any damages (other than punitive) on account of personal physical injuries or physical sickness.

Emotional Distress

- Is not a physical injury or sickness
- IRC Section 104(a)
- Damages excludable only
 - On account of personal physical injury or physical sickness
- Physical symptoms



Type of Damage/Award

- Punitive
 - IRC Section 104(a)
 - Taxable
 - Regardless of the underlying claim
 - Exception
 - Wrongful Death



Wrongful Death

- Compensatory Damages
 - Personal physical injuries
 - Excludable under IRC 104(a)(2)
- Punitive Damages
 - Not excludable
 - Exception
 - IRC Section 104(c)

- Tort
 - A civil wrong, not involving breach of contract, for which a remedy may be obtained
 - A wrongful act committed by one person against another person or his/her property
 - The breach of a legal duty imposed by law, other than by contract
 - May cause or constitute, but is not necessarily, a personal injury



Tort

A tort award may be received from litigation or settlement of a claim for physical injury or illness, mental pain and suffering, interference with economic relations, and/or property damage.



Contractual

- Claims based on rights given by contract.
- A remedy provided specifically by the contractual agreement or as interpreted by a court.

Whether damages based on a contractual claim are taxable usually depends on the underlying claim.



Types of Damage/Award

- Compensatory
 - Damages intended to compensate the taxpayer for a loss
 - This loss may be
 - purely economic or
 - personal
- Punitive



Example 1

- Claim or suit –
 - Medical expense
 - Lost wages
 - Pain and suffering
- Settled for \$30,000
- Amount excluded from gross income



- Wrongful Discharge
- Libel
- Discrimination suits
 - All not excludable
 - Exception
 - Injuries under IRC Section 104(a)
 - Revenue Ruling 96-65 (Discrimination suits)



Example 2

- Employee Vernon
 - Sued Warren Village
 - Employment Discrimination
 - Awarded back pay
 - Not excludable under IRC 104(a)



Example 3

- Employee York
 - Sued employer for \$6,000
 - Court ordered judgment
 - Sided in York's favor
 - Didn't stipulate allocation of the payment
 - Allocation
 - Wages subject to employment tax withholding
 - Based upon the original claim



Resolution of Claims

- Jury/Court Verdict
- Out of Court Settlement
 - Proper allocation of the payments
 - Arms length
 - Good Faith



Jury/Court Verdicts

- Generally, not challenged
- Damages clearly allocated
 - Identifiable claim
- Exception
 - Ratification of a settlement
 - Impartial and objective determination
 - *Robinson vs Commissioner*, 102 T.C. 116



Out of Court Settlements

- Nature of the claim
 - Actual basis for settlement
- Facts and circumstances
- Reallocation
 - Doesn't reflect the true economic substance



Example 4

- Allocation of \$1 million dollar settlement
 - \$800,000 – personal injury
 - \$200,000 – breach of contract
 - \$ 0 – punitive damages
- Disregarded by the IRS
- Reallocated
 - \$800,000 – non-personal injury



Reporting Requirements

- Form 1099-Misc
 - IRC 6041 & Treas. Reg. 1.6041-1
- Form W-2
 - IRC 6041 & 6051
- Excludable under IRC 104(a)
 - Not reportable for payee



Form 1099-Misc

- Taxable Damages (e.g. Non-physical injuries/sickness)
 - Reported in Box 3 of Form 1099-MISC
 - IRC 6041 & Treas. Regs. 1.6041-1
- Gross payments to attorneys, including law firms
 - Reported in Box 14 of Form 1099-MISC
 - IRC 6041(a) & 6045(f)



- Salaries, Wages, & Other Compensation
 - Back Pay
 - Front Pay
 - Subject to Income and FICA withholding
 - Reportable on W-2 in the year paid



Example 5

- Employee Perry
 - Sued City of Pike
 - Court ordered award
 - \$6,800 – back pay, interest, & attorney fees
 - Reporting
 - \$5,000 on W-2
 - \$ 600 on Form 1099-Misc, Box 3
 - \$1,200 on Form 1099-Misc, Box 14
 - If check made out to attorney, file Form 1099-MISC with respect to the attorney, showing amount of check as gross proceeds in Box 14



Example 6

- Employee Porter
 - Sued County of Wells
 - Settled for \$300,000
 - Check for \$200,000 – net of taxes
 - Reporting
 - \$300,000 on Form W-2
 - \$200,000 on Form 1099-Misc, Box 14

- Involuntary termination payments
 - Wages for federal employment tax purposes
- Characterization depends upon
 - Nature of the claim
 - Remedies sought
- Award or settlement proceeds
 - Maybe subject to withholding and reporting



Recap – Helpful Resources

Educational materials for government entities

- [Educational-Resources](#)

Link to download forms and publications and other educational resources

- www.irs.gov/Forms-&-Pubs