The tax rules for legal awards and settlements: What recipients should know

If you've recently received a settlement or award from a lawsuit, or you're expecting one, you may be wondering how the IRS views this money. Will you need to pay taxes on it? The short answer: It depends on the type of damages you received. Understanding the basic rules can help you avoid surprises.

Taxable vs. nontaxable awards

Not all lawsuit settlements or awards are treated the same under federal tax law. Generally, the IRS breaks them into two categories:

- **Taxable.** Awards for lost wages, lost profits, breach of contract and most punitive damages are taxable. For example, punitive damages and awards for unlawful discrimination or harassment are taxable. If you receive compensation for back pay or unpaid wages, the IRS treats it just like income you earn on the job. It's subject to both income and employment taxes. Also taxable are damages for emotional distress without a physical injury.
- **Nontaxable.** Settlements for personal physical injuries or physical sickness are typically excluded from income, meaning you don't owe taxes on them. However, the injury must be physical (such as a broken bone or illness), not emotional.

Special considerations and reporting rules

It's important to recognize that even when part of a settlement is nontaxable, other parts might not be. For example, a case involving both physical injury and lost wages will likely result in mixed tax treatment.

Attorneys' fees are another area that can trip recipients up. Even if your lawyer is paid directly out of your settlement, you're generally taxed on the full amount before fees are deducted. This means you may owe tax on money you never actually receive.

Settlements related to emotional distress or defamation are taxable unless they're tied to physical harm. And punitive damages are almost always taxable, regardless of the type of case.

Why professional help matters

Navigating the tax consequences of a lawsuit award can be tricky. In many cases, the settlement agreement will play a key role in determining how the IRS classifies the payment. How damages are described in the settlement can have an impact on your tax bill. For example, it's helpful to specify which portion of a split settlement is for physical injuries versus emotional distress or lost wages. In negotiating a settlement, it may be possible to stipulate that an award is for physical injuries, rather than emotional, and thus is nontaxable.

Without professional guidance, you could miss opportunities to minimize your tax liability or, worse, end up underreporting income. We can help you:

- Review a settlement agreement for tax implications,
- Determine how much of your award is taxable,
- Understand when estimated tax payments might be necessary, and
- Ensure you report everything accurately on your tax return.

Final thoughts

While winning or settling a lawsuit or legal claim can bring financial relief, it can also bring tax complexities. Don't assume that all settlement money is tax-free or that the IRS won't notice. You want to stay compliant, avoid surprises and make the most of your award. Contact us if you've recently received a settlement, award or judgment or you're expecting one.