



How are court awards and out-of-court settlements taxed?

Awards and settlements are routinely provided for a variety of reasons. For example, a person could receive compensatory and punitive damage payments for personal injury, discrimination or harassment. Some of this money is taxed by the federal government, and perhaps state governments. Hopefully, you'll never need to know how payments for personal injuries are taxed. But here are the basic rules — just in case you or a loved one does need to understand them.

Under tax law, individuals are permitted to exclude from gross income damages that are received on account of a personal physical injury or a physical sickness. It doesn't matter if the compensation is from a court-ordered award or an out-of-court settlement, and it makes no difference if it's paid in a lump sum or installments.

Emotional distress

For purposes of this exclusion, emotional distress is *not* considered a physical injury or physical sickness. So, for example, an award under state law that's meant to compensate for emotional distress caused by age discrimination or harassment *would* have to be included in gross income. However, if you require medical care for treatment of the consequences of emotional distress, then the amount of damages not exceeding those expenses would be excludable from gross income.

Punitive damages for any personal injury claim, whether or not physical, aren't excludable from gross income unless awarded under certain state wrongful death statutes that provide for only punitive damages.

The law doesn't consider back pay and liquidated damages received under the Age Discrimination in Employment Act (ADEA) to be paid in compensation for personal injuries. Thus, an award for back pay and liquidated damages under the ADEA must be included in gross income.

Attorney's fees

You can't deduct attorney's fees incurred to collect a tax-free award or settlement for physical injury or sickness. However, to a limited extent, attorney's fees (whether contingent or non-

contingent) or court costs paid by, or on behalf of, a taxpayer in connection with an action involving a claim under the ADEA, are deductible from gross income to determine adjusted gross income. Specifically, the amount of this above-the-line deduction is limited to the amount includible in your gross income for the tax year on account of a judgment or settlement resulting from the ADEA claim, whether by suit or agreement, and whether as lump sum or periodic payments.

Best possible tax result

Keep in mind that while you want the best tax result possible from any settlement, lawsuit or discrimination action you're considering, non-tax legal factors together with the tax factors will determine the amount of your after-tax recovery. Consult with your attorney as to the best way to proceed.