

SETTLEMENTS – TAXABILITY

The Internal Revenue Service recognizes that receiving a settlement award (amount) from a personal injury suit may create new tax issues for some individuals. The following information is provided to assist recipients of cash settlements.

The type of settlement you receive is determined by your Final Settlement Agreement. Your attorney should provide you with a copy of your Final Settlement Agreement.

Physical injuries or physical sickness settlements are generally non-taxable.

- If you receive a settlement for physical injuries or physical sickness and did not take an itemized deduction for medical expenses related to this injury in prior years, the full amount is non-taxable and generally does not need to be reported on your income tax return.

BUT

- If you receive a settlement for physical injuries or physical sickness and did deduct medical expenses related to the injury, the *tax benefit* amount is taxable and should be reported as "Other Income" on line 21 of the 2004 Form 1040.

Interest, punitive damages, emotional distress or mental anguish, and employment discrimination or injury to reputation settlements are generally taxable.

- **Interest:** Amounts on any settlement are taxable as "Interest Income" and should be reported on line 8a of the 2004 Form 1040.
- **Punitive Damages:** Amounts are taxable and should be reported as "Other Income" on line 21 of the 2004 Form 1040. It does not matter if punitive damages are related to a physical injury or physical sickness.
- **Emotional distress or mental anguish:** Amounts are taxable to the extent that it exceeds medical costs, not previously deducted, for treatment of emotional distress or mental anguish. A statement showing the entire settlement amount less related medical cost should be attached to the return. The net taxable amount should be reported as "Other Income" on line 21 of the 2004 Form 1040.
- **Employment discrimination or injury to reputation:** Amounts are taxable and should be reported as "Other Income" on line 21 of the 2004 Form 1040.

Loss-of use or loss-in-value of property settlements may be taxable if the settlement exceeds your basis in the property.

- Property settlements that are less than the adjusted basis of your property are not taxable and generally do not need to be reported on your tax return.
- When property settlements exceed your adjusted basis in the property, the gain is treated as a *gain on a capital asset*. Gains on personal capital assets are reported on Form 1040's *Schedule D, Capital Gains and Losses*. Gains on business capital assets are reported on Form 4797, *Sale of Business Property*.

Some settlement recipients may need to make estimated tax payments if they expect their tax to be \$1,000 or more after subtracting credits & withholding. Information on estimated taxes can be found in IRS Publication 505 Tax Withholding & Estimated Tax and in Form 1040ES Estimated Tax for Individuals.

For additional help contact the IRS at 1-800-829-1040.



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