

Settlements — Taxability

If you receive proceeds from settlement of a lawsuit, you may have questions about whether you must include the proceeds in your income. This publication provides information about whether you must include the proceeds of certain kinds of settlements in your income. Whether you must include the settlement proceeds in your income depends on all the facts and circumstances in your case.

A settlement payment may consist of multiple elements that have been allocated by the parties. For example, an agreement may include allocations to back pay, emotional distress, and attorneys' fees. Generally, the IRS will not disturb an allocation if it is consistent with the substance of the settled claims.

Personal physical injuries or physical sickness

- If you receive a settlement for personal physical injuries or physical sickness and did not take an itemized deduction for medical expenses related to the injury or sickness in prior years, the full amount is non-taxable. Do not include the settlement proceeds in your income.

BUT

- If you receive a settlement for personal physical injuries or physical sickness, you must include in income that portion of the settlement that is for medical expenses you deducted in any prior year(s) to the extent the deduction(s) provided a tax benefit. If part of the proceeds is for medical expenses you paid in more than one year, you must allocate on a pro rata basis the part of the proceeds for medical expenses to each of the years you paid medical expenses. See Recoveries in Publication 525 for details on how to calculate the amount to report. The tax benefit amount should be reported as "Other Income" on line 21 of Form 1040.

Emotional distress or mental anguish

- The proceeds you receive for emotional distress or mental anguish originating from a personal physical injury or physical sickness are treated the same as proceeds received for **Personal physical injuries or physical sickness** above.

BUT

- If the proceeds you receive for emotional distress or mental anguish do **not** originate from a personal physical injury or physical sickness, you must include them in your income. However, the amount you must include is reduced by: (1) amounts paid for medical expenses attributable to emotional distress or mental anguish not previously deducted and (2) previously deducted medical expenses for such distress and anguish that did not provide a tax benefit. Attach to your return a statement showing the entire settlement amount less related medical costs not previously deducted and medical costs deducted for which there was no tax benefit. The net taxable amount should be reported as "Other Income" on line 21 of Form 1040.

Lost wages or lost profits:

- If you receive a settlement in an employment-related lawsuit; for example, for unlawful discrimination or involuntary termination, the portion of the proceeds that is for lost wages (i.e., severance pay, back pay, front pay) is taxable wages and subject to the social security wage base and social security and Medicare tax rates in effect in the year paid. These proceeds are subject to employment tax withholding by the payor and should be reported by you as "Wages, salaries, tips, etc." on line 7 of Form 1040.
- If you receive a settlement for lost profits from your trade or business, the portion of the proceeds attributable to the carrying on of your trade or business is net earnings subject to self-employment tax. These proceeds are taxable and should be included in your "Business income" reported on line 12 of Form 1040. These proceeds are also included on line 2 of Schedule SE (Form 1040) when figuring self-employment tax. For more information about reporting self-employment income and paying self-employment tax, see [Publication 334](#), Tax Guide for Small Business (For Individuals Who Use Schedule C or C-EZ).



Settlements — Taxability (continued)

Loss-in-value of property

- Property settlements for loss in value of property 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. However, you must reduce your basis in the property by the amount of the settlement.
- If the property settlement exceeds your adjusted basis in the property, the excess is income. For more information, see the Instructions for Schedule D, (Form 1040) Capital Gains and Losses and the Instructions for Form 4797, Sales of Business Property.

Interest: Interest on any settlement is generally taxable as “Interest Income” and should be reported on line 8a of Form 1040.

Punitive Damages: Punitive damages are taxable and should be reported as “Other Income” on line 21 of Form 1040, even if the punitive damages were received in a settlement for personal physical injuries or physical sickness.

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 and Estimated Tax, and in Form 1040-ES, Estimated Tax for Individuals.

For additional information, see Publication 525, Taxable and Nontaxable Income, visit our website at www.irs.gov, or call toll-free at 1-800-829-1040.

All of the forms and publications referenced in this publication are available from the IRS at www.irs.gov. Paper copies can be ordered by calling 1-800-829-3676 (1-800-TAX-FORM).