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Book Review

Bar member writes his 3rd edition of lawsuit-taxing primer

Taxation of Damages Awards and Settlement Payments (3d Ed. 2005), by Robert W. Wood, member of the State Bar of Montana; published by the Tax Institute (2004).

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Tax practitioners who spend their days swimming through robustly regulated areas such as, say, the consolidated return rules, may find themselves fish out of water when tax planning the settlement of a lawsuit. Congress and Treasury have issued relatively scant guidance in this area and courts have not always stepped up with uniform rules.

It is this dearth of guidance that makes the recent publication of the third edition of “Taxation of Damage Awards and Settlement Payments” by Robert W. Wood an essential tool for practitioners. Wood, who is probably the most prolific author in this area, [Mr. Wood is a San Francisco attorney and author who is a member of the State Bar of Montana] has produced in the third edition a treatise that ties together and unifies a rich and diverse, but often conflicting and unsettled, area of tax law.

Scope

Wood’s focus is the federal income tax consequences of settlement awards and judgments. Plaintiffs and unfortunately sometimes even their own counsel often react in disbelief to learn on the eve of settlement that receipt of a recovery may be includible in gross income. As Wood notes, “Unlike the well-planned business transaction ... tax planning is oftentimes overlooked in view of seemingly more pressing aspects of the case.”

Wood’s treatise is a toolkit for tax planning in this area, providing valuable resources from the time a complaint is prepared to the reporting of a final recovery. It provides a comprehensive discussion of all relevant substantive areas, with chapters on personal injuries, employment recoveries, business injuries, substantiation, payor tax treatment, structured settlements, taxation of legal fees, divorce and will contests, and antitrust actions.

Origin of the Claim

The book leads off appropriately with a discussion of the origin of the claim doctrine, which permeates taxation of settlements and damages both for a plaintiff and a defendant. The doctrine requires a taxpayer to determine the appropriate tax treatment of a dispute-related payment by asking in lieu of what were the damages awarded? Anyone who has worked for any meaningful amount of time with this doctrine, especially in a multiple-claim action, knows the question rarely yields a uniform answer.

Wood collects decisions which have linked recoveries to various items, demonstrating the divergent tax consequences that result. For example, a recovery compensating for injuries to a capital asset can result in recovery of basis and favorable capital gain rates. On the other hand, a recovery linked to back pay is not only taxable as ordinary income but also subject to withholding, FICA and FUTA. Taxpayers have also linked claims to involuntary conversions, qualifying for nonrecognition under Section 1033, or to physical personal injuries, which are excludable from gross income under section 104(a)(2).

Section 104(a)(2), one of a handful of code provisions specifically directed to this area, excludes from gross income recoveries arising from certain qualifying injuries. The taxation of personal injury and employment discrimination awards changed dramatically in 1996 when Congress amended section 104(a)(2) to require a physical

injury or sickness, as opposed to merely a personal one. Wood discusses the lack of guidance as to the meaning of “physical,” and notes that section 104(a)(2) no longer applies to exclude from gross income damages received in the context of non-physical injuries, such as employment discrimination or injury to reputation.

Documenting Settlements

Wood is a strong advocate of allocating a settlement payment in the settlement documents. It is the taxpayer, of course, who must demonstrate what portion of a recovery is nontaxable or a capital item. He observes that: “Where a taxpayer goes to the trouble of specifying in a release the nature of the claims addressed and the tax treatment of that recovery, the taxpayer is far more likely to prevail.”

Indeed, tax planning for a litigant can never begin too early, since, as Wood explains, the complaint is the most important reference point in determining the taxation of a recovery. Nevertheless, Wood touts the settlement agreement as “vitaly important.” A failure to allocate in a settlement agreement will raise factual issues about the reason for the payment. His advice is straight-forward: “Unless you are sure that a recovery is entirely excludable, always allocate – it is just that simple. At least then you have a fighting chance.”

Wood also addresses the more mundane, although equally significant, issue of the proper reporting of settlement payments. He explains that one goal of a well-drafted settlement agreement is to “encourage and require that consistent tax treatment be applied by all parties.”

Other Areas

The treatise covers a host of other areas, including the celebrated rift in circuits on the inclusion of attorneys’ fees in the gross income of plaintiffs. For several years, a majority of circuits required a contingency-fee plaintiff to report in gross income attorneys fees. Wood describes how this tax treatment was recently altered in the American Jobs Creation Act of 2004 (P.L. 108-357) for claims of unlawful discrimination or specified claims against the government. (The circuit split was even more recently addressed by the Supreme Court in *Commissioner v. Banks*, 543 U.S. ____, 125 S. Ct. 826 (2005), a decision that post-dates the release of the third edition.)

Wood includes an entire chapter on structured settlements, addressing tax aspects of periodic payments both from the payee and payor standpoint. Similarly, there is a comprehensive analysis of the tax treatment of will contests, property settlements, alimony, spousal support and child support payments.

Practical Advice

One of the most rewarding aspects of the book is the assistance it provides to a tax practitioner. The book is littered with extensive and well-marked planning tips, cautions and examples. The chapter devoted to sample forms is an invaluable resource for practitioners in this area, containing numerous sample allocations, releases, settlements and assigns, along with relevant supporting authorities.

Wood’s treatise is an excellent reference for both tax and non-tax practitioners who plan settlements or damage awards. Wood’s contributions reflect his many years spent practicing and writing in this field.

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