

Settlement Agreements Without Tax Language Increase Your Taxes

By Robert W. Wood

Legal settlement agreements almost always involve tax issues. Money is being paid by someone and received by someone else. Defendants understandably want to deduct whatever they have to pay. Plaintiffs hope the money they are receiving is tax free. Or if they cannot have that Holy Grail, they want the settlement to be taxed as long term capital gain rather than as ordinary income.

Invariably, no plaintiff wants to pay taxes on their attorney fees. If the case is solely about personal physical injuries and if it settles before trial, it is reasonably safe to assume that the damages are all compensatory in nature, with nothing being attributed to punitive damages or interest. Compensatory damages for personal physical injuries are not taxable. But punitive damages and interest (even in a serious injury case) are always taxable.

That is one of the reasons why cases settling on appeal are always more difficult when it comes to how they will be taxed. The jury verdict may be on appeal, but anytime you have a verdict, you are no longer writing on a completely clean sheet of paper. The IRS can easily find out what the verdict said. Besides, it may be difficult for a tax lawyer to write a tax opinion post-verdict—or for a CPA to file a tax return—that treats 100% of an outsize post-verdict settlement as tax-free where most of the verdict was for punitive damages, particularly if the settlement is for more than the compensatory verdict.

Of course, most cases settle before trial, not post-verdict. So, if we put to the side post-verdict cases, do you have a completely free hand when it comes to settlements before trial? Not entirely. After all, the IRS will say that you can only settle the claims that you made in your complaint. For example, say you have a case about wrongful termination of employment, and that there are no allegations that the plaintiff was physically injured, became physically sick, or even had a pre-existing illness that grew worse as a result of alleged conduct of the employer.

When the case settles, is it credible to say that 90% of the settlement is for physical injuries or physical sickness? It is true that sometimes, last-minute allegations enter the negotiation process, and they may be bona fide. However, there is not too much latitude completely reshape what the case is about at the last minute.

Yet it is often surprising to people just how important settlement agreement wording can be to a later tax position. It can be worth pausing settlement negotiations to consider taxes, and to lobby for wording and tax allocations that make the most of the allegations you have. It can be a costly mistake to sign a settlement agreement that says little or nothing about taxes or the nature of the payment.

If a settlement agreement or general release says “\$100,000 for a complete release of claims,” does that give the plaintiff flexibility at tax time? Not really, and arguably it does the reverse. Often, the complaint alleges multiple claims.

Failing to allocate a settlement payment in the settlement agreement will raise factual questions about the reason for the payment and how it should be taxed.

For example, take a wrongful termination case where the plaintiff asks for past and future wages loss, emotional distress, and damages for PTSD that allegedly occurred from a particularly stressful workplace. How will the settlement be taxed if the settlement agreement calls for the release of all claims for a lump sum of \$1M? To begin with, given the employment context, the IRS is likely to say that the employer should have withheld taxes on at least some of the award.

With no allocation, the employer may have a hard time saying that no wages were paid, when a significant part of the case was about past and future wage loss. The tax law is clear that wage loss, severance pay, and other wage-based damages are subject to withholding and employment taxes, even if paid years after the termination of employment. In that sense, the employer may face potential liability to the IRS for failing to withhold taxes on any of the settlement.

What about the plaintiff side? Even if only the plaintiff is worried about taxes, how would you divide up the \$1M when it comes tax time? The plaintiff may want to argue that most of the settlement should be tax free for PTSD. There is no definitive tax case yet that says whether PTSD is a physical sickness qualifying for tax-free damages, but there are good arguments that it qualifies. Even so, the plaintiff will have a very hard time convincing the IRS with a lump sum settlement agreement that contains no tax allocation.

Indeed, the conventional IRS answer is likely to be that everything is taxed in such a case. In contrast, if the settlement agreement had said expressly that \$300,000 of the \$1M was paid on account of alleged physical sickness, the IRS would be much more likely to accept it. A general release that extinguishes all claims in return for a lump sum payment puts the plaintiff in a very tough position when it becomes tax return time.

To begin with, tax preparers may not be prepared to accept the plaintiff's do-it-yourself tax allocation. And even if they are, in an audit, the odds will clearly favor the IRS. Even if the plaintiff can show that she had and alleged physical injuries or physical sickness, if the settlement agreement does not earmark a particular dollar amount in payment of that claim, the IRS and the Tax Court are likely to take a conservative view and say it is 100% taxable.

Volumes of tax cases can be cited for the proposition that the defendant's intent in making the settlement payment, as evidenced by the wording of the settlement agreement, is of supreme importance. If the settlement agreement releases all claims for a lump sum, the IRS and the Tax Court will not know what the defendant considered important. Defendants may have tax concerns, such as wage withholding concerns in an employment case, where an employer may worry that they could face IRS penalties for not withholding on wages.

In most cases, though, the defense will be able to claim a tax deduction for the settlement payment, regardless of how the plaintiff will be taxed and on what claims. It is the plaintiff who almost invariably should be worried about tax allocation language in a settlement agreement. Without it, how the plaintiff will be taxed will be up for grabs.

The burden of proof in any tax audit or dispute will be on the plaintiff to demonstrate if any portion of a settlement should not be taxed, or should be taxed as capital gain rather than ordinary income. Courts frequently look at the complaint to see what the claims were about. However, in most cases, the IRS looks first and foremost at what the settlement agreement says. Plaintiffs are much more likely to have tax trouble if the settlement agreement is silent about the specific claims the defendant is paying for and in what amounts.

Often, courts refer to the absence of specific language in settlement agreements in holding against the taxpayer's preferred tax treatment. For example, in *Taggi v. United States*, 835 F. Supp. 744 (S.D.N.Y. 1993), aff'd, 35 F.3d 93 (2d Cir. 1994), the plaintiff was unsuccessful in treating any portion of a recovery as nontaxable because the settlement agreement was general. Similarly, in *Guidry v. Commissioner*, T.C. Memo 1994-127, the Tax Court specifically referred to the general release in denying the taxpayer's preferred tax treatment.

There are numerous cases in which a general release without negotiated allocations resulted in the plaintiff paying tax on 100%. For example, in *Taylor v. Commissioner*, T.C. Memo 1995-442, the taxpayer sued her employer and the labor union that represented her employee group. She executed a settlement agreement containing a general release, and she then undertook her own tax allocations. The IRS disagreed with her allocations, and when the case went to Tax Court, the Tax Court held that her entire recovery was taxable.

Whenever possible, try to nail down the desired tax treatment in the settlement agreement, including the related tax reporting. If you are a plaintiff, you don't want to be surprised later when Forms 1099 arrive in the mail or when the IRS disagrees with your tax return.

Robert W. Wood practices law with www.WoodLLP.com, and is the author of "*Taxation of Damage Awards & Settlement Payments*" (www.TaxInstitute.com). This discussion is not intended as legal advice.