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SETTLEMENTS AND TAXES: THE SEVEN DEADLY SINS

by Robert W. Wood

In the process of settling a case, lawyers who have no tax background can perhaps be forgiven for failing to consider tax consequences and the attendant tax planning opportunities. There is no such allowance made for tax practitioners. And, increasingly, lawyers and others associated with the litigation process are being asked to know at least the rudiments of these rules. There are seven deadly sins, or to put a positive outlook on the situation, seven areas of concern. These seven topics should be considered in every case before the settlement agreement is signed and the money is paid.

1. **Underlying Claims.** Consider the underlying claims, since the tax treatment to the plaintiff will depend in large part on the so-called “origin of the claim” doctrine. Thus, in a case in which wages alone are sought, the resulting settlement ought to be treated as wages. Of course, in the vast majority of cases, there is a mixture of different claims, making the origin of the claim inquiry more complex.
2. **Language of Settlement.** Consider the language of the settlement agreement. Does the tax treatment of the payment depend on what you end up calling it? The answer should be no, but in fact is at least partially yes. While calling a settlement payment “physical injury damages” does not make it so in a case arising in a dramatically different context, the parties should call the recovery what they think it is. As a plaintiff, if you fail to put in express language about what the payment is, and tax treatment (including withholding and/or tax reporting that is contemplated), you are making a mistake. While the IRS and the courts are not bound by such language, it does help.
3. **Consider Physical Injuries.** Section 104 of the Internal Revenue Code provides an exclusion from income for damages or settlements for physical personal injuries and/or physical sickness. Since the law was last changed (1996), there has been virtually no authority on what this new “physical” requirement means. Still, consider it where appropriate.
4. **Consider Attorneys’ Fees.** This has been a bugaboo of the tax system for a number of years. There is a hotly contested split in the circuits in the United States over the tax treatment of contingent attorneys’ fees. Should the plaintiff be taxed on the entire amount (even amounts paid directly to the plaintiff’s lawyer), or only the net amount? While a plaintiff will presumably be entitled to a deduction for the fees paid to the attorney (so you might think the plaintiff should be neutral how this comes out), the combination of the miscellaneous itemized deduction limitations, phase-out, and the alternative minimum tax, make this anything but equal. So far, not every circuit has decided this issue, but most have. Michigan, Alabama, Texas, Oregon, and perhaps Mississippi and Louisiana are all “good states” in which netting of attorneys’ fees is allowed. Stay tuned for details on this hot issue.

5. Consider Punitive Damages. The Internal Revenue Service has long taken the position that punitive damages are always taxable. After several aborted attempts to make the statute explicit, the Internal Revenue Service finally had its way with Congress in 1996. Now punitive damages are always taxable. The question, though, is just what constitutes “punitive damages.” The statute does not define it, nor do the regulations (nor the case law for that matter). If a case proceeds to judgment and the defendant writes a check to pay a punitive damage award, obviously this constitutes punitive damages. But what about if a case settles? If a case settles on appeal and something that looks like punitive damages gets paid, is it to be treated that way? What if the case settles before the trial is even concluded, so there is no way an amount could be viewed as punitives? Is this clear? The IRS doesn’t think so. Indeed, it has had success in a couple of cases imposing punitive damage treatment even where the case is settled early on. The IRS position is that the mere allegation of punitive damages in the complaint may be enough to import punitive damages treatment. Beware.

6. Consider 1099s. Tax reporting should always be considered by plaintiffs and defendants. So also should withholding. It is best if the withholding and tax reporting that is contemplated to all parties is expressly set forth in the settlement agreement. This avoids misunderstandings. Considering the web of reporting and withholding rules, there is often room for disagreement as well as various other foul-ups here. Try to avoid this by agreeing on everything in advance.

7. Consider Indemnity. The risks of the tax positions taken by defendant and plaintiff should always be considered. Though parties often do not want to explicitly invoke this topic, it seems foolish not to if you are a defendant and you are being asked to insert tax language and tax reporting language into a settlement agreement. Consider if you want to ask the plaintiff for indemnity. Is the plaintiff able to satisfy the indemnity later? Do you want to ask the plaintiff’s lawyer for indemnity, too? Do you demand a tax opinion? These and other issues should be addressed.

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