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Tax Law
Taxing Matters in Settling Cases

Even practitioners who have assiduously avoided concentrating on the intricacies of tax law still need to be aware of the possible tax ramifications in case settlements before finalizing them. Luckily, if you keep in mind a few basic principles, you should be in a position at least to help assess the risks, and to know when to get or recommend outside tax advice.

First, consider whether your client is receiving money or paying money. Receiving income is usually more important from a tax perspective, so most plaintiffs are more worried about tax issues than most defendants.

Tax Concerns for Plaintiffs

The overarching rule is that the origin of your client's claim will determine the tax consequences of a settlement. The U.S. Supreme Court laid down that rule more than a half century ago in *Arrowsmith v. Commissioner* (344 U.S. 6 (1952)). For example, if your client's claims are for wages, a settlement will generally be treated as wages for both income tax and employment tax purposes. (*See* Rev. Ruling 78—336, 1978-2 C.B. 225.) And if a business sues for harm to its goodwill, the resulting settlement should be treated as a recovery of goodwill, which usually means a capital gain.

Another fundamental tax rule is that all income is taxable unless there is a special rule to the contrary. In other words, you and your client should assume everything is taxable as a starting point. The biggest statutory exception to this rule is section 104 of the Internal Revenue Code, which states that damages for "personal physical injuries or sickness" are tax-free. California tax law has a parallel provision. (Cal. Rev. & Tax Code § 17131.)

Unfortunately, it is not clear what constitutes physical injury or sickness under the codes. The IRS view of physical injury is that there must be serious physical contact involved, such as an auto accident or battery. And the resulting injury needs to be serious enough to see—broken bones or bruises, for example. Prior to 1996, emotional-distress damages were tax-free, but the Internal Revenue Code was amended that year to add the "physical" requirement, dramatically tightening the scope of this exclusion. (I.R.C. § 104(a)(2), as amended by the Small Business Job Protection Act of 1996.) The primary target of the 1996 amendment was employment litigation, in which plaintiffs generally excluded from income emotional-distress and discrimination recoveries.

Figuring out what is excludable is tough. The legislative history of the 1996 Act indicates that mere symptoms of emotional distress, such as headaches, insomnia, and stomachaches, do not qualify as physical injuries or sicknesses, so recoveries for such items are not excludable. (H. Conf. Rept. 104—737 at 301 (1996), 1996-3 C.B. 741, 1041.) However, it is not clear whether an ulcer would be treated as a mere symptom of emotional distress and taxable, or as a bona fide physical injury or sickness, and therefore tax-free.

Not surprisingly, much of the relevant case law comes from employment claims, in which employees often allege that some portion of their recovery relates to physical injuries or sickness. The IRS is strict in imposing limits. However, when there is actual physical contact, such as sexual assault in a sexual-harassment case, it may be appropriate to claim some exclusion. In such cases, it is usually wise to get a tax professional involved for specific guidance.

The language of the settlement agreement is also important. Ideally, the plaintiff and the defendant should agree on what a settlement payment represents. The IRS and the California Franchise Tax Board will usually ask for a copy of the complaint in an audit to see the genesis of the claims and will also request a copy of the settlement agreement. And though government auditors are not bound by the agreement, they do consider it. A plaintiff who fails to include tax allocation and characterization language in a settlement agreement misses an opportunity to help mold the tax treatment of the recovery.

Another matter of critical importance is how the payments to the plaintiff are reported. IRS Form W-2 is used to report the wages paid to an employee each year; Form 1099 is used for most other payments.

If a payment is excludable from income, it should not be reported on a 1099. Virtually every business issues 1099s for payments made in the course of business. The 1099 forms reporting all payments made in the prior year are due to the taxpayer who receives the payment by January 31 of the following year. Then, the business must send copies of all of its 1099s, along with transmittal Form 1096, to the IRS before the end of February, leaving a one-month delay between the time Forms 1099 are due to the taxpayer and the time they must be sent to the IRS. That delay may provide a tactical advantage for your clients. If a client receives a Form 1099 that is incorrect, and immediately notifies the payer, there may be enough time to change it before the IRS receives it.

Returning to the primary precept that all settlements are taxable unless you can prove otherwise, it is also important to recognize that section 104 does not shield all damages from taxation, even in a case indisputably involving physical injury. For example, if a plaintiff is injured and rendered a quadriplegic, punitive damages awarded for the injury are still taxable. (*O'Gilvie v. United States*, 519 U.S. 79 (1996).) The same is true for prejudgment and postjudgment interest. (*Kovacs v. Commissioner*, 100 T.C. 124 (1993).) So if your client recovers money in a personal injury case, you still need to differentiate between damages for physical injuries and any amount awarded for interest or punitive damages in determining whether the money is excludable.

The toughest calls in determining the treatment of punitive damages or interest are in cases that settle on appeal. For example, suppose that an auto-accident case in which your client was awarded $500,000 in compensating damages and $2 million in punitives settles for $1 million pending appeal. Some portion of that settlement might be allotted to interest or punitive damages at trial. (*Rozpad v. Commissioner*, 154 F.3d 1 (1998).) It may be appropriate to seek the advice of competent tax counsel if you have a case involving such issues, preferably before the case settles.

Tax-reporting rules are one reason to expressly address tax issues in a settlement agreement. For example, if your client's settlement agreement says nothing about IRS Forms W-2 or 1099, and those forms are incorrect when issued, you may have little recourse. You can contact the defendant and plead your case, but very few defendants take such requests seriously.

In contrast, if the settlement agreement is specific—for example, there will be a W-2 for $500, a Form 1099 for $20,000, and a Form 1099 to the attorney for $10,000—you have something specific to address. If the forms come in any other manner, you can contact the defendant and assert that the settlement agreement was breached. Such discussions generally lead to corrections.

Other plaintiff recoveries. In addition to the tricky personal injury area, tax considerations play a part in virtually all other kinds of recoveries too. Again, assume everything is taxable.

You may also face the question of whether a recovery is ordinary income or a capital gain. The top tax rate for ordinary income is 35 percent while the top capital gain rate is 15 percent, so clients have big incentives to try to characterize their recovery as capital gains. In general, a recovery for a capital asset such as a business, a personal residence, or shares of stock follow a particular pattern. If the case you are handling relates to damages to assets, you must be mindful of the distinction between ordinary income and capital gains.

Intellectual property is another area ripe for tax planning. An intellectual property recovery may be treated as lost profits, such as lost royalty income on a patent license. It may also be treated as harm to the patent itself, in which case the recovery may be viewed as a capital gain, or even as a recovery of the patent holder's basis in the patent, and not taxable at all. Plainly, there can be huge tax savings depending on the characterization. It may also be wise to get tax counsel involved when you are handling an intellectual property case—again, preferably before the case is settled.

As added complications, there are special tax rules that apply when property is damaged, and unique provisions for gain on the sale of a personal residence, as well as tax provisions applying when property is involuntarily converted, for example, by fire or condemnation.

Attorneys fees. Finally, when considering awards to plaintiffs, be wary of the tax treatment of attorneys fees. In 2004, the tax law was amended to expressly allow an "above-the-line" deduction for attorneys fees in employment cases. (I.R.C. § 62, as amended by the American Jobs Creation Act of 2004.) The tax issue here is a fundamental one. Suppose you handle contingent-fee litigation for a client and recover $100,000, and your fee is 40 percent. Does the client have gross income of $60,000, or gross income of $100,000, followed by a $40,000 deduction? Economically, this may sound like a distinction without a difference, yet these two alternatives generally do not mean the same thing from a tax standpoint.

Resolving a vehement split in the circuit courts, the U.S. Supreme Court ruled in 2005 that a plaintiff in contingent-fee litigation generally must be treated as receiving 100 percent of the recovery for tax purposes, regardless of how the checks are cut or whether the plaintiff's lawyer is paid his or her share directly. (*Commissioner v. Banks*, 543 U.S. 426 (2005).) The statutory change, made a few months before the Supreme Court's holding, allows employment plaintiffs an above-the-line deduction so that, in effect, they are not taxed on the money paid to their lawyers.

However, excluding employment litigation, the client in the example above generally will have gross income of $100,000 and will have to find a way to deduct the $40,000 in legal fees. Usually those fees can be deducted only as a "miscellaneous itemized deduction," which means there are limitations and restrictions. In particular, the client will often be stung by the dreaded alternative minimum tax, or AMT.

Deductibility for Defendants

If you are representing a defendant, tax worries are less obvious than those of plaintiffs. But there are a few key rules to keep in mind.

First, nearly all defendants want to make sure they can deduct a payment as a business expense. In business litigation, this is usually not a problem, but it still merits close consideration. Some defendants get stung by capitalization rules, having to add the cost of a settlement to their tax basis, so they get no current deduction. That can occur in litigating environmental matters and in settling title to assets.

For example, if your client pays a settlement to resolve a dispute over who owns the land under an office building, that settlement payment will probably be viewed for tax purposes as a payment to quiet title. As such, the client probably cannot deduct it as an ordinary business expense, but instead would have to add it to his or her basis for tax purposes. Although the client would eventually receive a tax benefit for this payment when he or she sold the building, that may be a long wait. A current tax deduction is always better than a delayed tax benefit.

The tax treatment of attorneys fees generally follows the tax treatment of the underlying settlement or judgment. So, if your defendant client must capitalize, rather than deduct, a settlement payment, the attorneys fees the defendant pays will likely face the same unfavorable treatment.

Sometimes, tax planning at settlement time can help ameliorate these harsh tax consequences. Still, most settlement payments in a business context are tax-deductible, even punitive damages. Generally, a defendant wants to make sure to get a current deduction, even where there is some delay in getting the money to the plaintiff.

A larger topic relates to tax reporting and withholding. Business clients are subject to strict rules. If you are a defense lawyer, when the plaintiff's lawyer asks for certain tax language to be included in the agreement, review it carefully before incorporating it. If the plaintiff asks your client to characterize a patent royalty payment in a settlement agreement as "personal physical injury damages," don't do it. It may be tax fraud, and it is certainly inappropriate. However, if the plaintiff asks your defendant client not to issue a Form 1099 for one-third of a sexual-harassment settlement, this may be perfectly fine, depending on the facts. Consider whether that third of the settlement payment represents a fair allocation.

Probably the biggest exposure defendants face is for failure to withhold on taxes. If it is an employment case and the amounts paid to settle the case are wages, the defendant's liability for failing to withhold can be serious. For example, if your client is an employer and the case involves a claim for back wages, what if the plaintiff asks that there be no withholding on the settlement payment? If the case is 100 percent about wages, then under the origin-of-the-claim doctrine, the settlement payment should likewise be 100 percent wages. Wages are subject to withholding—and an employer that fails to withhold is liable for the taxes the employee does not pay, as well as for penalties and interest.

Thus, a plaintiff's seemingly simple request not to withhold taxes can result in major liability if the defendant agrees and the characterization is later determined to be improper. Often, a plaintiff will offer to indemnify the defendant for any tax problems as a way to get the tax language the plaintiff wants into the settlement agreement. But don't simply rely on the plaintiff's indemnification obligation, because those are rarely enforced. If your client is making a wage payment, but the plaintiff insists that it not be reported as wages, beware.

A defendant in a case that involves damages for personal injury or sickness can legitimately agree not to issue a Form 1099 for a portion of the settlement that is fairly allocated to such claims.

The attorneys fees tax-reporting rules are also highly complex. In general, in contingent-fee litigation, the defendant must issue a Form 1099 to both the plaintiff and to the plaintiff's lawyer.

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