



BUYNAK LAW FIRM

TAXES ON SETTLEMENTS (HOW TO INCREASE RECOVERIES AND MAXIMIZE DEDUCTIONS)

(Tax Advisory 2008 – 12)

Unless properly structured¹, monetary recoveries through litigation and settlement are generally taxed as income. With combined Federal and California income tax rates in the 19% to 44% range and with attorney fees included in gross income², it is essential to structure settlements to achieve the best possible result for all parties ó and many times, it is that 25% tax gap that will actually achieve a settlement.

This Advisory explores some basic tax implications of monetary settlements ó and the many ways of structuring them for the best result for tax payors and payees. Each settlement agreement³ should explicitly cover the tax arrangement, including what IRS Forms W-2 or 1099 are going to be issued ó or not issued.

This Advisory is neither exhaustive nor tailored to your specific situation. You should discuss your personal situation with us or with your own attorney. Our representation is only undertaken through a written engagement letter and not by the distribution of this Advisory.

Settlement Recovery Basics. Some basic tax concepts are:

- (1) The legal claims asserted and resolved determine the tax consequences of a settlement⁴ ó wage claims/recoveries yield ordinary income; goodwill recoveries, capital gain.
- (2) Settlement proceeds are taxable to the payee (and deductible to the payor) unless there is a special rule to the contrary.
- (3) Recoveries for serious õpersonal physical injuries or sicknessö are not subject to tax.⁵

¹Proper structuring begins with filing the complaint and asserting claims that can result in non-taxable recoveries.

² *Commissioner v Banks* (2005) 543 US 426

³ Buynak Law's standard settlement agreement contains several clauses; the form is part of the Advisories under litigations, available at www.BuynakLaw.com

⁴ IRC, Section 105; California Revenue & Tax Code, Section 7131

⁵ Emotional distress, insomnia, and other non-physical or non-serious recoveries are taxable; consider ulcers, miscarriages and bruises, all prime opportunities when supported by appropriate written descriptions in the settlement documentation.

- (4) Punitive damages (even those for a physical injury) as well as pre- and post- judgment interest are taxable as ordinary income.
- (5) Recoveries of a capital asset (stock, residence, patent, business) constitute current federal capital gain, with a federal capital gain rate of 15%.
- (6) Attorney fees are part of gross income, even if paid to the attorney directly, but attorney fees paid for an employment recovery are an above-the-line deduction (no tax is eventually paid on this type of attorney fees).

Settlement Payment Basics. Generally, for persons or entities paying settlements⁶, the deduction follows the treatment accorded to the payment of ordinary business loss/expense or capitalization. Some general rules of

- (1) The general issue is whether it is a business expense (deductible) or capitalized.
- (2) Payment of personal injury damages, although not taxable, may still be deducted as a business expense.
- (3) Attorney fee payment, like regular payments, follows the categorization of the underlying payment.

Tax Reportings. First, it is important to categorize the payment; an example might be, if the facts supported such allocation:

\$100,000 - Wages, with a W-2
\$100,000 - Non-reported
\$10,000 - Attorney Fees, Form 1099

Again, W-2s are issued for wages; 1099s for other types of income. All of which should be specified in the settlement agreement so that no one is surprised. Undoing an improper W-2 or 1099 is impossible unless there is an agreement specifying the exact obligations with an attorney fees clause. See Buynak Law's standard settlement agreement for an example.

Wage Withholding. On wages paid, withholdings must be undertaken by the payor/business, as otherwise the employee will be liable for the withholding plus penalties and interest.

⁶ Some parties consider contributing to a charity and thereby, resolve their differences and gain an offsetting deduction of for a payor or payee

Attorney Fees. Always issue a Form 1099 to an attorney if you have paid attorney fees to the attorney. The rules regarding these payments have become strict in recent years. For the payee, the question will be one of whether it is an above the line deduction (personal injury) or below the line deduction (others) unless it can be categorized as a business expense/loss.

Document, Document, Document. Use proper language in the settlement agreement to evidence the allocation and tax reportings that are specified. The IRS and Franchise Tax Board will scrutinize the agreement as well as the underlying pleadings, discovery and the source of the claim. Be safe in your allocations and be capable of supporting them by third party documentation and declarations, or in the proper occasion, by a tax opinion by a tax attorney. Sometimes, indemnifications are gained; rarely are they helpful as the parties and their attorneys have long ago parted ways when difficulties in enforcement arise.

The tax aspects of settlements are extremely important. Proper attention should be given to the tax characterization and tax deductibility of payment(s). Sometimes, a good understanding of the tax attributes can assist the settlement itself, as there may be no tax payable. The tax characterization and deductibility, along with reportings (W-2s, 1099s) should be specified in a settlement agreement, so each party properly reports the settlement to the IRS and FTB.

As always, you should be sure that legislation has not been enacted or that court decisions have not been rendered that would change the above advisements. This Advisory is neither exhaustive nor is it tailored to your specific situation. Your settlement should be individually reviewed so that its tax aspects are appropriate and clearly defined. For such a review or if you have any concerns or questions, please discuss your individual situation with us or your own attorney.

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This Advisory is one of a series of business, real estate and tax advisories prepared by the attorneys at the Buynak Law Firm. Should you have further questions regarding the information provided in this Advisory, please contact the author at the number listed above.

The Buynak Firm provides business legal services to individuals, business entities and nonprofit organizations from entity formation and start up, through day-to-day operations and exit strategies.