What Every Personal Injury Practice Needs to Know About the:

Taxation of Damage Award and Settlements

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The tax treatment of a personal injury settlement or judgment can have a significant economic impact on the parties. For obvious reasons, if a recovery is exludible from income, the economic consequences may be far easier for a client to bear. On the other hand, if a recovery is fully taxable or the client's attorneys' fees are not fully deductible, an otherwise successful outcome may be less than desirable. Unfortunately, lawyers often overlook the tax consequences of settlements and judgments and, as a result, fail to engage in timely and meaningful tax planning. Consequently, this article offers several tips for plaintiffs' attorneys regarding the taxation of damage awards.

1. Get Educated - Failure to advise clients about the tax consequences of litigation creates malpractice liability exposure. The tax consequences of a settlement or judgment are relevant in almost every case. Thus, it is not surprising that malpractice claims often arise from the alleged failure of an attorney to advise his or her clients about the tax consequences of litigation. An attorney familiar with the general principles applicable to the taxation of settlements and damage awards is better equipped to spot potential tax traps and reach out to tax professionals when necessary.

A myriad of tax consequences, both expected & unexpected, can result from litigation.

2. Plan Early - Tax planning should begin before the complaint is filed. One of the key principles in the taxation of damage awards is the "origin of the claim" doctrine. Under the origin of the claim doctrine, the origin or source of a party's claims controls the tax treatment of any recovery. As a result, the manner in which a party's claims are characterized has a direct impact on the tax consequences of any recovery. The IRS considers the complaint the single most important document for determining the tax consequences of a recovery. *See* Revenue Ruling (Rev. Rul.) 85-98, 1985-2 C.B. 51. As a result, if a practitioner fails to consider the tax consequences of litigation until after the complaint is filed, he or she will have missed the best opportunity to engage in effective tax planning.

3. Don't Overreach - The IRS narrowly construes the exclusion from income for personal injury awards. A common misunderstanding is that damage awards or settlement proceeds received in personal injury cases are always excludible from income under Section 104(a)(2) of the Internal Revenue Code. In general, Section 104(a)(2) excludes from gross income the amount of any non-punitive damages received on account of personal physical injuries or physical sickness. However, the IRS narrowly construes the meaning of "physical injury" and "physical

sickness" for tax purposes under its restrictive "bruising and bleeding" ruling. See Private Letter Ruling (PLR) 200041022. In PLR 200041022, the IRS concluded that, unless a plaintiff's injuries result in "observable bodily harm" (*i.e.*, bruises, cuts, swelling, and bleeding), a recovery is not excludible from income under Section 104(a)(2). As a result, damages recovered in cases involving sexual abuse or other physical injuries that do not result in bruising, bleeding, etc., may be subject to tax unless the plaintiff can establish some "observable bodily harm." Unless a practitioner is absolutely certain that a recovery is excludible under Section 104(a)(2), the client should be advised to consult with a tax professional.

4. Allocate, Allocate, Allocate – Don't let the IRS determine how to apportion a recovery. Settlement agreements also should be drafted with tax considerations in mind. A settlement agreement that clearly allocates the settlement proceeds between excludible personal injury damages and other damages can be binding on the IRS to the extent that the agreement was entered into by the parties at arm's length and in good faith. The absence of any allocation provision simply invites the IRS to determine the appropriate allocation itself.

5. Take Care With Confidentiality Provisions – Consider whether any part of the recovery is allocable to the confidentiality clause. The inclusion of confidentiality provisions in litigation settlement agreements has become commonplace, regardless of whether confidentiality is truly necessary. What many plaintiffs' attorneys don't know is that including a confidentiality provision can subject an otherwise nontaxable settlement to federal income tax. Under the auspices of *Amos v. Commissioner*, T.C. Memo 2003–329, it is becoming increasingly common for the IRS to take the position that a settlement payment was made in exchange for a confidentiality provision and not as compensation for an otherwise nontaxable claim or injury. Based on this argument, the IRS often makes its own allocation between the amount intended to compensate the plaintiff for the nontaxable injury and the amount intended as consideration for the confidentiality provision, which allocation may have little or no correlation with what the parties actually intended.

6. Be Thorough – Make sure to advise your client about the tax treatment of your legal fees. Attorneys often forget to advise their clients about the tax

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treatment of legal fees incurred throughout the litigation process. In general, if a taxpayer receives a taxable recovery, any attorney's fees paid by the taxpayer are not "netted" against the amount of the recovery. Rather, the taxpayer must include the entire recovery in income and then deduct the attorney's fees under an applicable provision of the Code. While legal fees incurred in connection with the taxpayer's trade or business typically are fully deductible, legal fees incurred in connection with the production of income and personal legal fees must be deducted as a miscellaneous itemized deduction subject to the 2% floor and such fees are not deductible for AMT purposes. Consequently, any tax advice given to a client also should include a frank discussion of the likely tax treatment of the client's legal fees.

A myriad of tax consequences, both expected and unexpected, can result from litigation. Conducting tax planning as early in the process as possible, and preferably even before sending a demand letter, can significantly reduce the economic impact of litigation on the client and the attorney's exposure to malpractice liability.

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