

## THE TAXMAN COMETH: TAX CONSEQUENCES OF SETTLEMENT NEGOTIATIONS

By: Nancy Gilmore

Settlement negotiations can often be long and complicated affairs. Once a final dollar amount is determined, how that settlement is classified (i.e., the elements of the claim to which each dollar of the settlement is attributed) is often the last thing the parties want to think about. However, the tax consequences of a settlement agreement can vary significantly depending upon how the settlement is classified. Failing to take those consequences into account during settlement negotiations can cost the parties dearly in unnecessary taxes.

Although every situation is unique, here are some general tax treatment guidelines that should be considered for different types of claims:

### A. Torts

When it comes to torts, the taxability of a settlement almost always turns upon whether the plaintiff suffered a physical injury. If so, the settlement amount attributable to that physical injury, including any resultant non-physical damage, is considered non-taxable compensation. If, however, a settlement amount is not attributable to a physical injury, it is generally considered ordinary income for the plaintiff and is taxed as such.

This basic principle may sound simple but determining whether the source of an injury is physical or non-physical can become quite complicated. For example, assume a woman is involved in a car accident and suffers from emotional distress. If the emotional distress is a result of being frightened by the experience, it is non-physical. If, however, the emotional distress is a result of being confined to a bed for six months to recover from physical injuries, then it would likely be considered part of the physical injury. Any money the woman receives for her emotional distress in the first scenario will be taxed as ordinary income even if she manifests physical symptoms of her distress, but any money the woman receives for her emotional distress in the second scenario will be non-taxable compensation.

### B. Punitive Damages

Punitive damages are almost always treated as taxable income. There is a small exception to this rule for wrongful death cases where state law restricts any damage award to punitive damages only.

### C. Wrongful Termination

A settlement agreement for a wrongful termination suit will almost always result in taxable income for the plaintiff. This tax treatment will have significant impact on the defendant. Unless otherwise specified, damages in a wrongful termination suit are generally deemed to be wages, and any damages categorized as wages are subject to employment taxes – including social security and unemployment – and withholding requirements. Failure to comply

with the employment tax and withholding requirements may result in the defendant being subjected to penalties and interest on top of the additional taxes owed.

D. Business Recoveries

When a case involves compensation to a business, the issue is whether the settlement is for lost profits or consists of other compensation. Lost profits are taxed as ordinary income to the business while other compensation may be treated as capital gains, dividends, or some other form of business income.

E. Attorney Fees

Attorney fees are not deductible if they are related to a purely personal matter and they must be capitalized if the origin of the claim is a capital asset. Otherwise, attorney fees are generally deductible as an ordinary and necessary business expense.

Regardless of how the parties decide to classify a settlement agreement, the most important thing to do is to make sure that the settlement agreement clearly designates the purpose of the recovery and how much of that recovery is attributable to each part of the claim. A failure to do so may mean that the Internal Revenue Service and/or a federal judge will reinterpret the agreement in a manner that is contrary to the parties' intentions.

If you are in the middle of settlement negotiations and require assistance in determining the tax implications of your agreement, please contact Nancy M. Gilmore (410-649-1244, or [ngilmore@rosenbergmartin.com](mailto:ngilmore@rosenbergmartin.com)) or any attorney in our tax group:

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