Tax planning in litigation

How to ensure optimal tax treatment

If you're a party to a lawsuit or other legal proceeding, the taxability or deductibility of an award or settlement for damages can have a big impact on the financial outcome. A little tax planning may help ensure the desired tax treatment.

Nature of the claim

Generally, the tax treatment of an award for damages depends on the nature of the underlying claim. For example, if you file a discrimination suit against your employer and receive a back pay award, the amount is taxable to you (and deductible by your employer). On the other hand, damages for injury to property are usually a combination of *non*taxable return of capital and capital gain.

In personal injury cases, the tax treatment of damages can be complicated. The Internal Revenue Code specifically excludes from taxable income compensatory damages received "on account of personal physical injuries or physical sickness," including certain other financial damages suffered as a result.

Compensatory damages related to *non*physical injuries, however, are taxable. And distinguishing between physical injuries or sickness and nonphysical ones — such as emotional distress — can be a challenge, particularly when nonphysical injuries lead to, or stem from, serious physical problems.

Punitive damages are taxable, as is compensation for lost wages.

Laying the foundation

Many lawsuits involve both taxable and nontaxable claims — or, from the defendant's perspective, both deductible and nondeductible claims. To ensure optimal tax treatment, it's important to do some tax planning early in the litigation. Why? Because the parties often have an opportunity to influence the allocation of damages among claims, or between punitive and compensatory damages.

The key to building a case is to lay the foundation early in the litigation. For example, a plaintiff who wants to ensure that the court allocates a significant portion of an award to damages on account of physical injuries or physical sickness should emphasize those claims in the complaint and bring them out at trial.

If parties settle out of court, they must be able to support their allocation of damages in order to survive an IRS challenge. In its publication *Lawsuits, Awards, and Settlements Audit Techniques Guide,* the IRS instructs auditors to review settlement agreements closely and challenge an allocation if "the facts and circumstances indicate that the allocation does not reflect the economic substance of the settlement."

To support an allocation to particular claims, the parties should ensure that those claims are asserted early in the settlement process and that the parties' settlement discussions and correspondence reflect their significance.

Pay attention to taxes

If you're involved in a legal dispute, taxes may not be your primary concern. But it's a good idea to consult your attorney early in the process to discuss possible opportunities to minimize your tax bill.

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