

LITIGATION  
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## ADVISER

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## Tax Planning in Litigation: Start Early, End Strong

Tax planning at the beginning of a case can have a significant impact on the eventual financial outcome for your client. There's a substantial difference between an award or settlement that's subject to income tax and one that's not. The parties have a certain amount of control over the characterization of damages for tax purposes, but it's important to start planning as early as possible, preferably *before* the complaint is drafted.

### Origin of the claim

Generally, the tax treatment of damages is based on the "origin of the claim." Thus, awards of lost wages in employment discrimination cases are taxable, while damages received "on account of personal physical injuries or physical sickness" are excluded from income under Internal Revenue Code Section 104(a)(2). Note that nonphysical injury damages are generally considered taxable income.

In commercial or securities litigation, lost profits are taxable, while damages for injury to a capital asset — such as physical damage to a building or the diminished value of a company's stock — are generally treated as part nontaxable return of

capital and part capital gain. Punitive damages and interest are taxable.

Even if damages aren't excluded from income, the distinction between wage and nonwage damages is important. Suppose, for example, that an employment discrimination victim recovers damages for both back pay and emotional distress, but suffers no physical injury or physical sickness. The damage award is subject to income tax (except for medical expenses related to emotional distress), but only the back pay portion is subject to FICA and other employment taxes.

### Laying the foundation

Most cases involve a combination of taxable and nontaxable claims; the ultimate tax treatment of an award or settlement depends on how it's allocated among those claims. The parties' characterization of the damages goes a long way, but it must have economic substance.

Suppose, for example, that an employer and employee settle an employment discrimination case for \$1 million, and the settlement agreement allocates half the proceeds to lost wages and half to emotional



distress damages. By allocating \$500,000 of the settlement to nonwage damages (emotional distress), the parties save about \$14,000 each in employment taxes.

To support this allocation, however, the plaintiff should be able to show that he or she:

- 1) sought emotional distress damages in the complaint, and
- 2) sought and received medical treatment for symptoms of emotional distress.

Otherwise, the IRS or a court may conclude that the party's allocation lacked economic substance and reallocate the entire settlement to taxable lost wages.

### Plan ahead to benefit your client

The tax treatment of a damage award or settlement may not be your highest priority when developing litigation strategies. But it pays to give some thought to tax issues early in the litigation so you can secure the most tax-advantageous result for your client. **h**

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