

## Tax Notes

### Book Reviews

---

DECEMBER 2, 1991

### 'TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENTS.'

---

Joseph L. Schiffhouer is of counsel with Jones, Day, Reavis & Pogue in Pittsburgh, and is adjunct professor of law at Duquesne University Law School.

"Taxation of Damage Awards and Settlement Payments," by **Robert W. Wood**, is available from Tax Institute, PO Box 192026, San Francisco, CA 94119, for \$119 plus \$10 shipping and handling (prepaid), or by calling 1-800-852-5515.

The tax consequences of litigation -- both to the winner and the loser -- is an often overlooked aspect of the litigation process. Locked in mortal combat, plaintiffs and defendants concentrate their efforts on victory and may not pause to reflect on the tax impact of a potential settlement or judgment. Sometimes when taxes are finally considered, it may be too late to make any difference. Filed pleadings and signed settlement agreements may have locked in place adverse consequences that not even the most accomplished tax lawyer can ameliorate.

Given the pervasive and significant tax aspects to litigation, it is curious that no comprehensive guide to the tax consequences of damage awards and settlements has been produced until now. **Robert W. Wood's** "Taxation of Damage Awards and Settlement Payments" (Tax Institute 1991) is, thus, both a needed and welcome addition to tax literature. Both the tax specialist and the general practitioner who is looking for guidance on issues relating to the tax consequences of litigation will find the book a helpful addition to their library.

From the standpoint of the recipient of a settlement payment or judgment award, the major issues will be: Is the award taxable and at what rate? Is it a capital recovery that can be offset against basis or is it ordinary income subject to taxation in full? The unlucky payer of a settlement or judgment, of course, will be looking for a current deduction. Timing, in

either case, may also be crucial. The answer to these issues may lie in the "origin" of the payment -- Was this a case based on lost profits? Was it damage to business reputation? Or was it a purely personal affair such as a divorce?

After a general introduction, which provides a helpful overview of the major tax issues at stake in this area, Wood provides comprehensive discussions of each significant area of litigation and the potential tax outcomes.

Chapter 2 is devoted to the important area of excludable personal injury recoveries. The business reputation/personal reputation distinction as well as the physical/nonphysical injury distinction is given comprehensive treatment. In addition, the detailed discussion of workmen's compensation recoveries and their distinction from nonexcludable retirement related benefits is helpful in clearing up the seemingly conflicting precedents in that area. In each case, lucid examples and helpful planning tips are provided. In addition, less common areas, such as the taxability of recoveries for violation of privacy rights are discussed.

Chapter 3 is devoted to the rapidly expanding area of employment discrimination, whether based on race, age, or gender. The recent important Third Circuit cases, *Byrne* and *Rickel*, which support excludability of wrongful termination awards, are emphasized here.

<sup>1</sup> A helpful discussion of how lawyers should approach the question of allocating settlement amounts in discrimination and wrongful termination suits is also included.

Wood devotes two full chapters, chapters 4 and 10, to recoveries for business injuries. Appropriate emphasis is given to distinguishing between lost profits and injuries to goodwill and other capital assets. Rather than giving a mere overview of these issues, however, chapter 4 is broken down in detail among specific types of litigation and the different concerns that each type of litigation [P. 1084] entails. Securities fraud, patent infringement, and eminent domain awards are among the important topics given consideration here. Instruction is also given concerning the availability of the tax benefit rule and exclusion of recoveries where the damages sought are additional federal tax payments. These two avenues for excluding damages from income are often overlooked by the general practitioner.

Chapter 10 is devoted exclusively to the treatment of antitrust damages. While the currently sparse antitrust enforcement environment may make this in-depth treatment a questionable editorial judgment, there is no question that Wood's treatment of this subject is comprehensive. His discussion of the deductibility of antitrust recoveries when there is a related criminal case is especially illuminating.

Chapter 5, "Methods of Substantiating Tax Treatment," should be of important assistance to the general practitioner. The primacy of the complaint in establishing the true nature of an injury is emphasized, but practical advice on how to structure the settlement agreement and/or how to use jury instructions and special verdicts to achieve a favorable tax result also is discussed. The extensive appendix, which contains a variety of forms of settlement agreements and related documents, provides a good starting point for drafting some of the more common documents arising in the litigation context.

While much of the foregoing discussion is devoted to the recipient of a settlement payment or a damage award, chapters 6 and 8 discuss the treatment of payers and the deductibility of their payments. Chapter 6 distinguishes between business and personal expenses, and between those business expenses that must be capitalized and those which can be currently deducted either by reason of section 212 or 162. The nondeductibility of fines and penalties and the important question of timing of deductions also is discussed here. Chapter 8 also deals with payers -- payers of legal fees. The general rules for deductibility of legal fees, business nexus and reasonability, are first reviewed in detail. The remainder of this chapter discusses the deductibility of legal fees relating to specific types of proceedings such as tax advice, criminal proceedings, and divorce.

Chapter 7 constitutes the most comprehensive discussion of the tax ramifications of the "structured settlement" that this reviewer has encountered. Discussion of the "qualified assignment" (a code-sanctioned, structured settlement device for personal injury cases) is one among many of the important topics given consideration here. Helpful planning tips also are given on the use of annuities and trust arrangements in structuring settlement payments.

The final topic -- the tax treatment of will contests and divorce -- is given exhaustive treatment in chapter 9. As first-time tax students are painfully aware, the complexities in this area -- particularly the taxation of divorce and child support payments -- are enormous. Thankfully, Wood treats these topics both comprehensively and comprehensibly. In fact, his treatment of property settlements, alimony payments, and child support is worth the price of the book to lawyers who have a substantial family law practice.

As is usual with any comprehensive treatment of any tax subject, the specialist will find quibbles with the treatment of certain topics. For example, in discussing the deductibility of settlement payments, one may wonder at the absence of a reference to abandonment losses under section 165, which has proved to be increasingly helpful in the area of failed mergers and leveraged buy-outs. Likewise, there are a few instances in which references from the case table are inaccurate. But these nits aside, "Taxation of Damage Awards and Settlement Payments" is an important and much needed contribution to an area that has been neglected in the tax literature. It is a recommended addition to any tax library.

## FOOTNOTE

<sup>1</sup> Byrne v. Commissioner, 883 F.2d 211 (3rd Cir. 1989) and Rickel v. Commissioner, 900 F.2d 655 (3rd Cir. 1990).

---

Tax Analysts Information

**Magazine Citation:** Tax Notes, Dec. 2, 1991, p. 1083

---

## 53 Tax Notes 1083 (Dec. 2, 1991)

---