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**TAX SETTLEMENT**  
**HOW TO INCREASE RECOVERIES AND MAXIMIZE DEDUCTIONS**  
*(Tax Advisory No. 5)*

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Unless properly structured<sup>1</sup>, monetary recoveries through litigation and settlement are generally taxed as income. With combined Federal and California income tax rates in the 19% to 44% range and with attorney fees included in gross income<sup>2</sup>, it is essential to structure settlements to achieve the best possible result for all parties – and many times, it is that 25% tax gap that may actually achieve a settlement.

This Advisory explores some basic tax implications of monetary settlements – and the many ways of structuring them for the best result for taxpayers and payees. Each settlement agreement<sup>3</sup> should explicitly cover the tax arrangement, including what IRS Forms W-2 or 1099 are going to be issued – or not issued<sup>4</sup>. The reporting burden falls to the paying party.

This Advisory is neither exhaustive nor tailored to your specific situation. You should discuss your personal situation with us or with your own attorney. Our representation is only undertaken through a written engagement letter and not by the distribution of this Advisory.

**Settlement Recovery Basics.** Some basic tax concepts are:

- (1) The legal claims asserted and resolved determine the tax consequences of a settlement<sup>5</sup> – wage claims/recoveries yield ordinary income; goodwill recoveries, capital gain.

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<sup>1</sup>Proper structuring begins with the filing the complaint and asserting claims that can result in non-taxable recoveries.

<sup>2</sup> Attorney fees are reportable to tax authorities, even if paid to the claimant’s attorney directly. Such fees are reportable as 1099 income. *Commissioner v Banks* (2005) 543 US 426

<sup>3</sup> Buynak, Fauver, Archbald & Spray, LLP’s standard settlement agreement contains several clauses; the form is part of the Advisories under the Litigation Practice Area, available at [www.BFASLaw.com](http://www.BFASLaw.com).

<sup>4</sup> Compensation recoveries are W-2 income; punitive damages, liquidated damages, attorney fees, and cost, as well as interest are reported as 1099 income. Personal injury damages do not need to be reported.

<sup>5</sup> IRC, Section 105; California Revenue & Tax Code, Section 7131

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- (2) Settlement proceeds are taxable to the payee (and deductible to the payer) unless there is a special rule to the contrary.
- (3) Recoveries for serious “personal physical injuries or sickness” are not subject to tax.<sup>6</sup>
- (4) Punitive damages (even those for a physical injury) as well as pre- and post- judgment interest are taxable as ordinary income.
- (5) Recoveries of a capital asset (stock, residence, patent, business) constitute current federal capital gain.
- (6) Attorney fees are part of gross income, even if paid to the attorney directly, but attorney fees paid for an employment recovery are an above-the-line deduction (no tax is eventually paid on this type of attorney fees).

**Settlement Payment Basics.** Generally, for persons or entities paying settlements<sup>7</sup>, the deduction follows the treatment accorded to the payment – ordinary business loss/expense or capitalization. Some general rules –

- (1) The general issue is whether it is a business expense (deductible) or capitalized.
- (2) Payment of personal injury damages, although not taxable, may still be deducted as a business expense.
- (3) Attorney fee payment, like regular payments, follows the categorization of the underlying payment.

**Tax Reportings.** First, it is important to categorize the payment; an example might be, if the facts supported such allocation:

\$100,000 -	Wages, with a W-2
\$100,000 -	Non-reported (physical injuries)
\$10,000 -	Attorney Fees, Form 1099

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<sup>6</sup> Emotional distress, insomnia, and other non-physical or non-serious recoveries are taxable, if not caused by physical injury or sickness; consider ulcers, miscarriages and bruises, all prime opportunities for non-reporting when supported by appropriate written descriptions in the settlement documentation. Emotional distress damages need not be reported if covered by medical insurance. *Moulton v. Commissioner, 2009 WL 416010*

<sup>7</sup> Some parties consider contributing to a charity and thereby, resolve their differences and gain an offsetting deduction – for a payer or payee

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Again, W-2s are issued for wages; 1099s for other types of income. All of which should be specified in the settlement agreement so that no one is surprised. Undoing an improper W-2 or 1099 is impossible unless there is an agreement specifying the exact obligations with an attorney fees clause. See our Firm's standard settlement agreement for an example.

**Wage Withholding.** On wages paid, withholdings must be undertaken by the payer/business, as otherwise the employee will be liable for the withholding plus penalties and interest.

**Attorney Fees.** Always issue a Form 1099 to an attorney if you have paid attorney fees to the attorney. The rules regarding these payments have become strict in recent years. For the payee, the question will be one of whether it is an above the line deduction (personal injury) or below the line deduction (others) unless it can be categorized as a business expense/loss.

**Document, Document, Document.** Use proper language in the settlement agreement to evidence the allocation and tax reportings that are specified. The IRS and Franchise Tax Board will scrutinize the agreement as well as the underlying pleadings, discovery and the source of the claim. Be safe in your allocations and be capable of supporting them by third party documentation and declarations, or in the proper occasion, by a tax opinion by a tax attorney. Sometimes, indemnifications by the employee or employer are gained; rarely are they helpful as the parties and their attorneys have long ago parted ways when difficulties in enforcement arise.

The tax aspects of settlements are extremely important. Proper attention should be given to the tax characterization and tax deductibility of payment(s). Sometimes, a good understanding of the tax attributes can assist the settlement itself, as there may be no tax payable. The tax characterization and deductibility, along with reportings (W-2s, 1099s) should be specified in a settlement agreement, so each party properly reports the settlement to the IRS and FTB.

As always, you should be sure that legislation has not been enacted or that court decisions have not been rendered that would change the above advisements. This Advisory is neither exhaustive nor is it tailored to your specific situation. Your settlement should be individually reviewed so that its tax aspects are appropriate and clearly defined. For such a review or if you have any concerns or questions, please discuss your individual situation with us or your own attorney.

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*This Advisory is one of a series of business and tax advisories prepared by the attorneys at Buynak, Fauver, Archbald & Spray, LLP. Should you have further questions regarding the information provided in this Advisory, please contact the author listed above.*

*Buynak, Fauver, Archbald & Spray, LLP provides business legal services to individuals, business entities and non-profit organizations from entity formation and start up, through day-to-day operations, litigation, and exit strategies.*

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