3 Tax Aspects of Litigation

ELIZABETH C. HESSELBACH
PATRICK B. MATHIS
Mathis, Marifian, Richter & Grandy, Ltd.
Belleville

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I. INTRODUCTION

A. [3.1] Scope of Chapter

This chapter is devoted primarily to a discussion of the federal income tax consequences of the receipt and payment of settlements and damages in some of the more common litigation contexts. Planning opportunities for minimizing or eliminating federal income tax on the receipt of such amounts or maximizing tax benefits on their payment are also discussed. Although this chapter focuses on the federal income tax consequences of settlements and damage awards, attorneys should also be alert to the impact that state and local taxes may have on such payments.

B. Importance of Tax Planning

1. [3.2] In General

The income tax consequences of a settlement of a claim or of a judgment achieved in litigation can significantly impact the economic result to both the payor and the recipient but are often overlooked or given just a passing thought by the parties and their attorneys, who are focused more on obtaining a recovery or avoiding liability, as the case may be. Even though many planning opportunities exist to maximize the tax benefits to the payor and/or minimize the tax impact on the recipient of a settlement or award, very often the tax issues are not given due consideration or are considered only after the opportunity for meaningful planning has already passed. It is always best to begin planning for the desired tax treatment from the inception of the litigation, even before the complaint is filed. Consideration of tax consequences may influence settlement negotiations or assist the parties in planning a recovery pursuant to a judgment to achieve favorable tax treatment.

2. [3.3] Economic Effect on Parties to Litigation

As of this handbook’s publication, the maximum tax rate on capital gains was 15 percent, whereas the maximum tax rate applied to ordinary income was 35 percent. See IRS Publication 17, pp. 112, 271. Thus, it would seem obvious that if a damage award or settlement is taxable to the recipient as capital gain, he or she is economically better off than if it is taxable as ordinary income. More obvious is the proposition that the recipient will be even better off economically if the damage award or settlement is not taxable to him or her at all. Conversely, the payor of a damage award or settlement will be better off economically if it is able to take a deduction on its income tax return for the amount of the payment.

3. [3.4] Malpractice Avoidance

It is clear that the tax consequences of a settlement or judgment should be considered in virtually every case. The economic effect to the parties of a particular tax characterization may be very large. It is worth noting, moreover, that some attorneys have faced malpractice claims based on a failure to consider the tax consequences of litigation or a settlement.

C. [3.5] Fundamental Principle: Origin of Claim Controls Tax Treatment

The fundamental principle governing the taxability of settlements and judgments is that the origin of the claim controls the tax treatment of any recovery, whether the recovery is received pursuant to judgment or pursuant to settlement. *United States v. Gilmore,* 372 U.S. 39, 9 L.Ed.2d 570, 83 S.Ct. 623 (1963). According to the U.S. Supreme Court, any recovery is to be taxed in the same manner as the item for which it is intended to be a substitute, *i.e.,* in the same manner as would be the case if received without the necessity of litigation. *Id.* As a general proposition, the converse is also true. The deductibility of a payment made pursuant to judgment or settlement depends on whether the amount could be deducted for federal income tax purposes if paid in the absence of litigation.

D. [3.6] Sale or Exchange Required for Capital Gain Treatment

Another fundamental principle governing the tax treatment of judgments and settlements is that there must be an underlying sale or exchange of property if the recovery is to be taxed as capital gain. See Rev.Rul. 74-251, 1974-1 Cum.Bull. 234, in which the Internal Revenue Service stated:

> **Unless it can be clearly established that there has been a sale or exchange of property, money received in settlement of litigation is ordinary income. The mere settlement of a law suit does not itself constitute a sale or exchange.**

The Tax Court applied the sale-or-exchange test in preference to the origin-of-the-claim test to find that proceeds received in settlement of a breach of contract action were includible as ordinary income, rather than recovery of capital or capital gain income, even though the underlying claim concerned the acquisition of a capital asset. *Nahey v. Commissioner,* 111 T.C. 256 (1998), *aff'd,* 196 F.3d 866 (7th Cir. 1999). The court summarily rejected the taxpayer's argument that the origin of the claim analysis was the proper test to apply, holding instead that no sale or exchange took place because the defendant failed to relinquish any property rights in the settlement. *Id.*

E. Application of Overriding Principles to Specific Situations

1. [3.7] Personal Injury Awards

Compensation for personal physical injury is nontaxable by statute. Internal Revenue Code (Code) §104(a)(2). Although it may seem quite clear that a suit seeking recovery for physical injury should result in a nontaxable damage award or settlement, such a suit may, and often does, make claim for various types of damages such as loss of wages for time spent in the hospital, reimbursement for medical bills, mental anguish, pain and suffering, and punitive damages. However, the damage exclusion extends only to amounts received "on account of personal physical injuries or physical sickness" and to reimbursement for medical expenses. *Id.* See §§3.11 – 3.25 below for a more detailed discussion of personal injury awards.

2. [3.8] Awards in Employment Litigation

Recoveries of backpay are taxed in the same manner as salary or wages and thus are taxable as ordinary income. *Hodge v. Commissioner,* 64 T.C. 616 (1975).

Backpay is also treated as wages for purposes of federal withholding, social security, and other employment taxes. *Id.* Quite often, claims asserted in the employment context also include claims for personal injuries. Prior to the enactment of the Small Business Job Protection Act of 1996 (SBJPA), Pub.L. No. 104-188, 110 Stat. 1755, employment-related recoveries could be nontaxable to the extent they were allocable to damages for personal injury (*e.g.,* emotional distress). The burden of proof is always on the taxpayer to establish the amount of a recovery properly allocable to personal injuries. *Evans v. Commissioner*, 40 T.C.M. (CCH) 260 (1980). See §§3.26 – 3.32 below, which discuss recoveries in employment-related contexts.

3. [3.9] Recoveries for Lost Profits

Recoveries for lost profits are normally taxable as ordinary income. *Estate of Longino v. Commissioner,* 32 T.C. 904 (1959). Although this proposition seems fairly obvious, in many situations it is difficult to determine whether a recovery is for lost profits (and thus taxable as ordinary income) or whether it is for damage to a capital asset (and may be taxable as capital gain). Again, the burden of proof will be on the taxpayer to establish the nature of the recovery. *Kempter v. Commissioner,* 22 T.C.M. (CCH) 274 (1963).

In addition, as discussed more fully in §§3.11 – 3.25 below, a recovery measured by lost profits when the underlying claim is for personal injuries may be nontaxable. Thus, lost profits sustained in a personal injury context may be afforded more favorable tax treatment than other claims for lost profits. See also §3.41 below.

4. [3.10] Recoveries for Damage to Tangible Property

In general, amounts received for damage to tangible property are treated, for tax purposes, as received from the sale or exchange of such property. In the case of a total destruction of property, the recipient of the damages recognizes gain or loss measured by the difference between the tax basis in the property and the amount of damages received. Whether such gain or loss is treated as capital or ordinary gain or loss depends on the nature of the property damaged and whether it has been held for more than 12 months by the recipient. See §§3.33 – 3.40 below for more discussion.

II. [3.11] PERSONAL INJURY AWARDS

As a general rule, amounts received on account of a personal physical injury or physical sickness are excludible from income under Code §104(a)(2). An exception to this rule exists if the taxpayer claimed a deduction for related medical expenses in any prior year so that the taxpayer has previously received a tax benefit.

A. [3.12] Overview of Code §104(a)(2)

Code §104(a) provides that "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness" is excluded from income "[e]xcept in the case of amounts attributable to (and not in excess of) deductions allowed under [Code] section 213 (relating to medical, etc., expenses) for any prior taxable year." At first glance, this provision seems to provide a straightforward rule of law. As long as a taxpayer has not previously claimed a medical expense deduction under Code §213, any amount received by the taxpayer as a result of a personal physical injury or physical sickness will not be included in his or her taxable income. If the taxpayer has previously claimed a deduction under Code §213, only the damages received in excess of the amount previously deducted are excluded from income.

The application of this provision in the real world, however, has not been nearly as simple as its text would imply. Rather, there are additional questions that must be addressed. The first of these is what constitutes "personal physical injuries or physical sickness." A second question is what constitutes "damages received . . . on account of" personal physical injuries or physical sickness. The Treasury Regulations add one more requirement: To qualify for exclusion under Code §104(a)(2), the award must be "based upon tort or tort type rights." Treas.Reg. §1.104-1(c).

The U.S. Supreme Court has held that two independent requirements must be met before a recovery can be excluded from income under Code §104(a)(2):

1. The taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is "based upon tort or tort type rights."

2. The taxpayer must show that the damages were received "on account of personal injuries or sickness." *Commissioner v. Schleier,* 515 U.S. 323, 132 L.Ed.2d 294, 115 S.Ct. 2159, 2167 (1995). (As discussed in more detail in §3.13 below, this definition was further narrowed by the enactment of the Small Business Job Protection Act of 1996, which added the requirement that the injury or sickness be "physical" in nature.)

The burden is on the taxpayer to prove that both requirements have been met. *Schleier, supra.*

It has been held that what constitutes a tort will generally be determined under state law. *United States v. Burke,* 504 U.S. 229, 119 L.Ed.2d 34, 112 S.Ct. 1867 (1992); *Threlkeld v. Commissioner,* 87 T.C. 1294 (1986), *aff'd,* 848 F.2d 81 (6th Cir. 1988). The IRS previously ruled that it is the nature of the injury that is determinative on this question and not the state law label, but that ruling has since been obsoleted. Rev.Rul. 85-143, 1985-2 Cum.Bull. 55, 56, *obsoleted by* Rev.Rul. 98-37, 1998-2 Cum.Bull. 133.

With respect to the on-account-of requirement, a direct link between the damages and the injury or sickness must be established. See Pvt.Ltr.Rul. 200121031 (Feb. 16, 2001) (taxpayer able to exclude all damages, including economic damages, based on direct link between physical injury suffered and damages recovered; IRS found that asbestos-related diseases contracted by taxpayer's husband were proximate cause of circumstances giving rise to taxpayer's loss of consortium claim, survival action, and wrongful death action). The Supreme Court in *O'Gilvie v. United States,* 519 U.S. 79, 136 L.Ed.2d 454, 117 S.Ct. 452, 454 (1996), held that the phrase "on account of" means only damages awarded "by reason of" or "because of" the personal injuries are excludible. In so holding, the Court rejected the taxpayer's argument that merely a "but-for" causal connection was required between the damages and the personal injury.

B. [3.13] Physical Injuries or Sickness Required for Income Exclusion

The Small Business Job Protection Act of 1996 limited the scope of the income exclusion of Code §104(a)(2) by requiring that the damages be received "on account of personal *physical* injuries or *physical* sickness." [Emphasis added.] Section 104(a)(2), as amended, further provides that damages received on account of a claim for emotional distress not accompanied by physical injury or physical sickness are excludible from income only to the extent of the amount paid for medical care attributable to emotional distress. H.R.Rep. No. 737, 104th Cong., 2d Sess. (Aug. 1, 1996), clarified the scope of Code §104(a)(2), as amended by the SBJPA, as follows:

> **If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from taxable income as under present law. . . . Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness.**

The amendments to Code §104(a)(2) requiring physical injury or physical sickness are effective with respect to amounts received after August 20, 1996. A grandfather rule provides, however, that the amendments do not apply to amounts received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995. Pub.L. No. 104-188, §1605(d), 110 Stat. 1839.

In Pvt.Ltr.Rul. 200041022 (July 17, 2000), the IRS stated that unwanted physical contact resulting in observable "bruises, cuts, swelling, and bleeding" are injuries excludable under Code §104(a)(2). This ruling involved an employer who assaulted his employee and resulted in the employee recovering for pain, suffering, emotional distress, and reimbursement of medical expenses through a settlement agreement.

Presumably, compensatory damages caused by a physical injury or physical sickness that are measured by lost profits or lost wages will continue to be nontaxable under Code §104(a)(2), as amended. An example of this interpretation was provided by the U.S. Supreme Court in

Commissioner v. Schleier, 515 U.S. 323, 132 L.Ed.2d 294, 115 S.Ct. 2159, 2164 (1995), in which the Court stated:

> **[**T**]he recovery for lost wages is . . . excludable as being "on account of personal injuries," as long as the lost wages resulted from time in which the taxpayer was out of work as a result of her injuries.**

See also Threlkeld v. Commissioner, 87 T.C. 1294, 1300 (1986) (hypothetical surgeon who loses finger through tortious action may exclude any recovery for lost wages because "[t]his injury . . . will also undoubtedly cause special damages including loss of future income"), *aff'd,* 848 F.2d 81 (6th Cir. 1988).

C. [3.14] Tax Treatment of Nonphysical Injuries Prior to Small Business Job Protection Act of 1996

Prior to the Small Business Job Protection Act of 1996, the primary areas of contention with respect to nonphysical injuries were whether the injury was "personal" or "professional" in nature and whether it was based on a tort or tort-type right or on some other type of legal theory, *e.g.,* breach of contract.

1. [3.15] Injury to Reputation; Personal vs. Professional Injuries

In the landmark case *Roemer v. Commissioner,* 716 F.2d 693, 695, 697 (9th Cir. 1983), which involved a "grossly defamatory" credit report that resulted in damage to the taxpayer's personal and business reputation, the Ninth Circuit held that the "relevant distinction that should be made is between personal and nonpersonal injuries, not between physical and nonphysical injuries." The Ninth Circuit reasoned that the fact that the taxpayer's damages were measured by his lost business income did not serve to convert the personal injury to one that was nonpersonal, stating:

> **[**A**]ll defamatory statements attack an individual's good name. This injury *to the person* should not be confused with the derivative consequences of the defamatory attack, *i.e.*, the loss of reputation in the community and any resulting loss of income. The nonpersonal consequences of a personal injury, such as a loss of future income, are often the most persuasive means of proving the extent of the injury that was suffered. The personal nature of an injury should not be defined by its effect. [**Emphasis added.**]** 716 F.2d at 699.

The IRS announced, however, that it would not follow the Ninth Circuit's decision in *Roemer.* Rev.Rul. 85-143, 1985-2 Cum.Bull. 55. In this ruling, the IRS took the position that damages awarded with respect to a claim in the nature of libel, which is "directed primarily to the individual in the individual's business capacity, with the result that the primary harm suffered by the individual [is a] loss of business income," should not be considered as received "on account of a personal injury." 1985-2 Cum.Bull. at 56.

In *Threlkeld v. Commissioner,* 87 T.C. 1294 (1986), *aff'd,* 848 F.2d 81 (6th Cir. 1988), the Tax Court adopted the Ninth Circuit's reasoning in *Roemer* and thus abandoned its previously long-standing recognition of a distinction between damage to one's personal reputation and damage to one's professional reputation. In this case, the Tax Court compared the nonphysical injury at issue with the hypothetical case of a surgeon's loss of a finger as the result of another's tort. Under this hypothetical example, the Tax Court noted that the loss of future income would be a major component in determining the surgeon's damages and yet there would be no argument that all such damages would be excludible under Code §104(a)(2). 87 T.C. at 1300. The Tax Court concluded that because Code §104(a)(2) was not then limited to physical injuries, the result should be no different when amounts are received on account of a nonphysical injury. *Id.*

In affirming *Threlkeld,* the Sixth Circuit repudiated Rev.Rul. 85-143 as making "an unreasonable distinction between injury to personal reputation and injury to professional reputation." 848 F.2d at 84. The Sixth Circuit specifically found that an injury to one's reputation is personal, regardless of whether its primary effect is on one's social or professional pursuits. *Id.*

In light of the Small Business Job Protection Act of 1996, *Roemer, Threlkeld,* and their progeny are now of limited use to taxpayers except for damages received on or prior to August 20, 1996 (the effective date of the Act), or for damages received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995. See §3.13 above.

2. [3.16] Emotional Distress

As discussed in §3.13 above, Code §104(a)(2) now provides that damages received on account of a claim for emotional distress not accompanied by physical injury or physical sickness are excludible from income only to the extent of the amount paid for medical care attributable to the emotional distress. On the other hand, all compensatory damages received with respect to a claim of emotional distress stemming from a physical injury or physical sickness are still excludible from income. Prior to the amendment of Code §104(a)(2) by the Small Business Job Protection Act of 1996, recoveries for emotional distress claims were held to be excludible from income, whether or not accompanied by physical injury or sickness. *Fono v. Commissioner,* 79 T.C. 680 (1982), *aff'd,* 749 F.2d 37 (9th Cir. 1984). See §3.13 above for a discussion of the effective date of the Code §104(a)(2) amendments and grandfather rules.

3. [3.17] Civil Rights Claims

Prior to its amendment by the Small Business Job Protection Act of 1996 (see discussion in §3.13 above), the application of Code §104(a)(2) to nonphysical personal injuries was not limited to those in the nature of a common-law tort. Injuries that resulted from deprivation of constitutional or statutory rights were held, in many situations, to be considered "tort type" and excludible from income. In each case, the particular statute on which the claim was based had to be analyzed to determine whether it provided compensation for tort-like personal injuries as opposed to providing compensation solely for economic losses, such as backpay. If it did not, amounts recovered on the claim were still taxable. *United States v. Burke,* 504 U.S. 229, 119 L.Ed.2d 34, 112 S.Ct. 1867 (1992).

For example, in *Bent v. Commissioner,* 87 T.C. 236 (1986), *aff'd,* 835 F.2d 67 (3d Cir. 1987), the Tax Court held that a recovery under 42 U.S.C. §1983, which provides damages for deprivation of constitutional or federal rights, was excludible under the prior version of Code §104(a)(2). In so holding, the Tax Court relied on the U.S. Supreme Court's decision in *Wilson v. Garcia,* 471 U.S. 261, 85 L.Ed.2d 254, 105 S.Ct. 1938, 1949 (1985), which held that all §1983 claims are claims for personal injuries. In affirming the Tax Court in *Bent,* the Third Circuit adopted the Ninth Circuit's analysis in *Roemer v. Commissioner,* 716 F.2d 693 (9th Cir. 1983), holding that the consequences of an injury (*e.g.,* loss of compensation) did not define the nature of the injury. 835 F.2d at 69.

D. [3.18] Allocation of Damage Award

To qualify for exclusion under Code §104(a)(2), (1) the amounts received must be compensatory (not punitive) damages paid on account of a personal physical injury or physical sickness and (2) the injury must have resulted from a tort or a tort-type cause. In many situations, a plaintiff will have several claims based on several different legal theories that may include a tort theory. Amounts received by the plaintiff, however, will be excludible under Code §104(a)(2) only to the extent they are paid under the tort theory and represent compensatory damages. If a recovery is based on some other theory or claim (*e.g.,* breach of contract) or represents punitive damages, it will not be excludible from income. Therefore, in drafting the complaint, conducting settlement negotiations, and drafting the settlement agreement, the plaintiff's attorney must consider the advantage to the client of having as much as possible of the damage or settlement award allocated to compensatory damages for the plaintiff's tort claim.

In the case of a judgment rendered by a jury or court, the parties may not have as much control over the allocation of damages to varying claims as in a settlement situation. In Rev.Rul. 85-98, 1985-2 Cum.Bull. 51, the IRS discussed the allocation of a judgment among various claim theories. Under this ruling, the IRS considered the taxpayer's complaint to be the "best evidence available" in determining which portion of the award related to the taxpayer's personal injury claim. In his complaint, the taxpayer had asked for "15x dollars" compensatory damages and "45x dollars" in punitive damages. Based on these proportions, the IRS considered 25 percent of the award to be paid as compensatory damages (and therefore nontaxable) and 75 percent to be paid as punitive damages (and therefore taxable).

The IRS has had some limited success in its position that failure to allocate the proceeds of a settlement, in the settlement agreement itself, results in inclusion of all the proceeds in income. *See Taggi v. United States,* 835 F.Supp. 744, 746 (S.D.N.Y. 1993), *aff'd,* 35 F.3d 93, 96 (2d Cir. 1994). More frequently, courts have held that an array of factors should be considered in making allocation determinations. *See Lane v. United States,* 902 F.Supp. 1439 (W.D.Okla. 1995), and cases cited therein. Those factors include the plaintiff's complaint, evidence presented at trial, and the jury verdict. *Id.* The Seventh Circuit has held that when the settlement agreement itself does not include express language stating the basis or allocation of the settlement, the most important factor is the intent of the payor. *Pipitone v. United States,* 180 F.3d 859, 864 (7th Cir. 1999).

Absent an express allocation within the settlement agreement or judicial order, creative arguments have to be raised after the fact to sustain the excludability of damages under Code §104(a)(2). Taxpayers have had some success in this regard. For example, in *Madson v. Commissioner,* 55 T.C.M. (CCH) 1351 (1988), the Tax Court found that the entire $41,000 award paid to a former police chief of the City of Green Bay was excludible under the former version of Code §104(a)(2) because the City's insurance carrier had paid the entire amount of the award and the insurance contract did not obligate the carrier to pay for a breach of contract. Thus, the Tax Court reasoned that the award must have been paid on account of the alleged violation of the taxpayer's equal protection rights, which amounted to a tort-type claim.

Historically, taxpayers have failed to convince the courts that awards were for personal injuries when the settlement agreement specifically indicated that such amounts were being paid for other reasons. For example, in *Agar v. Commissioner,* 290 F.2d 283 (2d Cir. 1961), *aff'g* 19 T.C.M. (CCH) 116 (1960), the Second Circuit held that when the settlement agreement indicated that the payments made to the taxpayer were severance pay rather than a settlement for defamation claims, the court would not allocate any portion of the damages received to the defamation claim. More recently, however, the Tax Court stated that express allocations are not necessarily determinative if other facts indicate that the payment was intended by the parties to be for a different purpose. *Bagley v. Commissioner,* 105 T.C. 396 (1995).

The Tax Court has ruled that it is not bound by the allocation of damages in a state court's final judgment reflecting a settlement between the parties but is entitled to determine independently the portion of the settlement proceeds that was attributable to the plaintiff's tort-like personal injuries. *Robinson v. Commissioner,* 102 T.C. 116 (1994), *aff'd in part, rev'd in part,* 70 F.3d 34, 37 (5th Cir. 1995). While the Tax Court is not bound by the state court's determination, it must give the state court's allocation "proper regard" when entered into in a bona fide adversary proceeding. 70 F.3d at 37. Nevertheless, the parties in a litigation involving both excludible and non-excludible claims clearly strengthen their chances of achieving the desired tax results by allocating the settlement and/or judgment among the various claims. *See also Goeden v. Commissioner,* 75 T.C.M. (CCH) 1581 (1998) (Tax Court looked to documentary and testimonial evidence to determine allocation of settlement proceeds to personal injury claims); *Kightlinger v. Commissioner,* 76 T.C.M. (CCH) 611 (1998) (intent of payor controls allocation of settlement proceeds if agreement is ambiguous as to allocation or unsupported by underlying causes of action). The First Circuit has held that in some cases the IRS may allocate a portion of the damage award or settlement proceeds to prejudgment interest when the document does not provide for such an allocation. *Rozpad v. Commissioner,* 154 F.3d 1 (1st Cir. 1998).

In Rev.Proc. 2001-3, 2001-1 Int.Rev.Bull. 111, the IRS stated that advance rulings or determination letters will not ordinarily be issued with regard to "[w]hether an allocation of the amount of a settlement award (including a lump sum award) between back pay, compensatory damages, punitive damages, etc. is a proper allocation for federal tax purposes." Unique and compelling reasons must be demonstrated to receive the issuance of an advance ruling on this issue.

E. [3.19] Wrongful Death Actions

Prior to the Small Business Job Protection Act of 1996, it was held that recoveries under wrongful death statutes, whether by the estate of the decedent or by the decedent's dependents, were nontaxable under Code §104(a)(2). See Rev.Rul. 54-19, 1954-1 Cum.Bull. 179; *Paton v. Commissioner*, 64 T.C.M. (CCH) 1150 (1992). The IRS ruled, however, that when the state's wrongful death statute provides exclusively for the recovery of punitive damages, no part of the recovery is excludible. Rev.Rul. 84-108, 1984-2 Cum.Bull. 32.

However, the IRS position expressed in Rev.Rul. 84-108 has been effectively overruled by the SBJPA amendments to Code §104. The SBJPA added a new Code §104(c), which specifically provides that punitive damages awarded in a wrongful death action and under an applicable state law (as in effect on September 13, 1995, and without regard to any modification after that date) that provides or has been interpreted to provide that only punitive damages may be awarded in a wrongful death action are excludible from income in the same manner as compensatory damages. The exception in the new Code §104(c) does not apply to any wrongful death actions filed after the first date on which the applicable state law ceases to provide or is no longer construed to provide that only punitive damages may be awarded. Pub.L. No. 104-188, §1605(c), 110 Stat. 1838 – 1839.

F. [3.20] Workers' Compensation Awards

Code §104(a)(1) provides that any amounts received "under work[ers'] compensation acts as compensation for personal injuries or sickness" may be excluded from the recipient's income. To qualify under this provision, the payments must be received under a statute that provides remedies for service-connected injuries or illnesses, although the statute does not have to be labeled a workers' compensation statute. Treas.Reg. §1.104-1(b). The definition of "workers' compensation act" has been broadly construed. There are literally hundreds of state and local laws that qualify as workers' compensation statutes. Examples of federal laws that qualify are the Longshoremen's and Harbor Workers' Compensation Act, the Federal Employees' Compensation Act, and the Public Safety Officers' Benefits Act of 1976. In addition, an ordinance or resolution adopted by a municipality or other political subdivision can qualify as a workers' compensation act if the adoption of the ordinance or resolution is authorized by state statute. Rev.Rul. 72-291, 1972-1 Cum.Bull. 36. In 1995, the IRS took the position that a city's "On-The-Job Injury (OJI) Program" qualifies as a workers' compensation statute for purposes of Code §104(a)(1) as the program was established pursuant to express statutory authority. Pvt.Ltr.Rul. 9546001 (July 27, 1995).

A workers' compensation statute must not provide for disability payments for any reason other than on-the-job injuries. *Take v. Commissioner*, 82 T.C. 630 (1984), *aff'd,* 804 F.2d 553 (9th Cir. 1986). It has been held, however, that if a statute provides different benefits for occupational and nonoccupational injuries, that portion of the statute that provides benefits for occupational injuries qualifies as a workers' compensation statute. Rev.Rul. 72-44, 1972-1 Cum.Bull. 31. Excludible benefits must be gauged by the nature or extent of the injury and cannot exceed the amount provided by the applicable workers' compensation statute. *Beisler v. Commissioner,* 787 F.2d 1325 (1986), *aff'd on reh'g en banc,* 814 F.2d 1304 (9th Cir. 1987). The exclusion does not apply to a pension or annuity to the extent it is determined by reference to the employee's age or length of service or the employee's prior contributions even if his or her retirement was caused by an occupational injury or illness. Treas.Reg. §1.104-1(b). Finally, it has been held that to qualify as a workers' compensation statute, the statute must provide the sole remedy for the injury in question if the employer is covered by the statute. *Gallagher v. Commissioner,* 75 T.C. 313 (1980).

The Code §104(a)(1) exclusion will apply to compensation received under a workers' compensation statute by the survivor of a deceased employee. Rev.Rul. 72-400, 1972-2 Cum.Bull. 75.

The IRS has held that disability benefits received under a union contract are not excludible from income because the contract does not qualify as a workers' compensation statute. Rev.Rul. 83-77, 1983-1 Cum.Bull. 37. This position was upheld by the Seventh Circuit in *Wallace v. United States,* 139 F.3d 1165 (7th Cir. 1998), in which the court held that an injury protection payment made to an injured professional football player under a union contract was not paid under a state workers' compensation statute within the meaning of Code §104(a) even though the payment was allowed as a credit against a subsequent workers' compensation award. In the case of public employees covered by a union contract that provides disability benefits for occupational injury, practitioners should be alert to the possibility of the statute or ordinance that approved the union contract being considered a workers' compensation statute. In Rev.Rul. 81-47, 1981-1 Cum.Bull. 55, the IRS held that payments made by a county to a police officer for an on-the-job injury under a union contract, the provisions of which were incorporated by reference into the county code, were excludible from the police officer's income as being paid under a workers' compensation statute; however, most cases and rulings that have considered this issue have concluded that payments made to a public employee pursuant to a union contract by reason of an on-the-job injury are not excludible from the recipient's income as a workers' compensation award. See, for example, Rev.Rul. 83-77, 1983-1 Cum.Bull. 37, which held that a union contract that provided for the payment of benefits to disabled New York City police officers did not qualify as a workers' compensation statute even though the city's administrative code provided for similar benefits.

As noted above, to qualify for exclusion from income, the payments must be received on account of an on-the-job injury or illness. In some cases, it is not always clear whether benefits are being paid by reason of an on-the-job injury or illness or for some other reason (*e.g.,* simple retirement because of old age). In these cases, taxpayers will often try to work with their employers to characterize the retirement benefits as being paid on account of on-the-job injury or illness. It should be noted that, in a close case, the taxpayer will have the burden of proving that the payments in question relate to an on-the-job injury or illness.

G. [3.21] Punitive Damages

The issue of the taxability or nontaxability of punitive damages received in a personal injury context has a long history. In *Commissioner v. Glenshaw Glass Co.,* 348 U.S. 426, 99 L.Ed. 483, 75 S.Ct. 473 (1955), the Supreme Court, relying on the fundamental principle that income includes all accretions to wealth not specifically and statutorily exempted, held that punitive and exemplary damages received in connection with fraud and antitrust claims were includible in the recipient's taxable income. A considerable body of caselaw sprang up around *Glenshaw Glass,* with the IRS consistently taking the position that exemplary and punitive damages were taxable as ordinary income to the recipient even if received with respect to a personal injury claim. Rev.Rul. 84-108, 1984-2 Cum.Bull. 32.

In 1989, Congress reconsidered the issue of the taxability of punitive damages received on a personal injury claim. The Omnibus Budget Reconciliation Act of 1989 (OBRA), Pub.L. No. 101-239, §7641(a), 103 Stat. 2379, amended Code §104 by providing that §104(a)(2) "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." The IRS had apparently lobbied and failed to get a legislative change that, at that time, would have confirmed its position that all punitive damages are taxable. Instead, the OBRA amendment, by directly referencing the includibility of punitive damages for nonphysical injuries, allowed the inference that punitive damages for physical injuries were excludible from income.

Additionally, H.R.Rep. No. 247, 101st Cong., 1st Sess. (Sept. 20, 1989), explained:

> **If an action has its origin in a physical injury or physical sickness, then all damages that flow therefrom are treated as payments involving physical injury or physical sickness. No allocation of damages is required among multiple claims if more than one type of claim is alleged in a personal injury action.**

Apparently, as long as the underlying claim was based on a physical injury or physical sickness, punitive damages awarded with respect to that claim would, under the OBRA amendments, be entirely excludible even though the damage award could also include compensation for nonphysical injuries.

After 1989, the IRS continued to dispute the excludability of punitive damages under Code §104(a)(2) and met with mixed results. In *Miller v. Commissioner,* 93 T.C. 330 (1989), *rev'd,* 914 F.2d 586 (4th Cir. 1990), the Tax Court held that the treatment of punitive damages under Code §104(a)(2) should be no different than the treatment of compensatory damages arising from the same incident. According to the Tax Court, if the compensatory damages were excluded, then an accompanying punitive award should be excluded as well. On appeal, the IRS was able to convince the Fourth Circuit that the punitive damages should be included in gross income. Essentially, the IRS' argument was that although the taxpayer suffered a personal injury, the punitive damages were received because of the tortfeasor's misconduct, not because of the injury. Because the punitive damages were not received "on account of personal injuries" but because of the tortfeasor's misconduct, Code §104(a)(2) was not applicable. *See also Kemp v. Commissioner,* 771 F.Supp. 357 (N.D.Ga. 1991).

In *Horton v. Commissioner,* 100 T.C. 93 (1993), *aff'd,* 33 F.3d 625 (6th Cir. 1994), the Tax Court reaffirmed its view as to the excludability of punitive damages received on account of a personal injury. The Tax Court, applying the Supreme Court's reasoning in *United States v. Burke,* 504 U.S. 229, 119 L.Ed.2d 34, 112 S.Ct. 1867 (1992), held that if the underlying claim is for a personal injury, then any damages received, including punitive damages, must be excludible.

The Ninth Circuit in *Hawkins v. United States,* 30 F.3d 1077 (9th Cir. 1994), concurred with Rev.Rul. 84-108 and *Miller, supra,* holding that punitive damages were not excludible from taxable income under Code §104(a)(2). The Fifth Circuit subsequently held that punitive damages were not excludible under Code §104(a)(2). *Wesson v. United States,* 48 F.3d 894 (5th Cir. 1995); *Estate of Moore v. Commissioner,* 53 F.3d 712 (5th Cir. 1995). In both of these cases, the Fifth Circuit reasoned that punitive damages are not received "on account of personal injury" but instead are designed to punish the wrongdoer. The Tenth Circuit then joined the Fourth, Fifth, and Ninth Circuits in holding that Code §104(a)(2) did not exclude punitive damages from income. *O'Gilvie v. United States,* 66 F.3d 1550 (10th Cir. 1995).

On December 10, 1996, the United States Supreme Court resolved the conflict of the circuits by affirming the Tenth Circuit's decision in *O'Gilvie. O'Gilvie v. United States,* 519 U.S. 79, 136 L.Ed.2d 454, 117 S.Ct. 452 (1996). The Court, holding punitive damages received in a personal injury context to be taxable, reasoned that punitive damages are designed not to compensate the victim but to punish the wrongdoer and thus cannot be considered as received "on account of" personal injuries.

The Small Business Job Protection Act of 1996 amended Code §104 to put an end to the confusion. Pub.L. No. 104-188, §1605(a), 110 Stat. 1838. Effective for amounts received after August 20, 1996 (except for amounts received under a "written binding agreement, court decree, or mediation award" in effect (or issued) on or before September 13, 1995), Code §104(a)(2) now provides that the income exclusion applies to

> **the amount of any damages (*other than punitive damages*) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. [**Emphasis added.**]**

H.R.Rep. No. 586, 104th Cong., 2d Sess. (May 20, 1996), gave the following reasons for this change:

> **Punitive damages are intended to punish the wrongdoer and do not compensate the claimant for lost wages or pain and suffering. Thus, they are a windfall to the taxpayer and appropriately should be included in taxable income. Further, including all punitive damages in taxable income provides a bright-line standard which avoids prospective litigation on the tax treatment of punitive damages received in connection with a case involving a physical injury or physical sickness.**

As stated in §3.19 above, an exception to the inclusion of punitive damages can be found at Code §104(c) when punitive damages are recovered pursuant to a state wrongful death law that permits only punitive damage awards.

PRACTICE POINTER

✓ A prudent strategy in pleading and settling a personal injury case that involve a punitive damage component is to allocate as much as possible to a claim for compensatory damages to reduce the risk of the IRS challenging the exclusion of punitive damages from income.

H. Interest on Damages

1. [3.22] Prejudgment Interest

As a general rule, prejudgment interest on a damage award (including a damage award for personal injuries) is includible in the recipient's taxable income. In *Aames v. Commissioner,* 94 T.C. 189 (1990), the Tax Court held that interest awarded as part of legal malpractice damages was not excludible from the recipient's income under Code §104(a)(2), reasoning that the interest was not paid on account of personal injury but because of the delay in payment. The Sixth Circuit reached the same conclusion in *Kovacs v. Commissioner,* 25 F.3d 1048 (6th Cir. 1994), holding that prejudgment interest on a wrongful death award was taxable to the recipient. *See also Pagliarulo v. Commissioner,* 68 T.C.M. (CCH) 917 (1994) (prejudgment interest on workers' compensation award taxable).

In *Brabson v. United States,* 859 F.Supp. 1360 (D.Colo. 1994), the U.S. District Court in Colorado disagreed with the conclusions reached in *Aames* and *Kovacs,* holding that prejudgment interest awarded in a personal injury case under a Colorado statute was tax free. According to the Colorado District Court, the prejudgment interest was an integral part of the plaintiff's claim for damages and thus should be excluded from the plaintiff's income on the same basis as the damage award. In *Brabson v. United States,* 73 F.3d 1040 (10th Cir. 1996), the Tenth Circuit reversed this decision on appeal, reasoning that prejudgment interest is not a traditional tort remedy, is not directly related to the injury (thus allowing exclusion under a *Schleier* analysis (*Commissioner v. Schleier,* 515 U.S. 323, 132 L.Ed.2d 294, 115 S.Ct. 2159 (1995)), and requires too broad an interpretation of Code §104(a)(2).

PRACTICE POINTER

✓ In a personal injury case in which prejudgment interest is an element, the practitioner should consider the tax effect of allocations to prejudgment interest if the suit is settled before final judgment is entered.

The Tax Court held in *McShane v. Commissioner,* 53 T.C.M. (CCH) 409 (1987), that the entire amount received by the taxpayer upon settlement of a personal injury lawsuit was excludible from income despite the fact that the taxpayer was entitled to prejudgment interest on the amount of the judgment. In *McShane,* a settlement agreement entered into before final judgment was entered on appeal specifically provided that the payment was made "without costs and interest." 53 T.C.M. at 410. The court relied on this settlement language and the testimony of the parties to find that the entire amount paid in settlement was to compensate the plaintiff for personal injuries and did not include interest.

When an amount has been received in settlement of a claim that has already been reduced to judgment and the settlement agreement does not contain any reference to prejudgment interest, the courts will consider the allocation made in the underlying judgment between personal injury damages and prejudgment interest to determine how much of the settlement payment is taxable as prejudgment interest. For example, in *Rozpad v. Commissioner,* 154 F.3d 1 (1st Cir. 1998), the taxpayer settled, on appeal, a judgment rendered in a personal injury suit that included prejudgment interest; the settlement agreement, however, made no allocation between the damages and prejudgment interest and in fact made no reference at all to prejudgment interest. The court applied the percentage of the underlying judgment constituting prejudgment interest to the settlement amount to determine how much of the settlement amount was taxable as prejudgment interest. *See also Francisco v. United States,* 267 F.3d 303 (3d Cir. 2001), *aff'g* 54 F.Supp. 427 (E.D.Pa. 1999), stating that the most persuasive evidence of the payor's intent is the previous damages award of the trial court.

Courts will find it irrelevant that the stipulation of dismissal states that the action is dismissed with "no interest." *See Rozpad v. Commissioner,* 74 T.C.M. (CCH) 1264 (1997), *aff'd,* 154 F.3d 1 (1st Cir. 1998), finding that "stipulations are not part of the settlement and do not relate to the allocation of settlement proceeds."

2. [3.23] Interest from Investment of Damage Award

Interest and other income earned from the investment of a damage award are taxable to the recipient. Rev.Rul. 76-133, 1976-1 Cum.Bull. 34; *Trez v. Commissioner,* 35 T.C.M. (CCH) 640 (1976). However, see the discussion of structured settlements in §3.24 below as a method by which to avoid the taxation of the interest component of periodic payments made in settlement of personal injury claims.

3. [3.24] Structured Settlements

Code §104(a)(2) provides that damages received on account of personal physical injuries or physical sickness are excludible from the recipient's income whether they are received "by suit or agreement and whether as lump sums or as periodic payments." In Rev.Rul. 79-220, 1979-2 Cum.Bull. 74, and Rev.Rul. 79-313, 1979-2 Cum.Bull. 75, the IRS held that periodic payments made by an insurance company to settle a personal injury claim were wholly excludible from the recipient's taxable income even though the payments contained an interest element.

In many cases, however, the plaintiff may not be comfortable with the defendant's ability to make the deferred payments called for under a settlement agreement. Similarly, a defendant may wish to permanently rid itself of any further liability with respect to such payments. In this situation, a structured settlement under Code §130 comes into play.

In general, Code §130 authorizes a defendant to assign its liability under a settlement agreement to a third party (typically, an insurance company) and pay a lump sum to the third party that will be invested and used to make the periodic payments called for under the settlement agreement. Code §130 also specifies those assets in which the lump sum may be invested in order to fund the structured settlement. If the technical requirements of Code §130 are complied with, the following are the tax results to the defendant, the plaintiff, and the third-party assignee:

a. The periodic payments, including the interest element, are wholly excludible from the plaintiff's taxable income.

b. The defendant is entitled to an immediate tax deduction for the payment made to the third-party assignee.

c. The third-party assignee recognizes no taxable income from the receipt of the lump-sum payment from the defendant.

If the technical requirements of Code §130 are not complied with, one or more of the following tax consequences may apply:

a. The interest component of the periodic payments may be taxable to the plaintiff.

b. A defendant using the accrual method of accounting may be denied an income tax deduction for the lump-sum payment in the year of payment. Instead, the defendant may be entitled to deductions only as and when periodic payments are made to the plaintiff by the third-party assignee. See Treas.Reg. §1.461-6.

c. The third-party assignee may recognize taxable income in the amount of the lump-sum payment.

Code §130(c) sets forth the following requirements for a "qualified assignment":

> **Qualified assignment. For purposes of this section, the term "qualified assignment" means any assignment of a liability to make periodic payments as damages (whether by suit or agreement), or as compensation under any workmen's compensation act, on account of personal injury or sickness (in a case involving physical injury or physical sickness) —**
>
> **(1) if the assignee assumes such liability from a person who is a party to the suit or agreement or the workmen's compensation claim, and**
>
> **(2) if —**
>
> **(A) such periodic payments are fixed and determinable as to amount and time of payment,**
>
> **(B) such periodic payments cannot be accelerated, deferred, increased, or decreased by the recipient of such payments,**
>
> **(C) the assignee's obligation on account of the personal injuries or sickness is no greater than the obligation of the person who assigned the liability, and**
>
> **(D) such periodic payments are excludable from the gross income of the recipient under paragraph (1) or (2) of section 104(a).**

Code §130(d) specifies the requirements for investment of the lump-sum payment by the third-party assignee as follows:

> **Qualified funding asset. For purposes of this section, the term "qualified funding asset" means any annuity contract issued by a company licensed to do business as an insurance company under the laws of any State, or any obligation of the United States, if —**
>
> **(1) such annuity contract or obligation is used by the assignee to fund periodic payments under any qualified assignment,**
>
> **(2) the periods of the payments under the annuity contract or obligation are reasonably related to the periodic payments under the qualified assignment, and the amount of any such payment under the contract or obligation does not exceed the periodic payment to which it relates,**
>
> **(3) such annuity contract or obligation is designated by the taxpayer . . . as being taken into account under this section with respect to such qualified assignment, and**
>
> **(4) such annuity contract or obligation is purchased by the taxpayer not more than 60 days before the date of the qualified assignment and not later than 60 days after the date of such assignment.**

A structured settlement under Code §130 may be used only in those cases involving "physical injury or physical sickness." It should be noted, however, that the legislative history of Code §130 indicates that if an action has its origin in a physical injury, then all damages (except punitive damages, as discussed in §3.21 above) paid with respect to the action qualify under Code §130 even though some of the damages may be attributable to a nonphysical personal injury or sickness.

Numerous technical requirements must be met in order for the structured settlement to achieve the desired tax results for the plaintiff, the defendant, and the third-party assignee. Further discussion of these technical requirements is beyond the scope of this chapter. Suffice it to say that the plaintiff's and the defendant's counsel are advised to confer with a competent tax attorney whenever a structured settlement under Code §130 is contemplated.

The Taxpayer Relief Act of 1997, Pub.L. No. 105-34, §962(b), 111 Stat. 788, amended Code §130(c) to provide for the exclusion from income of periodic payments of workers' compensation awards made through qualified structured settlements. The amendment is effective for workers' compensation claims filed after August 5, 1997.

4. [3.25] Special Needs Trusts

Although Code §104 excludes damages received on account of personal physical injuries from income for federal tax purposes, such damage recoveries are used to determine supplementary security income (SSI) and Medicaid eligibility. Many plaintiffs who are seriously injured at the hands of a third party are left to rely on SSI and Medicaid payments for their basic needs. Settlement proceeds from a personal injury case relating to the disability many times exceed the minimum resources requirements of government aid, thus wholly or partially disqualifying the injured party from receiving SSI or Medicaid benefits.

Beginning in August 1993, pursuant to the Omnibus Budget Reconciliation Act of 1993, Pub.L. No. 103-66, §13611(b), 107 Stat. 622 (1993), special needs trusts (SNTs) may be used to avoid the loss of government aid and still allow the injured party to benefit from the settlement or judgment proceeds. 42 U.S.C. §1396p. SNTs may be set up by "a parent, grandparent, legal guardian of the individual, or a court." 42 U.S.C. §1396p(d)(4)(A). In the case of proceeds from a personal injury suit or settlement, it is generally the legal guardian or court that establishes the SNT.

The trade-off for establishing the trust and continuing to receive SSI and Medicaid payments during the life of the disabled individual is that "the State will receive all amounts remaining in the trust upon the death of such individual up to an amount equal to the total medical assistance paid on behalf of the individual under a State plan under this title." *Id.*

An SNT is typically funded with an initial cash payment from the defendant followed by structured settlement payments (with all payments received before the disabled person is 65) for which the trust is named as the payee of the structured settlement under Code §130 (see discussion in §3.24 above). With proper planning, significant tax advantages can be achieved by using tax-free structured settlement payments as the funding vehicle for the SNT. See William L. Winslow, *Safeguarding Benefits for the Injured: A Primer on Special Needs Trusts,* 32 Trial 58 (June 1996).

For a more detailed discussion of the mechanics of special needs planning, please refer to SPECIAL NEEDS TRUSTS (IICLE, 2008).

III. TAXATION OF AWARDS IN EMPLOYMENT LITIGATION

A. [3.26] General Treatment of Employment Litigation Awards

In general, awards of a contractual nature such as backpay or severance pay are included in the recipient's income. *Knuckles v. Commissioner,* 349 F.2d 610 (10th Cir. 1965). Prior to the Small Business Job Protection Act of 1996, awards for wrongful discharge and employment discrimination were often considered by the courts to be compensation for personal injury and thus excludible from income. The SBJPA changed all of this by requiring that there be a physical injury or physical sickness (other than sickness related to emotional distress) to qualify for income exclusion under Code §104(a)(2). H.R.Rep. No. 737, 104th Cong., 2d Sess. (Aug. 1, 1996), explains:

> **The House bill also specifically provides that emotional distress is not considered a physical injury or physical sickness. Thus, the exclusion from gross income does not apply to any damages received (other than for medical expenses as**

> **discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. . . . [T]he exclusion from gross income specifically applies to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress.**

A footnote to the report states that the Committee intends that the term “emotional distress,” as used in the report, includes symptoms (*e.g.,* insomnia, headaches, stomach disorders) that may result from such emotional distress. *Id.*

The new rules apply to amounts received after August 20, 1996, unless received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

B. Tax Treatment of Awards for Sex, Race, and Age Discrimination Prior to Small Business Job Protection Act of 1996

1. [3.27] Sex and Race Discrimination Claims

Prior to the Small Business Job Protection Act of 1996, the tax treatment of an award for sex or race discrimination many times depended on the statute on which the claim was based and the remedies provided by that statute. Awards under the pre-1991 version of Title VII of the Civil Rights Act of 1964, 42 U.S.C. §2000e, *et seq.,* were taxable to the recipient. *United States v. Burke,* 504 U.S. 229, 119 L.Ed.2d 34, 112 S.Ct. 1867 (1992). In *Burke,* the Supreme Court held that damages for employment discrimination were excludible from income if they were based on a claim made under a statute that redresses a tort-like personal injury. Because the pre-1991 version of Title VII provided only the remedies of backpay, injunction, and equitable relief, the Court reasoned that awards under that statute were not damages on account of personal injury and thus did not qualify for exclusion under the previous version of Code §104(a)(2).

Title VII was amended in 1991 to provide that victims of disparate treatment (intentional) discrimination are entitled to compensatory damages for traditional tort-like injuries such as pain and suffering and emotional distress as well as punitive damages. See 42 U.S.C. §1981a. In Rev.Rul. 93-88, 1993-2 Cum.Bull. 61, the IRS ruled that damages, including backpay, for intentional discrimination under Title VII, as amended in 1991, were nontaxable.

In light of the Supreme Court’s decision in *Commissioner v. Schleier,* 515 U.S. 323, 132 L.Ed.2d 294, 115 S.Ct. 2159, 2167 (1995), discussed in §3.28 below, the IRS subsequently issued Rev.Rul. 96-65, 1996-2 Cum.Bull. 6, denying the exclusion from income of backpay awards in disparate treatment employment discrimination cases (no matter when received), effectively making Rev.Rul. 93-88 obsolete. Rev.Rul. 96-65 further held, however, that damages awarded for emotional distress in a disparate treatment employment discrimination case are excludible from income but only if received prior to August 20, 1996, or pursuant to a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

2. [3.28] Age Discrimination Claims

In *Commissioner v. Schleier,* 515 U.S. 323, 132 L.Ed.2d 294, 115 S.Ct. 2159, 2167 (1995), the U.S. Supreme Court resolved a conflict among the circuits as to the taxability, under the prior version of Code §104(a)(2), of backpay and liquidated damages received under the Age Discrimination in Employment Act of 1967 (ADEA), 29 U.S.C. §621, *et seq.* The ADEA provides for the recovery of backpay and, in cases involving willful age discrimination, an equal amount of liquidated damages. Unlike the post-1991 version of Title VII of the Civil Rights Act of 1964, the ADEA does not permit recovery of compensatory damages for pain and suffering or emotional distress.

In *Schleier,* the U.S. Supreme Court held that neither backpay nor liquidated damages received pursuant to an ADEA claim were excludible from the recipient's income. In so holding, the Court found that the ADEA was not sufficiently tort-like because it does not authorize the recovery of compensatory damages for personal injuries such as pain and suffering and emotional distress. As explained by the Supreme Court in *Schleier,* backpay and other lost income met the requirement that they be received "on account of personal injury" only if the recovery of backpay or lost income related to a period of time during which the taxpayer was incapacitated and unable to work as a result of personal injury. With respect to the excludability of liquidated damages under the ADEA, the Court found the liquidated damages to be punitive, not compensatory, in nature and thus not excludible from income.

Before *Schleier,* the Seventh Circuit stood alone among the circuits that had considered the issue in its view that recoveries for age discrimination under the ADEA were taxable as wages. *Downey v. Commissioner,* 33 F.3d 836 (7th Cir. 1994). The Third, Fifth, Sixth, and Ninth Circuits had all held that ADEA recoveries were excludible from income. *Rickel v. Commissioner,* 900 F.2d 655 (3d Cir. 1990); *Schleier v. Commissioner,* 26 F.3d 1119 (5th Cir. 1994), *rev'd,* 115 S.Ct. 2159 (1995); *Pistillo v. Commissioner*, 912 F.2d 145 (6th Cir. 1990); *Schmitz v. Commissioner,* 34 F.3d 790 (9th Cir. 1994).

In *Downey, supra,* the taxpayer filed suit under the ADEA, alleging that he was forced into early retirement by his employer. The employer eventually settled the suit for $120,000. The settlement agreement between the taxpayer and his former employer allocated half of the settlement amount to backpay and the other half to liquidated damages. The Seventh Circuit held that the entire $120,000 settlement was taxable. Like the U.S. Supreme Court in *Schleier,* the Seventh Circuit reasoned that Code §104(a)(2) did not apply because the ADEA is not sufficiently tort-like as none of the remedies provided under the ADEA compensate for pain and suffering, emotional distress, or other tort-like claims.

C. [3.29] Tax Treatment of Awards Under Americans with Disabilities Act Prior to Small Business Job Protection Act of 1996

The IRS ruled in Rev.Rul. 93-88, 1993-2 Cum.Bull. 61, that amounts received with respect to discrimination claims under the Americans with Disabilities Act of 1990 (ADA), 42 U.S.C. §12101, *et seq.,* were excludible from the recipient's income. In light of *Commissioner v. Schleier*, 515 U.S. 323, 132 L.Ed.2d 294, 115 S.Ct. 2159, 2167 (1995), and Rev.Rul. 96-65, 1996-2 Cum.Bull. 6, it is likely that damages received under the ADA will be taxed in the same manner as awards for sex, race, and age discrimination. See discussion in §§3.27 and 3.28 above.

D. Tax Treatment of Wrongful Termination Awards Prior to Small Business Job Protection Act of 1996

1. [3.30] Wrongful Termination Awards in General

Prior to the Small Business Job Protection Act of 1996, the tax treatment of a settlement or award for wrongful discharge depended largely on whether the basis for the claim was sufficiently tort-like so as to be considered in the nature of a personal injury. Thus, a recovery on a wrongful termination claim based solely on breach of contract was taxable as ordinary income. On the other hand, if a wrongful discharge claim could be framed in terms of a tort cause of action (*e.g.,* intentional infliction of emotional distress or race, sex, or age discrimination), the prospects for excluding any resulting recovery from income were improved.

In *Byrne v. Commissioner,* 883 F.2d 211 (3d Cir. 1989), the Third Circuit held that a settlement received for claims under the New Jersey wrongful discharge statute was excludible from the recipient's income under the prior version of Code §104(a)(2). The basis for the court of appeals' decision was its interpretation that the New Jersey statute addressed injuries that were personal in nature, as opposed to pure economic loss.

In *Slavin v. Commissioner,* 59 T.C.M. (CCH) 544 (1990), the taxpayer sued for wrongful termination under the Illinois School Code, under which the only remedies were reinstatement and backpay. The taxpayer did not allege a tort-type claim in his complaint. Under these circumstances, the Tax Court found that the backpay award was includible as wages in the taxpayer's income.

The Supreme Court's decisions in *United States v. Burke,* 504 U.S. 229, 119 L.Ed.2d 34, 112 S.Ct. 1867 (1992), and *Commissioner v. Schleier,* 515 U.S. 323, 132 L.Ed.2d 294, 115 S.Ct. 2159, 2167 (1995), indicate that if a state's wrongful termination statute does not provide for tort-like damages, any recovery under the statute should not be excludible from income even under the prior version of Code §104(a)(2).

2. [3.31] Severance Payments

In this era of corporate downsizing, employees are often offered financial incentives to take early retirement. In return for the payments they receive, these employees are frequently asked to sign broadly drafted releases of the employer from any employment-related claims such as wrongful discharge and discrimination.

The IRS predictably takes the position that such payments to downsized employees are taxable to them as wages. A 1994 decision of the Second Circuit affirms this view. In *Taggi v. United States,* 35 F.3d 93 (2d Cir. 1994), the taxpayer received a lump-sum payment for agreeing to early retirement. As a condition to receiving the payment, the taxpayer was required to sign a separation agreement pursuant to which he released his employer from any and all claims with respect to his employment or the termination of his employment, including "claims arising under federal, state, or local laws prohibiting age, sex, race or any other forms of discrimination." 35 F.3d at 94. The separation agreement made no specific allocation of any amount to the age discrimination claim. The taxpayer sought to exclude a portion of the termination payment from his income on the theory that it was in exchange for his release of an age discrimination claim. The Second Circuit, in finding the termination pay taxable, noted that the taxpayer did not assert an age discrimination claim prior to signing the separation agreement and no allocation of any amount was made to such a claim in the agreement itself.

The Tax Court adopted the Second Circuit's position in *Sodoma v. Commissioner,* 71 T.C.M. (CCH) 3178 (1996) (payments made to employee in return for general release and covenant not to compete taxable income rather than nontaxable payments in settlement of tort or tort-like claims); *Foster v. Commissioner*, 71 T.C.M. (CCH) 3181 (1996) (same); and *Webb v. Commissioner*, 71 T.C.M. (CCH) 2004 (1996) (payments includible severance pay when taxpayer made no claims based on personal injury before signing release). *See also Pipitone v. United States*, 17 F.Supp.2d 793 (N.D.Ill. 1998) (settlement payments includible as ordinary income when taxpayer unable to rebut objective evidence that former employer intended payment to be severance compensation), *aff'd,* 180 F.3d 859 (7th Cir. 1999).

E. [3.32] Withholding Issues in Employment Litigation

A settlement or judgment payment in employment litigation may result in a federal tax withholding requirement for the employer-payor if the payment constitutes taxable wages to the former employee. Inherent in this requirement is that an employment relationship existed at some time such that the payment constitutes "wages" within the meaning of the Code. This requirement is particularly troublesome in the context of "failure to hire" lawsuits in which an employer-employee relationship was never created. In *Newhouse v. McCormick & Co.,* 157 F.3d 582 (8th Cir. 1998), the Eighth Circuit has held that in such a case the payment cannot constitute "wages" under the Code even if the award represents backpay or front pay. In *Newhouse,* the defendant was found to have discriminated against a job applicant on the basis of age in violation of the Age Discrimination in Employment Act of 1967 and was ordered to pay backpay, front pay, and liquidated damages. The plaintiff refused to accept the payment tendered by the defendant, who had withheld income and FICA taxes. The court found the withholding improper because no employment relationship had existed that would create "wages" (and a resulting requirement to withhold taxes) within the meaning of the Code. Note, however, that the payments were includible in the plaintiff's income under *Commissioner v. Schleier,* 515 U.S. 323, 132 L.Ed.2d 294, 115 S.Ct. 2159, 2167 (1995).

The Sixth Circuit found that cash proceeds paid in settlement of a claim under the Employee Retirement Income Security Act of 1974, Pub.L. No. 93-406, 88 Stat. 829, for a prohibited "liability avoidance" scheme to deprive the taxpayers of retirement benefits were not subject to FICA withholding, even though an employment relationship had existed, when the payments did not represent wages within the meaning of the Code. *Gerbec v. United States,* 164 F.3d 1015 (6th Cir. 1999). The court based its decision on the finding that damages are not wages under the Code.

IV. DAMAGES TO TANGIBLE PROPERTY

A. [3.33] Destruction of Property

Generally, amounts received by a plaintiff due to the destruction of all or a portion of property are treated as received from a sale or exchange of the property, with the amount realized being equal to all amounts recovered from litigation and negotiation and any other recoveries such as salvage proceeds or the proceeds of the plaintiff's own insurance. In the case of a total loss or destruction of the property, the plaintiff realizes gain to the extent that the amount recovered exceeds the adjusted basis of the property. The character of the gain depends on the nature of the asset damaged; *i.e.*, the asset may be a "capital asset" as defined in Code §1221 or a "trade or business" asset under Code §1231. The holding period of capital assets will determine whether the gain is short-term or long-term capital gain under Code §1223. Code §1245 or §1250 may require that a portion or all of the gain be treated as ordinary income to the extent of the depreciation deductions claimed in prior periods on the asset.

B. [3.34] Partial Damages

If only a portion of the plaintiff's property is injured or destroyed, gain or loss may still be realized if the basis of the portion of the property destroyed may be determined. If the basis of the destroyed portion cannot be determined, then the damage award would be considered a return of capital, and a reduction in the whole property basis should be made. *Strother v. Commissioner,* 55 F.2d 626, 632 (4th Cir. 1932); *Inaja Land Co. v. Commissioner,* 9 T.C. 727 (1947).

C. [3.35] Tax Deduction for Plaintiff Suffering Loss

If a plaintiff's recovery is less than his or her adjusted basis in property that is totally destroyed, a tax deduction may be taken under Code §§165(c)(3) and 165(h). The deduction may be taken for all losses on property related to a trade or business (Code §1231 property). On casualties involving personal property, the loss may be taken only to the extent that it is an uninsured casualty loss, and the loss is deductible only to the extent that it exceeds $100. (For 2009, this limit is increased to $500 but reverts back to $100 in 2010). Net casualty losses are available only to the extent that they exceed ten percent of the injured party's adjusted gross income and only to taxpayers who itemize their deductions and forgo the standard deduction. A "casualty loss" is defined as a loss "from fire, storm, shipwreck, or other casualty, or from theft." Code §165(c)(3).

D. [3.36] Deferral of Gain by Rollover of Conversion Proceeds

Under Code §1033, a taxpayer may avoid recognition of gain realized from the proceeds recovered after total or partial destruction, theft, condemnation, or threat of condemnation of his or her property. To utilize Code §1033, the proceeds from the conversion must be reinvested in property "similar or related in service or use" to the property so converted. Code §1033(a)(1). A taxpayer who uses Code §1033 to avoid recognizing gain must carry over the basis from the property converted to the reinvestment property.

The reinvestment must take place within two years after the close of the first taxable year in which the conversion occurred. Note that this period runs from the date of conversion, not the date of the receipt of damage proceeds. Code §1033(a)(2)(B). If a lawsuit is pending, an extension of the reinvestment period may be obtained from the local district director of the IRS under Treas.Reg. §1.1033(a)-2(c)(3). Gain is recognized to the extent any portion of realized gain is not reinvested.

E. Condemnation Awards

1. [3.37] Amount of Gain or Loss Realized

The taking of property through condemnation and the receipt of condemnation proceeds are treated as a sale or exchange of the property for tax purposes, and gain or loss results under Code §1001 to the extent of the difference between the amount realized in condemnation proceeds and the adjusted basis of the property. Generally, the character of the gain or loss would be long-term capital gain or loss on all property held for more than 12 months. However, a real estate dealer holding property for sale to customers in the ordinary course of business may realize ordinary income from the sale of inventory. Amounts received as compensation for a delay between the taking of the property and the payment of the award are treated as interest and are not entitled to capital gain treatment. *Kieselbach v. Commissioner,* 317 U.S. 399, 87 L.Ed. 358, 63 S.Ct. 303 (1943); *Estate of Walter v. Commissioner*, 30 T.C.M. (CCH) 1051 (1971). A loss realized by a corporation or an individual (*i.e.,* the amount recovered is less than the plaintiff's adjusted tax basis) with respect to business property would be an ordinary loss. Other losses by individuals may be deductible as casualty losses subject to the requirements of Code §§165(c)(3) and 165(h).

2. [3.38] Rollover of Condemnation Proceeds

Just as casualty proceeds may be reinvested and gain deferred, so may condemnation payments under Code §1033. The term "condemnation" has been defined as the process by which private property is taken for public use without the consent of the property owner upon the award and payment of just compensation. Rev.Rul. 58-11, 1958-1 Cum.Bull. 273.

Section 1033 also encompasses sales that are made under "threat or imminence" of condemnation. Code §1033(a). "Threat or imminence" has been defined as those situations in which a property owner has been informed by authorities, either orally or in writing, of a decision to acquire his or her property for public use and the property owner has reasonable grounds to believe that necessary steps will be taken to force a sale if a voluntary sale is not arranged. *Maixner v. Commissioner,* 33 T.C. 191 (1959). Threat or imminence also exists in a sale to an agent of a public utility when the principal is identified and known to the seller even if it has no actual authority to condemn before or at the time of the sale but could readily obtain such authority. Rev.Rul. 74-8, 1974-1 Cum.Bull. 200; Rev.Rul. 63-221, 1963-2 Cum.Bull. 332.

Code §1033(a)(1) requires generally that condemnation proceeds be converted into "similar" property or property "related in service or use" to the involuntarily converted property. Note, however, that similar property under Code §1033(a)(1) is not as broad as property of a like kind under Code §1031 or Code §1033(g) (discussed below). For instance, in Rev.Rul. 77-192, 1977-1 Cum.Bull. 249, a taxpayer purchased a floating seafood processing plant with insurance proceeds from a land-based seafood processing plant that was destroyed by fire; the IRS held that the floating plant was not similar or related in service or use to the converted property and therefore did not qualify as replacement property. However, new equipment that was identical and used in the same manner on the floating facility as in the destroyed facility qualified as replacement property.

Code §1033 reinvestment of condemnation proceeds must be made by the last day of the second tax year following the first taxable year in which any part of the gain from the condemnation is realized unless an extension of time is secured under Treas.Reg. §1.1033(a)-2(c)(3).

Code §1033(g) provides another option for condemned real property held for productive use in trade or business or for investment. Proceeds of such property can be reinvested not only in property of similar use but also in real property of a "like kind to be held either for productive use in trade or business or for investment." Code §1033(g)(1). Code §1033(g) would permit the reinvestment of condemnation proceeds from improved real estate in unimproved land even though the general rule of §1033 requires reinvestment in similar use property. Code §1033(g)(4) also allows three years, instead of two, to reinvest the condemnation proceeds.

3. [3.39] Special Assessments

A special assessment may be levied in conjunction with a condemnation of real property against neighboring property to the condemned real estate on the theory that adjacent property is benefited by the improvement for which the condemnation is made. Treas.Reg. §1.1033(a)-2(c)(10) advises that the application of condemnation award funds to satisfy a special assessment levied against the remaining portion of the land is to be deducted from the gross condemnation award in determining the taxable gain realized on the condemnation.

4. [3.40] Severance Damages

Severance damages may be awarded for damages resulting to retained lands caused by the condemnation of adjacent property. Severance damages will not constitute taxable gain except to the extent that they exceed the remaining basis allocated to the retained portion of the property. Instead, any such recovery will first serve to reduce the basis in the retained property. Rev.Rul. 68-37, 1968-1 Cum.Bull. 359. The IRS has taken the position that an award will be considered severance damages only when it is designated by the stipulation of both the taxpayer and the condemning authority. Rev.Rul. 59-173, 1959-1 Cum.Bull. 201. The IRS has ruled that the provisions of Code §1033 apply to severance damages from a condemnation that destroyed the retained property's usefulness if the retained property is sold and replacement property is acquired at a cost exceeding the condemnation award, severance damages, and sale proceeds. Rev.Rul. 73-35, 1973-1 Cum.Bull. 367.

Special assessments against the retained property should first be offset against severance damages before any reduction of the condemnation award, and legal and other expenses will be allocated between the condemnation and severance damages proportionately if no other basis seems appropriate. Recognition of gain on severance payments received could be avoided by a rollover/reinvestment under the rules of Code §1033. *Conran v. United States,* 322 F.Supp. 1055 (E.D.Mo. 1971); Rev.Rul. 72-433, 1972-2 Cum.Bull. 470; Rev.Rul. 83-49, 1983-1 Cum.Bull. 191.

Nonrecognition of gain resulting from severance payments is possible even if the award is reinvested in property that is not similar or related in use to the condemned property under Code §1033(a)(1). The replacement property must qualify as like-kind property within the meaning of Code §1033(g).

V. [3.41] DAMAGES TO GOODWILL AND LOST BUSINESS PROFITS

The tax treatment of damages received as compensation for business injuries corresponds with the general rule for the taxation of damages in that awards of business damages are taxed according to their nature and source, regardless of the fact that litigation was ultimately required to obtain payment.

Payments for lost profits are taxable as ordinary income to the plaintiff. *Biocraft Laboratories, Inc. v. Commissioner,* 40 T.C.M. (CCH) 734 (1980). In Rev.Rul. 91-19, 1991-1 Cum.Bull. 186, the IRS held that damages recovered by commercial fishermen who were prevented from fishing in waters contaminated by a defendant represented lost profits.

Damages received for injuries to goodwill and business reputation are treated as a return of capital. *Raytheon Production Corp. v. Commissioner,* 144 F.2d 110 (1st Cir. 1944). If a plaintiff has a basis in goodwill (*i.e.,* through the purchase of goodwill incident to the acquisition of business assets), damages recovered for injury to goodwill may be tax free until they exceed the taxpayer's adjusted basis. Amounts recovered in excess of a plaintiff's basis in goodwill will be taxed as long-term capital gain. Trademarks and the goodwill associated with them are capital assets, and amounts received in settlement of trademark disputes and for injury to business goodwill are taxable as capital gains. *Inco Electroenergy Corp. v. Commissioner,* 54 T.C.M. (CCH) 359 (1987).

Obviously, the difference in treatment between recoveries for lost profits and those due to injuries to goodwill provides a strong incentive to plaintiffs to frame their cases in terms of damages to goodwill rather than lost profits. However, should there be a controversy over characterization of a recovery as lost profits or damaged goodwill, the IRS may challenge a taxpayer's characterization of a settlement on the basis that there was no loss of goodwill or going-concern value or may challenge the amount of damages allocated to the lost goodwill. The burden of proof in such cases is placed on the taxpayer. *Sager Glove Corp. v. Commissioner,* 311 F.2d 210 (7th Cir. 1962).

When evaluating the tax consequences of recoveries for infringed patents, distributorships, franchises, licenses, and even inventory, the underlying issue remains the same as in the case of goodwill — that is, whether the damage has been sustained to the plaintiff's property or whether the recovery replaces lost profits. *Inco Electroenergy, supra.*

In many instances, the defendant is another business that will have a deductible loss for payment of either type of compensatory damage and is not likely to object strongly to the plaintiff's characterization of the recovery. It is advisable for plaintiff's counsel to begin early to document damage to the client's goodwill and other property because of the potential for future tax litigation after the case against the original defendant has been settled.

A recovery measured by lost profits when the underlying claim is for personal injuries may be nontaxable. See discussion in §§3.11 – 3.25 above.

VI. [3.42] ANTITRUST RECOVERIES

In antitrust actions brought under §4 of the Clayton Act, 15 U.S.C. §15, a plaintiff may recover treble damages against a defendant. An injured party recovers one third of its award as compensatory damages and the remaining two thirds as punitive damages. The entire award is taxable income to the recipient. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 99 L.Ed. 483, 75 S.Ct. 473 (1955).

While the punitive damage portion of any award is taxable as ordinary income, the characterization of the compensatory damage portion of the award and the consequent tax treatment thereof will be determined by the source of the claim. If the underlying claim is based on damage to the plaintiff taxpayer's profits, the recovery of compensatory damages would be taxable as ordinary income. On the other hand, if the claim and resulting damages are based on damage to the value or goodwill of the business (*i.e.*, a reduction in value of an enterprise due to anticompetitive practices), the recovery may be tax free to the extent of the plaintiff's basis in the asset to which the recovery relates, with any excess possibly taxable as capital gain or subject to recapture under Code §1245 or §1250 if depreciable property. If loss or destruction of a noncapital asset is the source of a claim, it may be nontaxable to the extent of recovery of a plaintiff's basis in such an asset, with the excess then treated as ordinary income. Damages recovered for overcharges resulting from illegal price-fixing, pricing in restraint of trade, etc., may be treated as a reduction in the purchase price of property to which the illegal charges relate or, if the items were previously expensed, may require inclusion in income in the year of recovery.

The burden of proof as to the source of a claim and the allocation of damages is on the taxpayer. Thus, it is important to review carefully the basis for claims and the allegations contained in pleadings and awards. In settling antitrust claims, the parties may have significant flexibility to allocate damage awards with potentially taxable or nontaxable treatment, subject to a reasonable basis for such allocation.

The application of the *Glenshaw Glass* rule is not without potential inequity. Often an antitrust action is settled many years after the actual damages are sustained, but the losses that stem from those actual damages may give rise to net operating losses that are unusable because of a lack of income to utilize net operating loss carryforwards. Code §186 provides partial relief for taxpayers in this situation by allowing a tax deduction equal to the lesser of the compensatory amount (which would be one third of the antitrust recovery) or the unrecovered losses sustained as a result of the compensable injury, *i.e.*, the extent to which the losses did not yield a tax benefit. Note that Code §186 does not extend to punitive or exemplary damages, only to the compensatory amount received. The non-compensatory treble damage portion of an antitrust award received pursuant to §4 of the Clayton Act is ordinary income. *Glenshaw Glass, supra; Greene v. Commissioner,* 47 T.C.M. (CCH) 190 (1983).

Payments by a defendant made in settlement of or as a result of a judgment in a civil case are fully deductible if not related to a criminal proceeding. Treas.Reg. §1.162-22(f), Example 3. However, punitive damage payments made by a defendant in settlement or judgment will be nondeductible under Code §162(g) if they are related to an antitrust criminal action. A frequent issue is whether such payments are related to a criminal proceeding. See Treas.Reg. §1.162-22(c). This nondeductibility rule applies only if there is a conviction or plea of guilty or no contest in a related criminal proceeding. See Treas.Reg. §1.162-22(a). Treas.Reg. §1.162-22(a) clarifies Code §162(g) by providing that attorneys' fees, court costs, and other amounts paid or incurred in connection with the controversy that meet the general requirements for deductibility under Code §162(a) are deductible. Note that settlement of a filed suit is within the scope of Code §162(g), but settlements of unfiled actions will be completely deductible. *See Fischer Cos. v. Commissioner,* 84 T.C. 1319 (1985); *Flintkote Co. v. United States,* 7 F.3d 870 (9th Cir. 1993).

Code §§162(g) and 186 increase the necessity for counsel on both sides to fully consider the tax consequences before suit is instituted. Generally, it will be advantageous for the defendant to attempt to reach a settlement before the plaintiff files an antitrust action to avoid application of Code §162(g). On the other hand, an action must be filed before receipt or accrual of the compensatory amount in order for the plaintiff to take advantage of the relief provisions of Code §186.

VII. [3.43] TAX CONSEQUENCES TO PAYOR OF DAMAGES — CAPITAL EXPENDITURE OR DEDUCTIBLE EXPENDITURE

The determination of the tax effect of a judgment or settlement is dependent on the nature of the underlying claim. The fact that a case is settled or proceeds to judgment has no effect on the propriety of a taxpayer's treatment of payments of damages or payments made in settlement. *Old Town Corp. v. Commissioner,* 37 T.C. 845 (1962), *acq.,* 1962-2 Cum.Bull. 5.

In general, taxpayers conducting a trade or business may deduct payments made pursuant to a settlement or judgment even though the conduct that gave rise to the claim may be in violation of state or federal law. However, fines and penalties are nondeductible by statute, as are two thirds of treble damage payments made under antitrust laws. Code §§162(f), 162(g); Treas.Reg. §§1.162-21, 1.162-22.

However, there are exceptions to the general rule of deductibility derived from the origin-of-the-claim test. For instance, settlements that involve the surrender of property rights asserted by a claimant in exchange for money may be treated as capital expenditures by the defendant rather than deductible expenses. *Shannonhouse v. Commissioner,* 21 T.C. 422 (1953); *Turzillo v. Commissioner,* 346 F.2d 884 (6th Cir. 1965), *rev'g and remanding* 22 T.C.M. (CCH) 1664 (1963). *Turzillo* illustrates the rule that under Code §1222 a sale or exchange is required in order for a payment to be treated as expenditure by the taxpayer and as capital gain to the recipient.

The mere settlement of a lawsuit does not constitute a sale or exchange. Rev.Rul. 74-251, 1974-1 Cum.Bull. 234. The IRS has a tendency to classify as capital expenditure payments made that involve a sale of property or the release of rights to property in exchange for money. The converse is that expenditures made to preserve property are deductible expenses. *Braznell v. Commissioner*, 16 T.C. 503 (1951), *acq.*, 1951-2 Cum.Bull. 1. Expenditures made in settlement of suits to quiet title are capital in nature and are not currently deductible. *Harold Levinson Associates, Inc. v. Commissioner*, 74 T.C.M. (CCH) 1311 (1997).

The manner in which a dispute is settled and documented may result in a characterization of the transaction that is unfavorable to the taxpayer. In *Clark Oil & Refining Corp. v. United States*, 473 F.2d 1217 (7th Cir. 1973), a suit brought by the owner of land adjacent to the taxpayer's refinery for damages done to the property by the refinery was settled by Clark Oil by the purchase of the adjacent property. The court held that the entire purchase price, including the attorneys' fees, was a nondeductible capital expenditure. This decision was made in part because the documentation of the settlement did not clearly allocate part of the payment to be in lieu of damages the taxpayer may have caused the seller and in part because negotiations for the sale and purchase of the property had commenced before the suit, and the nature of the suit was primarily to compel the defendant to purchase the plaintiff's property at an equitable price.

In *G C Services Corp. v. Commissioner*, 73 T.C. 406 (1979), the taxpayer's documentation was inadequate to support an allocation to damages for his release of several claims against the corporation. The transaction between the plaintiff and the corporation also included a purchase of the plaintiff's stock in the corporation, and the taxpayer failed to meet his burden of proof to show that an allocation to damages was justified.

In a related issue, payments made to shareholders exercising their dissenters' rights on a proposed merger transaction were held to be additional compensation for the shares and as such were nondeductible capital expenditures. *Vermont Bank & Trust Co. v. United States*, 296 F.Supp. 682 (D.Vt. 1969).

Fines and penalties paid to a government authority for the violation of any law may not be deducted. Code §162(f). Fines and penalties include civil and criminal penalties, payments in settlement of actual or potential criminal liabilities, and payments made pursuant to guilty pleas or pleas of no contest. Treas.Reg. §1.162-21(b)(1).

Court-ordered payments that are remedial in nature are deductible and outside the ambit of Code §162(f). There is, however, a disagreement concerning the deductibility of restitution payments. Some courts have found that restitution payments ordered as part of a criminal conviction were in the nature of a fine and the taxpayer was therefore denied a deduction for payments made. *Waldman v. Commissioner*, 88 T.C. 1384 (1987), *aff'd*, 850 F.2d 611 (9th Cir. 1988). However, in *Stephens v. Commissioner*, 905 F.2d 667 (2d Cir. 1990), the Second Circuit held that a taxpayer's restitution of embezzled funds made in order to receive a shorter prison sentence was deductible. To justify its decision, the Second Circuit held that restitution payments were primarily remedial measures to compensate another party.

Payments will be nondeductible under Code §162(g) if they are related to an antitrust criminal action. A frequent issue is whether such payments are related to a criminal proceeding. See Treas.Reg. §1.162-22(c).

It is also possible to deduct amounts paid in settlement of an action under Code §212 as expenses for the production of income. The threshold question is whether the payments are made proximate to an income-producing activity. For instance, in *Guttmann v. United States,* 181 F.Supp. 290 (W.D.Pa. 1960), payments made by a taxpayer to avoid the imposition of a resulting trust on the taxpayer's corporate stock were held to be deductible as ordinary and necessary expenses proximate to the collection or production of income under Code §212. However, the mere fact that income-producing assets may be subject to forced sale or otherwise liquidated to pay a judgment against a taxpayer does not render payments on the judgment deductible under Code §212. Treas.Reg. §1.212-1(m).

As under Code §162, payments made to satisfy a judgment or a settlement agreement may be capital in nature and thus nondeductible as ordinary and necessary expenses under Code §212. For example, payments made in settlement of an action to require specific performance of a contract to sell capital assets are capital in nature. *Wheeler v. United States,* 61-1 U.S.T.C. (CCH) ¶9239 (W.D.Tex. 1961), *rev'd,* 311 F.2d 60 (5th Cir. 1962), *cert. denied,* 84 S.Ct. 54 (1963); *Rose v. United States,* 333 F.Supp. 1384 (N.D.Ill. 1971).

The regulations under Code §212 interpret the phrase "ordinary and necessary" as requiring a reasonable link between the payment and the income-producing activity. The expense must be "reasonable in amount and must bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation, or maintenance of property held for the production of income." Treas.Reg. §1.212-1(d). See also Treas.Reg. §§1.212-1(i), 1.212-1(j).

Payments related to litigation that is personal in nature are not deductible even when the payments are made for the purpose of protecting a taxpayer's business reputation or to prevent attachment and execution on income-producing assets. The Supreme Court has decided that the origin-of-the-claim test controls for all payments made to satisfy judgments and settlements and that even if payments are made to protect income-producing assets or business reputations (*e.g.,* a divorce proceeding), the origin of the claim is personal and still controls. *See, e.g., United States v. Gilmore,* 372 U.S. 39, 9 L.Ed.2d 570, 83 S.Ct. 623 (1963), *rev'g and remanding* 290 F.2d 1942 (Ct.Cl. 1961).

VIII. LITIGATION EXPENSES AND LEGAL FEES

A. [3.44] Deductibility of Expenses and Fees

In general, whether legal expenses are deductible or nondeductible or must be capitalized is controlled by the nature of the claim causing the expenditure. *United States v. Gilmore,* 372 U.S. 39, 9 L.Ed.2d 570, 83 S.Ct. 623 (1963), *rev'g and remanding* 290 F.2d 1942 (Ct.Cl. 1961); *Woodward v. Commissioner,* 397 U.S. 572, 25 L.Ed.2d 577, 90 S.Ct. 1302 (1970); *United States v. Hilton Hotels Corp.,* 397 U.S. 580, 25 L.Ed.2d 585, 90 S.Ct. 1307 (1970), *rev'g* 410 F.2d 194 (7th Cir. 1969). While the Code does not provide for the deduction of legal expenses expressly, legal expenses and litigation fees may be deductible under the general principles of Code §162 as "ordinary and necessary" business expenses or under Code §212 as ordinary and necessary expenses in connection with the "production of income."

As with most business and income-producing expenditures, there is always a question of whether the payments relate to the acquisition of a capital asset and are thus not deductible under Code §162 or §212 or relate to expenditures to preserve or maintain the production of income under §212 and therefore must be capitalized.

The origin-of-the-claim test is used to look through the effects of litigation to the underlying events leading up to the claim. For instance, if the suit has its roots in the acquisition of capital assets, then the legal fees must be capital expenditures. *See Reed v. Commissioner,* 55 T.C. 32 (1970). Note that because the origin-of-the-claim test is also used to determine the deductibility of payments made pursuant to a settlement or judgment, if the payments are deductible, so are the legal fees and expenses. *See also Dye v. United States,* 121 F.3d 1399 (10th Cir. 1997).

In situations in which an acquisition attempt goes awry and results in litigation, it is possible to apportion legal expenses between the acquisition and the litigation. While the acquisition expenses would clearly have to be capitalized, the litigation expenses may be deductible if the taxpayer can adequately substantiate the allocation. *See, e.g., Tennessee Valley Leather Co. v. Commissioner,* 1949 WL 7756 (1949); *Clark Oil & Refining Corp. v. United States,* 473 F.2d 1217 (7th Cir. 1973); *Singer v. Commissioner,* 34 T.C.M. (CCH) 337 (1975).

Legal fees incurred for tax advice in connection with the structuring of settlements and the allocation of payments are deductible under Code §212(3). See also Treas.Reg. §1.212-1(a)(1).

Legal fees in connection with a condemnation proceeding are capital in nature and therefore are not deductible. *Madden v. Commissioner,* 514 F.2d 1149 (9th Cir. 1975); *Soelling v. Commissioner,* 70 T.C. 1052 (1978). Taxpayers are entitled to deduct their legal expenses incurred in defending a criminal antitrust action. *Commissioner v. Tellier,* 383 U.S. 687, 16 L.Ed.2d 185, 86 S.Ct. 1118 (1966).

Legal fees paid by an employee in his or her suit for tortious interference with future employment against his or her former employer are deductible as a “miscellaneous itemized deduction, allowable only to the extent that the total of such deductions exceeds 2 percent of adjusted gross income.” *Bagley v. Commissioner,* 105 T.C. 396, 419 (1995).

For instance, the Tax Court in *Biehl v. Commissioner,* 118 T.C. 467 (2002), found that an attorney’s fee paid by an employer to an employee based on a wrongful termination suit could not be excluded from the employee’s gross income. In *Biehl,* the Tax Court rejected the taxpayer’s argument that the attorney’s fee was a business expense incurred by the company through the taxpayer acting on the company’s behalf and deductible under Code §62(a)(2)(A). The court held that the fees and costs incurred did not meet the “business connection” requirement of Code §62(a)(2)(A).

Code §6045(f) was enacted by the Taxpayer Relief Act of 1997, Pub.L. No. 105-34, §1021(a), 111 Stat. 788, to impose reporting requirements on any person engaged in a trade or business that makes payments to an attorney in the course of that trade or business after December 31, 1997. Code §6045(f)(2) provides that these reporting requirements apply to payments in connection with legal services even if the services are not performed for the payor.

Treas.Reg. §1.6045-5, which was adopted by the IRS in July 2006, interprets these reporting requirements. These regulations both clarify Code §6045(f) and provide examples of the application of the reporting requirements for various situations.

Under §6045(f) and the former proposed regulations, no de minimis exception was available. The new regulations provide that the Code §6045(f) reporting requirements will not be triggered unless aggregate payments of $600 or more are made during the calendar year to an attorney in connection with legal services.

If a check contains multiple attorney payees, an information return is required with respect to the attorney receiving the check. Although Code §6045(f) does apply even if payments are made jointly to an attorney and a client, no reporting will be required if the client is named sole payee on the check. This exception to reporting applies even if the attorney receives delivery of the payment. See Treas.Reg. §1.6045-5(f), Example 4.

The regulations do not identify the proper form on which to report these payments but direct the taxpayer to Treas.Reg. §1.6041-6 for time and place of filing the report, which indicates Form 1099 should be used. Furthermore, the regulations state that these reporting requirements are not affected even if other information returns are required by another IRS provision and regulation.

B. [3.45] Treatment of Contingent Attorneys' Fees

Prior to January 2005, there was a split in the circuits over the issue of taxability of contingent attorneys' fees in nonphysical injury cases. The IRS argued that the assignment-of-income doctrine should apply to include in the plaintiff's gross income that portion of a recovery paid as a fee to an attorney under a contingent fee agreement. Opposite the IRS argument was the idea that the contingent fee is actually earned by the lawyer, not the client, and therefore should not be included in the client's gross income.

The Supreme Court resolved the circuit split in favor of the IRS position in *Commissioner v. Banks,* 543 U.S. 426, 160 L.Ed.2d 859, 125 S.Ct. 826 (2005). The Court ruled that if a plaintiff's recovery is considered income, then that income includes any portion of the recovery paid to the plaintiff's attorney as a contingent fee. The Court applied the anticipatory-assignment-of-income doctrine and held that a contingent fee agreement is such an assignment. The Court rejected the argument that the attorney is the party who controls the earnings, stating that "the income-generating asset is the cause of action that derives from the plaintiff's legal injury." 125 S.Ct. at 832. The Court also stated that the attorney-client relationship is the "quintessential principal-agent relationship" and rejected the notion that the relationship should be characterized as a business partnership or joint venture. *Id.*

Under the Supreme Court ruling in *Banks,* any contingent fee paid to any attorney out of a client's settlement proceeds, assuming the settlement is taxable to the plaintiff, would be included in the client's gross income. Prior to October 2004, any legal fees paid, including contingent fees, were also deductible as a miscellaneous itemized deduction but were subject to the two-percent floor, meaning the only expenses that could be deducted were those that exceeded two percent of the taxpayer's adjusted gross income. Code §67. This would not be a big problem except for the alternative-minimum-tax (AMT) rule that provides that no miscellaneous itemized deductions are allowed for taxpayers subject to AMT. Code §56(b)(1). Thus, under the *Banks* rule, the taxpayer would be required to include as income a large contingent fee payment made to an attorney but would not be allowed any deduction of the payment for purposes of the AMT. It should be noted that in many cases the receipt by a plaintiff of a substantial recovery in a nonphysical injury case by itself subjects the plaintiff to the AMT. In these cases, the plaintiff is required to pay AMT on that portion of the recovery paid to the plaintiff's attorney with no corresponding deduction for attorneys' fees.

The American Jobs Creation Act of 2004, Pub.L. No. 108-357, 118 Stat. 1418, enacted in October 2004, alleviates this tax burden in some cases. The Act creates a new "above the line" deduction for contingent and non-contingent attorneys' fees and court costs incurred in three types of actions: (1) a claim of unlawful discrimination; (2) a claim against the federal government under 31 U.S.C. §§3721 – 3733; and (3) a claim made under 42 U.S.C. §1395y(b)(3)(A). Code §62(a)(20). Thus, if the cause of action falls within the scope of Code §62(a)(20), the taxpayer must include any contingent fees paid as income but will be entitled to an offsetting deduction for the attorneys' fees paid for both regular income tax and AMT purposes.

The Tax Relief and Health Care Act of 2006, Pub.L. No. 109-432, 120 Stat. 2922, provides additional relief for taxpayers in connection with whistleblower awards. Under new Code §62(a)(21), an above-the-line deduction is provided for attorneys' fees and costs incurred by a taxpayer in connection with any award under §7623(b) (relating to awards to whistleblowers.)

IX. ELEMENTS TO CONSIDER FOR TAX PLANNING

A. [3.46] Document Tort Claims

Every effort should be made by the plaintiff's attorney to document (*e.g.,* by demand letters, etc.) that the plaintiff has valid and substantial claims against the defendant. If both tort and non-tort claims are present, every effort should be made to emphasize the tort claims and raise the non-tort claims only in the alternative.

B. Preparing and Filing Complaint

1. [3.47] Emphasize Tort Claims

According to the IRS, the complaint is the most persuasive evidence of the tax treatment of an amount subsequently recovered by way of settlement. Rev.Rul. 85-98, 1985-2 Cum.Bull. 51. If both tort and non-tort claims are present, the plaintiff's attorney should, to the extent possible, emphasize the tort claims in the complaint and assert the non-tort claims in the alternative.

2. [3.48] Claims for Damage to Goodwill and Lost Profits

Any recovery in a business context is presumed to constitute lost profits; however, if the taxpayer can demonstrate that any recovery is allocable to damage to goodwill or injury to property, the recovery will be nontaxable to the extent of the taxpayer's basis in the goodwill or property, and any excess of the recovery over the taxpayer's basis may be taxable as capital gain. Thus, to the extent possible, the plaintiff should allege damage to business goodwill and/or injury to property rather than a loss of profits. Presumably, the lost profits can be used to prove up the damages to the plaintiff's business goodwill.

If an allegation such as loss of profits must be made, the plaintiff should at least give equal standing to the damage to goodwill or injury to property claim.

C. [3.49] Discovery

During the discovery process, the plaintiff should set forth as specifically as possible in answers to interrogatories, depositions, etc., the amount of damages incurred with respect to each category of claim being asserted, both taxable and nontaxable. Such evidence may later turn out to be helpful in substantiating the tax treatment of any recovery in the subsequent tax case.

D. Settlement

1. [3.50] Allocation of Settlement Amounts

As noted in §3.18 above, any settlement agreement should set forth a specific allocation of the settlement amount among the claims being released. In *McKay v. Commissioner,* 102 T.C. 465 (1994), *vacated,* 84 F.3d 433 (5th Cir. 1996), the Tax Court noted that the allocation set forth in the settlement agreement is the most important factor in determining whether a payment was made on account of personal injury and thus excludible from income. The Tax Court further observed, however, that such allocations must be negotiated at arm's length between adverse parties in order to be respected by the court.

2. [3.51] Tax Reporting

The settlement agreement should address whether the payor of the settlement is to report the payment to the IRS on Form 1099 or Form W-2. The plaintiff's counsel should keep in mind that there is no reporting obligation for payments made with respect to personal injury claims. Many IRS audits and tax cases have commenced because the payor has reported the payment to the IRS and the plaintiff has not included the amount of the payment on his or her tax return.

E. At Trial

1. [3.52] Evidence of Damages

Evidence of damages produced at trial should, to the extent possible, be presented to the judge or jury in such a way to allow division of the damages among the various claims presented.

2. [3.53] Allocation in Judgment

It may be possible to request the court to allocate the judgment among the various claims presented. Making such a request may, however, be a tactical mistake if a good argument can be made that the entire amount of the judgment is tax free, as in the case of compensatory damages in a personal injury suit.