Tax Aspects of Settlements and Judgments

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Presented:
September 29, 2014
Why Should I Care?

• **Every** Business Officer should have a basic understanding of the tax issues involved with settlements and judgments.

• Failure to properly report (and withhold where appropriate) on settlement or judgment payments may result in substantial additional liabilities for interest, penalties, and taxes.
What is Gross Income?

§61 Gross income defined
(a) General definition—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived....
Settlement v. Judgment

• It is irrelevant whether litigation (or the threat of litigation) is settled through adjudication or by agreement among the parties.

See Longino Estate v. Commissioner, 32 T.C. 904 (1959); Sager Glove Corp. v. Commissioner, 36 T.C. 1173, aff’d, 311 F.2d 210 (7th Cir. 1962).
Origin of the Claim Doctrine

- Amounts recovered by either settlement or judgment are taxed based on the nature of the claims resolved.

Origin of the Claim Examples

• Generally, if a litigant is paid compensatory damages which would have otherwise been fully taxable but for the harm caused by the defendant, the recovery is still fully taxable.
Origin of the Claim Examples

• A taxpayer sues his employer in an attempt to recover additional compensation.

• The employer settles to avoid costly litigation.

• The recovery is fully taxable just as if the amount had been paid to the employee as wages.

See McKim v. Commissioner, T.C. Memo. 1980-93.
Return of Capital

• If a recovery is intended to compensate a taxpayer for damage to a capital asset, then gain is recognized only to the extent the taxpayer’s basis in the asset (generally the asset’s cost) is exceeded.
Deduction for Settlement Costs

• Fines and penalties imposed as part of a settlement cannot be deducted. IRC §162(f).

• However, amounts treated as ordinary business expenses are deductible.

• See Daher, Disallowed Deductions, Chapter 1D:27 in LEXISNEXIS FEDTAX IN DEPTH (LexisNexis January 2007).
Deduction for Settlement Costs

• Bank of America reached a $16.65 billion settlement with the Dept. of Justice regarding the treatment of mortgage-backed securities (August 2014).

• $5 billion represents a non-deductible penalty, but $11.63 billion can be deducted as a business expense.
IRC Section 104(a)(2)

• Gross income does not include:

“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.”
Section 104(a)(2) Examples

• A taxpayer recovers $1M in damages as a result of physical injuries he sustained in an automobile accident.

• The entire amount (assuming the damages are not punitive damages) is excludable from gross income.
Emotional Distress Recoveries

- Emotional distress recoveries are excludable from gross income only if there is a related personal physical injury or physical sickness.

- Absent a related personal physical injury or physical sickness, emotional distress recoveries are fully taxable.
• If there is a physical injury, payments for emotional distress related to the injury are also excludable.

• See Comm’r v. Schleier, 515 U.S. 323 (1995) (medical expenses, pain and suffering, and lost wages received by an accident victim are excludable as “on account of personal injuries”).
Physical Symptoms of Emotional Distress

• Physical manifestations of emotional distress

• “…the term emotional distress includes physical symptoms, such as insomnia, headaches and stomach disorders, which may result from emotional distress”

• Can exclude amounts of out of pocket medical costs (provided no prior deduction).
Is a Formal Claim Needed?

• Assuming a recovery otherwise meets the requirements of the statute, there is no need to file an actual lawsuit in order for a recovery to be excludable under Section 104(a)(2).

Punitive Damages

- Punitive damages, even those paid on account of personal physical injury or physical sickness, are fully taxable.

Taxation of Interest

- Interest (pre-judgment and post-judgment) is fully taxable, even where the remainder of the recovery is excludable under Section 104(a)(2).

See *Kovacs v. Commissioner*, 100 T.C. 124 (1993), *aff’d*, 25 F.3d 1048 (6th Cir. 1994); TAM 199922056; IRC Section 61(a)(4).
ERISA Settlement

• In *Mayberry v U.S.*, 151 F.3d 855 (8th Cir. 1998), the court held payments received in an ERISA settlement to be taxable wages.

• The court stated wages included any payments made in the entire employer-employee relationship not otherwise specifically excluded.
Allocation to Nontaxable Benefits

• Amounts received to replace what would have been nontaxable fringe benefits may be nontaxable.

• Cash payments remain taxable.


Examples include:
1. Health insurance;
2. Working condition fringe benefits;
3. Qualified transportation fringes; and
4. Dependent care assistance, etc.
Common Examples of **Taxable** Recoveries

- Defamation;
- Discrimination based on race, age, or sex;
- Wrongful termination;
- ADA recoveries;
- ERISA recoveries;
- Lost profits;
- Fraud;
- Breach of Fiduciary Duty;
- Negligence; and
- False Claims Act recoveries.
Allocation of Payment

If a claim includes personal injury and other damages, allocation will generally be recognized if entered into by the parties in an adversarial context, at arm’s length, and in good faith.
LeFleur v. Commissioner

- In *LeFleur v. Commissioner*, T.C. Memo 1997-312, the Tax Court upheld a reallocation of settlement proceeds performed by the IRS.

- The settlement had allocated a large amount to emotional distress (nontaxable at the time of the settlement); however, that amount was reallocated and became taxable.
The Court stated: "... We conclude that petitioner suffered no injury to his health that could be attributed to the actions of the defendants, and we are not persuaded that such injury was the basis of any payment to him..."
IRS Guidance

• Market Segment Specialization Program – Lawsuits Awards and Settlements (May 2011).

• Office of Chief Counsel Memorandum (PTMA 2009-035), October 22, 2008.

• Publication 957.
Reporting Obligations

• Nontaxable payments – no reporting.

• Taxable payments that are not wages – Form 1099.

• Taxable wages – Form W-2.
In Rev. Rul. 85-97, an individual’s lump-sum payment for physical injury and lost wages when hit by a bus was all held to be excludable from gross income.

The payment was from the bus company, not the taxpayer’s employer.
In Rev. Rul. 61-1, the entire amount received by an employee in a settlement of claims against his employer was excludable from gross income even though it included amounts for lost wages.
Cleveland Indians Baseball

• Employment taxes are calculated based on the year of the payment rather than the year wages would have been payable.

• The Indians lost.

<table>
<thead>
<tr>
<th>Type of Payment</th>
<th>Taxable Income</th>
<th>Wages</th>
<th>Reporting Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Back, front, or severance pay</td>
<td>Yes</td>
<td>Yes</td>
<td>W-2</td>
</tr>
<tr>
<td>Lost wages due to personal injury</td>
<td>No</td>
<td>No</td>
<td>None</td>
</tr>
<tr>
<td>Tax gross up on wages</td>
<td>Yes</td>
<td>Yes</td>
<td>W-2</td>
</tr>
<tr>
<td>Payments for emotional distress (except if excluded under Sec. 104(a)(2))</td>
<td>Yes</td>
<td>No</td>
<td>1099</td>
</tr>
<tr>
<td>Punitive damages</td>
<td>Yes</td>
<td>No</td>
<td>1099</td>
</tr>
<tr>
<td>Interest and court costs</td>
<td>Yes</td>
<td>No</td>
<td>1099</td>
</tr>
<tr>
<td>Reimbursement of medical expenses</td>
<td>No</td>
<td>No</td>
<td>None</td>
</tr>
</tbody>
</table>
Payments Deferred Until Later Years

• Generally, under IRC Sec. 457(f), unless there is a substantial risk of forfeiture all amounts are taxable in the year of the settlement. The present value of all future payments would be the taxable income amount.
Opportunity to Use 403(b) Plan

- Governmental employers may be able to use their 403(b) plans to make payments for up to five years after termination.

- Not available to non-governmental employers due to nondiscrimination rules.
Employer reported settlement on form 1099 and employee sued alleging such reporting caused him emotional distress.

_Duse v. IBM, 252 F.3d 151 (2001)_
Netting of Attorneys’ Fees

• The taxation of contingent attorneys’ fees has been a hotly contested issue for decades.

See Cotnam v. Commissioner, 263 F. 2d 119 (5th Cir. 1959).
Netting of Attorneys’ Fees

• After *Cotnam*, a split in the Circuit Courts of Appeals developed as to whether recovered contingent attorneys’ fees were taxable to both the plaintiff and the plaintiff’s attorneys.
Netting of Attorneys’ Fees


  – “As a general rule, when a litigant’s recovery constitutes income, the litigant’s income includes the portion of the recovery paid to the attorney as a contingent fee.”

• See also *Unsettling Settlement of Contingent Attorney’s Fees Taxation*, PRACTICAL TAX STRATEGIES, Vol. 74, No. 5, p. 260 (May 2005).
Netting of Attorneys’ Fees

The American Jobs Creation Act of 2004 amended IRC Section 62(a)(20) to provide for a deduction “…for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination.”
Netting of Attorneys’ Fees

• The deduction for attorneys’ fees cannot exceed the amount included in income.

• This can create problems if attorneys’ fees are paid in a year other than the year in which the income is received.
Unlawful Discrimination

“Unlawful discrimination“ is defined in the IRC and includes acts unlawful under the following:

- Section 302 of the Civil Rights Act of 1991
- Certain sections of the Congressional Accountability Act of 1995
- The National Labor Relations Act
- The Fair Labor Standards Act
- Section 4 or 15 of the Age Discrimination in Employment Act
- Section 501-4504 of the Rehabilitation Act of 1973
- Section 510 of ERISA
- Title IX of the Education Amendments of 1972
“Unlawful discrimination“ is defined in the IRC and includes acts unlawful under the following (contd):

- The Employee Polygraph Protection Act
- The Worker Adjustment and Retraining Notification Act
- Section 105 of the Family and Medical Leave Act
- Sections 703, 704 and 717 of the Civil Rights Act of 1964
- Certain sections of the Fair Housing Act
- Certain sections of the Americans with Disabilities Act
- A provision of federal whistleblower laws
- A provision providing for the enforcement of civil rights
- Any provision regulating any aspect of the employment relationship
Payments to Attorneys

- Reporting to both plaintiff and attorney.
- Report gross wages on Form W-2.
- Report net payment amount on Form 1099.
Example of Inequity

- Jane files a suit for false imprisonment and recovers $5M total, including $4M of attorneys’ fees, which is fully taxable.

- Under the rule of *Banks* (and because IRC Section 62(a)(20) does not apply) Jane is taxed on the entire $5M recovery.
Example of Inequity

• Any deduction Jane is otherwise entitled to for regular tax purposes is disallowed for AMT purposes.

• This results in Jane owing almost $1.4M in federal income tax.

• The appalling result here is that Jane is out of pocket roughly $400K after “winning a lawsuit”.

We mean business in higher education
Taxation of Attorneys’ Fees

• Chief Counsel Memorandum POSTF-129928-13 (August 30, 2013)
  – If underlying recovery is taxable, the amount received for attorney’s fees is also taxable.
  – If portion of recovery specifically allocated to attorney’s fees, amount is not subject to employment taxes.
  – If no specific allocation and underlying recovery is subject to employment taxes (e.g., back pay, severance pay), full amount of recovery subject to employment taxes.