Lawsuits, Awards, and Settlements Audit Techniques Guide

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Chapter 1 Introduction and Issues

Introduction

This guide focuses on the treatment of lawsuit, settlements and awards proceeds received after August 21, 1996, the date of enactment of the Small Business Job Protection Act of 1996 (SBJPA) which revised IRC § 104(a)(2). Additional research may be warranted for issues involving proceeds received prior to August 21, 1996 or received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

Because a business entity cannot suffer a personal injury within the meaning of IRC § 104(a)(2), *P & X Markets, Inc. v. Commissioner,* 106 T.C. 441 (1996), *aff'd in unpublished order*, *P & X Markets, Inc. v. Commissioner,* 139 F. 3d 907 (9th Cir. 1988), this guide applies to recoveries by individuals only.

IRC § 61 states all income from whatever source derived is taxable, unless specifically excluded by another Code section. IRC § 104 is the exclusion from taxable income provision with respect to lawsuits, settlements, and awards.

The 1996 amendment added to IRC § 104(a)(2) the word physical to the clause "on account of personal physical injuries or physical sickness." Therefore, in order for damages to be excludible from income, the judgment or settlement must be derived from personal physical injuries or physical sickness. Prior to the 1996 amendment, IRC § 104(a)(2) was extensively litigated with respect to what was personal injuries.

In addition, the 1996 amendment added to the flush language of IRC § 104(a): "For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care … attributable to emotional distress." Thus, IRC § 104(a)(2) now provides that, in cases of non-physical injury, such as discrimination, fraud, etc., amounts excludable for emotional distress are limited to actual "out of pocket" medical costs. A footnote in the Conference Committee Report to the 1996 Act states that the term emotional distress includes physical symptoms, such as insomnia, headaches, and stomach disorders, which may result from emotional distress.

The 1996 amendment also clearly provides that punitive damages are not excludible under IRC § 104(a)(2), regardless of whether received in connection with a physical or non-physical injury. However, the 1996 amendment has raised the issue whether punitive damages received in connection with a wrongful death action are excludable from gross income. This question is discussed in detail in a subsequent section.

In certain situations an amount of a lawsuit settlement might be paid to reimburse a taxpayer for losses, and no gain would have to be recognized under IRC § 1001 because the amount paid did not exceed the taxpayer‟s basis (return of capital).

This guide will provide suggestions on conducting the examination, detail of issues, explanations of applicable terminology, synopses of several related court cases, etc.

Issues

The following determinations should be made when reviewing lawsuit verdicts and settlements received after August 20, 1996.

- Determine if any taxable lawsuit, award or settlement proceeds are unreported.
- Determine if proper amounts were allocated between compensatory and punitive damages. This is especially important for out of court settlements. Because many cases are settled to avoid the imposition of punitive damages, it is anticipated that some taxpayers may erroneously allocate amounts between excludable and punitive damages in these cases. This allocation may also have an impact on the deductibility of attorneys‟ fees and court costs since IRC § 265 expressly denies any deduction for expenses related to tax-exempt income.
- Determine if any of the lawsuit, award or settlement proceeds constituted punitive damages. All punitive damages are taxable whether received in relation to a physical or non-physical injury or sickness. (Caution: See IRC §104(c) exception when applicable State law provides only punitive damages may be awarded in wrongful death actions, i.e., Alabama.)
- Determine if any of the settlement proceeds are designated as interest, and if so, such interest is reported as income.
- Verify that amounts excluded from income were received in a case of *physical* injury or *physical* sickness. Damages for emotional distress on account of physical injuries or sickness are excludable by IRC § 104(a)(2). However, costs incurred to treat emotional distress, even those due to physical injury, are taxable if they were previously deducted as a medical expense in a prior year.
- Verify the amount of out of pocket expense excluded for emotional distress in non-physical injury cases (e.g., discrimination, fraud, etc.). Damages for emotional distress in these cases are only excluded to the extent of paid medical expenses.
- Verify that the taxpayer reported taxable amounts at gross rather than reporting them net of legal and other fees paid.
- Determine if allowable legal fees were deducted properly. They should be deducted on Schedule A as miscellaneous itemized deductions, unless the origin of the claim litigated is related to a Schedule C or a capital transaction. **This guide does not address the proper treatment of legal fees paid and deducted in taxable years prior to the year of recovery.**
- Verify that expenses were paid on or after October 24, 2004 in cases involving IRC § 62(a)(20) (relating to costs involving discrimination suits). For cases involving IRC § 62(a)(21) (relating to the deductibility of attorney fees paid in connection to a whistleblower‟s award), verify the information provided as part of the claim had been provided on or after December 20, 2006. In both instances, verify total deductions have been limited to the amount includible in the taxpayer‟s gross income on account of the underlying discrimination suit or whistleblower award. These sections allow above the line deduction of legal costs.

- Verify that for a non-corporate taxpayer, legal fees deducted as a Schedule A miscellaneous itemized deduction are not allowed for purposes of computing the alternative minimum tax (AMT).
- Verify that for purposes of the AMT Credit, legal fees that are disallowed for purposes of calculating the AMT do not contribute to the amount of the credit. They are "exclusion" items.

Chapter 2 Taxability of Lawsuit Payments

General rule relative to taxability of amounts received from lawsuit settlements is IRC §61 that states that all income is taxable from whatever source derived, unless exempted by another section of the Code.

Terminology/Definitions

Types of Claims

Tort:

- A civil wrong, not involving breach of contract, for which a remedy may be obtained;
- A wrongful act committed by one person against another person or his/her property;
- The breach of a legal duty imposed by law, other than by contract;
- May cause or constitute, but is not necessarily, a personal injury.

A tort award may be received from litigation or settlement of a claim for physical injury or illness, mental pain and suffering, interference with economic relations, and/or property damage.

Example 1

X punches Y, thus committing the tort of battery.

Example 2

X sets foot on Y‟s property, thus committing the tort of trespass, but causing no personal injury.

Contractual:

- Claims based on rights given by contract.
- A remedy provided specifically by the contractual agreement or as interpreted by a court.
- Whether damages based on a contractual claim are taxable usually depends on the underlying claim.

Example 3

X forces Y to leave his employment before the time specified in an employment contract, thereby breaching the contractual agreement.

Example 4

X refuses to pay Y the amount specified in a homebuilding contract, thereby breaching the contractual agreement.

Types of Damages/Awards

Compensatory

Damages intended to compensate the taxpayer for a loss, i.e., payment to compensate the injured party for the injury sustained, and nothing more. This loss may be purely economic, for example, arising out of a contract, or personal, for example, sustained by virtue of a physical injury.

Generally speaking, most people view the term "compensatory" to mean "nontaxable." However, the term "compensatory" merely means that the payment compensated the taxpayer for a loss. Thus, determinations of the taxability of lawsuit awards cannot always be made by simply referring to the terminology used, that is, compensatory or punitive; contractual or tort.

For example, not all torts constitute personal injuries. Some torts may involve invasion of property rights, conversion, interference with economic interests, tortious interference with contractual relations, purely personal interests, or defamation. Further, not all compensation payments for personal injuries are received on account of any personal physical injury or illness.

Moreover, damages arising from contractual claims can be taxable, such as those paid for lost wages and benefits, profits, and other forms of business receipts, or non-taxable. For example, X receives an insurance policy to replace one previously purchased that had lapsed due to an insurance agent"s misappropriation of premiums paid.

The facts and circumstances of each lawsuit settlement must be considered to determine the purpose for which the money was received. Then, it can be determined whether these amounts are excludable. A key question is "In lieu of what were the damages awarded?"

Finally, if prior deductions under IRC § 213 or any other applicable Code section were taken (that is, medical deductions; interest expense, attorney fees, etc.) then pursuant to the Tax Benefit Rule, amounts received for reimbursement of these expenses would be taxable to the extent includible under IRC § 111.

Punitive

Generally, punitive damages are not awarded for simple breach of contract or negligent tort. They are added to any compensatory damages where the defendant acted recklessly, with malice or deceit, or in any other manner that would justify penalizing the wrongdoer or making an example to others.

Punitive damages are often awarded when the defendant acted

- Knowingly
- Willingly
- Deliberately
- Recklessly
- Fraudulently

Generally**,** punitive damages are taxable, but there are exceptions (See "Wrongful Death" discussed below.)

Resolution of Claims

Determining the correct allocations among taxable payments and non-taxable payments is usually the most difficult part of an examination. Claims are generally resolved in one of two ways:

Jury/Court Verdicts

If damages have been clearly allocated to an identifiable claim in an adversarial proceeding by judge or jury, the Service will usually not challenge their character because of the impartial and objective nature of the determinations. However, care should be taken where the Court"s decision is simply a ratification of a settlement entered into by the parties. *See Robinson v. Commissioner*, 102 T.C. 116, 122 (1994), *aff'd in part and remanded,* 70 F.3d 34 (5th Cir. 1995) and *Kightlinger v. Commissioner*, T.C. Memo. 1998-357. In *Robinson,* the Court incorporated the parties" allocation of damages in its judgment by reference to their settlement agreement. However, the Service successfully argued that the allocation was not a "bona fide allocation that was reached at arms length." *Robinson,* 102 T.C.at 133. Although both of these cases are pre 1996 Amendment cases, they show how in cases where there was not an impartial and objective determination of the allocation of the award to its components, a reconsideration of the allocation is warranted.

Settlements Out of Court

Many lawsuits are settled prior to a jury verdict. When damages are received pursuant to a settlement agreement, the nature of the claim that was the actual basis for settlement controls whether such damages are excludable under IRC § 104(a)(2). These settlements should be closely reviewed, and the underlying facts and circumstances should be carefully determined. The allocation among the various claims of the settlement can be challenged where the facts and circumstances indicate that the allocation does not reflect the economic substance of the settlement. See these pre 1996 Amendment cases to illustrate such reallocations; *Bagley v. Commissioner,* 105 T.C. 396 (1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997); *Robinson v. Commissioner,* 102 T.C 116, 122 (1994), *aff'd in part and remanded,* 70 F.3d 34 (5th Cir. 1995);.*Phoenix Coal Company, Inc. v. Commissioner,* 231 F.2d 420 (2d Cir. 1956).

The Court in *LeFleur v. Commissioner,* T.C. Memo. 1997-312, a pre 1996 Amendment case, addressed the reallocation issue in a case involving claims for breach of contract, emotional distress (pain and suffering), and punitive damages. In an out-of-court settlement, the parties expressly agreed to allocate $800,000 of the $1 million sum to personal injuries, $200,000 to contract, and none to punitive damages. The taxpayers included the $200,000 of settlement proceeds allocated to the contract claim in their gross income on Schedule C, and excluded the $800,000 allocated to the personal injury claim under IRC § 104(a)(2).

The Service disregarded the terms of the written settlement agreement and reallocated the previously excluded $800,000 to income. The Tax Court upheld the IRS"s reallocation and referring to the settlement agreement stated, "the allocation did not accurately reflect the realities of the petitioner"s underlying claims." *LeFleur at 9.* In determining the $800,000 was not excludable under IRC §104(a)(2), the Court stated:

"In light of the facts and circumstances, 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 …." *LeFleur at 10.*

For additional information on issues dealing with the allocation or reallocation of settlements, see discussions of "Physical Injury or Sickness" and "Non-Physical Injury or Sickness" below.

Tax Treatment of Awards and Settlements

Awards and settlements can be divided into two distinct groups. One group includes claims arising from a physical injury and the other group includes those arising from a non-physical injury. The claims from each of the two groups will usually fall into three categories:

1. Actual damages resulting from the physical or non-physical injury;
2. Emotional distress damages arising from the actual physical or non-physical injury; and
3. Punitive damages

Physical Injury or Sickness

Physical

Prior to August 21, 1996, IRC § 104(a)(2) did not contain the word "physical" with regard to personal injuries or sickness. Consequently, many taxpayers were allowed to exclude from income amounts received on account of personal *non-physical* injuries and sickness while others erroneously failed to report as income almost all types of awards/settlements under IRC § 104(a)(2).

In 1996, IRC § 104(a)(2) was amended to exclude from gross income "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." IRC § 104(a)(2). However, the limitation to personal physical injuries or physical sickness contained in the 1996 amendment does not apply to any 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. 104-188, Title I, Sec. 1605(a).

The Service has consistently held that compensatory damages, including lost wages, received on account of a personal physical injury are excludable from gross income with the exception of punitive damages. Rev. Rul. 85-97, 1985-2 C.B. 50, *amplifying* Rev. Rul. 61-1; *see also Commissioner v. Schleier,* 515 U.S. 323, 329-30 (1995), in which the Supreme Court used an example of an automobile accident to illustrate in this employment discrimination case how "on account of" in IRC § 104(a)(2) is construed. In the example, the Court held medical expenses (not previously deducted), pain and suffering, and lost wages received by an accident victim are excludable from income as "on account of personal injuries." *Schleier,* 515 U.S. at 329. Specifically, the Court stated:

Consideration of a typical recovery in a personal injury case illustrates the usual meaning of "on account of personal injuries." Assume that a taxpayer is in an automobile accident, is injured, and as a result of that injury suffers (a) medical expenses, (b) lost wages, and (c) pain, suffering, and emotional distress that cannot be measured with precision. If the taxpayer settles a resulting lawsuit for $30,000 (and if the taxpayer has not previously deducted her medical expenses, see § 104(a)), the entire $30,000 would be excludable under § 104(a)(2). The medical expenses for injuries arising out of the accident clearly constitute damages received "on account of personal injuries." Similarly, the portion of the settlement intended to compensate for pain and suffering constitutes damages "on account of personal injury." Finally, the recovery for lost wages is also 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*, *e.g., Threlkeld v. Commissioner,* 87 T.C. 1294, 1300, 1986 WL 22061 (1986) (hypothetical surgeon who loses finger through tortious conduct 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 (CA6 1988). The critical point this hypothetical illustrates is that each element of the settlement is recoverable not simply because the taxpayer received a tort settlement, but rather because each element of the settlement satisfies the requirement set forth in § 104(a)(2) (and in all of the other subsections of § 104(a)) that the damages were received "on account of personal injuries or sickness."
Schleier, 515 U.S. at 329-30.

The House Committee Report to the 1996 Act (excerpts attached as Appendix A) states:

If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive) 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) 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.

The phrase "on account of" is of particular importance. Many cases have been litigated where the taxpayer has attempted to exclude from income awards based on emotional distress. Overwhelmingly, courts have held that in order for damage awards to be excluded from gross income they must have been received on account of personal physical injuries or physical sickness. *Commissioner v. Schleier,* 515 U.S. 323 (1995); *see Murphy v. IRS,* 493 F.3d 170 (2007)(D.C. Circuit sustained the district court"s holding that damages awarded in an administrative action against a former employer under whistleblower environmental statutes, for "mental pain and anguish" and "injury to professional reputation," were outside the Internal Revenue Code's "personal physical injuries or physical sickness" damages exclusion, even though the taxpayer no doubt had suffered from certain physical manifestations of the emotional distress on which the award was based); *Stadnyk v. Commissioner,* T.C. Memo. 2008-289; *Ballmer v. Commissioner,* T.C. Memo. 2007-295, and *Hawkins v. Commissioner,* T.C. Memo. 2007-286.

Emotional

As discussed above under Phsyical Injury or Sickness, to be excludible, an emotional distress recovery must be on account of (attributed to) personal physical injuries or sickness unless the amount is for reimbursement of actual medical expenses related to emotional distress that was not previously deducted under IRC § 213. The flush language of IRC § 104(a) states, "For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress". According to a footnote in the Conference Committee Report to the 1996 SBJPA, Public Law 104 -188, the term "emotional distress" includes physical symptoms, such as insomnia, headaches, and stomach disorders, which may result from such emotional distress.

In *Emerson v. Comr.*, T.C. Memo 2003-82, the Tax Court found that a tort recovery for various claims, including emotional distress, was not excludible under IRC § 104(a)(2) because the recovery was not received on account of personal physical injuries or physical sickness. Also, in *Witcher v. Comr.*, T.C. Memo 2002-292, the Tax Court held that a tort recovery for various claims, including emotional distress and defamation, was not excludible because it was not received on account of personal physical injuries or physical sickness.

Punitive Damages

Punitive damages are not excludable from gross income under IRC § 104(a)(2).

With the enactment of SBJPA, Public Law 104 -188, Section 1605(a) in 1996, Congress made it clear in IRC § 104(a)(2) that punitive damages are taxable, regardless of the nature of the underlying claim.

IRC § 104(a)(2) states gross income does not include --

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

While IRC § 104(a)(2) clearly indicates punitive damages are taxable, IRC § 104(c) provides a limited exception to the treatment of punitive damages awarded in certain civil wrongful death cases. See section entitled "Wrongful Death" discussed below.

In cases settled outside of court that are on account of personal physical injuries or sickness, it is important to review the original claim documents to determine how much, if any, of the settlement amount is actually punitive damages. A reallocation may be needed.

Wrongful Death

Claims for wrongful death usually encompass compensatory damages for physical and mental injury, as well as punitive damages for reckless, malicious, or reprehensible conduct. As a result, both claims may generate settlement amounts. Any amounts determined to be compensatory for the personal physical injuries are excludable from gross income under IRC § 104(a)(2). Any amounts determined to be punitive are not excludable under IRC § 104(a)(2). This is true regardless of whether the punitive amounts are received prior or subsequent to the August 20, 1996, amendment. *See O'Gilvie v. United States,* 519 U.S. 79 (1996).

Caution, however, should be used in applying the general rule that punitive damages received in wrongful death case are taxable. Historically, the courts have looked to the state statute under which the wrongful death claim was litigated to determine whether there could be compensatory and/or punitive damages awarded. This search may reveal a state statute which provides only for punitive damages in wrongful death claims. In these cases, IRC § 104(c) allows the exclusion of punitive damages for amounts received after 1996.

IRC § 104(c) provides as follows:

(c) **Application of prior law in certain cases.**
The phrase "(other than punitive damages)" shall not apply to punitive damages awarded in a civil action -
(1) which is a wrongful death action, and
(2) with respect to which applicable State law (as in effect on September 13, 1995, and without regard to any modification after such date) provides, or has been construed to provide by a court of competent jurisdiction pursuant to a decision issued on or before September 13, 1995, that only punitive damages may be awarded in such an action.

For wrongful death action awards received prior to the enactment of IRC § 104(c), it is likely those amounts would still be excluded if the award would have qualified under I.R.C. § 104(c). See *Burford v. United States,* 642 F. Supp. 635 (N.D. Ala. 1986)(a wrongful death action essentially is one for personal injuries and therefore excludable by I.R.C. § 104(a)(2))

In *Benavides v. United States,* 497 F.3d 526 (5th Cir. 2007), the Fifth Circuit Court of Appeals clarified the "applicable State law" provision of IRC § 104(c)(2) to include only the wrongful death laws of the state. The Court in *Benavides* held IRC § 104(c) does not exclude punitive damages from the gross income of the survivors of a deceased worker when the wrongful death laws of the state in question do not limit recovery to punitive damages, even if some other law of the state, such as its Workers' Compensation Act, might restrict some wrongful death recoveries to punitive damages. *Benavides,* 497 F.3d at 531.

Due to the exclusion allowed by IRC § 104(c), it is necessary to determine if your state‟s wrongful death statutes preclude awarding compensatory damages in wrongful death cases. If that is the case, then contact the appropriate Office of Chief Counsel for guidance on Service‟s position.

Product Liability

Product liability cases often include claims for personal physical and mental injury. For example, X brings a claim for personal injury against an auto manufacturer claiming a wreck was caused by a faulty steering column on his car, or Y brings suit against the manufacturer of a contaminated pesticide claiming damage to his ornamental plants, and injury to his nursery and his business reputation.

These type cases will usually involve the various elements relative to compensatory damages for physical and mental injury, discussed above, as well as punitive damages. Proper allocations among the taxable and nontaxable portions received must be determined.

Non-Physical Injury or Sickness

Prior to the amendment of August 20, 1996, the Service and the courts consistently interpreted IRC § 104(a)(2) as providing an exclusion for damages received in connection with claims of mental and emotional distress which arose from non-physical injuries. Examples of these type cases are employment wrongful discharge, discrimination, libel, etc. Please refer to Chapter 3 section on payroll and self-employment tax considerations for a discussion on FICA, FUTA, RRTA and SECA on back pay, lost wages, lost profits, etc. received in a lawsuit award or settlement.

The August 20, 1996, amendment has plainly resolved this issue on the side of the Government. With the exception of amounts paid to treat emotional distress, damages received after August 20, 1996, are excludable under IRC § 104(a)(2) only if received on account of physical injury or physical sickness. Therefore, a taxpayer receiving lawsuit proceeds from a non-physical injury claim cannot exclude any amount for payment to compensate for an intangible emotional distress value. The taxpayer can only exclude an amount for actual out of pocket medical costs. This exclusion would further depend upon whether the taxpayer had previously deducted those medical expenses on his or her tax return. See IRC §§ 111 and 213.

The law change put an end to heavily litigated cases involving an underlying claim on account of non-physical personal injuries even when there was clearly emotional distress injury resulting from the underlying claim cause. Some such areas are briefly described as follows:

Employment-Related

Employment-related lawsuits may arise from wrongful discharge or failure to honor contract obligations. Damages received to compensate for economic loss, for example, lost wages, business income, and benefits, are not excludable from gross income unless a personal physical injury caused such loss

The taxpayer can exclude under IRC § 104(a)(2) only an amount of damages for actual out of pocket medical costs paid to treat any emotional distress if those medical costs had not been deducted on his or her tax return. See IRC §§ 111 and 213.

Discrimination Suits (Employment-Related)

Discrimination suits usually are brought alleging infringements in the areas of age, race, gender, religion or disability. These types of cases can generate compensatory, contractual and punitive awards, none of which are excludable under IRC § 104(a)(2).

Revenue Ruling 96-65, 1996-2 C.B. 6 holds:

Current section 104(a)(2) - (after August 20, 1996). Back pay received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII is not excludable from gross income under section 104(a)(2) because it is completely independent of, and thus is not damages received on account of, personal physical injuries or physical sickness under that section. Similarly, amounts received for emotional distress in satisfaction of such a claim are not excludable from gross income under section 104(a)(2), except to the extent they are damages paid for medical care (as described in section 213(d)(1)(A) or (B)) attributable to emotional distress.

Rev. Rul. 96-65 provides that the entire amount received for emotional distress prior to the 1996 amendment to I.R.C. § 104(a)(2) is still excludable because they "are received „on account of personal injuries o[r] sickness."

Pursuant to the authority contained in IRC § 7805(b), Rev. Rul. 96-65 does not apply adversely to damages received under any provision of law providing tort or tort-type remedies for employment discrimination for race, color, religion, gender, national origin, or other similar classifications, if the damages are received (1) on or before June 14, 1995, the date that *Schleier* was decided by the Supreme Court, or (2) pursuant to a written binding agreement, court decree, or mediation award in effect on (or issued on or before) June 14, 1995.

Rev. Rul. 96-65 also contains information concerning its effect on other rulings and references to treatment of amounts as wages and compensation. Rev. Rul. 96-65 should be consulted for guidance in certain employment discrimination cases. The provisions of Rev. Rul. 96-65 apply to proceeds received for employment discrimination that is also prohibited by certain state and local laws. Rev. Rul. 93-88, although made obsolete by Rev. Rul. 96-65, contains a good explanation of various discrimination statutes.

Libel (Defamation of Character)

Libel (defamation of character) can result in awards resulting from damages to one"s reputation. Because damage to reputation, be it personal or business, is a non-physical injury, only compensation for out of pocket costs to treat emotional distress can be excluded if not previously deducted (IRC §§ 111 and 213). Any other compensatory and punitive damages arising from these cases are taxable. *See Lindsey v. Commissioner,* T.C. Memo 2004-113, *aff'd,* 422 F.3d 684 (8th Cir. 2005).

Other Non-Physical Personal Injury

Lawsuits against insurance companies, finance companies, etc., for negligence, fraud, breach of contract, etc., can include a variety of claims, and therefore can produce a variety of types of awards/settlements.

Subsequent to August 20, 1996, because these are nonphysical injuries, under IRC § 104(a)(2), only compensation for out-of-pocket amounts for medical costs incurred to treat any emotional distress claims would be excludable from income if not previously deducted (IRC §§ 111 and 213). All punitive damages received pursuant to these types of claims are taxable.

Chapter 3 Other Related Topics

Payroll and Self-Employment Tax Considerations

Questions may arise concerning pursuit of employment taxes on cases involving employment-related issues, and self-employment taxes on cases involving payments to self-employed persons related to their trade or business.

The employment taxes that may apply include the taxes imposed under the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages (income tax withholding). If the taxpayer is a railroad employer, the Railroad Retirement Tax Act (RRTA) may apply. FICA taxes, FUTA taxes, and income tax withholding are imposed on "wages" as defined in the Internal Revenue Code. "Wages" is broadly defined as "all remuneration for employment," with certain specific exceptions, for FICA and FUTA purposes (IRC §§ 3121(a) and 3306(b), respectively) and "all remuneration . . . for services performed by an employee for his employer," again with specific exceptions, for income tax withholding purposes (IRC § 3401(a)).

In determining the status of settlement payments, keep in mind the broad definitions of "wages." *See Social Security Board v. Nierotko,* 327 U.S. 358 (1946); *see also Hemelt v. United States,* 122 F.3d 204, 209-11 (4th Cir. 1997).

Be aware that the label placed on settlement payments by the plaintiff and the defendant does not necessarily control the employment tax treatment of such payments. *See* Treas. Reg. §§ 31.3121(a)-1(c), 31.3306(b)-1(c), and 31.3401(a)-1(a)(2) (the name by which remuneration for employment is designated is "immaterial"). Because both parties generally benefit by classifying payments as non-wage payments, the specific portion of a settlement agreement allocating payments to non-wage payments is generally not based on an arm"s length negotiation between adverse parties.

An allocation of the settlement that is reasonable and based on the facts and circumstances of the case should generally be accepted by the Service. A statement by the employer that the settlement payment was made merely to settle the case is of little value in determining whether the payment is wages for employment tax purposes. Generally, if no specific allocation of the settlement is made, the status of the payments would be determined by looking at the claims asserted by the plaintiff and the surrounding facts and circumstances, including the basis upon which the settlement proceeds were distributed. There has been a considerable amount of litigation in connection with the employment taxation of settlement payments; therefore, before relying on any particular case, care should be taken to verify that the case accurately reflects the Service"s position.

There is general agreement that to the extent damages are excludable from gross income, they are not subject to employment taxes. Also, there is general agreement among courts that to the extent a settlement payment made by an employer or former employer represents back pay for services by an employee for the employer, such payments are wages for employment tax purposes. Rev. Rul. 96-65.

Back pay paid to an employee or former employee by an employer in a settlement related to a claim under a workers" right statute or civil rights statute for a period during which no services were performed by the employee is also wages for federal employment tax purposes. Typically, back pay is awarded if an employee is illegally terminated by an employer, and, under those circumstances, the back pay relates to a period when no services for the employer were performed by the employee because of the illegal termination. The position that back pay is wages even though it is attributable to a period during which actual services were not performed is based on the Supreme Court"s holding in *Social Security Board v. Nierotko,* 327 U.S. 358 (1946), in which back pay awarded to an illegally terminated employee under the Fair Labor Standards Act (FLSA) was held to be wages for social security benefit purposes.

Nierotko has been applied in determining that wages for federal employment tax purposes includes back pay paid under a number of different workers" rights and civil rights statutes (for example, the Back Pay Act, the Age Discrimination in Employment Act (ADEA), and Title VII of the Civil Rights Act of 1964, and various state and local discrimination statutes). *See Tanaka v. Department of Navy,* 788 F.2d 1552, 1553 (Fed. Cir. 1986); *see also Blim v. Western Electric Co.,* 731 F.2d 1473, 1480 n. 2 (10th Cir. 1980); *but see Churchill v. Star Enterprises,* 3 F. Supp. 2d 622, 624-25 (E.D. Pa. 1998). The Court in *Churchill* held that an employer could not withhold FICA or income taxes from damages awarded for a violation of the Family and Medical Leave Act of 1993, 29 U.S.C.A. section 2601 *et seq. ("FMLA")*, because the employee was not performing services for the employer during the period for which the damages were awarded. *Churchill,* 3 F. Supp. at 624. The Court also stated that even if the wages were subject to withholding, the jury verdict did not distinguish between "an amount equal to any denied or lost wages" and "an amount equal to any denied or lost employment benefits," both of which are available damages under the FMLA. *Id.* Accordingly, the court could not determine if withholding was required.

Service"s position is that "front pay", which is pay awarded to the employee for future services (that is, generally service from the date of the settlement going forward) the employee would have performed but for the illegal actions of the employer, is also wages for federal employment tax purposes. Some courts have disagreed with this position. However, *Nierotko* supports the Service"s position. In addition, Service"s position is that settlements including cash payments made to employees by employers in lieu of providing benefits under employer plans (for example, paid in lieu of health insurance or qualified pension plan benefits) are also wages for federal employment tax purposes, because no exception from wages applies.

Back pay and front pay are wages subject to employment taxes in the year paid, and are subject to the tax rates and FICA and FUTA wage bases in effect in the year paid. *U.S. v. Cleveland Indians Baseball, Co* 532 U.S. 200 (2001).

There has been much litigation in the area of the employment tax status of settlement agreements, and the Service"s position has not been followed in many cases. For example, the issue of whether certain payments in settlement of a suit for violation of Employee Retirement Income Security Act (ERISA) are subject to income and FICA taxes has been litigated in four circuits. These cases related to a class action brought by former employees of an employer who engaged in a scheme of terminating employees before they qualified for certain pension benefits. Two circuits agreed with the Government"s position that the full amounts of the settlements were includible in income and subject to FICA taxes. *See Hemelt v. United States,* 122 F.3d 204 (4th Cir. 1997); *see also Mayberry v. United States,* 151 F.3d 855 (8th Cir. 1998). However, in *Dotson v. United States,* 87 F.3d 682 (5th Cir. 1996), the Fifth Circuit Court of Appeals held that only the back pay portion of the settlement was wages for FICA tax purposes. In *Gerbec v. United States,* 164 F.3d 1015 (6th Cir. 1999), the Court of Appeals for the Sixth Circuit held that only the portions of the settlement representing back pay and the front pay not attributable to personal injury were subject to FICA taxes. In looking at these four cases, be aware that the income tax result does not reflect the 1996 amendment to IRC § 104(a)(2) and that the income and FICA tax results in the cases the Government lost do not reflect *Mertens v. HewittAssociates,* 508 U.S. 248 (1993), a Supreme Court case which provides that tort damages are not available for ERISA violations.

In addition, the Service"s position is that back wages and front pay paid to individuals who are not hired as employees because of violation of workers" rights or civil rights statutes are wages for federal employment tax purposes. *See* Rev. Rul. 78-176 , which bases its holding on *Nierotko*. However, the position of this revenue ruling was rejected in *Newhouse v. McCormick & Co.,* 157 F.3d 582 (8th Cir. 1998).

As a general rule, dismissal pay, severance pay, or other payments for involuntary termination of employment are wages for federal employment tax purposes. *See* Rev. Rul. 90-72; Rev. Rul. 73-166; *see also Abrahamsen v. United States,* 44 Fed. Cl. 260 (1999), *aff'd*, 228 F.3d 1360 (Fed. Cir. 2000). In *Abrahamsen*, approximately 2,600 former employees of IBM sought refunds of income and FICA taxes on the basis that payments received under certain resource reduction programs were excludable from gross income as personal injury damages under the pre-1996 law and consequently were not wages. Noting that none of the plaintiffs instituted a claim against IBM before executing releases and receiving the payments, the court doubted that they satisfied

Schleier's first test for exclusion. Even if they did satisfy that test, the court concluded that the plaintiffs failed to satisfy the second test that the payments were received "on account of personal injuries." On the FICA issue, the court reasoned that because the payments were linked to salary and length of tenure, the payments were consistent with the notion of wages. In *CSX v. U.S.,* 518 F.3d 1328 (Fed. Cir. 2008), various types of severance pay arrangements were all ruled wages for federal employment tax purposes.

There are a number of exceptions to wages that may apply in settlement cases. For example, legally designated interest and attorney fees may be excepted from wages. Rev. Rul. 80-364.

"Liquidated damages" awarded under a Fair Labor Standards Act of 1938 (FLSA) settlement are not wages for federal employment tax purposes. Rev. Rul. 72-268. Under the FLSA, workers are entitled to such liquidated damages absent an employer‟s showing of a good faith defense "Liquidated damages" under the ADEA are similar but payable only in cases of willful violations. Generally, bona fide damages in settlement of tort claims for personal physical injury that were excludable from gross income under IRC § 104(a)(2) do not constitute wages for federal employment tax purposes.

In the case of a lawsuit settlement paid by an employer to an employee or former employee, caution should be exercised in determining the existence of any employment tax issues.

In contrast to the broad definition of wages for federal employment tax purposes set forth in *Nierotko* and other cases, many more recent cases have adopted narrow interpretations of what constitutes "self-employment income" for self-employment tax purposes. *See* IRC § 1402 (a) and (b). Under the test adopted by many courts, to be included in self-employment income for self-employment tax purposes, "any income must arise from some actual (whether present, past, or future) income-producing activity of the taxpayer." *Newberry v. Commissioner,* 76 T.C. 441 (1981)(business interruption insurance payments paid to a self-employed individual during the period his store was shut down because of a fire were held not to be self-employment income); *see also Jackson v. Commissioner,* 108 T.C. 130 (1997)(certain termination payments made to a retiring insurance agent were held not to be includible in self-employment income); *but see* Rev. Rul. 91-19(Service sets forth a slightly different test for inclusion in self-employment income).

Thus, before classifying settlement payments as subject to self-employment tax, care should be taken in determining that the payments can be attributed to the carrying on of a trade or business by the self-employed person.

Amount to be Included in Gross Income

In all cases, including those involving contingent fee arrangements, the gross award/settlement, without diminution for attorneys‟ fees or costs, should be included in the taxpayer's income. This treatment is in accord with IRC § 61 and the long established principle, "the fruit of the tree" theory, that income is taxable to the person who earns it and it cannot be assigned to someone else.

Taxing the gross amount from lawsuit proceeds has been often litigated and has historically been upheld in Tax Court, as well as various circuit jurisdictions. The issue was finally settled in *Commissioner v. Banks,* 543 U.S. 426 (2005). In this consolidated Supreme Court case, the Court held that attorney fees, including those paid directly to the litigant‟s attorney on a contingent fee basis, are fully includible in the gross income of the litigant. *Banks,* 543 U.S. at 430.

Prior to *Banks,* some courts, including those from Alabama, Michigan, and Texas, deferred to state law in determining whether attorney fees were includible in the litigant‟s gross income. *See Cotnam v. Commissioner,* 28 T.C. 947 (1957), a*ff'd in part, rev'd in part,* 263 F.2d 119 (5th Cir. 1959) (attorneys‟ fees paid directly to the attorney from the judgment under a contingency fee arrangement were not includible in the taxpayer‟s gross income because under Alabama law, attorneys had the same rights as their clients and that taxpayers could never have received the portion paid as attorneys‟ fees). *Banks*, however, resolved this issue by stating, "the attorney is an agent who is duty bound to act only in the interests of the principal, and so it is appropriate to treat the full amount of the recovery as income to the principal. . . . This rule applies whether or not the attorney-client contract or state law confers any special rights or protections on the attorney, so long as these protections do not alter the fundamental principal-agent character of the relationship." *Banks,* 543 U.S. at 436-37.

Deduction for Attorneys' Fees

Generally, individuals, as cash basis taxpayers, may deduct attorneys‟ fees in the year they are paid, assuming the attorneys‟ fees otherwise qualify as deductible. In the majority of such cases, the attorneys‟ fees are paid pursuant to a contingent fee arrangement once damages have been recovered. Where the ultimate recovery is excludable from gross income, either in whole or in part, the payment of contingent attorneys‟ fees allocable to exempt income are not deductible. IRC § 265(a)(1). The question of the timing and deductibility of attorneys‟ fees paid prior to resolution of the lawsuit on a noncontingent fee basis requires additional analysis that is not practical to provide in this guide. Examiners should consult with the appropriate Technical Advisor.

Numerous sections of the Code govern the deduction of attorney‟s fees. The most relevant of which are IRC sections 62(a)(relating to the definition of adjusted gross income), 162 (relating to trade or business expenses), 212 (relating to expenses for production of income), 262 (relating to the non-deductibility of personal, living, and family expenses), and 263 (relating to capital expenditures). Generally, one must look to the underlying lawsuit to determine which Code section applies. Except in rare cases, such as a compensatory recovery of self-employment income (for example, commissions that are reported on Schedule C) or recovery of capital gain income, legal fees will be a Schedule A miscellaneous itemized deduction, subject to the 2 percent floor and AMT. (This, of course, assumes that the lawsuit proceeds have been taxed at gross in the taxpayer‟s income.) Nevertheless, the Tax Court has ruled adversely to the Commissioner that a self-employed individual could deduct legal fees allocable to the recovery of punitive damages on Schedule C, rather than as a miscellaneous itemized deduction on Schedule A. *Guill v Commissioner,* 112 T.C. 325 (1999) (court held that the punitive damages recovered by the taxpayer were Schedule C income).

Review *Church v. Commissioner,* 80 T.C. 1104, 1110 (1983)(fees allocated to exempt income not deductible), a pre 1996 Amendment case, for an illustration of the need to allocate attorney fees to the various components of the award to determine their deductibility. *See also Alexander v. Commissioner,* T.C. Memo. 1995-51, *aff'd,* 72 F.3d 938 (1st Cir. 1995); IRC § 212.

Discrimination, Whistleblower, and Certain Other Suits - Above the Line Deduction for Attorney Fees

The American Jobs Creation Act of 2004 enacted IRC § 62(a)(20), thereby establishing an above-the-line deduction for attorney fees and court costs paid in connection with discrimination and certain other suits. In December 2006, the Tax Relief and Health Care Act of 2006 was enacted creating IRC § 62(a)(21), an above the line-deduction for attorney fees and court costs associated with suits involving whistleblower claims.

In order for IRC § 62(a)(20) to apply, attorney fees and court costs must have been paid after October 22, 2004, with respect to a judgment or settlement occurring after such date. Additionally, the suit must involve -

- Unlawful discrimination,
- Certain claims against the federal government, or
- A private cause of action under Medicare Secondary Payer statute

In order for IRC § 62(a)(21) to apply, the attorney fees or court costs must have been paid in connection with a whistleblower award for providing information regarding violations of tax laws as outlined in IRC § 7623(b), and the information must have been provided on or after December 20, 2006.

The deductions allowed under IRC §§ 62(a)(20) and 62(a)(21) are limited to the amount includible in the litigant‟s gross income for the taxable year in which the deduction is being claimed.

Legal Fees Relating to Non-Taxable Awards or Settlements

No legal fee deduction will be allowed for legal fees allocable to non-taxable awards or settlements. IRC § 265(a). Absent strong support to the contrary, legal fees relating to an award or settlement that is partially taxable will be allocated based on the ratio between the taxable award/settlement and the total award/settlement. *See Johnson-Waters v. Commissioner,* T.C. Memo. 1993-333; *Church v. Commissioner,* 80 T.C. 1104, 1110 (1983).

Accrued Interest on Court Judgments

Any interest associated with an award or settlement is always taxable. *Aames v. Commissioner,* 94 T.C. 189 (1990); *Kovacs v. Commissioner,* 100 T.C. 124, *aff'd,* 25 F.3d 1048, *cert. denied,* 513 U.S. 963 (1993); *Brabson v. United States,* 73 F.3d 1040 (10th Cir. 1996). Some states have enacted statutes requiring defendants to pay judgment interest in tort actions. Where the parties settle an appeal of a verdict, the Service has been successful in convincing the courts that a portion of the proceeds should be allocated to such interest. *Delaney v. Commissioner,* 99 F.3d 20 (1st Cir. 1996), *aff'g* T.C. Memo.1995-378.

Chapter 4 Examination Considerations

You may have discovered a lawsuit award or settlement while performing a bank deposit analysis, in your Accurint report, through the 1099 MISC, as a related return pick up from the examination of an attorney or in the interview. Based on the facts and circumstances as well as how the award/settlement was reflected on the return, you may have an issue.

The August 1996 change in IRC § 104(a)(2) clarified that the underlying claim had to be due to a personal physical injury or sickness to be exempt from income taxation, that punitive damages are never tax exempt even if from a physical injury, and that emotional distress is not tax exempt unless the underlying claim was due to personal physical injury with the exception of medical expenses paid to treat said emotional distress and not previously deducted. As a result, you would only need to evaluate this issue in cases in which any of the award or settlement was not fully reported as taxable at gross with attorneys‟ fee deducted in the appropriate place as discussed in Chapter 3. Refer to Chapter 2 for detailed discussions on taxability of lawsuit award or settlements based on the underlying claim and its respective components.

Where there is an issue, the most important step is the development of the facts. You should include in the case file all the documents requested that were needed to determine the issue and your position. If the case goes to Counsel, these documents are vital to the outcome. In addition, because of the provision of IRC § 7491 concerning the potential for shifting the burden of proof to the government when taxpayers reasonably cooperate with the IRS, examiners should carefully document the level of cooperation taxpayers demonstrated during the audit process.

Interview

An interview with the taxpayer can provide information regarding the case to assist you in making a determination of the depth of your probe of the issue. Questions may include, but are not limited to, the following:

- What was the nature (reason) of the underlying claim? Please described what happened that initiated the claim? (ie. Car accident, work discrimination, fraud incident, etc.)
- Who was the plaintiff? Who did you file the claim against?
- Did you file in court? Which court?
- Did you settle out of court or did the court issue an award?
- What was the amount of the award or settlement?
- Did your attorney provide you with information on how to report the award or settlement and/or how all the funds were disbursed? (Request it)
- Did you report the total amount of the award or settlement as taxable income and deduct the attorney fees separately on Schedule A (if deducted elsewhere, you will need to determine if that was proper (reference attorney fees issue in Chapter 3 for details)
- Did you receive a 1099 MISC?

- Did you receive medical costs as part of the award? Did you previously deduct as a medical expense on Schedule A any of the costs you received payment for? What was the total amount of the medical costs awarded and the amount of those costs you previously deducted?
- Did you receive any advance payments from the attorney for medical, living, court or any other expenses?

In Cases where the underlying claim was personal physical injury that settled out of Court ask:

- Was there any punitive damages requested in the original claim?
- Why did you settle out of court? Did you and your attorney discuss punitive damages with respect to the out of court settlement?
- Why did the party you filed a claim against, decide to settle out of court?
- Did you participate in any of the meetings which resulted in the settlement? Can you summarize the nature of the discussions?

Information Document Request

In cases where you do not have information to evaluate if the lawsuit proceeds were properly reflected on the tax return, you will need to issue an Information Document Request to the taxpayer requesting all or some of the following information, in relation to the lawsuit settlement or award, based on the facts and circumstances of your case:

- A copy of the original petition, complaint or claim filed showing grounds for the lawsuit.
- A copy of the lawsuit settlement agreement, which clearly characterizes the payments.
- Copies of the settlement checks that you received. If copies of checks are not available, present a schedule of payments received. The information should include the payor information.
- Documentation of the amount of legal fees you paid, including any written fee agreements with your attorney.
- Copy of the disbursement schedule or a clear statement of how the funds were disbursed.
- Documentation of letters or statements that your attorney provided to you that indicated that the lawsuit settlement proceeds you received were not taxable, if applicable.

Need for Third Party Letter or Summons

Third Party Contact Procedures detailed in IRM 4.11.57 need to be followed, including but not limited to a notice to the taxpayer be provided before a third party letter can be issued.

If not available directly from the taxpayer, examiners should initially attempt to secure needed information from the defendant companies (mainly insurance companies) by orally requesting the companies provide them with the information voluntarily. If a company declines to produce the information in response to an oral request, examiners should attempt to obtain the information using a third party request. Either the third party letter or a summons can be used to request information with respect to a specific taxpayer.

In a situation where a third party letter is issued to an insurance company, ask the insurance company‟s attorney to review the third party letter. Discuss the third party request, pointing out the letter is issued under the same Code section that authorizes issuance of a summons (IRC § 7602).

The Service is not responsible for any costs incurred in responding to a third party letter. Ask the insurance company's attorney to review the confidentiality clause in the settlement agreement, if applicable. If there is a confidentiality clause, it often does not restrict the release of the facts of the case to the Service. Even where it does restrict release of the facts, the Service may legally be entitled to that information per IRC § 7602 which authorizes the Service to obtain any information that may be relevant to the determination and collection of a tax liability.

The company may respond to the third party letter; however, some companies will require you to issue a summons.

Each decision to issue a summons should carefully weigh and evaluate what specific information or records need to be acquired. IRM 25.5.1.4, *Factors to Consider Before Issuing a Summons,* provides guidance examiners may use to help with weighing facts and circumstances.

Summons Procedures are found in the Summons Handbook in IRM 25.5 that includes how to prepare a Summons at IRM 25.5.2. The manager must approve the issuance of a summons.

Attorney - Client Privilege

It is standard practice for the insurance company (payor) to disburse the gross amount of the settlement to the plaintiff's attorney, who then disburses the money to his or her client. A third party letter can be issued to the plaintiff's attorney in an effort to obtain the names and amounts involved in the settlement payment. Often, the attorney will refuse to respond to the third party letter. If so, it is not recommended that a summons be issued to the plaintiff's attorney for disbursement information relevant to the settlement due to the potential for protracted litigation over claims of attorney-client privilege, which some attorneys may give as the reason for denying the requests for information. Although attorney-client privilege is a valid basis for not providing some requested information, fee arrangements usually fall outside the scope of the privilege. Such information ordinarily reveals no confidential professional communication between attorney and client. Determining whether this is true in a specific case requires coordination with the appropriate Office of Chief Counsel. A detailed discussion of attorney client privilege can be found in the Attorney Audit Technique Guide.

Due to the possibility of time-consuming litigation, it is recommended that all other means first be exhausted in securing the disbursement information. Contact the (taxpayer) to determine the amount paid by the insurance company and then disbursed through the attorney.

Determining the Allocation Between Punitive and Compensatory Damages in Personal Physical Injury Cases

The next critical step in the examination is to determine the allocation of lawsuit proceeds between punitive and compensatory damages. If the proceeds were received as a result of a litigated case, the amount of punitive and compensatory damages is usually made clear in the court documents, and there may be no further work to be done in making the allocation. However, it is more difficult to make that determination for cases settled out of court. The settlement agreement does not usually make a distinction between the punitive and compensatory damages awarded. These settlement agreements are usually silent as to the types of damages awarded, or they state that all of the damages awarded are "compensatory." Therefore, it is essential that all the facts surrounding the lawsuit be determined and documented. The allocation between compensatory and punitive damages must be made based on the facts of each case. In making this determination, the following items should be considered:

1. The intent of the payor in making the payment to the plaintiff. Why did the payor settle? For what was the payor paying?
2. The nature of the claim underlying the plaintiff‟s award. What was the reason for the suit?
3. The negotiations between the plaintiff and defendant. Review the case file. Was there a meeting of the minds by the parties?
4. The actual amount of money it would take to make the plaintiff whole. Did the plaintiff make insurance premium payments or was the plaintiff to receive a certain amount of insurance proceeds? The settlement amount that the plaintiff receives to reimburse him or her for these types of costs are usually compensatory.
5. If the plaintiff claims to have suffered from mental pain and anguish, determine if the plaintiff received medical treatment for the mental pain and anguish. If so, does he or she have verification of the amount spent for this treatment? Can he or she show that the treatment is directly related to the lawsuit case? In other words, the plaintiff must show that he or she was being made "whole" from the total amount of the settlement received in order for the whole amount of the settlement to be non-taxable. The taxpayer bears the burden at the audit stage of showing that the damages received are excludable from gross income under IRC § 104(a)(2), although that burden may shift to the government if the issue reaches litigation and the taxpayer satisfies the requirements of IRC § 7491.

Advances to Taxpayer

Determine if the taxpayer received any client advances from the attorney. If the taxpayer received advances from the attorney, ensure that the settlement proceeds were not reduced by these advances. Also, determine if the advances were erroneously characterized as legal fees that would provide the taxpayer with a deduction for personal expenses.

How to Report Taxable Amount and Attorney Fees

A detail discussion of the deductibility of attorney fees for various types of cases can be found in Chapter 3. The following is a discussion of how to allocate attorney fees and costs in cases in which some part of the award is non-taxable.

In cases involving personal physical injury or sickness, once a determination is made regarding the allocation of the punitive and compensatory damages, the punitive portion of the damages is considered taxable. As discussed in Chapter 3, in accordance with the Supreme Court Case *Commissioner v. Banks,* 543 U.S. 426 (2005), the Court held that attorney fees, including those paid directly to the litigant"s attorney on a contingent fee basis, are fully includible in the gross income of the litigant. In other words, the taxpayer cannot simply report the "net" punitive proceeds received.

The taxpayer must include in income the gross amount of the award deemed to be taxable. A deduction is allowed for the legal fees and court costs that are related to the taxable portion of the proceeds. Generally, legal fees and court costs are allowed as a miscellaneous itemized deduction subject to the 2-percent AGI limitation on Schedule A. See discussion in Chapter 3 for exceptions. The deductible fees and costs are determined by using the ratio of taxable proceeds to total proceeds and multiplying the total fees and costs by this ratio. The following is an example.

Total lawsuit proceeds received $100,000

Taxable lawsuit proceeds (80% taxable) is $80,000

Legal fees and court costs are $52,000

COMPUTATION OF DEDUCTIBLE FEES AND COSTS:

Total fees and costs $ 52,000

Times Taxable Ratio (80,000/100,000 or .80)

Equals Deductible fees and costs of $41,600

The deductible fees and costs are subject to 2% AGI limit as a miscellaneous itemized deduction.

NOTE: When allowing this as a deduction, consideration should also be given to any other itemized deductions to which the taxpayer may be entitled but did not deduct on the original return because their itemized deductions were less than the standard deduction amount.

Alternative Minimum Tax, AMT, Considerations

AMT must be considered because of the allowance of the miscellaneous itemized deduction. AMT usually becomes due when there is a large amount of miscellaneous itemized deductions.

Miscellaneous itemized deductions subject to the 2-percent AGI limitation are a tax preference item for alternative minimum tax purposes.

Additional Adjustments if Adjusting Reportable Income

The following issues should also be considered when making adjustments to income due to the lawsuit proceeds:

a. Earned Income Credit - If the taxpayer claimed the Earned Income Credit on the original filed return, then it may have to be recaptured as a result of the increase in income from the lawsuit.
b. Social Security Income - If the taxpayer received any type of Social Security income, the taxable portion of this income may be increased due to the increase in income from the lawsuit.
c. Exemption - The personal and dependent exemptions taken by the taxpayer may be limited or phased out due to the increase in income from the lawsuit.
d. Itemized Deductions - Itemized deductions taken by the taxpayer may be limited or phased out due to the increase in income from the lawsuit settlement.
e. Rental Real Estate Losses - Rental Real Estate Losses could be limited due to the increase in modified AGI. If the modified AGI exceeds the threshold, then passive losses will be limited.

Chapter 5 Penalties

Examiners are responsible for considering the application of penalties in all cases under examination. Many lawsuit settlement cases involve taxpayers who normally do not have to file returns except for the settlement proceeds received. However, returns are still not filed in some situations because the taxpayers and their representatives concluded the proceeds are not taxable. For returns that are not filed, the following penalties should be considered:

- Failure to file penalty (IRC § 6651(a)(1))
- Failure to pay penalty (IRC § 6651(a)(2))
- Estimated tax penalty (For Individuals: IRC § 6654)
- Fraudulent failure to file (IRC § 6651(f))

The accuracy-related penalty applies only where a return is filed and is not applicable to substitutes for returns filed under authority of IRC § 6020(b).

There is no reasonable cause exception to the IRC § 6654 penalty for underpayment of estimated tax by an individual. The penalties apply unless the taxpayer meets certain specified statutory exceptions. However, in the case of an individual, IRC § 6654(e)(3) provides that the Service may waive the penalty if the Service determines it would be inequitable, due to casualty, disaster, or other unusual circumstances. The Service may waive the penalty if the taxpayer has retired or became disabled during the taxable year. In addition, if it is determined that the underpayment was due to reasonable cause and not willful neglect the penalty may also be waived.

The failure to pay penalty applies to original and amended returns filed by the taxpayer. The Service may impose the failure to pay penalties where the taxpayer fails to file a return and a substitute return is prepared by the Service under IRC § 6020(b).

Lawsuit settlement cases usually result in significant adjustments to income. As in other cases where there are large amounts of unreported income, the accuracy-related penalty and fraud penalties must be considered. Factors to consider in determining whether penalties are warranted include:

1. Did the lawsuit settlement recipient adequately disclose all pertinent facts of his or her case to his or her attorney?
2. What advice, if any, did his or her attorney provide regarding the taxability of the settlement amount?
3. Should the taxpayer have questioned the advice of his or her attorney regarding the taxability of the payment?

All the facts and circumstances in each case should be considered before making a determination regarding penalties. If the taxpayer received interest income from the settlement and did not report it, more consideration should be given to assessing the accuracy-related penalty on the interest income issue.

If penalties are recommended, the examiner‟s workpapers should contain comments regarding the examiner‟s reasons for asserting penalties. If reasonable cause was available and considered, the examiner‟s workpapers should explain why it was or was not established.

Chapter 6 Form 1099-MISC - Reporting Requirements

IRC §§ 6041(a) and 6045(f), with regard to payments to attorneys, generally requires all persons engaged in a trade or business and making payment in the course of such trade or business to another person of fixed or determinable gains, profits, and income of $600 or more in a calendar year to file an information return with the Service. IRC § 6041(d) provides that each person required to make the return described in IRC § 6041(a) shall furnish to each person for whom a return is required a payee statement.

Treas. Reg. § 1.6041-1(c) states that income is fixed when it is paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The payor is required to determine whether payments are taxable and need to be reported. The Instructions for Forms 1099, 1098, 5498 and W-2G provides instructions on the items to be reported.

In lawsuit settlements, the person with the obligation to report payments to the plaintiff will generally be the defendant or its insurer rather than the plaintiff‟s attorney. In addition, the defendant or its insurer will also generally be responsible for reporting payments to the plaintiff‟s attorney.

Reporting of Damage Awards on Forms 1099-MISC

IRC §§ 6041 and 6051 and Treasury Regulations 1.6041-1(f) and 1.6041-2 are the operative provisions with respect to the reporting requirements for the client receiving the settlement or award.

Box 3 of Form 1099-MISC is used to report other income that is not reportable in one of the other boxes on the form. Generally, all punitive damages (even if they relate to physical injury or physical sickness), any damages for *non-physical* injuries or sickness, liquidated damages received under the Age Discrimination in Employment Act of 1967, and any other taxable damages are required to be reported in Box 3. Generally, all compensatory damages for non-physical injuries or sickness (for example, emotional distress) arising from employment discrimination or defamation are reportable in Box 3. However, if a taxpayer receives an award of back pay that constitutes wages, it generally would be reportable on Form W-2, not Form 1099-MISC.

The following damages (other than punitive damages) are not reportable in Box 3 of Form 1099-MISC:

1. Damages received on account of personal physical injuries or physical sickness;
2. Damages that do not exceed the amount paid for medical care for emotional distress; or
3. Damages received on account of non-physical injuries (for example, emotional distress) under a written binding agreement, court decree, or mediation award in effect on or issued by September 13, 1995.

Damages received on account of emotional distress due to non-physical injury or sickness, including physical symptoms such as insomnia, headaches, and stomach disorders, are reportable unless described in 2 or 3 above. However, damages received on account of emotional distress due to physical injuries or physical sickness are not reportable.

The amount of damages reflected on the Form 1099-MISC is not reduced by attorney"s fees. For example, a defendant settles a plaintiff"s claim for emotional distress from non-physical injuries by writing a $100,000 check naming the plaintiff and her attorney as joint payees. The attorney retains $40,000 in fees for services rendered and remits the remaining $60,000 to the plaintiff. The amount of damages reportable with respect to the plaintiff on Form 1099-MISC is $100,000.

Reporting Payments to Attorneys on Form 1099-MISC

IRC §§ 6041(a), 6051, and 6045(f) and their respective Treasury Regulations are the operative sections that provide instructions with regard to information reporting of payments to attorneys. Generally, in the context of lawsuits, awards, and settlements, payments of $600 or more that are paid by a defendant to an attorney must be reported to the Service.

In most situations, a defendant, or a defendant"s insurance company, will report the full amount of the payment to the attorney in Box 14 of the Form 1099-MISC. This indicates to the Service that the amount represents gross proceeds, and not necessarily taxable income, to the attorney.

However, there may be some circumstances where a defendant will be required to report the payments to the attorney in Box 7, to indicate to the Service that the payment represents income to the attorney. See *Johnson v. LPL Financial Services*, 517 F.Supp.2d. 1231, 1233 fn. 3 (S.D. Cal. 2007); see also Treas. Reg. § 1.6041-1(e).

The reporting requirement for payments made to an attorney apply regardless of whether the income is taxable to the plaintiff, and is in addition to the requirement to issue a Form 1099-MISC to the plaintiff for the full taxable amount of the settlement, as discussed above.

For example, an insurance company pays a plaintiff‟s attorney $100,000 to settle a plaintiff‟s claims for damages that are excludable from income of the plaintiff under IRC § 104(a)(2). The insurance company must report $100,000 in Box 14 of Form 1099-MISC to be issued to the plaintiff‟s attorney. No Form 1099-MISC is required for the plaintiff since the settlement is nontaxable.

These rules do not apply to profits distributed by a partnership to its partners that are reportable on Schedule K-1 (Form 1065), Partner‟s Share of Income, Credits, Deductions, etc., or to wages paid to attorneys that are reportable on Form W-2, Wage and Tax Statement.

The term "attorney" includes a law firm or other provider of legal services. Further, the exemption from reporting payments made to corporations no longer applies to payments for legal services. Therefore, attorney fees reported in Box 7 or gross proceeds reported in Box 14, as described above, paid to corporations providing legal services are reportable.

Treasury Regulation 1.6045-5 provides examples of the reporting requirements in various situations involving the payment of lawsuit and settlement amounts. The regulation also outlines the defendant‟s, as well as the attorney‟s, obligations in situations where other firms or referral attorneys are involved.

As follows are relevant examples from Treasury Regulation § 1.6045-5:

Example 1. One check--joint payees--taxable to claimant. Employee C, who sues employer P for back wages, is represented by attorney A. P settles the suit for $300,000. The $300,000 represents taxable wages to C under existing legal principles. P writes a settlement check payable jointly to C and A in the amount of $200,000, net of income and FICA tax withholding with respect to C. P delivers the check to A. A retains $100,000 of the payment as compensation for legal services and disburses the remaining $100,000 to C. P must file an information return with respect to A for $200,000 under paragraph (a)(1) of this section. P also must file an information return with respect to C under sections 6041 and 6051, in the amount of $300,000. See §§ 1.6041-1(f) and 1.6041-2.

Example 2. One check--joint payees--excludable to claimant. C, who sues corporation P for damages on account of personal physical injuries, is represented by attorney A. P settles the suit for a $300,000 damage payment that is excludable from C's gross income under section 104(a)(2). P writes a $300,000 settlement check payable jointly to C and A and delivers the check to A. A retains $120,000 of the payment as compensation for legal services and remits the remaining $180,000 to C. P must file an information return with respect to A for $300,000 under paragraph (a)(1) of this section. P does not file an information return with respect to tax-free damages paid to C.

Example 3. Separate checks--taxable to claimant. C, an individual plaintiff in a suit for lost profits against corporation P, is represented by attorney A. P settles the suit for $300,000, all of which will be includible in C's gross income. A requests P to write two checks, one payable to A in the amount of $100,000 as compensation for legal services and the other payable to C in the amount of $200,000. P writes the checks in accordance with A's instructions and delivers both checks to A. P must file an information return with respect to A for $100,000 under paragraph (a)(1) of this section. Pursuant to § 1.6041-1(a) and (f), P must file an information return with respect to C for the $300,000.

Example 4. Check made payable to claimant, but delivered to nonpayee attorney. Corporation P is a defendant in a suit for damages in which C, the plaintiff, has been represented by attorney A throughout the proceeding. P settles the suit for $300,000. Pursuant to a request by A, P writes the $300,000 settlement check payable solely to C and delivers it to A at A's office. P is not required to file an information return under paragraph (a)(1) of this section with respect to A, because there is no payment to an attorney within the meaning of paragraph (d)(4) of this section.

Example 5. Multiple attorneys listed as payees. Corporation P, a defendant, settles a lost profits suit brought by C for $300,000 by issuing a check naming C's attorneys, Y, A, and Z, as payees in that order. Y, A, and Z do not belong to the same law firm. P delivers the payment to A's office. A deposits the check proceeds into a trust account and makes payments by separate checks to Y of $30,000 and to Z of $15,000, as compensation for legal services, pursuant to authorization from C to pay these amounts. A also makes a payment by check of $155,000 to C. A retains $100,000 as compensation for legal services. P must file an information return for $300,000 with respect to A under paragraphs (a)(1) and (b)(1)(i) of this section. A, in turn, must file information returns with respect to Y of $30,000 and to Z of $15,000 under paragraphs (a)(1) and (b)(2) of this section because A is not required to file information returns under section 6041 with respect to A's payments to Y and Z because A's role in making the payments to Y and Z is merely ministerial. See § 1.6041–1(e)(1), (e)(2) and (e)(5) Example 7 for information reporting requirements with respect to A's payments to Y and Z. As described in Example 3, P must also file an information return with respect to C, pursuant to § 1.6041–1(a) and (f).

Chapter 7 Quick Cite and Brief Synopsis of Litigated Cases

Caution: The Small Business Job Protection Act of 1996 revised IRC § 104(a)(2). Prior to the 1996 amendment, § 104(a)(2) did not include the word “physical” with regard to “personal injuries or sickness.” As a result, many taxpayers were allowed to exclude income received prior to the amendment‟s August 21, 1996 effective date on account of non-physical injuries and sickness. When reviewing litigation on this issue, examiners should consider the date in which the settlement was received before relying on specific case law for their position.

Wrongful Death

Burford v. United States, 642 F. Supp. 635 (N.D. Ala. 1986).

The district court rejected Rev. Rul. 84-108 and concluded that Alabama wrongful death proceeds are excludable from gross income.

O'Gilvie v. United States, 519 U.S. 79 (1996).

The Supreme Court ruled that all non-compensatory punitive damages are taxable. This case also includes an in-depth discussion of the language, "on account of" as included in IRC § 104(a)(2).

Benavides v. United States, 497 F.3d 526 (5th Cir. 2007).

The Fifth Circuit Court of Appeals clarified that IRC §104(c) does not exclude punitive damages from the gross income of the survivors of a deceased worker when the wrongful death laws of the state in question do not limit recovery to punitive damages, even if some other law of the state, such as its Workers' Compensation Act, might restrict wrongful death recovery to punitive damages.

Age Discrimination

Commissioner v. Schleier, 515 U.S. 323 (1995).

The Supreme Court ruled that payments received under the federal statute outlawing age discrimination are 100-percent taxable. The ADEA does not provide for recovery of tort-like compensatory damages and the proceeds were not received on account of any personal injury.

Schleier outlined the original two-part test that must be met in order to exclude damages under IRC § 104(a)(2): (1) the underlying cause of action giving rise to the recovery must be based on tort or tort-type rights; and (2) the damages must "have been received on account of personal injuries or sickness." The word "physical" was added to the *Schleier* test in *Venable v. Commissioner*, T.C. Memo. 2003-240, in compliance with the 1996 update of IRC § 104(a)(2).

Sex Discrimination

United States v. Burke, 504 U.S. 229 (1992)

The Supreme Court ruled that back pay received in settlement of claims under Title VII of the Civil Rights Act of 1964, before the 1991 amendments, were not excludable under IRC § 104(a)(2).

The *Burke* case includes a very good discussion on tort injuries, physical, non-physical, etc.

Employment-Related

The following cases are Employment related and most deal with allocation issues and questions of taxable versus excludable. Almost all are pre-1996 Amendment cases.

Lindsey v. Commissioner, T.C. Memo. 2004-113, *aff'd*, 422 F.3d 684 (8th Cir. 2005).

This case involved an employment termination agreement in which the settlement occurred shortly after the 1996 Amendment. It reflects how the courts look at the underlying action generating the claim to determine the exemption of any physical injury compensation from taxation, which in this case involved emotional distress resulting from the termination agreement dispute.

Bagley v. Commissioner, 105 T.C. 396 (1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997).

This case involved claims for tortious interference with current and future employment, libel, and invasion of privacy. The trial resulted in a jury verdict that was appealed. A settlement agreement was reached prior to the new trial. This settlement agreement allocated the entire award to compensatory. The Tax Court looked to the facts of the case, including the trial determinations and the negotiations for settlement. The Tax Court determined that a portion should be allocated to punitive, even though the payor stated in negotiations that they would not agree to pay punitive damages. The Tax Court determined that both parties considered the clear possibility of punitive damages being recovered. The Tax Court pointed out that the taxpayer"s attorney became aware of the potential taxability of punitive damages during the negotiations.

Glatthorn v. United States, 818 F. Supp.1548 (S.D. Fla. 1993).

This case involved a breach of contract claim. The plaintiff received an out-of-court settlement with no settlement document. The court allocated 50 percent of the proceeds to the breach of contract issue and 50 percent as compensatory. When making this decision, the district court relied heavily upon the following:

The taxpayer offered to settle for $45,000. The defendants did not accept his offer until after the court had refused to dismiss the tort claims. Shortly after that time, the defendants accepted the settlement. The district court said that the defendants (attorneys, themselves) would not have settled a $47,000 breach of contract case for $45,000 in the early stages of the lawsuit so the settlement had to also relate to the tort claims. The taxpayer argued that at least 9/11 of the settlement is non-taxable, as 9 of the 11 counts sounded in tort. The district court refused to apply this mathematical formula, particularly since many of the tort counts stated the same cause against different defendants.

Miller v. Commissioner, T.C. Memo. 1993-49.

This was a defamation case against a former employer. There were two separate lawsuits. One involved a jury verdict and the other suit was not tried. A settlement was reached which covered both lawsuits. The settlement agreement did not allocate the proceeds between compensatory and punitive damages.

The question presented to the Tax Court was one of allocation between compensatory and punitive. The Tax Court ruled that the verdict by the jury was the best indicator of the payor‟s intent and the best measure of how the settlement should be allocated.

Miller includes good analyses and case cites pertaining to settlement allocations. It also includes comments concerning the importance of the nature of the claim versus the validity of the claim in determining the allocation.

Mitchell v. Commissioner, **T.C. Memo. 1990-617.**

The taxpayer had prepared a settlement document stating that most of the damages were for libel and slander. The Tax Court determined that all damages related to the employment contract. The taxpayer‟s employer viewed the libel/slander suit as a "nuisance" suit and gave it no weight in determining the settlement payments.

McKim v. Commissioner, **T.C. Memo. 1980-93.**

The taxpayer sued his former employer after being terminated. His first claim was for unpaid sales commissions and other unpaid job related amounts, such as fringe benefits and unreimbursed expenses. He also brought a claim for suffering, emotional distress, and for punitive damages. The court allocated the whole settlement to taxable wages. The court looked to testimony from the taxpayer‟s employer to determine which claim it had intended to settle. The employer stated it did not believe it had any exposure to liability for any claims for personal injury damages and that these claims did not figure into the settlement amount.

In conclusion, the Tax Court stated that even if it found that the employer had intended to pay some on each of the taxpayer‟s claims, the allocation to personal injury would have been minimal. The Tax Court totaled up all the amounts requested in each count (taxpayer had assigned monetary amount to each claim) and determined that the percentage of the personal injury amount requested would only be 15 percent.

Seay v. Commissioner, **58 T.C. 32 (1972).**

This case involved a breach of contract claim. The taxpayer was allowed to exclude a portion of the payment under IRC § 104(a)(2) for personal injuries. The taxpayer had suffered personal embarrassment, mental and physical strain, and injury to health and personal reputation.

The government argued that the taxpayer had not proven that his claim for personal injuries was valid or that he had actually incurred such injuries. The court gives an in-depth explanation concerning the fact that the taxpayer does not have to prove the validity of the claim. The taxpayer only has to prove that there was a personal injury claim and that the claim was included in the settlement payment. In this case, the taxpayer was able to show that the personal injury claim had been a part of the negotiations for settlement and that the payor intended to make payment in settlement of that claim. Note that this case was determined prior to the 1996 amendments to IRC § 104(a)(2).

Knuckles v. Commissioner, 349 F.2d 610 (10th Cir. 1965)

In *Knuckles*, the Tenth Circuit affirmed the Tax Court. The taxpayer was fired from his executive position based on allegations that he mismanaged the company's affairs. The taxpayer originally sued for breach of contract with no mention of personal injuries. During settlement negotiations the taxpayer's attorney suggested the payment be allocated to personal injuries in order to minimize the tax effect. The taxpayer's employer refused to allocate any damages to personal injury and admit to any liability for personal injury. The taxpayer filed a subsequent personal injury suit 9 months later. Both suits were dismissed with the out-of-court settlement. The Service allocated all to breach of contract (taxable). Taxpayer had allocated all to personal injury (non-taxable). The Tax Court upheld the Service‟s determination and the Appeals Court affirmed. The Appellate Court stated that the most important fact is "intent of payor."

Abrahamsen v. United States, 44 Fed. Cl. 260 (1999), *aff'd,* 228 F. 3d 1369 (2000).

In this consolidated case, approximately 2,600 former employees of IBM sought refunds of income and FICA taxes on the basis that payments received under certain resource reduction programs were excludable from gross income as personal injury damages and consequently were not wages. Noting that none of the plaintiffs instituted a claim against IBM before executing releases and receiving the payments, the court doubted that they satisfied the first test for exclusion. Even if they did satisfy that test, the court concluded, the plaintiffs failed to satisfy the second test that the payments were received "on account of personal injuries."

On the FICA issue, the court reasoned that because the payments were linked to salary and length of tenure, the payments were consistent with the notion of wages.

Sanford v. Commissioner, T.C. Memo. 2008-158.

The plaintiff experienced emotional distress due to sexual harassment which she suffered through her employment. The emotional distress manifested itself in physical symptoms. However, because these physical symptoms were not the basis of the award that the taxpayer received, the award was not excludible from the plaintiff‟s income.

Legal Fees

Commissioner v. Banks, 543 U.S. 426 (2005).

In this consolidated case, the Supreme Court ruled that payments made to litigants‟ attorneys on a contingency basis are fully taxable to the litigant, thus settling this often debated issue.

Church v. Commissioner, 80 T.C. 1104 (1983).

Case includes formula for allocating legal fees between taxable and non-taxable portions of awards and settlement proceeds for purposes of IRC sections 212 and 265.

Alexander v. Internal Revenue Service, 72 F.3d 938; (1st Cir. 1995).

Great case on legal fees issue. Gross versus net, itemized deductions, and AMT comments included. *See also Bagley,* 121 F.3d 393 (8th Cir. 1997); *Baylin,* 43 F.3d 1451 (Fed. Cir. 1995); Coady*,* T.C. Memo. 1998-291, *aff'd*, 213 F.3d 1187 (9th Cir. 2000); *Sinyard,* T.C. Memo. 1998-364, *aff'd*, 268 F.3d 756 (9th Cir. 2001); and *Benci-Woodward,* T.C. Memo. 1998-395, *aff'd*, 219 F.3d 941 (9th Cir. 2000).

Insurance Company Cases

Lane v. United States, 902 F. Supp. 1439 (W.D. Okl. 1995).

This case involves a claim on an auto insurance policy for uninsured motorists. Basically this is a punitive damage issue case. Note, however, that under Oklahoma law, compensatory damages awarded for insurance bad faith do not compensate for any personal injury. Rather, they constitute in large part compensation for the loss of the use of the contract damages, and in lesser part, additional attorney's fees incurred as a result of the insurer‟s failure to pay the claim in a timely fashion. Thus, under *Schleier*, they are not excludable from gross income. However, there are some good points in general concerning suits against insurance companies.

Est. of Wesson v. United States, 48 F.3d 894 (5th Cir. 1995).

Punitive damage issue that involved a bad faith claim against a life insurance company is addressed in this case.

Hawkins v. United States, 30 F.3d 1077 (9th Cir. 1994).

Punitive damage issue that involved breach of good faith and fair dealing claims against Allstate Insurance Company is addressed in this case. Contains a good explanation of the rationale behind excluding punitive damages in pre-1996 amendment cases.

Miscellaneous

Brabson v. United States, 73 F.3d 1040 (10th Cir. 1996), *rev'g* 859 F. Supp. 1360 (D. Colo. 1994).

This case involves a personal injury claim. The family was injured by a gas leak in their home. The only issue was the question of whether the pre-judgment interest is excludable under IRC § 104. The district court ruled that the interest was not taxable but the Tenth Circuit reversed.

Robinson v. Commissioner, 102 T.C. 116 (1994)*, aff'd in part, rev'd in part by Robinson v. Commissioner*., 70 F.3d 34 (5th Cir. 1995).

The taxpayer‟s out of court settlement allocation was set aside for tax purposes because the settlement did not represent a bona fide allocation based on an arms length negotiation.

Eisler v. Commissioner, 59 T.C. 634 (1973).

Eisler is often quoted in litigation cases. This case involved a business deduction issue. The issue was whether taxpayer could deduct the settlement payment and legal fees under IRC § 162 as a business expense or whether they were to be capitalized.

The court looked to the strength of the parties" various claims as perceived by their counsel in order to allocate a portion to ordinary and capital.

The case includes comments on doing the best you can with the information you have.

LeFleur v. Commissioner, T.C. Memo. 1997-312.

LeFleur is an employment related case, but its particular importance lies in the area of reallocation issues. In this case the IRS successfully reallocated $800,000 from nontaxable emotional distress claims to taxable contract/punitive damage claims. (See Chapter 2 for additional information.)

Kightlinger v. Commissioner, T.C. Memo. 1998-357.

The court applied the two prong test of *Schleier* to a pre-1996 settlement and held that amounts received due to the loss of a job do not constitute a personal injury. Also, the court concluded, the economic factors were not a measure of personal injury; rather, they were the injury itself that the taxpayer sustained. Further, the Tax Court, in view of all the contrary evidence in the record, rejected the district court"s holding that the suit was for personal injuries suffered by the class members.

*Gregg v. Commissione*r, T.C. Memo. 2001-245

In *Gregg*, the court rejected the taxpayers" argument that compensatory damages received for common law fraud and tortious interference with business relationship were excludable from gross income.

Hemelt v. United States, 122 F.3d 204 (4th Cir. 1997); *Mayberry v. United States*, 151 F.3d 855 (8th Cir. 1998); *Dotson v. United States*, 87 F.3d 682 (5th Cir. 1996); and *Gerbec v. United States*, 164 F.3d 1015 (6th Cir. 1999).

A conflict among the circuits exist on whether payments received in settlement of claims arising under ERISA qualify for exclusion under IRC § 104(a)(2). The Government"s position is that notwithstanding the subjective belief of the parties that the statute provided for tort relief, the subsequent determination of the Supreme Court that ERISA does not provide tort remedies is controlling for tax purposes. Two circuits (and two dissenters in the other circuits) agreed that taxpayers failed to meet the first requirement set forth in *Schleier* for exclusion. Notwithstanding the intercircuit conflict, the Solicitor General disagreed with Service"s recommendation that Supreme Court review is warranted. This disagreement is founded on the fact that Congress, in

1996, amended IRC § 104(a)(2) to provide that the exclusion applies to damages received for personal *physical* injuries only. Because ERISA does not authorize the recovery of such damages, the administrative importance of the income tax issue has diminished.

Venable v. Commissioner, T.C. Memo 2003-240.

The *Venable* decision states that emotional distress is not a physical injury or physical sickness, except for an exclusion for damages up to the amount paid for medical care necessitated by emotional distress. Because taxpayer was unable to substantiate the amount spent to obtain medical care, she was not permitted to take advantage of the exclusion.

The *Venable* case also updated the *Schleier* test by inserting the word "physical" into the second prong of the test.

Appendix A Excerpts from Legislative History of 1996 Amendment

5. Modify exclusion of damages received on account of personal injury or sickness (sec. 1605 of the bill and sec. 104(a)(2) of the Code)

Present Law

Under present law, gross income does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury or sickness (sec. 104(a)(2)).

The exclusion from gross income of damages received on account of personal injury or sickness specifically does not apply to punitive damages received in connection with a case not involving physical injury or sickness. Courts presently differ as to whether the exclusion applies to punitive damages received in connection with a case involving a physical injury or physical sickness.[22] Certain States provide that, in the case of claims under a wrongful death statue, only punitive damages may be awarded.

Courts have interpreted the exclusion from gross income of damages received on account of personal injury or sickness broadly in some cases to cover awards for personal injury that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving certain forms of employment discrimination and injury to reputation where there in no physical injury or sickness. The damages received in these cases generally consists of back pay and other awards intended to compensate the claimant for lost wages or lost profits. The Supreme Court recently held that damages received could not be excluded from income.[23] In light of the Supreme Court decision, the Internal Revenue Service has suspended existing guidance on the tax treatment of damages received on account of other forms of employment discrimination.

Reasons for 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 brightline 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.

Damages received on a claim not involving a physical injury or physical sickness are generally to compensate the claimant for lost profits or lost wages that would otherwise be included in taxable income. The confusion as to the tax treatment of damages received in cases not involving physical injury or physical sickness has led to substantial litigation, including two Supreme Court cases within the last four years. The taxation of damages received in cases not involving a physical injury or physical sickness should not depend on the type of claim made.

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[22] The Supreme court recently agreed to decide whether punitive damages awarded in a physical injury lawsuit are excludable from gross income. ***O'Gilvie v. U.S.,*** 66F.3d 1550 (10th Cir. 1995), ***cert. granted***, 64 U.S.L.W. 3639 (U.S. March 25, 1996)(No. 95-966). Also, the Tax Court recently held that if punitive damages are not of a compensatory nature, they are not excludable from income, regardless of whether the underlying claim involved a physical injury or physical sickness***. Bagley v. Commissioner***, 105 T.C. No. 27 (1995).

[23] ***Schleier v. Commissioner***, 115 S.Ct. 2159 (1995)