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What is the Tax Collector’s Cut of Judgments and Settlement Proceeds?

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What Is the Tax Collector's Cut of Judgments and Settlement Proceeds?

By F. Philip Manns Jr.

Settlements of lawsuits and satisfactions of judgments involving payments of money or other property by the defendant to the plaintiff raise two basic federal income tax issues. The first issue is whether the payment is deductible by the defendant. The second issue is whether the receipt of the payment constitutes income to the plaintiff. Resolution of these two issues is accomplished by the application of five principles.

The Five Principles

1. Even though a legal claim against a person is treated as property for many state law purposes and can be sold under state law, a legal claim is not treated as separate property for federal income tax purposes. Thus, the extinguishment of a claim by settlement or judgment is not treated as a sale of property for federal tax purposes. Instead, amounts paid and received are taxed by reference to the origin of the claims underlying the settlement or judgment. The theory is to tax the payment and receipt of the proceeds identically with the thing for which they substitute. Thus, if a plaintiff recovers money due under a contract, the payment is taxed just as if the defendant had paid the plaintiff in accordance with the contract.

2. It does not matter whether litigation concludes through settlement or judgment. (The taxation of private antitrust claims, however, can depend on whether suit was instituted before settlement.) References to settlement payments or settlement proceeds in this article will include amounts paid and received pursuant to both judgments and settlements.

3. The allocation of a settlement payment among the claims settled is like any allocation which has tax consequences. Taxpayers make allocations as they view the facts and circumstances; the IRS is able to challenge an allocation if it thinks the allocation is contrary to the facts and circumstances. Eisler v. Commissioner, 59 T.C. 634 (1973) (court allocated a settlement payment between deductible and capital expenditures where parties had made no allocation, but it was clear that claims of both types had been settled), acq., 1973-2 C.B. 1.

4. For a defendant actively conducting a trade or business, settlement payments made on claims arising from the conduct of the trade or business generally are deductible. Settlement payments are made nondeductible for public policy reasons (e.g., in the fines, penalties and antitrust areas) or because the underlying claims themselves would give rise to nondeductible (e.g., personal) or capitalized expenditures (e.g., expenses of defending title to property). Otherwise, settlement payments are deductible even if they arise because of wrongful conduct by the defendant.

When multiple claims are settled, both parties are required to make an allocation in computing their taxes but are not required to agree on an allocation. However, parties are well advised to agree to an allocation, since that materially increases the likelihood that the IRS will respect their allocations.

Allocation is a significant issue because, in the typical case, multiple claims will be involved—especially since recoveries wholly dependent on other claims often are considered to be separate claims. For instance, legal interest accrued on a judgment is taxable as interest income even if the judgment is excluded from income. Aames v. Commissioner, 94 T.C. 189 (1990).

In that regard, the look-through to the underlying claims likens the tax treatment of judgments and settlements to the sale of a business; those sales are not treated as the sale of a single asset but are treated as a sale of each underlying asset of the business.

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Settlement payments for the
following types of claims have
been held deductible: negligence
claims, Eisl er v. Commissioner,
supra; fraud claims, Ostrom v.
Commissioner, 77 T.C. 608, 611-
12 (1981); liquidated damages
C.B. 25; and punitive damages
claims, Rev. Rul. 80-211, 1980-2
C.B. 57.

5. For the plaintiff, the
receipt of settlement
proceeds generally gives rise
to income. Settlement proceeds
can be capital gain or a return of
basis if the underlying claim
relates to a sale or other transac-
tion involving the property of
the plaintiff. If a statutory exclusion
is available (e.g., damages recov-
ered on account of personal injury
are excluded from income), or if
the proceeds are a reduction in an
earlier paid expense that was not
deductible, no income is realized
on receipt of the settlement
proceeds.

Principles four and five demon-
strate that the issues of deducti-
bility by the defendant and in-
come to the plaintiff are not
causally linked. Among other res-
ults, a settlement payment could
be nondeductible by the defen-
dant but income to the plaintiff;
deductible by the defendant but
not income to the plaintiff; sub-
ject to capitalization by the defen-
dant but income to the plain-
tiff. Obviously, to the extent that
the two separate questions turn
on the intent of the parties or
other facts common to the settle-
ment, the determinations will be
related, but no formal causal link
exists.

Applying the Principles

For any settlement, the de-
ductibility and income issues
can be decided by application
of a test of two parts, one factual
and the other legal. First, the
settlement proceeds must be
allocated among the claims
settled. Second, the legal nature
of the claims must be analyzed
to determine if the claims give
rise to deductions or income for
which special rules apply. If not,
the general rules of a deduction
for the defendant on the making
of settlement payments and
income to the plaintiff on the
receipt of settlement proceeds
apply.

Special rules applicable to
settlements derive from two
sources. One, because the origin
of the claim analysis equates the
making of settlement payments
with payment on the underlying
claims, settlement payments will
be nondeductible whenever
payment of the expense for which
the claim substitutes would be
nondeductible. Similarly, settle-
ment proceeds will not be income
whenever receipt of the thing for
which the claim substitutes
would not constitute income.
Therefore, the special rules
applicable to settlements include
the rules applicable to all deduc-
tions and to all receipts. Since
those rules comprise a significant
portion of the body of tax law,
description in this article of all
situations in which a settlement
payment is not deductible or in
which the receipt of settlement
proceeds is not income is not
feasible.

Two, certain rules exist which
by definition apply only in litiga-
tion settlement contexts. For in-
stance, deductions are denied for
fines and similar penalties, and
damages recovered on account of
personal injury are excluded
from income. The most commonly
encountered of the special rules
applicable to settlements are de-
described below, without regard to
the source from which they arise.

Settlement Payments Not
Deductible by Defendant

• Personal Litigation. Code
Section 262 denies a deduc-
tion for personal, living or family
expenses. The denial of a deduc-
tion for settlement payments made
with respect to such claims is an
application of Code Section 262.
Accordingly, if the expenditure
for which the settlement pay-
ments substitute would be nonde-
ductible personal, family or living
expenses of the payor, the settle-
ment payments are not deduct-
able. Thus, if a taxpayer settles a
claim against him for rent for an
apartment occupied by him as a
personal residence, or settles a
suit for a tort not related to the
taxpayer's business, the settle-
ment payment is not deductible.
See Oden v. Commissioner, 56
T.C.M. (CCH) 851, 853 (1988)
(damages paid in connection with
a defamation suit were nonde-
ductible personal expenses).

• Disputes Relating to Prop-
erty. Under the Code, expenses
to "manage, conserve, or main-
tain" income producing property
are deductible currently. But
under the Treasury Regulations,
expenses "paid or incurred in de-
defending or perfecting title to
property" are not deductible.
Instead, those expenses are capital-
ized—i.e., they are added to the
cost of the property and may be
recovered through annual depre-
ciation deductions if depreciation
of the property is permitted. Dis-
tinguishing between maintenance
and title defense expenses, while
clear at the extremes, can cloud
considerably for expenses that
serve simultaneously to manage
property and to perfect title
to it.

Consider a suit involving a
mineral rights lessor and lessee
regarding the lessee's extraction
of minerals. Both the lessor and the lessee are perfecting title to their leasehold or lease interests while managing their mineral property in their businesses. For such expenses meeting both descriptions, deductibility may turn on whether the primary purpose of the litigation is to perfect title or to resolve a dispute relating to income from operation of the property.

At the extremes, however, the distinction of management and title defense expenses is reasonably clear. It is clear that if a buyer settles litigation over the purchase price of property by paying more money to the seller, the amount will be capitalized as an expense of perfecting title to the property; it would be treated as part of the purchase price.

And at the other extreme, it is clear that expenses incurred by a car rental company to repossess a rental car, although related to title, would be deductible. 

In addition, expenses that “add to the value, or substantially prolong the useful life, of property” must be capitalized. Therefore, if settlement payments are viewed as adding value to an existing asset, the settlement payments would have to be capitalized (e.g., settlement payments to a roofing contractor who constructed a new roof).

- **Fines and Related Civil Penalties.** Code Section 162(f) denies a deduction for “any fine or similar penalty paid to a government for the violation of any law.” Thus, when claims asserted by a government are settled, Code Section 162(f) must be considered. A “fine” is an amount paid pursuant to conviction or a plea of guilty or nolo contendere for a felony or misdemeanor in a criminal proceeding. Application of that disallowance is straightforward, but the disallowance for “similar penalties” is less so. When defining those civil penalties within the disallowance, the Treasury Regulations initially paint with a broad brush by including any civil penalty imposed by federal, state or local law. Treas. Reg. Section 1.162-21(b)(1)(ii). The regulations subsequently narrow the scope of “similar penalty,” however, when they indicate that Code Section 162(f) will not preclude the deduction of a civil penalty if the penalty represents compensatory damages paid to a government. Courts generally have adopted the compensatory/punitive dichotomy suggested in the regulations and distinguish deductible and nondeductible penalties as follows:

If a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, its purpose is the same as a fine expected under a criminal statute and it is “similar” to a fine. However, if the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it does not serve the same purpose as a criminal fine and is not “similar” to a fine within the meaning of section 162(f).

- **Antitrust Damages.** Code Section 162(g) denies a deduction for two-thirds of the payments in settlement of private antitrust claims when the defendant has committed a “hard core violation” of the antitrust laws. Since antitrust plaintiffs are entitled to treble damages, the two-thirds disallowance essentially denies a deduction for the “penal” portion of the settlement. The scope of the disallowance is narrow; it applies only when (1) the defendant has been convicted of, or pleaded nolo contendere to, a criminal antitrust violation; (2) the civil damages are based on the criminal violation or a related violation; and (3) the payment is made pursuant to a judgment or a settlement of a filed action. Otherwise, the entire amount of antitrust damages is deductible.

- **Other Nondeductible Settlement Payments.** Many other Code sections and judicial doctrines deny expense deductions and those disallowances potentially are applicable in a litigation context. For instance, Code Section 709 denies deductions for partnership syndication expenses; Code Section 267 restricts losses in transactions among related taxpayers; Code Section 162(c) denies deductions for illegal bribes and kickbacks; and courts, without specific statutory authority, have denied deductions for sham transactions and for transactions not entered into for profit. If the settlement payment substitutes for an expenditure that would be subject to any such disallowance, then the settlement payment would be nondeductible.

Settlement Proceeds Not Income to Plaintiff

- Recoveries Relating to Property of the Taxpayer. If settlement proceeds compensate for damages to property, the recovery will be treated as a nontaxable return of the owner's investment in the property to the extent of the adjusted tax basis of the property. Any excess would produce income under the IRS' view of the law, although a persuasive argument exists that the excess should produce capital gain.

Goodwill is property, so a taxpayer's recovery for harm to goodwill will be nontaxable to the extent of the taxpayer's adjusted tax basis in the goodwill. A recovery of lost profits, on the other hand, is taxable as income, since receipt of the thing for which lost profits substitute (profits) gives rise to income. Curiously, one of the permitted manners of establishing damage to goodwill is proof of lost profits. Settlement proceeds for damage to goodwill so proven are treated as nontaxable to the extent of the adjusted tax basis in the goodwill. Since proof of lost profits establishes either claim, mindful pleading can permit the plaintiff to select the taxation of settlement payments for lost profits.

Capital gain can result from other types of property disputes. E.g., if the settlement proceeds are an adjustment to the sales price of property, the proceeds will be treated as additional sales price, which generally will increase the capital gain on the sale.

- Statutory Exclusions from Income. Various sections of the Code exclude from income amounts received on account of certain claims. These claims include, among others, claims for:

  "Sometimes the tax tail can even wag the settlement dog because an otherwise uncooperative opposing party may be persuaded to settle when a tax advantaged settlement proposal is made."

  personal injuries and sickness, Code Section 104; life insurance proceeds, Code Section 101; gifts and inheritances, Code Section 102; state and local bond interest, Code Section 103. If settlement proceeds relate to such claims, no income is realized on their receipt.

  The most significant exclusion is Code Section 104(a)(2), excluding from income "the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness." The essential inquiry is whether the plaintiff's injury is "personal." While for physical injuries the application of Code Section 104(a)(2) usually is obvious, the application to such nonphysical injuries as dignitary torts continues to vex the federal courts. For instance, the IRS, the Tax Court, the Third Circuit and the Fourth Circuit hold different views on the application of Code Section 104(a)(2) to various elements of damages recovered under employment discrimination statutes. Richel v. Commissioner, 900 F.2d 655, 65 A.F.T.R.2d (P-H) 90-800, 90-1 U.S. Tax Cas. ¶ 50-200 (3d Cir. 1990), rev'd, 92 T.C. 510 (1989); Thompson v. Commissioner, 866 F.2d 709, 63 A.F.T.R. 2d (P-H) 89-677, 89-1 U.S. Tax Cas. ¶ 9164 (4th Cir. 1989).

Recent, the application of the Code Section 104(a)(2) exclusion to punitive damages received on account of personal injuries has been clarified by statute. Punitive damages are excludable only when recovered in cases involving physical injury or physical sickness. For punitive damages received in suits filed on or before July 10, 1989, or under any written binding agreement, court decree or mediation award in effect on, or issued on or before, July 10, 1989, the application of the exclusion is unsettled. The Tax Court excludes all such punitive damages from income, but the Fourth Circuit includes them. See Miller v. Commissioner, 93 T.C. 330 (1989), rev'd, 914 F.2d 586, 66 A.F.T.R.2d (P-H) 90-5620, 90-2 U.S. Tax Cas. ¶ 50,511 (4th Cir. 1990).

- Recovery of Expenses Not Deducted. If a taxpayer incurs an expense that is not deducted and subsequently recovers a settlement payment reducing that expense, the recovery is not income. Recovery of a security deposit for an apartment used as a personal residence would not give rise to income; but recovery of interest payable on the security deposit—as well as any penalty payable by the landlord to the taxpayer—would be income.

Conclusion

The importance of the taxation of judgments and settlement proceeds often is overlooked when litigation is begun or terminated. Meaningful tax planning can be accomplished at those times to maximize tax benefits to both plaintiff and defendant. Sometimes the tax tail can even wag the settlement dog because an otherwise uncooperative opposing party may be persuaded to settle when a tax advantaged settlement proposal is made.

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