

# Understanding the Tax Consequences of Tort Settlements and Awards

by Jeffrey R. Bergstrom

The *Civil Litigator* column addresses issues of importance and interest to litigators and trial lawyers practicing in Colorado courts. The *Civil Litigator* is published six times a year.

**This article addresses the significant tax consequences of litigation settlements and damages awards in tort cases. It is intended to assist counsel in advising clients as to the true net results of such settlements or awards.**

Awards and settlements for tort claims usually can be divided into two distinct groups. The first group comprises claims that arise from physical injuries; the second consists of claims arising from non-physical injuries. Regardless of the major group into which it falls, the resulting damages usually will be classified into one or more sub-categories: (1) actual damages; (2) emotional distress damages; and (3) punitive damages.

The tax consequences of each of these groupings may differ; therefore, each separate claim should be carefully categorized. Once the categories of the claim have been properly determined, the attorney should advise the client as to the net result of the settlement. This figure is of ultimate importance, because it is used to determine the amount of taxable income.

This article reviews the general rules that help determine whether the results of a lawsuit or settlement will be taxable to the recipient. It also analyzes taxability issues in the context of a typical scenario.

## Overview of Tax Consequences

An analysis of the tax consequences of a tort claim starts with two general rules of the Internal Revenue Code ("IRC" or "Code"). First, IRC § 61(a) broadly provides that all income, from whatever source derived, is included in a taxpayer's gross income, except if otherwise provided in the Code.<sup>1</sup>

Second, IRC § 104(a)(2) generally excludes certain amounts from gross income. The most common exclusions are for:

- Amounts received under workers' compensation
- Damages, other than punitive damages, received in a lawsuit or settlement of a claim on account of personal physical injuries or physical sickness
- Amounts received through accident or health insurance for personal injuries or sickness, except for certain amounts that are attributable to employer contributions or paid directly by the employer.

Despite the seemingly simple language of IRC § 104(a)(2), that statute probably has been one of the most litigated subsections of the Code. Historically, the issue usually centered on determining whether something was a personal injury. In other words, the issue was whether the claim encompassed physical or non-physical (mental distress) injuries and sickness, as well as whether any punitive damages received were on account of personal injuries.

## Physical Injury or Sickness Awards Nontaxable

Prior to the Small Business Job Protection Act of 1996 ("SBJPA"),<sup>2</sup> the definition of "personal injury" was arguably broad, as there did not need to be any sort of physical manifestation of the injury. For example, payments to settle a claim for "damage to reputation" possi-

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### Consideration of Capital Gains Versus Ordinary Income

Even if an award is included in the recipient's gross income, it might be characterized as capital gain rather than ordinary income. This distinction is important because each has different tax rates. Similar to the analysis of taxable versus non-taxable awards, it is necessary to look at the nature of the underlying claim to make this determination. For example, if a payment is meant to replace lost profits, the award is treated as ordinary income. However, if the payment is to redress an injury to a capital asset, the amount should be treated as capital gain.

bly could have been excludable from income. That is no longer the case. IRC § 104(a)(2) was amended by the SBJPA in 1996 to clarify that damages received on account of a non-physical injury—for example, for age discrimination or injury to reputation—are *not* excludable from gross income.

Thus, IRC § 104(a)(2) is now applicable only to damages “on account of personal physical injuries or physical sickness.”<sup>3</sup> (*Emphasis added.*) For the straightforward physical injury claim, there is not much to debate. The amount received in settlement of such a claim will be non-taxable.

Although it might be logical to assume that the taxability of a non-physical claim would be equally clear, that is not the case. The amendment to IRC § 104(a)(2) has done little to curtail taxpayers from continuing to test the boundaries of what types of payments are excludable from income under that provision.

### Taxability of Non-Physical Injury or Sickness

In an effort to provide some guidance as to claims of exclusion that have been tried without success, and in the tradition of the Tax Code, it is easier to describe what is *not* excluded by IRC § 104(a)(2) than to describe what *is* excluded. Except where exceptions apply, as described below, the following types of claims generally are not covered by the exclusion. Consequently, the amount received as either an award or settlement of such claims is taxable for: (1) emotional distress claims; (2) discrimination claims; (3) property damage or casualty loss claims; (4) lost earnings or lost compensation claims; and (5) corporate claims.

#### Emotional Distress Claims

Emotional distress itself is not a physical injury or physical sickness; therefore, amounts received to settle such a claim would be taxable.<sup>4</sup> However, the amount paid for the medical care attributable to emotional distress that arose as a result

of a physical injury or physical sickness would be treated as received for the physical injury or sickness. Thus, IRC § 104(a)(2) would apply to exclude them from income.<sup>5</sup>

#### Discrimination Claims

Discrimination claims are those alleging discrimination based on such factors as age, race, gender, religion, or disability. Such claims often have generated compensatory and punitive awards. Because these payments may be substantial, it is imperative for clients to know how their payment will be taxed.

In many of discrimination cases, the suit is filed under Title VII of the Civil Rights Act of 1964 or Age Discrimination in Employment Act of 1967.<sup>6</sup> Either way, the award or settlement constitutes an amount for back pay and, as such, the amount will be includable in gross income under IRC § 61.<sup>7</sup>

#### Property Damage or Casualty Loss Claims

Property damage or casualty loss awards ordinarily would be included in income pursuant to IRC § 104(a)(2). However, there is authority to support the position that the amount received in a settlement that represents damage for lost capital will be treated as a return of capital. As such, it would not be includable in the taxpayer's gross income, to the extent that this sum does not exceed the basis of the property damaged.<sup>8</sup>

#### Lost Earnings or Lost Compensation Claims

Employment-related lawsuits generally involve a breach of contract claim, and any award for back pay is meant to substitute for the payment of wages. Such lawsuits generally involve claims of wrongful discharge or failure to honor contract obligations. Usually, all amounts received in a settlement that represent a reimbursement for lost wages or business profits are includable in the taxpayer's gross income.<sup>9</sup>

A possible exception to this rule involves a personal injury that caused the loss. For example, the Internal Revenue Service (“IRS”) has held that compensatory damages, including lost wages, received on account of a physical injury are excludable from gross income.<sup>10</sup>

#### Corporate Claims

Although it may seem obvious, the IRC § 104(a)(2) exclusion is not available in the case of any damages awarded to a corporation. This is because a corporation cannot sustain “personal” injuries.<sup>11</sup>

#### Punitive Damages

Although historically the position of the IRS on the taxation of punitive damages has been less than consistent, that is no longer true. Punitive damages, whether related to a claim for damages from physical injury or sickness or unrelated to such claims, are *not* excludable from the recipient's gross income. For example, in *O'Gilvie v. United States*,<sup>12</sup> the Tenth Circuit held, “Non-compensatory punitive damages are not received on account of personal injuries, and thus are not excludable from gross income under IRC section 104(a)(2).”

An extremely limited exception exists under IRC § 104(c) for punitive damages awarded in a wrongful death action. Such exception applies if the applicable state law, as existing on September 13, 1995, allowed only for punitive damages.<sup>13</sup>

#### Interest Payments

Regardless of whether the principal amount of the payment is excludable from income, the interest portion of the payment will be includable in the recipient's gross income.<sup>14</sup> For example, in *Brabson v. United States*,<sup>15</sup> the Tenth Circuit held:

[P]rejudgment interest received in a personal injury suit under state [Colorado] law was not “damages received on account of personal injury or sickness” and, therefore, was not excludable from gross income.<sup>16</sup>

State law characterized the prejudgment interest as compensation for the lost time value of money and as an element of the damages. However, prejudgment interest was not a traditional remedy for personal injury; thus, there was no direct link between the injury and the interest.<sup>17</sup>

Even if the parties do not designate a portion of the payment as interest, it is possible that the IRS would recharacterize the total amount such that a portion

would be for "damages," which connotes "compensation or satisfaction imposed by law for a wrong or injury."<sup>18</sup> Thus, the balance would be "interest," meaning "the price paid for borrowing money."<sup>19</sup>

## Legal Fees

A plaintiff with a personal physical injury or sickness claim typically may not deduct the legal expenses incurred in the suit. This is because expenses incurred in the production of tax-exempt income are not deductible.<sup>20</sup>

## Allocation Issues

Many lawsuits involve more than one damage claim, but they often are settled by a single settlement payment. When advising clients in such situations, it is critical to determine the correct allocation of the payment among taxable and non-taxable claims, as discussed above.

If the different parts are designated by the court in a judgment or by the parties in a settlement agreement, the parties must generally follow these allocations for tax purposes. It is also helpful to know that, if a case does go to trial and if the award is the result of damages that were clearly allocated (to identifiable claims) in an adversarial proceeding by a judge or jury, the IRS will usually not challenge their character because of the impartial and objective nature of the determinations.<sup>21</sup>

Even if there is a settlement agreement with specific allocations, it is the substance of the transaction that matters, not the form. In other words, detailing the allocation in a written settlement agreement will not assist the parties unless the allocation of the settlement amount among the various claims accurately reflects the real economic substance of the settlement.<sup>22</sup>

As a guideline for the practitioner who is trying to advise a client as to how to allocate a settlement payment properly, it is probably best to start with the total payment and then subtract the actual and obvious economic losses (which are generally non-taxable). Only then should the practitioner proceed to allocate the balance between compensatory damages, punitive damages, and interest.

## Receipt of Attorney Fees

When structuring the settlement of a dispute, a factor that is often overlooked is the tax consequences of the payment and, particularly, receipt of contingent attorney fees. For the recipients, the issue is

whether the attorney fees that they receive will be treated as income to them—and then as a subsequent payment by them to their attorney. The alternative would be for the fees to be paid and taxed directly to the attorney and not included as income to the client.

The Circuits have been split as to whether contingent attorney fees are subject to taxation.<sup>23</sup> The key issue has been whether a contingency fee agreement gives the attorney a separate property right in the future award or whether the taxpayer is attempting to escape taxation by an anticipatory assignment of future income.<sup>24</sup>

Even if the result is that the attorney fees must be treated as income to the client, a portion of the fees still might be an allowable deduction on Schedule A as an income-production expense.<sup>25</sup> Historically, all income-production expenses have been deducted as miscellaneous itemized deductions, subject to some limitations.<sup>26</sup> If the amount was substantial, probably the most significant limitation has been that the legal fees that are deductible on Schedule A were always a tax preference item and might cause alternative minimum tax ("AMT") obligations.<sup>27</sup>

This is no longer the case for many claims involving "unlawful discrimination."<sup>28</sup> For fees and costs paid with regard to a judgment or settlement occurring after October 22, 2004, the rule was changed by §§ 703(b) and (c) of the recently enacted American Jobs Creation Act of 2004.<sup>29</sup> These expenses now are an "above-the-line" deduction and, therefore, can be claimed for AMT purposes.<sup>30</sup>

It is hoped that the issue will be settled in 2005. The U.S. Supreme Court heard arguments in November 2004 in *Banks v. Commissioner*<sup>31</sup> and *Banaitis v. Commissioner*.<sup>32</sup> In these cases, the Court is expected to answer the question of whether, under IRC § 61(a), a taxpayer's gross income from the proceeds of litigation includes the portion of damages recovery that is paid to his or her attorney pursuant to a contingent fee agreement.<sup>33</sup> A discussion of this issue and the two Supreme Court cases will be the topic of a future article in *The Colorado Lawyer*.

## Payment of Settlement Amounts

For the payor of a settlement or a judgment, the main issue is whether: (1) the amount paid can be immediately deducted; (2) the amount needs to be treated as a

capital expenditure; or (3) worse, it is entirely nondeductible. The following general rules should assist in making this determination.

Payments made to settle litigation are generally deductible if, among other things, they have a business origin.<sup>34</sup> A business origin is present when the activity or transaction causing the litigation originates in a trade or business.<sup>35</sup> Three tests are typically used to determine whether a settlement with a business origin is deductible. There must be a determination as to whether: (1) the taxpayer lacked confidence it would prevail; (2) the taxpayer made the settlement to avoid damages or liability; and (3) a reasonable person in the taxpayer's place would have thought settlement was necessary.<sup>36</sup>

On the other hand, the payment must be capitalized if it: (1) creates or enhances a separate and distinct asset; (2) produces a significant future benefit; or (3) is incurred in connection with the acquisition of a capital asset.<sup>37</sup> Finally, if no segregation of legal expenses can be made as between capital expense and business expense, no part may be deducted.<sup>38</sup> Although this determination is immaterial to the recipient, if counsel is representing the payor, it could be very significant.

## Typical Scenario

In analyzing the tax consequences of litigation settlements and damages awards in tort cases, it may be helpful to look at a common scenario. Suppose, as in a typical injury case, a plaintiff sues a motorist for injuries and damages sustained when the motorist missed a stop sign and ran into the plaintiff's car. The following damages are claimed: (1) medical expenses for treatment of physical injuries; (2) lost wages for time spent recovering; and (3) property damage to the plaintiff's car. The plaintiff retains the services of an attorney pursuant to a contingent fee arrangement under which the attorney is entitled to one-third of any recovery. Eight months after the accident, the two parties reach a settlement of the case and the defendant agrees to pay the plaintiff a lump sum of \$90,000.

Although these facts may seem simple, many attorneys might find that advising the plaintiff regarding the "net" result after considering the tax consequences of the settlement payment is not as straightforward. The following steps should be taken.

1. The plaintiff should subtract from the \$90,000 the amount needed to repair the vehicle. As long as this

amount did not exceed the plaintiff's basis in the vehicle, it would be excludable from income.

2. The plaintiff should subtract the amount for actual medical bills. This amount also would be excludable from income.
3. The plaintiff should subtract an amount for his lost wages. However, it is important to note that this amount likely would be taxable.
4. The plaintiff should subtract a reasonable rate for the eight-month delay in getting the above items reimbursed. This amount is considered interest and, as such, would also be taxable.

Finally, under present law, counsel should remind the plaintiff that currently the amount of attorney fees would be taxable in the Tenth Circuit—although this may change once the U.S. Supreme Court issues decisions in the *Banks* and *Banaitis* cases. In the meantime, any additional amount also would be taxable. Counsel then should advise the plaintiff that steps should be taken to: (1) report the amount of interest, attorney fees, and the "balance" as income on the plaintiff's tax return; (2) verify that the lost wages component was entirely for lost wages received on account of a physical injury; and (3) take a miscellaneous itemized deduction for part of the attorney fees.

## Conclusion

Although many of these general rules are becoming more settled, the one exception, with regard to the receipt of contingent attorney fees, appears poised for major change. As always, it is best to review the current status of any tax laws before giving advice.

Every client receiving an award or settlement payment obviously would benefit by having the amount excluded from his or her income. The easiest way to ensure this result is to qualify under IRC § 104(a)(2). However, the facts and circumstances of each lawsuit award or settlement must be carefully considered to ascertain the purpose for which the money was received. Only then can it be determined whether these amounts are excludable from income.

## NOTES

1. IRC § 61(a) provides: "... Except as otherwise provided in this subtitle, gross income means all income from whatever source derived..."

2. H.R. 3448, Pub.L. No. 104-188 (Aug. 20, 1996).
3. IRC § 104(a)(2).
4. IRC § 104(a).
5. *Id.*
6. 42 U.S.C. §§ 2000 *et seq.*; 29 U.S.C. §§ 621 *et seq.*
7. *Comm'r v. Schleier*, 515 U.S. 323 (1995).
8. *U.S. v. Safety Car Heating & Lighting Co.*, 297 U.S. 88 (1936).
9. *Raytheon Production Corp. v. Comm'r*, 144 F.2d 110 (1st Cir. 1944), *cert. denied*, 323 U.S. 779 (1944); *Kidd v. Comm'r*, T.C. Memo 2004-135, 2004 WL 1277962 (June 10, 2004); Rev. Rul. 81-152, 1981-1 C.B. 433; Rev. Rul. 73-161, 1973-1 C.B. 366.
10. Rev. Rul. 85-97, 1985-2 C.B. 50.
11. *P & X Markets, Inc. v. Comm'r*, 106 T.C. 441 (1996), *aff'd*, 139 F.3d 907 (9th Cir. 1998).
12. *O'Gilvie*, 66 F.3d 1550 (10th Cir. 1995), *aff'd*, 519 U.S. 79 (1996).
13. Chief Counsel Advice 200206053 (Dec. 12, 2001); IRC 104(c). *See also Burford v. U.S.*, 642 F.Supp. 635 (N.D.Ala. 1986).
14. IRC § 61(a)(4).
15. *Brabson*, 73 F.3d 1040 (10th Cir.), *cert. denied*, 519 U.S. 1039 (1996).
16. *Id.* at 1046.
17. *Id.*
18. *Quantum Co. Trust v. Comm'r*, 79 T.C.M. (CCH) 1964, 2000 WL 472841 (April 25, 2000).
19. *Id.*
20. IRC § 265.
21. *But see Robinson v. Comm'r*, 102 T.C. 116, 122 (Feb. 2, 1994), *aff'd in part, rev'd in part*, 70 F.3d 34 (5th Cir. 1995), *cert. denied*, 519 U.S. 824 (1996); *Kightlinger v. Comm'r*, 76 T.C.M. (CCH) 611, 1998 WL 712535 (Oct. 5, 1998).
22. *See Phoenix Coal Co. v. Comm'r*, 231 F.2d 420 (2d Cir. 1956) (where parties' agreement does not accurately reflect economic substance of transaction, IRS would likely disregard terms of agreement and reallocate payment); *Robinson, supra*, note 21; *Bagley v. Comm'r*, 105 T.C. 396 (Dec. 11, 1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997).
23. The Tax Court, Second, Fourth, Seventh, Ninth, Tenth, and Federal Circuits ruled that the entire award or settlement must be included in gross income. *See Raymond v. U.S.*, 355 F.3d 107 (2d Cir. 2004); *Campbell v. Comm'r*, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); *Sinyard v. Comm'r*, 268 F.3d 756 (9th Cir. 2001), *cert. denied*, 536 U.S. 904 (2002); *Kenseth v. Comm'r*, 259 F.3d 881 (7th Cir. 2001); *Young v. Comm'r*, 240 F.3d 369 (4th Cir. 2001); *Freeman v. Comm'r*, 82 T.C.M. (CCH) 643, 2001 WL 1150022 (Sept. 28, 2001), *aff'd*, 56 Fed.Appx. 842, 2003 WL 840909 (9th Cir. Mar. 5, 2003); *Baylin v. U.S.*, 43 F.3d 1451 (Fed.Cir. 1995); *O'Brien v. Comm'r*, 319 F.2d 532 (3d Cir. 1963), *cert. denied*, 375 U.S. 931 (1963). The rationale for this view is that it is the fundamental rule of taxation that income is to be taxed to the person who earns it, even when it is paid at that person's direction to someone else. *Lucas v. Earl*, 281 U.S. 111, 114-115 (1930).

24. The minority position, which has been adopted by the Fifth, Sixth, and Eleventh Circuits, allows contingent attorney fees to be excluded from the gross income of the client. *See Banks v. Comm'r*, 345 F.3d 373 (6th Cir. 2003), *cert. granted*, 124 S.Ct. 1712 (2004); *Foster v. U.S.*, 249 F.3d 1275 (11th Cir. 2001); *Srivastava v. Comm'r*, 220 F.3d 353 (5th Cir. 2000); *Davis v. Comm'r*, 210 F.3d 1346 (11th Cir. 2000); *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959). The support for this view comes from certain state property rights that the attorney may have in his or her contingent fee agreement, such that the agreement has the effect of creating a "partnership or joint venture." As a consequence, the income can be paid directly to the attorney from the proceeds of the litigation without ever coming into the possession of the client. *Coady v. Comm'r*, 213 F.3d 1187, 1190-91 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001) (relying in part on *Hagans, Brown & Gibbs v. First Nat'l Bank of Anchorage*, 783 P.2d 1164, 1168 (Alaska 1989)).

25. *Benci-Woodward v. Comm'r*, 219 F.3d 941, 943 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001) (miscellaneous itemized deductions defined as those itemized deductions that are not specifically enumerated within IRC § 67(b); legal expenses are not so enumerated and, thus, are classified as miscellaneous itemized deductions).

26. IRC § 67(a).

27. IRC § 56(b)(1)(A)(i).

28. "Unlawful discrimination" as defined and listed in IRC § 62(e).

29. H.R. 4520, Pub.L. No. 108-357 (Oct. 22, 2004).

30. IRC §§ 62(a)(19)[20] and 62(e).

31. *Banks, supra*, note 24.

32. *Banaitis v. Comm'r*, 340 F.3d 1074 (9th Cir. 2003).

33. In *Banks, supra*, note 24, the Court will review the decision of the Sixth Circuit Court of Appeals that, although a payment received by a taxpayer to settle a claim of employment discrimination against a former employer is not eligible for exclusion as personal injury damages, that portion of the settlement that the taxpayer pays to an attorney pursuant to a contingency fee arrangement is excludable from income. In *Banaitis, supra*, note 32, the Court will review the decision of the Ninth Circuit Court of Appeals, holding that portions of a settlement representing economic and punitive damages are includable in the taxpayer's gross income, but that the portion paid directly to the taxpayer's attorneys is excludable from gross income.

34. *Anchor Coupling Co. v. U.S.*, 427 F.2d 429 (7th Cir. 1970), *cert. denied*, 401 U.S. 908 (1971).

35. *U.S. v. Gilmore*, 372 U.S. 39, 44-51 (1963); *Anchor Coupling Co., supra*, note 34 at 433.

36. *Chief Indus., Inc. v. Comm'r*, 87 T.C.M. (CCH) 1002, 2004 WL 377058 (March 2, 2004).

37. *Winter v. Comm'r*, T.C. Memo. 2002-173 (U.S. Tax Ct. 2002).

38. *S. Eng'g & Metal Products Corp.*, 9 T.C.M. (CCH) 93, 1950 WL 7635 (1950). ■