

SETTLEMENTS AND JUDGMENTS – YOU MEAN I HAVE TO PAY TAXES?

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I. INCOME TO PLAINTIFF

- A. Distinction between settlements and judgments.
- B. Basic rule is the “origin of claims” test. The amounts received should be treated for tax purposes to place the plaintiff in the same position as if the harm to the plaintiff had never occurred and the plaintiff had continued on undisturbed. “In lieu of what were the settlement proceeds received?”
 - 1. United States Supreme Court has consistently adopted this approach. E.g., United States v. Gilmore, 372 U.S. 39 (1963).
 - 2. Is the amount received, or a portion thereof, income to the recipient?
 - 3. If an amount received constitutes income to the recipient, how should the income be characterized?
 - 4. Validity of the plaintiff’s claims is irrelevant. Taxation does not hinge on whether the recipient had a valid claim.
- C. Specific types of recoveries.
 - 1. Lost profits. Taxable as ordinary income. This is because the plaintiff would have had to pay tax on the amounts received had the harm to the plaintiff not occurred (i.e., the plaintiff is placed in the same position had the defendant not interfered).
 - 2. Harm to capital assets. Payments representing restoration of capital are taxable only to the extent the payments exceed the

recipient's basis in the property. See Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (CA 1 1944). Amounts received in excess of the basis of the property are taxed as capital gain rather than ordinary income.

3. Goodwill. Distinction between payments for lost profits and payments for damage to goodwill. The recipient often will have no basis in the goodwill (i.e., all amounts received will constitute capital gain).
4. Back Pay. Amounts received as back pay (except in cases involving personal physical injuries, described below) are taxable as ordinary income. Back pay amounts are also treated as wages for FICA and Medicare purposes. Therefore, plaintiffs often strive to characterize amounts received as other than back pay. However, wages paid on account of personal physical injuries (described below) are excluded from income entirely even though the plaintiff would have had to recognize the wages received as ordinary income had the injury to the plaintiff not occurred.
5. Workmen's compensation. Internal Revenue Code Section 104(a)(1) excludes from income amounts received under workmen's compensation acts as compensation for personal injuries or sickness.
 - a. This generally excludes from income amounts received by the injured worker or the injured worker's spouse or dependents.
 - b. The injury must be work-related.
 - c. Retirement benefits, even if occasioned by the injury, are not excludable if the benefits are payable without regard

to the type of injury or the manner in which the injury occurred.

6. Punitive damages. Always taxable no matter what the underlying claim.
 - a. Even if all other components of the recovery are excluded from income (such as recovery of capital or personal physical injuries) all punitive damage components will be fully taxable.
 - b. As a practical matter, punitive damages will not be present in most cases where the recipient's claims are settled.
 - c. However, some questions might arise as to the treatment of amounts received by a plaintiff that result from a settlement entered into by the parties after a judgment against the defendant containing punitive damages has been issued. In this case the IRS may look to characterize part of the settlement payments as punitive damages.
7. Interest. Always taxable no matter what the underlying claim.
 - a. Similar to punitive damages, even if all other components of the recovery are excluded from income, interest is fully taxable.
 - b. Many state statutes operate in a way that a large component of a plaintiff's claim against a defendant will be based on interest and the lost time value of money.

D. “Personal physical injury” recoveries. Internal Revenue Code Section 104(a)(2).

1. Statute. Internal Revenue Code Section 104 provides:

“gross income does not include ... the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness”
2. Like all other exceptions to income, the exception under Internal Revenue Code Section 104(a)(2) is to be narrowly construed.
3. Burden is on the plaintiff to prove settlement or judgment proceeds fit within the exclusion.
4. Rationale. Similar to the origin of claim doctrine. Intent is to make the plaintiff whole for suffering the injury.
5. Prior law. Prior law did not require the injury to be “physical.” Extensive litigation developed over the years interpreting what exactly was required to constitute an amount received on account of a personal injury.
 - a. Manifestation of physical harm.
 - b. Claim must be based on tort or tort-type rights.
 - c. Among the types of injuries that were questionably personal injuries:
 - i. Emotional distress.
 - ii. Injury to reputation.
 - iii. Alienation of affections.

- iv. Age, sex and race discrimination.
 - v. Wrongful termination.
 - vi. Claims for violations of constitutional rights.
 - vii. Violations of right of privacy.
- 6. Internal Revenue Code Section 104(a)(2) was significantly amended in August, 1996.
- 7. Salient language of Internal Revenue Code Section 104(a)(2) as amended:
 - a. “On account of.” Requires more than “but for” causation. Courts have not been willing to accept the argument that mere but for causation is required because all receipts would be excluded under this interpretation.
 - b. “Personal physical injuries.”
- 8. Physical injuries.
 - a. Much of the future litigation regarding the amended statute likely will focus on what constitutes a “physical” personal injury.
 - b. Medical expense offset.
 - i. The plaintiff cannot exclude amounts received that are attributable to medical expense deductions taken in prior years under Internal Revenue Code Section 213.
 - ii. However, to the extent not previously deducted, the plaintiff may exclude amounts received as

reimbursement for amounts paid by the plaintiff for medical care that is attributable to the plaintiff's emotional distress, even in the absence of a physical injury.

- c. Emotional distress recoveries. Emotional distress, itself, is not a physical injury. Therefore, amounts received on account of emotional distress only are not excludable from income. However, if the emotional distress has as its origin a physical injury, then the emotional distress damages are excludable.
 - 9. Punitive damages. Punitive damages are included in income regardless of whether the punitive damages are received in connection with a claim involving personal physical injuries. Punitive damages are not paid on account of the personal physical injuries.
 - 10. Interest. Interest is included in income regardless of whether the interest is received in connection with a claim involving personal physical injuries. Interest is paid on account of the lost time value of money and not on account of the injury to the plaintiff.
 - 11. Corporations not eligible for exclusion of damages under Internal Revenue Code Section 104.
- E. Does the language of the settlement agreement, if any, make a difference?
- 1. Damage components – taxable versus nontaxable.
 - 2. IRS not bound by settlement agreement breakdown.
 - 3. Court often will “rubber stamp.”

4. Complaint, if any, is critical document, in that this is an easy target for the IRS. However, the complaint often does not require specificity.
5. Attorneys and accountants often are not made aware of the pertinent facts of the complaint, the litigation, and the terms of the settlement agreement until after the claims have been resolved.

II. DEDUCTION FOR DEFENDANT

- A. Distinction between settlements and judgments.
- B. Business expenses.
 1. General rule of deductibility.
 - a. Compensatory damages.
 - b. Punitive damages.
 2. Deductible under Internal Revenue Code Section 162 if incurred in connection with a trade or business.
 3. Deductible under Internal Revenue Code Section 212 if incurred in connection with managing, conserving or maintaining property held for the production of income.
 4. Trade or business nexus. To deduct payments made to the plaintiff there must be a nexus between the trade or business or investment activity of the defendant and the origin of the plaintiff's claims.
- C. No deduction is available for fines and penalties paid to a government for violation of any law under Internal Revenue Code Section 162(f).

- D. Structured settlements. A structured settlement is any settlement that provides for payments to be made by the defendant to the plaintiff over time.

III. ATTORNEY FEES

- A. Treatment to the plaintiff.
 - 1. Business expense vs. expense incurred for the production of income.
 - 2. Alternative minimum tax problems.
- B. Treatment to the defendant.
- C. Treatment of contingent attorney fees to the plaintiff.
 - 1. Previously in Michigan a plaintiff was not required to include in his income fees paid to his attorney under a contingent attorney fee arrangement.
 - 2. However, in Banks v. Commissioner, decided January 24, 2005, the United States Supreme Court held that to the extent a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee.