Taxing Litigation Recoveries: Top Ten Developments

Robert W. Wood

Introduction

Over the last year, there have been plenty of tax law developments affecting litigation recoveries that continue to generate interest. Perhaps this is not surprising given our litigious society and the enormous monetary impact that taxes can have on the bottom-line of litigation. So with apologies to David Letterman, here is a top-ten list of recent tax law developments affecting litigation recoveries.

You should peruse this list if:

- You are involved in litigation;
- You have concluded litigation via settlement or judgment;
- You are a litigator whose clients might need tax advice; or
- You are a tax professional who occasionally delves into the tax consequences of litigation (at tax return time or otherwise).

#1: Section 104 Is Still Limited to "Observable Bodily Harm"

Section 104(a) of the Internal Revenue Code excludes from income damages paid on account of "personal physical injuries or physical sickness." Although this tax code provision has been around for 80 years, the "physical" part of it was added only in 1996. Twelve years thereafter, we still have no new regulations describing exactly what "physical" means.

Nevertheless, we do have various unofficial, nonprecedential items from the IRS (*e.g.*, Letter Rulings) that shed some light on the meaning of "physical." They make it clear that the IRS doesn't believe that any payment is excludable from income unless it results from "observable bodily harm." Think bruises and broken bones. But many litigants in employment cases still try to squeeze within the Section 104 exclusion when they have sleepless nights, stomachaches, and various other symptoms of emotional distress. Usually these plaintiffs lose in their tax cases, though there are some glimmers of hope (*i.e.*, IRS and Tax Court rulings) suggesting that more serious "physical sickness" may still qualify for exclusion.

#2: Sometimes the IRS Will Presume There Is "Observable Bodily Harm"

One of the big developments of the last year is IRS Legal Memorandum 200809001. This is an "unofficial" IRS release that people are relying on, even though technically it does not constitute precedent. This ruling involved a payment made to settle claims against an organization for sexual abuse of an individual who was a minor at the time of the incident, but was an adult when the settlement occurred. Given the nature of the sexual abuse and the number of years that had passed (and perhaps because the victim was a minor at the time), the IRS said, "it is reasonable for the Service to presume that the settlement compensated [the plaintiff] for personal physical injuries, and that all damages for emotional distress were attributable to the physical injuries." This may sound obvious, but it is an enormous leap for the IRS, since up to now, the IRS has presumed nothing and insisted that it had to see proof of physical harm. This also represents a big and positive development for taxpayers, who may have an easier time when trying to prove their own physical harm. See Wood, *IRS Allows Damage Exclusion Without Proof of Physical Harm*, 118 Tax Notes 1388 (Mar. 31, 2008).

#3: The Murphy Case Was Nice While It Lasted, But It Didn't Last

Remember Murphy's Law—if things can go wrong, they will. We had proof of that over the last year. First there was *Murphy v IRS* (DC Cir 2006) 460 F3d 79, which sent shock waves through the nation. The D.C. Circuit considered the tax treatment of a recovery for reputation injury in a whistleblower case. The court said it did not fall within the Section 104 exclusion for personal physical injuries and physical sickness, but held that taxing this kind of recovery was unconstitutional under the Sixteenth Amendment!

A short time later, no doubt assailed with outrage (and displeasure from the Justice Department and the IRS), the D.C. Circuit vacated its holding and scheduled the case for a second hearing. See *Murphy v IRS* (DC Cir 2006) 2006 US App Lexis 32293. The second time around, the *Murphy* case was a fairly pedestrian opinion, not even acknowledging that the first one was wrong, but nevertheless coming out 180 degrees in the other direction. See *Murphy v IRS* (DC Cir 2007) 493 F3d 170. Unfortunately, there's still a lot of misinformation circulating about *Murphy*. Some taxpayers are still reading and relying on the first case, but the Tax Court has said that taxpayers cannot rely on the first iteration of *Murphy*. See *Paul E. Ballmer*, TC Memo 2007–295, 2007 Tax Ct Memo Lexis 298; *Cecil R. Hawkins*, TC Memo 2007–286, 2007 Tax Ct Memo Lexis 291. Be careful.

#4: Semantics Really Matter in Tax Characterization

The exact language of a settlement agreement can dramatically influence tax consequences of the settlement. This is especially true in the wake of the *Murphy* case (see #3 above), as *both* versions of that infamous case underscore the importance of having the award (whether a judgment, arbitration award, or settlement agreement) say *exactly* what it is for.

After all, how can you receive something "on account of" personal physical injuries or physical sickness (see IRC §104(a)(2)) if the settlement agreement does not say anything about paying on account of such items? Apart from *Murphy,* there are other recent examples that make it clear you really should state the intent of the payment in the settlement agreement. See *Joyce M. Sanford,* TC Memo 2008–158, 2008 Tax Ct Memo Lexis 159. See also Wood, *Getting Physical: Emotional Distress and Physical Sickness*, 121 Tax Notes 281 (Oct. 20, 2008). Word choice is extraordinarily important.

#5: Wrongful Imprisonment Recoveries May Be Tax Free

In our CSI-obsessed society, crime scenes and technology seem to go hand-in-hand with law enforcement. But there are increasing signs that our criminal conviction process sometimes goes awry. With DNA evidence, more and more convictions are being overturned, and this has brought lawsuits and the enactment of various types of state and federal statutory schemes aimed at compensating persons who have been wrongfully convicted.

The tax treatment of such recoveries is debatable and is largely unclear at present. The IRS so far has not said anything about what it thinks. Ominously, though, the IRS has ruled that a number of older rulings dealing with payments for the deprivation of civil rights and incarceration (*e.g.,* on claims by Japanese internees as well as World War II and Korean War participants) are obsolete. See Rev Rul 2007–14, 2007–12 Int Rev Bull 747. The fact that the IRS declared these rulings obsolete suggests that it may think such recoveries are taxable. There are strong arguments for excluding a wrongful imprisonment recovery from income—*e.g.,* being locked up seems inherently physical, even if one doesn't suffer the injuries and trauma that often accompanies incarceration. Moreover, there's a tax bill currently pending that would make this explicit. However, it is too soon to say how this will all turn out. See Wood, *Are False Imprisonment Recoveries Taxable?*, 119 Tax Notes 279 (Apr. 21, 2008).

#6: Nonqualified Structured Settlements Have Been Approved

The structured settlement industry involves deferred payment mechanisms in settled lawsuits. Such structures have several goals, including allowing a tax-free accumulation of income and a spreading of payments out over a number of years to reduce the tax burden. There are both tax and investment questions at stake.

Traditionally, structured settlements have been used (with annuity products) in the case of tort victims (particularly in cases of severe or catastrophic injuries). Now, however, after years of experience in applying such structured settlements to nontaxable payments, the IRS has weighed in, saying that this vehicle is also perfectly acceptable for taxable damages. Letter Ruling 200836019 is a remarkable victory for the structured settlement industry. This case followed the same format as a traditional structured settlement, but involved the settlement of an employment case, in which the wages were separately paid with withholding and an IRS Form W-2. The rest was structured with an annuity and payments over time.

The IRS ruled that these payments are only taxable when the plaintiff receives each installment payment. This may not sound like much, but this just may be the most important tax development of the year in this field.

#7: Attorney Fee Structures Are Okay, Too

In the process of vetting the nonqualified assignment in Letter Ruling 200836019 (see #6 above), the IRS did something else remarkable. It not only cited *Richard A. Childs* (1994) 103 TC 634, aff'd (11th Cir 1996) 89 F3d 856, but it cited *Childs* several times with a kind of glowing tone. *Childs* was the seminal case that approved attorney fee structures for lawyers. The fact that the IRS has now cited *Childs* favorably and relied on it in issuing Letter Ruling 200836019 is another huge development.

#8: More Structured Attorney Fee Possibilities

Given the enormous boost to structured attorney fee arrangements (see #7 above), it seems safe to predict that creative tax planners will step outside the traditional annuity structure used for attorney fee structures in *Childs* and look to other investment vehicles. The structured attorney fee arrangement is first and foremost a deferred compensation arrangement; there are, after all, other vehicles used for deferred compensation besides annuities. We should watch this area. With annuity structures being blessed, some other structures may follow.

#9: Taxpayers Continue to Struggle With the *Banks* Decision on Attorney Fees

In January 2005, the U.S. Supreme Court decided *Commissioner v Banks* (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826. The Supreme Court said that, "as a general rule," plaintiffs will have gross income measured by the attorney fees paid to their lawyers, even if their lawyers are paid directly by the defendant. 543 US at 430, 160 L Ed 2d at 866. However, *Banks* did leave open various questions about attorney fees, including the possibility that a partnership between lawyer and client might circumvent this result. See Wood, *Attorney and Client as Partners*, 121 Tax Notes 167 (Oct. 13, 2008). The *Banks* court also left open the treatment of statutory attorney fee cases as well as cases involving injunctive relief.

The issue is important because there is usually a big difference between reporting a recovery on a net versus gross basis. If you report on a gross basis (including the attorney fees), you often cannot deduct all of the fees (*e.g.,* because of the alternative minimum tax). Although a 2004 statutory change to attorney fees enacted an above-the-line deduction for such fees available to employment law plaintiffs, that was only limited relief. See IRC §62.

Now that the Supreme Court in *Banks* has announced that attorney fees are usually gross income to the plaintiff, taxpayers continue to struggle through awkward deductibility issues in most causes of action. This area continues to be a mess. We should expect more authorities dealing with attorney fee deductibility problems.

#10: Reporting and Withholding Issues Never Go Away

One constant in the tax treatment of damage awards and settlement payments is reporting and withholding. Withholding is a big problem in employment cases, and practice is quite varied on what should be subject to withholding. There are frequent missteps here that can involve high stakes, so be careful. Wages, after all, are subject to employment and income tax withholding, and penalties for failing to withhold are severe.

Moreover, even apart from wages, there are significant reporting issues in most litigation. Form 1099 reporting is scrutinized more heavily than it used to be. Although the per-item penalty for failure to issue a Form 1099 is relatively small, most companies are concerned about these issues. Yet it is quite clear that if a payment is excludable from income under Section 104 (see #1 and #2 above), it *should not* be the subject of a Form 1099.

The best advice is for plaintiff and defendant to negotiate tax reporting matters in the settlement agreement itself. That way, everyone will know what forms and reporting will be required. It is almost always the following tax year before the forms are actually issued, and by then it can be too late to affect any kind of change. Try to know what to expect, so you are not surprised when tax forms arrive in the mail in January.