

Top 10 Tax Developments Impacting Litigation Recoveries

By Robert W. Wood

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Over the last year, there have been plenty of tax developments affecting litigation recoveries, and this area of the tax law continues to generate interest. Perhaps that is not surprising given our litigious society and the enormous dollar impact taking taxes into account can have on the bottom line of litigation. So, with apologies to David Letterman, here is the top 10 list affecting taxes in litigation. 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 these issues (at tax return time or otherwise).

1. Section 104 Still About ‘Observable Bodily Harm’

Section 104 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 in 1996. Twelve years thereafter, we still have no new regulations describing exactly what “physical” means.

However, we do have various “unofficial” nonprecedential items from the Internal Revenue Service. They make it clear that IRS does not believe any payment is excludable from income unless it results from observable bodily harm. Think bruises and broken bones.

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 is some glimmer of hope suggesting that more serious “physical sickness” may be treated differently and still qualify for exclusion.

2. Sometimes IRS Will Presume ‘Observable Bodily Harm’ Exists

One of the big developments of the last year is Chief Counsel Advice 200809001. ¹ 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 a minor. The victim was a minor at the time of the incident but was an adult when the settlement occurred.

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Given the nature of sexual abuse, and the number of years that had passed (and perhaps because the victim was a minor at the time), 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 IRS. It represents a big and positive development for taxpayers. ²

3. The ‘Murphy’ Case Was Nice While it Lasted, but It Did Not Last

There is an old saw about Murphy's Law—if things can go wrong they will. We had proof of that over the last year. First was a case called *Murphy* ³ in the D.C. Circuit Court of Appeals that 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/sickness but held that taxing this kind of recovery was unconstitutional!

A short time later, no doubt assailed with outrage (and displeasure from the Justice Department and IRS), the D.C. Circuit vacated its holding and scheduled the case for a second hearing. ⁴ The second time around, the *Murphy* ⁵ case was a pretty pedestrian opinion, not even acknowledging that the first one was wrong, but coming out 180 degrees the other direction.

Unfortunately, there is still a lot of misinformation circulating about *Murphy*. Some taxpayers are still reading the first case and are confused. The Tax Court has said taxpayers cannot rely on the first iteration of *Murphy*. ⁶ Be careful.

4. Semantics Really Matter In Tax Characterization

The exact language of a settlement agreement can dramatically influence tax consequences. This is especially true today in the wake of the *Murphy* case (see item 3 above). Both versions of the infamous *Murphy* 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 if the payor does not say anything about paying on account of such items? Sometimes, something is what you call it.

Apart from *Murphy*, there are other recent examples of this important phenomenon.⁷ 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. Today, though, there are increasing signs that our criminal conviction process sometimes goes awry. With DNA evidence, more and more convictions are being overturned. This has brought lawsuits as well as various types of compensatory schemes under both federal and state law to compensate persons who were wrongfully convicted. The tax treatment of such recoveries is debatable, but is largely unclear at present. IRS so far has not said anything about what it thinks. Ominously, though, IRS has obsoleted a number of old rulings that deal with payments for the deprivation of civil rights and incarceration (for example, by Japanese internees, World War II and Korean War participants, etc.).⁸

There are strong arguments for excluding a wrongful imprisonment recovery from income. Moreover, there is a tax bill currently pending that would make this explicit. However, it is now too soon to say how this will all turn out.⁹

6. Nonqualified Structured Settlements Have Been Approved!

The structured settlement industry involves deferred payment mechanisms to settle lawsuits. Such structures have several goals. They include 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 were used (with annuity products) in the case of tort victims (particularly in the case of severe or catastrophic injuries).

The holding of PLR 200836019 may not sound like much but it just may be the most important tax development of the year in this field.

Now, however, after years of experience with applying such structures to nontaxable payments, IRS has weighed in saying this vehicle is perfectly acceptable for taxable damages as well. Private Letter Ruling 200836019¹⁰ is a remarkable victory for the structured settlement industry. This case follows the same format as a traditional structured settlement, but involved the settlement of an employment case. The wages in the case were separately paid with withholding and an IRS Form W-2. The rest was structured with an annuity and payments over time.

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

7. Attorneys' Fee Structures OK Too!

In vetting the nonqualified assignment in PLR 200836019 (see item 6 above), IRS did something else remarkable. It cited *Childs v. Commissioner*.¹¹ Not only that, but it cited *Childs* several times with a kind of glowing tone.

Childs was the seminal case that approved attorneys' fee structures for lawyers. The fact that IRS has now cited *Childs* favorably, and relied upon it in issuing PLR 200836019, is another huge development.

8. More Structured Attorneys' Fee Possibilities

Given the enormous boost to structured attorneys' fees arrangements (see item 7 above), it seems safe to predict that creative tax planners will step outside the traditional annuity structure used for attorneys' fees structures in *Childs*, and may look to other investment vehicles.

The structured attorneys' fee arrangement is first and foremost a deferred compensation arrangement, and 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 'Banks' Decision on Attorneys' Fees

The U.S. Supreme Court in January 2005 decided *Commissioner v. Banks*.¹² The Supreme Court said that, "as a general rule," plaintiffs will have gross income measured by the attorneys' fees paid to their lawyers, even if their lawyers are paid directly by the defendant.

Nevertheless, *Banks* left open various questions about attorneys' fees, including the possibility that a partnership between lawyer and client might circumvent this result.¹³ The *Banks* court also left open the treatment of statutory attorneys' fees cases, as well as cases involving injunctive relief.

The issue is important, since 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 attorneys' fees), you often cannot deduct all of the fees (for example, because of the alternative minimum tax). While a 2004 statutory change to the treatment of attorneys' fees enacted an above-the-line deduction for such fees available to employment law plaintiffs, that was only limited relief.

For most causes of action, now that the Supreme Court in *Banks* announced that attorneys' fees are usually gross income to the plaintiff, taxpayers continue to struggle

through awkward deductibility issues. This area continues to be a mess. We should expect more authorities dealing with attorneys' fees deductibility problems.

10. Reporting, 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. The mistakes can involve high stakes, so be careful. Wages, after all, are subject to employment and income tax withholding. 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 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 items 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 accomplished. It is almost always the following tax year before the forms are actually issued, and by then it can be too late to effect any kind of change. Try to know what to expect, so you are not surprised when tax forms arrive in the mail in January.

¹ 41 TaxCore, 3/3/08.

² See Wood, "IRS Allows Damage Exclusion Without Proof of Physical Harm," Vol. 118, No. 14. *Tax Notes* (3/31/08), p. 1388.

³ *Murphy v. IRS*, 460 F.3d 79 (D.C. Cir. 2006).

⁴ 2006 U.S. App. LEXIS 32293 (D.C. Cir. 2006).

⁵ *Murphy v. IRS*, No. 05-5139, 2006 U.S. App. (Dec. 22, 2006)

⁶ *Hawkins v. Commissioner*, T.C. Memo 2007-286; *Ballmer v. Commissioner*, T.C. Memo 2007-295

⁷ See *Sanford v. Commissioner*, TC Memo 2008-158 (2008). See also Wood, "Getting Physical: Emotional Distress and Physical Sickness" Vol. 121 No. 3 *Tax Notes* (10/20/08), p. 281.

⁸ See Revenue Ruling 2007-14, 2007-12 IRB 747.

⁹ Wood, "Are False Imprisonment Recoveries Taxable?" Vol. 119, No. 3, *Tax Notes* (4/21/08), p. 279. Reprinted in *Substance & Forum* (5/23/08).

¹⁰ 173 TaxCore, 9/8/08.

¹¹ 103 T.C. 634 (1994), *aff'd without opinion* 89 F.3rd 56 (11th Cir. 1996).

¹² 543 U.S. 426 (2005).

¹³ See Wood, "Attorney and Client as Partners," Vol. 121 No. 2 *Tax Notes* (10/13/08), p. 167.