What Every Plaintiff or Defendant Litigator Should Know Regarding the Tax Effects of Litigation

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Taxation of Awards and Settlements

I. Overriding Principles

Commonly, the tax ramifications of litigating or settling a case are not considered until after the fact.

There are several reason why the tax consequences of litigation must be considered before a settlement or judgment is reached by both plaintiff and defendant attorneys.

1. The tax consequences of the litigation may have dramatic effects on all parties to the litigation
2. There are often opportunities by both plaintiff and defendant attorneys to impact the tax consequences of the litigation in order to maximize the after tax benefits to the plaintiff and to reduce the cash outflow through the leverage that comes from cooperation in tax planning by the defendant's counsel.
3. Effective tax planning for litigation is best performed at the outset of litigation even before the complaint is filed.

Plaintiff tax considerations:

If litigation is approached without proper tax planning, plaintiff attorneys are not only missing a valuable opportunity to fully maximize their client's net proceeds from a settlement or judgment, but they may be leaving significant amounts of money on the table in the form of taxes which may be entirely avoidable which could potentially open the attorney up to malpractice exposure. Take for example the recovery of $1,000,000 in damages.

In an all too typical worst case scenario, assume the entire recovery is taxable as ordinary income with an attorney contingent fee of 33% deducted as a miscellaneous itemized deduction subject to the 2% floor. The federal tax burden in this case would be $216,305. However, because of the applicability of the Alternative Minimum Tax ("AMT") in this situation, the deduction for attorney fees is disallowed and tax is applied to the entire $1,000,000 at a flat ~28% rate, resulting in a total federal tax liability of $276,500. After accounting for California income tax of $79,832, the taxpayer is left with a mere $313,668 out of a total $1,000,000 settlement. Hardly an encouraging result and one that is entirely avoidable in many situations.

For taxpayers who are able to deduct attorney fees on Schedule C as an ordinary and necessary business expense, the federal tax burden would be reduced to $235,868. After accounting for California income tax of $68,672, the taxpayer is left with $365,460, resulting in a net cash flow gain of $51,792. While somewhat better, this is still hardly a thrilling result for the plaintiff who believes that he has just "won" a $1,000,000 lawsuit.

In addition, a new Medicare Tax went into effect on January 1, 2013. Due to new fiscal cliff legislation, capital gains & dividend tax rates have increased from 15% to 20% for singles earning over $400,000 and couples earnings over $450,000. Additional changes include:

- Individuals making in the $36,250 to $400,000 range will see their capital gains continue to be taxed at a 15% tax rate. Meanwhile, earners in the lowest two income tax brackets will pay 0% on investment income.
- There will also be an additional 3.8% net investment income tax applied to singles earning over $200,000 and couples earning over $250,000. The purpose of these tax increases is to help fund Obamacare.
- Single filers who earn more than $200,000 in income from wages, compensation, or self-employment will be subject to an additional 0.9% additional Medicare Tax. The threshold amount increases to $125,000 for married taxpayers filing separately and $250,000 for married taxpayers filing jointly.
- These additional tax burdens make it more critical than ever that proper tax planning is implemented as soon possible in the litigation process.

Should the plaintiff be taxed at more favorable long term capital gains rates on their recovery, (currently 15% compared to 35% which is the highest individual tax rate in 2012 and 39.6% for 2013) the total federal tax liability drops by over half to $96,905. Accounting for California income tax of $70,513, the taxpayer is left in a significantly improved position of receiving $502,582; a difference of $188,914 from the worst case scenario. In addition, should the plaintiff be able to demonstrate that the payment constitutes a recovery of capital (such as compensation for loss or harm to a capital asset), the payment is taxable only to the extent that it exceeds the basis of the asset. In other words, the asset's basis may shelter part or all of the recovery from taxation.

However, the most favorable tax outcome for plaintiffs is obviously complete exclusion of the recovery from gross income, in which case $0 is lost to taxes and the defendant receives the full benefit of his recovery minus attorney fees. The net cash flow difference between this result and the worst case scenario is $356,332. In order to achieve this result, extensive tax planning and strong documentation at an early stage in the litigation is crucial.

The above examples illustrated the following truisms in this area of tax law:

1. The worst tax result to the plaintiff is where a settlement or judgment is fully taxable at ordinary income tax rates and the attorney's fees are only deductible as 2% miscellaneous itemized deductions.
2. Settlement and judgments taxable at capital gain rates are preferable to those taxed at ordinary rates.
3. Deductions for attorney's fees that are allowed above the line in reaching adjusted gross income are preferable to 2% miscellaneous itemized deductions.
4. Deductions that are allowed as business expenses are preferable to 2% miscellaneous deductions or above the line deductions as they reduce self-employment income and are not fazed out by AMT.
5. Settlement and judgments that are entirely tax free are obviously the most preferable type to a plaintiff.

Defendant tax considerations:

The consideration of the tax consequences of an award or settlement does not apply solely to plaintiffs, but to defendants as well. Payments made by a defendant may be fully tax deductible, partially deductible, or entirely non-deductible. There are also additional concerns if the payment is deducted as a miscellaneous itemized expense as opposed to an above the line deduction, where the 2% AGI floor and the AMT may reduce or completely eliminate the amount allowable as a deduction.

Other potential issues faced by defendants are where a payment must be capitalized rather than deducted. Where disputes involve capital improvements or the disposition of an asset, payments made by the defendant may need to be capitalized rather than deducted. Moreover, nondeductible expenses may arise where a payment is in relation to a fine or penalty levied on the defendant. Deductible fines and penalties may arise where fines and penalties are intended to be remedial or compensatory in purpose as opposed to solely punitive in nature.

Defendants themselves may also make use of tax avoidance strategies as a settlement tool to ultimately reduce the amount of damages paid out to plaintiffs in exchange for classifying payments made to them in a more tax advantageous manner.

As seen above, the tax treatment of an award or settlement will have a substantial and direct impact on the final amount received or paid by litigants. Therefore, it is absolutely crucial to undertake a tax analysis of any potential settlement or award from the outset of a case, where payments and claims can be classified in a manner that fully minimizes tax burdens for both defendants and plaintiffs alike.

In *Gregory v. Helvering*[1], Judge Learned Hand issued this famous quote:

> "Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes."

However, there is a fine distinction between perfectly legal tax avoidance as described by Judge Learned Hand, and tax evasion which carries stiff civil and criminal penalties. If one is unaware of that distinction, it would be best to consult with a tax attorney who is. In fact, the IRS itself is oftentimes unaware of this distinction, as evidenced by their repeated use of the term "tax avoidance" interchangeably with "tax evasion" on their website and throughout their published literature. This makes it even more vital that you seek wisdom from an experienced tax practitioner before embarking on tax motivated settlement negotiations, which may end up in a malpractice suit should the IRS deem that you fall on the other side of the ever shifting line between tax evasion and avoidance.

[1] 69 F.2d 809 (1934)

Malpractice exposure:

Attorneys can face malpractice claims for the failure to render competent tax advice on the tax consequences of litigation. In *Philips v. Giles*, a divorce attorney faced malpractice where he failed to advise his client that payments she received as a result of the divorce settlement were taxable. In *Jamison, Money and Farmer & Co. v Standeffer*, an accountant was found negligent for his advice concerning disability payments. In *Jalali v. Root*, an attorney was found negligent where his advice on the tax consequences of the litigation was incorrect. Factors that amplify exposure in this area of tax law is that courts are often reluctant to opine on the tax treatment of a judgment and to make matters worse the tax authorities do not have to respect the tax treatment afforded the litigation by judgment or settlement which makes giving tax advice in this area very uncertain. For example where a judge issues an award to the plaintiff of $5,000,000 in a defamation suit and states that such a recovery is tax free, the taxing authorities do not have to respect the courts tax classification.

Note: The bare bone basics of divorce taxation concern IRC Code section 1041 that renders property settlements related to divorce nontaxable and the treacherous rules surrounding alimony making it deductible to the payor and income to the recipient spouse if properly structured.

Making this a deeper quagmire is the fact that most of the primary authority for tax treatment of a recovery has developed through very nuanced case law rather than the certainty found by statute. The only statutory authority is found under IRC code section 104, 106 and 186 as to the classification of income and under code sections 162 and 212 for deductibility of legal fees.

The taxing authorities will look to the following in determing the tax consequence of litigation:

1. **The total amount sought**
2. **The various claims made**
3. **The evidentiary proof surrounding each claim**
4. **The settlement document or judgment which hopeful contains allocation of the recovery for each claim which may or may not be respected by the taxing authority.**

Lastly to make matters more convoluted, all of the rules given below will change if the litigation surrounds the following which is beyond the scope of this presentation:

1. **Whether the damage to the plaintiff is caused by a casualty or theft**
2. **Property is taken from the plaintiff or a sale is forced via a condemnation proceeding**

Basics of determining the tax effect of a judgment or settlement:

a. Settlement or Judgment

For federal income tax purposes, it is generally irrelevant whether the lawsuit results in a settlement or a judgment. However, from a practical aspect, settlements tend to offer greater tax

planning opportunities as the parties to litigation have significantly greater room in coming to a mutually acceptable resolution, as opposed to merely accepting the judgment of the court which may not lead to the creation of the most advantageous tax consequences. The confidentially of the settlement process also facilitates litigation tax planning.

b. Origin of the Claim Test

The origin of the claim test dictates that the tax result of a settlement or judgment should be determined by reference to the underlying claim which the lawsuit seeks to redress.[2] Simply put, the determinative inquiry as to the tax consequence of an award or settlement is: "In lieu of what were the damages awarded?"[3]

The underlying nature of a claim is determinative in whether a recovery should be treated as ordinary income or capital gain / loss.

Although the principle of the origin of the claim test is seemingly straightforward, the practical application can be extraordinarily complex, often times developing into an extensive facts and circumstances analysis where:

> "consideration must be given to the issues involved, the nature and objectives of the litigation, the defenses asserted, the purpose for which the claimed deductions were expended, the background of the litigation, and all the facts pertaining to the controversy."[4]

c. Classifying Recoveries

The taxing authorities define income as broadly as possible and narrowly construe exclusions from income and deductions. Section 61(a) of the Internal Revenue Code broadly defines gross income as "all income from whatever source derived." Case law has further elaborated upon the meaning of income as "an undeniable ascension of wealth, clearly realized, and over which the taxpayers have complete dominion."[5] Therefore, unless an applicable exclusion applies, gross income for federal income tax purposes is generally all encompassing. Under this framework, additional sections of the Code and Treasury Regulations expressly deal with specific items of income and expense in a myriad number of different ways which must be accounted for when ultimately determining the tax treatment of an award or settlement.

Typically, an award or settlement contains payments which compensate defendants for a number of different items, such as medical expenses, punitive damages, lost wages, and interest. In order for the tax treatment of a payment to be fully determined, considerable analysis is often necessary to classify and apportion an award or settlement into its constituent parts.

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[2] *U.S. v. Gilmore,* 372 U.S. 39 (1963)
[3] *Raytheon Production Corp. v. Commissioner,* 144 F.2d 110 (1944)
[4] *Bradford v. Commissioner,* 70 T.C. 584 (1978)
[5] *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955)

Quite obviously, this process has considerable tax ramifications. Classifying payments as solely punitive damages would cause full inclusion in gross income and tax to be applied at ordinary income rates, whereas classifying payments as a physical personal injury may result in full exclusion from ordinary income and no tax liability. Therefore, tax planning for awards and settlements is concerned chiefly with classifying and apportioning payments into categories of income with the most favorable tax treatment wherever possible.

II. Important IRC § 104 Exceptions

a. Personal Physical Injuries

Section 104(a)(2) provides a broad exclusion from gross income for non-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**."

This broad definition includes all payments for damages arising from a personal physical injury or sickness, regardless of whether the recipient of the payment is the injured party. For example, in Private Letter Ruling 200121031, a widow whose husband died from cancer after being exposed to asbestos received a recovery based on a claim for loss of consortium. The IRS held that under these circumstances, the recovery was excludable under Section 104(a)(2) because it was on account of a personal physical injury or sickness.

Similarly, in Private Letter Ruling 200029020, the taxpayer was killed in a fatal car accident. His estate received a settlement for wrongful death. The IRS held that the recovery was excludable as it resulted from the taxpayer's fatal, personal physical injury.

In addition to being on account of a personal injury or sickness, the recovery must also be "physical" in nature. Unfortunately, neither the Code nor Treasury Regulations offer much guidance as to the meaning of "physical." However, the IRS in a letter ruling stated that "we believe that direct unwanted or uninvited physical contacts resulting in **observable bodily harms** such as bruises, cuts, swelling, and bleeding are personal physical injuries…"[6]

Although case law, regulations, and the statute are vague as to what constitutes the physical component of a personal injury or sickness, the legislative history of Section 104 makes clear that **emotional distress** and any **attendant symptoms** do not constitute a physical injury or physical sickness. However, as with claims for loss of consortium or wrongful death (given above), payees may still exclude from income payments received as a result of emotional distress stemming directly from a personal physical injury or physical sickness.

For example, in Letter Ruling 200041022, the taxpayer was physically and sexually assaulted by her employer, resulting in observable bodily harm. The taxpayer filed suit alleging among other

[6] *PLR 200041022*

things intentional infliction of emotional distress. Under these facts, the IRS concluded that the damages received for emotional distress were excludable under Section 104(a)(2) because they were directly attributable to a personal physical injury.

Courts have also been notoriously capricious in determining when damages are deemed to be received "on account" of a personal physical injury or sickness when the personal physical injury or sickness is but one link in a chain of events leading to the plaintiff's cause of action. For example, in *Johnson v. United States*,[7] the plaintiff, a guard at a juvenile detention center, suffered physical injuries when assaulted by an inmate. The plaintiff subsequently brought suit under the American with Disabilities Act alleging that his employer failed to accommodate his physical debilities that resulted from the earlier assault incident. The court held that the plaintiff's recovery was not excludable from gross income because the "causal link [was] too tenuous to support exemption from taxation … and that the actual injury that Plaintiff recovered for was discrimination, which does not qualify as a physical injury…"

Therefore, in order for a payment to qualify for exclusion under Section 104(a)(2), it is critical that plaintiffs establish that settlement payments were received on account of a personal physical injury or sickness to the greatest extent possible. For example, had the plaintiff in *Johnson* linked his claim for wrongful termination and discrimination more closely to his personal physical injury, it might have yielded a different result.

b. Personal Physical Sickness

The Tax Court has recently held that personal physical injury or sickness might also include instances where the defendant either caused or aggravated a condition of the plaintiff, resulting in diagnosable physical symptoms requiring medical treatment.

For example, in *Domeny v. Commissioner*,[8] the taxpayer suffered from multiple sclerosis which was exacerbated by workplace problems caused by the employer. The Tax Court held that the taxpayer's settlement was excludable from gross income as a personal physical injury or sickness because the taxpayer had sufficiently demonstrated that the damages she received were intended to compensate her for "acute physical illness caused by her hostile and stressful work environment."

Similarly, in *Parkinson v. Commissioner*,[9] the taxpayer worked long hours under stressful conditions and consequently suffered a heart attack. The taxpayer then filed suit under the Americans with Disability Act alleging that his employer failed to accommodate his severe coronary artery disease. Here, the Tax Court also held that the plaintiff's recovery was non-taxable stating that "[i]t would seem self-evident that a heart attack and its physical aftereffects

[7] 76 Fed.Appx. 873 (2003)
[8] *Id.*
[9] T.C. Memo 2010-142

constitute physical injury or sickness rather than mere subjective sensations or symptoms of emotional distress…"

Thus, the physical "hook" in *Domeny* and *Parkinson* leading to excludability under Section 104(a)(2) involves documenting and distinguishing between medically diagnosable conditions which can be treated by a doctor, as opposed to the more nebulous aches, pains, and suffering that might result from emotional distress.

c. Workers Compensation Damages and Disability Benefits

Section 104(a)(1) excludes from gross income payments received under "workmen's compensation acts as compensation for personal injuries or sickness."

Treasury Regulation § 1.104-1(b) states that to qualify for exclusion under Section 104(a)(1), a settlement or award must be made under a statute that is "in the nature of a workers compensation act," and is for an injury "incurred in the course of employment."

In order to be considered "in the nature of a workers compensation act," a statute must contain specific language establishing **a nexus between payments and on the job injuries or sickness**.[10] Statutes which fail to distinguish between work related and non-work related injuries will not qualify as a workmen's compensation acts within the meaning of Section 104(a)(1).[11] However, statutes with dual purposes, of which one purpose contains the requisite nexus between payments and work related injuries may still be considered within the nature of a workmen's compensation act.[12] Therefore, the precise language and nuances of a statute are critical to determining the excludability of disability payments under Section 104(a)(1).

For example, in *Byrne v. Commissioner*,[13] the Tax Court held that the California Judges' Retirement Law is a dual purpose statute which provides both retirement benefits and benefits in the nature of workmen's compensation acts. The exact language of the statute at issue is as follows:

> "Any person who becomes a judge during the period of January 1, 1980, through December 31, 1988, shall not be eligible to be retired for disability unless the judge is credited with at least two years of judicial service or unless the disability is a result of injury or disease arising out of and in the course of judicial service."

The taxpayer in *Byrne* was allowed to exclude payments received under the statute because he received his benefits under the second portion of the statute that addressed injuries arising during

[10] *Wallace v. United States,* 139 F.3d 1165 (1998)
[11] *Craft v. United States*, 879 F. Supp. 925 (1995)
[12] *Byrne v. commissioner*, T.C. Memo 2002-319
[13] 84 T.C.M (CCH) 704, (2002)

the course of judicial service (and not the portion which conditions payments based upon years of service), which the Tax Court held to be within the nature of a workmen's compensation act.

Social Security disability benefits do not constitute workers compensation because benefits are paid regardless of whether or not the injury was incurred during the course of employment.[14] In addition, retirement, pensions, and annuity payments are generally not excludable under Section 104(a)(1) to the extent the amount paid is determined by reference to age, employee contributions, or length of service.[15]

d. Amounts Received Through Accident or Health Insurance for Personal Injuries or Sickness

Section 104(a)(3) excludes from gross income disability payments or benefits received from an accident or health insurance plan, except "to the extent such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee or are paid by the employer."[16] Plainly stated, payments received from an accident or health insurance plan are includable in gross income to the extent that the premiums for those plans were paid by the employer and not previously included in the taxpayer's income.

e. Unreimbursed Medical Expenses

Treasury Regulations specify that payments received on account of unreimbursed medical expenses are excludable under Section 104 for personal injury or personal sickness, even where no physical component exists.[17]

However, due to the tax benefit rule (See Section IV below), under Revenue Ruling 75-230, the IRS's position is that unless there is an express allocation for medical expenses in an award or settlement, medical expenses paid and deducted in previous taxable years are presumed to be recovered first out of total damages received and are includable in gross income. Conversely, allocations to future medical expenses are excludable from income but may not be deducted.[18]

Under Section 213, medical expenses are defined as payments made for medical care. Medical care is defined as the "diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body." Medical care may also include payments for "transportation primarily for and essential to medical care," prescription drugs, insulin, special diets prescribed by a physician to treat a specific illness, and qualified long term care services.

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[14] *Green v. Commissioner*, T.C. Memo 2006-39
[15] *Supra* 9
[16] *See Also* IRC §§ 105, 106
[17] Treas. Reg. §§ 1.104-1(a), 1.213-1
[18] Rev. Rul. 75-232

Medical care does not include cosmetic surgery or expenditures that merely improve general health (such as vacations). The service has gone into great detail and issued numerous rulings on the issue of what does and does not constitute medical care, even going so far as to rule that while pregnancy test kits are qualified medical expenses, banking umbilical cord blood as a precautionary measure is not. Before allocating recoveries to medical expenses then, it would be highly prudent to review the pertinent treasury regulations and IRS rulings to determine if the expense qualifies as medical care for tax purposes.

III. EMTALA and FCA Recoveries

a. EMTALA Recoveries

Generally speaking, EMTALA imposes on hospitals which have entered into provider agreements with the government, the duty to medically screen people seeking emergency medical care, and if an emergency medical condition exists to stabilize the person before either transferring or discharging them, without regard to their ability to pay.

Recoveries under EMTALA follow the general rules for inclusion and deductibility, where the origin of the claim test controls the tax treatment of the recovery.

Under EMTALA, hospitals which negligently violate the statute are subject to civil penalties of up to $50,000, or $25,000 if the hospital has fewer than $100 beds. Because civil penalties awarded by the statute are clearly punitive in nature, these civil penalties are generally includable in gross income to the recipient (See Section V below). This again emphasizes the importance of assessing all of the tax ramifications before classifying and apportioning awards and settlements. For example, should payments be classified as entirely on account of excludable personal physical injuries as opposed to civil penalties, the recovery would be entirely non-taxable. This allows room for the parties to negotiate, whereby a plaintiff might receive a tax beneficial recovery above what he would receive if the recovery was taxed, and where the defendant would pay less than what might be required under the statute.

EMTALA also allows injured persons a private right of action against hospitals for harm suffered as a result of a violation of the statute. This is where tax planning at the pleading stage is crucial to ensuring beneficial tax treatment. Where a recovery can be established on account of a physical injury or sickness, the recovery will be entirely non-taxable to the plaintiff. If however the recovery is deemed to be on account of pecuniary harms, discrimination, punitive damages, or interest, the taxpayer will generally be taxed on their recovery. Therefore, in order to achieve beneficial tax treatment, claims set forth in the complaint should generally be limited to personal injuries where possible.

Courts and the IRS will also typically look to all the facts and circumstances in determining whether an award or settlement will be respected for tax purposes, including what claims were made, the evidence presented, and the strength of those claims. For example, claims based upon

a breach of contract resulting in a recovery for lost profits that are later reclassified in the settlement agreement as "on account of physical injuries," will not be respected by the court. Therefore, it is imperative that the complaint set forth the proper claims for which later recoveries will be based upon.

And as *Johnson* (above) illustrates, recoveries that lack a strong causal link to personal physical injuries or sickness will be includable in gross income. Therefore the complaint and prayer for relief should attempt to link any claims presented and damages sought as tightly as possible to a personal physical injury or sickness in order to avoid inclusion of the recovery in income.

Under EMTALA, a hospital may also be liable for monetary damages to another hospital for any unreimbursed expenses resulting from a violation of the statute. In this case, the recovery represents lost income and would be taxable at ordinary income rates.

Lastly, an award of attorney fees are includable in gross income for the plaintiff (See Section VII below). The plaintiff must then deduct the fees either as an above the line deduction or a miscellaneous itemized expense.

b. FSA Recoveries

In general, the False Claims Act ("FSA,") allows for whistleblowers and private individuals, otherwise known as "relators," to sue on behalf of the government those defrauding the government and receive a portion of the recovery. If the government pursues the action, the relator may receive anywhere from 15-25% of the recovery. If the relator pursues the action, he may receive 25% to 30% of the recovery. Because the reward received by the relator is non-compensatory in nature, it constitutes income to the relator and is taxable at ordinary income rates.

Under the statute, the relator also receives all of the attorney fees and litigation costs from the defendant. The circuits are currently split over whether or not attorney fees recovered from the defendant may be excluded from income. The majority approach, also taken by the Ninth Circuit, is that attorney fees are includable in income under the anticipatory assignment of income doctrine.[19] The anticipatory assignment of income doctrine states that income is taxed to those who earn it, regardless of how that income is assigned prior to receiving it. This prevents taxpayers from shifting income to individuals in lower tax brackets and disrupting the progressive tax system put in place by the Code. Here, the relator holds complete dominion over the litigation and is the sole recipient under the statute of the reward. Therefore, the relator is deemed to have earned the income and any associated recovery for attorney fees is includable in income. As Judge Posner so eloquently stated, "it is often the case that to obtain income from an

[19] *Kenseth v. Commissioner*, 259 F.3d 881 (2001)

asset one must hire a skilled agent and pay him up front; that expense is a deductible expense, not an exclusion from income."[20]

Fortunately, Section 62 of the Code allows taxpayers to take an above the line deduction for attorney fees and court costs involving claims made under the False Claims Act. The benefit of taking an above the line deduction as opposed to a miscellaneous itemized deduction can significantly impact the plaintiff's net cash flow, as illustrated above.

As for defendants, the FSA allows for treble damages and civil penalties in addition to compensatory damages. Amounts paid as penalties or fines to a government entity because of a violation of law are generally non-deductible.[21] In addition, as illustrated in Private Letter Ruling 200502041, payments which are not specifically allocated to fines or penalties may still be non-deductible if they are of a punitive nature. Here, the taxpayer worked for several government agencies. The government suspected that the taxpayer overbilled the government, and the taxpayer settled. In the settlement agreement, the taxpayer denied any wrongdoing or liability in connection the government's claims. The settlement agreement also did not allocate payments to any specific claims. However, the IRS ruled that based upon government spreadsheets which showed that part of the settlement would serve a punitive purpose, that that portion of the payment constituted a non-deductible fine or penalty to the taxpayer.

IV. Business and Investment Recoveries

a. Lost Profits vs. Damage to Goodwill and Capital Assets

In determining the proper character of income for business and investment recoveries, the most important distinction is between a recovery for lost profits and a recovery for damage to goodwill or other capital assets. The burden of proof is on the taxpayer in determining the character of such a recovery. Generally, lost profits are taxable as ordinary income as it represents income that would have been taxable at ordinary income rates had it not been for the defendant's actions. In contrast, a recovery for harm to goodwill or other capital assets is typically taxed as a recovery of capital. Where a capital recovery does not exceed its basis no capital gain will result. The rationale for this is that no financial gain results for the recovery of one's un-depreciated investment in an asset. If no basis can be established by the plaintiff the entire amount will be treated as capital gain.

The general presumption with respect to damages in a business related recovery is that they are attributable to lost profits.[22] This is a relatively high threshold to cross. Thus, where a taxpayer cannot fully substantiate that an allocation to goodwill or capital assets is appropriate, the recovery will almost always constitute lost profits.

To reap the most benefit, taxpayers should attempt to allocate a recovery to capital assets wherever possible. To support an allocation to goodwill or capital assets, the lawsuit must

[20] *Id.*
[21] IRC 162(f)
[22] *Basle v. Commissioner,* 16 T.C. Memo 745 (1957)

involve harm to such assets which is readily ascertainable in value.[23]If the taxpayer can demonstrate a capital recovery, it will be non-taxable to the extent of the taxpayer's basis in the goodwill or assets and taxable at favorable capital gains rates to the extent that it exceeds basis.

Allocations may be found either in a judgment or a settlement, but if an allocation between lost profits and recovery of capital is not addressed the burden is on the taxpayer to do so.[24]The taxpayer will have to make an allocation based on the total amount sought, the various claims made, and the proof supporting those claims. An express allocation is not binding on the IRS, but in most cases it has been persuasive.

Where lost profits are personal service income are on account of personal injury or sickness they may be fully non-taxable.

b. Tax Benefit Rule

Under Section 111(a), a taxpayer's "income does not include income attributable to recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of tax…" Simply put, taxpayers need not include in income amounts recovered so long as they did not receive a tax benefit for the loss in a prior year. Conversely, taxpayers must include in income any amounts recovered if they received a tax benefit in a prior year for that loss. "Tax benefit," is to be interpreted broadly and includes any exclusion, deduction or credit which reduced federal income tax due in a prior year. A tax benefit also includes increases in unexpired carryover losses for which the taxpayer has not yet utilized.[25]

c. Tax Damages

The general rule for tax indemnity payments is that payments of a taxpayer's tax liability, whether direct or indirect, are taxable as income under Treas. Reg. Section 1.61-14(a). However, two exceptions apply. Where a taxpayer pays more in federal income taxes than he would have due solely to the actions of a third party, a tax indemnity payment is not includable in gross income as the payment only restores the taxpayer to the position he would have been in had it not been for the actions of the third party.[26]

Along these same lines, where a return preparer makes a mistake and reimburses a client for any resulting additional taxes or penalties paid by the taxpayer, the reimbursement is not includable in gross income.[27] However, if the return preparer initially pays the additional taxes or penalties incurred by the client, then that payment is taxable income to the client under Treas. Reg. 1.61-

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[23]*Arcadia Refining Co. v. Commissioner,* 118 F.2d 1010 (1941)
[24]*Raytheon Production Corp. v. Commissioner,* 144 F.2d 110 (1944)
[25] IRC 111(c)
[26]*Centex Corp. V. United States*, 55 Fed. Cl. 381 (2003)
[27]*Clark v. commissioner,*40 BTA 333 1939

14(a).[28] Therefore, it is always advisable to have the client pay the tax first and then receive reimbursement from the return preparer to avoid inclusion in income.

d. Gross Ups to Cover Tax Liabilities

Generally, it is extremely difficult to obtain a gross up of a court awarded judgment to account for additional taxes which must be paid by the plaintiff on such awards. However, there is some authority which allows the court to award additional damages to account for taxes paid where the plaintiff can demonstrate that receipt of a lump sum award results in a higher tax burden than having received that income over time, such as in instances where back pay is awarded.[29] In such cases, given the higher tax burden of a lump sum award, the award would not be sufficient to make the plaintiff whole. For example, in *O'Neill v. Sears Roebucks & Co.*,[30] the court reasoned that additional damages to account for the tax penalty of receiving wages as a lump-sum as opposed to over a period of time were appropriate under the Age Discrimination in Employment Act, because the intent of the Act was to make plaintiffs whole.

In addition, awards in federal jury trial cases cannot be grossed up as additur (gross up) is forbidden by the Seventh Amendment to the U.S. Constitution.

e. Non-Taxable Bequest or Inheritance

In disputes between competing beneficiaries of non-taxable gifts, bequests or inheritances made under Section 102(a), recoveries are fully excludable from gross income.[31] This is due to the fact that under the origin of the claim test, recovery of non-taxable income is in itself non-taxable. For example, in *Getty v. Commissioner*,[32] the court held that a $10 million dollar lump-sum settlement of a lawsuit between competing beneficiaries of Paul Getty's will to be non-taxable given that the property in dispute was Section 102 property. However, in *Edwards v. Commissioner*,[33] the court held that a widow who settled her claim against her husband's estate in return for periodic trust payments was fully taxable on those payments because the payments constituted income from Section 102 property which is expressly non-excludable from gross income under Section 102(b).

f. Recoveries Under Contract Rights

Generally, recoveries under contract rights are taxable as ordinary income, as a failure to perform by one of the contracting parties typically gives rise to a loss of income. However, in cases where a breach of contract involves a capital asset such as goodwill or stock, the taxpayer carries

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[28] *See Also* Ltr. Rul 7749029
[29] *O'Neill v. Sears Robucks & Co.*, 108 F. Supp 2d. 443
[30] *Id.*
[31] *Getty v. Commissioner,* 913 F.2d 1486 (1990)
[32] *Id.*
[33] 37 T.C. 1107 (1962)

the burden of showing that breach involved harm to a capital asset, that the portion of the recovery to be taxed at capital gains rates is directly attributable to that asset, and the actual basis of that asset.[34] Where the taxpayer is unable to establish one or more of these elements, the entire recovery is likely to be treated as ordinary income. For example, in *Raytheon Corp. v. Commissioner*,[35] the taxpayer received damages from RCA in settlement of an antitrust suit. While the taxpayer was able to establish its basis in certain capital assets such as its patent and license rights, the court held that with respect to the portion of the damages received for assets where the taxpayer could not establish its basis such as goodwill, that that entire portion was taxable as ordinary income.

In addition, the origin of the claim test is critical to determining the tax treatment of the recovery. Even where the contract primarily involves the sale or exchange of a capital asset, if the recovery provides compensation for the use of the capital asset as opposed to harm to the asset, the recovery will be taxable as ordinary income. In *Keller Street Development Co. v. Commissioner,*[36] the taxpayer received a settlement from the buyer of his brewery in regards to a minority shareholder derivative suit. The taxpayer treated the recovery as an adjustment in the sale price of the brewery. Although gain from the sale of the brewery constituted capital gain, the court held that the recovery was taxable as ordinary income because it compensated the taxpayer for the buyer's use of the brewery during the 10 years of litigation.

V. Punitive Damages and Interest

a. Punitive Damages

Punitive damages are typically described as damages designed to punish wrongdoers, rather than compensate victims. The general rule for these type of damages received on account of a personal physical injury or illness is that they are includable in gross income. Although neither the Code nor Treasury Regulations provide any guidance as to what constitutes punitive damages, the IRS has somewhat addressed the issue in Rev. Rul. 85-98. The Ruling states that where a plaintiff seeks both compensatory and punitive damages and recovers a lump sum payment, that the allocation between the two must be based on the "best evidence available." Given the potential unpredictability of this rule, settlement agreements offer significant advantages over court awarded judgments as there is greater flexibility in documenting and characterizing payments, and defendants rarely, if ever wish to characterize payments as punitive in nature. Therefore, where possible, characterization of a settlement as wholly excludable compensatory damages under Section 104 provides the most optimal tax consequences for most defendants.

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[34] *Supra* at 16
[35] 144 F.2d 110 (1944)
[36] 688 F.2d 675 (1982)

Section 104(c) provides two instances where certain types of punitive damages may be excludable from gross income, otherwise referred to as "qualified punitive damages." The first instance is where punitive damages are awarded in a wrongful death action. The second instance involves recoveries where under state law only punitive damages may be awarded in an action. In either of these situations, punitive damages are fully excludable from gross income.

b. Interest

Interest received generally constitutes taxable income under IRC § 61(a)(4), whether post judgment or pre-judgment. Even in cases where the recovery is ordinarily excludable from income under Section 104, under the origin of the claim test, interest compensates plaintiffs for the time value of money as opposed to any excludable physical personal injury or sickness and is therefore includable in gross income. Thus, it is critical that the parties to litigation specifically allocate payments in any settlement agreement to avoid payments being reclassified as interest.

To illustrate the planning in this area, a settlement that states that no interest has been paid or is sought and relates to personal injuries or sickness in fully excludible where if no mention of interest is made interest is likely to be imputed by the taxing authorities making the interest portion of the recovery taxable. However, an agreement that appears to simply deny that any interest whatsoever is being paid is not likely to be respected by the taxing authorizes. The solution is to allocate a reasonable but nominal amount to interest.

In M*cShane v. Commissioner,*[37] the language of the settlement agreement specifically provided that payments were to be made without interest and were determined solely on basis of the risks each party faced in continuing litigation. The court respected the allocation set forth in the settlement agreement, noting that the intention of the parties as stated by their attorneys was consistent with the payment of no interest.

In contrast, attempting to explicitly disclaim court awarded interest when drafting a post-trial settlement agreement will generally not be respected by the courts or the Service. In *Rozpad v. Commissioner,*[38] the taxpayer received a jury award which included prejudgment interest. On appeal, the taxpayers settled stipulating that none of the settlement amount would include interest. However, the court held that the no interest stipulation was ineffective and that the settlement should include a pro rata share of interest as determined by looking to the original award.

VI. Structured Settlements

Structured settlements are vehicles which allow plaintiffs to convert lump sum payments into a stream of periodic payments. **Warning: Failure to consider the tax advantages of a structured settlement for a client may lead to malpractice liability that cannot in my**

[37] T.C. Memo 1987-151
[38] 154 F.3d 1 (1998)

opinion by drafted away in an engagement letter. When lawyers and judges communicate regarding structured settlements they rarely mean that the defendant will pay overtime in installments. Typically, the defendant makes a single lump sum payment to a third party assignee (usually a life insurance company) who becomes obligated to make payments to the plaintiff. The insurance company than purchases or funds an annuity that there after funds the plaintiff's periodic payments. Due to the adversarial relationship between litigants, the third party assignee is typically a neutral party, such as an insurance company or annuity provider.

A major advantage of a structured settlement arrangement is that the initial lump sum payment which is invested in an annuity for the benefit of the plaintiff is funded on a pretax basis to the plaintiff. The additional sums of money that are earned over time by the annuity could easily be viewed as income by the taxing authorities accrues tax free similar to how a retirement plan grows tax free. By stark contrast, where a plaintiff receives a lump sum, after first paying what often amount to large sums of income tax, whatever is left to be invested in stocks bonds CD's or securities is taxed on an annual basis on the investment income.

Tax Law allows beneficial tax treatment to structured settlements because of the doctrines of constructive receipt and economic benefit. These doctrines prevent the immediate taxation to the plaintiff where the structured settlement is put in place before the plaintiff has a right to receive a lump sum or received a current economic benefit, either of which would made the lump sum taxable even if payment is delayed to a subsequent tax year if a right to receive a lump sum payment arises before a structured settlement is put in place. Additionally, the plaintiff does not own the annuity that is typically purchased or funded by an insurance company and thus has no rights to assign or transfer it which additionally does not trigger the above mentioned tax doctrines.

As each periodic payment is received by the plaintiff it becomes income in the year received which is a tremendous benefit from a tax standpoint that income tax rates are graduated as income rises. By stretching out the payments over time the highest marginal tax rates are avoided potentially saving the plaintiff large amounts of income tax. Stated another way, the federal income tax is a progressive tax system, meaning that as income is received in greater amounts it is taxed at progressively higher rates. Because structured settlements allow plaintiffs to receive a stream of smaller payments over time, those payments are taxed when received at a substantially lower rate than if the payment was made as a single lump sum. Structured settlements also provide long term security and stability for the care of minors or permanently disabled persons and prevent plaintiffs from otherwise squandering payments that may be needed over the long term.

In addition, where periodic payments are made on account of personal physical injury or sickness, under Section 104(a)(2), payments are fully excludable from gross income. This exclusion also includes any compounded growth or interest component. For example, in *A v.*

D,[39] a minor deformed by drugs administered to his mother during pregnancy received a lump sum payment of $225,000 which was used to purchase an annuity. The court in its opinion noted that if the boy lived to his normal life expectancy that the payments would total over $3,000,000, yet nevertheless held that the entire amount was excludable.

However, the disadvantages of a structured settlement must also be considered. One main concern for defendants is that a third party assignee or payor may become insolvent. Further compounding this issue is that generally plaintiffs may not hold any rights greater than that of an unsecured general creditor. Any ownership rights or security interest in an annuity or insurance policy may trigger inclusion in gross income of the entire settlement amount for the current year under the doctrines of Economic Benefit and Constructive Receipt.

In addition, future circumstances may also change, whereby the plaintiff may require immediate access to the entire settlement amount to pay for unanticipated or unexpected expenses. Unfortunately, the payment period and payment amounts of a structured settlement generally cannot be changed once finalized.

VII. Substantiating Tax Treatment

Substantiation is an issue of primary concern when attempting to draft settlement agreements that bring about a desired tax consequence. Never the less even with due diligence there will often be a certain amount of uncertainty in attempting to reach desired tax results. The greater the number of claims in a lawsuit the greater the uncertainty can become. Oftentimes, litigants in this situation are not adverse parties when it comes to the tax issues at hand. The IRS knows this, and has a strong motivation to scrutinize any agreed upon settlement to ensure that any stated payment classifications and allocations are truly bona fide. In making this determination, typically courts and the IRS will look to the language of the complaint, the settlement agreement, and the intent of the payor. While no one single factor is controlling, careful tax consideration, consistency in reporting, and documentation at every step will greatly improve the chances that the agreed upon settlement will be respected.

The most successful way of attempting to achieve a desired tax result is to include specific tax language in a settlement agreement. While the taxing authorities will not be bound by this technique practice shows that the taxing authorities will often not alter the desired tax treatment even when under direct scrutiny if the treatment is reasonable under the circumstances. Allocations surrounding multiple claims must also be reasonable and tied to the underlying nature of the case. Where a recovery is not taxable under IRC section 104 for example where related to a personal injury the settlement should state that the damages are not taxable and that a 1099 should not be issued by the plaintiff because a controversy with the taxing authorities is guaranteed if the taxpayer reports a recovery as nontaxable where a 1099 indicates the contrary. Note a 1099 should still be issued to the plaintiff's lawyer! Where a recovery relates to

[39] 482 A.2d 531 (1984)

employment the settlement should specify what portion of the recovery will receive wage treatment, reporting and withholding. If taxable non wages are paid the settlement should spell out the appropriate 1099 reporting.

a. The Complaint

Under Revenue Ruling 85-98, the IRS has stated that it considers the complaint as being the most persuasive piece of evidence concerning the character of a recovery. Factors such as the nature of the claims set forth in the complaint, the individual merit of the claims, and the prayer for relief are to be considered in determining validity of the classification and allocation of payments.

For example, where a complaint failed to state a claim based on personal physical injury or sickness, the Tax Court held that the settlement could not therefore be excludable under Section 104(a)(2).[40] Similarly, where a complaint sought only compensation for lost profits, a settlement agreement characterizing a recovery as a long term capital gain will not be respected.[41]

b. The Settlement Agreement

The crafting of precise and detailed language addressing the nature and release of specific claims is vital to ensuring that a settlement agreement is respected. Plaintiffs who fail to take such steps are often disappointed by the results. For example, in *Durret v. Commissioner*,[42]the court held that a taxpayer's belief that he was settling a claim which was not set forth in the settlement agreement was insufficient to support his claim that the recovery was excludable from gross income. Likewise, in *Foster v. Commissioner*,[43] the court held that correspondence between litigants which alluded to potentially excludable claims not included in the express language of the settlement agreement was also insufficient to support the taxpayer's argument that his recovery was excludable.

While careful drafting can greatly improve the chances that a settlement agreement will be respected, it is well established that the express language in a settlement agreement is not necessarily controlling. For example, in *Peaco v. Commissioner,*[44] the taxpayer settled a claim with his insurance company which included compensation for back and front pay and pain and suffering. The settlement agreement contained language which specifically stated that all payments made were for pain and suffering as a result of a personal physical injury and not for front or back pay. The court held that the entire recovery was taxable because the settlement

[40] *Gunderson v. Commissioner,* T.C. Memo 1979-99
[41] *Longino Estate v. Commissioner*, 32 T.C. 904 (1959)
[42] T.C. Memo 1992-682
[43] T.C. Memo 1996-26
[44] T.C. Memo 2006-48

agreement did not reflect the true intentions of the parties and that the taxpayer had failed to establish that any amount of the recovery was due to personal physical injury.

However, the Tax Court has held that under certain conditions, express allocations in a settlement agreement will generally be followed. Those conditions require that a settlement agreement be entered into by the parties in an adversarial context, at arm's length, and in good faith.[45] The IRS has also stated that allocations which bear a "reasonable relationship" to what a jury might have been expected to award will be respected.[46]

c. Intent of the Payor

Where the settlement agreement fails to specify the nature of the award in a settlement, courts will often look to the intent of the payor in making that determination. Even in cases where the language of the settlement agreement is explicit, Courts may still look behind the settlement agreement in order to determine the true nature of the award.

Determining the intent of the payor involves careful analysis of all the relevant facts and circumstances.[47] For example in *McCann v. Commissioner*,[48]the settlement agreement failed to specifically allocate $839,000 in damages. In making its determination that the payment was for $400,000 in damages and $439,000 in interest, the court in *McCann* noted that that same exact allocation was written on a check issued to the plaintiff by the defendant. And in *Hellesen v. Commisioner*,[49] the court found that absent any evidence that payment was made on behalf of a personal physical injury or sickness, that the issuance of Form 1099 by the payor to the defendant indicated that the payment was taxable.

VIII. Tax Treatment of Attorney's Fees

The tax treatment of legal expenses for plaintiffs, such as attorney fees ("fees"), is governed by the context in which those fees were incurred.

Fees incurred as ordinary and necessary business expenses are fully deductible under Section 162 in the year incurred. For this reason business defendants will rarely have difficulty or face audit challenges for deducting legal fees as business expenses. Although litigation and its attendant expenses are rarely questioned as being ordinary or necessary, care should be taken to establish a sufficient and direct nexus to a trade or business activity to ensure the full deductibility of fees. Also, it should be noted that only the payor-taxpayer is entitled to take the deduction. Fees paid for services rendered to another are generally not deductible as a business

[45] *McKay v. Commissioner*, 102 T.C. 465 (1994)
[46] Rev. Rul. 85-98
[47] *Robinson v. Commissioner*, 102 T.C. 116 (1994)
[48] 87 Fed.Appx. 359 (2004)
[49] T.C. Memo 2009-143

expense, except in the case where a company pays attorney fees on behalf of an employee or officer for its own benefit.[50]

Section 212 also allows a deduction for fees related to income producing or investment activities. However, under Section 265 no deduction is allowed for expenses allocable to tax exempt income. This in order to prevent taxpayers from realizing both the benefit of excluding a recovery from income while simultaneously deducting associated attorney fees. In addition, Section 262 provides that no deduction shall be allowed for personal, living, or family expenses. Thereby, attorney fees which are entirely personal in nature are non-deductible.

If a legal fee is partially deductible and partially non-deductible, the taxpayer must allocate the fee between the deductible and non-deductible portions. Lawyer fee statements that make a reasonable and good faith allocation are typically respected by the Service.

Furthermore, prior to 2004 a majority of attorney fees were considered miscellaneous itemized deductions subject to the general limitation for miscellaneous itemized deductions, resulting in less than full or even no tax benefit for fees which did not exceed 2% of the taxpayers AGI in the aggregate. Treating attorney fees as miscellaneous itemized deductions also has negative implications for taxpayers subject to the alternative minimum tax (AMT), since attorney fees classified as miscellaneous itemized deductions are not allowable as deductions for purposes of calculating the AMT.

The American Jobs Creation Act of 2004 provided much needed relief by specifically allowing above-the-line deductions for attorney fees and costs in connection with claims of "unlawful discrimination" and certain claims against the federal government. The amount that may be deducted above-the-line may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement. The newly enacted Section 62 defines "unlawful discrimination" to include a number of specific statutes, including any federal whistle-blower statute, any federal, state, or local law "providing for the enforcement of civil rights" or "regulating any aspect of the employment relationship…or prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law."

Lastly, the question arises whether the taxpayer should include the entire amount of damages in income and then take a deduction for the portion paid to the attorney, or should the taxpayer exclude the portion of the recovery paid to the attorney and claim no deduction. The Supreme Court resolved this issue in *Commissioner v. Banks*.[51] In *Banks*, the Court relied on traditional assignment of income rules in reaching its decision. Because the taxpayer retained "ultimate dominion and control over the underlying claim," the Court held that he should have the entire recovery included in his income. Therefore, the Court announced, "We hold that, as a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of

[50] *Concord Instruments v. Commissioner,* T.C. Memo 1994-248

[51] 543 U.S. 426 (2005)

the recovery paid to the attorney as a contingent fee." This rule applies whether or not the fee was paid on a contingent fee basis or under a fee-shifting statute.[52]

IX. Treatment of Payments by the Payor

Recipients of settlements and judgments generally worry more about the tax consequences of an award or settlement than payors do. Nevertheless, a defendant that is preparing to pay a substantial settlement or judgment should also find the tax treatment of the payment to be of the utmost importance.

The Internal Revenue Code does not expressly allow deductions for payments pursuant to an award or settlement. In fact, under Treasury Regulation 1.262-1, generally no deductions are allowed for any payments attributable to personal expenses, with the consequence that settlement payments made on account of personal liability or wrongdoing are not deductible.

Therefore, in order to realize a tax benefit in connection with an award or settlement payment, defendants must be able to characterize those payments as one of the following:

a. A Trade or Business Expense

In order to qualify as a deductible business expense under Section 162, payments must be ordinary, necessary, incurred during the tax year by the taxpayer, and possess a direct and sufficient nexus to the taxpayer's trade or business.

Generally, an expense is considered ordinary if it is a common and accepted expense for that type of trade or business, and necessary if the expense is one that is helpful and appropriate.[53] Given this broad language, rarely will the validity of an award or settlement payment be challenged for failing to meet the ordinary and necessary expense test.

Rather, the IRS will typically look for a direct connection between the underlying claim in a suit and the defendant's trade or business when determining whether or not a payment qualifies as an expense incurred while carrying on a trade or business. This is usually a non-issue where the business is named as a defendant in the suit, but problems may arise where individuals are named as defendants and settlement payments are made which personally benefit the defendant. For example, in *Kelly v. Commissioner*,[54] the defendant sexually assaulted a woman after entertaining clients at a sports club. The defendant was criminally charged and sought to deduct his legal fees as a business expense claiming that his actions were within the scope of his employment. The Tax Court held that the fees were non-deductible personal expenses as the sexual assault charges arose out of personal, rather than business related activities.

b. Expenses Related to the Production of Income

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[52] *Green v. Commissioner*, T.C. Memo. 2007-39
[53] *See* IRS Pub. 463
[54] T.C. Memo 1999-69

Generally, the requirements for a deductible expense related to the production of income is similar to that of a business expense, except that instead of demonstrating a direct connection to a trade or business, the taxpayer must prove a direct connection between the underlying claim and an income producing or investment activity.[55]

An income producing or investment activity expense encompasses any ordinary or necessary expense paid or incurred to "produce or collect income, to manage property held for producing income, or in connection with the determination, collection, or refund of any tax."[56] For example, in *Trust of Bingham v. Commissioner*,[57] attorney fees to contest an income tax deficiency paid by the trustee was held to be a deductible expense.

However, in contrast to trade or business expenses, expenses for the production of income are subject to the general limitations for miscellaneous itemized deductions. Under Section 67, many miscellaneous itemized deductions (including expenses for the production of income) are deductible only to the extent that they (in the aggregate) exceed 2% of the taxpayer's adjusted gross income. Furthermore, for taxpayers who are subject to the Alternative Minimum Tax, no deduction for income producing or investment expenses is allowed.

X. Tax Reporting and Withholding Considerations and Exposure

1. Recoveries such as Back Pay are treated as wages subject to withholding, FICA and FUTA in addition to state requirements.
2. Federal income tax withholding may be required where the Plaintiff is a nonresident alien at up to 30%.

Conclusion:

Because the taxation of damage awards and settlements has developed over time through case law it is highly nuanced. Additionally statutory authority is over simplistic and incomplete. Where an area of tax law is highly nuanced and coupled with simplistic and incomplete statutory authority, extreme care must be employed where tax considerations are contemplated. Failing to fully drill down into a fact pattern rather than relying on general principles and minutia buried in case law is a complicated task even when this function is performed by tax attorneys. Because of the uncertainty surrounding tax planning in this area, extreme caution should be employed when opining to clients on the tax ramifications surrounding a given litigation.

The controlling principles for determining the tax effects of litigation surrounding what the dispute is about, what claims the plaintiff is receiving recovery for, and how that item of recovery would have been taxed in the absence of the defendant's conduct can be

[55] I.R.C. § 212
[56] *Id*.
[57] 325 U.S. 365 (1945)

interpreted in a myriad of ways. Unfortunately, the taxing authorities' interpretation of these factors is often self-serving and biased.

Given the above factors, extreme caution and due diligence is necessary to avoid malpractice in this area of law.

Acknowledgement: A great deal of the content in this presentation was derived and paraphrased from a book entitled:

TAXATION OF DAMAGE AWARDS AND SETTLEMENT PAYMENT BY ROBERT L. WOOD OUT OF WOOD LLP IN SAN FRANCISCO.

Mr. Wood is a Tax Attorney's Tax Attorney whom I consider a friend and mentor and I wholeheartedly suggest that his book be added to your library if you plan to practice in this area of tax law.

Dave Klasing Esq. M.S.-Tax CPA