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SLICING THE PIE: INCOME TAX APPLICATION TO LITIGATION AWARDS AND SETTLEMENTS

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Special needs settlement planning attorneys should be familiar with the income tax aspects of litigation awards and settlements. The income tax result is the same regardless of whether the payments are made from a settlement or a judgment. Attorneys engaged to draft special needs trusts to hold litigation proceeds may be asked for advice on the tax aspects of personal injury or matrimonial awards and settlements. Accordingly, it is important to understand the tax consequences of personal injury lump sum payments, structured settlements, workers compensation awards, alimony, child support and estate and trust litigation.

Section 61 of the Internal Revenue Code ("I.R.C." or "Code") defines "gross income" as "all income from whatever source derived." Section 61(a) lists fifteen examples of items included as gross income, including: "(1) compensation for services, including fees, commissions, fringe benefits, and similar items; (2) gross income derived from business; (3) gains derived from dealings in property; (4) interest; (5) rent; (6) royalties; (7) dividends; (8) alimony and separate maintenance payments; (9) annuities; (10) income from life insurance and endowment contracts; (11) pensions; (12) income from discharge of indebtedness; (13) distributor's share of partnership gross income; (14) income in respect of a decedent; and (15) income from an interest in an estate or trust." I.R.C. 61(a), however, clearly states that gross

income is not limited to those items. Accordingly, all income is presumed to be gross income unless the items are specifically exempted in the Code.

PERSONAL INJURY CLAIMS

Workmen's Compensation

I.R.C. §104(a)(1) excludes from gross income amounts received from workmen's compensation acts for personal injuries or sickness. The injuries or sickness need not be physical. Compensation paid to a deceased employee's survivors also are excludable from income tax. Treas. Reg. §1.104-1(b). Retirement benefits received as a result of employee's retirement due to an occupational injury or sickness are includable in the calculation of gross income. *Id.* According to Treas. Reg. §1.104-1(b), section 104(a)(1) "does not apply to a retirement pension or annuity to the extent that it is determined by reference to the employee's age or length of service, or the employee's prior contributions, even though the employee's retirement is occasioned by an occupational injury or sickness."

Personal Physical Injuries or Physical Sickness

Prior to August 21, 1996, all damages for personal injuries were excluded from gross income under I.R.C. §104(a)(2). *See, e.g., Threlkeld v.* Comm'r, 87 T.C. 1294 (1986), *aff'd* 848 (F. 2d 81 (6th cir. 1988) (holding that damages for injury to professional reputation in malicious prosecution case were excluded under I.R.C. §104(a)(2)). On August 21, 1996, President Clinton signed into law the Small Business Job Protection Act of 1996, Public Law 104 -188, sec. 1605, 110 Stat. 1755, 1838-1839 (the "Act"). Among other things, the Act amended §104(a)(2) to exclude from gross income the amount of any damages, other than punitive damages, received on account of personal physical injuries or physical sickness.

The physical injury exclusion requires a touching that produces observable bodily harm. *See,* PLR 200222001 (July 7, 2000).. The Ruling states:

> The term "personal physical injuries" is not defined in either § 104(a)(2) or the legislative history of the 1996 Act. However, 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 under § 104(a)(2).

Origin of the Claim Doctrine

Generally, the origin of the claim will determine whether the award or settlement is taxable. *United States v. Gilmore*, 372 U.S. 39 (1963). Section 104(a)(2) excludes from gross income all amounts received from settlement agreements intended to compensate a person for physical sickenss or physical injury. The Internal Revenue Service ("IRS" or "Service"), however, is not bound by an allocation in a judgment or a settlement agreement. *Robinson v. Commissioner,* 70 F.3d 34 (5th Cir. 1995), *cert. denied*, 519 U.S. 824 (1996). The taxpayer bears the burden of validating the origin of the claim. U.S. Tax Ct. R. 142(a); *see also*, *Delaney v. Commissioner*, 99 F.3d 20 (1st Cir. 1996).

If a settlement agreement expressly allocates the settlement proceeds between physical injury damages and other damages, the allocation will be respected "to the extent that the parties entered into the agreement in an adversarial context at arm's length and in good faith." *Burditt v. Commissioner*, T.C. Memo 1999-117 (CCH) 1767, T.C.M. (RIA) 99117 (1999), *McKay v. Commissioner*, 102 T.C. 465 (1994).

Lawsuits often contain various claims and complicated facts. The characteristics of the claim and the intent of the parties in entering into a settlement agreement generally will determine the

tax treatment of the settlement proceeds. While the Service may accept the allocation set forth in a settlement agreement, a tax court may make its own allocation when the settlement agreement is silent on that issue. Generally, the court considers the complaint filed in the action and the intention of the payor in determining the allocation among the various claims.

In *Amos v. Commissioner*, T.C. Memo 2003-329 (2003), a television cameraman was kicked in the groin by Dennis Rodman during a game between the Chicago Bulls and the Minnesota Timberwolves. The cameraman was taken to the hospital, where he was treated and released. At the hospital he complained that he was in pain and limped. Six days later, both parties agreed to settle all claims for a $200,000 payment. The cameraman excluded the entire amount from his taxable income but the IRS determined that the entire amount, less one dollar, was taxable.

The tax court found that the "dominant reason" for paying the $200,000 was to compensate the cameraman for his physical injuries. Since the parties did not allocate the settlement amount in their settlement agreement, however, the tax court also decided that $80,000 of the settlement amount was paid to keep the settlement confidential as well as to ensure that the cameraman did not defame Rodman, assist in criminal prosecution or publicize the facts relating to the incident. Accordingly, the tax court held that $80,000 of the $200,000 settlement amount was taxable.

Lost Wages

Lost wages are excluded from taxable income if they resulted from a physical injury or sickness. *See, O'Gilvie v. United States,* 591 U.S. 79 (1996).

Emotional Distress

Damages for emotional distress are taxable unless they are the result of a personal physical injury. I.R.C. §104(a)(2). The legislative history of the 1996 Act states: "It is intended that the term emotional distress includes symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress." H. Conf. Rept. 104-737, at 301 n.56 (1996), 1996-3 C.B. 741, 1041 n.56. Therefore, if the emotional distress resulted directly from a physical injury, the damages ascribed to the emotional distress are excluded from taxable income.

The issue of whether the emotional distress is a direct result of physical injury is not always clear cut. In *Johnson v. United States*, 228 F.Supp. 2d 1218 (D. Colo. 2002), *aff'd*, 76 Fed. Appx. 873 (10th Cir. Colo. 2003), *cert. denied*, 542 U.S. 925 (2004), a corrections officer had been injured on the job and subsequently was fired when he was unable to return to his previous job because of his physical problems. The corrections officer filed suit against the State of Colorado under the Americans with Disabilities Act and prevailed on his discrimination claim. The IRS claimed that it erroneously issued a refund to the corrections officer because the claim was not on account of physical injury. The corrections officer argued that but for the physical injuries that he sustained while employed, he would not have had an ADA claim.

In denying the correction officer's summary judgment motion, the district court noted that the United States Supreme Court rejected a "but-for" causal connection in *O'Gilvie, supra.* The district court noted that the damages were awarded to the corrections officer "on account of" the ADA claim rather than "on account of" his physical injuries. Accordingly, the district court held that the front and back pay received by the corrections officer were taxable. Even if the

emotional distress does not flow from a personal physical injury, however, the damages up to the amount paid for medical expenses ascribed to the emotional distress are not taxable. I.R.C. §104(a)(2).

Punitive Damages

Punitive damages are taxable even if they are awarded in connection with a personal physical injury claim. I.R.C. §104(a)(2); *see also, O'Gilvie, supra,* 519 U.S. 79 (1996) (pre-1996 amendment case holding that punitive damages were not on account of personal injury but rather on account of jury's desire to punish wrongful conduct of defendant). Accordingly, the portion of a settlement that is allocated to punitive damages should be set forth in the settlement agreement. Otherwise, the IRS or a tax court may arrive at a determination based upon the complaint and the intent of the payor.

Punitive damages awarded in a wrongful death action are not taxable if the state law provides that only punitive damages may be awarded in such actions. IRC §104(c). Accordingly, the special needs attorney should become familiar with the types of damages allowable in wrongful death actions in his or her state.

Interest

Payments attributable to interest are taxable, even if the basis for the underlying claim is physical injury or physical sickness. *Delaney, supra,* 99 F.3d 20. Periodic payments received from a qualified structured settlement are not taxable. However, if a judgment or settlement agreement allocates any portion of periodic payments to interest, then that portion will be taxable.

Similarly, pre-judgment interest payments are taxable regardless of whether an allocation is made in a settlement agreement. *See, Rozpad v. Commissioner*, 154 F3d 1 (1st Cir. 1998). In *Rozpad*, a married couple and an individual brought medical malpractice claims. Following jury trials in both matters, final judgments were entered which included prejudgment interest as mandated by Rhode Island law. The parties subsequently negotiated settlements during the appeal periods. No mention of the prejudgment interest was made in the stipulations of settlement filed with the court. The Commissioner issued deficiency notices in both cases contending that a portion of the settlement constituted prejudgment interest. The Tax Court consolidated both cases.

In agreeing with the Commissioner, the First Circuit Court of Appeals held that when a settlement takes place after claim has been reduced to judgment, even if the judgment is not final, it provides a guideline for allocating the amount attributable to prejudgment interest and compensatory damages. Therefore, the appellate court ruled that an allocation of the settlement proceeds should be made in the same proportion as the antecedent judgment.

Post-judgment interest also is taxable. Pursuant to Tech. Adv. Mem. 199922056 issued on January 25, 1999, post-judgment interest is taxable in the year in which the judgment is final and the appeal period has ended, even if payment is made the following year.

Reimbursed Medical Expenses

Reimbursed medical expenses are not taxable regardless of whether they are received as a result of physical injury or sickness. IRC §104(a)(2). Accordingly, such reimbursements recovered on account of emotional distress unrelated to physical personal injury or physical sickness would be excludable. Under the tax benefit rule, however, if prior deductions for

medical expenses were taken under IRC §213, then amounts received for reimbursement of these expenses would be taxable to the extent includable under IRC §111. *See* Rev. Rul. 75-230.

Wrongful Death

Generally, when a lawsuit claims that someone died as a result of the negligent or wrongful acts of another, there are two separate parts to that lawsuit: a survival action and a wrongful death action. Wrongful death claims did not exist under common law as it was thought that the claims of the person who died as a result of the wrongful or negligent acts died with the victim. As a result, wrongful death actions are governed by state statutes. These statutes determine the types of damages that can be recovered.

Survivorship statutes permit recovery for the decedent's injuries until death. Such damages may include conscious pain and suffering, medical bills and loss of wages until death. Survivor actions also may result in the payment of punitive damages. Damages recovered in survivor actions are distributed to the decedent's estate. The compensatory damages attributable to the decedent's physical injuries are excluded from income tax. Punitive damages, on the other hand, are taxable. Although the compensatory damages are not subject to income tax, they may be subject to federal and state estate tax and inheritances taxes.

A wrongful death action allows the decedent's heirs to recover for their own losses that stem from the deceased person's death. Such damages may include the decedent's lost wages, loss of guidance, support and advice, funeral expenses, medical expenses after death, lost prospective earnings and lost companionship. Since these damages are on account of the physical injuries suffered by the decedent, they are excludable from income tax. In order to avoid death

taxes, personal injury attorneys may attempt to dismiss the survivorship action and have all of the compensatory damages paid under the wrongful death statute.

An important consideration in wrongful death cases is income in respect of a decedent. If amounts payable to the decedent's estate would have been income to the decedent before death, then such amounts are taxable.

MATRIMONIAL MATTERS

Attorneys who counsel matrimonial attorneys in cases involving spouses or children with disabilities should be familiar with the tax consequences of payments and property divisions in matrimonial matters.

Alimony

The recipient of alimony or separate maintenance payments must include such payments in the calculation of gross income if the payor spouse is entitled to deduct such payments under IRS §215. *See* IRC §71(a). Alimony or separate maintenance payments are defined as cash payments received by or on behalf of a spouse under a divorce or separation agreement which does not designate such payment as a payment which is not includable in gross income and not allowable as a deduction under IRC §215. In addition, the spouses, if legally separated, cannot be members of the same household and there is no liability to make any payments after the death of the spouse who is receiving the payments or liability to make any payment in cash or property as a substitute for such payments after the death of the spouse who is receiving the payments. IRC §71(b).

Child Support

Child support payments are not deductible by the payor spouse nor taxable to the payee spouse. IRC §71(c). Although the settlement agreement should specify those payments which are alimony or separate maintenance payments and those which are child support, the IRS is not bound by the settlement agreement. Pursuant to IRC §71(c), if payments are conditioned upon a contingency related to the child, such payments likely will be considered by the IRS to be child support payments.

A custodial parent may be entitled to a dependency exemption if the child receives more than 50% of his or her support from the parents, the parents are divorced or legally separated or separated under a written separation agreement or lived apart during the last six months of the calendar year and one or both parents have custody of the child for more than half the calendar year. IRC §152(e). The custodial parent may release the claim to the exemption for the year by signing a written declaration that the custodial parent shall not be entitled to the deduction. *Id., see also,* IRS Form 8332.

Equitable Distribution

A transfer of property from one spouse to another incident to a divorce is a nontaxable event. IRC §1041(a)(2). A transfer is "incident to divorce" if it "occurs within one year after the date on which the marriage ceases or ... is related to the cessation of the marriage." IRC §1041(c)(1) and (2). This rule, however, does not apply if the former spouse receiving the property is a nonresident alien. IRC §1041(d). The rule also does not apply to transfers in trust

where "the sum of the amount of liabilities assumed, plus the amount of the liabilities to which the property is subject," exceeds the adjusted basis of the transferred property. IRC §1041(e).

A transfer of property is related to the cessation of the marriage if the transfer is pursuant to a divorce or separation instrument and the transfer occurs not more than six years after the date on which the marriage ceases. Temp. Reg. §1041-1 T.B., Q & A – 7. There is a presumption that any transfer not pursuant to such an instrument and any transfer occurring after six years after the cessation of the marriage is not related to the cessation of the marriage. *Id.* The presumption, however, may be rebutted by showing that the transfer was made to effect the division of property owned by the former spouses at the time the marriage ceased. *Id.* For example, the presumption may be rebutted by showing that the transfer was not made during the one year or six year period because of legal or business impediments to the transfer or disputes over the value of the property and the transfer takes place promptly after the impediment is removed. *Id.*

Will Contests

Generally, the value of property acquired by gift, bequest, devise, or inheritance is excluded from gross income. IRC §102(a). If, however, the property received is income producing property, than the income generated from the property is includable in gross income.IRC 102(b). Settlement proceeds or judgment amounts received as a result of a will contest are treated as if the property was acquired by gift, bequest, devise or inheritance. *Chait v. Commissioner,* T.C. Memo 1983-272; *see also, Lyeth v. Hoey,* 305 U.S. 188 (1938).

It is important to consider income in respect of a decedent ("IRD") in determining whether income tax must be paid on property received as a result of a will contest. Essentially,

IRD refers to income earned by the deceased person during his lifetime that is paid after death, i.e., accrued dividends or vacation pay. *See,* IRC 691. Deductions for expenses, interest taxes, and depletion or credits in respect of a decedent are allowed. *Id.* In addition, the Code provides for the calculation of a deduction for estate tax for a person who includes an amount in gross income in respect of a decedent. *Id.*

When payments are made from estate income, they are taxable to the recipient even where there is an agreement between the parties to characterize the payments as distribution from principal. In *Lemle v. United States*, 579 F.2d 185 (2d Cir. 1978), a widow filed a notice of election contending that she received less than her elective share. When she began to receive payments from the estate, her attorney wrote to the executors' attorney stating that even though the payments were designated as income distribution, the payments were on account of the monies she ultimately was entitled to receive, whether by income or principal. The widow indicated on her tax returns that the payments she received were prepayments of her elective share. Although the widow had executed an ante-nuptial agreement waiving the elective share, the widow and the estate settled their dispute. Pursuant to the settlement agreement, all of the payments received by the widow were designated as pre-payment of the total settlement figure or principal. The IRS, however, determined that the payments should be treated as taxable income.

The Court of Appeals for the Second Circuit noted that under New York law, a widow who exercised her right of election was entitled to a pro rata share of the income received during the estate administration and the executors made the payments from the estate's income. Stating that payments made from estate income are taxable to the recipient, the appellate court ruled that the court was not bound to honor a subsequent agreement that monies received as income should be treated as principal.

Attorneys Fees

Generally, attorney fees are tax deductible if the fees were incurred in the course of a business-related or employment dispute or in matters involving income producing property and are subject to the 2% adjusted gross income floor. Legal fees for personal matters generally are not tax deductible.

Personal Injury Lawsuits

If a taxable award is recovered than legal fees may be deducted. If the award is not taxable, then the attorney fees incurred are not deductible. Since legal fees in wrongful death suits generally are not subject to income tax, the attorneys fees incurred are not deductible. If the defendant in a personal injury action is a business, the attorneys fees incurred by that defendant would be deductible because they are business related.

Matrimonial Actions

Legal fees to collect taxable income such as alimony are tax deductible. Legal fees incurred to defend against alimony demands are not deductible. Similarly, legal fees for divorce or property settlement agreements are not deductible.

Will Contests

Legal fees incurred in will contests generally are not tax deductible because the amounts received as an inheritance are not subject to income tax.