



Liberty University
DigitalCommons@Liberty
University

Faculty Publications and Presentations

Liberty University School of Law

3-1991

What is the Tax Collector's Cut of Judgments and Settlement Proceeds?

F. Philip Manns Jr.

Liberty University, fpmanns@liberty.edu

Follow this and additional works at: http://digitalcommons.liberty.edu/lusol_fac_pubs

 Part of the [Law Commons](#)

Recommended Citation

Manns Jr., F. Philip, "What is the Tax Collector's Cut of Judgments and Settlement Proceeds?" (1991). *Faculty Publications and Presentations*. Paper 18.

http://digitalcommons.liberty.edu/lusol_fac_pubs/18

This Article is brought to you for free and open access by the Liberty University School of Law at DigitalCommons@Liberty University. It has been accepted for inclusion in Faculty Publications and Presentations by an authorized administrator of DigitalCommons@Liberty University. For more information, please contact scholarlycommunication@liberty.edu.

South Carolina

Volume 2 Number 5 March/April 1991

LAWYER

Contents

South Carolina's Payment of Wages Law 11

By John P. Mann

The Federal Bench:

What Do They Expect From You? 14

By Blaney A. Coskrey III

What is the Tax Collector's Cut of Judgments and Settlement Proceeds? 22

By F. Philip Manns Jr.

The South Carolina Rules of Professional Conduct:

Conflicts of Interest 27

By Nathan M. Crystal

Truth in Sentencing 32

By Sean Kittrell

Depositions 101 39

By Sally Wiggins Speth

The Americans With Disabilities Act:

Some Highlights for South Carolina Lawyers 43

By Harriet McBryde Johnson

Tom Ogburn

DEPARTMENTS

The Scrivener 19

Legislative News 20

What's New? 48

Bar News 57

Classifieds 61, 64

Calendar 62

Cover:

Robert S. Peckar

JUSTICE

Oil, 40" X 30"

Copyright © 1982, West Publishing Company

What Is the Tax Collector's Cut of Judgments and Settlement Proceeds?

By F. Philip Manns Jr.

Settlements of lawsuits and satisfactions of judgments involving payments of money or other property by the defendant to the plaintiff raise two basic federal income tax issues. The first issue is whether the payment is deductible by the defendant. The second issue is whether the receipt of the payment constitutes income to the plaintiff. Resolution of these two issues is accomplished by the application of five principles.

The Five Principles

1. Even though a legal claim against a person is treated as property for many state law purposes and can be sold under state law, a legal claim is not treated as separate property for federal income tax purposes. Thus, the extinguishment of a claim by settlement or judgment is not treated as a sale of property for federal tax purposes. Instead, amounts paid and received are taxed by reference to the origin of the claims underlying the settlement or judgment. The theory is to tax the payment and receipt of the proceeds identically with the thing for which they substitute. Thus, if a plaintiff recovers money due under a contract, the payment is taxed just as if the defendant had paid the plaintiff in accordance with the contract.

In that regard, the look-through to the underlying claims likens the tax treatment of judgments and settlements to the sale of a business; those sales are not treated as the sale of a single asset but are treated as a sale of each underlying asset of the business.

2. It does not matter whether litigation concludes through settlement or judgment. (The taxation of private antitrust claims, however, can depend on whether suit was instituted before settlement.) References to settlement payments or settlement proceeds in this article will include amounts paid and received pursuant to both judgments and settlements.

3. The allocation of a settlement payment among the claims settled is like any allocation which has tax consequences. Taxpayers make allocations as they view the facts and circumstances; the IRS is able to challenge an allocation if it thinks the allocation is contrary to the facts and circumstances. *Eisler v. Commissioner*, 59 T.C. 634 (1973) (court allocated a settlement payment between deductible and capital expenditures where parties had made no allocation, but it was clear that claims of both types had been settled), acq., 1973-2 C.B. 1.

When multiple claims are settled, both parties are required to make an allocation in computing their taxes but are not required to agree on an allocation. However, parties are well advised to agree to an allocation, since that materially increases the likelihood that the IRS will respect their allocations.

Allocation is a significant issue because, in the typical case, multiple claims will be involved—especially since recoveries wholly dependent on other claims often are considered to be separate claims. For instance, legal interest accrued on a judgment is taxable as interest income even if the judgment is excluded from income. *Aames v. Commissioner*, 94 T.C. 189 (1990).

4. For a defendant actively conducting a trade or business, settlement payments made on claims arising from the conduct of the trade or business generally are deductible. Settlement payments are made nondeductible for public policy reasons (e.g., in the fines, penalties and antitrust areas) or because the underlying claims themselves would give rise to nondeductible (e.g., personal) or capitalized expenditures (e.g., expenses of defending title to property). Otherwise, settlement payments are deductible even if they arise because of wrongful conduct by the defendant.

Settlement payments for the following types of claims have been held deductible: negligence claims, *Eisler v. Commissioner*, supra; fraud claims, *Ostrom v. Commissioner*, 77 T.C. 608, 611-12 (1981); liquidated damages claims, Rev. Rul. 69-581, 1969-2 C.B. 25; and punitive damages claims, Rev. Rul. 80-211, 1980-2 C.B. 57.

5. For the plaintiff, the receipt of settlement proceeds generally gives rise to income. Settlement proceeds can be capital gain or a return of basis if the underlying claim relates to a sale or other transaction involving the property of the plaintiff. If a statutory exclusion is available (e.g., damages recovered on account of personal injury are excluded from income), or if the proceeds are a reduction in an earlier paid expense that was not deducted, no income is realized on receipt of the settlement proceeds.

Principles four and five demonstrate that the issues of deductibility by the defendant and income to the plaintiff are not causally linked. Among other results, a settlement payment could be nondeductible by the defendant but income to the plaintiff; deductible by the defendant but not income to the plaintiff; subject to capitalization by the defendant but income to the plaintiff. Obviously, to the extent that the two separate questions turn on the intent of the parties or other facts common to the settlement, the determinations will be related, but no formal causal link exists.

Applying the Principles

For any settlement, the deductibility and income issues can be decided by application

of a test of two parts, one factual and the other legal. First, the settlement proceeds must be allocated among the claims settled. Second, the legal nature of the claims must be analyzed to determine if the claims give rise to deductions or income for which special rules apply. If not, the general rules of a deduction for the defendant on the making of settlement payments and income to the plaintiff on the receipt of settlement proceeds apply.

Special rules applicable to settlements derive from two sources. One, because the origin of the claim analysis equates the making of settlement payments with payment on the underlying claims, settlement payments will be nondeductible whenever payment of the expense for which the claim substitutes would be nondeductible. Similarly, settlement proceeds will not be income whenever receipt of the thing for which the claim substitutes would not constitute income. Therefore, the special rules applicable to settlements include the rules applicable to all deductions and to all receipts. Since those rules comprise a significant portion of the body of tax law, description in this article of all situations in which a settlement payment is not deductible or in which the receipt of settlement proceeds is not income is not feasible.

Two, certain rules exist which by definition apply only in litigation settlement contexts. For instance, deductions are denied for fines and similar penalties, and damages recovered on account of personal injury are excluded from income. The most commonly encountered of the special rules applicable to settlements are described below, without regard to the source from which they arise.

Settlement Payments Not Deductible by Defendant

• **Personal Litigation.** Code Section 262 denies a deduction for personal, living or family expenses. The denial of a deduction for settlement payments made with respect to such claims is an application of Code Section 262. Accordingly, if the expenditures for which the settlement payments substitute would be nondeductible personal, family or living expenses of the payor, the settlement payments are not deductible. Thus, if a taxpayer settles a claim against him for rent for an apartment occupied by him as a personal residence, or settles a claim for a tort not related to the taxpayer's business, the settlement payment is not deductible. See *Oden v. Commissioner*, 56 T.C.M. (CCH) 851, 853 (1988) (damages paid in connection with a defamation suit were nondeductible personal expenses).

• **Disputes Relating to Property.** Under the Code, expenses to "manage, conserve, or maintain" income producing property are deductible currently. But under the Treasury Regulations, expenses "paid or incurred in defending or perfecting title to property" are not deductible. Instead, those expenses are capitalized—i.e., they are added to the cost of the property and may be recovered through annual depreciation deductions if depreciation of the property is permitted. Distinguishing between maintenance and title defense expenses, while clear at the extremes, can cloud considerably for expenses that serve simultaneously to manage property and to perfect title to it.

Consider a suit involving a mineral rights lessor and lessee regarding the lessee's extraction

of minerals. Both the lessor and the lessee are perfecting title to their leasehold or lease interests while managing their mineral property in their businesses. For such expenses meeting both descriptions, deductibility may turn on whether the primary purpose of the litigation is to perfect title or to resolve a dispute relating to income from operation of the property.

At the extremes, however, the distinction of management and title defense expenses is reasonably clear. It is clear that if a buyer settles litigation over the purchase price of property by paying more money to the seller, the amount will be capitalized as an expense of perfecting title to the property; it would be treated as part of the purchase price.

And at the other extreme, it is clear that expenses incurred by a car rental company to repossess a rental car, although related to title, would be deductible. *Crutenden v. Commissioner*, 70 T.C. 191, 204 (1978) (Sterrett, J., concurring), aff'd, 644 F.2d 1368, 48 A.F.T.R.2d (P-H) 81-5013, 81-1 U.S. Tax Cas. (CCH) ¶944D (9th Cir. 1981).

In addition, expenses that "add to the value, or substantially prolong the useful life, of property" must be capitalized. Therefore, if settlement payments are viewed as adding value to an existing asset, the settlement payments would have to be capitalized (e.g., settlement payments to a roofing contractor who constructed a new roof).

• **Fines and Related Civil Penalties.** Code Section 162(f) denies a deduction for "any fine or similar penalty paid to a government for the violation of any law." Thus, when claims asserted by a government are

settled, Code Section 162(f) must be considered. A "fine" is an amount paid pursuant to conviction or a plea of guilty or nolo contendere for a felony or misdemeanor in a criminal proceeding. Application of that disallowance is straightforward, but the disallowance for "similar penalties" is less so. When defining those civil penalties within the disallowance, the Treasury Regulations initially paint with a broad brush by including any civil penalty imposed by federal, state or local law. Treas. Reg. Section 1.162-21(b)(1)(ii). The regulations subsequently narrow the scope of "similar penalty," however, when they indicate that Code Section 162(f) will not preclude the deduction of a civil penalty if the penalty represents compensatory damages paid to a government. Courts generally have adopted the compensatory/punitive dichotomy suggested in the regulations and distinguish deductible and nondeductible penalties as follows:

If a civil penalty is imposed for purposes of enforcing the law and as punishment for the violation thereof, its purpose is the same as a fine exacted under a criminal statute and it is "similar" to a fine. However, if the civil penalty is imposed to encourage prompt compliance with a requirement of the law, or as a remedial measure to compensate another party for expenses incurred as a result of the violation, it does not serve the same purpose as a criminal fine and is not "similar" to a fine within the meaning of section 162(f).

Southern Pacific Transp. Co. v. Commissioner, 75 T.C. 497, 652 (1980).

• **Antitrust Damages.** Code Section 162(g) denies a deduction for two-thirds of the payments in settlement of private antitrust claims when the defendant has committed a "hard core violation" of the antitrust laws. Since antitrust plaintiffs are entitled to treble damages, the two-thirds disallowance essentially denies a deduction for the "penal" portion of the settlement. The scope of the disallowance is narrow; it applies only when (1) the defendant has been convicted of, or pleaded nolo contendere to, a criminal antitrust violation; (2) the civil damages are based on the criminal violation or a related violation; and (3) the payment is made pursuant to a judgment or a settlement of a filed action. Otherwise, the entire amount of antitrust damages is deductible.

• **Other Nondeductible Settlement Payments.** Many other Code sections and judicial doctrines deny expense deductions and those disallowances potentially are applicable in a litigation context. For instance, Code Section 709 denies deductions for partnership syndication expenses; Code Section 267 restricts losses in transactions among related taxpayers; Code Section 162(c) denies deductions for illegal bribes and kickbacks; and courts, without specific statutory authority, have denied deductions for sham transactions and for transactions not entered into for profit. If the settlement payment substitutes for an expenditure that would be subject to any such disallowance, then the settlement payment would be nondeductible. An excellent source surveying authorities in this area is K. Gideon, *Lawsuits and Settlements* (CCH Tax Transactions Library Vol. A6, 1990).

Settlement Proceeds Not Income to Plaintiff

• **Recoveries Relating to Property of the Taxpayer.** If settlement proceeds compensate for damages to property, the recovery will be treated as a non-taxable return of the owner's investment in the property to the extent of the adjusted tax basis of the property. Any excess would produce income under the IRS' view of the law, although a persuasive argument exists that the excess should produce capital gain.

Goodwill is property, so a taxpayer's recovery for harm to goodwill will be nontaxable to the extent of the taxpayer's adjusted tax basis in the goodwill. A recovery of lost profits, on the other hand, is taxable as income, since receipt of the thing for which lost profits substitute (profits) gives rise to income. Curiously, one of the permitted manners of establishing damage to goodwill is proof of lost profits. Settlement proceeds for damage to goodwill so proven are treated as nontaxable to the extent of the adjusted tax basis in the goodwill. Since proof of lost profits establishes either claim, mindful pleading can permit the plaintiff to select the taxation of settlement payments for lost profits.

Capital gain can result from other types of property disputes. E.g., if the settlement proceeds are an adjustment to the sales price of property, the proceeds will be treated as additional sales price, which generally will increase the capital gain on the sale.

• **Statutory Exclusions from Income.** Various sections of the Code exclude from income amounts received on account of certain claims. These claims include, among others, claims for:

"Sometimes the tax tail can even wag the settlement dog because an otherwise uncooperative opposing party may be persuaded to settle when a tax advantaged settlement proposal is made."

personal injuries and sickness, Code Section 104; life insurance proceeds, Code Section 101; gifts and inheritances, Code Section 102; state and local bond interest, Code Section 103. If settlement proceeds relate to such claims, no income is realized on their receipt.

The most significant exclusion is Code Section 104(a)(2), excluding from income "the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness." The essential inquiry is whether the plaintiff's injury is "personal." While for physical injuries the application of Code Section 104(a)(2) usually is obvious, the application to such nonphysical injuries as dignitary torts continues to vex the federal courts. For instance, the IRS, the Tax Court, the Third Circuit and the Fourth Circuit hold different views on the application of Code Section 104(a)(2) to various elements of damages recovered under employment discrimination statutes. *Rickel v. Commissioner*, 900 F.2d 655, 65 A.F.T.R.2d (P-H) 90-800, 90-1 U.S. Tax Cas. ¶ 50-200 (3d Cir. 1990), rev'g, 92 T.C. 510 (1989); *Thompson v. Commissioner*, 866 F.2d 709, 63 A.F.T.R. 2d (P-H) 89-677, 89-1 U.S. Tax Cas. ¶ 9164 (4th Cir. 1989).

Recently, the application of the Code Section 104(a)(2) exclusion to punitive damages received on account of personal injuries has

been clarified by statute. Punitive damages are excludable only when recovered in cases involving physical injury or physical sickness. For punitive damages received in suits filed on or before July 10, 1989, or under any written binding agreement, court decree or mediation award in effect on, or issued on or before, July 10, 1989, the application of the exclusion is unsettled. The Tax Court excludes all such punitive damages from income, but the Fourth Circuit includes them. See *Miller v. Commissioner*, 93 T.C. 330 (1989), rev'd, 914 F.2d 586, 66 A.F.T.R.2d (P-H) 90-5620, 90-2 U.S. Tax Cas. ¶ 50,511 (4th Cir. 1990).

• **Recovery of Expenses Not Deducted.** If a taxpayer incurs an expense that is not deducted and subsequently recovers a settlement payment reducing that expense, the recovery is not income. Recovery of a security deposit for an apartment used as a personal residence would not give rise to income; but recovery of interest payable on the security deposit—as well as any penalty payable by the landlord to the taxpayer—would be income.

Conclusion

The importance of the taxation of judgments and settlement proceeds often is overlooked when litigation is begun or terminated. Meaningful tax planning can be accomplished at those times to maximize tax benefits to both plaintiff and defendant. Sometimes the tax tail can even wag the settlement dog because an otherwise uncooperative opposing party may be persuaded to settle when a tax advantaged settlement proposal is made.

F. Philip Manns Jr. is an associate with King & Spalding, Atlanta.

South Carolina Lawyer