



Market Segment Specialization Program



Lawsuits Awards and Settlements

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LAWSUIT AWARDS AND SETTLEMENTS

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INTRODUCTION

NOTE: Because a business entity cannot suffer a personal injury within the meaning of IRC section 104(a)(2), *P & X Markets, Inc. v. Commissioner*, 106 T.C. 441 (1996), *aff'd in unpublished order*, (9th Cir., Feb. 13, 1988), this guide applies to recoveries by individuals only.

The information and techniques presented in this guide for lawsuit settlement examinations were developed during a project in Alabama, which began with media coverage of relevant tax issues. Analyses of newspaper articles revealed that numerous lawsuits were being resolved in the state either by verdict or settlement for substantial amounts. As a result, a separate project relating only to lawsuit verdicts and settlements was initiated and approved.

Early results of the project revealed that the vast majority of these lawsuit verdicts and settlements were escaping taxation. Virtually none of the payments were reported on Forms 1099. For this reason, it has been easy for these payments to fall through the gap of unreported income.

In the examination of 1994 and 1995 returns, it was often found that the taxpayer had classified all or most of the settlement as "compensatory," usually for "personal injuries," and therefore arrived at the determination that the proceeds were nontaxable. This pattern was found to be repeated in virtually all of the lawsuit cases, regardless of whether the claims were for fraudulent actions, defamation of character, employment related disputes, product liability, negligence, wrongful death, etc., and also regardless of whether or not claims for punitive damages were involved in the cases.

On the surface, the issue seems quite simple: Internal Revenue Code (IRC) section 61 states that all income from whatever source derived is taxable, unless specifically excluded by another Code section. In certain situations an amount of a lawsuit settlement might be paid to reimburse a taxpayer for losses, and no gain would have to be recognized under IRC section 1001 because the amount paid did not exceed the taxpayer's basis (return of capital). However, the only provision which specifically addresses income exclusions for any type of lawsuit proceeds is IRC section 104(a)(2). Prior to its amendment in 1996, this section excluded from income amounts paid by suit or agreement for personal injuries or sickness. This is the section which taxpayers have most often relied upon for authority to exclude from income lawsuit proceeds of all kinds, including punitive damages. This is where the appearance of a simple issue dissolves.

IRC section 104(a)(2) has been extensively litigated. The questions have centered on determining "what are personal injuries" for purposes of IRC section 104(a)(2). The issues have encompassed **physical** versus **non-physical** (mental anguish) injuries and sickness, and whether punitive damages are received on account of personal injuries. In 1989, Congress amended IRC section 104(a)(2) referencing punitive damages and non-physical injuries. However, due to the manner in which the statement was worded, the 1989 amendment only created more controversy. The Service's current position is that punitive damages are not received on account of personal injuries under IRC section 104(a)(2), and therefore are not excludable from gross income. In 1996, on the heels of several court decisions that had upheld the Service's position, Congress resolved the controversy and amended IRC section 104(a)(2). The 1996 changes clearly provide that punitive damages are not excludable under IRC section 104(a)(2), regardless of whether received in connection with a physical or non-physical injury or sickness. However, the 1996 amendment to IRC section 104(a)(2) has raised the issue whether punitive damages received in connection with a wrongful death are excludable from gross income. This question is discussed in detail in a subsequent section.

The 1996 changes further provide that amounts excludable for emotional distress are limited to actual "out of pocket" medical costs in cases of non-physical injuries, such as discrimination, fraud, etc. However, all amounts received on account of a physical injury, with the exception of punitive damages, are excludable under IRC section 104(a)(2), including amounts for emotional distress. These clarifying and limiting changes to the statute are effective for amounts received after August 20, 1996, unless received under a binding written agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

Although lawsuit settlements of clearly designated punitive damages received after August 20, 1996, should be easily identified by the taxpayers and the preparers as taxable proceeds, there are still issues for examination. This guide will provide information on how to identify tax returns with lawsuit payment issues, suggestions on conducting the examination; detail of issues, explanations of applicable terminology, synopses of several related court cases, and exhibits of pertinent forms.

Chapter 1

ISSUES

The following brief synopsis reflects the similarities and differences between the potential issues which may arise in lawsuit verdicts and settlements received prior to August 21, 1996, and those received on or subsequent to that date.

ISSUES FOR LAWSUIT PROCEEDS RECEIVED PRIOR TO AUGUST 21, 1996

1. Settlement proceeds are unreported.
2. All punitive damages are taxable whether received in relation to a physical or non-physical injury (caution: Alabama wrongful death cases).
3. Determine if any of the settlement proceeds are designated as interest, and if so, whether such interest is reported as income.
4. For out of court settlements, determine if the taxpayer reported correct allocations between taxable type awards, such as punitive, back wages, etc., and non-taxable amounts, such as emotional distress damages (caution: back pay may be excludable if received under circumstances described in Rev. Rul. 93-88, 1993-2 C.B. 61, *obsoleted* by Rev. Rul. 96-65, 1996-2 C.B. 6)
5. Verify that the taxpayer reported taxable amounts at gross rather than reporting them net of legal fees.
6. Allowable legal fees should be deducted on Schedule A as miscellaneous itemized deductions, unless the origin of the claim litigated is related to a Schedule C (independent contractor), or a capital transaction. **This guide does not address the proper treatment of legal fees paid and deducted in taxable years prior to the year of recovery.**
7. The legal fees deducted on Schedule A are a tax preference item for purposes of Alternative Minimum Tax (AMT).
8. For purposes of the AMT Credit, the legal fees which created AMT, are not allowed to generate the credit. They are "exclusion" items.

ISSUES FOR LAWSUIT PROCEEDS RECEIVED AFTER AUGUST 20, 1996

1. Lawsuit proceeds are unreported.
2. All punitive damages are taxable whether received in relation to a physical or non-physical injury (caution: Alabama wrongful death cases).
3. Determine if any of the settlement proceeds are designated as interest, and if so, such interest is reported as income.
4. Verify that amounts excluded from income were received in a case of physical injury. If it was not a physical injury, the only amounts excludable under IRC section 104(a)(2) are out of pocket costs for medical expenses incurred to treat emotional distress.
5. For out of court settlements for physical injury cases, determine if proper amounts were allocated between compensatory and punitive damages.
6. Verify the amount of out of pocket expense excluded for emotional distress in a non-physical injury case (that is, discrimination, fraud, etc.).
7. Verify that the taxpayer reported taxable amounts at gross rather than reporting them net of legal fees paid.
8. Allowable legal fees should be deducted on Schedule A as miscellaneous itemized deductions, unless the origin of the claim litigated is related to a Schedule C (independent contractor), or a capital transaction. **This guide does not address the proper treatment of legal fees paid and deducted in taxable years prior to the year of recovery.**
9. The legal fees deducted on Schedule A are a tax preference item for purposes of AMT.
10. For purposes of the AMT Credit, the legal fees which created AMT, are not allowed to generate the credit. They are "exclusion" items.

This comparison of issues before and after the 1996 law changes clearly reflects the fact that there is still much potential for adjustments in the area of lawsuit payments. By the time this guide is available service wide, a large portion of the examinations will probably be relating to post- August 20, 1996, payments. However, there may still be some pre-August 21, 1996, cases as well. For this reason, this guide provides assistance in examining the taxability of settlement payments received both on or prior and subsequent to, the amendment to IRC section 104 on August 20, 1996. **(Note the exception to the effective date of this amendment).**

For taxable years beginning after August 20, 1996, there will still be issues relating to allocations in out-of-court settlements. The allocation issues will be particularly important in out-of-court settlements for physical injury cases. Because many cases are settled to avoid the imposition of punitive damages, it is anticipated that the some taxpayers may erroneously allocate amounts between excludable and punitive damages in these cases. The allocation issue will not be as important in the non-physical cases because only out-of-pocket expenses for emotional distress are excludable under IRC section 104(a)(2) after August 20, 1996.

Chapter 2

TAXABILITY OF LAWSUIT PAYMENTS

General rule relative to taxability of amounts received from lawsuit settlements:

IRC section 61 states that all income is taxable from whatever source derived, unless exempted by another section of the Code.

TERMINOLOGY/DEFINITIONS

Types of Claims

Tort

- May cause or constitute, but is not necessarily, a personal injury;
- Any wrongful act, not involving breach of contract, for which a civil suit can be brought;
- A wrongful act committed by one person against another person or his/her property;
- The breach of a legal duty imposed by law, other than by contract.

Example 1

X punches Y, thus committing the tort of battery.

Example 2

X sets foot on Y's property, thus committing the tort of trespass, but causing no personal injury.

Contractual

- Claims based on rights given by contract.

Example 3

X forces Y to leave his employment before the time specified in an employment contract, thereby breaching the contractual agreement.

Example 4

X refuses to pay Y the amount specified in a homebuilding contract, thereby breaching the contractual agreement.

Punitive

The tort offense was committed:

- Knowingly
- Willingly
- Deliberately
- Negligently
- Fraudulently.

Generally, punitive damages are not awarded for simple breach of contract, although lawsuits often combine claims for breach of contract and related tort claims in the same suit.

Types of Damages/Awards

Tort

- May be received from litigation or settlement of a claim for physical injury or illness; mental pain and suffering; interference with economic relations and/or property damage.
- Usually non-taxable if received in connection with a physical injury or sickness. Property damages are not excludable under IRC section 104(a)(2). Damages received for invasions of economic interests are generally taxable. See *Gregg v. Commissioner*, T.C. Memo. 1999-10.

EXCEPTIONS:

1. Tax Benefit Rule - If prior deductions under IRC section 213 were taken (that is, medical deductions; interest expense, etc.) then amounts received for reimbursement of these expenses would be taxable to the extent includable under IRC section 111.
2. Compensatory awards from tort claims which represent lost business receipts, or other categories of taxable income may be includable in income.

Contractual

- A remedy provided specifically by the contractual agreement or as interpreted by a court.
- Often paid for lost wages and benefits, profits and other forms of business receipts.
- Usually taxable.
- However, some amounts may be non-taxable, for example, X receives an insurance policy to replace one previously purchased that had lapsed due to an insurance agent's misappropriation of premiums paid.

Compensatory

Generally speaking, most people view the term "compensatory" to mean "nontaxable." However, as the above examples reflect, determinations of the taxability of lawsuit awards cannot always be made simply by referring to the terminology used, that is, compensatory or contractual.

The term "compensatory" merely means that the payment compensated the taxpayer for a loss. This loss may be purely economic, for example, arising out of a contract, or personal, for example, sustained by virtue of a physical injury. Furthermore, not all torts constitute personal injuries. Some torts may involve invasion of property rights, for example, conversion, or interference with economic interests, for example, tortious interference with contractual relations, or purely personal interests, for example, defamation. Further, even in tort cases, where the damages compensate for the aggravated manner in which the defendant committed the tortious act, such damages are not received on account of any personal injury.

The facts and circumstances of each lawsuit settlement must be considered to determine the purpose for which the money was received. Then, it can be determined whether these amounts are excludable.

Punitive

- To Punish
- Taxable. (Caution: Alabama wrongful death proceeds)

Types of Settlements

Determining the correct allocations among taxable payments and non-taxable payments is usually the most difficult part of these examinations. There are two ways in which settlement proceeds are originally categorized:

Jury/Court Verdicts

If damages have been clearly allocated to an identifiable claim in an adversarial proceeding by judge or jury, the Service will usually not challenge their character because of the impartial and objective nature of the determinations. But see *Robinson v. Commissioner*, 102 T.C. 116, 122 (1994) and *Kightlinger v. Commissioner*, T.C. Memo. 1998-357.

Settlements Out of Court

Many lawsuits are settled prior to a jury verdict. These settlements should be closely reviewed, and facts and circumstances should be carefully determined. The allocation among the various claims of the settlement can be challenged where the facts and circumstances indicate that the allocation does not reflect the economic substance of the settlement. See *Phoenix Coal*

Company, Inc. v. Commissioner (CA-2) 56-1 U.S.T.C. ¶ 9366, 231 F.2d 420 (2d Cir. 1956); *Robinson v. Commissioner*, 102 T.C 116, 122 (1994); *Bagley v. Commissioner*, 105 T.C. 396 (1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997).

LeFleur v. Commissioner, T.C. Memo. 1997-312 addresses the reallocation issue in a case involving claims for breach of contract, emotional distress, and punitive damages. In an out-of-court written settlement, the payment was allocated as \$200,000 to contract, \$800,000 to emotional distress, and \$0 to punitive damages. The taxpayer excluded the \$800,000 from income under IRC section 104(a)(2).

The Service disregarded the terms of the written settlement agreement and reallocated the \$800,000 to contract/punitive damages. The Tax Court upheld the IRS reallocation. Referring to the settlement, the court stated that "the allocation did not accurately reflect the realities of the petitioner's underlying claims." In determining that the \$800,000 was not excludable under IRC section 104(a)(2), the court stated:

"In light of the facts and circumstances, we conclude that petitioner suffered no injury to his health that could be attributed to the actions of the defendants, and we are not persuaded that such injury was the basis of any payment to him by Blount."

For additional information on issues dealing with allocation or reallocation, see the following sections on "Physical Personal Injury or Sickness" and "Non-Physical Personal Injury or Sickness."

Tax Treatment of Awards and Settlements

Awards and settlements can basically be divided into two distinct groups. One group includes claims arising from a physical injury and the other group includes those arising from a non-physical injury. The claims from each of the two major groups will usually fall into three categories:

1. Actual damages resulting from the physical or non-physical injury;
2. Emotional distress damages arising from the actual physical or non-physical injury; and
3. Punitive damages.

Physical Personal Injury or Sickness

Physical

IRC section 104(a)(2) provides for an exclusion from gross income for damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury or sickness.

Section 7641 of the Omnibus Budget Reconciliation Act of 1989 amended IRC section 104(a)(2) by adding flush language: "Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." This amendment applies to punitive damages received after July 10, 1989, in tax years ending after that date.

Nevertheless, some taxpayers have erroneously failed to report as income almost all types of awards/settlements under IRC section 104(a)(2) due to personal injury. The Service has consistently held that compensatory damages, including lost wages, received on account of a physical injury are excludable from gross income. Rev. Rul. 85-97, 1985-2 C.B. 50, *amplifying* Rev. Rul. 61-1, 1961-1 C.B. 14. See also *Commissioner v. Schleier*, 515 U.S. 323, 329-330 (1995), in which the Supreme Court, employing a similar set of facts as the ruling, held that medical expenses not previously deducted, pain and suffering damages, and lost wages received by accident victim are excludable from income.

IRC section 104(a)(2) was amended in 1996. The amended section 104(a)(2) excludes from gross income damages received on account of personal **physical** injury or **physical** sickness **only**. However, the limitation to personal physical injuries or physical sickness contained in the 1996 amendment does not apply to any amount received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

The House Committee Report for the 1996 changes (excerpts attached as Appendix D) states:

If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income.

Emotional

The exclusion from gross income under IRC section 104(a)(2) also applies to any compensatory damages received based on a claim of emotional distress or mental/emotional injury that is attributable to a physical injury or physical sickness. For more information on damages paid for emotional injuries stemming from physical injury/sickness, see discussion under "Physical" above. Emotional claims pertaining to **non-physical** personal injury/sickness" is covered later on in this guide.

Determining the amounts allocable to mental/emotional injuries may not always be easy. The facts and circumstances of each award/settlement must be examined, and amounts which can be reasonably allocated to genuine mental injury should be allowed. The allocation is necessary when economic damages, for example, back pay, or punitive damages is requested as relief in a case involving a physical or non-physical personal injury.

- **Points to consider:**

- Did payor intend to compensate the recipient for his or her claim of mental distress? If so, how much? But see *Hemelt v. United States*, 122 F.3d at 208 ("the characterization of a settlement cannot depend entirely on the intent of the parties") citing *Dotson v. United States*, 87 F.3d at 687, and *Mayberry v. United States*, 151 F.3d at 859.

- What did the payor think? That is, whether he/she/it could win or lose (elements of the claim).
- Were there medical bills for mental disturbances?
- Was there psychological treatment or counseling?
- Were there lost workdays?
- Is there documentation for medications, antidepressants, etc?
- Did this situation cause taxpayer to be absent from work?
- Was there sick leave used?
- Did taxpayer continue to care for his/her family?
- Did taxpayer continue with daily affairs?

For the allocation, start with the total payment less the actual, obvious losses, then allocate between compensatory and punitive.

Punitive Damages

- ***Punitive damages are not excludable from gross income under IRC section 104(a)(2).***

The position of the IRS on the taxation of punitive damages has not been constant. In Rev. Rul. 58-418, 1958-2 C.B. 18, the Service published its position that punitive damages do not qualify for exclusion under IRC section 104(a)(2). See *Thomson v. Commissioner*, 406 F.2d 1006, 69-1 U.S.T.C. ¶ 9199 (9th Cir. 1969). In Rev. Rul. 75-45, 1975-1 C.B. 47, the Service changed its position and concluded that punitive damages were excludable. See *Roemer v. Commissioner*, 716 F.2d 693, 83-2 U.S.T.C. ¶ 9600 (9th Cir. 1983), following the Service reluctantly on this issue. Addressing the Alabama wrongful death statute, the Service ruled that punitive damages were again taxable. Rev. Rul. 84-108, 1984-2 C.B. 32. Accordingly, Rev. Rul. 75-45 was revoked. See *Burford v. United States*, 642 F. Supp. 635 (N.D. Ala. 1986), disagreeing with Rev. Rul. 84-108. Prior to 1989, the courts, however, often did not agree. After 1989, some commentators believed that the courts would interpret the additional verbiage to IRC section 104(a)(2) to exclude punitive damages paid relative to a physical injury or physical sickness.

However, in the Tenth Circuit's decision in *O'Gilvie v. United States*, 95-2 U.S.T.C., ¶50,508, 66 F.3d 1550, the court ruled that "non-compensatory punitive damages are not received on account of personal injuries, and thus are not excludable from gross income under IRC section 104(a)(2)."

In *O'Gilvie*, the Tenth Circuit applied the Supreme Court's ruling in the case of *Commissioner v. Schleier*, (1995 S.Ct.), 75 AFTR 2d 95-2675; 115 S.Ct. 2159, 515 U.S. 323, involving employment discrimination, to a case involving wrongful death. *Schleier* held that there are two independent tests which must be met for the IRC section 104(a)(2) exclusion to apply: (1) The underlying cause of action giving rise to the recovery must be based on tort or tort-type rights; and (2) the damages must "have been received on account of personal injuries or sickness."

Prior to this time, some of the courts had relied on only the first requirement of a tort-type underlying claim in holding that the damages were excludable. See, for example, *Hill v. United States*, 733 F. Supp. 88, 1990-1 U.S.T.C. ¶ 50,170 (D. Kan. 1990) (damages for tort of misrepresentation excludable from gross income).

The Supreme Court upheld the Tenth Circuit's decision. *O'Gilvie* 519 U.S. 79, 117 S. Ct. 452; 96-2 U.S.T.C. ¶ 50,664; 78 AFTR 2d 7454 (1996). With this decision, the courts finally have clear guidance, which coincides with the Service's position on the taxation of punitive damages prior to the 1989 amendment to IRC section 104(a)(2).

With the enactment of Public Law 104-188, Section 1605(d), Congress made it clear in IRC section 104(a)(2) that punitive damages are taxable, regardless of the nature of the underlying claim.

However, the courts have not decided a case involving punitive damages subject to the 1989 amendment to IRC section 104(a)(2). In *dictum*, the Supreme Court indicated that Congress amended IRC section 104(a)(2) in 1989 to allow the exclusion of punitive damages only in cases involving physical injury or physical sickness. *United States v. Burke*, 504 U.S. at 236, n.6. Faced with the taxation of punitive damages prior to the 1989 amendment and the specter of addressing the 1989 amendment in a subsequent case, the Supreme Court, retreating from the statement in *Burke*, rejected the taxpayer's argument that was based on this *dictum*. *O'Gilvie*, 519 U.S. at 89-90. The Court indicated that Congress' focus in 1989 was on what to do about non-physical personal injuries rather than on punitive damages under prior law. The Court's statement lays to rest the negative inference and provides support for the conclusion that, in enacting the 1989 amendment, Congress did not intend to create an exclusion for punitive damages received in connection with a physical injury or physical sickness. See, also, *Miller v. Commissioner*, 914 F.2d 586, 588, n. 4 (4th Cir. 1990) (Congress has amended IRC section 104(a)(2) so that it now explicitly does not exclude from gross income "punitive damages received in connection with a case not involving physical injury or physical sickness.")

Wrongful Death

Claims for wrongful death usually encompass compensatory damages for physical and mental injury, as well as punitive damages for reckless, malicious, or reprehensible conduct. As a result, both claims may generate settlement amounts. Any amounts determined to be compensatory for the personal injuries are excludable from gross income under IRC section 104(a)(2). The amounts determined to be non-compensatory, that is, punitive payments, are not excludable under IRC section 104(a)(2). This is true regardless of whether the punitive amounts are received prior or subsequent to the August 20, 1996, amendment. (See *O'Gilvie*, 519 U.S. 79, 117 S. Ct. 452; 96-2 U.S.T.C. ¶ 50,664; 78 AFTR 2d 7454.)

The exclusion available for personal injuries under IRC section 104(a)(2), as of August 20, 1996, reads as follows:

“* * * the amount of any damages (other than 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.”

As mentioned previously, caution should be used in applying this general rule that punitive damages received in wrongful death cases are taxable. The courts have generally looked to the state statute under which the wrongful death claim was litigated to determine whether there could be compensatory and/or punitive damages awarded. This search, at times, has revealed a state statute, which provides only for punitive damages in wrongful death claims. One court has ruled, that such damages received in wrongful death cases in that state are excludable from income. *Burford v. United States*, 642 F. Supp. 635 (N.D. Ala. 1986). The court's reasoning was that because the taxpayer is precluded from receiving any compensatory amounts, it is unfair to tax the amounts although they were classified as punitive.

Questions have arisen as to whether the 1996 amendment codified this judicial treatment of punitive damages in *Burford*. A new provision, IRC section 104(c), provides as follows:

(c) Application of prior law in certain cases.

The phrase "other than punitive damages" shall not apply to punitive damages awarded in a civil action -

(1) which is a wrongful death action, and

(2) with respect to which applicable State law (as in effect on September 13, 1995, and without regard to any modification after such date) provides, or has been construed to provide by a court of competent jurisdiction pursuant to a decision issued on or before September 13, 1995, that only punitive damages may be awarded in such an action.

Due to the inference raised by this language in the wrongful death claims area, it may become necessary to determine if your state is one having a statute precluding the awarding of compensatory damages in wrongful death cases. If that is the case, then contact the Office of Chief Counsel for guidance on Service position.

Product Liability

Product liability cases often include claims for personal physical and mental injury. For example, X brings a claim for personal injury against an auto manufacturer claiming a wreck was caused by a faulty steering column on his car, or Y brings suit against the manufacturer of a contaminated pesticide claiming damage to ornamental plants and the nursery, and injury to business reputation.

These type cases will usually involve the various elements discussed above, relative to compensatory damages for physical and mental injury, as well as punitive damages. Proper allocations among the taxable and nontaxable portions received must be determined.

Prior to the amendment of August 20, 1996, the Service and the courts consistently interpreted IRC section 104(a)(2) as providing an exclusion for damages received in connection with claims of mental and emotional distress which arose from non-physical injuries. Examples of these type cases are employment wrongful discharge; discrimination; libel; etc. Exclusions from gross income have been widely debated in prior years. Generally, the Service has challenged taxpayers' allocation of settlement proceeds to compensatory damages for mental/emotional distress when those allocations do not reasonably reflect the economics of the underlying claim. Thus, whether the Service must respect the specific allocations contained in a settlement agreement has arisen in several cases. The same considerations to proper allocations for emotional claims that were discussed earlier under "physical injuries" are applicable to the non-physical cases as well. (Refer to comments under "Emotional".)

The August 20, 1996, amendment has plainly resolved this issue on the side of the Government. With the exception of amounts paid to treat emotional distress, damages received after August 20, 1996, are excludable under IRC section 104(a)(2) only if received on account of physical injury or physical sickness.

The 1996 amendment changed the last sentence in paragraph (a) of IRC section 104 to include the following:

For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress.

The House Committee Report on the 1996 amendment to IRC section 104(a)(2) states:

*** the exclusion from gross income does not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress *** In addition, the exclusion from gross income specifically applies to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress.

As a result of the above 1996 changes to IRC section 104(a)(2), a taxpayer receiving lawsuit proceeds from a non-physical injury claim cannot exclude any amount for payment to compensate for an intangible emotional distress value. The taxpayer can only exclude an amount for actual out of pocket medical costs. This exclusion would further depend upon whether the taxpayer had previously deducted those medical expenses on his or her tax return. See IRC sections 111 and 213.

Employment-Related

Employment-related lawsuits may arise from wrongful discharge or failure to honor contract obligations. Whether a wrongful termination constitutes a tort under applicable state law is not controlling for IRC section 104(a)(2) purposes. As indicated earlier, the victim of a tort may suffer both personal injury and economic loss. Damages received to compensate for economic loss, for example, lost wages, business income, benefits, are not excludable from gross income unless a personal injury caused such loss.

If the payments in question are received prior to the 1996 amendment, there may be issues concerning the proper allocation between taxable and nontaxable proceeds. The taxpayer may be seeking to exclude substantial amounts for emotional/mental distress. After the 1996 changes, the taxpayer can exclude under IRC section 104(a)(2) only an amount of damages received not exceeding medical costs paid to treat any emotional distress.

Discrimination Suits (Employment-Related)

Discrimination suits usually are brought alleging infringements in the areas of age, race, gender, religion or disability. These types of cases can generate compensatory, contractual and punitive awards. Historically, the courts have usually looked to the underlying-cause-of-action statute to determine the nature of remedies allowed for the various types of discrimination.

Some courts, and, for a short time, the Service, permitted taxpayers to exclude amounts awarded which actually represented back pay. Rev. Rul. 93-88 was based on the interpretation of the Supreme Court's ruling in *Burke*, 504 U.S. 229 (69 AFTR 2d 92-1293). Rev. Rul. 93-88 held that amounts received under the following provisions, including, not only amounts for non-pecuniary losses, but back pay as well, were excludable under IRC section 104(a)(2):

1. Gender discrimination claims under the disparate treatment provisions of Title VII of the Civil Rights Act of 1964, 42 U.S.C. section 2000e *et seq.*, as amended by the Civil Rights Act of 1991, 42 U.S.C. section 1981a;
2. Racial discrimination claims under, 42 U.S.C., section 1981, and Title VII of the Civil Rights Act of 1964; and
3. Discrimination claims under the Americans with Disabilities Act, 42 U.S.C. sections 12101-12213.

The decision of the Supreme Court in the *Schleier* case, (1995, S. Ct.) 515 U.S. 323, 115 S. Ct. 2159, caused the Service to suspend Rev. Rul. 93-88 with the issuance of Notice 95-45, 1995-2 C.B. 330, on August 3, 1995. Notice 95-45 stated the following:

In *Schleier*, the Supreme Court held that back pay and liquidated damages received in settlement of a claim under the Age Discrimination in Employment Act of 1967, 29 U.S.C sections 621-634 (ADEA), are not excludable from gross income under section 104(a)(2). The Court concluded that section 104(a)(2) and its regulations set forth two requirements for a recovery to be excludable from income: (1) it must be based on tort or tort-type rights, and (2) it must be received "on account of personal injuries or sickness." The Court held that back pay and liquidated damages received under the ADEA meet neither requirement because (1) the ADEA provides no compensation for any of the other traditional harms associated with personal injury, (2) the back pay is completely independent of the existence or extent of any personal injury, and (3) the ADEA liquidated damages are punitive in nature.

In Notice 95-45, the Service requested public comments concerning the impact of *Schleier* on the above listed statutes; allocation of the excludable and nonexcludable portions of lump-

sum awards and settlements; and the extent to which IRC section 7805(b) relief should be granted in the event that guidance previously issued by the Service is modified. Notice 95-45 was superseded when the Service published Rev. Rul. 96-65, 1996-2 C.B. 6, in December of 1996.

After providing a brief history of the law and rulings relating to the discrimination cases, Rev. Rul. 96-65 holds:

1) Current section 104(a)(2) - (after August 20, 1996) Back pay received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII is not excludable from gross income under section 104(a)(2) because it is completely independent of, and thus is not damages received on account of, personal physical injuries or physical sickness under that section. Similarly, amounts received for emotional distress in satisfaction of such a claim are not excludable from gross income under section 104(a)(2), except to the extent they are damages paid for medical care (as described in section 213(d)(1)(A) or (B)) attributable to emotional distress.

2) Former section 104(a)(2). Back pay received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII is not excludable from gross income under former section 104(a)(2) because it is completely independent of, and thus is not damages received on account of, personal injuries or sickness under that section. However, damages received for emotional distress in satisfaction of such a claim are excludable from gross income under former section 104(a)(2) because they are received "on account of personal injuries of sickness."

Pursuant to the authority contained in IRC section 7805(b), Rev. Rul. 96-65 will not apply adversely to damages received under any provision of law providing tort or tort-type remedies for employment discrimination for race, color, religion, gender, national origin, or other similar classifications, if the damages are received (1) on or before June 14, 1995, the date that *Schleier* was decided by the Supreme Court, or (2) pursuant to a written binding agreement, court decree, or mediation award in effect on (or issued on or before) June 14, 1995.

Rev. Rul. 96-65 also contains information concerning its effect on other rulings and references to treatment of amounts as wages and compensation. Rev. Rul. 96-65 should be consulted for guidance in certain employment discrimination cases. The provisions of Rev. Rul. 96-65 apply to proceeds received for employment discrimination that is also prohibited by certain state and local laws. Rev. Rul. 93-88, although made obsolete by Rev. Rul. 96-65, contains a good explanation of various discrimination statutes.

Libel (Defamation of Character)

Prior to the 1996 amendment to IRC section 104, the government and the courts were at odds on the proper tax treatment of awards due to damage of business reputation. The government took the position that these damages could not be excluded from income. See Rev. Rul. 58-418, 1958-2 C.B. 18.

Although the Tax Court initially agreed with the government, *Roemer v. Commissioner*, 79 T.C. 398 (1982), *rev'd*, 716 F.2d 693 (9th Cir. 1983), it adopted the circuit court's rationale in *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988). As a result, the courts allowed taxpayers to exclude from gross income compensatory amounts received for injury to business reputation and malicious prosecution. See also *Srivastava v. Commissioner*, T.C. Memo. 1998-362 (defamation of a person is a personal injury under state law).

Recently, however, the Tax Court revisited this issue and concluded that damages received for injury to the taxpayer's business or professional reputation failed to qualify for the IRC section 104(a)(2) exclusion. *Fabry v. Commissioner*, 111 T.C. 305 (1998). The court held that whether damage to an individual's business or professional reputation constitutes a personal injury for IRC section 104(a)(2) purposes is an issue of fact, rather than a question of law. Because the taxpayer failed to allege any personal injury in the underlying product liability action, the court concluded that the portion of the proceeds allocable to injury to taxpayer's business reputation was not excludable under IRC section 104(a)(2). *Fabry* was decided under IRC section 104(a)(2) as it existed prior to the 1996 amendment.

However, the 1996 changes to IRC section 104(a)(2) should resolve this issue on the side of the government as well. Because damage to reputation, be it personal or business, is a non-physical injury, only out of pocket costs to treat emotional distress can be excluded. Any other compensatory and punitive damages arising from these cases are taxable.

Other Non-Physical Personal Injury

Lawsuits against insurance companies, finance companies, etc., for negligence, fraud, breach of contract, etc., can include a variety of claims, and therefore can produce a variety of types of awards/settlements.

For amounts received prior to August 21, 1996, the facts and circumstances of each case must be analyzed to determine the reasonable allocations between taxable and nontaxable amounts. Some taxpayers may erroneously categorize punitive damages and other non-compensatory amounts received in these cases as amounts received for personal injuries related to emotional distress.

Subsequent to August 1996, the taxable amounts in these cases are more easily determined. Because these are nonphysical injuries, under the current version of IRC section 104(a)(2), only out-of-pocket amounts for medical costs incurred to treat any emotional distress claims would be excludable from income. All amounts determined to represent punitive damages are taxable.

CHAPTER 3

OTHER RELATED TOPICS

PAYROLL AND SELF-EMPLOYMENT TAX CONSIDERATIONS

Questions may arise concerning pursuit of employment taxes on cases involving employment-related issues, and self-employment taxes on cases involving payments to self-employed persons related to their trade or business.

The employment taxes that may apply include the taxes imposed under the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages (income tax withholding). If the taxpayer is a railroad employer, the Railroad Retirement Tax Act (RRTA) may apply. FICA taxes, FUTA taxes, and income tax withholding are imposed on “wages” as defined in the Internal Revenue Code. “Wages” is broadly defined as “all remuneration for employment,” with certain specific exceptions, for FICA and FUTA purposes (IRC sections 3121(a) and 3306(b), respectively) and “all remuneration for services performed by an employee for his employer,” again with specific exceptions, for income tax withholding purposes (IRC section 3401(a)).

In determining the status of settlement payments, keep in mind the broad definitions of “wages.” See *Social Security Board v. Nierotko*, 327 U.S. 358 (1946), and *Hemelt v. United States*, 122 F.3d 204, 209-211 (4th Cir. 1997).

Be aware that the label placed on settlement payments by the plaintiff and the defendant does not necessarily control the employment tax treatment of such payments. Because both parties generally benefit by classifying payments as non-wage payments, the specific portion of a settlement agreement allocating payments to non-wage payments is generally not based on an arm’s length negotiation between adverse parties.

An allocation of the settlement that is reasonable and based on the facts and circumstances of the case should generally be accepted by the Service. A statement by the employer that the settlement payment was made merely to settle the case is of little value in determining whether the payment is wages for employment tax purposes. Generally, if no specific allocation of the settlement is made, the status of the payments would be determined by looking at the claims asserted by the plaintiff and the surrounding facts and circumstances, including the basis upon which the settlement proceeds were distributed. There has been a considerable amount of litigation in connection with the employment taxation of settlement payments, therefore, before relying on any particular case, care should be taken to verify that the case accurately reflects Service position.

There is general agreement that to the extent damages are excludable from gross income, they are not subject to employment taxes. Also, there is general agreement among courts that to the extent a settlement payment made by an employer or former employer represents back pay for services by an employee for the employer, such payments are wages for employment tax purposes. Rev. Rul. 96-65, 1996-2 C.B. 6.

Back pay paid to an employee or former employee by an employer in a settlement related to a claim under a workers' right statute or civil rights statute for a period during which no services were performed by the employee is also wages for federal employment tax purposes. Typically, back pay is awarded if an employee is illegally terminated by an employer, and, under those circumstances, the back pay relates to a period when no services for the employer were performed by the employee because of the illegal termination. The position that back pay is wages even though it is attributable to a period during which actual services were not performed is based on the Supreme Court's holding in *Social Security Board v. Nierotko*, 327 U.S. 358 (1946), in which back pay awarded to an illegally terminated employee under the Fair Labor Standards Act (FLSA) was held to be wages for social security benefit purposes.

Nierotko has been applied in determining that wages for federal employment tax purposes includes back pay paid under a number of different workers' rights and civil rights statutes (for example, the Back Pay Act, the Age Discrimination in Employment Act (ADEA), and Title VII of the Civil Rights Act of 1964, and state and local discrimination statutes). *See Tanaka v. Department of Navy*, 788 F.2d 1552, 1553 (Fed. Cir. 1986), and *Blim v. Western Electric Co.*, 731 F.2d 1473, 1480 n.2 (10th Cir. 1980). But see *Churchill v. Star Enterprises*, 3 F. Supp. 2d 622, 624-25 (E.D. Pa. 1998) holding that an employer could not withhold FICA or income taxes from damages awarded for a violation of the Family and Medical Leave Act, 29 U.S.C. section 2601 *et seq.*, because the employee was not performing services for the employer during the period for which the damages were awarded.

Service position is that "front pay", which is pay awarded to the employee for future services (that is, generally service from the date of the settlement going forward) the employee would have performed but for the illegal actions of the employer, is also wages for federal employment tax purposes. Some courts have disagreed with this position. *See Dotson v. United States*, 87 F.3d 682, 690 (5th Cir. 1996), holding that payments are not wages if not for services already performed. However, *Nierotko* supports the Service position. In addition, Service position is that settlements including cash payments made to employees by employers in lieu of providing benefits under employer plans (for example, paid in lieu of health insurance or qualified pension plan benefits) are also wages for federal employment tax purposes, because no exception from wages applies.

Back pay and front pay are wages subject to employment taxes in the year paid, and are subject to the tax rates and FICA and FUTA wage bases in effect in the year paid. See Rev. Rul. 89-35, 1989-1 C.B. 280; *Hemelt v. United States*, 122 F.3d 204, 210 (4th Cir. 1997); and *Mazur v. Commissioner*, 386 F. Supp. 752 (W.D. N.Y. 1997). The Service does not follow *Bowman v. United States*, 824 F.2d 528 (6th Cir. 1987), on the timing of FICA taxation of back pay issue.

There has been much litigation in the area of the employment tax status of settlement agreements, and the Service position has not been followed in many cases. For example, the issue of whether certain payments in settlement of a suit for violation of Employee Retirement Income Security Act (ERISA) are subject to income and FICA taxes has been litigated in four circuits. These cases related to a class action brought by former employees of an employer who engaged in a scheme of terminating employees before they qualified for certain pension benefits. Two circuits agreed with the Government's position that the full amount of the settlements were includable in income and

subject to FICA taxes. See *Hemelt v. United States*, 122 F.3d 204 (4th Cir. 1997), and *Mayberry v. United States*, 151 F.3d 855 (8th Cir. 1998). However, in *Dotson v. United States*, 87 F.3d 682 (5th Cir. 1996), the Fifth Circuit Court of Appeals held that only the back pay portion of the settlement was wages for FICA tax purposes. In *Gerbec v. United States*, 164 F.3d 1015 (6th Cir. 1999), the Court of Appeals for the Sixth Circuit held that only the portions of the settlement representing back pay and the front pay not attributable to personal injury were subject to FICA taxes. In looking at these four cases, please be aware that the income tax result does not reflect the recent amendment to IRC section 104(a)(2) and that the income and FICA tax results in the cases the Government lost do not reflect *Mertens v. Hewitt Associates*, 508 U.S. 248 (1993), a Supreme Court case which provides that tort damages are not available for ERISA violations.

In addition, the Service's position is that back wages and front pay paid to individuals who are not hired as employees because of violation of workers' rights or civil rights statutes are wages for federal employment tax purposes. See Rev. Rul. 78-176, 1978-1 C.B. 303, which bases its holding on *Nierotko*. However, the position of this revenue ruling was rejected in *Newhouse v. McCormick & Co.*, 157 F.3d 582 (8th Cir. 1998).

As a general rule, dismissal pay, severance pay, or other payments for involuntary termination of employment are wages for federal employment tax purposes. See Rev. Rul. 90-72, 1990-2 C.B. 211, and Rev. Rul. 73-166, 1973-1 C.B. 411. See also *Abrahamsen v. United States*, 44 Fed. Cl. 260 (1999), on downsizing payments. In that consolidated case, approximately 2,600 former employees of IBM sought refunds of income and FICA taxes on the basis that payments received under certain resource reduction programs were excludable from gross income as personal injury damages and consequently were not wages. Noting that none of the plaintiffs instituted a claim against IBM before executing releases and receiving the payments, the court doubted that they satisfied the first test for exclusion. Even if they did satisfy that test, the court concluded that the plaintiffs failed to satisfy the second test that the payments were received "on account of personal injuries." On the FICA issue, the court reasoned that because the payments were linked to salary and length of tenure, the payments were consistent with the notion of wages.

There are a number of exceptions to wages that may apply in settlement cases. For example, legally designated interest and attorney fees may be excepted from wages. Rev. Rul. 80-364, 1980-2 C.B. 294. Also, a limited exception exists for certain settlement payments made to settle claims for the cancellation of the remaining period of a contract for a term of years that is terminated prior to the completion of the contract. See Rev. Rul. 55-520, 1955-2 C.B. 393, and Rev. Rul. 58-301, 1958-1 C.B. 23. These two rulings should be applied only when the facts of the case are identical to the rulings, and comparison should be made with Rev. Rul. 74-252, 1974-1 C.B. 287, and Rev. Rul. 75-44, 1975-1 C.B.15, before applying Rev. Rul. 55-520 or Rev. Rul. 58-301 in any particular case.

"Liquidated damages" awarded under a FLSA settlement are not wages for federal employment tax purposes. Rev. Rul. 72-268, 1972-1 C.B. 313. Under the FLSA such liquidated damages cannot exceed the amount of back pay and must be based on a showing of willful intent of the employer. Similar rules apply to "liquidated damages" under the ADEA. Generally, bona fide damages in settlement of tort claims for personal injury that were excludable from gross income under IRC section 104(a)(2) do not constitute wages for federal employment tax purposes. See *Hemelt*, 122 F.3d at 210.

In the case of a lawsuit settlement paid by an employer to an employee or former employee, caution should be exercised in determining the existence of any employment tax issues.

In contrast to the broad definition of wages for federal employment tax purposes set forth in *Nierotko* and other cases, many recent cases have adopted narrow interpretations of what constitutes “self-employment income” for self-employment tax purposes. See IRC section 1402(a) and (b). Under the test adopted by many courts, to be included in self-employment income for self-employment tax purposes, “any income must arise from some actual (whether present, past, or future) income-producing activity of the taxpayer.” See *Newberry v. Commissioner*, 76 T.C. 441 (1981), in which business interruption insurance payments paid to a self-employed individual during the period his store was shut down because of a fire were held not to be self-employment income, and *Jackson v. Commissioner*, 108 T.C. 130, in which certain termination payments made to a retiring insurance agent were held not to be includable in self-employment income. See, however, Rev. Rul. 91-19, 1991-1 C.B. 186, in which the Service sets forth a slightly different test for inclusion in self-employment income.

Thus, before classifying settlement payments as subject to self-employment tax, care should be taken in determining that the payments can be attributed to the carrying on of a trade or business by the self-employed person.

AMOUNT TO BE INCLUDED IN INCOME

In cases involving contingent fee arrangements, the gross award/settlement, without diminution for attorneys’ fees or costs, should be included in the taxpayer's income. This treatment is in accord with IRC section 61 and the long established principle, "the fruit of the tree" theory, that income is taxable to the person who earns it and it cannot be assigned to someone else.

Taxing the gross amount from lawsuit proceeds has been upheld in Tax Court, as well as various circuit jurisdictions. See *Gadlow*, 50 T.C. 975, (1968)(Pennsylvania); *Baylin*, 43 F.3d 1451, 94-1 U.S.T.C. ¶ 50,029 (Fed. Cir. 1993)(Maryland); *Alexander*, 72 F.3d 938, 96-1 U.S.T.C. ¶ 50,011 (1st Cir. 1995), *aff’g* T.C. Memo. 1995-51(Massachusetts); *Coady*, T.C. Memo. 1998-291 *aff’d*, 231 F3d 1187 (9th Cir. 2000)(Alaska); *Srivastava*, T.C. Memo. 1998-362, *rev’d*, 86 AFTR2d ¶ 2000-5104 (Texas); *Sinyard*, T.C. Memo. 1998-364(Arizona); and *Benci-Woodward*, T.C. Memo. 1998-395, *aff’d*, 86 AFTR2d ¶ 2000-5102 (9th Cir. 2000) (California); *Kenseth*, 114 T.C. No. 26 (May 24, 2000). In *Kenseth*, the Tax Court held that the anticipatory assignment principles require a taxpayer to include in gross income the entire amount of judgment/settlement proceeds, undiminished by any contingent fee and regardless of the state where a fee agreement is signed. The Tax Court expressly rejected the principles enunciated in cases holding to the contrary.

Examiners handling cases involving payments of attorneys’ fees in lawsuits in Alabama, Michigan, and Texas, however, should be aware that there is contrary authority based on an interpretation of applicable state law.

In *Cotnam v. Commissioner*, 1959, 263 F.2d 119, 59-1 U.S.T.C. ¶ 9200, *rev'g on this issue*, 28 T.C. 947 (1957), the Fifth Circuit, one judge dissenting, determined that attorneys' fees paid directly to the attorney from the judgment under a contingency fee arrangement were not includable in the taxpayer's gross income. The majority of the court reasoned that under Alabama law, attorneys had the same rights as their clients and that Mrs. Cotnam could never have received the portion paid as attorneys' fees. This is a case from the Fifth Circuit, prior to the time a portion of the circuit was split off to form the Eleventh Circuit.

An Action on Decision in the *Cotnam* case states that the Service will not follow the court's ruling in future cases. The Government has requested the full Court of Appeals for the Eleventh Circuit to reconsider the *Cotnam* decision. In *Davis v. Commissioner*, T.C. Memo. 1998-248, *aff'd*, 210 F.3d 1346 (11th Cir. 2000), the Tax Court concluded it was bound by *Cotnam* in cases arising under Alabama law, and, thus, ruled adversely to the Commissioner. However, the Eleventh Circuit declined to reconsider *Cotnam* in the *Davis* appeal. Similarly, the Fifth Circuit followed *Cotnam* in reversing the Tax Court's decision in *Srivastava*. The panel agreed with the Tax Court's rationale in *Kenseth* but nevertheless, the majority of the panel elected to follow its precedent in *Cotnam*. The Service is considering whether to recommend to the Department of Justice that Supreme Court review is appropriate and warranted.

The Court of Appeals for the Sixth Circuit followed *Cotnam* in a case arising under the common law of Michigan. *Est. of Arthur L. Clarks*, 202 F.3d 854 (6th Cir. 2000). Reversing the judgment of the district court, the Sixth Circuit analogized Michigan common law of liens to the Alabama attorney lien statute. Because the Service did not believe that the Sixth Circuit created a direct conflict with opinions arising under other state laws, the Service did not recommend that the Government file a petition for a *writ of certiorari*.

Until this issue is resolved, the Action on Decision in *Cotnam* should be followed and taxpayers should not be allowed to net the proceeds of the direct payment of attorneys' fees in all cases arising under any law other than Alabama, Michigan, and Texas. The Service erroneously excluded the attorneys' fees from the taxpayers' income in *Francisco v. United States*, 85 AFTR 2d ¶ 2000-754 (E.D. Pa. 2000). Further, in cases arising under Alabama, Michigan and Texas law, consult with the appropriate local Office of Chief Counsel for the current status of this issue.

DEDUCTION FOR ATTORNEYS' FEES

Generally, individuals, as cash basis taxpayers, may deduct attorneys' fees in the year they are paid, assuming the attorneys' fees otherwise qualify as deductible. In the majority of such cases, the attorneys' fees are paid pursuant to a contingent fee arrangement once damages have been recovered. Where the ultimate recovery is excludable from gross income, either in whole or in part, the payment of contingent attorneys' fees allocable to exempt income are not deductible. IRC section 265(a)(1). The question of the timing and deductibility of attorneys' fees paid prior to resolution of the lawsuit on a noncontingent fee basis requires additional analysis that is not practical to provide in this guide. Examiners should consult with the appropriate Office of Chief Counsel for guidance.

Except in rare cases, such as a compensatory recovery of self-employment income, (for example, commissions that are reported on Schedule C) or recovery of capital gain income, legal fees will be a Schedule A miscellaneous itemized deduction, subject to the 2 percent floor and AMT. (This, of course, assumes that the lawsuit proceeds have been taxed at gross in the taxpayer's income.) Nevertheless, the Tax Court recently held adversely to the Commissioner that a self-employed individual could deduct legal fees allocable to the recovery of punitive damages on Schedule C, rather than as a miscellaneous itemized deduction on Schedule A. *Guill*, 112 T.C. 325 (1999). Consequently, the court held that the punitive damages recovered by the taxpayer were Schedule C income. The Service is considering the correctness of the court's holding and whether an AOD will be prepared.

See: *Church v. Commissioner*, 80 T.C. 1104, 1110 (1983); and *Alexander*, 96-1 U.S.T.C., ¶ 50,011; and IRC section 212.

LEGAL FEES RELATING TO NON-TAXABLE AWARDS OR SETTLEMENTS

No legal fee deduction will be allowed for legal fees allocable to non-taxable awards or settlements. IRC section 265(a). Absent strong support to the contrary, legal fees relating to an award or settlement that is partially taxable will be allocated based on the ratio between the taxable award/settlement and the total award/settlement.

See *Johnson-Waters*, T.C. Memo. 1993-333; and *Church*, 80 T.C. 1104, 1110 (1983).

ACCRUED INTEREST ON COURT JUDGMENTS

Any interest associated with an award or settlement is always taxable. *Aames*, 94 T.C. 189 (1990); *Kovacs*, 100 T.C. 124 (1993); *Brabson v. United States*, 96-1 U.S.T.C. ¶ 50,038, 74 AFTR 2d 572, 73 F.3d 1040 (10th Cir. 1996). Some states have enacted statutes requiring defendants to pay judgment interest in tort actions. Where the parties settle an appeal of a verdict, the Service has been successful in convincing the courts that a portion of the proceeds should be allocated to such interest. *Delaney*, 99 F.3d 20 (1st Cir. 1996), *aff'g* T.C. Memo. 1995-378.

CHAPTER 4

SOURCES OF INFORMATION

NOTE: The comments in this section concerning information sources must be used within the guidelines for compliance initiative projects. Additionally, the requirements for third party contacts and third party summonses outlined in RRA 98 must be followed.

Identifying taxpayers who have received large taxable lawsuit settlements can be a difficult process because a Form 1099 is not usually issued to the plaintiff. Most of the returns to be examined would not normally be selected through regular classification. The following sources may be used to identify large taxable lawsuit settlements.

NEWSPAPER ARTICLES

One readily available source of information is local newspaper articles. Large punitive damage verdicts generally make headlines. A coordinator can be responsible for reviewing and maintaining interesting newspaper articles.

This is an excellent source of identifying taxpayers that have gone to court and had a jury verdict. This does not identify individuals who settle prior to a jury verdict.

COURTHOUSE RESEARCH

Determine where civil lawsuits are originally filed in your jurisdiction. In many states cases are filed with the circuit clerk's civil division at the county courthouse where the lawsuit originates. There may be tens of thousands of civil cases filed in one year. Only a small portion of these cases will be punitive damage cases. Identifying punitive damage cases from this population can be a difficult process. Some of the techniques used to identify these cases include the following:

1. Scan the style of the case (plaintiff versus defendant) at each courthouse. Most of the circuit clerks' offices will be computerized, but some have hand-written records.
2. Identify insurance companies and finance companies who are defendants in the cases. These are typically the types of companies being sued for punitive damages.
3. Record the case file number.

4. Review the case file. Most of the cases are settled out of court and dismissed with prejudice. This means the case has received final settlement and cannot be further litigated. Typically the dollar amount of the settlement is not noted in the file if the case is settled out of court. Use a worksheet (see Appendix A for a sample) to gather pertinent information from the civil case file. Scanning the file is one of the most important techniques to become familiar with the type of lawsuit filed. Suits which seem to have non-physical damages (fraud, negligence, misrepresentation, etc.) are to be given priority.
5. Review cases which are large in size. This tends to indicate that the lawsuit was in process for an extended period of time, and this could be an indication of a large settlement.

COMPUTERIZED DATA

In some states it may not be necessary to manually research the courthouse as described above. Determine if your state has a centralized agency for recording all lawsuits filed. In some states information is sent to an Administrative Office of Courts (a state agency) on a monthly basis. This state agency should have a compiled list of the cases filed in counties having a computerized system. The list may provide information such as the case number, style (plaintiff versus defendant), type of case, date settled, and amount of damages awarded.

Once it has been determined that your state has a compiled listing of all civil cases, obtain the magnetic tape of the list for all open exam years. There may be a charge for this magnetic tape. The computer audit specialist (CAS) in your district can then manipulate the data on the tape to certain specifications. For example, the CAS could make a list of all civil cases that were settled by jury with specific dollar amounts designated as compensatory and punitive. In addition, the list could be sorted into geographic areas to fit post of duty locations. This POD data can then be reviewed for cases with exam potential. Specific courthouse files could be reviewed if deemed necessary.

SETTLEMENT PAYORS

This same computerized data just discussed can be used to identify settlement payors. Review the database to select those companies that appear as defendants most often. Insurance companies are usually the defendants in these cases and are a prime source of information for lawsuits or payments made in lieu of a lawsuit. A contact with the insurance company's legal department should be made to establish communication with the company. At that time you may explain the possible tax consequences of the payments and what information you need. Request that they provide you with the information.

Third party letters can be issued to the settlement payors requesting records needed to begin examinations (see Appendix B for sample attachment to third party letters). However, because of legal reasons, many insurance companies will require that you issue a summons to them before they release any information to you. Whether you are issuing a third party letter or a summons, the following information should be requested:

1. Copies of the complaint,
2. Copies of settlement agreements and/or waivers,
3. Copies of front and back of checks,
4. Addresses of the plaintiffs, and
5. Social Security Numbers of the plaintiffs.

When issuing a summons, it is recommended that you request assistance from the company's legal department in structuring your request for information. This enables you to obtain the information needed while minimizing their efforts.

It should be noted that the payors generally will not have a disbursement schedule. It is standard practice for payors to disburse the gross amount of the settlement to the plaintiff's attorney, who then disburses the money to his or her client(s). Therefore, the disbursement schedule can best be obtained from the taxpayer (plaintiff). This information may also be available from the plaintiff's attorney. Generally, this information would not be protected by the attorney-client privilege, but consult with the appropriate Office of Chief Counsel if the facts and circumstances warrant pursuing this action. Use of settlement payors has advantages in that the correct person can be easily found. In addition, you know the amount of the payment and the date it was made.

See Chapter 5, Third Party Contacts and Summons Information, for further information.

STATE DEPARTMENT OF INSURANCE

The State Department of Insurance may have a complaint file on insurance companies. These files may be reviewed for any additional leads on punitive damage cases.

STATE SUPREME COURT LIBRARY

The State Supreme Court Library records all the cases that the State Supreme Court has heard. Many of the large awards by jury are appealed to the State Supreme Court. This reference can be used to make sure that no large cases are omitted from possible exam consideration.

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CHAPTER 5

THIRD PARTY CONTACTS AND SUMMONS INFORMATION

NOTE: The following information concerning third party contacts and summons should be read in conjunction with the provisions of the 1998 RRA in IRC sections 7602 and 7609. These provisions require taxpayer notice in many cases prior to the commencement of third party contacts and new notice requirements for summons issued to third parties. In addition, compliance Initiative Project (CIP) guidelines should be followed.

Third parties may be potential sources of a variety of information. As indicated earlier in this guide, the Service may be seeking information about the very existence of lawsuit settlements. Moreover, even if aware of the existence of a settlement, the Service may need to contact insurance companies or plaintiffs' attorneys to identify the specific recipients, and/or determine the specific amounts disbursed to each of the recipients in the settlement. The various devices for obtaining such information from third parties are noted below.

THIRD PARTY LETTER

Examiners should initially attempt to secure needed information from the defendant companies (mainly insurance companies) by orally requesting the companies to provide the information voluntarily. If a company declines to produce the information in response to an oral request, examiners should attempt to obtain the information through the use of a third party request. Either the third party letter or a summons can be used both to request information with respect to a specific taxpayer or to request information on lawsuit settlement payments in general.

In a situation where a third party letter is issued to an insurance company, ask the insurance company's attorney to review the third party letter. Discuss the third party request, pointing out that the letter is issued under the same Code section which authorizes issuance of a summons (IRC section 7602). Where third party requests (either oral or written) do not pertain to a specific taxpayer, they are not subject to the same statutory control as a third party summons. However, in instances where the third party letter pertains to a specific taxpayer, IRC section 7602(c), as revised by the RRA, may apply to require that notice to the taxpayer be provided before the letter can be issued.

The Service is not responsible for any costs incurred in responding to a third-party letter. Ask the insurance company's attorney to review the confidentiality clause in the settlement closing agreement, if applicable. If there is a confidentiality clause, it often does not restrict the release of the facts of the case to the Service. Even where it does restrict release of the facts, the Service

may legally be entitled to the information, as IRC section 7602 authorizes the Service to obtain any information that may be relevant to the determination and collection of a tax liability.

The company may respond to the third party letter; however, some companies will require a summons.

ISSUANCE OF SUMMONS

The manager must approve the issuance of a summons. Form 1334, Requisition for Equipment, Supplies or Services, has to be submitted for approval. An estimate of the cost must be included on Form 1334. Ask the insurance company's attorney for an estimate of the costs. Use Form 6863, Invoice and Authorization for Payment of Administrative Summons Expense, to explain to the insurance company's attorneys the amounts the Service will reimburse. Once the requested information is received, the invoice should be submitted with a copy of the approved Form 1334, Form 6863, and a copy of the front page of the summons to the appropriate office for payment. These procedures may vary from location to location. In addition, discuss the prospective summons with the insurance company's attorney to attempt to determine whether the insurance company will honor a summons mailed to them, and the attorney's response should be documented in the case file.

Moreover, the summons should be carefully drafted to specify the information being sought. Certain procedures differ depending on whether the summons is issued with respect to a known taxpayer, specific taxpayers, or an unknown taxpayer. Where the taxpayer is known, he or she is required to be given notice of a summons issued to a third party, such as an insurance company, under section 7609 as amended by the RRA. This notice must be provided within 3 days of service of the summons on the third party. Moreover, where a summons is issued to a third party for information on more than one taxpayer, a separate summons must be issued with respect to each taxpayer. Where the specific taxpayer is not known, the requirements set forth below under "John Doe" summons are applicable. Be sure the insurance company's attorney understands what information you need because the Service is legally required to pay for the information, even if you cannot use it.

Follow up with the insurance company attorney after he or she receives the summons. Discuss items on the information request. Some companies do not want to release Social Security Numbers and other policy information because of privacy concerns. If the insurance company's attorney has a problem with any item, look for alternative sources to get your information. For instance, Social Security Numbers can be obtained through Integrated Data Retrieval System (IDRS) research.

Set a response date. The Manual provides that 23 to 26 days should be allowed for responding to a third party summons involving an identified taxpayer. This period cannot be extended unless the summoned party is unable to appear. Follow up every couple of weeks to see if there are problems or concerns.

"John Doe" Summons

In certain circumstances you may be faced with the situation of considering the use of a "John Doe" summons. This is the only means of serving a summons where information is sought with respect to one or more unknown (nonspecific) taxpayers. IRC section 7609(f) defines a "John Doe" summons as "* * * any summons which does not identify the person with respect to whose liability the summons is issued." The Code requires the Service to obtain court approval to serve a "John Doe" summons. Moreover, the Code requires the Service to show the court that the following conditions are met:

1. The summons relates to an investigation of a particular person or an ascertainable group or class of persons,
2. There is a reasonable basis for believing that such persons or group or class of persons may fail or may have failed to comply with any provisions of the Internal Revenue law; and
3. The information sought to be obtained from the examination of the records (and the identity of the person or persons with respect to whose liability the summons is issued) is not readily available from other sources.

Due to these restrictions on serving a "John Doe" summons, this type of summons is only appropriate in limited circumstances. The appropriate Office of Chief Counsel must be involved at the very beginning of any plans to use a "John Doe" summons. Always consult the IRM when considering a "John Doe" summons. Request only information on cases for which settlement payments have been made, that is, ask the company to note which cases are on appeal.

Third-Party Summonses

IRC section 7609 as revised by RRA 98 requires notice procedures for issuance of a summons to all third parties.

OTHER CONSIDERATIONS

Attorney-Client Privilege

It is standard practice for the insurance company (payor) to disburse the gross amount of the settlement to the plaintiff's attorney, who then disburses the money to his or her client(s). A third party letter can be issued to the plaintiff's attorney in an effort to obtain the other names, and the amounts involved, in the settlement payment. Often, the attorney will refuse to respond to the third party letter. If so, it is not recommended that a summons be issued to the plaintiff's attorneys for disbursement information relevant to the settlement due to the potential for protracted litigation over claims of attorney-client privilege, which some attorneys may give as the reason for denying the requests for information. Although attorney-client privilege is a valid basis for not providing some requested information, fee arrangements usually fall outside the scope of

the privilege. Such information ordinarily reveals no confidential professional communication between attorney and client. Determining whether this is true in a specific case requires coordination with the appropriate Office of Chief Counsel.

Moreover, due to the possibility of time-consuming litigation, it is recommended that all other means be exhausted in securing the disbursement information. Contact each plaintiff (taxpayer) to determine the amount paid by the insurance company and then disbursed through the attorney. Review the MSSP audit techniques guide on Attorneys for more information concerning attorney-client privilege.

References

1. Refer to IRM on the following:
 - a. The definitions of specific terms relative to the summons and its issuance;
 - b. The use and enforcement of a summons; and
 - c. The restrictions on issuance of third party summons.
2. See IRC sections 7602, 7203, and 7604.
3. MSSP audit techniques guide on Attorneys.

CHAPTER 6

BUILDING THE CASE FILE

An examination case file is set up for individual taxpayers when a determination is made on which lawsuits to pursue. The case file should include information needed to conduct the examination.

IDENTIFYING THE TAXPAYER

There are usually three ways to secure the taxpayer's Social Security Number (SSN). If third party contacts were made, then the SSNs and addresses of these taxpayers will have been secured through these requests. Another method is to use Corporate Files on Line (CFOL) commands to obtain SSNs. If the examiner is still unable to get a SSN through these techniques, a more thorough review of the case file at the courthouse may reveal additional leads. The case file may have a SSN that was overlooked during the initial gathering of information or it may provide another address to use in the IDRS research.

INFORMATION NECESSARY FOR THE EXAMINATION CASE FILE

Use CFOL commands to determine if the plaintiff filed a tax return and to obtain a copy of the return. Look at the copy of the return to determine if the lawsuit proceeds were included in income. If the plaintiff did not include the lawsuit proceeds in income, an examination should commence. Follow the usual procedures to start an examination. If no return was filed, follow delinquent return procedures.

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CHAPTER 7

EXAMINATION CONSIDERATIONS

SCOPE OF EXAMINATION

The scope of the examination may be limited to the lawsuit proceeds issue. However, the scope should be expanded in cases where other issues need to be addressed using customary examination criteria. Sufficient steps should be taken to thoroughly develop the facts of each case to determine the factual basis of each settlement.

EXAMINATION ACTION PLAN

1. Once a constructed file, which includes the necessary IDRS research, is received by the examiner, he or she will contact the taxpayer to set up the initial appointment. The appointment letter to be used will depend on whether the taxpayer has filed a tax return or not. The appointment letter should include a document request including the items shown in Appendix C. NOTE: This step in the examination process can be done by group clerks or management aides. Due to the nature of the issues involved, and the fact that most of the taxpayers involved are wage earners, most of these examinations will probably be held in the office. However, there are instances that would require field visits. For example, the taxpayer has a business that also requires examination.
2. The most important step of the examination is the development of the facts. The case file should include, at minimum, the original complaint and pleadings, the settlement agreement or release, the disbursement schedule or a clear statement of how the funds were disbursed, and a copy of the agreement relating to the attorney's fee arrangement. These documents are critical in the development of the facts of the case and are vital to Counsel if the case should go to court. In addition, because of the provision in IRC section 7491 concerning the potential for shifting the burden of proof to the government when taxpayers reasonably cooperate with the IRS, examiners should carefully document the level of cooperation taxpayers demonstrated during the audit process.
3. The next critical step in the examination is to determine the allocation of lawsuit proceeds between punitive and compensatory damages. If the proceeds were received as a result of a litigated case, the amount of punitive and compensatory damages is usually made clear in the court documents, and there may be no further work to be done in making the allocation. However, it is more difficult to make that determination for cases settled out of court. The settlement agreement does not usually make a distinction between the punitive and compensatory damages awarded. These settlement agreements are usually silent as to the types of damages awarded, or they state that all of the damages awarded are "compensatory." Therefore, it is essential that all the facts surrounding the lawsuit be determined and

documented. The allocation between compensatory and punitive damages must be made based on the facts of each case. In making this determination, the following items should be considered:

- a. The intent of the payor in making the payment to the plaintiff. Why did the payor settle? For what was the payor paying?
- b. The nature of the claim underlying the plaintiff's award. What was the reason for the suit?
- c. The negotiations between the plaintiff and defendant. Review the case file. Was there a meeting of the minds by the parties?
- d. The actual amount of money it would take to make the plaintiff whole. Did the plaintiff make insurance premium payments or was the plaintiff to receive a certain amount of insurance proceeds? The settlement amount that the plaintiff receives to reimburse him or her for these types of costs are usually compensatory.
- e. If the plaintiff claims to have suffered from mental pain and anguish, determine if the plaintiff received medical treatment for the mental pain and anguish. If so, does he or she have verification of the amount spent for this treatment? Can he or she show that the treatment is directly related to the lawsuit case? In other words, the plaintiff must show that he or she was being made "whole" from the total amount of the settlement received in order for the whole amount of the settlement to be non-taxable. The taxpayer bears the burden at the audit stage of showing that the damages received are excludable from gross income under IRC section 104(a)(2), (although that burden may shift to the government if the issue reaches litigation and the taxpayer satisfies the requirements of IRC section 7491).

NOTE: The most difficult issue in these cases is the determination of the punitive and compensatory damages when there is a settlement agreement. Normally, it is reasonable for some portion to be allocated to compensatory damages in most cases. Develop the facts carefully and objectively for each case.

4. Determine if the taxpayer received any client advances from the attorney. If the taxpayer received advances from the attorney, ensure that the settlement proceeds were not reduced by these advances. Also, determine if the advances were erroneously characterized as legal fees that would provide the taxpayer with a deduction for personal expenses.
5. Once a determination is made regarding the allocation of the punitive and compensatory damages, the punitive portion of the damages is considered taxable. It is the Service's position that the taxpayer is to be taxed on the full amount of the punitive damages before the attorney is paid any fees. In other words, the taxpayer cannot report the "net" punitive proceeds received. **Note:** this is an issue that has been litigated continuously.

The taxpayer must include in income the gross amount of the award deemed to be taxable. A deduction is allowed for the legal fees and court costs that are related to the taxable portion of the proceeds. The legal fees and court costs are allowed as a miscellaneous itemized deduction subject to the 2-percent AGI limitation on Schedule A. The deductible fees and costs are determined by using the ratio of taxable proceeds to total proceeds and multiplying the total fees and costs by this ratio. The following is an example.

Total lawsuit proceeds received	\$100,000
Taxable lawsuit proceeds(80% taxable)	80,000
Legal fees and court costs	52,000
COMPUTATION OF DEDUCTIBLE FEES AND COSTS:	
Total fees and costs	\$52,000
Taxable Ratio (80,000/100,000)	X .80

Deductible fees and costs*	\$41,600*
	=====
*subject to 2% AGI limit	
NOTE: When allowing this as a deduction, consideration should also be given to any other itemized deductions to which the taxpayer may be entitled but did not deduct on the original return because their itemized deductions were less than the standard deduction amount.	

6. AMT must be considered because of the allowance of the miscellaneous itemized deduction. AMT usually becomes due when there is a large amount of miscellaneous itemized deductions. Miscellaneous itemized deductions subject to the 2-percent AGI limitation are a tax preference item for alternative minimum tax purposes. The Report Generating Software (RGS) program for producing Revenue Agent reports will automatically compute this tax.
7. The following issues should also be considered when making the adjustment to income for the lawsuit proceeds:
 - a. Earned Income Credit — If the taxpayer claimed the Earned Income Credit on the original filed return, then it may have to be recaptured as a result of the increase in income from the lawsuit.
 - b. Social Security Income — If the taxpayer received any type of Social Security income, the taxable portion of this income may be increased due to the increase in income from the lawsuit.

- c. Exemption — The personal and dependent exemptions taken by the taxpayer may be limited or phased out due to the increase in income from the lawsuit. This is an automatic adjustment and will be computed by the RGS program for producing Revenue Agent reports.
- d. Itemized Deductions — Itemized deductions taken by the taxpayer may be limited or phased out due to the increase in income from the lawsuit settlement. This is another automatic adjustment that will be computed by the RGS program for producing Revenue Agent reports.
- e. Rental Real Estate Losses — Rental Real Estate Losses could be limited due to the increase in modified AGI. If the modified AGI exceeds the threshold, then passive losses will be limited. The RGS program for producing the Revenue Agent reports will not automatically compute the allowable passive losses.

CHAPTER 8

PENALTIES

Examiners are responsible for considering the application of penalties in all cases under examination. Many lawsuit settlement cases involve taxpayers who normally do not have to file returns except for the settlement proceeds received. However, returns are still not filed in some situations because the taxpayers and their representatives concluded the proceeds are not taxable. For returns that are not filed, the following penalties should be considered:

1. Failure to file penalty (IRC section 6651(a)(1))
2. Estimated tax penalty (For Individuals: IRC section 6654)
3. Fraud or negligence (Pre-1989 only: IRC section 6653)
4. Fraudulent failure to file (Post 1988: IRC section 6651(f))

The accuracy-related penalty applies only where a return is filed and is not applicable to substitutes for returns filed under authority of IRC section 6020(b). These provisions apply to all returns due to be filed after December 31, 1989, without regard to extensions filed.

There is no reasonable cause exception to the IRC section 6654 penalty for underpayment of estimated tax by an individual. The penalties apply unless the taxpayer meets certain specified statutory exceptions. However, in the case of an individual, IRC section 6654(e)(3) provides that the Service may waive the penalty if the Service determines it would be inequitable, due to casualty, disaster, or other unusual circumstances. The Service may also waive the penalty if the taxpayer has retired or become disabled during the taxable year and his or her underpayment was due to reasonable cause and not to willful neglect.

The failure to pay penalty applies to original and amended returns filed by the taxpayer. With regard to returns due prior to June 30, 1996, the failure to pay penalty does not apply when the taxpayer does not file a return or if the return is filed under IRC section 6020(b) substitute for return procedures. With regard to returns due after June 30, 1996, the Service may impose the failure to pay penalties where the taxpayer fails to file a return and a substitute return is prepared by the Service under IRC section 6020(b). IRC section 6651(g).

Lawsuit settlement cases usually result in significant adjustments to income. As in other cases where there are large amounts of unreported income, the accuracy-related penalty and fraud penalties must be considered. Factors to consider in determining whether penalties are warranted include:

1. Did the lawsuit settlement recipient adequately disclose all pertinent facts of his or her case to his or her attorney?
2. What advice, if any, did his or her attorney provide regarding the taxability of the settlement amount? and
3. Should the taxpayer have questioned the advice of his or her attorney regarding the taxability of the payment?

All the facts and circumstances in each case should be considered before making a determination regarding penalties. If the taxpayer received interest income from the settlement and did not report it, more consideration should be given to assessing the accuracy-related penalty on the interest income issue.

If penalties are recommended, the examiner's workpapers should contain comments regarding the examiner's reasons for asserting penalties. If reasonable cause was available and considered, the examiner's workpapers should explain why it was or was not established.

CHAPTER 9

FORM 1099-MISC – REPORTING REQUIREMENTS

IRC section 6041(a) generally requires all persons engaged in a trade or business and making payment in the course of such trade or business to another person of fixed or determinable gains, profits, and income of \$600 or more in a calendar year to file an information return with the Service. IRC section 6041(d) provides that each person required to make the return described in IRC section 6041(a) shall furnish to each person for whom a return is required a payee statement.

Treas. Reg. section 1.6041-1(c) states that income is fixed when it is paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The payor is required to determine whether payments are taxable and need to be reported. The Instructions for Forms 1099, 1098, 5498 and W-2G provides instructions on the items to be reported.

In lawsuit settlements, the person with the obligation to report payments to the plaintiff will generally be the defendant or its insurer rather the plaintiff's attorney. In addition, the defendant or its insurer will also generally be responsible for reporting payments to the plaintiff's attorney.

REPORTING OF DAMAGE AWARDS ON FORMS 1099-MISC

Box 3 of Form 1099-MISC is used to report other income that is not reportable in one of the other boxes on the form. Generally, all punitive damages (even if they relate to physical injury or physical sickness), any damages for non-physical injuries or sickness, liquidated damages received under the Age Discrimination in Employment Act of 1967, and any other taxable damages are required to be reported in box 3. Generally, all compensatory damages for non-physical injuries or sickness (for example, emotional distress) arising from employment discrimination or defamation are reportable in box 3. However, if a taxpayer receives an award of back pay that constitutes wages, it generally would be reportable on Form W-2, not Form 1099-MISC.

The following damages (other than punitive damages) are not reportable in box 3 of Form 1099-MISC:

1. Damages received on account of personal physical injuries or physical sickness.
2. Damages that do not exceed the amount paid for medical care for emotional distress; or
3. Damages received on account of non-physical injuries (for example, emotional distress) under a written binding agreement, court decree, or mediation award in effect on or issued by September 13, 1995.

Damages received on account of emotional distress due to **non-physical** injury or sickness, including physical symptoms such as insomnia, headaches, and stomach disorders, are **reportable** unless described in 2 or 3 above. However, damages received on account of emotional distress due to **physical** injuries or physical sickness are **not reportable**.

The amount of damages reflected on the Form 1099-MISC is not reduced by attorney's fees. For example, a defendant settles a plaintiff's claim for emotional distress from non-physical injuries by writing a \$100,000 check naming the plaintiff and her attorney as joint payees. The attorney retains \$40,000 in fees for services rendered and remits the remaining \$60,000 to the plaintiff. The amount of damages reportable with respect to the plaintiff on Form 1099-MISC is \$100,000.

REPORTING PAYMENTS TO ATTORNEYS ON FORM 1099-MISC

Fees paid to an attorney of \$600 or more, paid in the course of the payor's trade or business, are reportable in box 7 of Form 1099-MISC. However, for 1998 and later years, if the payor pays an attorney in the course of its trade or business for legal services and the attorney's fee cannot be determined, the total amount paid to the attorney (gross proceeds) must be reported in box 13 with Code A.

For example, an insurance company pays a plaintiff's attorney \$100,000 to settle a plaintiff's claims for damages that are excludable from income under IRC section 104(a)(2). The attorney's fee cannot be determined by the insurance company. Therefore, the insurance company must report \$100,000 in box 13 of Form 1099-MISC with Code A. If the insurance company knows that the attorney's fee is, for example, \$34,000, the insurance company must report \$34,000 in box 7 and nothing in box 13.

These rules apply whether or not the legal services are provided to the payor, and whether or not the attorney is the exclusive payee (for example, the attorney's and claimant's names on one check). However, these rules do not apply to profits distributed by a partnership to its partners that are reportable on Schedule K-1 (Form 1065), *Partner's Share of Income, Credits, Deductions, etc.*, or to wages paid to attorneys that are reportable on Form W-2, *Wage and Tax Statement*. The term "attorney" includes a law firm or other provider of legal services.

In addition, the exemption from reporting payments made to corporations no longer applies to payments for legal services. Therefore, for 1998 and later years, attorney fees (in box 7) or gross proceeds (in box 13), as described above, paid to corporations providing legal services are reportable.

CHAPTER 10

QUICK CITE AND BRIEF SYNOPSIS OF LITIGATED CASES

WRONGFUL DEATH

Burford v. United States, 642 F. Supp. 635 (N.D. Ala. 1986).

The district court rejected Rev. Rul. 84-108 and concluded that Alabama wrongful death proceeds are excludable from gross income.

O'Gilvie v. United States, (1996 S. Ct.) 519 U.S. 79, 117 S. Ct. 452; 96-2 U.S.T.C. ¶ 50,664; 78 AFTR 2d 7454.

The Supreme Court ruled that all non-compensatory punitive damages are taxable.

AGE DISCRIMINATION

Commissioner v. Schleier, (1995 S. Ct.) 515 U.S. 323, 75 AFTR 2d 95-2675, 115 S. Ct. 2159.

The Supreme Court ruled that payments received under the federal statute outlawing age discrimination are 100-percent taxable. The ADEA does not provide for recovery of tort-like compensatory damages and the proceeds were not received on account of any personal injury.

Schleier outlined the two-part test that must be met in order to exclude damages under IRC section 104(a)(2): 1) the underlying cause of action giving rise to the recovery must be based on tort or tort-type rights; and 2) the damages must "have been received on account of personal injuries or sickness."

SEX DISCRIMINATION

United States v. Burke, (1992 S. Ct.) 504 U.S. 229, 112 S. Ct. 1867, 92-1 U.S.T.C. ¶ 50,254.

The Supreme Court ruled that back pay received in settlement of claims under Title VII of the Civil Rights Act of 1964, before the 1991 amendments, were not excludable under IRC section 104(a)(2).

The *Burke* case includes a very good discussion on tort injuries, physical, non-physical, etc.

DISCRIMINATION CASES PRIOR TO *BURKE* AND *SCHLEIER*

The following is a list of other cases that deal with various discrimination claims. All of these are prior to the Supreme Court rulings of *Burke* and/or *Schleier* which contain our present authority for these types of cases. While these cases fluctuate on the question of taxability or exclusion (because they are prior to the clear guidance of *Burke* and *Schleier*) they contain some good discussions concerning the questions of defining torts and personal injuries, physical and non-physical.

1. *Downey v. Commissioner*, (1994 7th Cir.) 94-2 U.S.T.C. ¶ 50,441; 74 AFTR 2d 6015. In *Schleier*, the Supreme Court agreed with the discussion relating to torts and the court's holding on the exclusion issue.
2. *Johnson-Waters v. Commissioner* (1993 Tax Court) 66 T.C.M. 252; T.C. Memo. 1993-333. This case includes good comments about the taxpayer having the burden of proof and "self serving testimony" concerning an out of court settlement allocation. The IRS reallocation to back pay with a small amount for tort-mental distress was upheld. Note, however, the court's holding that the back pay portion recovered under 42 U.S.C. section 1981 is taxable is inconsistent with the rationale underlying Rev. Rul. 93-88.
3. *Stocks v. Commissioner*, (1992 Tax Court) 98 T.C. 1. This case involves an employment breach of contract and race discrimination issue. No actual lawsuit was filed, but claims were "settled" with an employment termination agreement. The Tax Court looked at the payor's intent in allocating 5/6 of the settlement to the contract and 1/6 of the settlement to the discrimination claim. The evidence showed that the employer was aware of the possibility of the discrimination lawsuit. Their intent was that the payment would settle the potential discrimination lawsuit along with the breach of contract issue. The employer admitted it would not have made the payment unless the taxpayer released them from any discrimination claim as well as the contract claim.
4. *Pistillo v. Commissioner*, (1989 Tax Court) 57 T.C.M. 874; T.C. Memo. 1989-329. The Tax Court found that an ADEA back pay settlement was 100-percent taxable. This decision was later reversed by the 6th Circuit, but contains good comments on several areas of interest including damages and settlements arising from employment contracts, back pay, etc., not excludable under IRC section 104(a)(2). The taxpayer argued that his employer's failure to withhold any federal income tax or social security taxes from the settlement demonstrated its intent to compensate for personal injury. The taxpayer further argued that because the District Court, his attorney, and the IRS stated that the settlement payment was not income, the amount is excludable.
5. *Bent v. Commissioner*, (1987 3d Cir.) 88-1 U.S.T.C. ¶ 9101; 61 AFTR2d 301; 835 F.2d 67. The court ruled that the settlement amount received for violation of the taxpayer's rights to freedom of speech was excludable under IRC section 104(a)(2). If decided after *Schleier*, taxpayer would fail the second test for exclusion. See *Kightlinger v. Commissioner*, T.C. Memo. 1998-357, *infra*.

6. *Metzger v. Commissioner* (1987 Tax Court) 88 T.C. 834. This was a case involving employment breach of contract and discrimination by sex and national origin. The continued

vitality of this case is questionable in light of *Burke* and *Schleier*. The Service does not believe that economic damages such as wages can be a measure of a personal injury. Such damages are distinct from personal injury damages.

EMPLOYMENT-RELATED

The following cases are Employment related and most deal with allocation issues and questions of taxable versus excludable.

1. *Barnes v. Commissioner*, (1997) T.C. Memo. 1997-25.

This case involved an out-of-court settlement received due to wrongful discharge with mental distress. The Tax Court allocated 50/50 to mental distress and punitive damages because the mental distress manifested as pre-cancerous tumors.

2. *Bagley v. Commissioner*, (1995) 105 T.C. 396, *aff'd*, 121 F.3d 393 (8th Cir. 1997).

This case involved claims for tortious interference with current and future employment, libel, and invasion of privacy. The trial resulted in a jury verdict that was appealed. A settlement agreement was reached prior to the new trial. This settlement agreement allocated the entire award to compensatory. The Tax Court looked to the facts of the case, including the trial determinations and the negotiations for settlement. The Tax Court determined that a portion should be allocated to punitive, even though the payor stated in negotiations that they would not agree to pay punitive damages. The Tax Court determined that both parties considered the clear possibility of punitive damages being recovered. The Tax Court pointed out that the taxpayer's attorney became aware of the potential for taxability of punitive during the negotiations.

3. *Glatthorn v. United States*, (1993) 93-1 U.S.T.C. ¶ 50,338; 71 AFTR 2d 1878; 818 F. Supp. 1548 (District Ct -Florida).

This case involved a breach of contract claim. The plaintiff received an out-of-court settlement with no settlement document. The court allocated 50 percent of the proceeds to the breach of contract issue and 50 percent as compensatory. When making this decision, the district court relied heavily upon the following:

The taxpayer offered to settle for \$45,000. The defendants did not accept his offer until after the court had refused to dismiss the tort claims. Shortly after that time, the defendants accepted the settlement. The district court said that the defendants (attorneys, themselves) would not have settled a \$47,000 breach of contract case for \$45,000 in the early stages of the lawsuit — so the settlement had to also relate to the tort claims.

The taxpayer argued that at least 9/11 of the settlement is non-taxable, as 9 of the 11 counts sounded in tort. The district court refused to apply this mathematical formula, particularly since many of the tort counts stated the same cause against different defendants.

4. ***Miller v. Commissioner***, (1993) 65 T.C.M. 1884; T.C. Memo. 1993-49.

This was a defamation case against a former employer. There were two separate lawsuits. One involved a jury verdict and the other suit was not tried. A settlement was reached which covered both lawsuits. The settlement agreement did not allocate the proceeds between compensatory and punitive damages.

The question presented to the Tax Court was one of allocation between compensatory and punitive. The Tax Court ruled that the verdict by the jury was the best indicator of the payor's intent and the best measure of how the settlement should be allocated.

Miller includes good analyses and case cites pertaining to settlement allocations. It also includes comments concerning the importance of the nature of the claim versus the validity of the claim in determining the allocation.

5. ***Mitchell v. Commissioner*** (1990) 60 T.C.M. 1368; T.C. Memo. 1990-617.

The taxpayer had prepared a settlement document stating that most of the damages were for libel and slander. The Tax Court determined that all damages related to the employment contract. The taxpayer's employer viewed the libel/slander suit as a "nuisance" suit and gave it no weight in determining the settlement payments.

6. ***McKim v. Commissioner*** (1980) 40 T.C.M 9; T.C. Memo. 1980-93.

The taxpayer sued his former employer after being terminated. His first claim was for unpaid sales commissions and other unpaid job related amounts, such as fringe benefits and unreimbursed expenses. He also brought a claim for suffering, emotional distress and for punitive damages. The court allocated the whole settlement to taxable wages. The court looked to testimony from the taxpayer's employer to determine which claim it had intended to settle. The employer stated it did not believe it had any exposure to liability for any claims for personal injury damages and that these claims did not figure into the settlement amount.

In conclusion, the Tax Court stated that even if it found that the employer had intended to pay some on each of the taxpayer's claims, the allocation to personal injury would have been minimal. The Tax Court totaled up all the amounts requested in each count (taxpayer had assigned monetary amount to each claim) and determined that the percentage of the personal injury amount requested would only be 15 percent.

7. ***Seay v. Commissioner*** (1972) 58 T.C. 32.

This case involved a breach of contract claim. The taxpayer was allowed to exclude a portion of the payment under IRC section 104(a)(2) for personal injuries. The taxpayer had suffered personal embarrassment, mental and physical strain, and injury to health and personal reputation.

The government argued that the taxpayer had not proven that his claim for personal injuries was valid or that he had actually incurred such injuries. The court gives an in-depth explanation concerning the fact that the taxpayer does not have to prove the validity of the claim. The taxpayer only has to prove that there was a personal injury claim and that the claim was included in the settlement payment. In this case, the taxpayer was able to show that the personal injury claim had been a part of the negotiations for settlement and that the payor intended to make payment in settlement of that claim.

8. *Knuckles v. Commissioner* (1965) 65-2 U.S.T.C. ¶ 9629; 16 AFTR 2d 5515; 349 F.2d 610.

Tenth Circuit affirmed the Tax Court. The taxpayer was fired from his executive position based on allegations that he mismanaged the company's affairs. The taxpayer originally sued for breach of contract with no mention of personal injuries. During settlement negotiations the taxpayer's attorney suggested the payment be allocated to personal injuries in order to minimize the tax effect. The taxpayer's employer refused to allocate any damages to personal injury and admit to any liability for personal injury. The taxpayer filed a subsequent personal injury suit 9 months later. Both suits were dismissed with the out-of-court settlement. The Service allocated all to breach of contract (taxable). Taxpayer had allocated all to personal injury (non-taxable). The Tax Court upheld the Service's determination and the Appeals Court affirmed. The Appellate Court stated that the most important fact is "intent of payor."

9. *Abrahamsen v. United States*, 44 Fed. Cl. 260 (1999) *appeal pending*, No. 99-5136 (Fed. Cir.).

In this consolidated case, approximately 2,600 former employees of IBM sought refunds of income and FICA taxes on the basis that payments received under certain resource reduction programs were excludable from gross income as personal injury damages and consequently were not wages. Noting that none of the plaintiffs instituted a claim against IBM before executing releases and receiving the payments, the court doubted that they satisfied the first test for exclusion. Even if they did satisfy that test, the court concluded, the plaintiffs failed to satisfy the second test that the payments were received "on account of personal injuries."

On the FICA issue, the court reasoned that because the payments were linked to salary and length of tenure, the payments were consistent with the notion of wages.

LEGAL FEES

1. *Church v. Commissioner* (1983) 80 T.C. 1104.

Case includes formula for allocating legal fees between taxable and non-taxable portions of awards and settlement proceeds for purposes of IRC sections 212 and 265.

2. *Alexander v. Internal Revenue Service* (1995) 96-1 U.S.T.C. ¶ 50,011; 72 F.3d 938; (1st Cir.).

Great case on legal fees issue. Gross versus net, itemized deductions, and AMT comments included. See also *Bagley*, 121 F.3d 393 (8th Cir. 1997); *Baylin*, 43 F.3d 1451 (Fed. Cir. 1995); *Coady*, T.C. Memo. 1998-291, *aff'd*, 213 F.3d 1187 (9th Cir. 2000); *Srivastava*, T.C. Memo. 1998-362, *rev'd*, 86 AFTR2d ¶ 2000-5104 (5th Cir. 2000) ; *Sinyard*, T.C. Memo. 1998-364; and *Benci-Woodward*, T.C. Memo. 1998-395, *aff'd*, 86 AFTR2d ¶ 2000-5102 (9th Cir. 2000).

INSURANCE COMPANY CASES

1. *Lane v. United States* (1995) 95-2 U.S.T.C. ¶ 50,455, 76 AFTR2d 6085; 902 F. Supp. 1439 (Dist. Ct. Oklahoma).

This case involves a claim on an auto insurance policy for uninsured motorists. Basically this is a punitive damage issue case. Note, however, that under Oklahoma law, compensatory damages awarded for insurance bad faith do not compensate for any personal injury. Rather, they constitute in large part compensation for the loss of the use of the contract damages, and in lesser part, additional attorney's fees incurred as a result of the insurer's failure to pay the claim in a timely fashion. Thus, under *Schleier*, they are not excludable from gross income. However, there are some good points in general concerning suits against insurance companies.

2. *Est. of Wesson v. United States* (1995) 95-1 U.S.T.C. ¶ 50,186, 75 AFTR2d 1540; 48 F.3d 894 (5th Cir.).

Punitive damage issue that involved bad faith against a life insurance company is addressed in this case.

3. *Hawkins v. United States* (1994) 94-2 U.S.T.C. ¶ 50,386, 74 AFTR2d 5363; 30 F.3d 1077 (9th Cir.).

Punitive damage issue that involved breach of good faith and fair dealing against Allstate Insurance Company is addressed in this case. Contains a description of shifting Service position on taxation of punitive damages.

MISCELLANEOUS

1. *Brabson v. United States* (1996) 96-1 U.S.T.C. ¶ 50,038, 77 AFTR2d 572, 73 F.3d 1040

(10th Circuit), *rev'g* 859 F. Supp. 1360 (D. Colo. 1994).

This case involves a personal injury claim. The family was injured by a gas leak in their home. The only issue was the question of whether the pre-judgment interest is excludable under IRC section 104. The district court ruled that the interest was not taxable but the Tenth Circuit reversed.

2. ***Robinson v. Commissioner*** (1994) 102 T.C. 116 (Tax Court) (affirmed on allocation by 5th Cir.).

The taxpayer's out of court settlement allocation was set aside for tax purposes because the negotiations were not conducted in an adversarial manner. The taxpayer was given the freedom to allocate as he wanted in order to minimize the tax effect.

3. ***Eisler v. Commissioner*** (1973) 59 T.C. 634.

Eisler is often quoted in litigation cases. This case involved a business deduction issue. The issue was whether taxpayer could deduct the settlement payment and legal fees under IRC section 162 as a business expense or whether they were to be capitalized.

The court looked to the strength of the parties' various claims as perceived by their counsel in order to allocate a portion to ordinary and capital.

The case includes comments on doing the best you can with the information you have.

4. ***LeFleur v. Commissioner***, (1997) T.C. Memo. 1997-312.

LeFleur is an employment related case, but its particular importance lies in the area of reallocation issues. In this case the IRS successfully reallocated \$800,000 from nontaxable emotional distress claims to taxable contract/punitive damage claims. (See Chapter 2 for additional information.)

5. ***Fabry v. Commissioner***, 111 T.C. 305 (1998).

In *Fabry*, the Tax Court amplified its prior holdings on the taxability of damages received for injury to an individual's business/professional reputation. The court rejected taxpayer's argument that such injury is, as a matter of law, a personal injury for IRC section 104(a)(2) purposes. Instead, the court held, whether injury to one's business or professional reputation constitutes a personal injury is a question of fact to be resolved by consideration of all the facts and circumstances. Because the taxpayer made no claim for personal injury in the underlying product liability action, the court concluded that the portion of the settlement proceeds allocable to taxpayer's claim for injury to his business reputation was not excludable from gross income.

6. *Kightlinger v. Commissioner*, T.C. Memo. 1998-357.

In *Kightlinger*, the court correctly interpreted *Schleier* and held that loss of a job does not constitute a personal injury. Also, the court concluded, the economic factors were not a measure of personal injury; rather, they were the injury itself that the taxpayer sustained. Further, the Tax Court, in view of all the contrary evidence in the record, rejected the district court's holding that the suit was for personal injuries suffered by the class members.

7. *Gregg v. Commissioner*, T.C. Memo. 1999-10.

In *Gregg*, the court rejected the taxpayers' argument that compensatory damages received for common law fraud and tortious interference with business relationship were excludable from gross income.

8. *Hemelt v. United States*, 122 F.3d 204 (4th Cir. 1997); *Mayberry v. United States*, 151 F.3d 855 (8th Cir. 1998); *Dotson v. United States*, 87 F.3d 682 (5th Cir. 1996); and *Gerbec v. United States*, 164 F.3d 1015 (6th Cir. 1999).

A conflict among the circuits exist on whether payments received in settlement of claims arising under ERISA qualify for exclusion under IRC section 104(a)(2). The Government's position is that notwithstanding the subjective belief of the parties that the statute provided for tort relief, the subsequent determination of the Supreme Court that ERISA does not provide tort remedies is controlling for tax purposes. Two circuits (and two dissenters in the other circuits) agreed that taxpayers failed to meet the first requirement for exclusion. Notwithstanding the intercircuit conflict, the Solicitor General disagreed with Service's recommendation that Supreme Court review is warranted. This disagreement is founded on the fact that Congress, in 1996, amended IRC section 104(a)(2) to provide that the exclusion applies to damages received for personal *physical* injuries only. Because ERISA does not authorize the recovery of such damages, the administrative importance of the income tax issue has diminished.

Appendix

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Sample

LAWSUIT INFORMATION DATA SHEET

County _____

Case Number _____

Date Settled _____

Plaintiff _____

v.

Defendant _____

Plaintiff's SSN _____

Plaintiff's
Address _____

Defendant's
Address _____

Plaintiff's
Attorney _____
& Address _____

Defendant's
Attorney _____
Address _____

	Compensatory	Punitive	Other
Original Damages	_____	_____	_____
Final Damages	_____	_____	_____

Additional Comments:

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Sample Attachment to Letter

With respect to the settlements your company paid to the following (the name of your state) residents:

List of Plaintiffs

Please provide the following information:

- 1) Plaintiff's address, phone number, and Social Security Number,
- 2) Copies of the complaints,
- 3) Copies of the settlement agreements and/or waivers,
- 4) Copies of front and back of the checks.
- 5) Copies of any records documenting correspondence between your company and the plaintiffs with respect to negotiations affecting the outcome of the cases.

Please notify me as soon as possible if the requested information will require a summons.

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FORM 4564	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Req. Number 01
TO:		Subject:
<p>Please present the following items at our first meeting:</p> <p>A. Copies of your ____, ____ and ____ federal income tax returns.</p> <p>B. In relation to the lawsuit settlement you received from _____ present the following:</p> <ol style="list-style-type: none"> 1) A copy of the original petition or claim filed showing cause for the lawsuit. 2) A copy of the lawsuit settlement agreement. 3) Copies of the settlement checks that you received. If copies of checks are not available, present a schedule of payments received. 4) Documentation of the amount of legal fees you paid, including any written fee agreements with your attorney. 5) Copy of the disbursement schedule or a clear statement of how the funds were disbursed. 6) Documentation of letters or statements that your attorney provided to you that indicated that the lawsuit settlement proceeds you received were not taxable. 		
FROM:	Name and Title of Requester	Date
	Office Location	
FORM 4564		

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Excerpts from Legislative History of 1996 Amendment

5. Modify exclusion of damages received on account of personal injury or sickness (sec. 1605 of the bill and sec. 104(a)(2) of the Code)

Present Law

Under present law, gross income does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injury or sickness (sec. 104(a)(2)).

The exclusion from gross income of damages received on account of personal injury or sickness specifically does not apply to punitive damages received in connection with a case not involving physical injury or sickness. Courts presently differ as to whether the exclusion applies to punitive damages received in connection with a case involving a physical injury or physical sickness.²² Certain States provide that, in the case of claims under a wrongful death statute, only punitive damages may be awarded.

Courts have interpreted the exclusion from gross income of damages received on account of personal injury or sickness broadly in some cases to cover awards for personal injury that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving certain forms of employment discrimination and injury to reputation where there is no physical injury or sickness. The damages received in these cases generally consists of back pay and other awards intended to compensate the claimant for lost wages or lost profits. The Supreme Court recently held that damages received could not be excluded from income.²³ In light of the Supreme Court decision, the Internal Revenue Service has suspended existing guidance on the tax treatment of damages received on account of other forms of employment discrimination.

Reasons for Change

Punitive damages are intended to punish the wrongdoer and do not compensate the claimant for lost wages or pain and suffering. Thus, they are a windfall to the taxpayer and appropriately should be included in taxable income. Further, including all punitive damages in taxable income provides a bright-line standard which avoids prospective litigation on the tax treatment of punitive damages received in connection with a case involving a physical injury or physical sickness.

Damages received on a claim not involving a physical injury or physical sickness are generally to compensate the claimant for lost profits or lost wages that would otherwise be included in taxable income. The confusion as to the tax treatment of damages received in cases not involving physical injury or physical sickness has led to substantial litigation, including two Supreme Court cases within the last four years. The taxation of damages received in cases not involving a physical injury or physical sickness should not depend on the type of claim made.

²²The Supreme court recently agreed to decide whether punitive damages awarded in a physical injury lawsuit are excludable from gross income. *O'Gilvie v. U.S.*, 66F.3d 1550 (10th Cir. 1995), *cert. granted*, 64 U.S.L.W. 3639 (U.S. March 25, 1996)(No. 95-966). Also, the Tax Court recently held that if punitive damages are not of a compensatory nature, they are not excludable from income, regardless of whether the underlying claim involved a physical injury or physical sickness. *Bagley v. Commissioner*, 105 T.C. No. 27 (1995).

²³*Schleier v. Commissioner*, 115 S.Ct. 2159 (1995).

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