CLE & Ski

January 19, 2002

Big Sky, Montana

TAX LAW FOR THE LITIGATOR - 2001 UPDATE

Richard M. Baskett
Attorney - CPA
Baskett Law Office
Suite 234
210 North Higgins Avenue
Missoula, Montana 59802
(406) 549-1110

TABLE OF CONTENTS

TAX LAW FOR THE LITIGATOR - 2001 UPDATE

by

RICHARD M. BASKETT
Attorney - CPA

1. Introduction

At last year's CLE & Ski, I provided a broad overview of tax law for the litigator. This year, I will examine some of the developments in this area.

2. Circuit Court Decisions

[1] Foster

In Foster v. U.S., 87 AFTR2d Par. 2001-865, Mattie Foster won a jury verdict in Alabama state court for $50,000 in compensatory damages, $1 million in punitive damages, and, by the time she was paid, $156,032.80 in post-judgment interest. Before the original complaint was filed, Foster signed a contingency fee agreement with her lawyers, guaranteeing them 50% of all money awarded. After the trial, but before the appeal, they entered into a new agreement, and Foster offered her lawyers all of the post-judgment interest, rather than just the original 50%, if they continued to represent her through the appeal. Of the $1,206,032.80 eventually paid by the original state court defendants in 1994, Foster received $525,000, and the remainder was paid to her lawyers. Foster did not declare any of her share of the judgment on her federal income tax return.

Foster claimed she should not have to pay taxes on the post-judgment interest paid to her lawyers for their work on the appeal under Cotman v. Commissioner, 263 F.2d 119 (5th Cir. 1959). The Eleventh Circuit agreed and, looking to Cotnam, held that Foster's agreement to pay the attorneys the remaining postjudgment interest was excludable from her gross income. The Court noted that when the second fee agreement was signed, there was no guarantee that Foster would ultimately receive the amount awarded by the jury or how long the process would last, which would play a role in the calculation of the postjudgment interest. The Court concluded that the preappeal agreement is analogous to the pretrial agreement, and, thus, the remaining postjudgment interest is excludable from her gross income.

[2] Kenseth

In Kenseth v. Comm'r, the Seventh Circuit held that attorney's fees, paid out of an age discrimination settlement, were includable in income and that the legal fees were a deductible expense and not an exclusion from income.

The Court noted there was a split among the Circuits:

> The circuits are split on whether a contingent fee is, as the Tax Court held in this case, a part of the client's taxable income. Compare Foster v. United States, 249 F.3d 1275, 1279-80 (11th Cir. 2001); Srivastava v. Commissioner, 220 F.3d 353, 364-65 (5th Cir. 2000); Davis v. Commissioner, 210 F.3d 1346 (11th Cir. 2000) (per curiam); Estate of Clarks v. United States, 202 F.3d 854 (6th Cir. 2000); Cotnam v. Commissioner, 263 F.2d 119, 125-26 (5th Cir. 1959), all rejecting the Tax Court's position, with Young v. Commissioner, 240 F.3d 369, 376-79 (4th Cir. 2001); Benci-Woodward v. Commissioner, supra; Coady v. Commissioner, 213 F.3d 1187 (9th Cir. 2000), and Baylin v. United States, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995), all accepting it. We have not yet had occasion to take sides in the controversy. But with all due respect to those who disagree, we think the Tax Court's resolution of the issue is clearly correct. Taxable income is gross income minus allowable deductions. 29 U.S.C. sec. 63(a); United States v. Whyte, 699 F.2d 375, 378 (7th Cir. 1983). If a taxpayer obtains income of $100 at a cost in generating that income of $25, he has gross income of $100 and a deduction of $25, see sec. 162(a), yielding taxable income of $75; he does not have gross income of $75. If, therefore, for some reason the cost of generating the income is not deductible, he has taxable income of $100. See sec. 62(a)(1) and, with specific reference to legal fees incurred for the production of income, Alexander v. IRS, 72 F.3d 938, 944-46 (1st Cir. 1995). That is Kenseth's situation under the alternative minimum tax.

This is an issue that may well end up in the Supreme Court.

[3] Francisco

In Francisco v. U.S., Docket No. 00-1802, (C.A. 3, October 1, 2001) the Third Circuit upheld the IRS's allocation of settlement proceeds between taxable and non-taxable portions. The parties had failed to allocate the settlement proceeds themselves. The Court also held that "delay damages" were awarded to remedy the time value of the award lost during the period before judgment and were taxable as the equivalent of interest income.

3. Tax Court Decisions

[1] Breach of contract

The Tax Court held that damage awards paid to an individual from a suit against a former employer for breach of contract were taxable income under §104(a) because the award was not paid on account of a tort or tort-type claim. Freeman v. Comm'r, T.C. Memo. 2001-25.

[2] Fair Labor Standards Act claim

Amounts taxpayer received under a class action settlement of a claim under the Fair Labor Standards Act of 1938 because the damages weren't paid on account of her personal injury. Ramey v. Comm'r, T.C. Summary Opinion 2001-156.

[3] Fraudulent inducement and interference with a business relationship

An individual was required to include in income the damages award he received for fraudulent inducement and interference with a business relationship, because he failed to show the payment arose from a personal injury. Gregg v. Comm'r, T.C. Memo. 2001-245.

[4] Social Security Disability Benefits

In Thomas v. Comm'r, T.C. Memo. 2001-120, the Tax Court held that an individual's social security disability benefits weren't excludable from income as accident or health insurance benefits.

The taxpayer, who was disabled by diabetes, received social security disability benefits and 10 years later also began receiving benefits from his former employer's health and accident plan. He and his wife claimed a disability exemption on their 1997 tax return and didn't include the social security disability benefits in their income, as a health and accident insurance benefit under §§104(a)(3) and 105(e).

The Tax Court held that social security disability benefits have been treated like other social security benefits since 1984 --they are subject to tax under §86.

[5] Business Reputation

In Henry v. Comm'r, T.C. Memo. 2001-86, the Tax Court, on remand held that a former orchid grower failed to prove payments he received arose from a personal injury under §104(a)(2), and therefore were includable in income.

E.I. Du Pont de Nemours & Co. made "assistance payments" to people who filed claims for alleged damage due to use of the fungicide, Benlate. Henry didn't report the payments asserting the payments were a gift or in the alternative that the settlement was paid because of his business reputation or the loss of his reputation.

The Tax Court took note of the lawsuit which had alleged negligence and strict liability in tort of du Pont and nothing in the record, the court said, indicated that any of the settlement amount was paid on account of business reputation losses. The court also noted several other factors that the taxpayer had failed to establish, such as being consistent about the claims for damages. The court also rejected Henry's contention that damage to reputation, as a matter of law, was a personal injury under section 104(a)(2).

[6] Attorney fees excluded from recovery

In Griffin v. Comm'r, T.C. Memo. 2001-5, the Tax Court held that a businessman was required to pay taxes on a settlement award that did not specifically include personal injury damages, but he wasn't required to pay taxes on contingency fees he paid from his settlement to his lawyers.

Although Griffin showed the underlying cause of action for his settlement was based on tort or tort-type rights, he failed to show the settlement was received on account of personal injury or sickness. Thus, the award was not excludable from income under §104(a)(2). The court distinguished Griffin's case from Fabry v. Commissioner, 223 F.3d 1261 (11th Cir. 2000) (2000 TNT 164-4). There, the court found that damages to an individual's business reputation amounted to a personal injury under §104(a)(2). Griffin's suit against Toyota, however, included no claim for his personal business reputation as opposed to HGTG's reputation.

The court held that Griffin was not required to include in gross income the part of his settlement paid to his attorneys. The court adhered to a prior holding that contingent fee agreements fall under the assignment of income doctrine and are not includable in an individual's gross income as part of that individual's lawsuit recovery. See Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959) (95 TNT 38-83).

[7] Attorney fees deductible

In Lawrence, et al., v. Comm'r, T.C. Memo. 2001-1, the Tax Court held that a portion of the award for legal fees received under an employment discrimination settlement was deductible under §162 as an expense for the protection of the individual's employment status.

Francis Remkiewicz feared termination from his job and hired an attorney to protect his reputation and future employment potential. The attorney attended meetings at which Remkiewicz's future employment was discussed. Remkiewicz filed a discrimination action under title VII of the Civil Rights Act of 1964 that was settled and he received $140,000 for emotional distress. He paid $55,127 in legal fees and costs, $10,000 of which is attributable to the attorney's efforts to protect Remkiewicz's professional reputation. Remkiewicz deducted the legal fees on Schedule A, Itemized Deductions, of his Form 1040 and excluded the $140,000 under section 104.

The IRS agrees that the settlement is exempt from tax under §104(a)(2). However, it argues that the legal fees are not deductible because they are allocable to the exempt income and nondeductible under section 265(a)(1). Remkiewicz argues that the attorney was hired to protect his future earning ability and the fees are attributable to employment status and not the exempt income.

Tax Court Judge Joel Gerber sustained the IRS's position that $45,127 of the legal fees were not deductible because they were attributable to exempt income. However, the court also held that $10,000 of the legal fees was attributable to the lawyer's representation of Remkiewicz to protect his future employment potential and were deductible under §162.

4. Private Letter Rulings

[1] Survival Action, a Wrongful Death Action, and a Loss of Consortium Claim Excludable - LTR 200121031

The Service has ruled that payments a wife received in settlement of a survival action, a wrongful death action, and a loss of consortium claim on behalf of her husband who died from cancer associated with asbestos fiber inhalation are excludable from gross income under section 104(a)(2).

After the husband, a sheetrocker, was diagnosed with cancer associated with asbestos fiber inhalation, the husband and wife filed a class action against the manufacturers and other defendants in state court. The complaint sought recovery of compensatory and punitive damages for personal injuries, and the loss of consortium. After the husband died, the wife amended the complaint. The manufacturers settled the case, and the wife received economic and noneconomic damages from the survival action, the wrongful death action, and the loss of consortium.

The Service determined that because the diseases were the proximate cause of the circumstances giving rise to the wife's claims, there was a "direct link" between the physical injuries and the damages recovered. Thus, the Service concluded that the wife may exclude the damages from income.

[2] Workers' Comp Not Taxable

For a ruling holding that worker's compensation benefits are excludable from income, see LTR 200013005.

[3] Disability Benefits Excludable

Several private letter rulings hold that disability payments are excludable from income. *See* LTR 200138008; LTR 200123004; LTR 200108007; andLTR 200106011.

[4] Disability Benefits Partially Includable / Partially Excludable

For private letter rulings holding disability benefits partially includable and partially excludable from income, see LTR 200016012; LTR 200115014; and LTR 200116040.

[5] Death Benefits Excludable

[a] LTR 200130005

In order to be excluded, the payment has to be due to an injury or illness that is work-related. In LTR 200130005, the Service ruled that death benefits received after plan amendment by a fireman's wife whose husband died in the line of duty were excludable from gross income. After the husband died in the line of duty fighting a fire, his spouse began receiving survivor benefits, which were includable in her gross income. The terms of the plan under which she was paid was determined not to be a statute in the nature of a workmen's compensation act because it authorized the payment of a benefit for all deaths, not just those occurring in the course of employment. Subsequently, the plan was amended and the wife began to receive her benefits from the provision of the plan that paid benefits only to members who died or became disabled by injuries in the line of duty.

5. IRS Market Segment Specialization Reports

In January 2001, the IRS issued a report titled "Lawsuit Awards and Settlements" designed as a guide for its agents in lawsuit settlement examinations. Anyone dealing with issues related to the taxation of settlements may want to review this report, given that it outlines the IRS position in this area. A copy of the report is attached as Appendix A to this outline. The report can also be downloaded at http://ftp.fedworld.gov/pub/irs-mssp/a9lawsut.pdf.

Appendix A

Market Segment Specialization Program

Lawsuit Awards and Settlements