IRS Taxes Legal Settlements, But Some Are Capital Gain

The IRS taxes most lawsuit settlements, and exact wording matters if you are trying to avoid that grim result. However, a suit about intellectual property might produce capital gain when it settles. So might a case about a landlord tenant dispute, where the tenant is bought out of a lease. A suit about damage to or conversion of property? That might be capital gain too. So might a suit about construction defects, harm to property or diminution in its value. How about a suit against an investment adviser for losing your money? There too, capital gain is a possibility, or even basis recovery. You might be getting your own money back with nothing taxable. Even a lemon lawsuit about a defective vehicle can produce capital gain or basis recovery. Of course, as you might expect, the IRS can and does push back, but all of these examples can represent legitimate opportunities for capital gain rather than ordinary income. It’s one of the IRS rules about legal settlements and legal fees.

Tax rates may go up, but right now, ordinary income is taxed at 37%. Capital gain (depending on income level and the size of the gain) can be taxed as low as 0% and as high as 23.8%. Plainly 23.8% is better than 37%. But it isn’t entirely about tax rates, because capital gain reporting can involve recouping
basis too. If you spent $1M in sunk development costs that you have not deducted, that is basis that can be repaid without tax before you start reporting gain. If you receive an IRS Form 1099 saying you received “other income,” is that ordinary or capital? The default IRS answer is ordinary. But a tax adviser may opine it is capital, and your tax return might sail through fine. Even in audit, you might convince the IRS it is capital. And failing that, you can go up the IRS administrative chain to dispute the IRS. You can even go to court.

That is what happened in NCA Argyle LP, Newport Capital Advisors, LLC, where the IRS and the taxpayer faced off over the treatment of a $23 million legal settlement. The taxpayer claimed that the money was capital gain for its interests in the failed joint ventures. The IRS said the money was really future fees the joint ventures would reap, plus punitive damages, both of which are clearly taxed as ordinary income. You can read more about the case
here. The mess started when Newport Capital Advisors, LLC (NCA) entered into several real estate joint ventures with Commonfund Realty. When disputes developed, Commonfund disavowed the joint ventures and walked away. When the dispute reached trial, the jury agreed with NCA, awarding more than $16 million in compensatory damages, and twice that in punitive damages. After an agreement to halve the punitive damages award, like any good commercial litigant, Commonfund appealed the verdict.

While the case was on appeal, the parties settled for a lump-sum $23 million payment. The deal called for Commonfund to pay NCA in exchange for NCA’s relinquishing whatever rights it had in the joint ventures. A simple sale, right? NCA reported it as capital gain on its taxes, but the IRS pushed back hard. By the time the tax dispute got to Tax Court, the IRS was willing to treat $5 million as capital gain for the joint venture interests, but the rest, said the IRS, was ordinary income.

Settlement tax wording is always helpful, but it does not bind the IRS. The settlement agreement between NCA and Commonfund was quite clear, stating that NCA received all $23 million in exchange for its interests in the joint ventures. The Tax Court relied heavily on the express allocation in the settlement agreement, and was inclined to agree with the taxpayer that these were sale proceeds and capital gain. However, the IRS had plenty of other arguments why the settlement was ordinary income. For example, the IRS claimed that the settlement did not comport with economic reality, noting that the stream of payments NCA would have collected if the deals had survived would all have been ordinary. The IRS also took aim at the punitive damages award at trial, since punitive damages are always ordinary income.

But the taxpayer still persuaded the Tax Court. In rejecting the IRS’s barrage of ordinary income arguments, the Tax Court thought the way damages
were calculated in the case was important. The damages analysis at trial projected future fees only to value the interests, the court said. Indeed, a jury eventually awarded NCA damages for the value of the joint venture interests plus punitive damages. That value was estimated, in part, based on the anticipated revenue stream the joint ventures were expected to produce. The IRS harped on that, saying that it showed that what the litigation produced was all ordinary income. But the Tax Court ruled solidly for the taxpayer and rejected all the IRS arguments. The settlement agreement wording had a lot to do with that. So did what the Tax Court called the adverse tax interests of the parties, noting that they had bargained over the wording.

No one wants to go through a protracted legal dispute. After enduring that process, no one wants to go through another dispute about taxes on the money they recovered, or the money they had to pay. Despite these truths, many people don’t focus on taxes when they write up a legal settlement. What does it matter what we call it in a settlement agreement? The answer is that it matters a lot. Most plaintiffs about to receive money usually have a big interest in any taxes they will pay. Defendants seem less likely to focus on taxes at settlement time, but even they are much more likely to make sure taxes are addressed. In any but the most pedestrian and tiny of legal disputes, it seems foolish to sign a settlement agreement without considering taxes, and asking for the wording you want.

Reporting clearly matters to both sides, things like tax withholding, Forms W-2, and 1099. Who receive or issues them, to whom, in what amounts, and even what box on a Form 1099 should be completed, those are all nice to nail down. Otherwise, you might end up in another dispute about tax reporting or withholding (plaintiffs do sometimes sue again if they are surprised). Capital gain v. ordinary income disputes can be consequential too, and the Form 1099 reporting choices are less obvious. But as NCA Argyle illustrates, it pays to get
tax advisers involved well before any documents are signed. Don’t miss out on a chance to help shape the tax result.

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