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Legal Settlements as Capital Gain: A Playbook to Avoid Ordinary Income

by Robert W. Wood

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In this article, Wood examines *NCA Argyle*, in which a legal settlement using express tax language resulted in a capital gain victory for the taxpayer.

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Legal settlements are usually taxed as income, and they are usually ordinary income. Apart from the annoyingly confusing scope of the exclusion for personal physical injuries and physical sickness,[1] you must generally account for every dollar as ordinary income. In fact, since 2018, you might even have to pay taxes on your gross recovery, without a deduction for the legal fees you paid to collect it.[2] Welcome to the strange world of taxing litigation recoveries.[3]

What about legal disputes regarding assets? You might be suing about real estate, stock investments, a sale of a company, or damage to a building, goodwill, or intellectual property. If you win or settle, shouldn't you get the lower tax rates applicable to capital gain? It depends. Let's first note that you must be the type of taxpayer who qualifies for capital gain rates.

Those taxpayers include individuals and passthrough entities (partnerships, limited liability companies, and S corporations). C corporations pay a flat rate, only 21 percent, although distributions are taxed again to shareholders. Individuals can pay a rate up to 37 percent, but they might qualify for the passthrough deduction — whittling their effective tax rate below 30 percent. And they might get capital gain rates of 15 to 23.8 percent, with the 3.8 percent add-on tax being the Affordable Care Act's net investment income tax.

On big recoveries, the tax stakes can be equally big. There can be basis recovery issues too, which hopefully are not taxed at all. Thus, suppose you paid $1 million for property, sued for defects, and collected $1.5 million. You might have only $500,000 of gain, taxed as (hopefully long-term) capital gain. But if your $1.5 million settlement is ordinary income, all $1.5 million is taxed.

Make no mistake, the IRS tends to think first and foremost of ordinary income, so getting to a capital gain position is not always foolproof. But a recent Tax Court case involving failed real estate joint ventures is a useful reminder that the IRS can be wrong, and that wording and negotiations on a settlement are key. Having a playbook of what to say and do as a case creeps toward settlement and toward tax filings can be pretty comforting.

Ideally, of course, you want to take whatever position you can support on your tax return and never be asked about it by the IRS or state tax authorities. But some people are audited, and sometimes your number is going to come up, particularly if how you explain the issue on your tax return is not pristine. For example, failing to

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[1] Robert W. Wood, "Taxing Emotional Distress and Physical Sickness: Chicken or Egg?" *Tax Notes*, Dec. 11, 2017, p. 1635.

[2] Wood, "12 Ways to Deduct Legal Fees Under New Tax Laws," *Tax Notes Federal*, Oct. 7, 2019, p. 111.

[3] Wood, "Settlement Awards Post-TCJA," *Tax Notes*, June 18, 2018, p. 1771.

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account for a Form 1099 is virtually guaranteed to result in some kind of IRS query. And queries can turn into full-blown tax disputes.

Disputed Deal

In *NCA Argyle*,[4] 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 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. How the Tax Court responded provides a nice playbook for settling legal cases and for documenting and proving the nature of damages.

The mess started when Newport Capital Advisors LLC (NCA) entered into several real estate joint ventures with Commonfund Realty. The two companies executed a term sheet in 2005, and each created separate entities for the various projects they planned. In 2008 Commonfund disavowed the joint ventures and walked away. Shortly thereafter, Commonfund filed suit seeking a declaratory judgment that there was no joint venture. NCA cross-claimed for breach of fiduciary duty, and the litigation continued for years.

Perhaps the most remarkable thing about this multiple joint venture real estate deal was that it was not reduced to writing. The parties were working on an agreement, but unlike most commercial deals, it was not completed when sparks had already started to fly. When the dispute reached trial, the jury agreed with NCA, awarding more than $16 million in compensatory damages, and twice that amount in punitive damages. Like any good commercial litigant, Commonfund appealed.

During the appeal, the parties entered into a carefully negotiated settlement agreement. Commonfund agree to pay $23 million in exchange for NCA's relinquishing whatever rights it had in the joint ventures. A simple sale, right? NCA went to considerable pains to document the settlement as a sale, taxable as capital gain. NCA reported it as such, but the IRS pushed back hard. By the time the dispute got to the Tax Court, the IRS was willing to treat $5 million as joint venture interests, but the rest, said the IRS, was ordinary income.

Express Allocation of Settlement

The tax treatment of settlement proceeds depends on the nature of the claim, the so-called origin of the claim test.[5] Yet there are often disputes about how to apply this amorphous test to the facts. And the IRS has a tendency to consider where the greatest dollars can be collected. Express settlement agreement wording can help shape the tax treatment of a recovery, even though that wording is not actually binding on the IRS.

Binding or not, when a settlement agreement expressly allocates the settlement proceeds, the courts will generally follow it, provided that the agreement was reached by adversarial parties in arm's-length negotiations and in good faith.[6] In fact, in the particularly well-known case of *McKay*,[7] the Tax Court stated that "express language in a settlement agreement is the most important factor" in determining why the settlement payment was made.

The court in *McKay* said that express allocations in settlement agreements must be negotiated at arm's length between adverse parties to be respected by the courts, a point the IRS argued over in *NCA Argyle*. The *McKay* case — and now also *NCA Argyle* — underscore the proposition that taxpayers who fail to take advantage of the chance to get explicit tax wording into their settlement agreements are missing an incredibly valuable opportunity. Although it will not bind the IRS, it can help.

Other cases also underscore the importance of taking these steps. For example, in *Fresenius Medical Care Holdings*,[8] the court noted that a "characterization agreed upon by the parties, and/or announced by a judicial officer, may well be determinative for purposes of taxation." Given those statements, why wouldn't you want to ask

[4] *NCA Argyle LP v. Commissioner*, T.C. Memo. 2020-56.

[5] *United States v. Burke*, 504 U.S. 229, 237 (1992).

[6] *Bagley v. Commissioner*, 105 T.C. 396, at 4 (1995).

[7] *See McKay v. Commissioner*, 102 T.C. 465, 482 (1994), *vacated on other grounds*, 84 F.3d 433 (5th Cir. 1996).

[8] *Fresenius Medical Care Holdings Inc. v. United States*, No. 1:08-cv-12118, at *7 (D. Mass. May 9, 2013), *aff'd*, 763 F.3d 64 (1st Cir. 2014).

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adverse parties for tax language to maximize your position? It is hard to think of a credible answer.

In my experience, in an audit setting, the IRS will frequently accept the language of the settlement agreement and not even ask for additional documents. It is true that the IRS may not accept it or may ask for additional documents. But once you have had the IRS say, "Ah, OK, then your return as filed is fine," you tend to think that express wording in your favor is pretty important.

The settlement agreement between NCA and Commonfund was express, stating that NCA received all $23 million in exchange for its interests in the joint ventures. The IRS even argued that a parenthetical "if any" in the wording meant that NCA really did not own anything, an argument the Tax Court found unpersuasive. Besides, the jury had already found that NCA *did* have joint venture interests.

Adversarial, Arm's Length

Express wording matters, and perhaps that is the most important lesson for all of us. After all, express wording alone can sometimes be enough to turn back a budding audit. But if you are questioned, it is also important that the negotiations appear to be real, be at arm's length, and be between adverse parties. NCA and Commonfund were adverse parties, but aren't all litigants adversarial? Yes, but not always about tax issues. Here, the parties even had adverse tax interests, the Tax Court said.

Capital gain to the plaintiff (treating the funds as paid for the interests) meant that the defendant would have to capitalize the settlement to the project rather than deduct it. Notably, though, Commonfund was not a party to the *NCA Argyle* tax case, and the opinion itself does not state that Commonfund in fact followed through with the sale treatment on its own tax returns. Parties do sometimes take inconsistent tax positions — even in the face of express agreements in a settlement agreement — that they will report in a particular way.

And frequently, the parties may not have such clearly defined adverse tax interests, at least not to the degree that the Tax Court underscored in *NCA Argyle.* For example, if a defendant settles a claim with a plaintiff, do they have adverse tax interests depending on whether the plaintiff's money is reported on a Form 1099 and taxable, or is excludable from income as physical injury damages under section 104? Arguably no, because a business defendant will deduct the settlement in any event.

Of course, the defendant will still do its own due diligence to determine if it must issue a Form 1099, so there is at least that adversity. In any case, the Tax Court agreed with NCA that the adverse tax interests in this case were clear. Various drafts of the settlement agreement were examined in the Tax Court trial. The drafts of the settlement agreement exchanged by the parties revealed that NCA wanted the settlement agreement to reflect both that it actually possessed joint venture interests and that it was selling them to Commonfund.

In contrast, Commonfund wanted language that supported its contention that NCA only claimed to have interests, a point still in contention. After drafts and redrafts went back and forth, the final settlement agreement stated that Commonfund acknowledged that it was paying to acquire whatever interests NCA had. The parties' tax interests were adverse, because payments to compensate NCA for services would be ordinary income, taxable to NCA's members as ordinary income. Commonfund could deduct those payments as a business expense. But sale proceeds paid to NCA as capital gain would mean that Commonfund would have to capitalize the payments.

Measuring Damages

The Tax Court relied heavily on the express allocation in the settlement agreement. However, the IRS had plenty of other arguments for 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.

It can be a dangerous argument, because many types of damages are computed based on income streams. Here, the Tax Court found that NCA had its damages computed based on the value of its joint venture interests. The plaintiff's damages expert had used lost fees only as a way to value those interests. Similarly, if a plaintiff injured in a car crash has a low-paying job, the lost

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income while he is injured may be low. If the plaintiff has a high-paying job, the stream of lost income owing to the injuries may be large.

But the mere reference to and calculation of wages the plaintiff would have earned but for the accident does not make the plaintiff's damages taxable as wages. The plaintiff in either case should receive tax-free damages under section 104, unless something can be viewed as punitive damages or interest because of the procedural posture or history of the case.

In rejecting the IRS's barrage of ordinary income arguments, the Tax Court in *NCA Argyle* thought the way damages were calculated in the case was important. Under California law that applied at trial, the victim of repudiation of a partnership interest can choose several methods of measuring damages. NCA chose the conversion measure of damages, which is the value of what was taken on the date of repudiation.

NCA hired an expert to value the repudiated joint venture interests. His three estimates valued them at $16,375,968, $20,660,207, and $24,608,097. He considered future fees the joint ventures expected to receive, estimated business risks, and other factors. The jury instructions asked that damages be measured by the reasonable value of the joint venture interests. The jury awarded damages of $16,375,968, the lowest estimate, and then added punitive damages of $33,980,816.

After the jury verdict, Commonfund asked for a new trial, claiming that the punitive damages were excessive. The judge conditionally granted the motion but allowed NCA to avoid a new trial by accepting a total judgment of $32,751,936 — 50 percent economic and 50 percent punitive. Commonfund appealed, and the parties settled for $23 million, expressly documented as a sale of NCA's interests in the joint ventures.

Punitive Damages

Arguably, it never hurts to state in a settlement agreement that the defendant is not paying any punitive damages. Defendants may have their own nontax reasons for those statements. The issue comes up most frequently when there has been a verdict for punitive damages and the parties settle on appeal. The issues on appeal are important. The defendant alone might appeal, arguing that punitive damages are unwarranted. Or the plaintiff too might cross-appeal, asking for additional compensatory damages.

The case for no punitive damages is easiest if the case settles for less than the compensatory damages awarded at trial, or if the plaintiff is asking for additional compensatory damages. When punitive damages were awarded at trial, the IRS tends to assume they were paid. Notoriously, the IRS may even choose to argue for punitive damage treatment when a case settles before trial, and punitive damages were simply requested in a complaint.[9]

In *NCA Argyle*, the IRS argued that this "it's all capital gain" settlement lacked economic reality in several ways. The IRS claimed the parties were not adverse about punitive damages, so some of the settlement proceeds had be allocated based on the jury verdict's ratio of punitive to economic damages. That is, if a case is one-third compensatory and two-thirds punitive and it settles on appeal, the IRS says two-thirds must be punitive.

The IRS relied on *Healthpoint*,[10] in which the court said that when settlement wording "is incongruous with the 'economic realities' of the taxpayer's underlying claims," the court did not need to accept it. The IRS argued that NCA and Commonfund were adverse on the underlying litigation and on the amount of the settlement, but not on the allocation of the settlement proceeds. In *Healthpoint*, it was clear that both plaintiff and defendant did not want anything allocated to punitive damages, so the Tax Court did not follow the express allocation in the settlement agreement.

But on this point too, the Tax Court in *NCA Argyle* said the parties were adverse as to the tax treatment, having different tax interests regarding the tax treatment of the payment. Punitive damages would be taxable to NCA and deductible to Commonfund. In contrast, money allocated to the transfer of joint venture interests would be taxed differently to both parties. Thus,

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[9] *See Barnes v. Commissioner*, T.C. Memo. 1997-25.

[10] *See Healthpoint Ltd. v. Commissioner*, T.C. Memo. 2011-241, at *379, *382.

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the court said the "no punitive damages" wording in the settlement agreement should be respected.

Conclusions

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, it can sometimes be hard to argue with a litigator or client who just wants to document a legal settlement as a business deal, letting the tax people worry about taxes later. Taxes aren't the litigator's job, and surely the money paid or received is what it is, they might say.

What does it matter what we call it? The rejoinder is that it matters a lot. Most plaintiffs about to receive money 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 these days to make sure taxes are addressed. In any but the most pedestrian and tiny of legal disputes, it seems downright foolish to sign a settlement agreement without considering taxes and asking for the wording you want.

You may not get everything you want, but you have to start somewhere. The specifics of reporting clearly matter also, to both sides, things like tax withholding, Forms W-2, and Forms 1099. Who receives or issues them, to whom, in what amounts, and even what box should be completed — these details are all nice to nail down. Otherwise, you might end up unhappy, or even in another dispute about tax reporting or withholding (plaintiffs do sometimes sue again if they are surprised).

Most plaintiffs who think they will not receive a Form 1099 will be unhappy if they do. Most lawyers who expect to receive a Form 1099 reporting the money as gross proceeds paid to an attorney (the old Box 14 of Form 1099-MISC, but now Box 10 on the 2020 Form 1099-MISC) will be unhappy if the money is reported in Box 3 as other income. Most plaintiffs who expect an "other income" Form 1099 (Box 3 of Form 1099-MISC) but who receive the new Form 1099-NEC for non-employee compensation will be unhappy too. Non-employee compensation generally means self-employment tax.[11]

Capital versus ordinary income disputes may seem to be the sleeper in the settlement room. But the disputes there can be consequential too, and the Form 1099 reporting choices less obvious. But as *NCA Argyle* illustrates, it pays to get tax advisers involved well before any documents are signed. Why miss out on a chance to help shape the tax result? ■

[11] *See* Wood and Matthew L. Roberts, "Whistleblowers Face Self-Employment Tax Worries Too," *Tax Notes Federal*, Dec. 9, 2019, p. 1627.

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