Litigation Settlements: Are They Ordinary Income or Capital Gain?

by Robert W. Wood

Robert W. Wood practices law with Robert W. Wood, P.C., in San Francisco. He is the author of *Taxation of Damage Awards and Settlement Payments* (2d Ed. © 1998), published by Tax Institute (800/852-5515; e-mail info@taxinstitute.com).

It has long been true that a plaintiff will generally prefer receiving a capital gain as opposed to ordinary income. This nearly universal maxim can be seen in all types of litigation. Where a plaintiff has a large capital loss that will be absorbed by a capital gain, the situation may be even more desperate. Yet, even where there is no capital loss to be absorbed, capital gains rates (for individuals) are almost uniformly more attractive than ordinary rates.

For part of the history of our tax code, corporations have had capital rate preferences. For part of that history they have not. Still, there have been many litigated cases in which a corporation (or other business entity) strives mightily to have a litigation settlement payment (or payment pursuant to a judgment) characterized as capital rather than ordinary. (The expenses of litigation, such as legal fees, are another matter, with incentives running in contrary directions.)

Brian L. Nahey, et ux. v. Commissioner, 111 T.C. No. 256, *Doc 98-31324 (17 pages), 98 TNT 204-14* (1998), is an important case involving the distinction between capital gain and ordinary income in the context of business litigation. Now, the other shoe has fallen with the publication of the Seventh Circuit Court of Appeals opinion in the case, Dkt. No. 99-1149, 84 AFTR2d Par. 99-5521, *Doc 1999-36745, 1999 TNT 223-9* (7th Cir. 1999). The Seventh Circuit affirmed the Tax Court, holding that the settlement proceeds two S corporations received constituted ordinary income. The lawsuit, agreed the Seventh Circuit, which the two corporations had acquired in an asset purchase, would have resulted in ordinary income to the seller.

Capital Facts

The facts arose out of Mr. Nahey's ownership of shares in Wehr Corp. Wehr sued Xerox in 1985 for breach of contract and misrepresentation. Wehr requested damages for lost profits in excess of $15 million. Xerox counterclaimed, and Nahey then informed Wehr's chairman that he believed Wehr could recover as much as $10 million.

Here's where the facts get confusing. In December 1986 Nahey formed two S corporations and then had them purchase all of Wehr's assets and assume all of Wehr's liabilities. Wehr was then liquidated. Accountants allocated no part of the purchase price to the Xerox lawsuit, believing the claim was "too speculative." The S corporations continued the lawsuit in Wehr's name and settled in 1992, with Xerox agreeing to pay a whopping $6.2 million. The S corporations reported the settlement proceeds as long-term capital gain, which under the S rules flowed through to Mr. Nahey. The IRS disagreed, determining that the payments were ordinary.

The Tax Court did not have too much trouble agreeing with the IRS. With significant dollars at stake and not the clearest legal principle in question, Nahey appealed. Now, the Chief Judge of the Seventh Circuit, Richard A. Posner (recently in the news as Microsoft mediator), has agreed with the Tax Court.

> ***Perhaps the most disturbing aspect of the Seventh Circuit's analysis concerned the issue of whether there must be a sale or exchange for there to be a capital gain or loss to the seller.***

The payments, Judge Posner says, were ordinary. After all, the court reasoned, even Mr. Nahey conceded that if Wehr had not been sold, the entire settlement would have been ordinary income to Wehr. The Seventh Circuit found no practical reason why the tax treatment of the proceeds of a suit should change merely because of an intervening change in ownership.

Is a Sale Required?

Perhaps the most disturbing aspect of the Seventh Circuit's analysis concerned the issue of whether there must be a sale or exchange for there to be a capital gain or loss to the seller (or in this case, the settling plaintiff). According to Judge Posner, the purchaser, when he prosecuted the suit to judgment and collected it, or when he settled the case and received the proceeds of the settlement, would be taxable on the net gain at ordinary income rates. According to Judge Posner, a settlement resembles a sale because it extinguishes the plaintiff's claim, but it is nevertheless different. It must be different, Judge Posner said. Otherwise, had Wehr not been sold (if instead a settlement had been negotiated with Xerox), the proceeds would be capital gain to Wehr.

I have a hard time even trying to follow this reasoning, and I even went to the University of Chicago Law School in the 1970s. (During that era, and especially at that institution, Professor Posner's economic analysis reigned supreme.) The bottom line, though, was that the Seventh Circuit did not find a sale or exchange in this particular case. (That I can understand — I don't like it but I understand it.) Concluding that rules of taxation should be simple and should be neutral (that's a set-up phrase if I ever heard one), the Seventh Circuit pronounced that a corporate acquisition should not affect the tax treatment of any claims that are transferred in the acquisition.

Adding to the Confusion?

It is troubling that there seems no definitive decision as to whether there must be a sale or exchange (in the lawsuit context) for capital treatment. True, there must be a sale or exchange for a *sale* transaction to qualify for capital treatment. But doesn't the settlement of a lawsuit by definition involve the transfer of rights? That was the conclusion of the Second Circuit in the now famous case of *Commissioner v. Ferrer,* involving the famed motion picture actor. In *Commissioner v. Ferrer,* 304 F.2d 125 (2d Cir. 1962), *reversing in part* 35 T.C. 617 (1961), the taxpayer (Mr. Ferrer) had received the right to produce a play from the play's author, as well as the right to prohibit the playwright from assigning film rights. In return for securing the leading role in the film, Mr. Ferrer subsequently surrendered both the right to produce the play and the right to restrict the assignment of film rights.

The Second Circuit in *Ferrer* sensibly held that there was no distinction between the release and sale of Mr. Ferrer's rights. Disturbingly, the Tax Court in *Nahey* distinguished this seminal decision by stating that in *Ferrer*, the right to produce the play (and restrict film rights) reverted to the author, while in *Nahey*, all rights in the suit "disappeared" on settlement of the case. (See *Nahey*, 111 T.C. at 264-265.) Isn't this a distinction without a difference?

Other cases leave one similarly unsatisfied. Some rather hoary authority from many years ago concludes that the settlement of a suit is not a sale. A good example of such aging authority is *Hale v. Helvering,* 85 F.2d 819 (D.C. Cir. 1939), in which the settlement of a note for less than face value was held to be an ordinary loss. The mere fact that this case carries "*Helvering*" in its title (a *very* early IRS Commissioner), shows the case was decided as our tax law was just starting to take shape.

Although perhaps not carrying the pejorative "old enough to be a *Helvering* case" distinction, *Hudson v. Commissioner,* 20 T.C. 734 (1953), is also rather ancient. It suggests that in common parlance (even among lawyers), a settlement simply is not a sale. What legal analysis here!

Is this related to Judge Posner's comment that a settlement is like a sale but it's different? (For further discussion, see Note, "Lawsuit Proceeds Were Ordinary Income: *Nahey v. Commissioner,*" *Tax Lawyer,* Vol. 52, No. 4, p. 881 (Summer 1999).)

More Bad News

All of the cases dealing with this troublesome sale or exchange notion are not quite so hoary, however. The Service flatly ruled in Revenue Ruling 74-251, 1974-1 C.B. 234, that acceptance of payments in settlement of claims in a lawsuit does not a sale or exchange make. Several other decisions are not so absolute, but rely on the factual question of whether the lawsuit and its settlement were *structured* to reflect a sale or exchange. See *Kempter v. Commissioner,* 22 T.C.M. 274 (1963) (burden of proof on the taxpayer in settlement of a lawsuit to show a sale or exchange). See also *Sanders v. Commissioner,* 121 F.Supp. 584 (D. Okla. 1954), *aff'd and rev'd in part* 225 F.2d 629 (10th Cir. 1955), *cert. denied*, 350 U.S. 967 (1956). The court in *Sanders* held that a compromised settlement did not constitute a sale or exchange either. The theory of this decision, though, was really an "origin of the claims" notion. The money that would have been received had the breached contract been fulfilled would have been taxed as ordinary income.

Form vs. Substance?

Does the mere form of the agreement control, then? The answer does not seem to be clear. As Judge Posner might say, it is but it isn't. *Truzillo v. Commissioner,* 346 F.2d 884 (6th Cir. 1965), held that the settlement and release of a suit relating to a former employee's contractual rights to purchase stock was a surrender of property rights in exchange for money. Hence, sale treatment (and capital gain) followed. Interestingly, this Sixth Circuit decision reversed the Tax Court's finding that the settlement had been ordinary.

> ***Does the mere form of the agreement control? The answer does not seem to be clear. As Judge Posner might say, it is but it isn't.***

As in so many other areas of the tax law, form does seem awfully important. Cases for this proposition include *GC Services Corp. v. Commissioner,* 73 T.C. 406 (1979), in which a shareholder sold stock and simultaneously released several legal actions pending against the corporation. Result: all capital. The court seemed to rely primarily on the structure of the deal and the fact that the written agreement dealt primarily with the purchase and sale of stock. The court was therefore comfortable allocating the entire payment to the stock purchase. Of course, since the court was dealing with the deduction side of the equation, it found the entire payment to be a nondeductible capital expenditure! Ouch! So it may depend on which side one represents whether the form of the settlement is controlling.

Slightly less ridiculous is *Clark Oil & Refining Corp. v. U.S.*, 473 F.2d 1217 (7th Cir. 1973). There, the taxpayer's refinery caused damages to adjacent property and a lawsuit followed. The taxpayer settled the suit by purchasing the adjacent realty. The court found that the entire purchase price (including attorneys' fees) was a nondeductible capital expenditure. The court's reasoning? No part of the payment was in lieu of damages that the taxpayer may have caused the seller as a result of the refinery operation. The court found support for this somewhat dubious conclusion by noting that negotiations to purchase the property had commenced *before* the suit was filed. Moreover, the suit, although a tort suit, was evidently brought to compel the defendant to purchase the plaintiff's property at an equitable price.

Concurring Opinion

Turning back to the Seventh Circuit's recent *Nahey* decision, it is worth noting the concurring opinion in the Seventh Circuit (written by Circuit Judge Richard D. Cudahy). The concurring opinion was troubled by the majority's (Judge Posner's) analysis. (At least someone besides me was troubled!) The concurring opinion pointed to several cases involving similar transactions, addressing the issue of expenses rather than income. The concurring opinion referred both to the seminal case of *Arrowsmith v. Commissioner,* 344 U.S. 6 (1952), and to *Pacific Transport Co. v. Commissioner,* 483 F.2d 209 (9th Cir. 1973).

The courts in these cases, noted the concurring opinion, held that the expenses or losses had to be capitalized. At least in the past, Judge Cudahy pointed out, the Seventh Circuit had aspired to treat settlement payments *made* and settlement payments *received* consistently. In a nice (yet decorously understated) barb to the majority, the concurring opinion lamented that "the cause of symmetry has waned." (Take that, Judge Posner!) The concurring opinion stated that "it is hard to see how Nahey's gain as ordinary income is a simple or neutral rule when, if he had sold the claim for the settlement amount, he would have realized capital gain." Read this: form is important!

> ***The 'sale or exchange requirement' in the context of a capital gain recovery in a litigation settlement or judgment has long been a source of confusion. Unfortunately, I'm afraid that confusion may get even worse.***

The concurring opinion was also uncertain about the majority opinion's conclusion that the nature of income was unchanged by the corporate sale. In truth, the concurring opinion stated, "an intermediate transaction such as a sale generally changes the identity, circumstances and economic function of the taxpayer in ways that ought to be recognized."

Conclusion

Where does this leave us now? Judge Posner is a brilliant and well-known jurist, and now will be even more well-known given his new mantle as Microsoft mediator (or is that toga?). Of course, he is not a tax lawyer and tax theory, whatever else it may be, is not pure economics. The "sale or exchange requirement" in the context of a capital gain recovery in a litigation settlement or judgment has long been a source of confusion. Unfortunately, with *Brian L. Nahey, et ux. v. Commissioner* now decided by the Seventh Circuit, I'm afraid that confusion may get even worse.