Who Said Settlement Agreement Tax Language Was Binding?

By Robert W. Wood


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Tax language in litigation settlement agreements is becoming more and more prevalent, and with good reason. Inside or outside the context of section 104, it can spell the difference between success and failure in a tax position. Yet as the decision in *Healthpoint Ltd. v. Commissioner* reminds us, tax language alone is often not enough.

Tax lawyers must negotiate a bloated and Byzantine tax code. Even relatively simple tax disputes can involve dozens of interconnected and conflicting provisions. One faces the code, revenue rulings, regulations, and all manner of non-authorities (not technically authority but still important) that one should read from the IRS. And that is even before one gets to case law. Case law applies the law to the facts, often with complicated tax concepts and provisions.

In contrast, the tax treatment of litigation payments and recoveries is simple. There are few code provisions and regulations. Even the case law has a pristine simplicity. The disputes that arise, after all, are usually about the underlying facts and the emphasis of the *litigation*, not about which tax rules apply once the facts have been made clear. If one truly understands the underlying case and the claims involved, discerning the tax treatment should be straightforward.

In that sense, this area of the tax law is (refreshingly) haiku simple. That does not mean there are no disputes. It also does not mean that everything is what you call it. As frustrating as it is for taxpayers not to know how something will be taxed, it is also frustrating for the IRS to read a settlement agreement that purports to accurately set forth the nature of the payments, only to look behind the settlement agreement to find something very different.

All this was on my mind as I read *Healthpoint Ltd. v. Commissioner*.[1] That case involves the increasingly popular question whether an amount received in resolution of litigation should be taxed as capital gain or ordinary income. Some taxpayers may not care too much, but this taxpayer (a partnership) certainly did.

Healthpoint is a specialty pharmaceutical company. It sold its tissue management division in 2008 but retained some products, including a prescription ointment, Accuzyme, to treat wounds. Healthpoint owned the exclusive rights to the Accuzyme trademark and associated goodwill and spent millions of dollars promoting it. By 2001, Accuzyme became the most prescribed ointment on the market in its class.

The defendant in the underlying litigation, Ethex Corp., is a wholly owned subsidiary of KV Pharmaceuticals. It introduced Ethezyme, packaged and marketed as a generic form of Accuzyme. Although Ethezyme contained different ingredients, Ethex marketed it in such a way that made medical practitioners and consumers believe those two products were identical. Unfortunately, they were not.

Because everyone seemed to assume the two drugs were identical, when patients had negative results after using Ethezyme, practitioners did not order Accuzyme in its stead. The sales results of Accuzyme were predictable. Healthpoint lost its market and eventually filed suit in 2000.

The suit alleged that Ethex was liable for false advertising, unfair competition, and trademark dilution under the Lanham Act. It also alleged unfair competition, misappropriation, and business disparagement under Texas law. The parties repeatedly tried to settle the case, but the matter

[1] T.C. Memo. 2011-24, *Doc 2011-20881*, *2011 TNT 192-12*.

eventually went to trial. There, Healthpoint presented expert testimony on its lost profits and a Healthpoint vice president testified as to lower-than-projected sales.

Meanwhile, Ethex continued to tinker with Ethezyme. In 2001 Healthpoint filed a second lawsuit alleging that Ethex was marketing a new formulation of Ethezyme called Ethezyme 830. In this second suit, Healthpoint not only claimed that Ethex was liable for false advertising, unfair competition, and trademark dilution under the Lanham Act, but also alleged the theft of trade secrets.

Healthpoint attempted to combine the two suits, but the judge refused. In 2001 the jury in the first case returned a verdict in favor of Healthpoint. It found that Ethex had engaged in false advertising and unfair competition, and even that Ethex had acted with malice. It did not, however, find that Ethex had knowingly or intentionally diluted Healthpoint's trademark or that Ethex had disparaged Healthpoint's business.

Almost a year after the verdict, on December 10, 2002, the court released findings of fact and conclusions of law. Of the nearly $16.5 million awarded to Healthpoint, the court allocated the damages as follows:

Table 1	
Actual damages	$5 million
Disgorgement of Ethex profits from false advertising and unfair competition	$1,640,000
Punitive damages	$3,174,515
Lanham Act enhanced damages	$6,349,030

Ethex appealed to the Fifth Circuit. Settlement talks ensued again, still unsuccessfully. The parties then brought the second case into mediation. That, too, was unsuccessful. Healthpoint and Ethex resumed settlement discussions in December 2003.

During that round, Healthpoint proposed settling both cases for approximately $25 million. Ethex countered at $8 million. Both offers were rejected. Ethex then proposed settling the cases with a royalty arrangement on profits from future sales of Ethezyme.

Healthpoint rejected the offer, countering with $13 million plus a royalty and some additional terms. Ethex rejected that counter, offering $9 million immediately along with $250,000 payable over four years, and royalty payments on increased sales of Ethezyme 830. Healthpoint again declined.

In August 2004 the second case was nearing trial. Oral arguments in the Fifth Circuit on appeal of the first case were also approaching. Settlement talks started anew. Finally, the parties agreed to settle the first case for $12 million and the second case for $4.5 million. But agreeing on numbers was one thing. Agreeing on other provisions was something else.

Discussion about non-disparagement and confidentiality provisions were especially contentious. Ethex wanted Healthpoint to request a vacatur of pleadings and to remove the pleadings in the first case from public view. Healthpoint declined. The parties eventually agreed to a non-disparagement provision allowing Healthpoint to use public domain documents to promote Accuzyme and to distinguish it from Ethezyme. Conversely, Ethex was prohibited from using the settlement agreement for those same purposes.

Still more settlement discussions ensued. On August 29, 2004, Ethex sent Healthpoint a draft settlement agreement. Of the $16.5 million total, the draft proposed allocating $12 million for the settlement of the first case to "compensatory damages arising out of alleged unintentional product disparagement." That same phrase was used for the $4.5 million allocated to resolve the second case.

Healthpoint then sent its own proposed settlement agreement. Healthpoint's tax counsel prepared an outline of the categories of damages included in the agreement. However, he did not assign dollar amounts to those categories. As the Tax Court noted, "without the aid of tax counsel," Healthpoint proposed allocating $15.8 million as follows:

Table 2	
Damage	**Amount**
Ethex I	
Lanham Act — false advertising:	
Damage to goodwill and reputation	$7.6 million
Lost profits/disgorgement of profits	$1.25 million
Unfair competition:	
Damage to goodwill and reputation	$1.75 million
Lost profits/disgorgement of profits	$100,000
Punitive damages	$1.1 million
Ethex II	
Lanham Act — false advertising:	
Damage to goodwill and reputation	$2.35 million
Lost profits/disgorgement of profits	$450,000
Unfair competition:	
Damage to goodwill and reputation	$1.2 million

Healthpoint also wanted to allocate a small amount to a third party and to make several minor adjustments. Ethex responded with an e-mail stressing that it could not accept any language suggesting willful misconduct on its part. With minor additional changes on September 2, 2004, Ethex and Healthpoint finally signed the settlement agreement in both cases. The final settlement agreement allocated the damages as follows:

Table 3	
Damage	**Amount**
Ethex I	
Damage to goodwill and reputation	$10.45 million
Lost profits/disgorgement of profits	$1.35 million
Ethex II	
Damage to goodwill and reputation	$4.05 million
Lost profits/disgorgement of profits	$450,000

Notably, the settlement agreement stated that ''no part of the sums paid pursuant to this agreement are for willful misconduct'' or for punitive damages.

The Tax Court observed that Healthpoint maintained no business documentation related to goodwill nor made any calculations during settlement negotiations to justify the allocations in the agreement. The court also noted that Healthpoint was aware that allocating money to ordinary income rather than capital gain would generate a higher tax burden. Yet Healthpoint's tax counsel was not involved in any discussion of the total amount of the settlement, or in any discussion of the amount of each individual allocation.

When Healthpoint filed its partnership tax return in April 2005, it reported $14.5 million of long-term capital gain and $1.8 million of ordinary income. The IRS determined that all proceeds were ordinary income and that a section 6662(a) penalty applied. Before the Tax Court trial, however, the commissioner conceded that the $6,349,030 awarded by the jury for loss of goodwill under the Lanham Act was indeed taxable as long-term capital gain. The Tax Court then considered the remaining issues.

Jury vs. Agreement?

Not surprisingly, the IRS focused on the allocation made by the jury in the first piece of litigation. The taxpayer argued that the allocations made in the subsequent settlement agreement could not be disregarded. Both the taxpayer and the government agreed that proceeds for goodwill or damage to reputation were capital gain. The taxpayer and the government also agreed that proceeds for lost or disgorged profits or punitive damages were ordinary income.

The law was clear. But what was paid for what here? Citing *Robinson v. Commissioner*,[2] the Tax Court said that ''the determination of the nature of the underlying claim is a factual one and is generally made by reference to the settlement agreement considered in the light of the facts and circumstances surrounding the settlement.'' But the court was unwilling to look only at the settlement agreement.

Express allocations, the Tax Court said, generally will be followed if a settlement agreement is entered into by the parties in an adversarial context, at arm's-length, and in good faith. Conversely, express allocations in settlement agreements when specific facts indicate that both parties intended payments to be for different purposes are not necessarily determinative.[3] Which platitudes were appropriate to apply to these two cases and their combined settlement?

Judicial approbation of express settlement allocations, the court was certain, would not be warranted when circumstantial factors reveal something untoward. Were the allocations the result of adversarial arm's-length and good-faith negotiations? Or were they instead incongruous with the economic realities of the taxpayer's underlying claims?

In the face of those questions, the taxpayer took great comfort in *McKay v. Commissioner*.[4] *McKay* involved a settlement agreement reached on appeal of the underlying case. The settlement agreement expressly disclaimed any payment of punitive or treble damages. The Tax Court in *McKay* upheld the allocations in the settlement agreement, but in doing so noted that the allocations in the settlement agreement were roughly the same as those in the jury verdict. Further, the Tax Court concluded that the allocations in the settlement agreement reflected an arm's-length and adversarial negotiation, as well as the clearest embodiment of the payer's intent. Of course, the IRS pointed out that no court is bound by a settlement agreement's tax language.

Indeed, whatever one thinks of *McKay*, the IRS in *Healthpoint* observed that when a payer decries having any portion of the payment characterized as punitive damages, that does not necessarily establish that no portion of the amount paid was for punitive damages or in lieu of punitive damages.[5] As for adversity, any reading of the record would make clear that Healthpoint and Ethex were quite adverse throughout the entire negotiating process. Consequently, Healthpoint argued that the agreement should be respected because of that adversity. Yet, the Tax Court countered that *general adversity* between parties should be expected. This is litigation, after all.

[2]102 T.C. 116 (1994), *Doc 94-1439*, *94 TNT 23-18*, *aff'd in part, rev'd in part, and remanded on another issue* to 70 F.3d 34 (5th Cir. 1995), *Doc 95-10932*, *95 TNT 238-7*.

[3]*See Bagley v. Commissioner*, 105 T.C. 396 (1995), *Doc 95-11034*, *95 TNT 241-12*, *aff'd*, 121 F.3d 393 (8th Cir. 1997), *Doc 97-23130*, *97 TNT 153-8*.

[4]102 T.C. 465 (1994), *Doc 94-3399*, *94 TNT 60-9*, *vacated on other grounds*, 84 F.3d 433 (5th Cir. 1996), *Doc 96-13888*, *96 TNT 92-7*.

[5]*See Bagley*, 105 T.C. 396, 121 F.3d 393.

Moreover, said the court, if the parties were generally adverse but ultimately allocated funds in such a way that did not reflect the claims they intended to settle, the allocations in the settlement agreement need not be respected. Although Healthpoint argued that its refusal to sign the first settlement agreement proved that the allocations had been adversely negotiated, the Tax Court was persuaded only that Ethex wished to avoid any mention of the words ''punitive damages.'' Indeed, the court found that Ethex was indifferent about how Healthpoint chose to allocate the funds as long as the allocation did not imply intentional wrongdoing on Ethex's part. To the court, that Ethex was solely concerned about labeling was insufficient to establish that the allocations in the agreement were the product of an adverse, arm's-length negotiation between the parties.

Tax Benefits

Then there were the tax benefits. Healthpoint was aware that the settlement allocations Ethex proposed, which characterized damages as a ''loss of goodwill,'' would result in a more favorable tax rate. During the negotiations, Healthpoint had proposed an allocation to punitive damages that was significantly less than the amount delineated in the jury award.

To the Tax Court, this suggested that for Healthpoint, tax considerations had greater importance than punitive motives. After the taxpayer's reliance on *McKay*, the court volleyed back. That the taxpayer in *McKay* had never been given the freedom to structure the settlement on his own did not mean the court would substitute its judgment only for a settlement agreement containing a truly unilateral allocation.

The IRS was effective in its reliance on the jury verdict. With all the hues and cries of litigation, after all, a jury verdict is often the best evidence of what the case was about and of which amounts were being rewarded for which claims. The first case had gone to trial, and the verdict was clear and specific.

With little further discussion and attention to the taxpayer's arguments, the Tax Court agreed with the IRS that the verdict in the first trial should be applied to the settlement agreement. However, what of the second piece of litigation? The court noted that other cases have supported using a jury verdict in one case to determine the character of settlement proceeds for another similar case brought by the same taxpayer.

That is appropriate, said the court, when the second case did not go to verdict but the two cases have been jointly settled. In *Miller v. Commissioner*,[6] for example, the court considered two related cases in which an allocation to emotional distress damages was in question. The court held that because the jury did not award damages for emotional distress in the first case, the parties did not intend the settlement in the second case to include emotional distress either.

Yet, to apply that reasoning it was first important to prove that the two cases were connected or similar. How similar were the two *Healthpoint* cases? Although the complaint in the second case was slightly different, the cases shared some fundamentals. Further, the damages in the settlement agreement were similarly allocated.

With those conclusions behind it, the Tax Court said that Healthpoint failed to meet its burden of showing that the allocations in the settlement agreement for the second case should be respected. The IRS had resoundingly prevailed. The court then considered penalties.

Penalties, Too

Was Healthpoint negligent? If so, it faced a 20 percent accuracy-related penalty. Negligence amounts to failing to make reasonable attempts to comply with the code. One can be negligent if one is careless. Carelessness is defined by the failure of a taxpayer to exercise reasonable diligence in determining the correctness of a return position contrary to a rule or regulation.[7]

The IRS showed that the penalty was appropriate based on the burden of production of evidence. To escape it, the taxpayer had to demonstrate that the penalty was inappropriate. One way of doing that would be to establish that the taxpayer had substantial authority for its position. That was clear here, Healthpoint argued. Nevertheless, with little discussion, the Tax Court said the case law did not show substantial authority.

Also, Healthpoint had not adequately disclosed its position taken regarding the settlement allocations on its return. Turning to whether the company had acted with reasonable care and in good faith, Healthpoint argued that it relied on the advice of its tax counsel who had been hired to oversee the settlement agreement. Even if that were true, the Tax Court argued, Healthpoint still failed to prove that this tax counsel offered an opinion on the propriety of the allocations in the agreement. The court further noted that although Healthpoint's tax counsel *did* provide the outline of the allocations

[6]93 T.C. 330 (1989), *rev'd on other grounds*, 914 F.2d 586 (4th Cir. 1990).

[7]*See* reg. section 1.6662-3(B)(2).

used in the settlement agreement, he did *not* participate in the negotiations regarding the total amount of the settlement or the amount of each individual allocation.

Healthpoint countered that the reason its tax adviser was not involved was because negotiations were completed between the parties without regard to tax consequences. Even if true, that did not save it from the penalty, said the Tax Court.

Conclusion

There have been many tax cases in which taxpayers have prevailed when faced with an IRS query on the tax aspects of their settlements. Although there may be luck involved, good documentation is still essential. After all, it is the taxpayer that has the burden of proof. No matter how good the language in a settlement agreement may be — and Healthpoint's was less explicit than it could have been — the taxpayer must be able to produce other documents to support it.

Taxpayer myopia about tax language in settlement agreements is understandable. But tax language in a settlement agreement is not the be-all and end-all of the desired tax treatment. Documentation and testimony also deserve due attention.

One may be asked how one came up with an allocation and whether it is reasonable under the circumstances. One should have logical and convincing answers. In *Knevelbaard v. Commissioner*,[8] the Tax Court upheld express allocation language — $19.3 million to excludable claims and $700,000 to taxable interest — because it found the taxpayers' testimony quite convincing.

There is no easy answer for how Healthpoint could have avoided this bitter result. The company has until January 3, 2012, to appeal the case, and it is certainly possible that an appellate court would view Healthpoint's arguments and facts more favorably than the Tax Court. However, most of the steps that might have expedited the process — perhaps even obviating the need to go to Tax Court — would have been appropriate when the settlement was being negotiated and before tax return filing time. Here are some ideas:

First, Healthpoint might have tried to document the building blocks that went into its allocation at the time of the settlement. It had the first jury verdict, but it also had considerable history thereafter. There were developments in the appeal positions in the first case, and even more moving pieces that could have affected the tax issues in the trial of the second case. Because that trial was approaching when the settlement was being negotiated, there were probably motions in limine about particular evidence being developed, expert reports being finalized, and trial strategies being mapped out. One or more of those items could have been helpful, especially if they supported Healthpoint's claim that the recovery was really on account of harm to capital.

In short, Healthpoint could have done a far better job with its internal documentation. One can try to document the adverse and arm's-length nature of negotiations, but the focus should have been on the reasonableness — indeed, correctness — of the allocation. Although admittedly self-serving, file memoranda also could have documented that someone was making an assessment of the damages.

Apart from memoranda, declarations from the lawyers, experts, and officers might have also helped. Given the amounts of money involved, an outside evaluation by an appraiser, economist, or tax lawyer could have been beneficial. While losing a case and just avoiding penalties is hardly a victory, the tax counsel point seems apparent here.

Healthpoint relied on in-house tax counsel for its substantive position and penalty protection. The Tax Court accorded weight to neither. The court held that there was not substantial authority for Healthpoint's position and that it failed to spend sufficient time, money, and due diligence to be relieved of penalties. Additional documentation, no matter how self-serving, could well have made a pivotal difference.

[8]T.C. Memo. 1997-330, *Doc 97-21376*, *97 TNT 140-4*.