Optimizing Tax Treatment of Interest: More Practical Advice

To the Editor:

I am writing to comment on the recent article by Bill and Burgess Raby, ''Was the Interest Paid 'on Account of' the Accident?'' *Tax Notes*, Mar. 7, 2005, p. 1167. As usual, it reflects thoughtful analysis. I have several observations, and several areas of disagreement.

The IRS, the courts, and practitioners have generally viewed interest as taxable regardless of how paid and regardless of whether it constitutes prejudgment or postjudgment interest. One analytical argument against this position, as noted by the Rabys, was raised in *Brabson v. U.S.*, 73 F.3d 1040, *Doc 96-3551*, *96 TNT 25-24* (10th Cir. 1996), in which the court suggested that under the 1982 Periodic Payment Settlement Act (which ensconced structured settlements in federal tax law), at least some ''interest'' should not be taxable. There has been almost no discussion of that argument, and perhaps it is a dead end.

However, the practical side of the interest question clearly needs underscoring. The Rabys draw the distinction between a case such as *Chamberlain v. U.S.*, No.03-31136, *Doc 2005-3443, 2005 TNT 34-7* (5th Cir. 2005), in which prejudgment interest on a judgment is held taxable, and *Frank L. McShane et al. v. Commissioner*, T.C. Memo. 1987-151, *87 TNT 54-41* (1987), in which a lump sum (which probably included some economic increment of interest but decried that characterization) was held wholly excludable under section 104. The dramatic difference in result between those cases should escape no one.

Although the IRS and the courts are quick to point out that language in settlement agreements is not binding on the IRS or the courts, and likewise, that even judicial determinations are not binding for tax purposes, the language of a settlement agreement will very frequently be respected. In *McShane*, the taxpayer was entitled to the verdict plus prejudgment interest under state law. The case was noticed for appeal, but before appellate briefs were filed, the case settled for more than the jury verdict, but less than the verdict plus the statutory prejudgment interest that presumably would have been awarded in a successful appeal. That compromise amount, according to the settlement agreement between the parties, was a liquidated lump sum and included no costs or interest.

The judge in *McShane* considered the settlement agreement (which was clear in its 100 percent personal injury characterization), as well as the plaintiff and defendant's records, for how they arrived at the figure. Despite an internal defense memorandum that suggested interest had been taken into account in arriving at the settlement figure, the Tax Court found the entire recovery to be excludable, with no amount constituting interest. The court was strongly influenced by the insistence of the various attorneys involved that the settlement agreement be clear in its tax language, negating any costs or interest.

Unfortunately, the court was also moved by the fact that the taxpayer, his attorneys, and the defense attorneys all testified that the tax considerations of the settlement were never considered in negotiations. Why that should matter to the court is beyond me, because other cases have held that good faith bargaining at arm's length between adverse parties over the tax consequences of a settlement actually *strengthens* the nature of the tax allocation.

One of the most significant cases on this point (regarding the scope of section 104 allocations) is *McKay v. Commissioner*, 102 T.C. 465, *Doc 94-3399*, *94 TNT 60-9* (1994), *vacated on other grounds* 84 F.3d, *Doc 96-13888, 96 TNT 92-7* (5th Cir. 1996). The Tax Court's opinion in *McKay* notes that the express language of a settlement agreement is *the most important factor* in determining whether a payment is excludable under section 104. The court caveats that express allocations in a settlement agreement must be negotiated at arm's length between adverse parties in order to be respected by the courts. The court distinguishes another notable case, *Robinson v. Commissioner*, 102 T.C. 116, *Doc 94-1439*, *94 TNT 23-18* (1994), *aff'd in part* 70 F.3d 34, *Doc 95-10932*, *95 TNT 238-7* (5th Cir. 1995), *cert. denied* 117 S.Ct. 83 (U.S. 1996). McKay's settlement was the result of truly hostile and adversarial negotiations, while Robinson was essentially allowed to structure the settlement any way he wanted. In *Robinson*, a settlement agreement expressly allocated 5 percent to taxable items and 95 percent to a section 104 exclusion. The court went behind this allocation, found there to have been no *bona fide* adversarial negotiations, and did its own allocation resulting in 37.33 percent being excludable.

I'm not sure interest should be treated differently, particularly where there are attorney fees to argue over, as well as the uncertainty of appeal (and even cross-appeals). Although some of the reasoning of *McShane* may be puzzling, on the whole it is a thoughtful and appropriate opinion, one that reflects the realities of negotiating settlements. For every *McShane* fact pattern, I believe there are dozens (perhaps even hundreds) of cases in which taxpayers settle cases arguably involving some "interest" element, yet who nevertheless successfully escape the interest taint. I believe the same holds true for the counterpart to interest, punitive damages.

Indeed, cases like *O'Gilvie*, 519 U.S. 79, *Doc 96-31894, 96 TNT 240-1* (1996), in which punitive damages are actually paid as such after the conclusion of a case or an appeal, rather than compromised in a settlement, are few and far between. The lion's share of punitive damage tax issues arise in compromises, where murky characterization questions abound. Frequently, all parties desire (probably for a mix of tax and nontax reasons) to avoid punitive damage characterization. There is nothing inappropriate in this.

Despite the *Brabson* court's notation that structured settlements suggest that interest might be excludable in some circumstances, it seems likely that being careful in the settlement agreement and having supporting evidence regarding the settlement negotiations (on tax and nontax matters) will carry the day in many cases. The Rabys suggest that there may be invitations to manufacture supporting evidence in the form of self-serving language in a settlement agreement, and that the circumstances need careful handling. I agree with the Rabys that those issues raise ethical concerns.

> ***Although the reference in McShane to tax-driven settlement language may be troublesome, the weight of authority suggests that there is nothing wrong with considering tax issues and bargaining over them to arrive at settlement language.***

However, the Rabys suggest that: "When the tax practitioner gets involved early in the settlement process, paradoxically that very involvement might later be used against the taxpayer as evidence that tax considerations were a part of the lump-sum settlement language finally agreed to." (*Tax Notes*, Mar. 7, 2005, p. 1170.) I find the risks of proceeding without tax advice far greater than proceeding with it. Although the reference in the *McShane* case to tax-driven settlement language may be troublesome, the weight of authority suggests that there is nothing wrong with considering tax issues and bargaining over them to arrive at settlement language.

In fact, I don't find interest characterization cases to be at odds with the bulk of other authorities dealing with the degree to which settlement language will be respected by the IRS and the courts. Indeed, I would hate to think that taxpayers may conclude that they have a better chance of avoiding interest characterization by *not* thinking about tax issues and by inserting a simple "there is no interest" provision in the settlement agreement, which is what the Rabys seem to suggest.

Finally, I recognize that the facts in each case require analysis, and that some cases require tax return disclosure and that some do not. For many cases, however, I do not believe that excluding an interest element in a "no-interest" lump-sum settlement will require a full return disclosure on Form 8275 as the Rabys state. While I recognize that the Rabys and I are both talking in generalities rather than with reference to particular fact patterns, I disagree that a Form 8275 would generally be necessary in such a case. In fact, I also disagree with the last sentence of the Rabys' article, in which they state that unless the facts are quite close to *McShane*, *despite* the filing of an 8275, it is unlikely there would be a reasonable basis for the taxpayer to avoid the accuracy-related penalty.

Very truly yours,

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March 15, 2005