Tax Treatment of Settlements And Judgments

By Robert W. Wood

I’ve been sleepwalking, and my lips hurt. To figure this one out (is he nuts, or does he think he is playing “Clue”?), you’ll have to read this column. Hey, at least it’s not in Aramaic. This time out, I want to hit five topics.

I will begin with a look at recent developments in the tax treatment of settlements and judgments by noting the Supreme Court’s recent decision to grant certiorari in two attorney fee cases.

I will then turn to a discussion of consistency in reporting clauses. As Tax Notes readers are likely aware, those clauses are frequently used to attempt to ensure that parties to a settlement agreement report the settlement payments to the IRS (and state taxing authorities) in an identical manner. A recent case, Polone v. Commissioner, provides guidance as to how the IRS might attack consistency in reporting clauses.

Next, I have to comment on Oyelola v. Commissioner, in which the Tax Court found that amounts received for emotional distress in a racial discrimination case when there is no physical injury are fully taxable.

Fourth, I’ll turn to Tamberella v. Commissioner, in which the Tax Court found that amounts received in employment litigation when there is no physical injury are fully taxable.

Last, my current infatuation on the deduction side lies with Chief Industries v. Commissioner. You will see why I am smitten with this one, in which the Tax Court found that settlement payments made to a company founder are deductible, even though they were paid concurrently with redemption payments. (Quite slick, huh?)

Certiorari Granted in Banks and Banaitis


The majority has held that contingent attorney fees are gross income to both the attorney and the plaintiff. See Alexander v. Commissioner, 72 F.3d 938, Doc 96-602, 96 TNT 1-74 (1st Cir. 1995); Raymond v. United States,
I hope I am wrong about my prediction in nontaxable. I was also wrong about
(1995), would find age discrimination recoveries to be
taxable to both the plaintiff and the attorney. Sheepish-
majority and hold that contingent attorney fees are
has finally decided to resolve this issue. One thing is
(by amending section 104) and the Supreme Court
their seats until then. Who knows, maybe 2005 will

It will likely be quite a long while before the Court’s decisions in Banks and Banaitis are handed down. Some tax practitioners (and clients) will be on the edge of their seats until then. Who knows, maybe 2005 will turn out to be like 1996, in at least one sense.

In 1996, within a matter of months, both Congress (by amending section 104) and the Supreme Court (through its decision in O’Givie v. United States, 519 U.S. 79, Doc 96-31894, 96 TNT 240-1 (1996)) recognized that punitive damages constitute taxable income. Perhaps Congress will decide to provide us with a legislative solution while we are waiting for the Court’s decisions in Banks and Banaitis.

Consistency in Tax Reporting Clauses

Consistency in tax reporting clauses is part of just about every settlement agreement. The basic idea behind them is to get everybody involved in the settlement to report it to the IRS in an identical manner. From time to time, most of us have been involved in a settlement in which the parties fail to follow through. That can dramatically increase audit risk. Few things get the IRS moving more quickly than inconsistent reporting.

There are various ways to encourage a defendant to report a settlement in a specific way — which should be consistent with the settlement agreement. The most effective way to achieve that result is to include a consistency in tax reporting clauses in the settlement documents. Those clauses essentially require the parties to report the settlement consistently to the IRS (and other taxing authorities). If you are a plaintiff, the last thing you want is the defendant issuing you a Form 1099 or W-2 you were not expecting.

Frequently, settlement documents will also contain some type of tax indemnity clause that essentially punishes the breaching party for prohibited conduct. The basic idea is that if the other side costs you extra money in taxes by engaging in prohibited conduct, it will cover the extra amount (plus interest and penalties, and perhaps attorney fees). That may make the other side think twice before breaching the consistency in tax reporting provision, though it may not prevent inconsistent reporting.

It may be that a provision like that sometimes is not even enforceable. I use the word “may” since I think that is a debatable point. It appears improbable that a court would make a defendant cover the extra amount of taxes that a plaintiff incurred because the defendant attempted to comply with the tax laws. Even so, most of the tax indemnity clauses are simply never enforced, so their enforceability is never tested. Indeed, only once in my 25 years of practice as a tax lawyer have I seen a tax indemnity clause (in a settlement context) enforced. Hence, I’ve never worried too much about this topic.

If the IRS discovers that you employed a consistency in tax reporting provision, I suppose it could assert that the settlement was motivated purely (or partly) by tax considerations. The IRS could conceivably increase its level of scrutiny of the settlement documents because of the provision, although I believe that is unlikely.

In any case, the Tax Court recently addressed some of those issues in Polone v. Commissioner, T.C. Memo. 2003-339, Doc 2003-26585, 2003 TNT 242-8. In that case, Polone, a hotshot talent agent for Hollywood celebrities, was fired by his talent agency. To ice it off, the talent agency allegedly leaked the news of Polone’s termination to the press. Not surprisingly, the leak resulted in a field day for the press. Polone was not pleased by the turn of events. He promptly filed suit against his former employer. The parties settled the matter for $6 million, of which $4 million was related to a defamation claim and $2 million was related to a
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breach of contract claim. As you might guess, the settlement agreement contained a consistency-in-tax-reporting clause.

Under the pre-1996 incarnation of section 104(a)(2), claimants were generally allowed to exclude tort recoveries from gross income to the extent they were received on account of personal injuries (such as defamation), but even then claimants were still taxable on contract recoveries.

The IRS contended that, because the settlement documents contained a consistency-in-tax-reporting clause and a tax indemnity provision, the negotiations between the parties were not at arm’s length. Accordingly, the IRS attempted to reallocate the taxable and nontaxable portions of Polone’s settlement. The Tax Court sided with the taxpayer. It found that the provisions did not alter or impede the arm’s-length nature of the negotiations between the parties. Hence, it respected the allocations of the parties contained in the settlement documents. (For a hot tip on this point, see the last few paragraphs of this column.)

Ultimately, the express language of a settlement agreement is vitally important to any later disagreement with the IRS. See McKay v. Commissioner, 102 T.C. 465, Doc 94-3399, 94 TNT 60-9 (1994), vacated and remanded on other grounds 84 F.3d 433, 465, 96 TNT 92-7 (5th Cir. 1996). Ergo, the next time you go to sign settlement documents, you might want to take a long, hard look at the consistency-in-tax-reporting and tax indemnity provisions. As Alfred E. Newman says, “What, me worry?”

Damages for Just Emotional Held Taxable


Shortly thereafter, Connecticut Mutual Life Insurance Co. and Massachusetts Mutual Life Insurance Co. merged. Oyelola continued working for the surviving entity, Massachusetts Mutual Life Insurance Co. In 1998 Oyelola sued Mass. Mutual under Title VII for alleged discrimination based on race, color, ancestry, and national origin. The suit was settled a few months later.

The settlement agreement stated that it was intended “to resolve any and all differences that may now exist, or may arise in the future as a result of any act that has heretofore occurred, under state or federal law regarding employment with and separation from the Company.” The settlement agreement also provided that Mass. Mutual would pay Oyelola, among other amounts, $30,000 for emotional distress and $90,000 as compensation for lost wages.

On his 1998 tax return, Oyelola did not report the $30,000 emotional distress recovery. In 2002 the IRS expressed its dissatisfaction with Oyelola’s failure to report that amount as gross income by issuing a notice of deficiency. The matter ended up before the Tax Court, which dismissed Oyelola’s claim that the amount he received for emotional distress was excludable under section 104(a)(2). Citing Commissioner v. Glenshaw Glass, 348 U.S. 426, 429-431 (1955), the Tax Court noted that section 61 provides that gross income is income from whatever source derived (unless specifically excepted).

Oyelola alleged that as a result of the racial discrimination, he suffered severe emotional distress, which caused him to sleepwalk into a wall and sustain injury to his lips (that would have sounded more ludicrous had not Barry Manilow recently claimed to have broken his nose in the same manner). The Tax Court attempted to ascertain the validity of Oyelola’s claim by applying the Schleier test. Schleier requires that for a recovery to be excludable under section 104(a)(2) it must be based on tort or tort-type rights and the damages must be received “on account of personal injuries or sickness.” Citing Venable v. Commissioner, T.C. Memo. 2003-240, Doc 2003-18653, 2003 TNT 157-5, the Tax Court noted that the Schleier test has since been extended to apply to the post-1996 incarnation of section 104, with the corresponding second prong now requiring proof that the personal injuries or sickness for which the damages were received were physical personal injuries or physical sickness.

While the Tax Court found that Oyelola satisfied the first prong of Schleier, Oyelola was not as successful in convincing the court that he also satisfied its second prong. Oyelola contended that despite the clear language of the settlement agreement that the $30,000 had been received for emotional distress, it was actually received on account of physical injury (the injury to his lips). The Tax Court was not persuaded by that argument. It noted that the ongoing racial discrimination, not the alleged physical injury to Oyelola’s lips, was the primary source of Oyelola’s emotional distress. Accordingly, the $30,000 that was paid for emotional distress was found to be taxable.

Absent Physical Injury, Recovery Is Taxable

In Tamberella v. Commissioner, T.C. Memo. 2004-47, Doc 2004-4540, 2004 TNT 43-12, the Tax Court found that an amount received in an employment recovery was not excludable under section 104(a)(2) when it was not paid on account of personal physical injuries.

From 1994-1996 Tamberella worked as a bus contractor for ATC-Vacom. Sometime in 1996 Tamberella invited his boss to come live with him, his live-in girlfriend, and her two kids. After about two months, Tamberella’s boss left Tamberella’s home, along with Tamberella’s former live-in girlfriend and her children. Needless to say, Tamberella was not happy with that turn of events.

Shortly thereafter, Tamberella was diagnosed with high blood pressure and mental illness. Tamberella was terminated from his employment with ATC-Vacom in 1996 and filed suit alleging negligence, breach of contract, breach of public policy, and wrongful discharge. The case was submitted to nonbinding arbitration and in 1997 Tamberella and ATC-Vacom entered into a settlement agreement.
Under the settlement agreement, Tamberella was paid roughly $25,000 in back wages and about $89,000 in settlement of his various claims against ATC-Vacom. While nobody, not even Tamberella, contested the taxability of the $25,000 payment for back wages, there was a clear difference of opinion as to how the $89,000 payment should be treated for tax purposes. The settlement agreement went as far as to state that ATC-Vacom would report that payment on Form 1099 and that some or all of it might be taxable.

Not surprisingly, ATC-Vacom reported the entire amount on Form 1099-MISC as nonemployee compensation. Tamberella did not report any portion of that amount on his 1997 tax return. When questioned about his rationale for that exclusion, Tamberella asserted that the amount was excludable from his gross income because it constituted proceeds from a lawsuit settlement received from a former employer for medical conditions of a permanent and debilitating nature.

The Tax Court, citing United States v. Burke, supra, noted that the nature of the claim underlying the settlement payment is the focus for determining whether damages are excludable under section 104(a)(2). The Tax Court then attempted to ascertain the validity of Tamberella’s claim by applying the Schleier test. Of course, Schleier requires that for a recovery to be excludable under section 104(a)(2) it must be based on tort or tort-type rights and the damages must be received “on account of personal injuries or sickness.” Citing Prasil v. Commissioner, T.C. Memo. 2003-100, Doc 2003-9085, 2003 TNT 69-39, the Tax Court noted that the Schleier test has since been extended to apply to the post-1996 incarnation of section 104, with the corresponding second prong now requiring proof that the personal injuries or sickness for which the damages were received were physical personal injuries or physical sickness.

The Tax Court found that some of Tamberella’s claims may satisfy the first prong of the Schleier test. However, Tamberella was not as successful in convincing the court that he also satisfied the second prong of Schleier. The Tax Court found that a review of the settlement agreement could not support Tamberella’s contention that the amount was paid on account of personal physical injuries.

As a matter of fact, there was no evidence to support that claim other than Tamberella’s own testimony that he “was physically injured” by ATC-Vacom. The Tax Court was not persuaded by his testimony and cited Shea v. Commissioner, 112 T.C. 183 (1999), and Tokarski v. Commissioner, 87 T.C. 74 (1986), as not requiring it to accept a taxpayer’s “self-serving, unverified, and undocumented testimony.” Because Tamberella failed to prove that any portion of the roughly $89,000 had been recovered on account of personal physical injuries, the Tax Court found the entire amount to be taxable.

Settlement Payment to Co. Founder Is Deductible

Now, here is my favorite of this column. In Chief Industries v. Commissioner, T.C. Memo. 2004-45, Doc 2004-4436, 2004 TNT 42-11, a corporation was permitted to deduct settlement payments it made to its founder to cancel his employment agreement and quash future attacks on the business. The deduction was permitted even though the amounts were authorized by a settlement agreement that also included a substantial payment to redeem the founder’s stock.

Eihusen founded Chief Industries in 1954. In 1987 Eihusen voluntarily stepped down as Chief’s president, and his son took over as president. Even so, Eihusen stayed on as Chief’s CEO and a member of its board of directors. In 1993 Eihusen and Chief Industries inked an employment deal that named Eihusen chairman of the board emeritus.

In 1995, without Eihusen’s knowledge or consent, Chief Industries agreed to acquire another company. When Eihusen learned of the planned acquisition, he was furious. Eihusen sued the members of the board for breach of fiduciary duty. Eihusen went as far as to ask the court to nullify the acquisition agreement.

In 1996 Eihusen and Chief Industries settled the lawsuit. In the settlement agreement, Chief Industries (and Eihusen’s son) agreed to purchase all of Eihusen’s stock for roughly $37 million. The settlement agreement also provided that Chief Industries would pay Eihusen roughly $3 million to settle other claims Eihusen had against Chief and to terminate Eihusen’s employment contract. Predictably, Chief Industries deducted the roughly $3 million payment as a section 162(a) business expense.

The IRS did not agree with Chief’s characterization of the $3 million payment. The IRS asserted that the payment had been made in connection with the reacquisition of stock and that its deduction was therefore barred by section 162(k)(1). The Tax Court found for Chief Industries. It held that the entire $3 million payment was paid to cancel Eihusen’s employment agreement and to defend against further attacks on the business, both of which constituted ordinary and necessary business expenses for purposes of section 162(a).

Ultimately, the Tax Court dismissed the Service’s claim that the $3 million payment had been made in connection with the reacquisition of Eihusen’s stock and was therefore nondeductible under section 162(k)(1). The Tax Court held that the payment of $37 million and $3 million amounts at the same time, and by way of the same settlement instrument, did not conclusively establish that the $3 million was paid as part of the redemption. Accordingly, the Tax Court found the $3 million payment to be deductible under section 162(a) and not barred by section 162(k)(1). You see, reasonable expense allocations — something I’ve long preached about on street corners and in dingy Left Coast coffee houses — truly can work.