

IRS Targets Lawsuit Recoveries for Audit

By Robert W. Wood



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<http://www.taxinstitute.com>. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Wood discusses the IRS release of a new version of its Audit Guide for Lawsuits, Awards and Settlements for 2011. The guide suggests that auditors will give increasing scrutiny to the wage versus non-wage distinction in employment cases. More generally, it portends even closer examination of settlement agreements and the background that produced them and new attention to the deductibility of attorney fees.

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A considerable portion of my tax practice involves counseling litigants. Perhaps for that reason, I have a myopic perspective on litigation. When you see lawsuits day in and day out that settle, many for large dollar amounts and large tax issues, you tend to believe that the tax issues are of vast significance. Tax advisers are understandably myopic about taxes.

In legal settlements, this myopia is justified. A \$1 million tax-free settlement is vastly better than one eaten up by hundreds of thousands of dollars in taxes. Similarly, even when it is clear that a settlement is taxable, the difference between capital and ordinary rates can be significant. Even something as seemingly innocuous as legal fees can have a huge financial impact. For tax purposes, legal fees and costs cannot always be taken "off the top" but must be deducted in ways that are not intuitive.

When plaintiffs begin to prepare their returns in the year following their settlement, many learn that they must pay tax (alternative minimum tax at least) on the contingent legal fees paid to their lawyer. In most cases, the plaintiffs never saw their lawyer's share of the recovery.

Just as I regularly see that tax issues matter in litigation and its resolution, so does the IRS. The IRS has long tried to address this subject in audits, and it has a history of taking cases to court. In one recent year, the Tax Court docket was literally clogged with cases involving section 104, the personal physical injury exclusion.

National Taxpayer Advocate Nina Olson lamented this in her 2010 annual report to Congress.¹ Although it is true that Tax Court petitions are filed by taxpayers and not by the IRS, the IRS issues notices of deficiency. Both the IRS and taxpayers can be faulted for taking intransigent positions concerning section 104. As Olson noted, the law regarding section 104 exclusions is in a state of disarray. Disputes are rampant and very inefficient for everyone.

Formal guidance to IRS auditors on what to look for when auditing lawsuit recoveries is not new. The IRS issued its first guidebook for IRS auditors on this topic in 2001, the 2001 Market Segment Specialization Program Audit Guide for Lawsuit Awards and Settlements.² At the time, the country enjoyed a better economy and a considerably smaller budget deficit.

The IRS has now revamped, revised, and reissued its *Lawsuits, Awards, and Settlements, Audit Technique Guide* (herein 2011 Audit Guide).³ Some of the revisions are predictable. For example, the 2001 audit guide tiptoed through the attorney lien

¹See "National Taxpayer Advocate 2010 Annual Report to Congress" (Dec. 31, 2010), at 469, *Doc 2011-220, 2011 TNT 4-23*.

The question of when damage awards can be excluded from taxable income continues to confuse taxpayers. Even when taxpayers seek legal advice before filing a complaint for damages or accepting settlement proceeds, they might not understand how to characterize the damages in the complaint to make them excludable under section 104(a)(2), and might be confused about the proper tax treatment of the proceeds.

²*Doc 2001-2574, 2001 TNT 18-6*.

³*Doc 2011-22273, 2011 TNT 205-68*.

laws that were so hotly debated in the run-up to the Supreme Court's 2005 *Banks*⁴ decision.

In 2001 the IRS had to acknowledge that in some states, attorney lien laws had been held strong enough to import ownership of the fees to the lawyer alone, thus obviating the AMT. Post-*Banks*, however, it is a different story. The tax treatment of attorney fees might not be exactly settled, but most taxpayers seem resigned to their fate.

In an employment, civil rights, or Federal False Claims Act case, plaintiffs receive an above-the-line deduction for their fees.⁵ If the case is a trade or business dispute, the taxpayer — any kind of taxpayer — receives a full business expense deduction.⁶ But in between (including a huge amount of litigation involving investors), the legal fees are usually deductible only as miscellaneous itemized expenses. As a result, the 2001 and 2011 audit guides differ in their coverage of the attorney fee issue.

Individual Scope

The 2011 Audit Guide limits its scope to individuals, noting in the first passage that because a business entity cannot suffer a personal injury within the meaning of section 104(a)(2),⁷ this guide applies to recoveries by individuals only.⁸

Audit List

The IRS tells auditors to make the following determinations when reviewing lawsuit verdicts and settlements:

1. Determine if any taxable lawsuit, award, or settlement proceeds are unreported.
2. Determine if the compensatory and punitive allocation was proper. Many cases are settled to avoid the imposition of punitive damages, and some taxpayers erroneously allocate amounts to excludable damages. The allocation may also have an impact on the deductibility of attorney fees and court costs.
3. Determine if any of the lawsuit, award, or settlement proceeds are punitive damages. Punitive damages are taxable even for a physical injury or sickness.

⁴543 U.S. 426 (2005), *Doc 2005-1418, 2005 TNT 15-10* (in which the Court held that when a taxpayer's recovery from a money judgment or settlement constitutes income, the portion paid to his attorney under a contingent fee arrangement is included in the taxpayer's taxable income).

⁵See section 62(a)(20) and (e).

⁶See section 162.

⁷*P & X Markets Inc. v. Commissioner*, 106 T.C. 441 (1996), *Doc 96-17544, 96 TNT 117-7, aff'd in unpublished order*, 139 F.3d 907 (9th Cir. 1988).

⁸2011 Audit Guide, *supra* note 3, at 4.

4. Determine if any of the settlement proceeds constitutes interest, and whether the interest is reported as income.

5. Verify that amounts excluded from income were received in a case of physical injury or physical sickness. Damages for emotional distress on account of physical injuries or sickness are excludable. However, costs incurred to treat emotional distress, even those due to physical injury, are taxable if they were previously deducted as a medical expense in a prior year.

7. Verify the amount of out-of-pocket expense excluded for emotional distress in non-physical-injury cases (for example, discrimination, fraud, etc.). Damages for emotional distress in these cases are only excluded to the extent of paid medical expenses.

8. Verify that the taxpayer reported taxable amounts at gross rather than reporting them net of legal and other fees paid.

9. Determine if allowable legal fees were deducted properly. They should be deducted on Schedule A as miscellaneous itemized deductions, unless the origin of the claim litigated is related to a Schedule C or a capital transaction.

10. For above-the-line legal fee deductions, verify they were post-October 23, 2004, for employment suits or post-December 20, 2006, in whistleblower cases. In both instances, verify total deductions have been limited to the amount includable in the taxpayer's gross income on account of the underlying discrimination suit or whistleblower award.

11. Verify that for a non-corporate taxpayer, legal fees deducted as a Schedule A miscellaneous itemized deduction are not allowed for purposes of computing the AMT.

12. Verify that for purposes of the AMT credit, legal fees that are disallowed for purposes of calculating the AMT do not contribute to the amount of the credit. They are "exclusion" items.⁹

Compensatory vs. Punitive Damages

According to the IRS, most people view "compensatory" as a synonym for "nontaxable."¹⁰ However, compensatory merely connotes loss. The "tort" label is similarly deceptive, because not all torts involve personal injuries, let alone physical

⁹*Id.* at 5.

¹⁰*Id.* at 8.

ones. Some torts involve property rights, conversion, interference with economic interests, tortious interference with contractual relations, purely personal interests, or defamation.

The IRS notes that damages from contractual claims can be taxable, such as those paid for lost wages and benefits, profits, and other forms of business receipts. The facts and circumstances of each lawsuit settlement must be considered to determine the purpose for which the money was received. A key question is: "In lieu of what were the damages awarded?"

The IRS says that determining the correct allocation is usually the most difficult part of an examination.¹¹ Claims can be resolved by verdict or by settlement. If damages have been clearly allocated to an identifiable claim in an adversarial proceeding by judge or jury, the Service will usually not challenge it. The 2011 Audit Guide notes the impartial and objective nature of the determinations in that setting.

However, even if a judge hands down a decision, the IRS tells its auditors to watch closely to see its decision is merely a ratification of a settlement entered into by the parties.¹² This indicates that settlement agreements between private parties deserve even greater IRS scrutiny. When damages are received under a settlement agreement, the 2011 Audit Guide says auditors must determine the claim that was the *actual basis* for settlement, for that will control whether the damages are excludable.

The IRS wants these settlement agreements to be closely reviewed and the underlying facts and circumstances to be carefully examined. Allocations can be challenged when the facts and circumstances indicate the allocation does not reflect the economic substance of the settlement. For example, the 2011 Audit Guide notes that in *LeFleur v. Commissioner*¹³ the Service disregarded the terms of the written settlement agreement and reallocated the previously excluded \$800,000 to income.¹⁴ The Tax Court upheld the IRS's reallocation and referring to the

settlement agreement stated, "the allocation did not accurately reflect the realities of the petitioner's underlying claims."¹⁵

Physical Injuries or Sickness

I had hoped that the 2011 Audit Guide would take on more of the "what is physical?" question. Unfortunately, it does not, and perhaps that would be a Herculean task given that the regulations still haven't addressed the question. The 2011 Audit Guide does recite the usual references to the 1996 addition of the "physical" requirement.¹⁶

Yet the Service still focuses a great deal on the "on account of" language. The IRS illustrates the meaning of "on account of personal injuries":

A taxpayer is injured in an automobile accident and as a result suffers (a) medical expenses, (b) lost wages, and (c) pain, suffering, and emotional distress that cannot be measured with precision. If the taxpayer settles a resulting lawsuit for \$30,000 (and if the taxpayer has not previously deducted her medical expenses, see section 104(a)), the entire \$30,000 would be excludable under section 104(a)(2). The medical expenses for injuries arising out of the accident clearly constitute damages received "on account of personal injuries." Similarly, the portion of the settlement intended to compensate for pain and suffering constitutes damages "on account of personal injury." Finally, the recovery for lost wages is also excludable as being "on account of personal injuries," as long as the lost wages resulted from time in which the taxpayer was out of work as a result of her injuries.¹⁷

Of course, the IRS refers to emotional distress as not itself being enough, and almost alludes to the chicken or egg nature of many of these cases. In a footnote to the 1996 conference committee report, the IRS stated that emotional distress includes physical symptoms, such as insomnia, headaches, and stomach disorders, that may result from that emotional distress.¹⁸

Although the IRS refers to a few cases on this nettlesome line, it says little. It notes that in *Emerson v. Commissioner*,¹⁹ the Tax Court found that a tort

¹¹*Id.* at 9.

¹²See *Robinson v. Commissioner*, 102 T.C. 116, 122 (1994), *aff'd in part and remanded*, 70 F.3d 34 (5th Cir. 1995), *Doc 95-10932*, 95 TNT 238-7; *Kightlinger v. Commissioner*, T.C. Memo. 1998-357, *Doc 98-29823*, 98 TNT 193-9.

¹³T.C. Memo. 1997-312, *Doc 97-19780*, 97 TNT 130-11.

¹⁴For a more recent case involving disregard for terms of the settlement agreement, see Robert W. Wood, "Who Said Settlement Agreement Tax Language Was Binding?" *Tax Notes*, Nov. 21, 2011, p. 1031, *Doc 2011-21999*, or 2011 TNT 224-11.

¹⁵*LeFleur*, T.C. Memo. 1997-312, at 9.

¹⁶2011 Audit Guide, *supra* note 3, at 11.

¹⁷See, e.g., *Threlkeld v. Commissioner*, 87 T.C. 1294, 1300 (1986); see also 2011 Audit Guide, *supra* note 3, at 11-12.

¹⁸H.R. Conf. Rep. No. 104-737, at 301, n.56 (1996).

¹⁹T.C. Memo. 2003-82, *Doc 2003-7295*, 2033 TNT 55-7.

recovery for various claims, including emotional distress, was not excludable under section 104(a)(2) because the recovery was not received on account of personal physical injuries or physical sickness. Conversely, the audit manual does not discuss or even cite *Parkinson v. Commissioner*²⁰ or *Domeny v. Commissioner*.²¹

This seems significant because *Domeny* and *Parkinson* are two of the most important cases in the last few years to push back against the IRS notions that physical injuries must involve observable bodily harm and that it isn't really clear what physical sickness means.

Wrongful Death

The 2011 Audit Guide briefly covers wrongful death cases.²² It states that they usually involve compensatory damages for physical and mental injury, plus punitive damages for reckless, malicious, or reprehensible conduct. Compensatory amounts for personal physical injuries are excludable, but any punitive amounts are not.

Finally, in some rare cases, the 2011 Audit Guide notes it is possible via section 104(c) to have a state wrongful death statute award only punitive amounts that are then viewed as compensatory for tax purposes.²³ In that event, the 2011 Audit Guide says to contact the chief counsel for guidance.

Nonphysical Injuries or Sickness

After the 1996 amendment to section 104, of course, one must satisfy the "physical" requirement for exclusion beyond mere medical expenses. The 2011 Audit Guide states that one may exclude a reimbursement of amounts to treat emotional distress. But beyond that, one qualifies for exclusion under section 104(a)(2) only if the amount is received on account of physical injury or physical sickness.

Therefore, a taxpayer receiving lawsuit proceeds from a nonphysical injury claim cannot exclude any amount for payment to compensate for emotional distress value. That segues into coverage of employment claims, which surely must occupy a great deal of audit time.

²⁰T.C. Memo. 2010-142, *Doc 2010-14364*, 2010 TNT 124-12.

²¹T.C. Memo. 2010-9, *Doc 2010-787*, 2010 TNT 9-9. For more extensive discussion of *Domeny* and *Parkinson*, see Wood, "Tax-Free Physical Sickness Recoveries in 2010 and Beyond," *Tax Notes*, Aug. 23, 2010, p. 883, *Doc 2010-16739*, or 2010 TNT 165-7; see also Wood, "Is Physical Sickness the Next Emotional Distress?" *Tax Notes*, Feb. 22, 2010, p. 977, *Doc 2010-2454*, or 2010 TNT 37-11.

²²2011 Audit Guide, *supra* note 3, at 13.

²³See Wood, "Tax-Free Wrongful Death Punitive Damages?" *Tax Notes*, Dec. 13, 2010, p. 1257, *Doc 2010-24065*, or 2010 TNT 241-7.

Employment-Related

Employment-related lawsuits may arise from wrongful discharge or failure to honor contract obligations. The 2011 Audit Guide makes the obvious point that damages received to compensate for economic loss, lost wages, business income, and benefits are not excludable.²⁴ The taxpayer can exclude under section 104(a)(2) only an amount of damages for actual out-of-pocket medical costs paid to treat any emotional distress if those medical costs had not been deducted on his tax return.²⁵ Once again, the 2011 Audit Guide fails to acknowledge *Parkinson* or *Domeny*.

Other Nonphysical Personal Injury

The 2011 Audit Guide notes that lawsuits against insurance companies or finance companies for negligence, fraud, breach of contract, etc. can produce various types of settlements.²⁶ Because these are nonphysical injuries, under section 104(a)(2), only compensation for out-of-pocket amounts for medical costs incurred to treat any emotional distress claims would be excludable from income if not previously deducted.²⁷ All punitive damages, of course, are taxable.

Employment Tax Issues

The 2011 Audit Guide spends considerable time on the importance of employment taxes.²⁸ This part of the 2011 Audit Guide arguably can be read as a "we're ramping up" manifesto. Employment litigation lawyers — many of whom seem to think they can simply obviate wage payments and "get it all on a Form 1099" — should read this.

The IRS notes, of course, that if damages are excludable from gross income, they are not subject to employment taxes. Yet if an employer pays back pay for services, the payments are wages for employment tax purposes.²⁹ According to the 2011 Audit Guide, back pay received in settlement under a workers' rights statute or civil rights statute for a period during which no services were performed *is also* considered wages for federal employment tax purposes.³⁰

The IRS's position is that "front pay" — pay awarded to the employee for future services (generally service from the date of the settlement going forward) that the employee would have performed but for the illegal actions of the employer — also

²⁴2011 Audit Guide, *supra* note 3, at 15.

²⁵See sections 111 and 213.

²⁶2011 Audit Guide, *supra* note 3, at 17.

²⁷See sections 111 and 213.

²⁸2011 Audit Guide, *supra* note 3, at 18 et seq.

²⁹Rev. Rul. 96-65, 1996-2 C.B. 6, *Doc 97-327*, 97 TNT 1-24.

³⁰2011 Audit Guide, *supra* note 3, at 19.

constitutes wages for federal employment tax purposes. Some courts have disagreed with this position. The IRS's position is that settlements including cash payments made to employees in lieu of benefits under employer plans (for example, paid in lieu of health insurance or qualified pension plan benefits) are *also* wages for federal employment tax purposes.

In fairness, there was some foreshadowing of the importance of these wage issues. In July 2009, the IRS released a memorandum entitled "Income and Employment Tax Consequences and Proper Reporting of Employment-Related Judgments and Settlements."³¹ Although the memorandum had a more singular focus, it certainly suggested that the wage versus non-wage line would be given more scrutiny prospectively.³² The 2011 Audit Guide reiterates this point.

The Banks Issue: Gross Income on Legal Fees

The IRS must be very pleased to be able to revise its 2001 Audit Guide to streamline and simplify its discussion of attorney fees. After deleting all the nuances of state attorney fee lien laws that were obviated by the Supreme Court in *Banks*, the IRS can now simply state:

In all cases, including those involving contingent fee arrangements, the gross award/settlement, without diminution for attorneys' fees or costs, should be included in the taxpayer's income.³³

The 2011 Audit Guide notes that this inclusion in income results from applying the fruit-of-the-tree theory — that income is taxable to the person who earns it and cannot be assigned to someone else. After considerable litigation, the 2011 Audit Guide notes, the issue was finally settled in *Banks*.

Post-*Banks* plaintiffs therefore look for ways to deduct their attorney fees. Generally, the 2011 Audit Guide says, individuals may deduct attorney fees in the year paid, assuming they qualify as deductible. In the majority of cases, the attorney fees are paid under a contingent fee arrangement.

According to the 2011 Audit Guide, when the ultimate recovery is excludable from gross income, either in whole or in part, the contingent attorney fees allocable to exempt income are not deductible.³⁴ The timing and deductibility of attorney fees

paid before resolution of the lawsuit on a non-contingent-fee basis requires additional analysis that is not practical to provide in the 2011 Audit Guide. Auditors are directed to consult a technical adviser.

The 2011 Audit Guide spends some time on the different ways attorney fees could be deducted.³⁵ The most relevant possibilities are sections 62(a) (relating to the definition of adjusted gross income), 162 (relating to trade or business expenses), 212 (relating to expenses for production of income), 262 (relating to the non-deductibility of personal, living, and family expenses), and 263 (relating to capital expenditures). Generally, one must look to the underlying lawsuit to determine which section applies.

Except in rare cases, such as a compensatory recovery of self-employment income (for example, commissions that are reported on Schedule C) or recovery of capital gain income, legal fees will be a Schedule A miscellaneous itemized deduction, subject to the 2 percent floor and AMT.

Conclusions

My guess is that not very many taxpayers or advisers will read the new 2011 version of the IRS lawsuit audit guide. The overwhelming focus of the 2001 version of the guide was the attorney fee issue, which many advisers and taxpayers did read about at the time. The attorney fee issue may not be a dead letter, but *Banks* says what it says, so no one wants to hear about attorney lien laws and the split in the circuits.

However, there are several pieces of information revealed in the 2011 Audit Guide that are worth knowing. Here are the points I see as significant:

1. The IRS cares more than ever before about wages. Perhaps the practice of allocating virtually nothing to wages in employment suits has gotten to the IRS. I've long thought that the IRS should focus more on the wage versus non-wage allocation. If the 2011 Audit Guide is any indication, it appears to be doing so.

This will affect employment cases in which plaintiffs ask for little or no wage allocation and employers agree. Employers could face failure-to-withhold liability, and therefore should attempt to arrive at a real wage figure, not one that is vacuously low. Plaintiffs are ill-advised to insist on no wage allocation.

To a larger extent, however, the implicit admonitions in the 2011 Audit Guide should affect class action cases. The IRS firmly states its views that back pay and front pay are wages, period. It doesn't matter whether services were rendered.

³¹PMTA 2009-035, Doc 2009-15305, 2009 TNT 129-19. Although the program manager technical assistance was released in July 2009, it bears the date October 22, 2008.

³²For discussion, see Wood, "IRS Speaks Out on Employment Lawsuit Settlements," *Tax Notes*, Sept. 14, 2009, p. 1091, Doc 2009-18678, or 2009 TNT 175-4.

³³2011 Audit Guide, *supra* note 3, at 21.

³⁴Section 265(a)(1).

³⁵2011 Audit Guide, *supra* note 3, at 22 et seq.

2. Settlement agreements may be examined more closely. The IRS suggests that court orders are more deserving of respect, but it cautions that some court orders merely recite what the parties agreed in a settlement. The 2011 Audit Guide goes on to admonish auditors to look behind settlements to ensure that the claims that purport to be paid are really the ones being paid. Taxpayers and their advisers will need to do a more thorough job of documenting their claims and settlements. Tax opinions are probably going to become more common.

3. Attorney fee deductions are going to be more closely scrutinized. This was probably inevitable on the heels of the Service's victory in *Banks*, but it certainly is clear now. The IRS notes that you can't gerrymander your way into Schedule C to net your legal fees. And the 2011 Audit Guide lays out the various types of deductions that may apply.

I think it is safe to assume that regular taxpayers who are stuck claiming attorney fees as miscellaneous itemized deductions are likely to find that anything else they try to avoid those unfortunate

results could bring IRS scrutiny. However, one bright spot on the attorney fee front is that the Service does not devote much attention to the above-the-line deduction for employment, civil rights, and False Claims Act cases. Some people push the envelope there.

4. Finally, there's section 104. The IRS doesn't give auditors much information about this nettlesome section. The 2011 Audit Guide says that emotional distress isn't physical and that in most litigation, the only exclusion under section 104(a)(2) is likely to be for out-of-pocket medical expenses (which it does acknowledge could be for treating emotional distress).

Sadly, the section 104 issue will probably still occupy significant auditor time and disproportionately clog the Tax Court docket. And although the 2011 Audit Guide may not mention *Domeny* and *Parkinson*,³⁶ taxpayers surely will.

³⁶See *supra* text accompanying notes 20 and 21.