Tax Notes

Viewpoint

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INTEREST CHARACTERIZATION IN SETTLEMENT AGREEMENTS.

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There have been relatively few cases to explicitly consider the tax treatment of interest in the context of a litigation settlement. Few tax practitioners would argue that calling something "interest" in any context probably will make it taxable. Nonetheless, at the core of the structured settlement notion is the principle that receiving a stream of payments for tort damages will not make any portion of the payments taxable.

Stated differently, absent the doctrines of constructive receipt and economic benefit, a structured settlement may make it possible to effectively receive "interest" on a tax-free basis. However, in virtually any other situation, an interest element, certainly if explicitly so denominated, will be includable in income.

Although it may not be fair, prejudgment interest has not fared very well in the Tax Court and other federal courts. The recent case of Laurel A. Forest v. Commissioner, 75 AFTR2d Par. 97-310, Doc 97- 1138 (18 pages) (1st Cir., Dec. 18, 1996), is an interesting recent development dealing with statutory prejudgment interest. This decision arose out of Laurel Forest's injury, a back fracture sustained when she slipped and fell in her employer's walk-in refrigerator. Forest brought a products liability action against the manufacturer of the refrigerator. The jury returned a $2.6 million verdict, which yielded a $5 million judgment including prejudgment interest.

The trial court found that this verdict shocked the conscience, and ordered a new trial unless Forest agreed to a remittitur. Forest agreed to the remittitur and the trial court entered a $1.4 million judgment, plus $1.6 million of prejudgment interest. The manufacturer appealed and the parties ultimately settled for $2 million. The settlement agreement did not allocate the $2 million between damages and interest. However, the stipulations filed by the parties indicated that judgment was entered for $1.4 million plus interest and costs.

As a result of the settlement, in 1992, Forest received $1.3 million, with the remaining $700,000 being paid to her attorneys. Forest did not report any portion of the settlement on her 1992 return. The IRS determined that $600,000 of the settlement amount represented interest, hence not excludable under section 104. The Tax Court agreed.

On appeal to the First Circuit, the court acknowledged that the settlement agreement was ambiguous with respect to the interest in question. However, the court did not find the ambiguity sufficient to render the Tax Court's decision clearly erroneous. The court of appeals emphasized in its decision that the settlement had been negotiated under the shadow of a judgment that did include prejudgment interest. The court also noted that the stipulations specified that the settlement represented a $1.4 million judgment plus interest, and that the parties did not consider the tax consequences in their negotiations.

Not the First Case

A holding that prejudgment interest is taxable is nothing new, of course. In Kovacs v. Commissioner, 100 T.C. 124 (1993), aff'd 25 F.3d 1048, 94 TNT 126-16 (6th Cir. 1994), the court so held. Kovacs was a wrongful death case in which, despite a lump sum payment for wrongful death damages, the court determined that the interest portion of the award (which was awardable under Michigan law), simply did not constitute damages on account of personal injuries.

Other cases have made similar findings. See Aames v. Commissioner, 94 T.C. 189, 90 TNT 47-21 (1990) (involving a stated interest element that was held taxable on a personal injury award); Robert Pagliarulo, et ux. v. Commissioner, T.C. Memo. 1994-506, 94 TNT 201-11 [P. 1338] (1994) (a workers' compensation award, the interest element on which was held taxable); and James V. Crews, et ux. v. Commissioner, T.C. Memo. 1994-64, 94 TNT 36-10 (1994) (involving the reciprocal question whether attorneys' fees allocable to prejudgment interest were deductible by the payer).

In John Leonard Meyer v. Commissioner, T.C. Memo. 1994-536, 94 TNT 210-8 (1994), the Tax Court faced a situation where the taxpayer's daughter was disabled and entitled to nontaxable benefits. The taxpayer eventually received the nontaxable benefits for his daughter, plus interest for the delay. The IRS determined, and the Tax Court agreed, that the interest element was taxable.

While few would argue that prejudgment interest when specifically stated to be such should be treated any differently from any other interest, some of the case law has dealt with the characterization of an amount as interest despite such segregation. Occasionally, questions have even arisen as to who is taxable on the interest element. In Gerald Jarvis, et ux. v. Commissioner, 899 F.Supp. 320, 95-2 USTC par. 50,452, 76 AFTR2d par. 95-5277 (E.D. Mich. 1995), the court held that interest on a wrongful death action was taxable to the parents, rather than to their child's estate.

In Joseph J. Delaney, et ux. v. Commissioner, T.C. Memo. 1995- 378, 95 TNT 155-8 (1995), appeal docketed No. 95-2066 (1st Cir. Oct. 4, 1995), the Tax Court found that a portion of a settlement amount that was payable in connection with a tort action had to be allocated to prejudgment interest. The matter had gone to trial and settled on appeal. At trial, the plaintiff was awarded statutory prejudgment interest under state law. Consequently, the IRS prorated the amounts of the verdict to determine what portion of the settlement figure represented interest income.

The Tax Court agreed. Indeed, this area has become significant enough to the IRS that it even issued advice to its field representatives showing how to compute interest on a lump sum tort settlement. See Tax Notes, Nov. 21, 1994, p. 975.

Perhaps the most publicized case involving prejudgment interest is Brabson v. U.S., 73 F.3d 1040, Doc 96-3551 (19 pages) (10th Cir. 1996). Many savvy plaintiffs' lawyers know that in some cases interest can be added to an award. Savvy tax advisors know that calling something "interest" generally results in that amount being taxable, even though there might be an argument that the amount is not taxable if it is called something else. This commonsense maxim was underscored by the Tenth Circuit Court of Appeals in Brabson.

Brabson involved what was indisputably a tort claim. Mary Brabson and her children were awarded $2.9 million in a 1988 judgment. The case arose out of the explosion of the Brabsons' household due to a gas leak. The $2.9 million award included $370,723 of mandatory prejudgment interest. The Brabsons did not include this prejudgment interest in their 1988 tax return, treating it as excludable under section 104.

The IRS argued that this part was taxable. The Brabsons paid the tax deficiency and then sought a refund. The district court granted the refund request, ruling that because the Brabsons' underlying claim sounded in tort, and because the prejudgment interest was part of the compensatory damages, the interest also had to be regarded as tort damages. The district court relied on Kovacs v. Commissioner.

The Tenth Circuit Court of Appeals reversed the district court, noting that it was the first published case in which a court of appeals had to review the lower court decisions (including Kovacs) on this matter. The circuit court in Brabson viewed Kovacs as drawing a fine line between the concept of "damages" on the one hand and "interest" on the other. The circuit court in Brabson reviewed the district court's conclusion about how the state law (in this case, Colorado) applied to prejudgment interest.

Schleier Invoked

In a move that many tax lawyers viewed as foreboding, the Tenth Circuit in Brabson invoked the Supreme Court's Schleier decision, Commissioner v. Schleier, 115 S.Ct. 2159, 95 TNT 116-8 (June 14, 1995). Reciting the formula of Schleier, the court said that to exclude any recovery from income, the taxpayer must show: (1) that the underlying action was based on tort or tort-type rights; and (2) that the disputed amount represents damages received on account of personal injuries or sickness. The Tenth Circuit in Brabson acknowledged that the prejudgment interest awarded to the Brabson family did satisfy the first requirement (the underlying action was based on tort or tort-type rights). Then, the court looked to Colorado law to decide whether the second requirement was satisfied. Did this amount of prejudgment interest represent damages received "on account of" personal injuries?

Looking to Colorado law regarding awards of prejudgment interest, the Tenth Circuit quoted from Colorado decisions to the effect that prejudgment interest amounted to compensatory damages in personal injury cases that were awarded to compensate the plaintiff for the time value of the award that was eventually obtained. This kind of language would seem to go a long way toward the conclusion that prejudgment interest in a strictly tort case should go along with the tax-free character of the tort recovery. However, the IRS argued persuasively that interest to compensate one for the time value of money is simply not "damages" within the meaning of section

104.

Finding no guidance in the language of the statute or the regulations, the Tenth Circuit found it was not convinced by the Tax Court's approach to the language of the statute. The Tenth Circuit also found nothing in the legislative history to suggest that Congress had ever considered the tax treatment of prejudgment interest. The court pointed out that prejudgment interest at common law was rarely available, and never for personal injuries. The court then noted that the Colorado statutory definition of damages was contrary to the concept of damages for personal injuries. Consequently, the court refused to "broaden" the scope of the section 104 exclusion to cover prejudgment interest, even when received on an indisputably tort case.

In another foreboding comment, the court relied for its conclusion on the Supreme Court's Schleier opinion, **[P. 1339]** noting that "compensation for the lost time value of money is caused by the delay in attaining judgment." Thus, according to the Brabson court, Schleier supports a strict analysis of section 104 that requires one -- as a purely practical matter -- to evaluate just why the money was paid.

On its face, the Brabson decision establishes that at least in the Tenth Circuit, prejudgment interest in a strictly tort case is taxable. Arguably, it should be taxable only if it is expressly called "prejudgment interest." In a negotiated settlement, it may be possible to obtain an additional element of damages attributable to delay, but it would generally not be labeled with the pejorative prejudgment interest title. The Brabson case may be yet another reason why -- from a tax perspective at least -- a settlement is nearly always better than a judgment. See also Raby, "When Interest Is Not Interest," Tax Notes, Oct. 10, 1994, p. 229.

Conclusion

What may be the most disturbing element of all of this is that even before a trial, a settlement may be allocated by a court between what it divines to be the likely interest and the balance of the recovery. Laurel A. Forest does not go that far. Indeed, it suggests implicitly that a different result could apply to a settlement in which prejudgment interest is specifically negated in favor of an increased "real tort" recovery.

Tax Analysts Information

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