

Tax Notes

Letters to the Editor

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SHEPPARD ARTICLE INTERESTS THIS PRACTITIONER.

To the Editor:

[1] I read with interest Lee Sheppard's article "Interesting Aspects of Divorce Settlements" (Tax Notes, Dec. 8, 1997, p. 1092). I thought it interesting (pardon the pun) that in this Lee Sheppard article (unlike most), you actually are soliciting comments, at least to the relevant Internet discussion group. [Editor's note: Tax Notes welcomes comments on all articles within these pages, whether or not explicitly solicited.] Since I lead one of those discussion groups (on the taxation of damage awards, a subject that is at least marginally relevant to Lee Sheppard's current article), I would like to comment.

[2] As always, Lee Sheppard is a gifted writer, colorfully and provocatively covering subjects that interest (sorry) us all. However, she appears to have attempted to fire up your readership that section 1041 somehow should not contemplate the exclusion of interest characterization in divorce settlements. She characterizes the question of interest under section 1041 as "elective," a notion that Ms. Sheppard appears to dread.

[3] Isn't the question of interest already somewhat elective in the litigation arena, too? For example, consider section 104, where even after the 1996 Small Business Job Protection Act changes, a recovery for physical injury is excludable. However, label an element of a settlement or judgment as "interest," and surely the government will come calling.

[4] To take another example, if a physical injury plaintiff takes a lump sum award and invests it, the income or interest earned on the investment will be taxable. However, if the plaintiff insists on a structured settlement, with payments payable over many years, then the periodic payments will all be tax-free. All of us know that a portion of these payments effectively represents interest. Although interest rates may be low at the moment, in high interest rate times this phenomenon can be quite dramatic.

[5] The case law has already considered the tax treatment of interest in many of these contexts. *Kovacs v. Commissioner*, 100 T.C. 124 (1993), *aff'd* in unpub. opinion, 25 F.3d 1048 (6th Cir. 1994), held that the interest portion of a lump sum payment for wrongful death damages was not excludable under section 104. Then, in *Laurel A. Forest v. Commissioner*, T.C. Memo. 1995-377 (1995); *aff'd* without op., 104 F.3d 348 (1st Cir. 1996), a tort case was settled on appeal. The Tax Court sustained the IRS's determination that the plaintiff was taxable on interest income as part of her settlement even though the settlement agreement did not allocate any portion of interest.

[6] Finally, in *Brabson v. U.S.*, 73 F.2d 1040 (10th Cir. 1996), Mrs. Brabson and her children were awarded substantial personal (and physical) injury amounts after a household gas leak. However, their \$2.9 million award included \$370,723 of mandatory prejudgment interest. The IRS argued that this part was taxable. The Brabsons paid the tax, sued for a deficiency, and attempted to claim a refund, which the district court rejected (based on *Kovacs*). The Tenth Circuit, however, noted that the *Kovacs* line of cases had drawn a fine line between the concept of damages on the one hand and interest on the other. The Tenth Circuit in *Brabson* invoked the Supreme Court's *Schleier* decision, *Commissioner v. Schleier*, 115 S.Ct. 2159 (1995), requiring a two-tier analysis. Ultimately, the court struggled to find guidance under local Colorado law and eventually found the prejudgment interest in the case taxable anyway.

[7] It remains to be seen just how "elective" these kinds of situations will be, inside or outside the divorce context. There are many other cases, apart from these few I have mentioned, in which the tax treatment of interest elements in a recovery have been recently and hotly contested. I do not think that section 1041 is an aberration in this area. I think we should wait for congressional guidance.

[8] Perhaps Ms. Sheppard is right that Congress did not consider the interest element in enacting section 1041. However, it seems to me that section 1041 was intended to be extremely broad. It also seems to me that in this context taxpayers should be free to claim whether or not interest is payable. I think Ms. Sheppard agrees with this, although she seems not to even like the notion that payments can be explicitly structured as alimony (and

thus outside section 1041). That topic should be beyond question.

[9] Where she and I clearly differ is on the notion that all divorce settlements should be alike. I suppose she is correct that it would level the playing field if interest were imputed at the applicable federal rate whether or not the taxpayer so states. However, Congress has not so stated. I personally do not think that Congress should or that Congress will.

Very truly yours,

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Tax Analysts Information

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