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Letters to the Editor

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TAXATION OF SETTLEMENTS RAISES NUMEROUS DIFFICULT QUESTIONS.

To the Editor:

I am writing concerning Bill Raby's thought-provoking article "Why Should Anyone Pay Taxes on Litigation Settlements?" (Tax Notes, Apr. 11, 1994, p. 213). I agree with Raby that the treatment of litigation settlements is in considerable turmoil. I differ with a few of Raby's conclusions.

Although it may be an academic point, I am puzzled by Raby's premise at the beginning of his article that the IRS might be motivated to rewrite the section 104 regulations or encourage appeals courts to reconsider the proper scope of section 104(a). Although the latter is certainly a possibility, the notion of rewriting the regulations at this late date seems drastic. If there is inequity in this inherently factual area, perhaps it can be resolved only by statute. The statute can be amended, as it was in 1989 with respect to punitive damages. (Punitive damages are now excludable from income only if they relate to physical, as opposed to merely personal, injuries). Although there may well still be debates over what are considered physical injuries for this purpose (e.g., is psychiatric harm physical?), Congress, with the IRS's urging, can do this sort of line-drawing.

I also take issue with the notion that now taxpayers receiving any sort of litigation settlement may "with relative safety" take a filing position that the amounts received are not includable. True, Guidry suggests that this area of the law is so fouled up that such filing positions may be reasonable. But there are cases to the contrary as well. While I would be the first to invoke this favorable language in Guidry on behalf of a client, I think practitioners should not (on the basis of this one case) assume that there will never be penalties from now on.

Raby quotes several judges with approval (including Justice Scalia) to the effect that not every tort involves personal injuries or sickness within the meaning of section 104(a)(2). The historical treatment of damage awards has used this tort-contract dichotomy as the linchpin for determining excludability under section 104. And, there are many torts that do not involve demonstrable physical injury. Defamation is a prime example, and yet defamation is a tort. Apart from a flurry of case law about whether personal and professional defamation should be treated differently for tax purposes (a case law debate that was ultimately resolved in favor of excludability for all defamation recoveries), there has been no doubt that defamation recoveries are excludable.

Likewise, as far as I know, there is no debate within the Service over questions such as whether intentional or negligent infliction of emotional distress should result in excludable payments. Once again, these are torts, although perhaps without the august tradition of defamation claims. Indeed, Raby's quotes of judges who suggest that not every tort involves a personal injury might just as easily be reversed, to say that not every personal injury involves a tort. True, there are torts that may seem difficult to pigeon-hole into the section 104(a)(2) language. Business torts, including fraud and misrepresentation, may or may not fit neatly into the statutory language of section 104(a)(2). Obviously, if there is only a corporate plaintiff involved, this difficulty is manifest.

But ultimately, one of the central problems in this area is the growth of claims that were not traditional common law torts. The best example, one referred to by Raby, is statutory discrimination claims (such as the Title VII claim at issue in Burke). One way of resolving this quandary would have been to treat recoveries from anything except traditional common law torts as taxable. But the Supreme Court already declined this approach in Burke, saying instead that we must look to the underlying remedial scheme of the statute and determine whether that remedial scheme seeks to redress tort-like damages. To me, this seems just another way of saying that we must look to the nature of the harm to see whether it is "personal," although, admittedly, the focus of the remedial scheme is meant to foster a more objective analysis.

On that topic, it seems revealing that a resort to the remedial provisions of the age discrimination in employment act (ADEA) has not resolved the debate over whether recoveries for ADEA violations are taxable. The IRS has reviewed these provisions and determined that they do not provide the panoply of benefits provided, for example, by Title VII. The courts, on the other hand, have with few exceptions held that ADEA recoveries are excludable. Thus, Burke and even the IRS's subsequent pronouncement in Rev. Rul. 93-88, have not resolved that issue.

The recent cases discussed by Raby, Pat G. Guidry v. Commissioner, T.C. Memo. 1994-127, Bill E. McKay Jr. v. Commissioner, 102 T.C. No. 16 (1994), and Edward E. Robinson, et ux. v. Commissioner, 102 T.C. No. 7 (1994), make interesting reading. These cases, along with many others over the last several years, make it obvious that the taxpayer who is armed with a fully negotiated and carefully crafted settlement agreement stands tall next to the hapless taxpayer with a general release.

However, where Raby overstates his case concerns certainty. He states:

The McKay and Robinson opinions make it quite clear that if properly allocated to tort counts [p. 485] in the complaint, amounts paid in lieu of compensation or lost profits will be excludable from income under the Tax Court's view of section 104(a). It is not necessary to prove that torts actually occurred. The language of the settlement agreement will be sufficient to control the tax outcome. [Raby then qualifies this to state that the record should show that the allocation was adversarial, and that a judge should review it.]

I think this overstates the matter considerably. To begin with, the complaint must generally support the allocations. Plus, there should be evidence that the tort claims were not thrown into the complaint merely to achieve some tax goal. Indeed, in McKay (a case that Raby seems to suggest stands for the proposition that the settlement agreement is likely to control in all events), the Tax Court was quite specific that "[t]he allocations in the settlement agreement are consistent with the entire record in that petitioner's pleadings and jury verdict reflect a lawsuit sounding primarily in tort, although it did have a contractual component." Perhaps Raby means this by saying that the allocation will be upheld if it is "properly" allocated to tort counts in the complaint, but this in itself is a murky concept.

I share with Raby his wonderment over the relevance of bargaining specifically over the tax allocation. Regardless of whether the Tax Court judges in McKay and Robinson focus on the presence or absence of adversarial negotiations with respect to the allocation in the settlement agreement, there is no easy way to determine what portion of an amount -- that is by definition contested and, in the context of settlement, by definition has not been fixed by trial -- is excludable. I agree with Raby, though, that at least in light of these recent cases it may be a good idea to maintain a record showing that there was in fact bargaining over the allocation in the settlement agreement. Yet, I suppose such a record could be detrimental, showing that perhaps a recovering plaintiff was too concerned over allocation language.

Raby has raised a number of important and fascinating questions about the context of settlement discussions and their ethical ramifications. If, in the context of bargaining over a settlement figure in a combined tort and contract action, the plaintiff accepts a smaller total sum on the condition that a large share of it is allocated to the tort recovery, it would seem, as Raby implies, that the contingent-fee attorney is in an ethical dilemma. On the other hand, in my experience, most plaintiffs' attorneys are not equipped (and most expressly recognize it) to make the judgment whether and how much of a claim to allocate in a certain fashion for tax purposes. The presence of another adviser to the plaintiff at settlement time (a tax attorney or accountant is all but a necessity), may help ameliorate this ethical problem.

Some of the other questions Raby raises (perhaps rhetorically) do not have definite answers either. Perhaps we cannot expect them to in this inherently factual quagmire. For example, Raby asks: "How much potential tort in the underlying complaint is sufficient to justify treating the bulk of the settlement as attributable to the tort counts?" In some cases, 1 tort count among 10 causes of action may be sufficient to justify treating most of the recovery as attributable to the single tort count. In other cases, a single contract count among several tort counts may mandate that the lion's share of the recovery be attributed to the contract count. To me, this question is more a substantive tax question than it is an ethical question (although, admittedly, it raises ethical questions too). Ultimately however, it cannot be answered with a formula.

Very truly yours,

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[Ed. Note. Wood is the author of Taxation of Damage Awards & Settlement Payments (Tax Institute 1991, with 1994 suppl).]