

Tax Notes

Letters to the Editor

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WHEN IS INTEREST TAXABLE IN A JUDGMENT?

To the Editor:

The tax treatment of damage awards and settlements has become increasingly controversial over the past few years. Most of the controversy has surrounded the question whether punitive damages should be taxable, as well as the area of employment discrimination claims and related employment litigation. In the case of discrimination and other employment litigation, the question has been how close such claims by employees are to true torts, thereby qualifying for the exclusion from income provided by section 104 of the Internal Revenue Code. In recent years the IRS has invariably argued (and lately with some success) that discrimination and other such claims amount more to contract claims than tort claims.

One facet of the tax treatment of recoveries that has largely gone unnoticed, however, relates to the treatment of interest. 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 common sense maxim was recently underscored by the Tenth Circuit Court of Appeals in *Mary Brabson, et al v. United States*, No. 94-1591, 96 TNT 11-6 (10th Cir. Jan. 7, 1996).

Prejudgment Interest not Excludable

Despite all the recent employment litigation, 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 total \$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 came in and said this part was taxable. Interest, after all, is interest. 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 upon a Tax Court decision in this field, *Kovacs v. Commissioner*, 100 T.C. 10, 93 TNT 45-22 (1993), aff'd without published opinion 25 F.3d 1048 (6th Cir. 1994).

Tenth Circuit Says No

The Tenth Circuit Court of Appeals reversed the district court, noting in so doing 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. Interest, noted the court, is normally taxed.

Thus, the circuit court in Brabson reviewed the district court's conclusion about how the state law (in this case, Colorado law) applied the prejudgment interest statute to the case in question. The appeals court even noted that both the Tax Court in Kovacs and the district court in Brabson had issued reasoned opinions. So far so good.

Schleier Evoked

In a move that many tax lawyers may see as foreboding, the Tenth Circuit in Brabson then went on to invoke the Supreme Court's Schleier decision, *Schleier v. Commissioner*, 115 S.Ct. 2159, 95 TNT 116-8 (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, after all, 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 [P. 1056] 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 would 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.

Coffin's Nail

Perhaps the last nail in the coffin for these taxpayers (excuse the pun, since the Tenth Circuit opinion in *Brabson* was penned by Judge Coffin) was the court pointing 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, in its words, "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, noting that "compensation for the lost time value of money is caused by the delay in attaining judgment." Thus, according to the court, *Schleier* supports a strict analysis of section 104 that requires one to -- as a purely practical matter -- evaluate just why the money was paid.

Prejudgment Interest Only?

On its face, the *Brabson* decision establishes that at least in the Tenth Circuit, prejudgment interest in a strictly tort case will now be taxable. Of course, it will presumably be taxable only if it is expressly called "prejudgment interest." The pejorative moniker here is obviously "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.

Indeed, if one thinks about it, the whole notion of a periodic payment settlement, in which the recovering plaintiff in a tort case is paid amounts spread over a number of years, is at odds with the notion that prejudgment interest is taxable. After all, section 104 by its terms is clear that periodic payments do not make a tort case part interest and part excludable award. Of course, it is customary in that context not to use the prohibited words "interest."

All in all, the *Brabson* case may be yet another reason why -- from a tax perspective at least -- a settlement is nearly always better than a judgment.

Sincerely,

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Tax Analysts Information

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