taxanalysts tax practice and accounting news

edited by Robert J. Wells and Jon Almeras

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Securities Lawsuit Recoveries: Capital Gain or Ordinary Income?

By Robert W. Wood

Robert W. Wood practices law with Robert W. Wood, P.C., in San Francisco (http://www.rwwpc.com). He is the author of 31 books, including *Taxation of Damage Awards and Settlement Payments* (3d Ed. 2005), published by the Tax Institute and available at http://www.damageawards.org.

Over the last few years the economy, corporate conduct, major upsets in the securities markets, or some combination of those factors has produced a wave of lawsuits against corporate America. The resolution of those cases can raise many tax issues, not the least of which is how plaintiffs must treat their recoveries. On the defendant's side, questions also arise whether the defendant's payments are deductible, although most defendants surely assume that they are.

The lawsuits and arbitration claims arising out of the collapse of the dot-com bubble are still working their way through the system. Not only is there a never-ending raft of individual broker claims (each of which is generally in the hundreds of thousands to millions of dollars), but some class actions against banks and brokerage firms involve staggering amounts, with claims in the billions of dollars. For example, J.P. Morgan recently announced a record $2.2 billion settlement arising out of the collapse of Enron. That $2.2 billion settlement resolves a class-action lawsuit filed by Enron investors after the company failed nearly four years ago.

The settlement comes on the heels of a $2 billion settlement in the same case reached by Citigroup Inc.[1] That lawsuit was brought as a class action by the plaintiff's lawyer William Lerach, who contends that investors lost approximately $40 billion in equity and $2.5 billion in bond investments when Enron collapsed. The lead plaintiff in Lerach's case is the University of California. Enron filed for protection under chapter 11 of the Bankruptcy Code in 2001, but the lawsuits brought on behalf of investors seek to recover against various financial institutions on the theory that they helped to falsify Enron's financial statements and hide debt, issued falsely positive and misleading reports, and otherwise contributed to Enron's downfall.

That isn't the only Enron lawsuit either. The case brought by Lerach is just one of numerous suits tied to the collapse of the Houston energy concern. In another case, J.P. Morgan, Citigroup, Merrill Lynch, CSFB, and Bank of America recently agreed to pay $49 million to Retirement Systems of Alabama to settle that separate lawsuit related to the pension fund's Enron losses.[2]

Those megasettlements seem to be increasing in both frequency and magnitude. Perhaps it is irrelevant whether this type of lawsuit represents the tail end of the dot-com-bubble litigation or a new post-Sarbanes-Oxley phenomenon. The companies paying these amounts will deduct them as ordinary and necessary business expenses. Sadly, the landscape for recovering plaintiffs is not so simple.

The Replacement Doctrine

To determine the tax treatment of a recovery from a lawsuit, whether it is received as a result of a settlement or a judgment, the courts and the IRS ask what a recovery was paid in lieu of.[3] The theory is that a recovery should be taxed in the same manner as the item for which it is intended to substitute.[4] The nature of the claim is determined by reference to the claims raised in the complaint, those claims that are pursued, and those that are resolved in a verdict or settlement.[5] Still, the IRS generally views the complaint as the most persuasive evidence of the nature of the claim.[6]

Because this doctrine seeks to determine what the plaintiff would have received had it not been for the actions leading up to the lawsuit, the substitute (the amount of the settlement or judgment) should be taxed just like the original would have been. For example, a claim for unfair competition that resulted in the plaintiff losing profits in his business would be taxed as lost profits, and thus as ordinary income. Conversely, when a plaintiff claims that a capital asset has been harmed (for example, the defendant harmed a building owned by the plaintiff), the recovery may be a nontaxable return of capital, assuming the plaintiff had paid enough for the building to recover the lawsuit proceeds. The amount of any excess over that tax basis may constitute a capital gain.

---

[1]*See* Sidel and Pacelle, "J.P. Morgan Settles Enron Lawsuit," *The Wall Street Journal*, June 15, 2005, p. A-3.

[2]*Id.*

[3]*See Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir.), *cert. denied* 323 U.S. 779 (1944); LTR 200108029, *Doc 2001-5469*, *2001 TNT 38-23*.

[4]*Knowland v. Commissioner*, 29 B.T.A. 618 (B.T.A. 1933).

[5]*State Fish Corp. v. Commissioner*, 48 T.C. 465, 474 (1967), *acq.* 1968-2 C.B. 3, *modified* 49 T.C. 13 (1967).

[6]Rev. Rul. 85-98, 1985-2 C.B. 51.

Despite those simple examples, applying this doctrine can be surprisingly difficult. And in most modern litigation, the causes of action are anything but clear cut, typically comprising an amalgam of claims that tax professionals may later want (or need) to dissect. An investor who settles his claim that he lost an investment return because of the action of a company, bank, or brokerage firm will have an obvious incentive to assert that the loss was capital in nature and that his settlement should be too. The IRS, on the other hand, will have an incentive to argue for ordinary income treatment.

Using Settlement Agreements

The plaintiff who receives a settlement or judgment has the burden of establishing the nature of the award from a tax perspective. There is nearly always more flexibility with a settlement than with a judgment. As discussed below, the plaintiff would be well-advised to attempt to structure the recovery in advance to achieve the desired tax result, rather than waiting until tax return time. Although tax language in a settlement agreement isn't binding on the IRS or the courts, it can go a long way toward helping the taxpayer achieve the desired tax treatment.

From a tax perspective, the settlement agreement represents the only opportunity for setting out the intended tax treatment of the payment in a document that both plaintiff and defendant will sign. Even though that tax language isn't binding on the IRS, in my experience, the IRS does pay attention to it. That means failing to address tax issues in a settlement agreement is like passing up a free lunch. Besides, with reporting disputes (over Forms 1099 and W-2) becoming more common, addressing tax issues in a settlement agreement can also help to avoid those issues. It is far better to work those issues out at the time of settlement than to be faced with them as an unpleasant surprise on January 31 of the following year when the Forms W-2 and 1099 arrive.

Of course, even taking advantage of a chance to add tax language to a settlement agreement cannot change the fundamental character of a payment. For example, a plaintiff who has complained that he lost interest on a debt obligation (assume the plaintiff got the debt principal back) would be treated as receiving ordinary income on a recovery, because the only damage the plaintiff is claiming is interest, and interest is ordinary income. However, in litigation over mismanagement, fraud, or other malfeasance giving rise to investment losses, in most cases the plaintiff will be claiming a complete or partial loss of the investment (a loss or a diminution of value).

Thus, the plaintiff will generally be asserting that the recovered funds are nontaxable as a recovery of basis or represent a capital gain. That may invite questions into what the plaintiff has already done on his tax return regarding that investment loss. If the plaintiff has already claimed a tax loss on the investment (the worthlessness of Enron, for example), that loss must be taken into account in determining how the proceeds of any ultimate recovery will be treated for tax purposes.

In the typical investment loss case, the plaintiff is claiming that the defendant's conduct (accounting problems, mismanagement, conversion, fraud, and so forth) led to the loss or diminution in value of the plaintiff's investment.

Different Fact Patterns

A couple of examples may be helpful:

Example 1: Sam Shareholder holds a large volume of shares in Dastardly Inc. He purchased his shares several years ago for $100 each, and, before the market tanked, Dastardly stock had gone up to $1,000 a share. As a result of actions by Dastardly management that Sam thinks are actionable, the Dastardly shares declined in value to $200 per share. That means his economic loss from the market high point is $800 per share ($1,000 minus $200). Of course, Sam paid only $100 for the shares. Sam brings a claim for securities violations against Dastardly and ultimately recovers $300 per share.

Sam has a $300 tax event. Assuming he continues to hold the Dastardly shares, the entire $300 would be taxable income. The question is whether it would constitute capital gain or ordinary income. Sam will mostly likely argue that the entire $300 represents capital gain, relating to his position in Dastardly stock. Once Sam has paid the capital gain tax on the $300, Sam's basis in the stock should be $400 ($100 plus $300).

As discussed below, the authorities differ on whether it is necessary for Sam to dispose of his Dastardly stock to qualify for capital gain treatment. The better view is that a disposition of the stock isn't needed, so Sam can receive his capital gain treatment.

Example 2: Penny Stockpicker owns a significant position in the common stock of Behemoth Ltd. Penny bought the stock 18 months ago for $500 a share, and it climbed to a market value of $1,000 a share. As a result of bad behavior by Behemoth management, the stock price plummeted to $100. Thus, Penny's economic loss is $900 per share.

Penny brings a securities lawsuit against Behemoth for her losses and eventually recovers $400 per share. Because Penny paid $500 per share, and the market value of her stock at the time of her recovery is only $100 per share, she presumably will take the position that the entire $400 recovery represents a return of basis and is nontaxable. That basis recovery would mean that though Penny pays no tax on that $400, her basis in her Behemoth stock thereafter would be $100 per share ($500 minus $400 equals $100).

Example 3: Ivan Investor purchases stock in Conglomerate for $500 per share. Over the next couple of years, Conglomerate stock climbs to $1,000 per share. Then, as a result of bad management and fraud, Conglomerate stock plummets and becomes worthless. Thus, Ivan has a loss of $1,000 per share. Ivan files a securities action against Conglomerate and its banks. Ivan eventually recovers $500 per share in a settlement. The $500 recovery can be treated as a basis recovery.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Example 4: Assume the same facts as Example 3. However, although Ivan has commenced a suit against Conglomerate and its banks to recover on his shares, he decides to claim a worthless securities loss for the shares on his tax return. After all, he may never recover in the securities lawsuit. Ivan's basis was $500 per share, and the market value of his stock was $1,000 per share. Thus, he has an economic loss of $1,000 per share. Under the worthless securities loss rules, Ivan claims a loss for $500 per share.[7]

Eventually (and unexpectedly), Ivan recovers $500 per share in a settlement with Conglomerate and its bankers. Although Ivan's stock became worthless, which means Ivan should have no trouble with the sale or exchange requirement, none of the $500 he recovers in his lawsuit can be treated as a basis recovery. After all, Ivan has already written off his investment as worthless. Thus, the $500 would all constitute income. Whether it is ordinary or capital might be debated, but Ivan should be on solid ground claiming that the entire $500 is capital gain, because it relates to his underlying Conglomerate stock.

Recovery of Basis and Character of Assets

If a recovery compensates a plaintiff for injuries to a capital asset, the recovery may constitute a tax-free return of capital to the extent of the taxpayer's basis in the injured asset.[8] The rationale is that no economic gain results from a basis recovery.[9] Only amounts received in excess of basis constitute income. An award may therefore produce capital gain or reduce capital loss, depending on the taxpayer's basis in the asset.

A lot of blood is spilled in tax cases over the taxpayer's ability (or inability) to prove his basis in the asset. To a lesser extent, character questions (is this a capital asset?) also arise. As a general rule, when there is injury to an identifiable capital asset, recoveries in excess of basis are treated as capital gain. For example, in *Daugherty v. Commissioner*[10] the Tax Court stated: ''If the claim is for damage to a capital asset, the amount received in settlement is treated as a return of capital, taxable at capital gain rates if the recovery exceeds the asset's basis.''[11]

One of the best-known cases in this area is *Big Four Industries Inc. v. Commissioner*.[12] It demonstrates that even though a taxpayer may succeed on the overall character question (proving that the lawsuit relates to capital assets, not to lost profits), that will get the taxpayer only halfway home. If the taxpayer expects to shelter any of the recovery against basis, the taxpayer must be able to demonstrate that basis.

In *Big Four Industries*, the IRS argued that the recovery was lost profits and therefore constituted ordinary income. The taxpayer argued that the recovery represented a payment for damage to goodwill and shouldn't be taxable at all. The case arose out of a patent infringement action. Although the court disagreed with the IRS's assertion that this was merely a lost profits case, and the court sided with the taxpayer on whether the recovery was for damage to goodwill, the court couldn't agree that the recovery was nontaxable.

Instead, because the taxpayer had no basis in its goodwill, the court held that the entire amount represented — and had to be taxed as — capital gain.[13] Of course, with the long-term capital gains rate at only 15 percent that would still be an attractive result today compared with ordinary income. In other decisions, the Tax Court stated that awards in excess of basis constitute capital gains, whether or not the taxpayer retains asset.

For example, in *Bresler v. Commissioner*,[14] the court considered an antitrust recovery, noting that the award could represent lost profits, which would be taxable as ordinary income. When the award represents damages for injury to capital assets, though, it is taxable as capital gain to the extent it exceeds basis. That principle seems to cut across a wide variety of litigation.

Thus, in *Wheeler v. Commissioner*,[15] the court acknowledged that rule and stated that when ''a judgment substitutes for a capital asset, an amount equal to the taxpayer's basis in the asset is recoverable tax-free and any excess is taxable at capital gains rates.''[16] Those principles have been applied to stocks, bonds, real estate, and many other types of assets. For example, in FSA 200228005[17] the IRS ruled that settlement proceeds arising from the acquisition of environmentally damaged land that are ''in excess of Taxpayer's basis in the land should be treated as capital gain.''

Despite that positive authority, the IRS has sometimes concluded that a recovery in excess of basis (even of a capital asset) constitutes ordinary income. For example, in Rev. Rul. 68-378,[18] the taxpayer previously had recovered a large portion of its basis in an asset through amortization deductions. Although the ruling is not clear on this point, it seems likely that any recovery the taxpayer received in excess of its basis represented a recapture of amortization deductions (that are taxable as ordinary income under section 1245). That may explain the ordinary income taint the IRS applies in that ruling.

Sale or Exchange Requirement?

It should be apparent from the above discussion that one of the important analytical issues is what triggers the capital treatment. A capital gain is generally defined by reference to the gain produced on the sale or exchange of a capital asset.[19] Is a sale or exchange required (or is it

---

[7] *See* section 165(b).
[8] *Raytheon Production Corp., supra* note 4, 144 F.2d at 113; Rev. Rul. 68-378, 1968-2 C.B. 335; Rev. Rul. 81-277, 1981-2 C.B. 14.
[9] Rev. Rul. 81-277.
[10] 78 T.C. 623, 638 (1982).
[11] 78 T.C. at 639.
[12] 40 T.C. 1055 (1963); *acq.* 1964-1 C.B. (Pt. 1) 4.
[13] *See also Freeman v. Commissioner*, 33 T.C. 323 (1959).
[14] 65 T.C. 182, 184 (1975), *acq.* 1976-2 C.B. 1.
[15] 58 T.C. 459 (1972).
[16] 58 T.C. at p. 461.
[17] *Doc 2002-16265, 2002 TNT 135-16* (Mar. 29, 2002).
[18] 1968-2 C.B. 335.
[19] Section 1222.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

automatically deemed to occur) when you settle a lawsuit? That, it turns out, is not an easy question to answer.

In general, the answer is that the mere settlement of a lawsuit is not deemed to constitute a disposition. That brings up the question whether a disposition is even required. In the context of recovering damages in lawsuits, the courts and the IRS have often allowed capital gain treatment even though there was no sale or exchange. Making the issue more puzzling, capital gain treatment is often accorded without any mention of the necessity for a sale or exchange.

Unfortunately, the authority isn't uniform. Several cases and rulings have allowed a taxpayer to recover his basis and report the excess as capital gains even though the taxpayer retained the asset. For example, in *Inco Electroenergy Corp. v. Commissioner*[20] the taxpayer sued Exxon for infringing on one of its existing trademarks. Exxon agreed to pay the taxpayer $5 million in damages, and the taxpayer continued to use the trademark. In analyzing the origin of the claim, the court stated that "amounts received for injury or damage to capital assets are taxable as capital gains, whereas amounts received for lost profits are taxable as ordinary income."

The court first found that the claim was for damages to the trademark and associated goodwill. It then stated that "we need only to characterize the nature of these assets," which it found were capital assets.[21] Using that approach, the court held that the award was taxable as capital gain. It didn't mention a sale or exchange requirement.

Similarly, in *State Fish Corp.*,[22] the taxpayer purchased all the assets of a company, including its goodwill. The seller violated a noncompete agreement that was entered into in connection with the sale, and the taxpayer sued for injury to its goodwill. Although there was no sale or exchange of the goodwill, the court held that the award constituted a tax-free recovery of basis.[23]

Perhaps it isn't surprising that the courts would accord that treatment, either dispensing with the sale or exchange notion, or failing to mention it altogether. However, it may seem more surprising that the IRS has also ignored any notion of a sale or exchange in reviewing the tax treatment of proceeds of litigation. That suggests the sale or exchange requirement isn't very important in this context.

Indeed, the IRS has allowed recovery of basis and capital gain characterization for recoveries to injuries to capital assets, even though the taxpayers didn't sell or exchange those assets. For example, in FSA 200228005[24] the IRS issued a determination concerning the tax treatment of settlement proceeds arising from a taxpayer's purchase of contaminated property. The taxpayer recovered the proceeds from the seller. The IRS found that the taxpayer's claim arose from the taxpayer's purchase of the property. Although the taxpayer retained the contaminated property, the IRS ruled:

> Because land is a capital asset, the settlement proceeds represent amounts for injury or damage to a capital asset. Therefore, the proceeds should be treated as recovery of Taxpayer's basis in the land. Any proceeds in excess of Taxpayer's basis in the land should be treated as capital gain.[25]

Similarly, in Rev. Rul. 81-152,[26] a condominium management association recovered an award against a developer for defects in the units. No sale or exchange of a capital asset was involved. The IRS ruled that the award was received on behalf of individual unit owners. The ruling concluded that the proceeds represented "a return of capital to each unit owner to the extent the recovery does not exceed that owner's basis in his or her property interest in the condominium development." The ruling also noted that the unit owners must reduce their individual bases in the property by their share of the award.

There is a series of published and private rulings involving construction defects. In LTR 9335019[27] a homeowners association brought a claim for damages against developers for construction defects. In analyzing the origin of the claim, the IRS ruled that the proceeds "represent amounts to repair or restore the property that the builder agreed would be properly constructed." As a consequence, the IRS ruled that the settlement payments "are not income to the unit owners, but instead represent a return of capital to each unit owner to the extent each unit owner's portion of the recovery does not exceed that owner's basis in his or her property interest." The IRS instructed the unit owners to reduce their bases by the amount of their share of the recovery.

In LTR 9343025[28] another homeowners association settled a claim against a developer and county for injury to common roads and land regarding housing developments. Although there was no sale or exchange of any capital asset, the IRS ruled that because the funds were intended to mitigate against expected damage to the developments, "the receipt of the settlement proceeds represents a return of capital to the Association's unit owners to the extent that each unit owner's portion of the recovery does not exceed that owner's basis in his or her property interest."

Rev. Rul. 81-277[29] involved a contractor who agreed to construct a power plant for the taxpayer for a fixed fee. Because of regulatory changes, the taxpayer was required to hire a third party to complete the work, causing the taxpayer to pay more than the specified contract price. In a settlement with the contractor, the taxpayer recovered the excess funds it expended on construction. The IRS ruled that the award constituted a tax-free recovery of basis. The ruling required the taxpayer to reduce its basis

[20]T.C. Memo. 1987-437, 1987 Tax Ct. Memo LEXIS 434.

[21]*Id.*, 1987 Tax Ct. Memo LEXIS 434, at 16.

[22]48 T.C. 465 (1967), *acq.* 1968-2 C.B. 3, *modified* 49 T.C. 13 (1967).

[23]*See also Dye v. United States*, 121 F.3d 1399, *Doc 97-24123*, *97 TNT 162-3* (10th Cir. 1997) (holding that recovery for diminution of value of securities investments constitutes capital gain).

[24]*Supra* note 18.

[25]*Id.*

[26]1981-1 C.B. 433.

[27]*93 TNT 185-25* (June 2, 1993).

[28]*93 TNT 224-50* (July 30, 1993).

[29]1981-2 C.B. 14.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

in the power plant by the amount of basis recovery. In reaching its decision, the IRS stated that ''payments by the one causing a loss that do no more than restore a taxpayer to the position he or she was in before the loss was incurred are not includible in gross income because there is no economic gain.''[30]

Decisions Requiring a Sale or Exchange

It would be nice to say that the sale or exchange requirement can be dispensed with in this context. Although I think that is nearly true today, I don't think we're all the way home. In some decisions and in one notable ruling, the IRS appears to have required a sale or exchange for there to be a recovery of basis and capital gain characterization. Perhaps the authority that has proven most nettlesome is Rev. Rul. 74-251.[31] There the IRS ruled that acceptance of payments in settlement of claims in the lawsuit considered in the ruling did not constitute a sale or exchange. The ruling states that:

> Unless it can be clearly established that there has been a sale or exchange of property, money received in settlement of litigation is ordinary income. The mere settlement of a lawsuit does not in itself constitute a sale or exchange.

I believe that this ruling, and the bold statement that the mere settlement of a lawsuit does not constitute a disposition, has accounted for significant confusion. It has often been taken to mean that one needs a sale or exchange in every case to achieve the nirvana of capital gain. I think that is a significant overstatement.

Rev. Rul. 74-251 involved a unique set of facts. The IRS determined as a factual matter that there had been no damage to a capital asset. In the ruling, shareholders of Y corporation brought a derivative suit against former shareholders of X corporation, Y's former investment adviser. The Y shareholders alleged that X (some of whose shareholders were also directors of Y) had entered into an investment advisory contract that was unfair to Y and that resulted in excessive profits to X shareholders when they sold their X stock. The case settled.

Y contended that the settlement proceeds resulted from an unlawful taking by X shareholders of valuable property owned by Y, namely its ''intangible right to select its investment advisor.'' For that reason, they claimed there was a sale or exchange of an asset. The IRS disagreed. It found that Y merely recovered from X's shareholders amounts they had received on their sale of stock ''representing anticipated profits'' from the contract. In effect, the IRS found that there had been no damage to a capital asset. Given those facts and the conflicting authority on the need for a sale or exchange, the ruling should not be read to mean that a settlement can never give rise to capital gain.

Of course, Rev. Rul. 74-251 is not the only adverse authority. In fairness to those who argue that a sale or exchange of the underlying asset is required, the courts have occasionally denied capital treatment for litigation proceeds based on the lack of a sale or exchange. The Tax Court has required sale or exchange treatment, although once again the relevant decisions arise when a taxpayer argues that a settlement of a lawsuit itself constitutes a sale or exchange.

For example, in *Steel v. Commissioner*,[32] the taxpayers through a series of transactions conveyed and then reacquired interests in a lawsuit in connection with a business sale. When the lawsuit settled, the taxpayers treated the income as additional compensation from the stock sale and reported it as capital gain. The Tax Court rejected that argument, stating that because the additional amount received was from a settlement — not from a sale or disposition of a capital asset — the amount was ordinary income, not capital gain.[33]

A few other courts have done likewise. The Tenth Circuit, in *Sanders v. Commissioner*,[34] held that the settlement of claims for services rendered under a government construction contract did not constitute a sale or exchange. The court found that the money would have been taxed as ordinary income for services rendered had it been collected when originally due. The court noted that the character of income doesn't change merely because the taxpayer recovers the income through a lawsuit or settlement.

As the above authorities suggest, there has been no definitive ruling by the IRS or a court that a sale or exchange of the asset in an investment loss case must occur to achieve basis recovery or capital gain treatment. Thus, it is an overstatement to say that a sale or exchange of the underlying investment is required to have a chance at capital treatment. But it is an understatement to say the sale or exchange requirement is never imposed in this context.

Tax Treatment of Related Legal Fees

In addition to controlling the treatment of settlements and judgments, the origin of the claims test is also used to determine the tax treatment of legal fees.[35] Whether legal fees can be deducted or must be capitalized is controlled by the nature of the matter regarding which of the expenses were incurred.[36] Section 263(a) denies a deduction for any amounts expended for permanent improvements or betterments ''made to increase the value of any property or estate.'' Although legal fees are not highlighted in that language, the regulations make it clear that the cost of capital expenditures includes the cost of defending or perfecting title to property.[37] The regulations further provide that expenses paid or incurred in recovering property constitute part of the cost of the property and are therefore not deductible.[38]

---

[30]*Id.*

[31]1974-1 C.B. 234.

[32]T.C. Memo. 2002-113, *Doc 2002-10804*, *2002 TNT 88-23*.

[33]*See also Nahey v. Commissioner*, 111 T.C. 256, *Doc 98-31324*, *98 TNT 204-14* (1998).

[34]225 F.2d 629 (10th Cir. 1955), *cert. denied* 350 U.S. 967 (1956).

[35]*See Woodward v. Commissioner*, 397 U.S. 572, 574-79 (1969).

[36]*United States v. Gilmore*, 372 U.S. 39, 49 (1963); FSA 200228005, *supra* note 18 (''the deductibility of the payments and legal fees at issue depends on the origin of the claim from which the settlement arose'').

[37]Reg. section 1.263(a)-2(c).

[38]Reg. section 1.212-1(k).

Taxpayers are inclined to consider all legal expenses to be deductible, but capitalization issues come up more frequently than you might imagine. For example, in *Leigh v. United States*,[39] the taxpayer entered into an agreement to sell stock of a manufacturing company. The deal soured, culminating in litigation between buyer and seller. The court found that the buyer's suit originated out of the taxpayer's disposition of stock and that the stock was a capital asset. It held that the taxpayer had to capitalize the legal fees under section 263.

Many of the issues seem largely to be questions of degree. That is kind of an origin of the claim analysis. The courts and the IRS have ruled that legal fees must be capitalized when they bear a ''direct relationship'' to an asset acquired or preserved by a lawsuit. For example, in *Lange v. Commissioner*[40] a taxpayer sought to deduct legal fees in litigation over his ownership interest in a closely held holding company. The Tax Court rejected that position, holding that the fees must be capitalized because the origin of the claim was to protect, defend, and acquire ownership interests in the corporation.

Similarly, in *Winter v. Commissioner*[41] the Tax Court held that taxpayers must capitalize legal fees incurred in a lawsuit seeking damages arising from an increased purchase price of a capital asset.[42] Litigation over the purchase of an asset seems almost invariably to require capitalization. Thus, in FSA 200228005[43] the taxpayer paid legal fees to prosecute an action arising from its purchase of contaminated land. The IRS stated that because the legal fees related to environmental damage were allegedly caused by the defendant, they had to be capitalized.

In many investment loss cases, the legal fees can be viewed as protecting the investment and paid or incurred to recover damages arising from the reduction in value of the investment. Consequently, legal fees incurred in the action should often be treated as capital expenditures made regarding the investment and applied to increase the plaintiff's basis in the stock.[44] In my experience, there is rarely a problem with the tax treatment of the legal fees in investment loss cases when the legal fees are all paid or incurred in the year of the settlement.

Thus, in contingent fee cases, everything tends to work out fine. If the investor/taxpayer has a recovery in the case and incurs legal fees in that process, the legal fees can normally be offset against the recovery on Schedule D of the investor's return. In other words, if the settlement of the case produces a capital gain, the associated legal fees merely reduce the amount of that gain (in effect constituting a related capital loss).

Problems tend to occur, however, when the investor/plaintiff has been paying legal fees over several years on an hourly basis. In my experience, taxpayers usually will have deducted those legal expenses as they are paid (presumably as investment expenses under section 212). That means those legal fees will be subject to the limitations noted above (the 2 percent threshold for miscellaneous itemized deductions, phaseout, and, most seriously, alternative minimum tax). Depending on the numbers, those can be significant limitations.

Conclusion

More and more taxpayers seem to be recovering amounts related to investments from lawsuits and arbitration proceedings. More and more companies, banks, brokerage firms, and investment advisers seem to be falling subject to those claims. Because the tax issues for the recovering plaintiffs revolve around ordinary income versus capital gain and gain versus basis recovery issues, the federal income tax stakes can be high.

---

[39] 611 F. Supp. 33 (N.D. Ill. 1985).

[40] T.C. Memo. 1998-161, *Doc 98-14273*, *98 TNT 87-13.*

[41] T.C. Memo. 2002-173, *Doc 2002-17047*, *2002 TNT 141-10.*

[42] *See also Spector v. Commissioner*, 71 T.C. 1017 (1979), *rev'd and remanded on another issue* 641 F.2d 376 (5th Cir. 1981).

[43] *Supra* note 18.

[44] *See Dye, supra* note 24 (holding that legal fees incurred in prosecuting claims for diminution in value to investments are capital expenses).

(C) Tax Analysts 2005. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.