

# Viewpoint

## Stakes Loom Large in Determining Taxation of Investment Loss Lawsuit Recoveries

By ROBERT W. WOOD

If your stockbroker, investment adviser, real estate investment trust, mutual fund (or any company in which you invest) causes you to lose money, what would you do?

Some investors may be forgiving, others not. Perhaps as a result of the rise and fall of the markets during the dot-com era, a huge volume of disputes over securities—a veritable tsunami of lawsuits and arbitration claims—is working its way through the system. Many investment loss claims are brought as arbitration proceedings, as many plaintiffs will be restricted to NASD arbitration proceedings, even though they would probably rather proceed in court.

Yet whether the matter involves an arbitration claim, an individual court case or a class action, the basic theory is likely to be the same: You caused me to lose money. The legal grounds for the claim may involve alleged breaches of fiduciary duty, churning, violations of the securities laws, Racketeer Influenced and Corrupt Organizations Act violations, simple failures to diversify, negligent or fraudulent accounting practices, and so on.

In no small measure, we now live in a climate where investigations and scandals are the norm. Even if an Eliot Spitzer-style investigation of a given industry does not cause a particular company within that industry to go down the drain a la Enron, any drop in stock price these days is likely to trigger some kind of claim. Indeed, even a small drop in stock price may cause an investor to sue, saying that even though he made money, he made much less money than he would have made had the company (brokerage firm or whatever) not behaved inappropriately.

Given the current climate of corporate scandal, investigations, and phobia over corporate governance, I think it is safe to assume that we have not seen the last wave of lawsuits against Corporate America. The resolution of these cases will almost inevitably raise tax issues, not the least of which is how the plaintiffs must treat their recoveries. On the defendant's side, questions also arise regarding whether the defendant's payments are deductible, though most defendants surely assume that they are.

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On the plaintiff's side, whether the claim is a good old-fashioned (and simple) one that your stockbroker did not execute a trade when he should have, or some complex post-Sarbanes-Oxley Act multiparty proceeding, the tax issues are likely to be the same.

Not only is there a never-ending raft of individual broker claims (each of which may be in the hundreds of thousands to millions of dollars), but some class actions against banks and brokerage firms involve truly staggering numbers. Citigroup and J.P. Morgan recently settled—for more than \$2 billion each—a suit arising out of the collapse of Enron.<sup>1</sup>

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This class action lawsuit was filed by Enron investors after Enron's incineration nearly four years ago. Peripatetic plaintiff's lawyer William Lerach contends that investors lost approximately \$40 billion in equity and \$2.5 billion in bond investments when Enron imploded.

There are other Enron lawsuits, too. In another case, J.P. Morgan, Citigroup, Merrill Lynch, Credit Suisse First Boston, and Bank of America agreed to pay \$49 million to the Retirement Systems of Alabama to settle that separate lawsuit related to the pension fund's Enron losses.<sup>2</sup>

### Perennial Tax Issues

An investor who settles a claim that he lost investment return and/or principal owing to the action of a company, bank, or brokerage firm, will have an obvious incentive to assert that this loss was capital in nature, and that his settlement should be too. The Internal Revenue Service, on the other hand, will have an incentive to argue for ordinary income treatment.

To resolve this standoff, we first look to the origin of the claim. It controls the tax treatment of a recovery

<sup>1</sup> See Sidel and Pacelle, "J.P. Morgan Settles Enron Lawsuit" *Wall Street Journal*, June 15, 2005, p. A-3.

<sup>2</sup> *Id.*

from a lawsuit, whether it is received as a result of a settlement or a judgment.<sup>3</sup>

The question is, in lieu of what was the recovery paid?<sup>4</sup> A recovery should be taxed in the same manner as the item for which it is intended to substitute.<sup>5</sup>

The origin of the claim is determined by reference to the claims raised in the complaint, the claims that are actually pursued, and those that are resolved in a verdict or settlement.<sup>6</sup> IRS generally views the complaint as the most persuasive evidence of the origin of the claim.<sup>7</sup>

Many situations are relatively easy to resolve. 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, where a plaintiff claims that a capital asset has been harmed (e.g., the defendant harmed a building owned by the plaintiff), the recovery may be a nontaxable return of capital, assuming that the plaintiff had paid a sufficient amount for the building to cover the full amount of the lawsuit proceeds. The amount of any excess over that tax basis may constitute a capital gain.

Despite these simple examples, applying the origin of the claim test can sometimes be quite difficult. In the vast majority of 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. Still, in investment loss cases, the plaintiff will generally be asserting that the recovered funds are nontaxable as a recovery of basis, and/or represent a capital gain. This necessarily may invite questions into what the plaintiff has already done on his tax return in relation to this investment loss.

If the plaintiff has already claimed a tax loss on the investment (the worthlessness of Enron, for example), then that tax 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, etc.) lead to the loss or diminution in value of the plaintiff's investment. The plaintiff should not get a double benefit in the form of favorable taxation on the recovery, plus a tax deduction for the investment loss that gave rise to the dispute.

**Examples.** A couple of illustrations may be helpful:

**Situation 1.** 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 plummets 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 therefore is nontaxable.

This basis recovery would mean that though Penny does not pay tax on this \$400, her basis in her Behemoth stock thereafter would be \$100 per share (\$500 minus \$400 equals \$100).

**Situation 2.** 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 that his economic loss from the market high point is \$800 per share (\$1,000 minus \$200). Of course, Sam only paid \$100 for the shares.

Sam brings a claim for securities violations against Dastardly and ultimately recovers \$300 per share. Sam has a \$300 taxable event. Assuming that 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 take the position that the entire \$300 represents capital gain, relating to his position in Dastardly stock. Once Sam has paid the capital gains 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 in order to qualify for capital gain treatment. The better view is that a disposition of the stock is not needed, so Sam can receive his capital gain treatment.

**Situation 3.** Ivan Investor purchases stock in Conglomerate for \$500 per share. Over the course of 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 prepares to bring a securities action, which he does file against Conglomerate and its banks. Ivan eventually recovers \$500 per share in a settlement. The \$500 recovery can be treated as a basis recovery.

**Situation 4.** Assume the same facts as Situation 3 (Ivan Investor and Conglomerate). However, while 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.<sup>8</sup>

Eventually (and unexpectedly), Ivan recovers \$500 per share in a settlement with Conglomerate and its bankers. Although Ivan's stock became worthless, which means that Ivan should not have any 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

<sup>3</sup> See, e.g., *United States v. Gilmore*, 372 U.S. 39, 49 (1963); *Hort v. Commissioner*, 313 U.S. 28 (1941).

<sup>4</sup> See *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir.); *cert. denied*, 323 U.S. 779 (1944); P.L.R. 200108029 (2001).

<sup>5</sup> *Knowland v. Commissioner*, 29 B.T.A. 618 (B.T.A. 1933).

<sup>6</sup> *State Fish Corp. v. Commissioner*, 48 T.C. 465, 474 (1967); *acq.* 1968-2 C.B. 3; *mod.*, 49 T.C. 13 (1967).

<sup>7</sup> Rev. Rul. 85-98, 1985-2 C.B. 51 (1985).

<sup>8</sup> See I.R.C. Section 165(b).

should be on solid ground taking the position that the entire \$500 is capital gain, since it relates to his underlying Conglomerate stock.

### Proving Basis and Character of Assets

If a recovery compensates a plaintiff for injury 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.<sup>9</sup> The rationale for this principle is that no economic gain results from a basis recovery.<sup>10</sup>

As a general rule, when there is injury to an identifiable capital asset, recoveries in excess of basis are treated as capital gain. 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 good deal of blood is spilled in tax cases over the taxpayer's ability (or inability) to prove his basis in the asset. Character questions (i.e., is this a capital asset?) also arise.

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One of the best known cases in this area is *Big Four Industries Inc. v. Commissioner*.<sup>11</sup> In *Big Four Industries*, 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 therefore should not be taxable at all.

The case arose out of a patent infringement action. Although the court disagreed with IRS's assertion that this was merely a lost profits case, and the court sided with the taxpayer on the issue whether the recovery was for damage to goodwill, the court could not agree that the recovery was nontaxable. 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.<sup>12</sup>

Basis recovery treatment is wonderful, of course, but with the current long-term capital gain rate at only 15 percent, even if no portion of the recovery is sheltered by basis, capital gain is still an attractive result compared with ordinary income.

In any case, *Big Four Industries* demonstrates that even though a taxpayer succeeds on the overall character question (proving that the lawsuit relates to capital assets, not to lost profits), that only gets you halfway home. If the taxpayer expects to shelter any of the recovery against basis, the taxpayer must be able to prove that basis.

<sup>9</sup> *Raytheon Production Corp.*, supra, 144 F.2d at 113; Rev. Rul. 68-378, 1968-2 C.B. 335 (1968); Rev. Rul. 81-277, 1981-2 C.B. 14 (1981).

<sup>10</sup> Rev. Rul. 81-277.

<sup>11</sup> 40 T.C. 1055 (1963), acq. 1964-1 C.B. (Pt. 1) 4.

<sup>12</sup> See also *Freeman v. Commissioner*, 33 T.C. 323 (1959).

The principle is often 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."<sup>13</sup> This idea cuts across a wide variety of litigation. For example, in *Wheeler v. Commissioner*,<sup>14</sup> the court acknowledged this rule and stated that where "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."<sup>15</sup>

These principles have been applied to stocks, bonds, real estate, and many other types of assets. For example, in Field Service Advice 200228005, 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 this positive authority, IRS has sometimes concluded that a recovery in excess of basis (even of a capital asset) constitutes ordinary income. For example, in Revenue Ruling 68-378,<sup>16</sup> 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 IRS applies in this ruling.

### Must There Be a Sale or Exchange?

One of the key analytical issues is what triggers capital treatment. A capital gain is generally defined by reference to the gain produced on the sale or exchange of a capital asset.<sup>17</sup> Is a sale or exchange required (or is it automatically deemed to occur) when you settle a lawsuit?

The "deemed" part of this question is easy. In general, the answer is that the mere settlement of a lawsuit is not deemed to constitute a disposition.

Yet that brings up the question of whether a disposition is even required. That is a tougher question. In the context of recovering damages in lawsuits, the courts and IRS have often allowed capital gains treatment even though there was no sale or exchange.

Either explicitly or implicitly, the Tax Court has stated that awards in excess of basis constitute capital gains, whether or not the taxpayer retains the asset. For example, in *Bresler v. Commissioner*,<sup>18</sup> the court considered an antitrust recovery, noting that the award could represent lost profits, which would be taxable as ordinary income. Where the award represents damages for injury to capital assets, though, it is taxable as capital gain to the extent it exceeds basis. In fact, capital gain treatment is often accorded without any mention of the necessity for a sale or exchange.

A number of 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.

<sup>13</sup> *Daugherty v. Commissioner*, 78 T.C. 623, 639 (1982).

<sup>14</sup> 58 T.C. 459 (1972).

<sup>15</sup> 58 T.C. at p. 461.

<sup>16</sup> 1968-2 C.B. 335 (1968).

<sup>17</sup> I.R.C. Section 1222.

<sup>18</sup> 65 T.C. 182, 184 (1975), acq. 1976-2 C.B. 1.

For example, in *Inco Electroenergy Corp. v. Commissioner*,<sup>19</sup> 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 broadly 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.<sup>20</sup>

Using this approach, the court ruled that the award was taxable as capital gain. It did not mention a sale or exchange requirement.

Similarly, in *State Fish Corp.*,<sup>21</sup> the taxpayer purchased all the assets of a company, including its goodwill. The seller violated a noncompete agreement that was entered into pursuant to the sale, and the taxpayer sued for injury to its goodwill. Although there was no sale or exchange of the goodwill, the court ruled that the award constituted a tax-free recovery of basis.<sup>22</sup>

Given the ambiguity, I find it a little surprising that IRS has sometimes ignored any notion of a sale or exchange in reviewing the tax treatment of proceeds of litigation. That suggests the sale or exchange requirement is not terribly important in this context.

It is much less surprising that the courts would accord this treatment, either dispensing with the sale or exchange notion, or failing to mention it altogether. However, it seems a bit more surprising that IRS has also allowed recovery of basis and capital gain characterization for recoveries to injuries to capital assets, even though the taxpayers did not sell or exchange those assets.

For example, in Field Service Advice 200228005, 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. IRS found that the origin of the taxpayer’s claim was 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.

Similarly, in Revenue Ruling 81-152,<sup>23</sup> 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. IRS ruled that the award was received on behalf of individual unit owners. The ruling concluded that the proceeds repre-

sented “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 Private Letter Ruling 9335019, a homeowners’ association brought a claim for damages against developers for construction defects. In analyzing the origin of the claim, IRS ruled that the proceeds “represent amounts to repair or restore the property that the builder agreed would be properly constructed.”

As a consequence, 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.” IRS instructed the unit owners to reduce their bases by the amount of their share of the recovery.

In P.L.R. 9343025, another homeowners’ association settled a claim against a developer and county for injury to common roads and land relating to housing developments. Although there was no sale or exchange of any capital asset, 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.”

Revenue Ruling 81-277<sup>24</sup> involved a contractor who agreed to construct a power plant for the taxpayer for a fixed fee. Due to 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.

IRS ruled that the award constituted a tax-free recovery of basis. The ruling required the taxpayer to reduce its basis in the power plant by the amount of basis recovery. In reaching its decision, the service stated that “[p]ayments 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.”<sup>25</sup>

All of this favorable authority may make you think your recovery is capital no matter what. That may make you think you can entirely ignore the sale or exchange issue entirely. Unfortunately, the authority is not uniform.

## Vestiges of Sale or Exchange Requirement

It would be nice to say that the sale or exchange requirement can be entirely dispensed with in this context. While I think this is nearly true today, I do not think we are all the way home. In some decisions and in one notable ruling, IRS appears to have required a sale or exchange in order for there to be a recovery of basis and capital gain characterization.

<sup>19</sup> T.C. Memo. 1987-437 (1987), 1987 Tax Ct. Memo LEXIS 434.

<sup>20</sup> *Id.*, 1987 Tax Ct. Memo LEXIS 434, 16.

<sup>21</sup> 48 T.C. 465 (1967), *acq.*, 1968-2 C.B. 3, *modified* 49 T.C. 13 (1967).

<sup>22</sup> See also *Dye v. United States*, 121 F.3d 1399 (10th Cir. 1997) (holding that recovery for diminution of value of securities investments constitutes capital gain).

<sup>23</sup> 1981-1 C.B. 433 (1981).

<sup>24</sup> 1981-2 C.B. 14 (1981).

<sup>25</sup> *Id.*

Perhaps the authority that has proven most nettlesome is Revenue Ruling 74-251.<sup>26</sup> There, 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 stated 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 law suit does not in itself constitute a sale or exchange.

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

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In fact, Revenue Ruling 74-251 involved a unique set of facts. 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 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 this reason, they claimed there was a sale or exchange of an asset. 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, 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, this ruling should not be read to mean that in no circumstances can a settlement give rise to capital gain.

Of course, Revenue Ruling 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 *Steele v. Commissioner*,<sup>27</sup> 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 this argument stating that since 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.<sup>28</sup>

A few other courts have done likewise. The 10th Circuit Court of Appeals in *Sanders v. Commissioner*,<sup>29</sup> 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 does not 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 IRS or a court that a sale or exchange of the asset in investment loss case must occur in order to achieve basis recovery and/or capital gain. Thus, it is an overstatement to say that a sale or exchange of the underlying investment is required in order to have a chance at capital treatment. Yet it is an understatement to say that the sale or exchange requirement is never imposed in this context.

## 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 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 is not binding on 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 such tax language is not binding on IRS, in my experience IRS does pay attention to it. That means failing to address tax issues in a settlement agreement is a little like passing up a free lunch.

Besides, with the reporting disputes (over Forms 1099 and W-2) becoming ever more common, addressing tax issues in a settlement agreement can also help to avoid those issues. It is far better to work these issues out at the time of settlement rather than being faced with them as an unpleasant surprise on Jan. 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 (let us assume that the plaintiff got the principal of the debt back), would be treated as receiving ordinary income on a recovery, since the only dam-

<sup>26</sup> 1974-1 C.B. 234 (1974).

<sup>27</sup> T.C. Memo. 2002-113 (2002).

<sup>28</sup> See also *Nahey v. Commissioner*, 111 T.C. 256 (1998).

<sup>29</sup> 225 F.2d 629 (10th Cir. 1955), cert. denied 350 U.S. 967 (1956).

age 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 the vast majority of cases the plaintiff will be claiming a complete or partial loss of the investment (a loss or a diminution of value).

### Legal Fees

Taxpayers are inclined to consider all legal expenses to be deductible. Yet issues of capitalization come up more frequently than you might imagine.

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 with respect to the investment, and applied to increase the plaintiff's basis in the stock.<sup>30</sup>

In my experience, there is rarely a problem about the tax treatment of the legal fees in investment loss cases where the legal fees are all paid or incurred in the year of the settlement. Thus, in contingent fee cases everything tends to work out just 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, where the investor/plaintiff has been paying legal fees over the course of several years on an hourly basis. Frequently taxpayers will have deducted those legal expenses as they are paid (presumably as investment expenses under Section 212). That means that those legal fees will be subject to the various limitations noted above (the 2 percent threshold for miscellaneous itemized deductions, phase-out, and most seriously, alternative minimum tax). Depending on the numbers, these can be significant limitations.

In *Leigh v. United States*,<sup>31</sup> 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 therefore held that the taxpayer had to capitalize the legal fees under Section 263.

Many of the issues seem largely to be questions of degree. This is kind of an "origin of the claim" analysis. In addition to controlling the treatment of settlements

<sup>30</sup> See *Dye v. U.S.*, 121 F.3d 1399 (10th Cir. 1997) (holding that legal fees incurred in prosecuting claims for diminution in value to investments are capital expenses).

<sup>31</sup> 611 F. Supp. 33 (N.D. Ill. 1985).

and judgments, the origin of the claims test is also used to determine the tax treatment of legal fees.<sup>32</sup> Whether legal fees can be deducted or must be capitalized is controlled by the nature of the matter with respect to which the expenses were incurred.<sup>33</sup>

Section 263(a) expressly 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 this language, the regulations make it clear that the cost of capital expenditures includes the cost of defending or perfecting title to property.<sup>34</sup> 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.<sup>35</sup>

The courts and 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*,<sup>36</sup> a taxpayer sought to deduct legal fees in litigation over his ownership interest in a closely held holding company. The Tax Court rejected this position, ruling that the fees must be capitalized because the origin of the claim was to protect, defend, and acquire ownership interests in the corporation.

Thus, in Field Service Advice 200228005, the taxpayer paid legal fees to prosecute an action arising from its purchase of contaminated land. IRS stated that, given that the legal fees related to environmental damage allegedly caused by the defendant, the legal fees had to be capitalized. Similarly, in *Winter v. Commissioner*,<sup>37</sup> 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.<sup>38</sup> Litigation over the purchase of an asset seems almost invariably to require capitalization.

**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 these claims. Since 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 quite large.

<sup>32</sup> See *Woodward v. Commissioner*, 397 U.S. 572, 574-79 (1969).

<sup>33</sup> *United States v. Gilmore*, 372 U.S. 39, 49 (1963); F.S.A. 200228005 (2002) ("the deductibility of the payments and legal fees at issue depends on the origin of the claim from which the settlement arose").

<sup>34</sup> Reg. Section 1.263(a)-2(c).

<sup>35</sup> Reg. Section 1.212-1(k).

<sup>36</sup> T.C. Memo. 1998-161 (1998).

<sup>37</sup> T.C. Memo. 2002-173 (2002).

<sup>38</sup> See also *Spector v. Commissioner*, 71 T.C. 1017 (1979), *rev'd and remanded on another issue*, 641 F.2d 376 (5th Cir. 1981).