Should Prejudgment Interest Be Taxable?

by Robert W. Wood

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Most tax professionals, and even litigators with only passing knowledge of tax law will answer this question with an unreserved yes. Interest, after all, is interest. A series of cases has, however, analyzed the issue with considerably finer detail.

Related to the structured settlement point made above is to what extent, even outside the structured settlement context, a payment of interest to a personal injury plaintiff should be taxable. Although it may sound simplistic, it is a reasonable assumption that an amount denominated as interest in almost any context will be treated as taxable income. Sometimes the determination of whether "interest" has been paid is not obvious.

In *Frank L. McShane*,[1] the Tax Court considered a settlement agreement arising out of an action for injuries received in a gas explosion. The IRS argued that a portion of the settlement amount constituted interest. The Tax Court reviewed the settlement agreement and the evidence contained in the record, and concluded that the payments did not include interest because: (1) the agreement provided that the settlement was to be paid without costs and without interest; (2) the intentions of all parties as stated by their attorneys were consistent with the payment of no costs or interest; and (3) the taxpayers and the attorneys uniformly testified that the tax consequences of the settlements were never considered in the negotiations, and instead that the settlement was based on the risks each party faced in continuing the appeal.

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In *Andrew Benjamin Aames, a/k/a Larimore S. Brooks v. Commissioner*,[2] the taxpayer suffered serious personal injuries, and later settled with the defendant. The taxpayer then sued his attorney for malpractice, alleging that the lawyer had negligently persuaded him to accept an unreasonable settlement. In the malpractice action, the taxpayer received $605,685 in damages, and interest of $158,283. The taxpayer was also awarded $16,280 in damages on a second count plus $4,254 in interest. The taxpayer did not include either interest amount in his income. The Tax Court concluded that the interest was includable in the taxpayer's income. Although the underlying damages qualified as personal injury damages, the court held that the interest was awarded merely because of delay, and therefore was taxable.

In a properly structured settlement, of course, there should be no taxable interest element. For example, the IRS held in a news release that payments received under a settlement fund distributable to victims of exposure to Agent Orange could receive those settlement payments tax-free.[3] The exclusion applied not only to the principal of the fund, but also to earnings on it, so that neither the fund nor the recipients are taxable on the interest element.

The subject of interest received considerable attention in *Kovacs v. Commissioner*.[4] There, the Tax Court held that the interest portion of a lump-sum payment for wrongful death damages is not excludable from the recipient's income under section 104. Kovacs was killed by a train operated by the defendant, and his

[1] T.C. Memo. 1987-151, *87 TNT 54-41*.

[2] 94 T.C. 189, *90 TNT 47-21* (1990).

[3] IR 90-79 (May 16, 1990).

[4] 100 T.C. 124, *93 TNT 45-22* (1993); *aff'd* 25 F.3d 1048 *94 TNT 126-16* (6th Cir. 1994); *cert. denied* 513 U.S. 963 (1994).

wife sued for wrongful death. After receiving a court award, the plaintiff also received interest on the damages from the commencement of the suit under applicable Michigan law. The Tax Court relied upon a dictionary definition of the word "damages" to conclude that the interest element of the recovery was taxable.[5]

Planning Tip: In a settlement there should be substantially more flexibility to avoid the problem. Most prejudgment interest statutes simply could not kick in until there is a judgment of the court. Nonetheless, some cautious plaintiffs and their advisors may wish to include in the settlement document an express disclaimer of prejudgment interest.[6]

Settlements on Appeal

The tax treatment of interest in cases settling on appeal has been the subject of increased scrutiny by the IRS and the courts. For example, in *Laurel A. Forest v. Commissioner,*[7] a case involving a tort action 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 to interest. The court reasoned that the verdict at trial did give prejudgment interest to the plaintiff. Consequently, a share of the recovery had to be allocated to the interest.

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This decision arose out of Laurel Forest's back fracture sustained when she slipped and fell in her employer's walk-in refrigerator. Forest brought a products liability action against the manufacturer of the refrigerator. The jury returned a $2.6 million verdict, which yielded a $5 million judgment including prejudgment interest. The trial court found that this verdict shocked the conscience, and ordered a new trial unless Forest agreed to a $1 million *remittitur.* Forest agreed to the *remittitur* and the trial court entered a $1.4 million judgment, plus $1.6 million of prejudgment interest. The manufacturer appealed and the parties ultimately settled for $2 million. The settlement agreement did not allocate the $2 million between damages and interest. However, the stipulations filed by the parties indicated that judgment was entered for $1.4 million plus interest and costs.

As a result of the settlement, in 1992, Forest received $1.3 million, with the remaining $700,000 being paid to her attorneys. Forest did not report any portion of the settlement on her 1992 return. The IRS determined that $600,000 of the settlement amount represented interest, hence not excludable under section 104. The Tax Court agreed. On appeal to the First Circuit, the court acknowledged that the settlement agreement was ambiguous with respect to the interest in question. However, the court did not find the ambiguity sufficient to render the Tax Court's decision clearly erroneous. The court of appeals emphasized in its decision that the settlement had been negotiated under the shadow of a judgment that did include prejudgment interest. The court also noted that the stipulations specified that the settlement represented a $1.4 million judgment plus interest, and that the parties did not consider the tax consequences in their negotiations.

Planning Tip: The First Circuit's statements in *Laurel A. Forest* almost read as an admonition to advisors to take the tax bull by the horns and attempt to plan around what the First Circuit seems implicitly to acknowledge is an unfortunate result. Until there is definitive case law to the contrary, the First Circuit seems to invite express disclaimers or waivers of prejudgment interest, presumably in exchange for a payment of a larger portion of the compensatory damages. This seems to be essentially the same type of issue faced by taxpayers settling on appeal where there have been punitive damages awarded by the trial court. And, as in that context, there are many considerations by the parties that would seem to argue against a rigid pro rata allocation of a settlement based on the trial court's judgment (a judgment that by definition is on appeal, sometimes cross-appeal). However, this area has become significant enough to the IRS that it has issued advice to its field representatives showing how to compute interest on a lump sum tort settlement.[8]

A similar case is *Joseph J. Delaney, et ux. v. Commissioner.*[9] There, the Tax Court found that a portion of a settlement amount that was payable in connection with a tort action had to be allocated to prejudgment interest. The matter had gone to trial and settled on appeal. At trial, the plaintiff was awarded statutory prejudgment interest under state law. Consequently, the IRS pro rated the amounts of the verdict to determine what portion of the settlement figure represented interest income. The Tax Court agreed.

In *Robert Pagliarulo, et ux. v. Commissioner,*[10] the Tax Court held that interest on a workers compensation award was not excludable damages. Relying on its decision in *Kovacs* (which had then been affirmed by the Sixth Circuit), the court found no conceptual distinction between interest on a personal injury award under section 104(a)(2) and interest on a workers compensation award under section 104(a)(1).

In *James V. Crews, et ux. v. Commissioner,*[11] the Tax Court considered the reciprocal question of whether

[5]For further discussion, see Wood, "With Planning Can Pre-Judgment Interest Be Excludable?," *Practical Accountant* (Vol. 26, no. 5, May 1993), p. 54; *see also* Wood, "In the Interest of Taxation," *The Recorder,* September 13, 1993, p. 8.

[6]*See also* Koplin, "Taxability of Prejudgment Interest," *ABA Section of Taxation Newsletter,* (Vol. 14, no. 1, Fall 1994), p. 7.

[7]T.C. Memo. 1995-377, *95 TNT 155-7; aff'd without published opinion* 104 F.3d 348, *97 TNT 8-69* (1st Cir. 1996).

[8]*See Tax Notes,* Nov. 21, 1994, p. 975.

[9]T.C. Memo. 1995-378, *95 TNT 155-8; aff'd* 99 F.3d 20, *96 TNT 216-11* (1st Cir. 1996).

[10]T.C. Memo. 1994-506, *94 TNT 201-11.*

[11]T.C. Memo. 1994-64, *94 TNT 36-10; aff'd in part, rev'd in part, and remanded* 78 AFTR2d par. 96-5793 (9th Cir. 1996); *amended* 96 C.D.O.S. 6656 (9th Cir. 1996).

attorneys fees that were allocable to an award of prejudgment interest were deductible by the payor. Noting that prejudgment interest in such a circumstance (even in a personal injury case) has been held by the Tax Court not to be excludable from income, the court determined that such attorneys fees were deductible because they relate to the production of income.

***Brabson v. United States* and Prejudgment Interest**

Perhaps the most publicized case involving prejudgment interest was *Brabson v. United States.*[12] *Brabson* involved what was indisputably a tort claim. Mary Brabson and her children were awarded $2.9 million in a 1988 judgment arising out of the explosion of the Brabsons' household due to a gas leak. The $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 argued that this portion of the award was taxable. The Brabsons paid the tax deficiency and then sought a refund. The district court granted the refund request,holding 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 *Kovacs v. Commissioner.*[13]

The Tenth Circuit reversed, noting 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. The circuit court in *Brabson* reviewed the district court's conclusion about how state law (in this case, Colorado) applied to prejudgment interest.

The Tenth Circuit in *Brabson* invoked the Supreme Court's decision in *Commissioner v. Schleier,*[14] in stating 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 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 Colorado decisions to the effect that prejudgment interest amounted to compensatory damages in personal injury cases, compensating the 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 should go along with the tax-free character of the tort recovery. However, the IRS argued 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 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. The court pointed 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 "broaden" the scope of the section 104 exclusion to cover prejudgment interest, even when received on an indisputably tort case.

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According to the *Brabson* court, *Schleier* supports a strict analysis of section 104 that requires one — as a purely practical matter — to evaluate just why the money was paid. The court found that "compensation for the lost time value of money is caused by the delay in attaining judgment."

Planning Tip: The *Brabson* decision establishes that at least in the Tenth Circuit, prejudgment interest in a strictly tort case is taxable. Arguably, it will be taxable only if it is expressly called "prejudgment 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. The *Brabson* case may be yet another reason why — from a tax perspective at least — a settlement is nearly always better than a judgment.[15]

Occasionally, questions have even arisen as to who is taxable on the interest element. In *Gerald Jarvis, et ux. v. Commissioner,*[16] the court held that interest on a wrongful death action was taxable to the parents, rather than to their child's estate. In *John Leonard Meyer v. Commissioner,*[17] the Tax Court faced a situation where the taxpayer's daughter was disabled and entitled to nontaxable benefits. The taxpayer eventually received the nontaxable benefits for his daughter, plus interest

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[12]73 F.3d 1040, *96 TNT 25-24* (10th Cir. 1996); *cert. denied* 117 S. Ct. 607 (1996).

[13]Note 4 *supra.*

[14]515 U.S. 323, *95 TNT 116-8* (1995).

[15]*See also* Raby, "When Interest is Not Interest," *Tax Notes,* Oct. 10, 1994, p. 229; and Koplin, "Prejudgment Interest Component of Personal Injury Settlement Found Taxable by First Circuit," *ABA Section of Tax'n Newsletter* (Vol. 16, no. 2, Winter 1997), p. 5.

[16]899 F. Supp. 320, *95 TNT 170-24* (E.D. Mich. 1995).

[17]T.C. Memo. 1994-536, *94 TNT 210-8.*

for the delay. The IRS determined, and the Tax Court agreed, that the interest element was taxable.[18]

Recent Cases

The recent case of *Michael J. Woods, et ux., et al. v. Commissioner,*[19] underscores the need to be clear about the taxability of interest.

The *Woods* case arose out of an injury to Jacqueline Woods's shoulder during birth in 1985. Her parents sued the doctor and hospital on their own behalf as well as on the baby's behalf. After a jury trial, the jury awarded damages to the baby and her parents, and the court clerk added prejudgment interest. Prejudgment interest was apparently 42.5 percent of the total amount awarded.

During the pendency of the doctor's appeal, the parties settled the case. The settlement agreement did not allocate any portion of the settlement proceeds to anything other than damages. In other words, interest was not mentioned. In 1992, the doctor's insurer issued two checks, one to the baby and her lawyer for $1.86 million and one check to the baby's parents and the lawyer for $184,000. The attorney for the Woodses retained his portion of the payment for legal fees and paid the balance to the plaintiffs.

Neither the baby nor her parents reported any portion of the settlement proceeds on their tax returns. The IRS determined deficiencies, asserting that the plaintiffs received the taxable interest income from the settlement proceeds. The Tax Court held that the IRS correctly applied the percentage resulting from the state court's judgment to apportion the total settlement proceeds between damages and prejudgment interest. The court cited and relied upon *Rozpad v. Commissioner.*[20] The *Rozpad* case, which the court took to be controlling authority in the First Circuit, was particularly relevant because the *Woods* case in the Tax Court would be appealable to the First Circuit. The Tax Court noted that the First Circuit in *Rozpad* had rejected the contention that prejudgment interest is part of damages under Rhode Island law.

Companion Case

In another decision, *Joseph M. Perry v. Commissioner,*[21] the IRS determination was also upheld in a case that similarly involved a state court (Rhode Island) settlement. Mr. Perry's case involved a vehicular accident and he received a jury verdict to which the court clerk added prejudgment interest. The case settled on appeal, but the settlement agreement did not state whether any portion of the settlement proceeds constituted interest. Mr. Perry did not report any portion of the proceeds as taxable, and the IRS determined that a percentage of the proceeds was taxable interest.

As in *Michael J. Woods,* the Tax Court in *Joseph M. Perry* found that the IRS had correctly applied the percentage resulting from the state court's judgement to apportion the total settlement proceeds between nontaxable damages and taxable prejudgment interest. Again, the court cited with approval *Rozpad v. Commissioner.*[22]

Watch Out for Interest Designation

Woods is another one of those cases that one has to cringe about. After all, the plaintiffs in this case and their counsel probably all figured that this was a real physical injury case, so they probably assumed that there was no question about the applicability of section 104(a)(2). And, since the case settled during the pendency of an appeal, all parties probably thought that any verdict rendered by the trial court was really unimportant. What was important, it must have seemed, was that a settlement was ultimately reached and the defendant was paying to get rid of this personal injury lawsuit.

Unfortunately, the parties apparently did not even consider the applicability of the underlying verdict, which resulted in a whopping 42.5 percent of the assertedly nontaxable award being treated as taxable interest. One can imagine the consternation faced by a plaintiff who has received an amount only to find out some years later (in 1998), that the amount was partially taxable. Finding out that 42.5 percent of the total settlement amounted to taxable interest could be a crushing blow (not to mention one that could conceivably lead to malpractice claims).

It is not clear whether there is a way to prevent the result that obtained in this case. On the surface, one would hope that specifically mentioning (and negating) the applicability of any prejudgment interest in the settlement agreement might result in a different conclusion. After all, if an amount was awarded at trial and appealed, and if there is also a cross-appeal on the actual damages, one would hope that the settlement figure would be regarded as purely that, a settlement of a disputed amount for personal injuries. Specifically negating the payment of any prejudgment interest might help to avoid the unfortunate result that obtained in this case.

Keep in mind that this same type of issue is now occurring with respect to payments of punitive damages. If an amount of punitive damages is awarded at trial but the case settles on appeal for an amount between the actual damages and the total of actual and punitive damages awarded, the defendant will normally insist that no amount is being paid for punitive damages. The defendant will typically insist on such an express statement in the settlement agreement. It is not for tax reasons that defendants typically so insist. It is normally for reasons relating to insurance coverage, publicity, and other factors. Time will tell how successful plaintiffs will be in receiving amounts that are not characterized as punitive damages in a settlement on appeal.

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[18]For several helpful articles concerning interest and its taxability, see McNaner, "Interest Not Excludable Under Section 104(a)(1): *Pagliarulo v. Commissioner,* 48 *Tax Lawyer* 1075 (Summer 1995); *see also* Michael Knoll, "A Primer on Prejudgment Interest," *U.S.C. Law School unpublished monograph* (Feb. 20, 1996). *See also* Koplin, "Taxability of Recovery for 'Delay' Damages in Personal Injury Lawsuits," *ABA Section of Tax'n Newsletter* (Vol. 14, no. 1, Fall 1994), p. 8.

[19]T.C. Memo. 1998-435, *98 TNT 238-9.*

[20]154 F.3d1, *98 TNT 166-4* (1st Cir. 1998).

[21]T.C. Memo. 1998-433, *98 TNT 238-10.*

[22]Note 20 *supra.* For yet another recent case holding a portion of a settlement to be prejudgment interest, see *Manuel J. Serpa Jr., et ux. v. Commissioner,* T.C. Memo. 1998-453.