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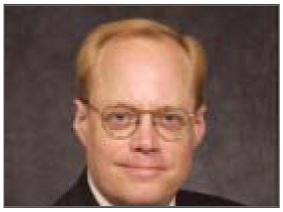

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Untangling Bear Stearns' $275M Investor Settlement

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Investor lawsuits were hardly a surprise after the collapse of Bear Stearns in 2008. Its shares dropped off a cliff during the year preceding March 14, 2008. On its deathbed, Bear Stearns was snapped up by J.P. Morgan Chase at a deep discount. Investors sued claiming they were misled.

Now the case is settling for $275 million. Not surprisingly, top executives of Bear Stearns like James E. Cayne and Alan "Ace" Greenberg were named defendants. See Bear Stearns in $275 million shareholder settlement. However, a rich $9 billion fund was set aside by J.P. Morgan Chase when it struck its 2008 deal for Bear Stearns.

That pot of gold is expected to pay the full settlement so execs won't have to pony up. See Bear Stearns Accord Turns Another Page. Of course, this is not the only settlement in the wake of the financial crisis. Countrywide Financial's settlement was $600 million and Merrill Lynch paid $475 million. Washington Mutual paid $208.5 million, and a $90 million settlement was recently approved to resolve investor claims against Lehman Brothers.

If you are a claimant in one of these and receiving money how do you determine its tax treatment? Say you bought Bear Stearns stock for $159, and one year later it was worth $2 a share. (No, those numbers aren't made up.) See 12 key dates in the demise of Bear Stearns. If you receive $75 in a settlement, is it income? It depends.

In investment loss cases, the plaintiff will generally assert that recovered funds are non-taxable as a recovery of basis or represent long-term capital gain. Usually, this invites questions into what the plaintiff has already claimed on his tax return for this loss. See Stakes Loom Large in Determining Taxation of Investment Loss Lawsuit Recoveries. If the plaintiff has already claimed a tax loss, it must be taken into account in determining how the recovery will be taxed.

The plaintiff should not get favorable taxation on the recovery ***and*** a tax deduction for the investment loss. See Securities Lawsuit Recoveries: Capital Gain or Ordinary Income? One key issue is what triggers capital treatment. A capital gain is generally defined by reference to the gain on the sale of a capital asset. See IRS Tax Topic 409, Capital Gains and Losses. In the context of recovering damages in lawsuits, the courts and IRS have often allowed capital gain treatment even though you still hold the investment.

Thus, if you bought Bear Stearns at $159, it drops to $2, and you recover $75, you might have a nontaxable recovery of basis even if you still hold the stock. But the facts are key.

Many taxpayers recover amounts related to investments from companies, banks, brokerage firms, and investment advisers. The tax issues for the recovering plaintiffs often revolve around ordinary income versus capital gain and gain versus basis recovery. The federal income tax stakes can be large so plan ahead.

For more, see:

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Facebook IPO Lawsuits: Will IRS Share?

Carried Interests Taxed As Capital Gain? It's Poetry

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