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Recent Damage Awards Decisions

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There have been several recent decisions involving various aspects of litigation recoveries. The recent decisions seem to fall into two areas: section 104 and the continuing debate over the tax treatment of contingent attorney fees. The former represents a seemingly endless stream of authority that attempts to interpret a code section that has had no regulatory attention since long before its statutory overhaul in 1996. The latter issue — the tax treatment of attorney fees — might have been solved by the Supreme Court's *Banks*[1] decision this January. However, the Supreme Court left open certain questions that have proven to be nettlesome.

Background of Issues

To set the stage for the recent decisions, let me detour briefly into the status of each topic. Section 104 of the Internal Revenue Code, in one form or another, is almost as old as the tax law itself. It has long excluded recoveries from personal injuries or sickness. Then, in 1996, primarily because of perceived abuses arising out of employment litigation (in which plaintiffs generally could treat their recoveries for emotional distress as personal injuries), Congress narrowed section 104.

Since 1996 the section has protected only damages for personal *physical* injuries and *physical* sickness. Unfortunately, the precise definition of physical is not clear. More exactly — there is nothing precise about it — there simply *is* no definition. Most tax advisers are able to divine some of the IRS's views from private letter rulings,[2] and the IRS has taken an aggressive posture in case law. Yet there is no litmus test for determining what constitutes a physical injury.

Perhaps more significantly, there is virtually no discussion about the second prong of the section 104 exclusion, for recoveries related to physical sickness. Physical sickness, after all, often does not come with outward manifestations of harm, such as bruising. There is at least one private letter ruling in which the IRS recognized that a recovery for cancer is excludable under section 104, but even then the analysis is not clear.

The courts continually trot out an analysis based on *Commissioner v. Schleier*,[3] but that test hasn't been as helpful as a definitive Supreme Court decision is supposed to be. In *Schleier* the Supreme Court ruled that the underlying cause of action had to be based on tort or tort-type rights, and that the damages must be received ''on account of'' personal physical injuries or physical sickness. That is two tests, not one, and the second test has been especially enigmatic.

Attorney Fee Quandary

The attorney fee dilemma is something I have found difficult to explain to nontax lawyers. I believe that stems primarily from what seems to be a lack of common sense about that area. The fundamental question is whether a plaintiff who recovers in a contingent fee case should have gross income measured by the full amount of the recovery (including attorney fees), or rather merely receive income measured by the net amount (in other words, excluding payments that are made directly to the lawyer). Although it might seem that the results would be the same, they are quite different in many circumstances because of various technical tax rules, most notably, the alternative minimum tax.

The authorities in this area have followed a tortured path. Until this year, there was a pronounced split within the circuit courts around the United States, with some circuits taxing proceeds one way and some taxing them another (and remember, we're talking about federal tax law, so having a different treatment depending on where the lawsuit is brought doesn't make sense). For employment claims and federal False Claims Act cases, the issue was favorably resolved by statute, at least for cases settled after October 22, 2004. For cases not covered by statute, though, the Supreme Court announced just this year the general rule that plaintiffs *will* have gross income measured by the full amount of the recovery.[4]

That means plaintiffs generally cannot net their attorney fees against their gross award. That means in many cases the deduction they receive for the attorney fees paid will *not* put them in the position they would have been in if they could have netted fees. Since the *Banks*

[1]125 S. Ct. 826, *Doc 2005-1418, 2005 TNT 15-10* (2005).

[2]For example, in LTR 200041022, *Doc 2000-26382, 2000 TNT 201-10*, the IRS made it clear that it wants to see physical touching and overt manifestations of physical harm, such as bruising or broken bones.

[3]515 U.S. 323, *Doc 95-5972, 95 TNT 116-8* (1995).

[4]*See Commissioner v. Banks*, *supra* note 1.

case was decided in January, there continue to be questions around the edges, the Supreme Court having (intentionally or not) left taxpayers at least some wiggle room to avoid the general rule.

Section 104 Cases

The Tax Court recently decided *Robert E. Corrigan*.[5] The facts in *Corrigan* are extraordinarily detailed and complicated. The section 104 issue, though, is fairly simple. During 1984 Mr. Corrigan borrowed $390,000 from Prudential, his employer. He repaid $65,000 but owed $325,000 when he resigned his employment in 1985. Prudential pursued collection, and Corrigan counterclaimed for breach of contract, breach of the covenant of good faith, fraud, negligent misrepresentation in his hiring, and punitive damages.

Five years later, in 1990, Corrigan and Prudential executed mutual releases. As part of that release, Corrigan was relieved of responsibility to repay the $325,000. He treated it as an amount excludable under section 104. The IRS disagreed, asserting that it represented income. The release was a general release not specifying tax treatment. Interestingly, though, the taxpayer was able to produce a letter from his attorney stating that during the settlement discussions, Prudential expressed willingness to reclassify the $390,000 loan as a punitive damage settlement award.

Of course, the punitive damage characterization would not have helped the taxpayer in any event, because punitive damages always represent ordinary income. The court was able to quickly dispose of the section 104 argument by noting the two-pronged test established in *Schleier*[6] for amounts excludable under section 104. The taxpayer did not meet the test.

Trent v. U.S.[7] is a more interesting and important case. There, the district court considered a tax refund action arising out of a court-approved settlement of an automobile accident case. The auto accident occurred in 1991, a lawsuit was filed in 1993, and a settlement was reached in 1999. The injured party, Clinton Michael Trent (the child of the taxpayers), was to receive $5 million in the settlement. Clinton was disabled and severely injured and, though he was an adult at the time of the accident, he required full-time care.

The court approved the settlement, and in so doing, the court directed that $729,874 of the $5 million settlement be disbursed to Trent's mother, Dorlis Trent. The order mandating that distribution stated that this money was ''for the past attendant care and support which she and Clinton Michael's father have provided their son since he sustained his injuries.'' Unfortunately, Dorlis Trent was not a plaintiff in the underlying auto accident case, and that fact proved important to the tax consequences here.

The Trents filed their federal income tax return in 2000 and reported the $729,874 as ''other income,'' describing it as ''reimbursement for nursing and attendant care services.'' Their tax return even disclosed that this was money arising out of the settlement of the serious-injury accident involving their son, and that the $729,874 was paid for attendant care services that Dorlis provided to her son after the injury. About a year later, the Trents filed an amended income tax return, claiming a refund for the tax paid on the $729,874 Dorlis received.

The theory of the refund claim was that there was clearly a physical injury — and a serious one at that — and that all the proceeds should therefore come within the ambit of section 104. The IRS denied the refund claim and the matter wound up in district court. The matter came before the court on the IRS's motion for summary judgment. Even with the relatively high standards against which summary judgment motions must be evaluated, the district court ruled that the IRS was entitled to summary judgment.

Who Is Injured?

I believe most people who read the *Trent* case would find the result unfortunate, though that result is probably predictable given the facts and the procedural posture. The district court goes through the usual tax principles from the case law, including the classic cases that define gross income as broadly as possible and that construe exclusions from income as narrowly as possible.

Looking at some of the facts in *Trent*, the court noted that there was no evidence that the parents were signatories to the settlement agreement resolving their son's civil action. The parents were not parties to the action, and the court therefore found that they had no right to any portion of the settlement. That the state court in the case had directed certain portions of the total settlement monies to be used for the payment of previously incurred obligations did not matter. Those amounts included litigation costs, attorney fees, previous treatment paid for by the West Virginia Department of Health and Human Resources, as well as the disbursement to Dorlis Trent for past attendant care and support. In other words, the mother was treated as just another creditor.

Although the court noted that the total amount paid to the injured son on account of his personal physical injuries was unquestionably excludable, the court said it does not follow that subsequent expenditures out of those funds when received by others are excludable as well. The court found that Dorlis Trent had to establish some independent right in the settlement proceeds, which she did not do. Dorlis was not a plaintiff and had not made any claim herself. In what I think is fair to characterize as a Hail Mary pass, Dorlis Trent argued that the $729,874 payment ordered by the court could be considered a gift. The court easily rejected that contention.

Settlement Time Versus Refund Claim

What I think is most interesting about *Trent* is that the case probably would never have been brought (and there would have been no need) if a few preventative steps had been taken. First, a good deal of thought should have been given to the tax return filing position *before* it was taken. Had Mrs. Trent excluded her recovery on her initial return, she probably never would have been queried. If she had been, a few facts about the lawsuit,

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[5]T.C. Memo. 2005-119, *Doc 2005-11355, 2005 TNT 99-22* (May 23, 2005).

[6]*Supra* note 1.

[7]95 AFTR 2d 2005-__, *Doc 2005-11230, 2005 TNT 101-9* (S.D. W. Va. May 2, 2005).

recovery, and court order might have been sufficient to make the auditor go away, despite the fact that she was individually not a plaintiff and did not sign the release.

The situation with an amended return is different. I expect most tax practitioners would have advised Mrs. Trent that if she reported and paid tax on her settlement amount and then claimed a refund, the refund claim would be denied. That is not to say that characterization questions transmute after the filing of a return. However, the tax posture is altered significantly once an initial return position is taken. And the stakes go up materially.

Second, the case underscores the importance of the pleadings. The district court in *Trent*, facing a motion for summary judgment by the IRS, had to note that Mrs. Trent was not a plaintiff. That was correct. Yet she surely had a cause of action of some sort arising out of the accident. The cause of action that leaps to mind is loss of consortium, though perhaps she had other causes of action, too.

Had she received her $729,000 by way of settlement of her loss of consortium claim regarding her disabled son, surely her tax return preparer would have advised her that she need not treat that amount as income. Then, in all likelihood, she never would have been audited. If she had been audited, she would have prevailed.

Moreover, even if Mrs. Trent was not listed as a plaintiff in the action, some thought could still have been given to any rights she had. If she had tax advice at the time of the settlement, perhaps she could have volunteered to personally sign a release, and perhaps that could have helped. After all, I'll bet she did have a valid loss of consortium claim, even if she had not (as of then) asserted it.

If that sounds aggressive, consider whether it should matter who brings up the release. If Mrs. Trent volunteers to sign a release of her claims, her claims appear to be less real than if the defendant demands it. But I'm not sure it should matter who raises the topic, as long as she has a claim. Of course, that means it probably would matter if she could still technically assert her claims if she chose to. That means it may be important to verify that the statute of limitations on her own claim(s) has not run.

In evaluating all that, also consider that sometimes a lawyer may consider a claim asserted de facto even if it is not in fact asserted. If you probed the facts in this case, you would find that the plaintiffs' lawyer said a *maximum* of $5 million was available for the case and that adding Dorlis as a plaintiff would not have changed the total recovery. Obviously, you would want some explicit manifestation of Dorlis's claim, but I'm not sure it would need to be as formal as a court filing. After all, in other cases, the courts (and to a lesser extent, even the IRS) have looked behind correspondence to ask what was really going on. A demand letter can be enough. The courts have even occasionally stretched to find that a suggestive (but not really threatening) letter is a demand letter sufficient to characterize the recovery.[8]

I frequently see cases in which a defendant demands signatures on a settlement agreement by persons who are nominally not plaintiffs but presumably may have some claim. That often occurs with claims against entities such as corporations (in which shareholders are *also* expected to sign). I have also seen it occur when certain family members are plaintiffs, and yet other (nonplaintiff) family members are asked to sign releases as well as the plaintiffs. If those other family members are required to sign a release, it may not be unreasonable to allocate something to them. It would not seem a stretch of the imagination for one to postulate that Mrs. Trent *could* have sued for loss of consortium and that she may have in some respects manifested a claim on that score, even if she did not file a complaint.

The fact that there was a court order requiring the distribution of some monies to Mrs. Trent was both fortunate and unfortunate. It was fortunate because it recognized that she did have some entitlement. It was unfortunate in that her entitlement seemed to be solely for the performance of services. Perhaps the court could have been helpful here. If Mrs. Trent had asked, the court might have even alluded to a loss of consortium claim in its order, as long as it believed she could have brought the claim. Once again, a little tax knowledge on the part of the taxpayer or the local court (which can often be asked to assist the taxpayer) could well have made all the difference.

Intent of the Payer

One of my favorite cases, in which a court went behind a complaint to look for the gravamen of a case and the reason money was paid, is *Paton v. Commissioner*.[9] Mrs. Paton was held to have received her entire settlement as excludable in the nature of a wrongful death claim, even though she filed no lawsuit and had merely hinted at a tort action. The settlement was held to be nontaxable based primarily on the testimony of Mrs. Paton's attorney that the "implied" claim for wrongful death was a valid one and that it *would have resulted* in an excludable judgment had it been litigated.

That doesn't seem too different from the situation in *Trent*. However, presumably yet another difficulty in *Trent* is that it does not appear that anyone thought of that at the settlement agreement stage. Had Mrs. Trent been added as a party to the settlement agreement, expressly releasing any claims that she might have for loss of consortium, it might have come out differently.

Cases regarding the intent of the payer are, of course, legion. If the IRS or the courts cannot discern the intent of the payment from the settlement agreement, the input from the defendant/payer may also be relevant. Defendants are generally not going to be cooperative once the settlement agreement has been signed, but they are likely to be cooperative before the settlement agreement is signed. Although that does not mean that the IRS and the courts are bound by the tax language in the settlement agreement (as they are clearly not bound), my practical experience is that the IRS does pay attention in most cases to what the settlement agreement says. Again, that could have made all the difference to Mrs. Trent.

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[8]*See Paton v. Commissioner*, T.C. Memo. 1992-627.

[9]*Id.*

Finally, I think *Trent* raises one other interesting point. Frequently in cases arising out of severe disabilities there is a Hobson's choice about how to allocate monies. Let's assume that in *Trent* the husband, wife, and son were all plaintiffs. In the case of a debilitating injury, plaintiffs' counsel is probably not in the best position to judge whether a large or small amount should be allocated to the parents or the child.

That raises not only income tax issues (although, let's assume that in a case of this sort with properly filed loss of consortium claims, the entire amount regardless of to whom paid would be excludable under section 104). It also raises estate tax consequences. I have seen cases in which the bulk of the award is allocated to the child, and the child unexpectedly dies a short time later. Because section 104 does not extend to the estate tax, that may result in a large taxable estate, thus eviscerating the benefits section 104 was intended to provide.

Conversely, if most of the money is allocated to the parents in accident cases, that also may cause problems. Usually it is necessary to get advice from several people, including a tax lawyer, a structured settlement broker, and even a special-needs trust lawyer. A special-needs trust is often used as a way of continuing to provide eligibility for Social Security and other public benefits.

Allum

Another recent case involving section 104 is *Robert L. Allum v. Commissioner*.[10] That case arose out of a suit the taxpayer filed after being terminated from his employer. The 1991 lawsuit alleged wrongful termination, defamation, and violations of Nevada's RICO statute. A jury found against the taxpayer on his wrongful termination and defamation claims, and the district court dismissed the RICO claim.

Undaunted, in 1994 Allum sued Bank of America, as successor to his employer, and various other defendants — including a member of the Nevada Supreme Court who had participated in affirming the dismissal of his RICO claim! In 1994 Allum brought the case as a civil rights case under section 1983, arguing that the defendants had violated his civil rights during the state court proceedings and had conspired to violate federal and state RICO statutes.

You have to admire Allum's pluck. His tax case makes good reading; it episodically runs through the various claims he brought and the colorful raft of accusations he flung vitriolically at the various defendants. Allum alleged that he suffered unspecified physical and emotional damages by virtue of those civil rights violations. The district court dismissed those claims, but the Ninth Circuit reversed the district court's order denying Allum's discovery motions, as well as the district court's granting of summary judgment on the due process claim.

Still undaunted, Allum filed another action in district court in 1999, this time against the state of Nevada, members of the Office of the Attorney General of Nevada, and a former Nevada Supreme Court justice. Again his case was a civil rights case. This time Allum started talking settlement and hired a lawyer to represent him for an agreed fee of $75,000 if settlement negotiations were successful. Allum eventually received a settlement of $500,000.

Notably, the settlement agreement stated that the defendant (Bank of America) took no position on the tax effects of the $500,000 payment and noted that the bank would issue Allum a Form 1099. Allum received his $500,000 and paid his lawyer $75,000 from it. When Allum filed his 1999 tax return, he excluded the entire $500,000. The IRS sent him a notice of deficiency, showing the entire $500,000 as income, including the $75,000 Allum paid to his lawyer.

The section 104 discussion in the case is probably more complete than it needs to be. Far from arguing about exactly what constitutes a physical injury or sickness (for example, cases such as *Nancy J. Vincent v. Commissioner*,[11] in which the status of ulcers was debated), the Tax Court addressed Allum's argument that the settlement payment was for the alleged loss of his license and that the loss was a personal physical injury, so the entire settlement should be excludable. The court easily disposed of his argument that any portion of the recovery was excludable. Allum also argued (unsuccessfully) that section 104(a)(2) was unconstitutionally vague.

Attorney Fees

Although Allum's section 104 arguments were weak and the case's holding on that score is unexceptional, the importance of the case to attorney fee taxation is notable. Allum basically argued that *Banks* should not control his case because his relationship with his lawyer was different. Indeed, he engaged a lawyer solely for the purpose of arriving at a settlement agreement with the defendant. The court rejected that ''one event relationship'' argument, saying it provided no meaningful distinction from the facts in *Banks*.

Significantly, the Tax Court confronted the taxpayer's argument that there was a subchapter K partnership between lawyer and client. That partnership avenue, after all, was one of the routes left open by *Banks*. After describing the law regarding the formation of a partnership, the Tax Court turned to the facts in Allum's case. It found no evidence that the taxpayer had intended to form a partnership with his lawyer.

In fact, the court said that the record contained only an argument, made for the first time in the Tax Court, that a de facto partnership existed merely because of the combination of Allum's interest in his legal claims and his attorney's professional license. Moreover, the court found it significant that Allum testified at trial and submitted to the court statements that he ''hired'' his lawyer ''to represent him'' in the settlement of his claims. The court found that Allum had demonstrated that he did not view his attorney as a co-owner of his claims in any respect, but merely as a service provider.

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[10]T.C. Memo. 2005-177, *Doc 2005-15466, 2005 TNT 139-9* (July 20, 2005).

[11]T.C. Memo. 2005-95, *Doc 2005-9343, 2005 TNT 85-6*. *See* discussion in Wood, ''Ulcers and the Physical Injury/Physical Sickness Exclusion,'' *Tax Notes*, June 20, 2005, p. 1529.

Finally, the court noted that there was no evidence (from the attorney's side of the equation) that the attorney intended a partnership either. The taxpayer apparently did not try to bring the attorney into the tax litigation, nor to get documents from him supporting the partnership claim. Calling the attorney as a witness would, I think, have been appropriate. Not seeing any sign of the lawyer, the court made the negative inference that the lawyer was unlikely to support the partnership claim.

Should You Take *Banks* to the Bank?

I'm tempted to say that the IRS seems to be banking on the result in *Banks*. Conversely, I don't think taxpayers can bank on a fair deal. There are now two Tax Court cases post-*Banks* that, in my view, don't give a fair reading to the Supreme Court's opinion. In *Vincent*,[12] the Tax Court rejected a section 104 claim. The taxpayer excluded an employment recovery on the theory that the bulk of the payment was for the exacerbation of ulcers. Skirting the question whether an exacerbation of ulcers could constitute a physical injury or physical sickness under section 104, the Tax Court said that there was no evidence the jury was ever presented with the exacerbation question, so the taxpayer's facts didn't support the allocation.

The attorney fee issue in *Vincent* is more troubling. Nancy Vincent had a contingent fee agreement with her lawyer, stating that the lawyer would receive a specific percentage of any recovery. However, the contingent fee agreement stated that the attorney would receive the contingent recovery unless there was a statutory fee-shifting statute in effect. Here, there was an applicable fee-shifting statute, and there was even a court award of fees. The Tax Court therefore duly noted that the tax treatment of attorney fees in fee-shifting statute cases had not been presented to the Supreme Court in *Banks*.

The court stated that if the attorney fees had been received under the contingent fee agreement rather than the statute, *Banks* would control. Because *Banks* did not cover the fee-shifting statute, the court turned to the authority concerning fee-shifting statutes. In *Sinyard v. Commissioner*,[13] the taxpayer had signed a contingent fee agreement similar to the one Vincent signed. The settlement agreement apportioned some of the settlement amount to pay the attorney fees and costs under the fee-shifting provisions. In effect, the *Sinyard* court treated the obligation to pay fees as decisive even when the fee-shifting statute was in effect. With surprisingly little analysis, the Tax Court found that the presence of the fee-shifting statute did not save Vincent.

The taxpayer had an alternative argument. The taxpayer argued that a California state decision, *Flannery v. Prentiss*,[14] made the attorney fees the property of the lawyer, not the client. The Tax Court apparently did not take the *Flannery* argument seriously, simply stating that it was not bound by state law classifications as to the ownership of income.[15]

In fact, the Tax Court said that any contingent fees would be income under *Banks* and that the taxpayer could not escape that outcome by arguing that because her fees and costs were awarded by a court under a fee-shifting provision, that income was properly attributable to her attorney. Again, the court cited *Sinyard*. The court stated that it was not presented with (and did not address) the question whether the taxpayer would have been taxed on the attorney fees paid to her attorney if she had been represented by a nonprofit legal foundation.

In *Vincent* the Tax Court gives a negative view on the possibility that taxpayers will be able to sidestep the attorney fee quagmire with the statutory fee argument unless there is an actual court award of fees, or the express ''in lieu of'' statement in the settlement agreement and/or fee agreement. Of course, the Supreme Court implied that in *Banks*, but the tone of the Tax Court in *Vincent* suggests that may be a tough road.

In *Allum* the Tax Court suggests that it will want to see much more than a mere argument that a type of relationship existed that *could* be considered a de facto partnership. Allum and his lawyer did not create a good record. However, the court seemed to suggest that a partnership agreement (and even a partnership tax return) might be necessary.

Semantics may also be important, because the Tax Court found it significant that Allum testified at trial (and submitted statements to the court) that he had ''hired'' his lawyer. I suppose those colloquialisms may end up not being decisive. Yet, if the taxpayer and the lawyer have at least made a good record (for example, a partnership agreement or a fee agreement that reads like a partnership agreement), that will probably help.

Conclusions

As to section 104, there seems no doubt that the controversy will continue. Although the IRS has been curiously quiet on the regulatory front, its litigating posture is a strong one, and it has done a good job of producing a litany of cases in which taxpayers generally lose. Of course, I don't believe taxpayers are usually very well-prepared. In *Vincent*, for example, I think the taxpayer would have won (or the case would have settled on a favorable basis) if the exacerbation claim had been made in the pleadings and presented to the jury. The fact that something like that can become the linchpin of a case may seem surprising, but it does indicate that the courts and the IRS are trying to get at *why* a payment was made.

Regarding attorney fees, I continue to believe that the various exceptions identified by the Supreme Court in *Banks* have some teeth. I think the statutory fee argument is a good one, and that the Supreme Court has created a kind of road map, despite the *Vincent* case. I also think

[12] *Supra* note 11.

[13] 268 F.3d 756, *Doc 2001-24862, 2001 TNT 188-11* (9th Cir. 2001).

[14] 26 Cal.4th 572 (2001).

[15] For this proposition, the court cited *Burnet v. Harmel*, 287 U.S. 103 (1932).

addressing statutory fees in a fee agreement or in a settlement agreement may make a lot of difference, despite *Vincent*.

In *Vincent*, after all, that wasn't done. Addressing the ''in lieu of'' point in the settlement agreement or the attorney fee agreement would seem, on the surface anyway, to take one out of the *Banks* gauntlet. Of course, merely being out of *Banks* does not get you home free, as all of the prior circuit court cases will evidence. Still, any argument is better than no argument at all, for those taxpayers who have the risk tolerance and fortitude to take a position and, if necessary, to fight a battle down the road.

Apart from statutory fees, I even think the partnership argument continues to have merit, despite the recent trouncing it received in *Allum*. Besides, if you read *Allum* with a ''glass half full'' mentality, it is possible to read it as *endorsing* the difference in tax results that a partnership between lawyer and client would produce. *Allum* just suggests that the standard for what constitutes a partnership may be pretty high, higher than one-time lip service. *Allum* plainly did not have good facts (proving the old adage about bad facts making bad law). I think better-prepared taxpayers will take on the partnership argument and will stand a better chance of succeeding.

Call me an optimist.