

edited by Robert J. Wells

## Taxation of Damage Awards and Settlement Payments

Reviewed by Lawrence B. Gibbs

*Taxation of Damage Awards and Settlement Payments* (Third Edition), by Robert W. Wood. Published by Tax Institute. Compression bound, 794 pages. Price: \$249 plus shipping. Order at <http://www.damageawards.org>.

Rob Wood has done it again. For years he has been the preeminent authority for tax practitioners on the federal taxation of damages and settlement payments. However, his most recent third edition of his comprehensive treatise on that subject surpasses his previous efforts. And his timing is perfect. With the onslaught of public and private litigation in the post-Enron, Sarbanes-Oxley Act era, in addition to the ever-increasing settlements and judgments of our litigious society, his new edition is a must for tax planners, tax controversy specialists dealing with the IRS, and tax litigators. Whether you practice on Main Street or Wall Street or someplace in between, you should have this book in your library or on your bookshelf.

The Small Business Job Protection Act of 1996 made substantial changes to the taxation of recoveries in and settlements of personal injury litigation, including workers' compensation, wrongful death, and other physical and employment-related injury claims. Historically, section 104 of the Internal Revenue Code has permitted exclusion of compensation for injuries and sickness from the recipient's income. Like many areas of tax law, the variety of factual circumstances in which those claims can arise and the difficulty of distinguishing between the personal and profit-seeking aspects of those claims has given rise to a significant amount of litigation between the IRS and taxpayers. The author devotes much of two full chapters to an exploration of the impact of those developments, including the effect of the 1996 statutory changes and that of the Supreme Court's 1996 decision in *O'Gilvie v. United States* on the now-settled ordinary income treatment to recipients of punitive damage recoveries in this area.

Another vexing area for tax advisers is the tax treatment of recoveries for business injuries, including lost profits, damage to goodwill, fraud, misrepresentation, breach of fiduciary duties, breach of covenants not to compete, stock claims, patent infringement, contractual disputes, and liquidated damages recoveries. The author deals carefully and expertly with the capital-versus-ordinary issues and the difficulty in applying the Supreme Court's "origin of the claim" doctrine to determine the tax consequences to the recipient that often

make planning, reporting, and defending decisions by professionals difficult in this area. The chapter dealing with the tax effects of antitrust recoveries is thorough and written so that even the novice tax adviser not accustomed to dealing with this area can understand the ins and outs of its tax and nontax intricacies.

There is a helpful separate chapter on the deductibility of the payer's business-related payments to help the reader understand the fine distinctions between the ordinary-versus-capital, business-versus-personal, compensatory-versus-fines-and-penalties, and the variety of timing issues that often are of concern to careful tax advisers. The chapter on antitrust actions provides a complete discussion of the payer's (as well as the recipient's) tax consequences of payments under antitrust settlements or decrees. A separate chapter with a detailed explanation of structured settlements is certain to be of interest to those payers (and their recipients) that use that technique to pay large damage amounts to plaintiffs who recover in personal injury and other similar tort actions.

Finally, there are two long, detailed chapters dealing with the tax treatment of legal fees and of payments related to divorce and will contests that in themselves are worth the cost of the third edition. Although the limitations on the deduction of section 212 expenses under section 67 and the nondeduction of those expenses for alternative minimum tax purposes under section 56(b)(1)(A)(i) has diminished the tax adviser's interest in many otherwise potentially deductible, nonbusiness expenses of individual taxpayers in this area, the size of occasional fee payments and the changes made by the American Jobs Creation Act of 2004 to permit above-the-line deductions of certain payments on account of claims of unlawful discrimination or claims against the government makes this subject of continuing interest even in this area. And the deduction of business-related legal fees under section 162 continues to be an important area for tax advisers. The "origin of the claim" test of the Supreme Court in *Gilmore*, *Hilton Hotels*, *Woodward*, *Tellier*, and other decisions, with its own origin in the proximate cause area of the tort law, has never been an easy test to apply with precision or assurance. The author's discussion of the application of the test in a variety of situations is as well done as anything I previously have read.

If the above were not enough, the author has included a chapter on the methods for substantiating the parties' desired tax treatments of damage awards and settlement payments that tax advisers — whether they be planners, controversy types, or litigators — will find most helpful. One of the most important, difficult, and frequently frustrating things for any controversy and litigation tax practitioner is to find that the client and the client's adviser during the prior litigation and settlement or entry of judgment in a case failed to understand and appreciate

the importance of the various types of written and oral evidence that bear on the client's ability to subsequently sustain the desired tax consequences to the client of the awards and payments by or to the client in the event of a subsequent IRS audit. And if tax practitioners become frustrated in those situations, one can easily imagine the client's reaction to unpleasant tax surprises that later advisers determine could have been avoided. For that reason, practitioners in this area will find this chapter instructive and useful, as are the almost 130 pages of forms the author has provided as part of this treatise. Those useful practice aids, along with the numerous, helpful planning and practice tips that are provided throughout the volume, and the well-done tables and index at the end of the volume, make the new third edition particularly user friendly.

My only disappointment was that some of the most recent developments in the area of the taxation of damage awards and settlement payments could not be included, in part because of the publication schedule for the new edition. Those omissions include the tax treatment of some of the unenacted provisions of the Jobs Act, dealing with denials of deductions of punitive damages, fines, penalties, and other amounts under section 162, and the recent decision by the Supreme Court in the *Banks* and *Banaitis* cases, upholding the decisions by a majority of lower courts that contingent fee recoveries are taxable to both the plaintiffs and the plaintiffs' attorneys. Although the former were not enacted last year, the Senate's proposals raise revenue and for that reason

alone deserve mention to alert practitioners to be mindful of the effective dates of later tax change proposals in advising clients about matters that might be affected by later changes. The latter contingent fee issue is one of the most widely discussed issues in the federal tax area today because of the apparent unfairness of the impact of the Supreme Court's decision, particularly if the plaintiff is subject to the AMT, in which event the plaintiff's taxes can exceed the net amount of the recovery after payment of legal fees. Although the Jobs Act provides limited relief in creating new section 62(a)(20), it does so only on a prospective basis for certain contingent fees and costs paid after October 22, 2004, and some already are raising issues about the insufficiency of the relief provided.

The good news is that Rob Wood will be providing purchasers of the third edition with his insights and helpful suggestions on an ongoing basis in the future if they wish to subscribe to receive periodic, usually annual, supplements to reflect periodic changes in the area. In light of the constant change, continued complexity, and increasing importance of the tax law in this area, practitioners should be grateful for Rob Wood's complete, lucid, helpful, and periodically updated summary of the developing law in this important area.

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