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Non-Taxable Settlement Proceeds Require Careful Documents

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Taxpayers have been reminded often of the need to carefully document the nature of the money received as judgments or in settlements. Apparently, more reminders are needed.

Generally, taxpayers start at a disadvantage because "gross income" is broadly defined to include "all income from whatever source derived" except as specifically provided in the Internal Revenue Code Section 61(a). On top of that, "every deduction from gross income is allowed as a matter of legislative grace" and "only as there is clear provision therefore

can any particular deduction be allowed.... A taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms." *White v. U.S.*, 305 U.S. 281 (1938), quoting *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934).

One of the "items specifically excluded from gross income" is Internal Revenue Code Section 104, entitled "compensation for injuries or sickness." In 1996, however, the portion related to lawsuits was narrowed to apply only to "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness...."

The 5th U.S. Circuit Court of Appeals recently tackled this issue in *Espinoza v. Commission*, (Case No. 10-60778, March 28). In this case, Isidra Elizabeth Espinoza filed suit against her employer, the Texas Health and Human Services Commission, for discrimination based on gender, religion, national origin and retaliation. She sought both compensatory and exemplary relief for actual damages, back pay, mental pain and anguish, and intentional infliction of emotional distress. Her lawyer calculated the medical bills for physical and psychological ailments at \$50,000, and told her that the amount - if recovered - would not be taxable. With her approval, the lawyer reached a settlement with the employer.

The release and settlement agreement recited that it was "to resolve and settle all differences...between the parties...and...avoid further litigation...." The \$50,000 was paid in "compromise of all claims, but without admitting liability." Espinoza received a 1099-MISC from her employer. Her accountant told her that the settlement amount was tax exempt and so, her tax return did not include the settlement payment.

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The Internal Revenue Service, however, objected and assessed \$9,000 in tax and

SPECIAL REPORT

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Our annual list of the Top Women lawyers in the state.



Thursday, May 12, 2011

Discipline

Receiver Sues Sedgwick For Malpractice

Sedgwick LLP has been hit with a \$200 million malpractice suit over its work for accused fraudulent investment company Medical Capital Holdings Inc.

Health Care & Hospital Law

Former Biotech GC Acquitted

A U.S. judge acquitted former GlaxoSmithKline general counsel Lauren Stevens on Tuesday of all six charges against her in an investigation of the company's marketing practices for an anti-depressant.

Zoning, Planning and Use

The Curse of Chavez Ravine

Are the Dodgers' financial problems a case of delayed retribution for how Dodger Stadium came about? By **Gideon Kanner** of Loyola Law School

International

The Benefits of Bilateral Investment

Treaties When Investing in China

Bilateral investment treaties operate as "free insurance" with its minimal costs and direct benefits. By **Allan Marson**, **Grant Hanessian**, and **Michiel Kloes** of Baker & McKenzie

Construction

What to Do With a Busted Project

Distressed real estate projects are getting a shot of much needed adrenaline from preferred equity. By **Anita F. Sabine** of O'Melveny & Myers LLP

Letter to the Editor

America Is a Fair Country

Leon Snaid responds to "Death of Osama bin Laden: Could There Have Been a Trial?"

Criminal

Panel Lawyers Could Be Curtailed

A committee of federal judges is considering whether to create a new "alternate" public defender's office in the Central District of California that would be independent of the existing institution.

Judge Bars Gang Injunction Enforcement

A federal judge has approved an unusual permanent injunction against the Orange County district attorney, barring him from enforcing a gang injunction won in state court against 48 people.

\$2,000 in penalties. Seeking recourse in the U.S. Tax Court, Espinoza lost on the main issue but won on the issue of penalties. The Tax Court found that Espinoza "failed to present objective and credible evidence that [the employer] intended that any part of [the] settlement proceeds be allocated to her medical expenses" and that the "preponderance of the evidence is that the settlement was unallocated among multiple claims, many of which were not for physical injuries or physical sickness." She appealed.

To determine whether payments were made in lieu of damages for physical injuries or physical sickness, the 5th Circuit must "first look to the language of the agreement itself for indicia of purpose." Then, if the settlement agreement "lacks express language of purpose, the court looks beyond the agreement to other evidence that may shed light on the intent of the payor as to the purpose in making the payment." On that basis, Espinoza was in trouble: Some of the monies she received was taxable. For example, any amounts received for back pay or purely for mental pain and anguish would not be received due to "personal physical injury or physical sickness" and would therefore be taxable income. The settlement agreement also did not indicate that the employer tried to settle the dispute over medical costs versus the dispute over back pay.

With that lack of evidence, Espinoza had the burden of presenting other evidence establishing that the employer made the settlement payment in place of damages for medical care and treatment. She sought to prove that she and her husband considered the \$50,000 to be compensation for medical expenses, e.g., she had received treatment for enlarged lymph nodes, liver cirrhosis, hyperthyroidism, depression and post-traumatic stress disorder. She attributed those conditions to the alleged discrimination. However, that was inadequate to prove the employer's intent in making the payment.

This case could have been the first time a Court of Appeal addressed the issue of whether damages or settlement proceeds received for medical care or treatment for the physical manifestations of emotional distress are taxable. However, the 5th Circuit did not reach this issue because it did not find that any portion of the settlement proceeds was allocable to the emotional distress claims or that the proceeds were paid by the employer with the intent to reimburse or cover medical costs. Previously, the Tax Court has held that settlement money "paid for emotional distress not attributable to physical injury or physical sickness is includable in income, and any amounts paid in such circumstances for physical symptoms of emotional distress are similarly includable as income." *Wells v. Commissioner*, Tax Court Memo 2010-5. In addition, the Tax Court has found that settlement money "paid for medical care to treat...[the] emotional distress" is excludable under Section 104(a)(2).

There is no substitute for a carefully drafted settlement agreement that includes a clause allocating the damages among the various causes of action. Without it, the IRS is free to assert its own allocation, presumably based on the origin of the claim and based on its reading of the pleadings. Remember that the payor's interests may be opposed to the payee's. Typically a settlement agreement, as was the case with Espinoza, denies all liability. Thus, any allocation as to a specific type of injury or recovery could be viewed as an admission of liability. Certainly, the payor wants the entire amount to be deductible, and the allocation that favors the payee may raise deductibility problems for the payor. So taxpayers and their counsel must begin the lawsuit and the settlement process with tax issues in mind.

Judicial Profile Making Her Mark

A framed reproduction of Botticelli's *Calumny of Apelles* hangs in U.S. Magistrate Judge Jennifer L. Thurston's chambers. The colorful painting, rich in allegory, depicts Slander dragging Innocence - the victim of false accusations by Envy,

Intellectual Property Nevada Newspaper Pursues Copyright Cases

Despite some recent unfavorable court rulings, a Nevada company appears to be doubling down on its bet that suing hundreds of defendants for infringing the copyright of a Las Vegas newspaper is a winning strategy.