Tax Issues: Damages, Rescission and Debt Cancellation as Client Income

by Dennis Brager

Many clients and some lawyers assume that damages received in a lawsuit are not taxable. As far as the tax consequences of rescission and debt cancellation are concerned, these questions have been relegated to the dark corners of the legal world where some say only tax lawyers dare tread. The purpose of this article is to take some (but not all) of the mystery out of these subjects.

Damages

The starting point is § 61 of the Internal Revenue Code[1] which provides that gross income means all income from whatever source derived except amounts specifically excluded. Section 104(a)(2) is the portion of the law which provides the basic exclusion for some personal injury awards. It states that gross income does not include "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." Taxpayers must meet two independent requirements before they can exclude a recovery under § 104(a)(2). First, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is "based upon tort or tort-type rights"; and second, the taxpayer must show that the damages were received "on account of personal injuries or sickness." *See Comm'r v. Schleier*, 515 U.S. 323 (1995). State law controls whether there is a tort-type injury. *See, e.g., Brabson v. United States*, 73 F.3d 1040, 1044 (10th Cir. 1996).

The issue in *Schleier* was the taxability of a taxpayer's recovery of back wages under the Age Discrimination in Employment Act of 1967. The Supreme Court held that the recovery did not fall within the § 104(a)(2) exclusion of damages received on account of personal injury or physical sickness. The taxpayer's employer fired him when he reached age 60, making age, not personal injury or physical sickness, the proximate cause of his lost income. Although the taxpayer's unlawful termination may have caused some psychological or "personal" injury, no part of his recovery of back wages was attributable to that injury. Nor could the liquidated damages award be excluded from gross income within the meaning of the applicable regulation to § 104(a)(2) because it was not received through prosecution or settlement of an action based upon tort or tort-type rights, and was not received on account of personal injuries or sickness. *Schleier*, 515 U.S. at 330.

The requirement that the damages be on account of "personal *physical* injuries or physical sickness" was added in 1996 generally for amounts received after August 20, 1996. P.L. 104-188, § 1605(c) (the "1996 Act"). If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as damages received on account of personal physical injuries or physical sickness whether or not the recipient of the damages is the injured party. "For example, damages (other than punitive damages) received by an individual on a claim of loss of consortium due to the physical injury or physical sickness of that individual's spouse are excludable from gross income." H.R. Conf. Rep. No. 104-737, at 301 (1996), *reprinted in* 1996 U.S.C.C.A.N. 1474, 1589. If the tortious act causes physical injuries, which in turn cause other damages such as lost wages or pain and suffering, then all of the damages are "on account of" physical injury. *See Banaitis v. Comm'r*, 340 F. 3d 1074 (9th Cir. 2003).

The Internal Revenue Code does not define physical injuries, however it does indicate that physical injuries do not include emotional distress. § 104(a). Footnote 56 of the House Conference Report states: "It is intended that the term emotional distress includes symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such distress." H.R. Conf. Rep. No. 104-737 at 301.[2]

Although damages from personal physical injuries are excludable, punitive damages are not. IRC § 104. *O'Gilvie v. United States*, 519 U.S. 79 (1996). Punitive damages are not defined in either the Internal Revenue Code or the Treasury Regulations. They have been defined by the courts, however, as damages which are non-compensatory as determined pursuant to state law. *See Bagley v. Comm'r*, 105 T.C. 396 (1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997).

Settlements

Allocation issues often arise between taxable and non-taxable damages. In cases where punitive damages are awarded pursuant to a jury verdict, the amount allocable will be clear. In cases that are settled, or settled on appeal, the determination may be more difficult. In *Barnes. v. Comm'r*, 73 T.C.M. (CCH) 1754 (1997), the Tax Court allocated ½ of the settlement award to punitive

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damages based upon allegations in the complaint and testimony of plaintiff's attorney as to the strengths and weaknesses of the underlying causes of action.

The taxpayer bears the burden of proving that the IRS erred in determining that the settlement proceeds are not damages on account of personal injuries or sickness. *Barnes*, 73 T.C.M. (CCH) 1754 at *8-9. Determining the exclusion from gross income depends on the nature of the claim that was the actual basis for the settlement, not the validity of the claim. *Seay v. Comm'r*, 58 T.C. 32, 37 (1974). The proper inquiry is in lieu of what were damages awarded or paid. *Church v. Comm'r*, 80 T.C. 1104, 1107 (1983); *Delaney v. Comm'r*, 99 F.3d 20, 23-24 (1st Cir. 1996); *Fono v. Comm'r*, 79 T.C. 680, 694 (1982), *aff'd without pub. opinion*, 749 F.2d 37 (9th Cir. 1984). Courts generally will look to the characterization of the proceeds in the settlement agreement itself. *See Bagley*, 105 T.C. at 406. However, the Tax Court is not bound by a settlement agreement, but must "give 'proper regard' to allocations made by state courts when such allocations are entered by the court in a bona fide adversary proceeding." *Robinson v. Comm'r*, 70 F.3d 34, 37 (5th Cir. 1995). Courts must consider all facts, including the allegations contained in the taxpayer's complaint, the evidence presented and arguments made in the court proceeding, and the intent of the payor. *Threlkeld v. Comm'r*, 87 T.C. 1294, 1306 (1986), *aff'd*, 848 F.2d 81 (6th Cir. 1988).

Where the settlement agreement does not expressly specify an allocation of the proceeds among the various claims, the most important factor in deciding how to allocate the proceeds is what motivated the payor to pay the settlement amount. *Knuckles v. Comm'r*, 349 F.2d 610, 613 (10th Cir. 1965), *aff'g* T.C. Memo. 1964-33, 23 T.C.M. (CCH) 182 (1964). In determining the payor's intent, the Court may look at the pleadings, jury awards, or any other court orders or judgments. *Miller v. Comm'r*, T.C. Memo. 1993-49, 65 T.C.M. (CCH) 1884 (1993), *supplemented by* T.C. Memo. 1993-588, 66 T.C.M. (CCH) 1568 (1993), *aff'd without pub. opinion*, 60 F.3d 823 (4th Cir. 1995).[3]

Attorneys' Fees

There is a split in the Circuits as to whether attorneys' fees must be included in the plaintiff's income. The issue is best illustrated by example. Assume that the client receives an award of $1,000,001, of which all but $1.00 is for punitive damages, and is therefore taxable. Further assume that attorneys' fees are 40% of the recovery. According to the majority view, the entire $1,000,000 is included in income. *See, e.g., Benci-Woodward v. Comm'r*, 219 F.3d 941 (9th Cir. 2000). The client is allowed an itemized deduction for $400,000; however, for purposes of the alternative minimum tax, legal fees may not be deducted and the client will wind up paying taxes on the full $1,000,000![4] The rationale is that under longstanding judicially developed doctrines, a taxpayer may not assign income she has earned to another party and thereby escape taxation on it. *See Lucas v. Earl*, 281 U.S. 111, 114-15 (1930).

The Fifth Circuit has held, however, that contingent fees paid directly to one party's attorney by another party were not includable in income. *Cotnam v. Comm'r*, 263 F.2d 119 (5th Cir. 1959). The Court reasoned that under Alabama law (which governed the fee agreement), the attorney had an ownership interest in the lawsuit so there was no assignment of income. The Fifth Circuit reached a similar conclusion about the operation of Texas law, *see Srivastava v. Comm'r*, 220 F.3d 353 (5th Cir. 2000),[5] and the Sixth Circuit has held that under Michigan law, attorneys' fees are excludable. *Estate of Clarks v. United States*, 202 F.3d 854, 856 (6th Cir. 2000). In *Banks v. Comm'r*, 345 F.3d 373, 386 (6th Cir. 2003), the Sixth Circuit expanded its rationale to hold that, without regard to state law, attorneys' fees are excludable since the Supreme Court's decision in *Lucas v. Earl* and its progeny did not apply to the attorneys' fee issue. *Banks* dealt with California law, and thus the Sixth Circuit is in direct conflict with the Ninth on this point.[6]

Debt Cancellation[7]

Section 61(a)(12) specifically provides that income from the discharge of a debt is included in gross income.[8] However, § 108 provides for the exclusion from gross income of discharge of debt income in two circumstances. First, if the discharges occurs in a bankruptcy case, or second, if the discharge occurs when the taxpayer is "insolvent."

Insolvent means that liabilities exceed the fair market value of assets. § 108(d)(3). Until recently, a long-established rule provided that in determining the amount of the taxpayer's assets, any assets that were not subject to the claims of creditors under state law were not included in determining a taxpayer's insolvency. *See Cole v. Comm'r*, 42 B.T.A. 1110 (1940); *Marcus Estate v. Comm'r*, 34 T.C.M. (CCH) 38 (1975). However, in *Carlson v. Comm'r*, 116 T.C. 87 (2001), the Tax Court ruled that due to 1980 changes in the tax law, exempt assets must be included in determining whether a taxpayer is insolvent. *Carlson* has not been reviewed by an appellate court, and some commentators have criticized it. *See, e.g., Note & Comment: Measuring Assets and Liabilities Under the I.R.C. 108 Insolvency Exclusion*, 19 Bank. Dev. J. 429 (2003). *Carlson*'s viability remains uncertain, so consideration should be given to

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Illustrations of the operation of § 108 on a taxpayer's obligation to pay tax on income from the cancellation of debt.

Example 1

An unmarried taxpayer's only asset is a home worth $300,000 with a mortgage of $250,000. He also has 2 credit card debts, one for $15,000 and the other $10,000. On October 15, 2003, one of the credit card companies writes off its $10,000 debt and sends the taxpayer a Form 1099-C.

Since the taxpayer's assets exceed his liabilities, he must report income of $10,000. However, if the Tax Court's decision in *Carlson* is incorrect, then at least in California due to the homestead exemption, his assets subject to the claims of creditors are 0; since on that basis he is insolvent, he can exclude all of the income.

Example 2

Assume the same facts, but on Feb. 15, 2003, the taxpayer files a Chapter 7 bankruptcy, and receives a discharge 4 months later. Since the discharge occurred in a bankruptcy case, no part of the debt write-off is included in income, regardless of whether *Carlson* is correct.

Example 3

Assume the same facts, but the taxpayer doesn't file bankruptcy until 2004, after the credit card company has written off the debt. Since the debt wasn't discharged in a bankruptcy case, the $10,000 must be included in income. The remaining $15,000 will not be included in income.

Example 4

Assume instead that the taxpayer owns stocks worth $60,000 and owes credit card bills totaling $100,000. Assume the credit card companies forgive $60,000 of debt. After the debt is forgiven, the taxpayer has assets exceeding the amount of the debt by $20,000 which is the amount which must be included in income.

what position to take on a tax return and how much disclosure is necessary or appropriate.

Contingent liabilities are included in determining a taxpayer's insolvency only if it is "more likely than not" that the taxpayer will be called upon to pay the obligation in the amount claimed. *Merkel v. Comm'r*, 109 T.C. 463, 483 (1997), *aff'd*, 192 F. 3d 844 (9th Cir. 1999). If a taxpayer is partially insolvent, the amount of income in excess of the amount of the insolvency is not excludable. § 108(a)(3).

Cancellation of debt should not be confused with income resulting from foreclosure, or a deed in lieu of foreclosure. Generally, a foreclosure is treated as a sale or exchange within the meaning of § 1001. *Helvering v. Hammel*, 311 U.S. 504, 510 (1941). Since gain is equal to the difference between the amount realized and the basis of the property, it is necessary to first determine the amount realized.[9] The amount realized generally includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Treas. Reg. § 1.1001-2(a)(1); *Comm'r v. Tufts*, 461 U.S. 300, 312 (1983).

An exception to the general rule is provided by Treas. Reg. § 1.1001-2(a)(2), which bifurcates the gain for recourse debt.[10] That regulation provides that the amount realized on a disposition of property that secures a recourse liability does not include amounts that are income from the discharge of indebtedness. Under this exception, the mortgagee's amount realized equals the *fair market value of the asset*. In addition, the mortgagee has income from the cancellation of indebtedness equal to the excess of the debt over the fair market value of the property transferred. *See* Treas. Reg. § 1.1001- 2(a)(2), Ex. 8; *Bressi v. Comm'r*, 62 T.C.M. (CCH) 1668, 1674 (1991). If the debt on the property is non-recourse, then under § 7701(g), the fair market value of the property transferred is treated as not being less than the amount of the non-recourse debt. Therefore, the amount realized by the mortgagee would be the full amount of the debt, and there would be no income from cancellation of debt.

The amount bid by the lender at the foreclosure sale is not necessarily the fair market value of the property, yet lenders typically issue Forms 1099 in the amount of the bid.[11] The tax results can be quite different depending upon the fair market value, as illustrated in *Frazier v. Comm'r*, 111 T.C. 243 (1998). The Fraziers owned real property in Texas, and in 1984 they executed a recourse note for $850,000, using the property as collateral. In 1989, the lender foreclosed on the property with an outstanding debt on the mortgage of $585,943. The Fraziers were insolvent at the time. At the foreclosure sale, the lender made the sole bid for the property in the

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amount of $571,179. However, the lender did not attempt to collect the difference between the outstanding loan balance and the price it bid at the foreclosure sale. At the time of the foreclosure, the Fraziers' adjusted basis in the property was $495,544. The property was sold two-and-a-half years later for approximately $382,000.

The IRS asserted that the Fraziers had realized $571,179 on the foreclosure sale, based on the lender's bid. The Fraziers argued that the lender's bid did not represent the fair market value of the property, and that it was worth only $375,000, the amount of an appraisal they had obtained. The Tax Court agreed and held that the Fraziers had a capital loss of $120,500 on the foreclosure arising from the difference between the fair market value and the couple's adjusted basis of $ 495,000. The Court also held that the Fraziers realized $ 211,000 in discharge of debt income generated from the difference between the fair market value and the indebtedness canceled. Furthermore, since the Fraziers' insolvency exceeded the income derived from the discharge of indebtedness, the Court held that the income was excludable from gross income under IRC § 108(a)(1)(B). Had the IRS prevailed, the Fraziers would have been required to pay tax on a gain of more than $75,000.

Rescission

There is very little case law dealing specifically with the tax consequences of rescission. In *Schlifke v. Comm'r*, 61 T.C.M. (CCH) 1697 (1991), the Tax Court considered the consequences of the taxpayers' exercise of their right to rescind a real estate loan secured by the second deed of trust on their personal property. The taxpayers purchased a single-family house in Huntington Beach, California in 1977 for $315,000. On June 26, 1980, the taxpayers obtained a loan from Republic Home Loan ("Republic") in the amount of $225,000. The loan was secured by the second deed of trust. During the tax years 1980 through 1983, the taxpayers paid Republic interest and finance charges totaling $140,625, and deducted those amounts on the tax returns, to the extent paid in each of those years. In February 1983, the taxpayers were advised that Republic had failed to make the loan disclosures required by the Truth in Lending Act (TILA). TILA gave the taxpayers the right to rescind the loan for a 3-year period; they were required, as a condition of rescission, to repay Republic the amount of the principal advanced to them, less any payments made by them. In May 1983, the taxpayers paid Republic $84,375, the amount agreed by the parties to accomplish rescission. This amount was calculated as follows:

Initial principal amount		$225,000
Less:		
Principal payments	$ 0	
Finance charges, commissions, fees	34,895	
30 interest payments @ $3,562	106,860	
Adjustments	(1,130)	
Total Paid		<u>$140,625</u>
Amount paid by taxpayers for rescission		<u>$ 84,375</u>

The IRS asserted that the taxpayers realized income from discharge of indebtedness in the amount of $140,625, representing the Republic loan principal of $225,000 less the $84,375 paid in May 1983 to discharge the obligation. Alternatively, the Service asserted that if the court determined that the taxpayers did not have discharge of indebtedness income, then the previous deductions for interest and finance charges ($140,625) for the tax years 1980 through 1983 constituted a tax benefit, the recovery of which is taxable under the tax benefit rule. The taxpayers argued that their interest deductions were proper with respect to an obligation that existed during the years paid, and that the act of rescission was totally independent of that obligation.

The Tax Court did not address the service's discharge of indebtedness argument, but ruled for the IRS under the "tax benefit" rule. Traditionally, the tax benefit rule requires taxpayers to recognize income when they "recover" an item or amount deducted in a previous tax year. *Schlifke*, 61 T.C.M. (CCH) 1697 at *5, *citing Hillsboro Nat'l Bank v. Comm'r*, 460 U.S. 370 (1983); *see also Rojas v. Comm'r*, 90 T.C. 1090, 1097-98 (1988), *aff'd* 901 F.2d 810 (9th Cir. 1990). The Tax Court stated that the tax benefit rule formulated in *Hillsboro* applied since any deduction clearly would have been foreclosed if the payment and credit had occurred in the same year. *Schlifke*, 61 T.C.M. (CCH) 1697 at *7 & n.1. The court concluded that under the tax benefit rule, the taxpayers had taxable income in 1983 in the amount of $140,625, representing the previously deducted interest and finance charges.

Conclusion

As even the casual reader will note, the actions taken by consumer attorneys on behalf of their clients can have significant tax consequences. Attorneys thus need to be aware of these consequences so they can plan to

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minimize them, or at least inform their clients of the possible outcomes so the clients can obtain appropriate counsel in making decisions—including whether to settle. After all, a client may not be as quick to settle if she discovers that after attorneys' fees and taxes, her $500,000 award actually may be worth only about 1/3 of that amount.

Endnotes

1. Unless otherwise specified, all section references are to the Internal Revenue Code of 1986, as amended, found at Title 26 of the U.S. Code.

2. The IRS has held in a non-precedential ruling that when a taxpayer receives damages for assault, but there is no observable bodily harm, the damages are not received on account of physical injury. Priv. Ltr. Rul. 200041022 (July 17, 2000).

3. *Planning Tip*. In light of the taxability of punitive damages, consideration should be given to whether to include a claim for punitive damages where there is little realistic chance of recovery. Also, in cases that are settled, any letters from the defense denying liability for punitives should be preserved for possible later litigation with the IRS.

4. The alternative minimum tax was devised to ensure that high income taxpayers would not be able to use certain deductions to escape tax entirely. To simplify somewhat, the taxpayer must pay the higher of the alternative minimum tax or the regular tax. While the computation can be quite complicated, the problem for present purposes is that legal fees paid by an individual generally are not deductible when computing the alternative minimum tax.

5. The Ninth Circuit has held that fees paid to attorneys under Oregon law are not includable in the plaintiff's income. *Banaitis*, 340 F.3d at 1083. An intriguing question is whether adding a clause to a California fee agreement adopting Oregon law would allow for the exclusion of attorneys' fees.

6. Perhaps the best advice that can be given to California taxpayers is to move to the Sixth Circuit.

7. A few of the basic rules regarding income from debt cancellation are illustrated by the examples in the accompanying box.

8. Note that "forgiveness" of disputed debts does not give rise to income. *Zarin v. Comm'r*, 916 F.2d 110 (3d Cir. 1990). Thus, where there is an ongoing dispute, and the debt is not "liquidated," income will not result.

9. Gain is not subject to tax if the property was used as the taxpayer's principal residence for 2 of the preceding 5 years. § 121(a). The amount of the exclusion is limited to $250,000, or $500,000 on a joint return.

10. In some states, such as California, a lender that advances money for the purchase of certain residential real estate has no recourse against the assets of a defaulting debtor other than the real estate securing the loan. Such debts generally are referred to as "non-recourse" debts.

11. In some cases clients have received Forms 1099 and they or their accountants have assumed the amount shown on the forms as the amount of debt cancelled had to be reported in income. If an error is subsequently discovered, the client generally has the later of three years from the due date of the tax return, or two years from the date of the tax payment, to file a refund claim for the overpaid tax. *See* § 6511. In some circumstances, this period may be longer. On the other hand, if the taxpayer fails to include required items of income on her tax return, the IRS generally will have three years from the filing date of the tax return to make an assessment. § 6501(a). If the amount that is not included on the tax return exceeds 25% of the amount reported, the IRS will have six years from the time the return is filed to make an assessment. § 6501(e)(1)(A). However, if an appropriate disclosure is made on the tax return, even though the income is not included, the IRS will have only three years to make its assessment. § 6501(e)(1)(A)(ii). Therefore, if a decision is made not to report an item, the taxpayer may wish to consult tax counsel to determine how best, or whether, to make the disclosure.

Bio

Dennis Brager, a California State Bar Certified Tax Specialist, acquired in-depth knowledge of tax law as a Senior Trial Attorney for the IRS Office of Chief Counsel. In addition to representing the IRS in court, he advised the agency on complex civil and criminal tax issues. After leaving the IRS, Brager was associated with the national law firms, Wood, Lucksinger, and Epstein, and then Kadison, Pfaelzer, Woodard, Quinn and Rossi. He now has his own three-attorney firm in Los Angeles, where he limits his practice to representing clients with disputes with the IRS, Franchise Tax Board, State Board of Equalization, and the Employment Development Department, at the trial and administrative levels. Brager is the former Chair of both the Tax Compliance, Procedure and Litigation Committee of the Los Angeles County Bar Association, and the California State Bar Tax Procedure and Litigation Committee. He received a B.B.A. (Accounting/Finance) from Pace University, and his law degree from NYU.■