

Subject: Taxation of Damage Awards 3:04

MORE ALIMONY DISPUTES

As was noted in this discussion group before, there are frequently disputes about the tax treatment of various payments made pursuant to a divorce. Several recent decisions confirm that these disputes continue unabated.

In *Mary K. Heckaman v. Commissioner*, T.C. Memo 2000-85, Tax Analysts Doc. No. 2000-7516, 2000 TNT 50-7 (2000), the payments a spouse received under a provisional maintenance order were held to constitute alimony even though the order did not specify how the payments should be treated for tax purposes, or whether the payment terminated on the spouse's death. The court found that the maintenance payments Ms. Heckaman received were includable in income as alimony, basing its decision on Indiana state law which provided that maintenance payments terminate on either spouse's death. The court also found that applicable state law provided that maintenance was strictly for support of the spouse (not in the nature of a property settlement). Thus, the payments were held taxable as alimony even though the separate maintenance agreement did not specifically call for the traditional indices of alimony.

In *Hermine Levinthal v. Commissioner*, T.C. Memo 2000-92, Tax Analysts Doc. No. 2000-8552, 2000 TNT 55-14, housing costs that were paid on behalf of a spouse were held to be alimony. This case concerned the deduction side of the equation. The Tax Court held that the man could deduct as alimony housing payments that he made on behalf of his wife. The court found that a series of letters qualified as a written separation agreement, dealing with the maintenance and operation of the couple's two residences.

The letters were exchanged between the lawyers for Harvey and Hermine Levinthal, proposing separate living and maintenance arrangements. No form of settlement agreement between the man and woman was executed until some years later. In the earlier years, though, Harvey lived in the couple's apartment and Hermine lived in the marital home. Then, after two months of this, they would switch addresses (talk about weird!). Harvey paid the rent, the mortgage and other expenses associated with the two addresses. Harvey treated the amounts for housing payments as alimony, deducting them, but Hermine did not include them in income.

When the matter went to Tax Court, the court held that most of the amounts Harvey claimed as alimony did not qualify because there was no written separation agreement. However, the court found that the exchange of attorney letters did qualify as a written separation agreement calling for Harvey to pay all maintenance and operation expenses for the apartment and for the marital home. The court reduced the apartment payments by half, because Harvey benefited by living there half of the time. Because Hermine owned the marital home herself (it was titled in her name), the court found that all maintenance

payments on the home benefited her and were therefore alimony.

EMPLOYMENT DISPUTE PAYMENTS INCOME

Several recent cases have found that payments in settlement of employment disputes constitute gross income to the settling employee. In *Joseph Henry Metelski v. Commissioner*, T.C. Memo 2000-95, Tax Analysts Doc. No. 2000-8739, 2000 TNT 56-10 (2000), the Tax Court found that a lump-sum payment received from the taxpayer's former employer was not excludable under Section 104. Metelski had agreed to participate in a "voluntary" retirement program that included a lump-sum payment. The payment was based on years of service and the age of the employee. Metelski simply failed to prove that his employer paid any portion of this lump sum on account of a tort or tort-type claim. The release included only general language releasing the employer from any and all claims.

The facts and holding in *Marsha Bland v. Commissioner*, T.C. Memo 2000-98, Tax Analysts Doc. No. 2000-8906, 2000 TNT 57-10 (2000), are quite similar. There, the Tax Court found that another lump-sum payment received by a former employee was not excludable. Marsha Bland also agreed to participate in a "voluntary" retirement program. Again, the employee was unable to prove that any amount paid under a general release was attributable to tort or tort-type claims.

ANOTHER BIG ATTORNEYS' FEE CASE ON THE WAY

In the wake of *Estate of Arthur L. Clarks v. US.*, Tax Analysts Doc No. 2000-1776, 2000 TNT 10-21 (6th Cir., Jan. 13, 2000), many practitioners are waiting to see what the IRS will do next. Watchers of this important area should know that another case is pending in the Ninth Circuit dealing with the attorneys' fee question. The pending case is *James T. Sinyard, et ux. v. Commissioner*, 9th Cir. Dkt. No. 99-71369. The Justice Department is arguing (not surprisingly) that a plaintiff must include in his gross income the contingent legal fee portion of a settlement. The underlying litigation arose out of two class action lawsuits against IDS Financial Services. The class actions involved age discrimination claims. The class plaintiffs signed contingency fee agreements with the law firm, calling for the firm to be paid one-third of any recovery. The agreement stated that any attorneys' fees awarded would be considered part of the plaintiff's total recovery.

Back in 1992, Mr. Sinyard received \$862,900, of which \$252,600 was allocable to attorneys' fees attributable to the taxable portion of his award. Sinyard simply netted the amount, not including the \$252,600 in income on his 1992 tax return. The IRS determined a deficiency, and the matter wound up in Tax Court. The Tax Court held that the portion of the settlement proceeds attributable to attorneys' fees was includable in income, and only deductible as a miscellaneous itemized deduction. For the Tax Court decision, see Tax Analysts Doc. No. 98-29997, 98 TNT 195-10.

On appeal, the Ninth Circuit will have to decide whether the attorneys' fee portion of the settlement really belonged to Sinyard or not. Sinyard claims that the fee-shifting provisions in the Age Discrimination in Employment Act (ADEA), call for a reasonable attorneys' fee to be determined and awarded by the court *directly* to the attorneys.

The Justice Department, though, says that reliance on the ADEA provisions is misplaced. In this case, says the Justice Department, the attorneys' fees were paid in accordance with the terms of a settlement agreement. The ADEA provisions therefore don't control. According to the Justice Department, for the attorneys' fees to be paid under the ADEA, there must actually be a judgment for the plaintiffs in the case, and the district court must calculate the fee by making a lodestar computation. (This means that the court must determine the number of hours reasonably spent on the litigation, and multiply that figure by what the court determines is a reasonable hourly rate.)

Here, the court simply approved the settlement agreement providing for the payment of attorneys' fees in connection with the terms of the contingent fee agreements. Because the procedures under the ADEA were not followed, says the Justice Department, Sinyard would have to include this portion of his attorneys' fees in gross income.

We will wait to see what the Ninth Circuit does here. There has previously been a Ninth Circuit case suggesting that the Ninth Circuit will likely side with the government. See *Benci-Woodward, et al. v. Commissioner*, T.C. Memo 1998-395, Tax Court Dkt. No. 3769-96 (Nov. 9, 1998), now on appeal to the Ninth Circuit, 9th Cir. Dkt. Nos. 99-70136, 99-70137 and 99-70138 (filed May 4, 1999).

Note About Punitive Damages

The subject of punitive damages is not involved in the *Sinyard* case. Yet, think about the government's argument in the Ninth Circuit. Basically, it is arguing that since the attorneys' fees were not paid pursuant to a court order, the ADEA provisions cannot apply, and the attorneys' fees cannot be considered awarded pursuant to a court. Doesn't this same argument apply in the case of punitive damages? We've worried before that a court could take the position that punitive damages could be considered "awarded" merely because punitives were asked for in the complaint and the case was settled. Or, perhaps further along the chain of events, there might be a punitive damages award at trial which is then on appeal and the case is settled on appeal.

In both of these situations, the government has been taking the position that "punitive damages" have been paid. It seems to me that the position that the Justice Department is taking in the *Sinyard* case about the attorneys' fee provision could well work against the government (here, here!) when it comes to the punitive damages argument. Stay tuned for further information.

THE OTHER SIDE OF LEGAL FEES

Since we frequently cover the tax treatment of attorneys' fees ---and the specific problem of the plaintiff in the contingent fee legal case (such as an employment action)-- let's look at the other side of legal fees. There's no problem on the deductibility of legal fees, of course, if they constitute expenses incurred in a trade or business. The object is to convert an otherwise miscellaneous itemized deduction (subject to the 2% floor on deductibility and subject to the AMT) into a business expense that is taken "above the line."

That is just what happened in *Thomas F. Noones, et ux. v. Commissioner*, T.C. Memo 2000-106, Tax Analysts Doc. No. 2000-9438, 2000 TNT 61-15. The Tax Court there held that an individual could not deduct legal fees as a business expense, but could only take them as a miscellaneous itemized deduction.

Mr. Noones incurred \$197,000 in legal fees defending himself from an indictment related to his corporation's purchase of a note from the FSLIC. He deducted the legal fees on his Schedule C as a business expense. The IRS would characterize the fees as incurred in the production of income (deductible under Section 212). The result (as we all should know by now) was that the legal fees were subject to the 2% floor. They also generated an alternative minimum tax liability.

The Tax Court agreed with the IRS, noting that Mr. Noones was never regularly engaged in the trade or business of buying and selling underperforming promissory notes, and that the corporation owned the note, not Noones. His corporation should have incurred no legal fees, it would seem!

MORE EMPLOYMENT RECOVERIES TAXABLE

In *Frances G. Lagaite v. Commissioner*, T.C. Memo 2000-103, the Tax Court held that a lump sum payment an individual received from his former employer was not excludable. The employer was Air Products and Chemicals, Inc., and it provided the taxpayer with a lump sum severance offer in exchange for a general release of all claims. These claims included the kitchen sink, in particular a release under the ADEA. The taxpayer argued that he received the payment in settlement of claims for emotional distress suffered as a result of age discrimination. The court, though, found that the payment was calculated by reference to his years of service (sounds awfully like severance). The Tax Court concluded that the taxpayer had failed to prove that his employer paid any portion of the lump sum on account of personal injuries or sickness. The release, as we have almost come to expect by now, was a general release which included no tax language.

SECTION 468B DESIGNATED SETTLEMENT FUND COMMENTS

A couple of recent items of interest concern the designated settlement fund rules under Section 468B. The Information Reporting Program Advisory Committee (IRPAC) suggested

changes to the proposed regulations on qualified settlement funds. For details, see Tax Analysts Doc. No. 2000-7627, 2000 TNT 62-19.

In addition, the law firm of Caplan & Drysdale has submitted proposed changes on the qualified settlement fund regulations. For the text of these proposed changes, see Tax Analysts Doc. No. 2000-8315, 2000 TNT 62-20.

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Robert Wood
Robert Wood, P.C.
San Francisco

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