Settlement Allocation Principles, In Action

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When amounts are paid in settlement of litigation, different tax consequences can apply based on what the payments are for. For example, punitive damages will typically generate ordinary income for the recipient, while payments for damage to goodwill can generate capital gain. Such differing tax consequences bring about taxpayer efforts to characterize payments in the manner most favorable to them.

Two principles are important in determining whether the IRS will respect an agreed-upon characterization of settlement proceeds.

The first is the origin of the claim doctrine, under which the tax treatment of the proceeds of a settlement or judgment will depend on the nature of the claims made and the actual basis of the recovery. The tax consequences of a settlement depend on the nature of the claim that was the basis for the settlement, rather than the validity of the claim.

The second is that the IRS will be more likely to respect a settlement allocation of the parties if they have adverse interests as to that characterization. If one party is indifferent to the allocation, or both parties obtain tax advantages from the same characterization, the risk of IRS challenge is heightened.

A recent Tax Court case demonstrates the real world application of these principles. The case involved the settlement of a lawsuit for false advertising, unfair competition, and trademark dilution, with damages relating to loss of goodwill and reputation, lost profits, and punitive damages.

ORIGIN OF THE CLAIM. The Tax Court determined that the character of the settlement proceeds paid was to be allocated among the various claims made, in accordance with the origin of the claim doctrine. The parties characterized only a relatively small portion of the settlement to lost profits (an item which would produce ordinary income and not capital gain to the recipient) and no portion to punitive damages (another ordinary income item). Under the origin of the claim doctrine, the settlement proceeds should have been allocated among all the claims made.

ALLOCATION AMONG CLAIMS – NO ADVERSE INTERESTS. The court determined that the parties' allocation was suspect since the payor was generally indifferent to the characterization (and the payee would benefit from allocations away from ordinary income items). Thus, the parties did not have an adverse interest to each other and their allocation was subject to much higher scrutiny. As to the punitive damages question, the taxpayer pointed out that the payor was against paying punitive damages and was not indifferent, since it would put the payor in a bad light and implied wrongdoing. Thus, the implied argument was the allocation away from punitive damages was not collusive and done solely to avoid ordinary income for the recipient, but was a bargained for element by the payor and was perhaps sought but compromised away by the recipient. This was an interesting argument, but the Tax Court did not buy into it since the payor was agreeable to the amount to be paid for punitive damages but just didn't like the label applied.

An important aspect of this case is that just because the settlement arises from a bona fide dispute involving unrelated and truly adverse parties, the parties cannot count on IRS acceptance of a damages allocation unless the parties have adverse interests over the allocation itself. The type of adversity that most impresses courts in these circumstances is where a given type of payment produces a tax negative for one party while producing a better tax result for the other – that was not the situation here.

ALLOCATION AMONG CLAIMS – THE SEARCH FOR OBJECTIVE EVIDENCE. The origin of the claim doctrine does not provide any direct guidance on how to allocate settlement proceeds among various claims when there is more than one. In this situation, one can expect taxpayers, the IRS, and courts, to search for objective guidelines to use in the allocation. Such objective guidelines may not always exist – however, in the instant case they did. The lawsuit at issue was actually the second lawsuit arising from similar facts and claims. Since the original lawsuit was tried and a judgment was made by a jury that allocated the damages, the Tax Court used the percentage allocations from that case and applied them to the settlement.

ALLOCATION AMONG CLAIMS – OTHER HELPFUL ASPECTS. Taxpayers seeking to uphold an allocation that does not involve truly adverse issues should look long and hard for some methodology or expert opinion to help backstop their allocation. Such contemporaneous methodology and analysis will put the taxpayer in a better defensive position than the parties simply agreeing on an allocation with no methodology or analysis to justify it.

Healthpoint, Ltd, et al, TC Memo 2011-241

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