Was the Interest Paid 'On Account of' the Accident?

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Section 104(a)(2) excludes from income "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." (Emphasis added.) Chad Chamberlain, who was severely injured while swimming, recovered $9,253,551.58 from the state of Louisiana, whose negligence caused the injuries. Of that, $3,791,741.53 was prejudgment interest. Was the interest paid to Chad (and his parents) part of the excludable damages? It should be if "on account of" means "as a direct or indirect result of" (as in "They stayed together on account of the children"), which is certainly one "ordinary meaning" of that phrase.

State Law Classification vs. Federal Tax Law Realities

The Chamberlains' argument for excluding the interest actually went beyond one common usage of "on account of," however. Under applicable Louisiana law, prejudgment interest is considered part of the damages being paid. It is a hornbook law half-truth that federal tax law recognizes the primacy of state law when it comes to creating legal interests.[1] Thus, the Chamberlains, acting on behalf of their disabled son, were behaving reasonably when they treated the entire $9,253,551.58 as excludable from income under section 104(a)(2) when filing federal income tax returns. The IRS disagreed with the exclusion of the interest element, however. The Service viewed the prejudgment interest as taxable interest and assessed over $1 million in income tax deficiencies, which the Chamberlains paid. They then sued for a refund.

In Chad A. Chamberlain, et al. v. United States, 286 F. Supp.2d 764, Doc 2003-23889, 2003 TNT 219-13 (E.D. La. 2003), District Court Judge Eldon E. Fallon considered the state law argument and rejected it. He explained that although "states have the power to create legal interests and legal rights, [they] do not have the power to dictate the federal tax consequences of those interests and rights." He pointed out that even though the Fifth Circuit, in whose jurisdiction Louisiana falls, had not addressed the taxability of prejudgment interest in tort damage cases, the circuits that had addressed it had unanimously held it taxable. "Both pre- and post-judgment interest is paid on a tort judgment to compensate the injured party for the lost time value of money, not to compensate the injured party further for the injuries," concluded Judge Fallon. He denied the refund claim.

The Fifth Circuit, in Chad A. Chamberlain, et al. v. United States, No. 03-31136, Doc 2005-3443, 2005 TNT 34-7 (5th Cir. 2005), affirmed. Circuit Judge Patrick E. Higginbotham agreed with the district court that while the matter of prejudgment interest was one of first impression for the Fifth Circuit, the opinions of other circuits were consistent in finding that interest taxable. An important question, he believed, was the meaning of the phrase "on account of" as used in section 104(a)(2). Those words, he said, "do not readily admit of a precise and unambiguous meaning, and neither the Code nor the relevant Treasury Regulations attempt to define them." He turned to the Supreme Court decision in United States v. O'Gilvie, 519 U.S. 79, Doc 96-31894, 96 TNT 240-1 (1996) for guidance.

Two Competing Interpretations

In O'Gilvie, which dealt with punitive damages, the Supreme Court set forth two competing interpretations of the phrase "on account of" as used in section 104(a)(2):

[1]The other half of that half-truth, however, is that the courts will ignore the forms of transactions, and the state law property law niceties, and look to substance and total effect when necessary to implement congressional intent. *See, e.g., Commissioner v. P. G. Lake, Inc.*,356 U.S. 260 (1958).

> On one linguistic interpretation of those words, that of petitioners, they require no more than a "but-for" connection between "any" damages and a lawsuit for personal injuries. They thereby bring virtually all personal injury lawsuit damages within the scope of the provision, since: "but for the personal injury, there would be no lawsuit, and but for the lawsuit, there would be no damages."
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> On the Government's alternative interpretation, however, those words impose a stronger causal connection, making the provision applicable only to those personal injury lawsuit damages that were awarded by reason of, or because of, the personal injuries. To put the matter more specifically, they would make the section inapplicable to punitive damages, where those damages "'are not compensation for the injury [but] [i]nstead . . . are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence.'". . . . [T]here is no strong reason for trying to interpret the statute's language to reach beyond those damages that, making up for a loss, seek to make a victim whole, or, speaking very loosely, "return the victim's personal or financial capital."

Judge Higginbotham then concluded that:

> 1. While prejudgment interest might have a "but for" connection to the actual physical injury, it lacks that direct relationship to the injury that would make it "because of" that injury. "Damages," he said, "are not excluded from taxation under section 104(a)(2) solely by virtue of having been awarded in a personal injury lawsuit."
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> 2. To be excludable, the damages must be "compensatory and restorative" in nature.
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> For example, an individual's physical health is, in itself, an untaxable human "asset." When that asset is wrongfully converted by a tortfeasor, damages paid to compensate an individual for that harm are exempt from taxation because they serve to replace otherwise untaxable "human capital."
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> 3. Prejudgment interest, however, compensates for something else -- the lost time value of the money that is being awarded to replace the human capital. If the damages were paid at the time of the injury, there would be no prejudgment interest. Thus, that interest is caused by delay rather than by the injury itself.

Interest on State Indebtedness

The obligation of Louisiana to the Chamberlains, in an interest-calculation sense, arose as of the date of Chad Chamberlain's accident, according to Judge Higginbotham. Why then would it not be excludable as interest from the state of Louisiana? Under section 103(a), interest on a state bond is excludable from gross income, while under section 103(c)(1), a state bond is "an obligation of a state." The Chamberlains did not raise that point, but plaintiffs' attorneys do sometimes raise it in discussions of prejudgment and postjudgment interest when a defendant is a state or a subdivision thereof.

While section 103 excludes from income any interest on an obligation of a state, the tax realities are that not all interest paid by a state or a political subdivision thereof is excludable. Just as with the business purpose doctrine in corporate reorganizations, the courts have applied a gloss to interest paid by state and local

government units that eliminates some of it from section 103 exclusion treatment. For the interest to be excludable from the recipient's income, the obligation must have been created in the exercise of the governmental body's borrowing power. The rationale for that? The exclusion for municipal interest was designed to prevent the federal government from impinging on the rights of the states to borrow by imposing taxes on the interest paid by the states (and their subdivisions). As the court said in United States Trust Co. of New York v. Anderson, 65 F.2d 575, 578 (2nd Cir. 1933), a property condemnation case, "It disregards the whole purpose of the exemption to apply it to interest upon obligations of a state which it can compel a citizen to take in exchange for the fair value of his property."

Thus, in J. Robert King Jr. et ux. v. Commissioner, 77 T.C. 1113 (1981), the issue focused on whether land purchased by the Trinity River Authority (TRA) was acquired under TRA's power of eminent domain or under its power to borrow. "It is undisputed that taxpayers conveyed their land to TRA under the threat of condemnation," concluded the court. "The fact that TRA allowed them and other landowners to elect to receive compensation on a deferred basis, and thereby to obtain the additional tax advantage of installment reporting, did not convert the transaction into a voluntary one." Nor did it prove sufficient to allow them to exclude from income the interest on the installment obligations they received.

While exercise of the power of eminent domain is a far remove from negligence that causes personal injury, both have one attribute in common: Neither can be said to be an exercise of the governmental body's power to borrow. Thus, the Chamberlains had no basis for even claiming that the prejudgment interest was excludable under section 103.

Settlements Without Prejudgment Interest

Most personal injury cases are ultimately settled -- sometimes without trial, sometimes during trial, or even sometimes while an appeal is pending. Once the taxability of prejudgment interest is understood, the next question to arise is usually, How can we word the final settlement documents so that prejudgment interest is not a problem? The idea is that when the defendant in the case will suffer no tax detriment because the damages are either as fully deductible as the interest or are equally nondeductible, the labels will matter only to the plaintiff. Because a settlement is being reached, the total amount is the defendant's only concern.[2]

That, however, is a tricky tax trail to take. The leading authority supporting exclusion of the total settlement wherein a settlement agreement set forth that the agreed amount was to be paid "without costs and interest" is Frank L. McShane, et al. v. Commissioner, T.C. Memo. 1987-151, 87 TNT 54-41. Tax Court Judge Perry Shields there dealt with four taxpayers injured in 1971 by a gas explosion and ensuing fire at their construction job site in a railroad yard. They filed suits against the gas company, the railroad, and the contractor.

The lawsuits were successful and the jury awarded McShane $830,000 and the other three an aggregate of $445,000, a total of $1,275,000. Those amounts were for damages alone and did not include prejudgment interest, to which the defendants were entitled under state law. The defendants appealed and initiated settlement discussions. Because that was the first Massachusetts personal injury case ever to award more than

[2] *But see* Robert W. Wood, "Defendants in Litigation Should Worry About Nondeductible Settlement Payments," *Doc 2005-3447, 2005 TNT 35-33.*

$1 million, the parties were concerned that the appeals court would remand for a new trial. Before any appellate briefs were filed, the parties arrived at a settlement. McShane would get $1,001,032 and the other three an aggregate of $528,102, for a total settlement of $1,529,134, or $254,134 more than the judgment.

At the insistence of the gas company defendant, all of the settlements were to be paid as lump sums "without costs and interest." A memo from the gas company files showed a calculation that started with the total jury verdict of $1,275,000, added statutory interest to an arbitrarily chosen date, and then took a 5 percent discount. The taxpayers reported no income as a result of the amounts they received. The IRS, however, seized on the evidence that showed the settlement amount was the product of a calculation that included interest, and found a tax deficiency as a result of failure to report that interest.

Settlement Agreement Language vs. Settlement Memo Calculation

Judge Shields thus faced the dilemma of a taxpayer argument, supported by the settlement agreement, that the settlement contained no element of interest; and an IRS argument, supported by the settlement memorandum from the principal defendant's files, that the settlement amounts had been arrived at by taking into account an interest element. As a starting point, Judge Shields expressed agreement with a basic plank in the taxpayers' argument:

> Petitioners argue that prior to their settlements there was no fixed indebtedness upon which to compute interest since there were no existing unconditional enforceable obligations to pay a principal sum. We agree. [Citations omitted.] Such obligations would only exist if and when a final decision was rendered. Without such a final decision, we must carefully review the settlement agreements and all other evidence in the record in order to determine whether the payments ultimately received included interest.

After making that review, Judge Shields noted that:

> 1. At the insistence of the principal defendant, the agreements clearly provided that the settlements were to be paid "without costs and interest."
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> 2. The attorneys for the parties all testified that no interest was intended in the settlement.
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> 3. McShane, his attorneys, and the gas company attorneys all "uniformly testified in an honest and forthright manner that the tax consequences of the settlements were never considered in the negotiations, but instead the settlement amounts were arrived at solely from a consideration by each party of the risks it would be subjected to by continuing the appeal."

What about the memorandum explaining that the amount of the settlement was the amount of the jury verdict plus statutory interest less a 5 percent discount? That was written by a gas company claims attorney not involved in the settlement discussions, was written after the fact, and was written to justify the decision to pay more than the amounts in the jury verdict. Judge Shields therefore concluded that the memorandum was "not persuasive" and that the IRS's "reliance upon the memorandum as a basis for determining that the settlements included interest is in error."

Evaluating McShane

The facts in McShane, as brought out at trial, were considerably different from the situation in which it's the injured party that insists that the settlement language read "without costs and interest" and the defendant is indifferent. In McShane, the defendants insisted on the "without costs and interest" language. We have heard it speculated that they intended thereby to minimize problems with their insurance carrier. Whatever the reason for the facts, the evidence in McShane indicated that the settlement language was neither taxpayer-initiated nor tax-motivated.

Contrast McShane with Delaney v. Commissioner, T.C. Memo. 1995-378, Doc 95-7782, 95 TNT 155-8, aff'd 99 F.3d 20, Doc 96-29336, 96 TNT 216-11 (1st Cir. 1996). The Delaney case also involved a tort action, a jury verdict for the plaintiffs for $287,000, and an appeal. During the pendency of the appeal, the parties entered into an agreement settling the case for $250,000 "without costs or interest" and without regard to the tax consequences.

The original judgment of $287,000, unlike the jury verdicts in McShane, included prejudgment interest ($112,000). Tax Court Judge Thomas Wells explained that in McShane, "our decision was based on the express language in the settlement agreements that payments were made 'without costs and interest' as well as other evidence in the record which established that the inclusion of the language in the settlement agreements was the result of bona fide arm's length negotiations."

In the Delaney case, the jury award of $287,000 included $112,000 in statutory prejudgment interest. In Delaney, the record, said Judge Wells, "is devoid of evidence that the [no interest] provision of the stipulation was the product of arm's length negotiations between the parties." He added that "the only evidence in the record is that the parties did not discuss the tax implications of such aspect of the stipulation." Judge Wells therefore concluded that the taxpayers had failed to carry their burden of proof "that there was no interest component to the settlement."

So yes, there is support for the proposition that a settlement agreement that stipulates there is no interest in or on the settlement can be effective. However, that is a facts-and-circumstances thing, and judges are apt to be understandably skeptical when the "no interest" settlement comes after a court verdict that explicitly, or as a matter of law, includes prejudgment interest.

Structured Settlements

We have heard it argued that settlements providing for periodic payments and containing no explicit interest component are also an effective way of avoiding the problem of prejudgment interest. No case has ever dealt squarely with a fact situation in which a state law mandated prejudgment interest and a case was settled on a structured settlement basis after a court had reached a judgment and pending appeal. In fact, the only potentially relevant mention of structured settlements that we have encountered is in Brabson v. United States, 73 F.3d 1040, Doc 96-3551, 96 TNT 25-24 (10th Cir. 1996). In a footnote, that decision, which found prejudgment interest under Colorado law taxable as interest, commented that:

> Taxpayers argue that the 1982 Periodic Payment Settlement Act ("PPSA") . . . evidences legislative intent that time value of money considerations were not to be treated separately under Section(s) 104(a)(2). The PPSA amended Section(s) 104(a)(2) and provided that a victim of personal injuries who received damages in periodic payments rather than a lump sum could exclude the entire periodic payment from gross income.

We are not convinced that the PPSA, which applies solely to periodic payments, sheds light on whether Congress intended to exclude prejudgment interest under section 104(a)(2). There is nothing in the act or in the revenue rulings themselves that indicates a general congressional or administrative position toward the exclusion of prejudgment interest. Indeed, given the difficult task of differentiating interest and damages in the context of periodic payments, it is probable that the driving force behind the act was a concern for administrative convenience.

The taxpayer argument did not convince the court in Brabson, which did not involve a structured settlement, merely an unsuccessful attempt to piggyback on the existence of the provision to show that Congress did not want interest considerations reflected in the tax analysis of personal injury awards. The taxpayer will have a better chance in court with a structured settlement than with a lump sum settlement in a jurisdiction where prejudgment interest is part of the statutes.

Conclusion

Since the Tax Court decided Kovacs v. Commissioner, 100 T.C. 124, Doc 93-2636, 93 TNT 45-22 (1993), it has taken the position that prejudgment interest was fully taxable. All of the appeals courts that have considered the question have agreed. Less settled is the effect of settlement agreements stipulating that there is no interest element in the settlement amount. Cases since McShane have generally distinguished their facts from the McShane facts. If a "no interest" court decision is the product of a bona fide adversary proceeding, of course, both the IRS and the courts will give it some weight without treating it as conclusive.

The tax practitioner faces a problem in that situation. If asked to advise the plaintiff's attorney as to what needs to be done to minimize the plaintiff's income tax liability in documenting the settlement of a personal injury suit, the possible answer might be to provide a summary of the McShane facts and the Delaney facts and explain that documenting the facts that bring the settlement closer to McShane should optimize the taxpayer situation. The ethical problem involved, of course, is that even providing that answer seems an invitation to manufacture supporting evidence, as in the form of self-serving language in the final settlement agreement, that will not be supportable if the parties involved in the settlement testify truthfully at any subsequent tax trial. A structured settlement is less likely to be attacked by the IRS, although the IRS could still challenge a structured settlement of a principal amount that by law included prejudgment interest.

When the tax practitioner gets involved early in the settlement process, paradoxically that very involvement might later be used against the taxpayer as evidence that tax considerations were a part of the lump sum settlement language finally agreed to. It will be seldom that "without interest" language will be insisted on by the defendant, as happened in McShane. Thus, the successful personal injury plaintiff entering into a settlement needs to be advised that a "no interest" provision in the settlement agreement is unlikely to prevent the IRS from asserting that there is an interest component that will be subject to income tax.

Depending on the specific facts and the tax practitioner's evaluation of them in the light of the case law, of course, excluding the interest element in a "no interest" lump sum settlement may be nonfrivolous, thus allowing the practitioner to prepare a return taking that position if there is full disclosure (Form 8275). Unless the facts come close to McShane, however, it is unlikely that there would be

"reasonable basis" sufficient for even the Form 8275 to insulate the taxpayer from a possible accuracy-related penalty.