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EXCLUSION OF DAMAGES DERIVED FROM PERSONAL INJURY SETTLEMENTS: TAX-PLANNING CONSIDERATIONS IN LIGHT OF MCKAY V. COMMISSIONER

Jon O. Shields

I. INTRODUCTION

Following a jury verdict in an employment dispute, an attorney negotiates a large settlement award for a client. The pleadings alleged theories grounded in both tort and contract. The settlement agreement and jury award did not specify which claims were satisfied by the payment—only that the payment satisfied all claims against the defendant. The client now wants to know whether the proceeds from the settlement award are subject to federal income tax and should be included in gross income on the client’s tax return for that year. In these circumstances the answer will depend largely on whether express language found in the settlement agreement is supported by the facts and circumstances surrounding the agreement. Under the recent Tax Court decision in McKay v. Commissioner,¹ and decisions preceding it, the answer could well be that the settlement award is taxable. However, awareness of the relevant case law and proper planning by the practitioner throughout the litigation process could change that answer.

McKay v. Commissioner, together with other decisions discussed in this Note, demonstrate the broad interpretation given by courts to section 104(a)(2) of the Internal Revenue Code excluding damages received “on account of personal injuries.”² Analysis of these decisions also reveals traps that can be avoided through proper planning, thereby leading to favorable tax treatment of a client’s damage award.

This Note identifies the factors the Tax Court has examined to determine whether the section 104(a)(2) exclusion will apply to certain allocations of damages made in settlement. Part II of

¹. 102 T.C. 465 (1994).
this Note examines *McKay*, recounting the facts and comparing the Tax Court’s reasoning in that case with *Robinson v. Commissioner*, another pivotal case dealing with settlement agreement allocations. Part III provides historical background and analysis of the decisions that established the factors applied in *McKay* and a critique of the *McKay* decision. Finally, Part IV summarizes *McKay’s* significant effect on tax consequences of damages received on account of personal injury.

II. *McKay v. Commissioner*

A. The Facts

In 1976, Ashland Oil, Incorporated (the Company), recruited taxpayer Bill E. McKay (*McKay*) because of his experience in and specialized knowledge of the petroleum industry. When the Company first approached McKay, he was reluctant to accept a position based on his awareness that the Company allegedly had made questionable payments to domestic and foreign officials to secure oil during the 1960s and 1970s and had also made several illegal political contributions during the Watergate era. Nevertheless, he accepted employment, eventually handling all of the Company’s crude oil supply acquisitions.

In December of 1980, Orin Atkins (Atkins), the Company’s Chief Operating Officer and McKay’s superior, made arrangements for payment of a $1.35 million bribe to Yehia Omar (Omar), an official of the Sultanate of Oman, for the purchase of his government’s crude oil. Atkins insisted that McKay arrange the transfer of funds, but McKay refused as it was his belief that such a payment would violate the Foreign Corrupt Practices Act (FCPA) as well as a 1975 consent decree that the Company had made with the Securities and Exchange Commission (SEC). Despite McKay’s persistent efforts to prevent it, the payment was made. Subsequently McKay learned of the Company’s attempt to retrieve the bribe from Omar, but only by making another payment to Omar as an incentive to rescind the earlier deal. McKay also objected to this payment and attempted to

4. McKay filed a 1988 joint income tax return with his wife Lana S. McKay. 102 T.C. at 465. Their joint return was the subject of the deficiency action brought by the Service and which is the subject of this Note. However, for the purposes of this Note, only McKay will be referred to as the taxpayer.
5. Id. at 468.
prevent it as well.\(^6\)

In September of 1981, Atkins was replaced by John Hall (Hall). Hall assured McKay that the Company's disguised payments and bribes would stop. Despite Mr. Hall's assurances, the Company continued to make such payments.\(^7\)

McKay's opposition to the payments to Omar tainted his employment relationship with the Company. As a result, McKay retained legal counsel to represent him in negotiating a satisfactory termination of his employment with the Company. McKay and the Company, however, were unable to reach a mutually acceptable termination agreement.\(^8\)

During October and November of 1982, the Internal Revenue Service (the Service) contacted McKay and requested his response to inquiries known as the "Five Questions." These questions all pertained to the Company's questionable business transactions. The Company pressured McKay to sign responses favorable to its position, and similar to responses already submitted by Hall to the Service. McKay refused to sign the responses since he believed the statements contained therein to be false. McKay instead gave answers which were significantly different than the Company's predetermined responses.\(^9\)

In May of 1983, the SEC subpoenaed McKay to testify regarding the Company's disguised payments and his responses to the Service's Five Questions. Shortly thereafter, the Company officially terminated McKay's employment.\(^10\)

**B. The Legal Proceedings**

One year after his termination, McKay initiated a civil action against the Company in a United States district court asserting claims for wrongful discharge, breach of employment agreement, violations of the Racketeer Influenced and Corrupt Organizations (RICO) statutes, and for punitive damages. The jury found that the Company breached its employment agreement with McKay and wrongfully discharged him in violation of public policy.\(^11\)

\(6. \) *Id.*

\(7. \) *Id.* at 469.

\(8. \) *Id.*

\(9. \) *Id.*

\(10. \) *Id.*

\(11. \) *Id.* at 470. The case was entitled McKay v. Ashland Oil, Inc., 120 F.R.D. 43 (E.D. Ky. 1988)(the wrongful discharge action). McKay's wrongful discharge action was consolidated for discovery and trial with a suit brought against Ashland by an-
On the basis of its findings at trial, the jury awarded McKay $1,602,103 as damages for lost compensation. The jury also awarded McKay “future” damages of $12,846,209. Due to the Company’s RICO violations the damages were trebled to more than $43 million. Finally, the jury awarded McKay punitive damages for wrongful, malicious, and oppressive acts in the amount of $500,000 from the Company, and $750,000 from Hall.

Following the jury award and judgment, counsel for both sides met to negotiate a settlement. While the negotiations were hostile, the parties were nonetheless able to reach a settlement agreement whereby the Company agreed to pay McKay $16,744,300.12 The settlement agreement allocated $12,250,215 of that amount to payment of the wrongful discharge tort claim, and $2,044,085 to payment of the breach of contract claim.13 The remaining $2,450,000 were allocated as partial reimbursement by the Company of McKay’s legal expenses.14

Throughout the negotiations, the Company refused to agree on the allocation of any part of the settlement to either the RICO claim or punitive damages. By contrast, McKay desired that a portion of the settlement proceeds be allocated to the RICO claim in order to publicize the Company’s unlawful activity. McKay reluctantly agreed to settle without such allocations because of both the risks he would face on appeal and the fact that the Company threatened to prolong the litigation for fifteen to twenty years. The settlement agreement therefore expressly stated that none of the settlement proceeds were being paid pursuant to

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12. McKay, 102 T.C. at 471.
13. Id. at 472.
14. Id. at 473. With regard to the parties’ allocations, the settlement agreement provided:

G. Based upon the nature and origin of each Claim, Ashland and McKay have agreed that:

(1) The sums allocable to the Wrongful Discharge Tort Claim, representing compensatory damages payable on account of an alleged tort-type invasion of rights that McKay is granted by virtue of being a person in the sight of the law, are properly excludable from McKay’s gross income under [§] 104(a)(2) . . . . and

(2) The sums allocable to the Contract Breach Claim, representing compensatory damages payable on account of Ashland’s alleged breach of McKay’s employment contract, constitute gross income to McKay within the meaning of [§] 61 . . . .

Id. at 472.
RICO or for punitive damages.\(^{15}\)

The United States district court judge presiding over McKay's wrongful discharge action concluded that the allocations in the settlement agreement were reasonable and fairly reflected the relative value of McKay's claims. McKay included the amount of the settlement proceeds he and the Company allocated to the breach of contract claim ($2,044,085) in gross income on his 1988 federal income tax return.\(^{16}\) However, he excluded the entire amount of settlement proceeds allocated to the wrongful discharge tort claim ($12,250,215). The Service determined that the entire amount of settlement proceeds McKay received from the Company constituted compensation to him during 1988, and therefore should have been included in his gross income for that year.\(^{17}\)

C. The Holding

The United States Tax Court held that McKay could exclude from gross income the amount of settlement proceeds he and the Company allocated to the wrongful discharge claim in their settlement agreement.\(^{18}\) The court based this holding on its findings that the settlement agreement resulted from bona fide, arm's length negotiations between adversarial parties\(^^{19}\) and that the allocations accurately reflected the substance of the claims settled by McKay and the Company.\(^{20}\) Accordingly, the $12,250,215 payment allocated to the wrongful discharge claim represented a payment for compensation of a tort-type personal injury excludable under section 104(a)(2) of the Internal Revenue Code.\(^{21}\)

15. McKay, 102 T.C. at 473.
16. McKay also included the settlement proceeds allocated as partial reimbursement of legal expenses from Ashland ($2,450,000). McKay's inclusion of this amount in gross income is not, however, germane to the analysis in this Note.
17. Id. at 474.
18. Id. at 487.
19. Id. at 483-84.
20. McKay, 102 T.C. at 484.
21. Id. at 487. The tax court ruled on several other issues that are not applicable to the analysis in this Note. First, the tax court held that McKay could deduct legal expenses that the settlement agreement with Ashland allocated to his expenses in a shareholder's derivative suit against him, but could deduct his remaining legal expenses (which were allocated to the wrongful discharge action) only to the extent of wrongful discharge settlement proceeds. Id. at 487-94.

Second, the Tax Court held that McKay could not deduct payments made to the law firm representing him, amounts claimed as "other legal expenses," maintenance and storage expenses for business records, or expenses incurred as a consul-
D. The Court's Analysis

The starting point for the court's reasoning in *McKay* was the relationship of the relevant sections of the Internal Revenue Code. Section 61 states that "all income from whatever source derived" must be included in gross income. Section 104(a)(2) adds that "the amount of any damages received (whether by suit or agreement and whether as lump sums or periodic payments) on account of personal injuries" may be excluded from gross income. The court noted that the Treasury Regulations broadly interpret the language of section 104(a)(2) to include damages received "through prosecution of a legal suit or action based on tort or tort-type rights, or through a settlement agreement entered into in lieu of such prosecution." The court noted that the section 104(a)(2) exclusion encompasses damages received for both physical and non-physical (i.e., mental or emotional) injuries.

The court explained that in personal injury cases, it must make a factual inquiry to determine the true substance or nature of the settled claim. The court will therefore examine all the facts and circumstances surrounding the settlement in the following ways:

(a) if no lawsuit was initiated the court must consider relevant documents, letters, and testimony;

(b) in a case where a lawsuit was filed but not settled, or if settled but no express allocations were made among the various claims in the settlement agreement, then the court must consider the pleadings, jury awards, or any court orders or judgments;

22. *Id.* at 494.


25. *McKay*, 102 T.C. at 481 (citing Treas. Reg. § 1.104-1(c) (as amended in 1970)).

26. *Id.* at 481 (citing United States v. Burke, 112 S. Ct. 1867 (1992)).
and

(c) if (like McKay), the taxpayer's claims were settled and express allocations among the various claims are contained in the settlement agreement, the court must carefully consider the various claims. 27

The Service argued that, contrary to the express statements in the settlement agreement, the entire amount of settlement proceeds was attributable to McKay's breach of contract claim. Thus, the proceeds were not excludable under section 104(a)(2) but rather constituted gross income. 28

The Service supported its overall position with three specific arguments. First, the Service argued that since the Company could claim a section 162 business expense deduction on any payments for damages, the Company was not actually adverse to any particular allocation scheme. Section 162 provides that taxpayers may deduct the cost of "ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business." 29 The section 162 deduction encompasses civil damages. Therefore the Company's settlement payments to McKay could indeed be deducted.

Second, the Service argued that the character of the claims in the settlement agreement must be based on the character of the claims litigated against the Company. McKay plead four claims at trial: wrongful discharge, breach of contract, RICO violations, and punitive damages. However, the settlement agreement included only two claims: tort and contract.

Third, the Service argued that all of the settlement proceeds should be included in gross income because the jury awarded treble damages derived from McKay's RICO claim, which was based on injury to McKay's business or property. Since business and property damages are outside the scope of the 104(a)(2) exclusion, the proceeds from those claims would be properly includable in gross income. 30

By arguing that the Company could deduct any payments made to McKay, the Service attempted to dispel the notion that

27. Id. at 482-83.
28. Id. at 481.
30. The Service also advanced two alternative arguments in the McKay case: First, that all of the settlement proceeds should be included in McKay's gross income because they represented an accession to wealth—not a return of capital. Second, since the claims in the Williams case were based on a contract theory and were litigated contemporaneously with McKay's case, the two cases should reflect similar claims. McKay, 102 T.C. at 484-487.
the Company and McKay were adverse with respect to the tax consequences of the settlement. The court disposed of that argument noting that while deductibility of the payor's payment might be one factor to be considered in a determination of whether the parties were adverse to their allocation, it is not controlling.

In making the argument that the character of settled claims must reflect litigated claims, the Service focused on the jury's award of back and future pay in its contention that McKay's claims were purely contractual under Kentucky law. The court rejected those assertions, thereby refusing to disregard the express language of the settlement agreement since the agreement was consistent with Kentucky law, which recognizes both contract and tort claims in employment dispute litigation.

The court quickly dismissed the Service's third argument that since the jury awarded treble damages for McKay's RICO claim, which was based on injury to McKay's business or property, all of the settlement proceeds should have been included in gross income. The court stated that since the parties had not expressly allocated any damages to RICO, the settlement agreement would control.

The McKay court further dismissed the Service's first alternative argument—that the entire settlement proceeds should be included in McKay's gross income because such proceeds represented an accession to wealth. The court explained that the

31. Id. at 485; Concord Control, Inc. v. Commissioner, 78 T.C. 742, 745 (1982); Black Indus., Inc. v. Commissioner, T.C. Memo. 1979-61. The Service cited these two cases in support of its argument. The court distinguished these cases on their facts by pointing out that both cases involved allocations made in the purchase price of a business, while the instant case dealt with hostile litigation—two sets of circumstances that were altogether different.

32. McKay, 102 T.C. at 485.
33. Id. at 486.
34. Id. at 486-87.
35. Id. Two theories have emerged with regard to the taxability of damages awarded for personal injury: the return of capital theory and the accession to wealth theory. Under the return of capital theory, damages awarded are intended to compensate the injured party for injuries to one's personal rights and attributes (although this theory is difficult to support given that under ordinary tax principles, to apply the return of capital theory, one must establish an investment of capital in the asset in question—a basis). The accession to wealth theory posits that taxpayers who receive damages with no discernible basis realize gain to the extent of the damage award. Taxpayers who receive punitive damages are generally regarded as having acceded to wealth since punitive damages are not meant to compensate the injured party. For an extensive discussion of the history and underlying tax policy of those two theories and the § 104(a)(2) exclusion generally, see Douglas A. Kahn, Compensatory and Punitive Damages for a Personal Injury: To Tax or Not to Tax?, 2
Service had failed to recognize *Burke* for the proposition that damages received on account of a tort or tort-like personal injury are excludable under section 104(a)(2).36 The court also dispelled the Service's second alternative argument, that the court should compare McKay's claims with those of McKay's co-plain-tiff, Williams. The court stated that it failed to see why Williams' claims, which were based upon a different legal theory than McKay's claims, should affect the instant case.37

Taking the opposite position, McKay argued that the allocations in the settlement agreement should be respected and that the settlement proceeds expressly allocated to his wrongful discharge tort claim should be excludable under section 104(a)(2). The court accepted McKay's argument that the settlement agreement was entered into by adverse parties at arm's length. The court noted that, similar to previous decisions, the most important factor bearing on the question of whether a payment was made on account of tortious injury for purposes of exclusion under section 104(a)(2) is the express language in the settlement agreement itself.38 The *McKay* court, relying heavily on *Robinson v. Commissioner*,39 stated that it would not be bound by any "factor or factors that are inconsistent with the true substance of the taxpayer's claim" nor by express allocations in the document itself if the parties did not "engage in bona fide, arm's length, adversarial negotiations."40

In *Robinson*, the Tax Court considered the circumstances under which it would disregard specific allocations of settlement proceeds made in a written agreement. *Robinson* involved an action initiated by the taxpayers (the Robinsons) in state court against a Texas bank (the Bank) for failure to release a lien on the Robinsons' property. Following a jury verdict of approximately sixty million dollars in the Robinsons' favor—including six million dollars for lost profits, $1.5 million for mental anguish, and fifty million dollars in punitive damages—the parties set-

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37. *Id.* at 487.
40. *McKay*, 102 T.C. at 482.
tled. The settlement agreement provided that the Bank pay the Robinsons ten million dollars in consideration for the release of the Bank from further liability. A final judgment was entered allocating ninety-five percent of the ten million dollar settlement payment to mental anguish and five percent to lost profits.41

The Robinsons reported $246,758 on their 1987 Form 1040 as miscellaneous income.42 The Service brought a deficiency action against the Robinsons arguing that only five percent of the settlement proceeds was excludable from gross income.43 The Tax Court rejected the allocation in the final judgment because it was uncontested, nonadversarial and entirely tax-motivated and therefore did not accurately reflect the underlying claims.44

Since the allocations in the Robinson settlement agreement were so disproportionate to the jury's damage award and because the settlement agreement did not provide adequate evidence of the Bank's intent in making its payments, the court looked to other facts and circumstances to determine the Bank's intent. Specifically the court analyzed the Bank's interests in characterizing the proceeds as either tort or contract damages and whether the Bank intended that the settlement proceeds be allocated to the tort and contract claims in the proportions that they were. Regarding these questions the court noted that the Bank's interests were adverse to those of the Robinsons only to the extent of the negotiations regarding the amount of the settlement and that the Bank did not intend to "settle one claim to the exclusion of another."45 Since the Bank evidently was indifferent to the allocation of the settlement between the contract and tort claims, the court further found that the Bank did not intend the allocations as they appeared in the settlement agreement. The Robinson court therefore concluded that the settlement negotiations between the Robinsons and the Bank could in no way be characterized as arm's length or adversarial with regard to the characterization of the settlement proceeds.46

42. Of the $10 million in settlement proceeds the Bank paid out, the Robinsons received $4,935,151.72. The balance of $5,064,848.28 went to the Robinsons' attorneys. The $246,758 the Robinsons reported was five percent of the total of the $4,935,151.72. Id. at 124.
43. Id. at 117.
44. Id. at 133-34.
45. Id. Although it is not stated, the Tax Court presumably took note of the fact that the bank could deduct its payment as a § 162 trade or business expense. I.R.C. § 162 (1988).
46. Robinson, 102 T.C. at 129.
The *McKay* court distinguished the *Robinson* decision on the grounds that the parties in *McKay* were "hostile adversaries with respect to the allocations made in the settlement agreement,"\(^{47}\) while the payor Bank in *Robinson* "was not concerned with the allocation among the taxpayers' various claims."\(^{48}\) The court characterized *McKay*'s interests in the negotiations as "want[ing] the settlement award to be as high an amount as possible to compensate him for his losses and want[ing] [the Company] to be punished for its behavior."\(^{49}\) The Company's interests in the negotiations, on the other hand, were "to minimize the amount it needed to pay petitioner as well as avoid making any payment on account of petitioner's RICO claim."\(^{50}\) The court further pointed out that the Company adamantly refused to settle if any of the damages were to be allocated to RICO claims.\(^{51}\) Because the parties expressly memorialized this understanding in the settlement agreement, the *McKay* court found that evidence bearing on the questions of hostile or adverse negotiations and on the intent of the payor could be found in the settlement agreement itself.\(^{52}\)

Ultimately the court accepted the parties' express allocations in the settlement agreement and held that the $12,250,215 payment allocated to the wrongful discharge tort claim represented a payment for a tort-type personal injury. The court therefore allowed McKay to exclude the payment from his gross income under section 104(a)(2).

### III. ANALYSIS

#### A. Background

Prior to initiating lawsuits involving a personal injury, practitioners should carefully analyze the potential tax consequences of a jury or settlement award in their clients' cases. *Robinson* and *McKay* apply a number of principles developed in previous cases dealing with the section 104(a)(2) exclusion,\(^{53}\) and identify

\(^{47}\) *McKay*, 102 T.C. at 484.

\(^{48}\) *Id.* at 483.

\(^{49}\) *Id.* at 484.

\(^{50}\) *Id.*

\(^{51}\) *McKay*, 102 T.C. at 484.

\(^{52}\) *Id.* at 483-84.

\(^{53}\) The author relies substantially on analysis of the relevant case law decided prior to *Robinson* and *McKay* as developed in *Limits*, supra note 2, at 38-40. In *Limits* the authors concluded that the proceeds of most employment disputes are derived from non-physical personal injuries and should logically be taxable. *Id.* If
distinct factors that courts will consider when determining whether to respect the allocation of damages or settlement awards tax purposes. As the case law interpreting section 104(a)(2) reveals, taxpayers have met both success and failure in their efforts to characterize payments as "damages on account of personal injury." The results of those efforts provide a helpful map to practitioners who seek the safe harbor of section 104(a)(2) exclusion for damages awards.

Only damages or compensation received on account of personal injury or sickness are excludable from gross income under section 104(a)(2). The Service and the courts have allowed taxpayers to exclude damages for both physical personal injuries, and non-physical personal injuries.54 Because most of the recent case law in the area of non-physical personal injury has emanated from the employment arena, the issue that frequently arises in tax litigation is whether the action was based on tort or tort-like rights, or, instead, was contractual in nature.

In employment cases, the Service has regularly focused on the nature of damages claimed rather than on the nature of the injury. The United States Supreme Court settled that issue in Burke, concluding that the proper inquiry into the character of jury or settlement awards for damages focuses on the nature of the injury.55 The Service nonetheless persists in arguing that damages awarded by a jury or agreed upon in a settlement agreement are based on contractual rather than tort or tort-like rights, as it did in McKay.56

When courts decide whether to respect a settlement based on tort or tort-like rights for purposes of section 104(a)(2), the most important determination is whether the payor intended the award to satisfy tort or tort-like claims. The court will therefore analyze evidentiary factors found both inside and outside the settlement agreement to determine the payor's intent. The most important factor bearing on the question of the payor's intent is the express language contained in the settlement agreement.57

In the absence of an express allocation in the settlement agree-

that were the state of the law, McKay would not have been litigated, since the compensatory damages from McKay's settlement with the Company were derived from non-physical personal injuries and would be includable in gross income.

57. See supra note 42 and accompanying text.
ment, the court will analyze the surrounding facts and circumstances to determine the payor’s intent. However, the McKay decision indicates that even if express allocation language appears in the agreement, the court will analyze the underlying facts and circumstances to determine if the settlement allocations are meaningful. Evidentiary factors that courts have examined in such a determination include pleadings and other court documents, correspondence between parties, insurance contracts, and a payor’s issuance of a Form 1099 to a taxpayer.

If a settlement agreement lacks express allocation language and the underlying facts and circumstances do not convincingly indicate the payor’s intent to extinguish tort or tort-like claims, the result will be fatal to a taxpayer’s case. In Agar v. Commissioner, the Second Circuit held that the plaintiff-taxpayer could not exclude amounts received from his employer upon the employee’s resignation from the company. In that case, the court concluded the evidence did not indicate that the company intended its payments to satisfy tort or tort-like claims. Some evidence indicated that the taxpayer had resigned because of accusations and criticisms leveled against him, but the settlement agreement was devoid of any reference to those matters. The settlement agreement only indicated that the taxpayer was leaving his employment because of a desire to return to public accounting. The record further showed the employer intended its payments to be a form of severance pay rather than compensation for any possible defamation claims that the taxpayer may have had. The Agar court thus emphasized that the taxpayer failed to demonstrate that the company intended to compensate the taxpayer for tort or tort-like claims. The court noted the lack of any express language in the settlement agreement allocating proceeds to compensation for specific types of injury.

63. 290 F.2d at 284.
64. T.C. Memo. 1960-21, 19 T.C.M. (CCH) at 118.
65. 290 F.2d at 284.
66. Id.
As it became clear to the taxpayers in McKay and Robinson, a court's findings of fact on the payor's intent is crucial. Because the McKay court respected the express language in the settlement agreement in its findings, McKay won his case on the issue of allocation. If, like Robinson, the court refuses to respect the allocations in the settlement agreement, the taxpayer will lose the case. Therefore, an ideal settlement agreement would contain, among other provisions, specific allocations of damages in compensation for tort or tort-like injuries alleged and a specific statement indicating that the payor intends to compensate the plaintiff for the injuries alleged.

The importance of initiating a lawsuit with pleadings that raise tort or tort-like causes of action was made clear in Knuckles v. Commissioner. In that case, a life insurance company fired an employee for allegedly mismanaging the company. The taxpayer sued the company for breach of contract. The taxpayer and his counsel apparently overlooked the importance of section 104(a)(2) from the outset, since they did not plead a personal injury. Only after a settlement was reached, allocating compensation to the contract claim, did the taxpayer introduce such a theory. Not surprisingly, after securing a settlement without admitting liability for a tort or tort-type act, the company refused to later acknowledge liability for the benefit of the taxpayer. Since the settlement agreement did not require the company to admit liability for a tortious act, the company had no reason to admit liability later simply to allow the taxpayer to avoid tax on his damages award. On the basis of the content of the settlement agreement and the company's refusal to acknowledge liability for any wrongdoing, both the Tax Court and the Tenth Circuit determined that the company intended the settlement proceeds only as compensation for breach of contract.

The McKay court analyzed McKay's pleadings and other court documents and found that they supported McKay's claim that the action primarily raised the tort claim of wrongful discharge, although breach of contract violations were alleged as well. Because it found that the pleadings reflected the sub-

68. T.C. Memo. 1964-33, 23 T.C.M. (CCH) at 182.
69. Id. at 184.
70. Id.
71. Id.
72. See supra notes 21, 27-28 and accompanying text.
stance of the allocations in the settlement agreement, the court respected the allocations.\textsuperscript{73} The jury did not specify the proportion of damages it allocated to either theory of recovery.\textsuperscript{74} In assessing the allocations in the settlement agreement, the court relied on McKay's pleadings at trial. Absent guidance from the jury, the court had no precise way of independently analyzing the parties' allocations. Since McKay allocated a reasonable portion of settlement proceeds to the contract theory, the court willingly accepted his allocations.

The presence of tort or tort-like theories of recovery in McKay's pleadings proved to be one of the factors that legitimized the parties' allocations. In the \textit{Robinson} decision, however, the court ignored the causes of action in the Robinsons' pleadings, finding that the claims were unsupported by the surrounding facts and circumstances. The \textit{Robinson} court, in contrast to the McKay court, focused its analysis on the proportion of damages allocated to the various claims in the jury verdict at trial.\textsuperscript{75} That court concluded that the allocations in the settlement agreement should reflect the allocations made by the jury in its verdict.\textsuperscript{76} Thus, the \textit{Robinson} decision stands for the proposition that taxpayers who are too greedy in their allocations to tort or tort-like claims in a settlement document will not succeed in the Tax Court when challenged. The allocations in the document should be reasonably proportionate to the litigated claims, particularly when the jury specifies its allocations. The \textit{Robinson} court, based on the proportions in the jury verdict, allowed an exclusion of 37.331\% of the settlement amount.\textsuperscript{77} The Robinsons claimed that ninety-five percent of their settlement attributable to tort or tort-like theories.\textsuperscript{78} By making such a disproportionate claim, the Robinsons invited a challenge from the Service.

Practitioners initiating lawsuits on behalf of injured clients should carefully consider the initial theories they will plead. This is particularly important in cases where damages such as lost

\textsuperscript{73} McKay, 102 T.C. at 484.
\textsuperscript{74} Id. at 471.
\textsuperscript{75} Robinson, 102 T.C. at 134.
\textsuperscript{76} Id. at 134. The percentages of the allocations in the jury verdict are listed \textit{infra} note 106. The McKay court likely gave the parties more discretion with respect to the proportion of allocations in the agreement since the jury's damages verdict did not allocate with specificity between the tort and contract claims. Thus it follows that a verdict which does not specifically allocate damages to claims should give taxpayers more leeway than one with specific allocations.
\textsuperscript{77} Robinson, 102 T.C. at 135.
\textsuperscript{78} Id. at 123.
wages can be characterized either as tort or contract damages. A successful recovery raising claims only in contract will yield a taxable damage award to the plaintiff. Thus, practitioners should think expansively when selecting theories. However, when the claims are drafted into pleadings, the cases indicate that pleadings which contain a clear tort component accompanied by a clear contract component generate more credibility for the taxpayer.

In this regard, practitioners should not ignore their ethical obligations to accurately and honestly portray the nature of the claim. Nonetheless, the scope of the term "personal injury" is quite broad, allowing ample opportunity for counsel to characterize injuries as "personal" in appropriate cases. Thorough and thoughtful lawyering, combined with prudent strategy and diligent research, may yield both a tort and a contract claim applicable to the factual circumstances.

In *Seay v. Commissioner*, 79 the taxpayer successfully convinced the Tax Court that part of a settlement he received from his former employer constituted compensation for injury to his personal reputation. The *Seay* decision reveals the importance of securing a meaningful statement that the tortfeasor-payor intended to pay damages on account of personal injury. In *Seay*, the taxpayer's position as a corporate president was terminated when a dispute arose between the taxpayer and the owners of the corporation. 80 The taxpayer refused to vacate his position; consequently, the owners brought a highly-publicized trespass action against him. 81 The taxpayer felt his personal reputation was damaged by the publicity. 82 The settlement agreement reached between the owners and the taxpayer provided for payment of one year's salary plus $45,000 for any damages caused by the newspaper publicity. 83 An agreement in a letter specifically stated that the $45,000 was intended as "compensation for such personal embarrassment, mental and physical strain and injury to health and personal reputation in the community" that the taxpayer suffered. 84 The court in *Seay* found the evidence indicated that the owners made the $45,000 payment to the taxpayer to compensate him for any personal injuries suffered—a

79. 58 T.C. 32 (1972).
80. *Id.* at 33.
81. *Id.* at 33-34.
82. *Id.* at 34.
83. *Id.* at 34-35.
84. *Id.* at 33-35.
tort or tort-like claim.\textsuperscript{85} The taxpayer therefore qualified for the benefits of the 104(a)(2) exclusion.\textsuperscript{86} Even if, as in Seay, the statement appears in a letter or document outside the settlement agreement, the statement itself could provide significant evidence that allocations made in a settlement agreement truly reflected the payor's intent.

In contrast to the taxpayer in Seay, the taxpayers in Robinson failed to convince the court that their settlement agreement contained a meaningful statement of the payor's intent.\textsuperscript{87} The Bank knew that the Robinsons wanted to allocate any settlement proceeds in a manner that would minimize their taxes, that the Bank did not care about the manner of allocation, and that the Bank allowed the Robinsons to allocate the settlement proceeds in any manner they desired. Thus, the Robinson court found no facts or circumstances that rendered the taxpayers' allocation of damages in the final judgment meaningful.\textsuperscript{88} None of the evidence indicated that the allocations were reached as a result of arm's length negotiations. Instead, the court found:

Petitioners . . . were given . . . the unfettered discretion to allocate the settlement proceeds in any manner they desired in order to minimize their Federal income tax liability. We find that petitioners deliberately and unilaterally arrived at the allocations contained in the final judgment solely with a view to Federal income taxes, and not to reflect the realities of their settlement.\textsuperscript{89}

On the other hand, the McKay court found that "the settlement agreement provides the clearest embodiment of the payor's intent . . . ."\textsuperscript{90} The court made that determination based on the surrounding facts and circumstances, which supported the parties' statements in the settlement agreement. Those facts and circumstances included the hostile nature of the parties' negotiations regarding the RICO claim, the nature of the claims in the initial pleadings, the entire court record, and the trial judge's involvement in the negotiations.\textsuperscript{91} The McKay court's finding on the Company's intent shows that even a somewhat vague statement\textsuperscript{92} explaining why the parties allocated settlement proceeds

\begin{thebibliography}{99}
\bibitem{85} Id. at 40.
\bibitem{86} Id.
\bibitem{87} Robinson v. Commissioner, 102 T.C. 116 (1994).
\bibitem{88} Id. at 128-29.
\bibitem{89} Id. at 129.
\bibitem{90} McKay v. Commissioner, 102 T.C. 465, 484 (1994).
\bibitem{91} Id.
\bibitem{92} In its determination of the Company's intent, the McKay court focused on
\end{thebibliography}
as they did may lead a court to find the payor's intent sufficiently demonstrated, provided the other facts and circumstances surrounding the allocations render that statement meaningful.

In Madson v. Commissioner,93 the Tax Court considered evidence of a tortfeasor's intent found in an insurance contract to allow the taxpayer's exclusion of his settlement award. There, the taxpayer argued for the exclusion of his entire settlement in an action against the City of Green Bay, Wisconsin, for forcing him to retire at age sixty from his position as police chief.94 Following a trial, the state court found that Green Bay had violated the taxpayer's right to equal protection and had also breached its employment contract with the taxpayer. The court awarded damages on the basis of lost earnings, loss of state retirement, and loss of social security benefits. The court also determined that the amount of damages would have been equal under both the contract or equal protection causes of action.95 During an appeal by Green Bay, the parties agreed to settle the dispute for $41,000.96 The Tax Court found that the payment compensated for the taxpayer's equal protection claim.97 The court reasoned that because Green Bay's insurer paid the $41,000 and because the insurance contract specifically excluded payments for breach of contract, Green Bay must have intended to pay the taxpayer for violation of the taxpayer's equal protection rights, a tort-type injury.98 Therefore, the 104(a)(2) exclusion was appropriate.

One might argue that determining a tortfeasor/payor's intent, based on the language in an insurance contract, is somewhat artificial. Provided that other facts and circumstances render the statement or language meaningful, however, the McKay and Madson decisions together indicate that the court will find the payor's intent sufficiently demonstrated even with a less than direct statement from the parties. The McKay court accepted the vague reference to estimates of appellate success in much

the following language in the settlement agreement: “Ashland and McKay have both relied upon their appellate counsel[s'] consensus estimate of McKay's probability of appellate success with respect to [the wrongful discharge tort claim and the breach of contract claim].” Id. at 484. Therefore, in similar situations, if taxpayers memorialize their estimates of appellate success and if the facts and circumstances surrounding the allocation to the various claims render that statement meaningful, those precautions should be sufficient to determine the intent of the payor.

94. Id. at 1615.
95. Id.
96. Id.
97. Id.
98. Id.
the same way that the Madson court accepted the payor's intent as discerned from the terms of the insurance contract. In other words, both courts stretched to find that the payors intended their payments to compensate for personal injuries.

Regardless of the language employed or whether the statement of the payor's intent is found in a settlement document, letter, or elsewhere, both the Robinson and McKay decisions show that a court will analyze the underlying facts to determine if the statement is meaningful. Therefore, such a statement should be a concise explanation of the tort or tort-like injury for which the taxpayer is being compensated. Again, the statement must be meaningful because it could cause a court to deny the payor's intent.99 Practitioners should demand that a settlement document contain both express allocation language specifying that payments will extinguish tort or tort-like claims and a specific statement of the payor's intent in doing so. Leaving one or the other out of an agreement could expose settlements to unnecessary judicial scrutiny.

The importance of express language in the settlement agreement and careful attention to the consequences of bargaining was highlighted in Ray v. United States.100 In Ray, the Singer Company settled a labor dispute arising from the closure of one of its manufacturing plants. The union filed a complaint against Singer for breach of the collective bargaining agreement and sought injunctive relief, based on the allegation that Singer had engaged in misrepresentation and fraud.101 The federal district court refused to enjoin Singer, but found that Singer had breached its collective bargaining agreement and indicated that it would award monetary damages. The parties ultimately agreed to a monetary settlement and the documents indicated that all claims of the union were released and discharged.102 After paying them, Singer issued each of the settlement distributees a Form 1099.103 Finding no express language in the settlement agreement allocating settlement proceeds to personal injury and considering Singer's intent as indicated by the issuance of Form 1099, the Claims Court held section 104(a)(2)

99. It is worth noting that the taxpayer carries the burden of proving that the settlement allocations were made in good faith. See Robinson, 102 T.C. at 128 n.19.
101. 25 Cl. Ct. at 536-37.
102. Id.
103. Id. at 541.
inapplicable. Based on its holding on the collective bargain-
ing agreement, the court never had to reach the issues of fraud and misrepresentation.

Ray suggests the importance of drafting settlement agree-
ments carefully. Because the complaint alleged tortious actions (fraud and misrepresentation) on Singer's part, it would appear that the union gave up an excellent opportunity to negotiate for the allocation of at least part of the settlement proceeds to per-
sonal injury. No such effort was made, however. Unlike the McKay court, the Ray court found no evidence of negotiation or discussion between the parties regarding the tax implications of the awards made to the employees. Ray also suggests that the issuance of a Form 1099 by a payor will, almost without excep-
tion, demonstrate to the court that the payor intended that the payment constitute income to the taxpayer. Practitioners should therefore negotiate, as part of the settlement, that either no Form 1099 be issued, or that it be issued with the qualifica-
tion that the settlement compensates for tort-like injuries.

B. The McKay Court's Liberal Application of Section 104(a)(2)

The Robinson and McKay decisions were decided within one month of each other and reflect the application of the principles established in earlier 104(a)(2) cases. However, the McKay deci-
sion appears to be more generous to the taxpayer. The McKay court, like the Robinson court, applied the standard that express allocations in settlement agreements will be respected for tax purposes if they are entered into in an adversarial context, at arm's length, and in good faith.

Unlike the Robinson court, the McKay court found that the parties involved negotiated adversarially in allocating damages between tort and contract theories. However, the court relied on vague language in the settlement agreement to support that finding and to demonstrate the intent of the Company. The McKay settlement agreement referred to the wrongful discharge

104. Id.
105. Id. at 540.
106. McKay, 102 T.C. at 472. The McKay finding is arguably suspect if one closely examines the primary focus of the Company-McKay negotiations, which appear to have been on the RICO claims, and the overall amount of the settlement as opposed to the characterization of the proceeds as derived from either tort or con-
tract claims.
107. 25 Cl. Ct. at 541.
and breach of contract claims only as "the two other claims." The court referred to no other express allocation language that might explain how the parties arrived at the allocation of damages to tort or contract theories.

The opinion contains few facts that would clearly support a finding that the tort and contract allocation negotiations were adversarial. Instead, the court seemed to apply the adversarial negotiation context of the RICO claim to the negotiations on tort and contract allocations. The court noted that "Ashland wanted to minimize the amount it needed to pay [McKay] as well as avoid making any payments on account of [McKay's] RICO claim." Regardless of the amount, the Company would not have benefitted by allocating damages to the contract claim instead of the tort claim. Under either allocation scenario, the Company could have claimed a section 162 ordinary and necessary business expense deduction for its payment of tort or contract damages. The McKay court responded to the Service's same argument, noting that the Bank in Robinson "was not concerned with the allocation among the taxpayers' various claims." The court concluded that "[a]lthough the deductibility of the payor's payment might be [one] factor to consider in deciding whether the parties are adverse to their allocations, it is not controlling."

The Company resisted any mention of RICO violations in the settlement document because it wished to avoid negative publicity. A wrongful discharge tort claim or a breach of contract claim would have generated little, if any, negative publicity to the Company. Therefore publicity considerations probably had little impact on the Company's negotiation posture with regard to tort and contract allocations.

It is reasonable to conclude that once the Company and McKay had agreed to exclude any mention of RICO violations in the settlement agreement, the only issue remaining was the amount of damages the Company would pay for the wrongful

108.  McKay, 102 T.C. at 484.
109.  McKay, 102 T.C. at 484; see also supra note 88.
110.  McKay, 102 T.C. at 484.
111.  Id. at 483.
112.  Id. at 485.
discharge and breach of contract claims. In footnote nineteen, the McKay court noted that although the court did not decide the issue, if the Company had in fact made a settlement payment on account of RICO, "the deductibility of such a payment to [the Company] could be uncertain," an assertion that seems altogether irrelevant to the issue properly before the court: whether the tort and contract allocation negotiations were actually adverse or not.

Although the statements in the settlement agreement were somewhat indirect as to the Company's intent, other persuasive facts and circumstances clearly affected the McKay court's decision. First, the court noted that, unlike Judge Evins in Robinson, the presiding trial judge in McKay played a primary role in the negotiations process between the Company and McKay. In fact, the trial judge encouraged the settlement figure upon which the parties eventually agreed. Although the court did not explicitly state it, presumably the trial judge would have had an opportunity to independently review the allocations in the McKay settlement agreement.

Second, the McKay court noted that "the allocations in the settlement agreement are consistent with the entire record in that petitioner's pleadings and jury verdict reflect a lawsuit sounding primarily in tort." Similarly, a comparison of the proportions of the jury verdicts in Robinson and McKay reveals that the McKay allocations were far closer to the proportions allocated by the jury than those in Robinson. In Robinson, the jury awarded 2.76 percent of damages to the tort claim of mental anguish, yet the parties allocated ninety-five percent to mental anguish in the settlement agreement. In McKay the jury did not clearly allocate between the tort or contract theories of recovery, but the aggregate amount of the verdict derived from the tort and contract theories closely paralleled that in the McKay settlement agreement. The court specifically stated that the pleadings and other court documents reflected a case sounding primarily in tort with a contract component. Also, the trial

113. Id.
114. McKay, 102 T.C. at 484.
115. Id.
116. Id.
117. The Robinsons' jury awarded $1,500,000 of a total verdict of $54,260,000 for past and future mental anguish. Robinson, 102 T.C. at 121, 123. The author calculated the percentage as follows: 1,500,000/54,260,000 = 2.76%.
118. McKay, 102 T.C. at 471-72.
119. Id. at 484.
judge would presumably have noted an inappropriate allocation to one theory over another.

Third, the language McKay's counsel used in the pleadings and settlement agreement indicates that they clearly understood the relevant case law under section 104(a)(2). Although there may be some question as to how adversarial the settlement negotiations on allocation of damages to tort or contract theories actually were, McKay's counsel presented the court with a finely tailored settlement agreement and set of facts that supported a favorable ruling.

**C. A Well Concealed Punitive Damage Award**

The *McKay* ruling was quite favorable to McKay from another perspective. While the court respected the damage allocations, the size of the total damages award seemed directly connected to the treble punitive damages the jury assigned to the RICO claim.\(^{120}\) According to the court, McKay's slim chance of preserving his entire jury award on appeal influenced the settlement agreement.\(^{121}\) Since the parties' allocation of damages closely paralleled the jury allocation to tort and contract claims, the parties appeared to project that the appellate court would reverse the punitive damage award and leave the entire compensatory award untouched. The *Robinson* court reasoned that "the jury verdict... should be taken into account in our apportionment of th[e] settlement."\(^{122}\) Following this rationale, the *McKay* court should have made a similar comparison of the proportion of damages in the settlement agreement to original theories alleged at trial. Under other circumstances, the estimate may have been reasonable, but the evidence of the Company's RICO violations and the jury's findings on the RICO claim indicate that an appellate award would have allocated some damages based on the Company's blatant RICO violations. The estimate of the proportion of appellate damages found in the settlement agreement, and the court's subsequent acceptance of those estimates, therefore appears contrived.

The importance of this issue lies in the fact that punitive damages do not generally qualify for the section 104(a)(2) exclusion from gross income. Only punitive damages derived from

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120. *Id.* at 471.
121. *See supra* note 88.
physical injury qualify for the exclusion.\textsuperscript{123} If the parties had allocated the settlement proceeds in proportion to reduced appellate damages on tort, contract, RICO, and punitive theories of recovery, only damages allocated to the tort theory would have been excluded. If damages had been allocated in the settlement agreement in proportion to the jury award allocations on the four theories of tort, contract, RICO and punitive damages, and the court had held such a RICO/punitive component includable in gross income, approximately 67.6 percent of the settlement proceeds would have been taxable income to the McKays. Under the court's holding, however, approximately 14.3 percent of the aggregate amount of proceeds allocated to the tort and contract claims in the settlement agreement were included in gross income.\textsuperscript{124} Ultimately, the entire amount of the compensatory component of the jury award was preserved in the settlement agreement. Clearly one could not overstate the significant tax benefit which accrued to McKay as a result.

IV. CONCLUSION

Ultimately, any case involving the issue of exclusion of settlement awards under section 104(a)(2) will be a fact—specific inquiry into the circumstances surrounding litigation and settlement negotiations. McKay demonstrates that the court will respect express language in settlement documents if the evidence shows that the parties negotiated in an adversarial context and at arm's length with regard to allocation of damages to personal injury claims. McKay shows that the prime hurdle of the 104(a)(2) exclusion—intent of the payor—can be overcome if the facts show that the express allocation language of settlement

\textsuperscript{123} For settlements taking place after July 10, 1989, \S 104(a) excepts punitive damage awards in cases not involving physical injury or physical sickness from the exclusion provisions of \S 104(a)(2). I.R.C. \S 104(a) (1988 & Supp. I 1989). Prior to July 10, 1989, the issue of whether any punitive damages were deductible was very much in doubt. For an excellent example of the arguments in favor and against the exclusion of punitive damages, compare the majority opinion and Judge Trott's dissenting opinion in Hawkins v. Commissioner, 30 F.3d 1077 (1994) with the majority opinion and Judge Trott's concurring opinion in Schmitz v. Commissioner, 34 F.3d 790 (1994). For an in-depth discussion of the case law background and an analysis of the effect of the 1989 amendment on punitive damage recoveries, see Margaret Henning, Recent Developments in the Tax Treatment of Personal Injury and Punitive Damage Recoveries, 45 TAX LAW. 783 (1992). See also James D. Ghidardi, The Federal Taxation of Punitive Damage Awards, 11 J.L. & COM. 1 (1991).

\textsuperscript{124} These percentages were calculated by the author using the figures found in McKay, 102 T.C. at 471-74.
agreements is bona fide.

Taxpayers can rest assured that in light of decisions like Robinson and McKay, the Service will continue to contest the exclusion of settlement proceeds under section 104(a)(2) in similar circumstances. Therefore, a practitioner wishing to avail an injured client of the benefits of 104(a)(2) should be fully informed of the factors courts focus on in allowing the exclusion. The lessons provided by previous taxpayer efforts provide a useful recipe to practitioners. Those lessons should be carefully studied and applied from the opening of a case file, through the litigation stage, and into the settlement phase if necessary. Properly applied, the principles elicited from McKay and prior personal injury exclusion cases could well lead a taxpayer to the safe harbor of the section 104(a)(2) exclusion.