

# INCOME TAX CONSEQUENCES RELATED TO COMMERCIAL DAMAGES AWARDS



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Tax counsel understand that companies often suffer damages due to the wrongful actions of other parties. Those other parties may be employees, customers/clients, competitors, suppliers, company directors, joint venturers, potential acquirers, bankers, contract counterparties, and even government and regulatory authorities. In addition, the company owners (whether they are shareholders, limited liability company members, or partners) can also suffer damages due to the wrongful actions of other parties. These other parties could include the company itself, the company directors, other shareholders/owners, the company acquirer (actual or attempted), contract counterparties, and others.

For purposes of this discussion, the party (whether institutional or individual) suffering the damages is referred to as the damaged party and the party causing the damages is referred to as the damaging party.

When parties (whether companies or owners) believe they have been damaged, they often pursue a legal claim in order to receive compensation for their damages. That legal claim may be pursued through litigation or through some alternative type

of legal proceeding. For example, many contract-related disputes have to be prosecuted through an arbitration proceeding according to the terms of the contract. Regardless of the legal venue, the damaged party typically retains counsel to prosecute the claim while the damaging party typically retains counsel to defend against the claim. Counsel for both parties typically retain (or at least consult with) forensic specialists to assist in the dispute process.

Counsel understand that there are numerous issues involved in any legal proceeding. With regard to most damages claims, there are at least three issues that are relevant to this discussion: (i) causation; (ii) liability; and (iii) damages measurement. These three issues are only relevant to this discussion if one first accepts the following foundational assumption: that the damaged party actually experienced a damages event and suffered a measurable amount of damages.

The principal question related to the causation issue is: who or what caused the damages event? The principal question related to the liability issue is: who or what is legally responsible for the damages event? That liability question considers what party has a

duty (contractual or otherwise) to the damaged party. The principal question related to the damages measurement issue is: what is the amount of damages suffered by the damaged party? That damages measurement question considers the amount of cash (or the value of property) needed to restore the damaged party to the economic position that the party enjoyed before the damages event.

The damages measurement analysis often considers what is typically called the “but for” scenario. That is, what economic (or wealth) position would the damaged party be in but for (or without) the impact of the damages event? And what amount of compensation (whether cash or property) should be paid to the damaged party to restore that party to the economic (or wealth) position it enjoyed before—or but for—the damages event?

As mentioned above, in these damages claim disputes, counsel often retain damages forensic specialists (hereinafter damages analysts) to measure the amount of damages experienced by the damaged party. These damages analysts can be forensic accountants, economists, financial analysts, engineers, industry specialists, business appraisers, or other types of professionals. Such damages analysts measure, and provide expert opinions regarding, the amount of damages experienced by the damaged party.

The damages analyst is typically not the same professional who assesses, and provides expert opinions with regard to, the causation or liability issues in the dispute. The damages analyst measures the impact of the damages event on the damaged party. In so doing, the damages analyst may be instructed to assume that the damaging party: (i) performed a wrongful action; (ii) caused the damages to the damaged party; and (iii) is legally liable for the damages suffered by the damaged party. However, it is typically not the responsibility of the damages analyst to assign fault or blame or responsibility to the damaging party. The damages analyst typically does not independently conclude that the damaging party is the wrongful party. Rather, the damages analyst quantifies how much the wronged party

was damaged—not who is responsible for the damages or who is liable for making the damaged party whole.

This article focuses entirely on commercial damages measurement issues—not on causation or liability issues. In particular, this article focuses on one technical, but important, issue related to the measurement of the amount of commercial damages: the income tax considerations related to the damages measurement. Tax counsel understand that these income tax considerations relate to: (i) the income recognition and the taxation of any compensation-related payments received by the damaged party; (ii) the tax deduction and the taxation of any compensation-related payments made by the damaging party; and (iii) the measurement of the amount of the judicial award (or the negotiated settlement) required to make the damaged party whole—after any adjustments necessary with regard to the related income tax considerations.

In addition, this article will discuss what the tax counsel—and the damaged/damaging company, the company owners, litigation counsel for these parties, and each party’s damages analyst—need to know about the income tax considerations related to damages measurements and damages awards (or negotiated settlements).

## TYPES OF DAMAGES CLAIMS

Tax counsel understand that commercial damages claims are typically categorized into the following two categories, breach of contract claims and tort claims. Of course, breach of contract claims typically generate from a contract. Tort claims typically relate to an alleged breach of one party’s duty to another party, where that duty is not documented in a contract.

Breach of contract claims may relate to the damaging party’s alleged breach of, for example, a contractor/subcontractor agreement, a client/customer purchase agreement, an employment agreement, a noncompetition/nonsolicitation agreement, a supplier agreement, a stock purchase or asset purchase acquisition agreement, a joint venture or joint

development agreement, a franchise agreement, an intellectual property license, a real estate lease, or any other type of commercial contract. The contract specifies the respective duties and responsibilities of the counterparties. If one of the counterparties allegedly violates a specified duty or responsibility, then the other counterparty may be damaged as a result of that breach of contract.

Tort claims may relate to the damaging party's alleged breach of a noncontractual duty or a responsibility. For example, a company and its directors have duties to the company's shareholders. A company's controlling shareholder has duties to the company's noncontrolling shareholders. A lender financial institution has duties to its borrowers. Competitor companies have certain duties to each other. Partners have certain duties to each other (outside of the duties documented in the partnership agreement). Public companies have duties to both regulators and to the investor market in general. Trustees have duties to the trust beneficiaries. If one party commits a tortious action and violates its duty to another party, then that secured party may be damaged as a result of the tortious action.

The damages analyst typically considers the above-described categorization of commercial damages claims. This damages claim categorization—as either a breach of contract or a tort—may impact which of the generally accepted damages measurement methods the analyst applies in the damages measurement analysis. The damages analyst also considers another categorization regarding damages claims—whether the receipt of the damages award (or negotiated settlement) is a taxable event to the damaged party. In other words, the analyst considers if the receipt of the damages award (or settlement) is ordinary income, a capital gain or loss, or a nontaxable event to the damaged party. The analyst may also consider whether or not the payment of the damages award (or settlement) results in an income tax deduction to the damaging party. And, finally, the analyst may consider these income tax consequences when recommending the amount of the judicial award (or the amount of a negotiated settlement) with regard to the damages claim.

## INCOME TAX CONSIDERATIONS

Even during the normal course of business, a company or a company shareholder may become the recipient—or the payer—of a damages-related judicial judgment or negotiated settlement. That judicial judgment or negotiated settlement may be the result of a commercial litigation, an arbitration, or some type of alternative dispute resolution proceeding. Tax counsel understand that the income tax considerations of such judgments, awards, or settlements can impact both the recipient and the payer. And, the income tax considerations related to the commercial damages measurement may impact the amount of the judgment or settlement that would be required to make the damaged party economically “whole.”

Tax counsel understand that these income tax issues affect both the recipient and the payer of the damages judgment, award, or settlement. The specific terms of the judgment or the settlement typically impact whether the payment is:

- Tax deductible or not tax deductible;
- Taxable income or not taxable income; and
- If taxable income, whether the income is treated as ordinary or capital gain.

As with most taxation issues, the taxpayer has the burden of proof regarding both the tax treatment and the income characterization (whether ordinary or capital gain) of the judgment or settlement payment. These issues are typically determined by reference to the particular language included in the underlying litigation documents. Such documents include the pleadings, the court's order or the arbitration award, and/or the settlement agreement. Taxpayers (including both parties to the dispute) and litigation counsel should consult with tax counsel regarding these taxation issues when drafting such litigation-related documents.

The income tax treatment of the payment is not influenced by whether the award is the result of a court order, an arbitration order, or a settlement agreement between the parties. Generally, however,

taxation issues are easier to deal with in the case of a settlement agreement that is drafted by counsel to the parties, who are often more sensitive than a court to the particular wording that should be used in order to influence the desired tax treatment. Therefore, taxation issues are often more difficult to deal with in regard to a court's order or an arbitrator's award.

## THE ORIGIN OF THE DAMAGES CLAIM

The origin of the damages claim may directly influence the tax treatment of the judicial award or the settlement payment. Many courts have applied the so-called origin-of-the-claim test with regard to this taxation issue. That is, the courts typically consider the question: "in lieu of what was the damages payment award?" This consideration affects the tax characterization of the damages payment. This test has been applied by the courts since at least *Raytheon Production Corp v. Commissioner*.<sup>1</sup>

For the recipient of a settlement payment, the origin-of-the-claim test may determine whether the payment receipt is taxable or not taxable. If the receipt of the settlement payment is taxable, then this test may determine if the income should be characterized as ordinary income or as capital gain. Typically, a damages award received pursuant to either a judgment or a settlement is considered to be taxable income to the recipient.

However, the receipt of certain damages payments is not considered to be taxable income. Examples of such nontaxable payments include gifts or inheritances, payments as compensation for a personal physical injury, certain disaster relief payments, amounts for which the taxpayer did not previously receive a tax benefit, cost reimbursements, the recovery of capital, or a property or business acquisition purchase price adjustment.

A damages award is typically taxable as ordinary income if the payment relates to a claim of lost profits. However, such an award may be characterized as a capital gain (to the extent that the amount of damages exceeds the property's tax basis) if the claim relates to the damage of a capital asset.

For the payer of the damages award, the origin-of-the-claim test will determine whether the payment is tax deductible or not tax deductible. In addition, the test will determine whether a tax-deductible payment will be currently deductible or whether it has to be capitalized. For example, a damages payment related to a personal transaction will be considered a nondeductible personal expense. In contrast, a damages payment related to a business activity may be deductible under Internal Revenue Code (Code) section 162. And, business-related damages payments related to interest, taxes, or certain losses will be deductible under section 163, section 164, or section 165, respectively.

Certain types of damages payments are not tax deductible. Other types of damages payments would have to be capitalized. For example, damages payments would have to be capitalized when the payer receives an intangible asset or an intellectual property license, say as part of a negotiated settlement, in exchange for the payment.

Again, the burden of proof is on the taxpayer to establish the appropriate income tax treatment related to the receipt or the payment of the damages judgment or settlement. The types of documents that the Internal Revenue Service (IRS) typically considers with regard to the tax treatment issue include the following: the legal filings, the terms of a settlement agreement, any correspondence between the parties to the dispute, any internal memos of the parties, party press releases, company annual reports, and news-related publications. As a general guideline, the IRS considers the initial complaint (or the equivalent legal document) to be the most persuasive evidence. This general guidance is presented in Revenue Ruling 85-98.

## HOW TO ALLOCATE THE DAMAGES PAYMENT

Sometimes the judicial award payment or the negotiated settlement payment can cover more than one claim. In that case, the parties to the dispute may have to allocate the payment for federal income tax purposes. Such an allocation is necessary when part of the payment represents a taxable event and

another part of the payment relates to a nontaxable event. In addition, such an allocation may be necessary when there are either multiple plaintiffs (claimants) or multiple defendants (respondents).

Some of the factors that the parties to the dispute should consider in that payment allocation process include the following:

- Who made and who received the payment?
- Who was economically harmed or economically benefited by the damages event?
- Which party were the allegations asserted against?
- Which party controlled the litigation?
- Whether the dispute-related costs or receipts were required to be shared contractually; and
- Whether there was joint and several liability among the parties related to the damages claims.

The court's order or the settlement document may provide for an allocation in the document narrative. If an allocation is already specified in the judicial judgment, then the IRS and the taxpayers are typically bound by that allocation. In addition, the IRS will typically accept an allocation that is specified in a negotiated settlement agreement.

However, the IRS may challenge a settlement-related allocation if it concludes that the taxpayer had another (nontaxation) reason for the agreed-upon allocation. As with most issues, the taxpayer has the burden of proof with regard to defending the claimed award allocation before the IRS.

## **STATUTORY DEDUCTION DISALLOWANCE**

The Code specifically disallows tax deductions related to certain payments or liabilities incurred with respect to a court's judgment or a negotiated settlement.

As amended by the Tax Cuts and Jobs Act (TCJA), Code section 162(f) disallows a tax deduction (under any provision of Chapter 1) related to amounts paid

or incurred: (i) by a lawsuit, an agreement, or otherwise; (ii) to, or at the direction of, a government or governmental entity; and (iii) in relation to a violation of law—or an investigation or inquiry into a potential violation of law.

This tax deduction disallowance does not apply to payments for: (i) the restitution (including the remediation of property); (ii) taxes due; and (iii) amounts paid pursuant to a court order when no government or governmental agency is a party to the dispute.

The Treasury Regulations also indicate that this tax deduction disallowance does not apply: (i) to disputes in which the government enforces its rights as a private party—for example, in a breach of contract dispute; or (ii) to routine audits or inspections not related to a possible wrongdoing.

The restitution exception to the tax deduction disallowance only applies if the court order or the settlement agreement identifies the damages payment as a restitution or remediation payment or a payment to come into compliance with the law (collectively referred to as the identification requirement). In addition, the taxpayer must establish that the damages payment was made for restitution or remediation or to come into compliance with the law (collectively referred to as the establishment requirement).

The taxpayer may satisfy the identification requirement if the court order or the settlement agreement specifically states that the payment constitutes restitution, remediation, or coming into compliance with the law—or uses some form of similar language. The taxpayer may satisfy the establishment requirement by providing the IRS with documentation evidence of the elements of establishment.

The TCJA also added section 162(g) related to tax deductions with regard to damages payments. Section 162(g) disallows an income tax deduction (under any provision of Chapter 1) for a settlement or other payment related to sexual harassment or abuse and the corresponding attorneys' fees—if there is a nondisclosure agreement. However, this section 162(g) tax deduction disallowance does not

apply to the attorneys' fees incurred by the sexual harassment/abuse victim.

There are various other Code sections that disallow tax deductions related to certain types of damages payments. For example, section 162(i) disallows a tax deduction related to illegal bribes and kickbacks. And section 162(q) disallows a tax deduction related to the treble damages imposed for antitrust violations.

## **ADJUSTING THE DAMAGES MEASUREMENT FOR INCOME TAX CONSEQUENCES**

The damages analyst often will adjust the initial damages measurement amount for the income tax consequences of the damages award receipt. Without such a tax-related adjustment, the damaged party will not be "made whole" by the receipt of the damages award. The damaged party would not be "made whole" by the damages award receipt if the damages award or settlement payment was recognized as taxable income to the damaged party recipient. In addition, without such a tax-related adjustment, the damaging party may benefit from the income tax deduction associated with certain damages-related payments.

For example, let's assume that Alpha Company is the damaged party and that Omega Company is the damaging party. In this hypothetical example, Omega wrongfully caused Alpha to suffer \$12 million of damages related to lost profits. Alpha brings a damages claim against Omega. The finder of fact finds Omega to be liable and orders that Omega pay a \$12 million damages award to Alpha. In compliance with the judgment, Omega pays the \$12 million damages award amount to Alpha.

Let's further assume that the lost-profits-related damages award is recognized as taxable income to Alpha. To simplify the calculation, let's assume a 25 percent effective combined federal and state income tax rate for Alpha.

Alpha suffered \$12 million in lost profits damages. If Alpha receives a \$12 million damages award, Alpha will pay \$3 million in income taxes. After tax, Alpha

will be left with only \$9 million. Accordingly, Alpha will not be "made whole" by the \$12 million damages award.

If Alpha recognizes taxable income related to the \$12 million damages award receipt, it is likely that Omega will qualify for a tax deduction related to the payment. That is, after considering the income tax impact, Omega will end up with \$9 million less cash (even though Omega paid a \$12 million payment to Alpha).

So, while Omega was determined to be liable for the \$12 million of damages to Alpha, Omega will only suffer a \$9 million negative economic impact. And, although Alpha was determined to have suffered \$12 million in damages, Alpha will only recover \$9 million in economic benefit.

Tax counsel should be aware that there are two different tax-related adjustment procedures that the damages analyst may apply to account for these income tax considerations.

The first adjustment procedure is to calculate the present value of the pretax lost profits suffered by the damaged party using an after-tax present value discount rate. In theory, this tax-related adjustment procedure increases the amount of the lost profits damages by the amount of the income tax impact on the lost profits damages award. This adjustment procedure may be the less frequently applied of the two tax-related adjustment procedures. This adjustment procedure really only works in a lost profits damages measurement calculation and is generally not applicable to many other damages measurement methods—such as the cost to cure damages measurement method, for example. And, the apparent mismatch in the damages measurement (i.e., the application of an after-tax present value discount rate to a pretax lost profits amount) may be somewhat difficult to explain to the finder of fact in the dispute.

The second adjustment procedure, generally applicable to all damages measurement methods, is more frequently applied by damages analysts. Additionally, this procedure is fairly easy to explain

to a finder of fact—and to other parties involved in the dispute. In this second tax-related adjustment procedure, the damages analyst simply identifies and quantifies the two components of the recommended judicial award.

Let's return to the Alpha and Omega example. To apply this second tax-related adjustment procedure, the damages analyst will quantify both the amount of the lost profits damages that Alpha suffered and the amount of the income tax liability that Alpha will incur with regard to the receipt of the damages award payment. The sum of these two economic components would represent the total amount of the judicial award that the analyst would recommend to the finder of fact.

So, in our example, the analyst would conclude the following recommendation with regard to the total amount of the damages award (or negotiated settlement):

**Total Amount of Damages Award  
Recommendation Income Tax  
Adjustment Procedure Analysis**

Measurement of the Amount of the Damages Suffered by Alpha	\$12 million
Divided by: 1–25% Effective Income Tax Rate	75%
—————	
Equals: Total Damages Payment Required to Make Alpha Whole	<b>\$16 million</b>

That is, the analyst would recommend that the finder of fact award (or that the parties agree to in a negotiated settlement) a \$16 million total payment to Alpha. Based on the receipt of the \$16 million total payment, Alpha will incur a \$4 million (i.e., \$16 million × 25 percent) income tax liability. After that \$4 million income tax liability is expensed (i.e., paid to the federal and state taxing authorities), Alpha will be left with \$12 million. That is, as a result of the receipt of a \$16 million total award payment, Alpha will be made whole with regard to the \$12 million of lost profits damages related to the damages event.

Again, assuming the type of damages in this illustrative example relates to a taxable event, Omega will typically benefit from a \$16 million income tax deduction if Alpha recognizes \$16 million of taxable income. In other words, after the income tax impact (assuming the illustrative 25 percent income tax rate), the \$16 million payment will decrease Omega's economic position (after considering the income tax impact) by \$12 million.

Tax counsel should be aware that this second tax adjustment procedure is more typically applied by damages analysts when recommending the total amount of a judicial award (or negotiated settlement) because it separately reveals the impact of income taxes on the recommended amount of the damages award. This tax-related adjustment procedure clearly identifies that the total recommended damages award should include two components: (i) the amount of the damages suffered by the damaged party; and (ii) the income tax impact of the receipt of the damages award or the settlement payment on the damaged party.

**SUMMARY AND CONCLUSION**

Tax counsel understand that companies may suffer commercial damages due to the wrongful actions of various other parties. These commercial damages may be caused by a breach of contract, a tortious act, or some other reason. And, the wrongful party may be a competitor, customer, employee, shareholder, banker, supplier, government agency, or other party.

When a company is damaged, it typically retains legal counsel to prosecute the legal claim. Such counsel typically retain a forensic accountant, economist, business appraiser, or some other type of damages analyst to measure the amount of damages suffered by the damaged party. In the development of the damages analysis, that damages analyst—and all of the parties to the dispute—should consider all of the income tax consequences to the parties. Tax counsel may have to advise all parties to the dispute—including the litigation counsel—regarding such income tax considerations.

Tax counsel understand that there are income tax consequences related to the receipt and payment of amounts related to a judicial order or a negotiated settlement. The taxable income recognition, the tax deduction, and the income character (whether ordinary or capital gain) of the payments typically depend on: (i) the type of the damages claim; and (ii) the identity of the damaged party and the damaging party. These taxation-related issues are typically reflected in the legal documents related to the dispute. In particular, certain income tax deduction disallowances may apply with regard to the damages award payments.

All parties to a damages dispute should consider the income tax consequences of any damages payment when negotiating a dispute settlement agreement

or when considering a court order or an arbitrator's award. In addition to the damaged party and the damaging party, damages analysts, litigation counsel, and other professionals involved in the dispute should consider these taxation issues. Tax counsel may be called on to advise the parties with regard to such tax consequences. With some planning on the part of tax counsel and cooperation among the parties to the dispute, some unfavorable tax consequences could be avoided. In any event, all relevant income tax consequences should be accounted for in the damages measurement analyses, in any damages award recommendations or deliberations, in the dispute settlement negotiations, and in the litigation prosecution and defense. 🍀

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## Notes

- 1 Raytheon Production Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944).