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Date:

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PLR-115879-05

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Dear _____ :

This letter is in response to your request for a letter ruling concerning the tax treatment of certain amounts you received pursuant to a settlement of an opt-out class action lawsuit and attorneys' fees received by class counsel. Specifically, you request the following two rulings:

- 1) The amounts to which you became entitled pursuant to a settlement of a class action lawsuit in exchange for your right to receive periodic and lump sum payments arising out of a prior lawsuit for personal physical injuries are excludable from your gross income under § 104(a)(2) of the Internal Revenue Code.
- 2) Attorneys' fees paid to class counsel in the class action lawsuit are not included in your gross income.

FACTS

The Personal Injury Lawsuit

On Date 1, you were in an automobile accident during a business trip for your employer. You suffered permanent physical injuries. An employee of C caused the accident. On or about Date 2, you filed a complaint against C. The complaint asserted that C was

PLR-115879-05

liable under the doctrine of respondeat superior because, at the time of the accident, C's employee was acting within the scope of his office or employment.

On or about Date 3, you and C entered into a structured settlement agreement (Settlement Agreement I "). Under the terms of Settlement Agreement I, C was required to make the following payments for your physical injuries: a payment of \$e on Date 4; payments of \$e thereafter on each and every Dates Z, ending with the final payment due Date 7; and a payment of \$b on Date 7. Notwithstanding the foregoing payment schedule, at any time after Date 6 and before Date 7, C could elect to discharge its remaining obligations under Settlement Agreement I by paying you the sum of (i) \$e multiplied by q and (ii) \$b.

As contemplated by Settlement Agreement I and your consent, C assigned to X, and X assumed, C's liabilities to you. X committed itself to establish a trust (ZZ), of which X would be the trustor and sole beneficiary. You did not have the right to accelerate, defer, increase, or decrease the periodic payments or the lump sum payment. Thus, X became liable to you for all payments required under Settlement Agreement I.

To implement these arrangements, X, as trustor, entered into a trust agreement (JJ) with Y, as trustee. The terms of the JJ and Settlement Agreement I required X to transfer \$c to Y. In turn, Y was required to invest \$c in U.S. Treasury Bonds in a principal amount calculated to earn sufficient interest to fund the payments under the structured settlement agreement. The bonds were to be redeemed to fund the final lump-sum payment. Until that time, the bonds were to be retained in the ZZ and dedicated exclusively to carrying out the periodic payment obligations established by Settlement Agreement I. You excluded the periodic payments from income under § 104(a)(2). You have also represented that such amounts were excludable from your gross income under § 104(a)(2).¹

The Class Action Lawsuit

In Date 8, the ZZ ceased making periodic payments to you. At the same time, LLs established by X ceased making periodic payments to approximately g other individuals. Each of these other individuals also had suffered catastrophic personal physical injuries (or was a successor-in-interest to such an individual) and was entitled to receive periodic payments under an individually established, structured settlement arrangement referred to as an "LL Agreement."

In Year 3, a class action lawsuit in the case *V Lawsuit* was filed on behalf of you and these other individuals (Class Action Plaintiffs) in the Court. The complaint alleged that

¹ For purposes of this ruling we have assumed, but do not decide, that all of the payments you were entitled to receive under Settlement Agreement I were excludable from your gross income under § 104(a)(2).

PLR-115879-05

the defendants breached contractual or fiduciary responsibilities to the Class Action Plaintiffs to assure that the U.S. Treasury bonds were used for their sole intended purpose of making payments to the Class Action Plaintiffs or to refrain from engaging in or facilitating transactions that would result in the bonds not being so used. The complaint further alleged that due to the breach of these duties the shareholders of the assignment company (X and/or its successors) were able to use the assets of the LLs as collateral for their personal investments and business activities. Pursuant to these arrangements, the shareholders purported to give Z certain rights to the U.S. Treasury bonds held as assets of the LLs as collateral for personal loans. In Year 2, after the shareholders had defaulted on their personal loans, Z sold the Treasury bonds. Shortly thereafter, in Date 8, periodic payments to the Class Action Plaintiffs ceased.

The complaint stated that the Class Action Plaintiffs demanded various forms of relief including compensatory, consequential, and incidental damages, interest at the maximum legal rate, and punitive and exemplary damages.

V Lawsuit was subsequently resolved through settlement agreements. In total, there were four separate settlements. Of these, three were entered into in Year 3 and were with (1) L for \$d, (2) Z for \$f, and (3) K for \$x. Finally, a global settlement was entered into as of Date 9, with R, Y, J, S, T, and U for \$y (the "Global Settlement Agreement"). In exchange, the Settling Defendants under the Global Settlement Agreement will receive a complete release of all claims that were or could have been asserted against them in the class action lawsuit.

In order to determine the aggregate amount to be paid by the Settling Defendants, the parties determined the present value of all future periodic and lump-sum payments and confirmed the amount of all past due lump sum payments payable to each of the Class Action Plaintiffs under their respective structured settlement arrangements. In making these calculations, it was assumed that the U.S. Treasury bonds used to fund the original LLs would have been called as of the earliest possible call date. Thus, the present value of all future payments was based on the early call date of the underlying bonds in the various LLs. The payments were discounted to Date 10 at the prime lending rate of U.S. banks. The total amount determined to be payable by the Settling Defendants pursuant to these calculations is hereinafter referred to as the Plaintiffs' Substituted Recovery Amount.

In the final judgment and order of dismissal, the Court found that all amounts paid from Year 3, and to be paid, to the Class Action Plaintiffs (except amounts for attorneys' fees or residual distributions) pursuant to the Global Settlement Agreement are in lieu of payments relating to their structured settlement arrangements.

The actual sum recovered from the Settling Defendants for the Class Action Plaintiffs is slightly larger than the sum of the Plaintiffs' Substituted Recovery Amount and the permitted attorneys' fees. This excess is referred to as "Consequential Damages" and

PLR-115879-05

represents that amount, if any, that you may receive in excess of past due and the net present value of all future periodic and lump sum payments that you will receive in lieu of the periodic payments contemplated under Settlement Agreement I. The amounts, if any, payable as Consequential Damages has not yet been determined and will not be determined until the Court fixes the amount of the attorneys' fees and costs. It is expected that your portion of the Consequential Damages, if any, will not exceed \$m. In addition, the law firms that were class counsel ("Class Counsel") applied to the court for determination of attorneys' fees in an amount not to exceed \$z to be paid out of the settlement common fund. In the application to the court, Class Counsel sought "a fee award from the common fund created by their labors, calculated either as a percentage of that fund or by the lodestar/multiplier method." You represent that *V Lawsuit* was an opt-out class action lawsuit. The order granting the notice of the class action states that the Class Action Plaintiffs certified in the class action include "all persons and entities who are parties to structured settlements with a company variously known as P whose structured settlements provided for payments to be paid out of the interest and principal paid on U.S. Treasury bonds held in trust and who have not received payment in full of the amounts due to them under their structured settlements." You never signed a retainer agreement with, or became an individual client of, any of the Class Counsel. Those firms only represented the class, of which you were a member.

LAW AND ANALYSIS

Section 61(a) provides that, except as otherwise provided by law, gross income means all income from whatever source derived. Thus, under § 61, an accession to wealth is presumed to be gross income unless the taxpayer can demonstrate that the accession fits into one of the specific exclusions created by other sections of the Code.

Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), 1955-1 C.B. 207.

Section 104(a)(2), as amended by § 1605 of the Small Business Job Protection Act of 1996 ("the Act"), excludes from gross income the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or periodic payments) on account of personal physical injuries or physical sickness.

Section 1605(d)(2) of the Act provides that the amendments made by § 1605 shall not apply to any amount received under a written binding agreement, court decree, or mediation award in effect (or issued on or before) September 13, 1995.

Section 104(a)(2), prior to its amendment by § 1605 of the Act excluded from gross income the amount of any damages received (whether by suit or agreement and whether as lump sums or periodic payments) on account of personal injuries or sickness.

"'[W]hether a claim is resolved through litigation or settlement, the nature of the underlying action determines the tax consequences of the resolution of the claim.' ... In

PLR-115879-05

characterizing the settlement payment for tax purposes, we ask, ‘In lieu of what were the damages awarded?’” *Getty v. Commissioner*, 913 F. 2d 1486, 1490 (9th Cir. 1990).

In *Sanders v. Commissioner*, 225 F.2d 629 (10th Cir. 1955), Mr. Sanders entered into a contract with the United States government to perform certain construction work. During the construction period, there were many changes made in the plans and specifications as well as demands that much of the work be accelerated. As a result, the cost of construction greatly increased and Mr. Sanders made claims for additional compensation. Mr. Sanders brought an action in the United States Court of Claims against the United States to recover an amount alleged to be due on the construction contract. Mr. Sanders and the United States entered into a compromise settlement agreement. Upon receipt of the settlement money, Mr. Sanders dismissed his action with prejudice. He reported the settlement money as a capital gain. The court concluded that the settlement money was not derived from sale or exchange of a capital asset but was a compromise settlement of an amount claimed for the services rendered. In doing so, the court stated:

[T]he settlement of the litigation and the belated payment to Mr. Sanders represented a sum due him for work performed under the terms of the contract. This was gross income as defined by the Revenue Act. The object of the suit was to recover for this work. If the sum had been paid when due, it would have represented ordinary income. The fact that the sum was recovered in a lawsuit or in the settlement of a lawsuit does not change the character of the income regardless of the intervening time. The income must be considered in the light of the claim from which it was realized.

See *Sanders* at 635. (See also *Spangler v. Commissioner*, 323 F.2d 913, 916 (9th Cir. 1963), in which the court stated, “[I]n determining whether receipts are taxable as ordinary income or return of capital, it is immaterial whether taxpayer effected collection amicably or by resolving a dispute through compromise or litigation. It is the nature of the underlying claim that controls and not the manner of collection.”)

Under Settlement Agreement I, you were entitled to receive damage payments on account of personal injuries that you represent were excludable from gross income under former § 104(a)(2). Subsequently, the amounts that had been paid into the ZZ to fund the periodic payments of the damages were dissipated. Various defendants have made payments under the four settlement agreements to satisfy claims that they violated contractual and fiduciary responsibilities resulting in the dissipation of the assets of the ZZ and the LLs of the other Class Action Plaintiffs. That you recovered, in whole or in part, the payments to which you were entitled under Settlement Agreement I through settlement of a lawsuit resolving the foregoing claims does not change the character of the income. Your portion of the Plaintiffs’ Substituted Recovery Amount was intended to be in lieu of each of the remaining periodic payments and the lump sum

PLR-115879-05

amount. In addition, the amount of the payments that you will receive that will be allocated to your portion of the Plaintiff's Substituted Recovery Amount is less than the total payments you would have received under Settlement Agreement I had the trustee of the ZZ exercised its right to terminate the periodic payments as of Date 7. Thus, the payments representing your portion of the Plaintiffs' Substituted Recovery Amount that you receive pursuant to the Global Settlement Agreement are treated as being received in lieu of, and have the same character for federal income tax purposes as, the payments you were entitled to receive under Settlement Agreement I.

The attorneys' fees awarded to Class Counsel from the common fund are not includible in your gross income. These amounts awarded to Class Counsel were awarded in an opt-out class action lawsuit, in which the members of the plaintiff class do not have any express contractual relationship with class counsel. This conclusion is similar to Rev. Rul. 80-364, 1980-2 C.B. 294, situation 3, involving the settlement of a lawsuit brought by a union against an employer to enforce a collective bargaining agreement. Class actions are employed by the judicial system to consolidate in one lawsuit a group of common claims against the same defendants. Class actions frequently come about as representative litigation in which the class representatives pursue the claims of a great many similarly interested individuals. Under the class action at issue, a class member obtains the benefits of the settlement by merely coming within the definition of the class. The conclusion that the attorneys' fees awarded to Class Counsel are excluded from the gross income of class members is specific to the facts of this case. *Cf. Sinyard v. Commissioner*, T.C.M. 1998-364, *aff'd*, 268 F.3d 756 (9th Cir. 2001), *cert. denied sub nom, Sinyard v. Rossotti*, 122 S.Ct. 2357 (2002) (fees awarded under the ADEA); *Fredrickson v. Commissioner*, T.C.M. 1997-125, *aff'd in unpub. opinion*, 97-71051 (9th Cir. 1998) (settlement of mandatory, Title VII class action in which class members personally signed settlement agreements providing for compensation of counsel).

CONCLUSIONS

Based strictly on the information submitted and representations made we conclude:

- 1) The amounts of damage payments properly allocable to the Plaintiffs' Substituted Recovery Amount payments you received pursuant to the Global Settlement Agreement in satisfaction of your claims to receive periodic and lump sum payments under Settlement Agreement I are excludable from your gross income under former § 104(a)(2) (provided that all of the periodic and lump sum payments under Settlement Agreement I would have been excludable from your gross income under former § 104(a)(2)).
- 2) Payments of attorneys' fees to Class Counsel in *V Lawsuit* are not includible in your gross income under § 61.

CAVEATS

PLR-115879-05

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Except as expressly provided above under CONCLUSIONS, no opinion is expressed or implied concerning the tax consequences of any item discussed or referenced in this letter. In addition, we do not express any opinion on the following matters:

- 1) Whether payments under Settlement Agreement I were excludable from gross income under former § 104(a)(2).
- 2) Whether the allocation of damages under the Global Settlement Agreement and the Court orders is effective for federal income tax purposes. Under section 4.01(7) of Rev. Proc. 2005-3, 2005-1 I.R.B. 118, 122, the Internal Revenue Service ordinarily does not rule whether an allocation of the amount of a settlement award (including a lump sum award) between back pay, compensatory damages, punitive damages, etc., is a proper allocation for federal tax purposes.
- 3) Whether the portion of the damage payments made by R in exchange for litigation claims assigned to R under section 8(d)(iii) of the Global Settlement Agreement are excluded from your gross income under former § 104(a)(2).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter showing the deletions proposed to be made when it is disclosed under § 6110. In addition, in accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Michael J. Montemurro
Branch Chief
Office of Associate Chief Counsel
(Income Tax & Accounting)