Current Federal Tax Developments

Week of November 28, 2022

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LANGUAGE OF SETTLEMENT AGREEMENT DID NOT MENTION ANY COMPENSATION FOR PHYSICAL INJURIES, SO ENTIRE AWARD WAS TAXABLE INCOME

Tillman-Kelly v. Commissioner, TC Memo. 2022-111, 11/21/22

The taxation of legal settlements creates a lot of confusion, with taxpayers and their advisers not realizing that, most often, such settlements are going to be considered taxable income. One such recent case is that of *Tillman-Kelly v. Commissioner*, TC Memo. 2022-111.[1]

The facts that led to Mr. Tillman-Kelly's award are outlined in the opinion as follows:

> In September 2009 CSU hired Mr. Tillman-Kelly as project director of a federal grant that CSU had received. Mr. Tillman-Kelly reported directly to Dr. Akujieze, a dean at CSU, and Robert Warner, the dean's executive assistant. A few months into his employment Mr. Tillman-Kelly expressed concerns to the U.S. Department of Education and CSU's Ethics Office that certain grant funds were being misappropriated. On June 17, 2010, CSU terminated Mr. Tillman-Kelly's employment.
>
> Mr. Tillman-Kelly thereafter filed suit against the Defendants in Illinois state court, alleging that they retaliated against him for his complaints of misuse of funds.2 He stated that he "was subjected to humiliation, isolation, harsher discipline and different and comparatively more negative terms and standards of employment, [than] other university employees, denial of benefits, demotions, and ultimately, termination." Specifically, Mr. Tillman-Kelly asserted that Dr. Akujieze threatened to "do what he had to do" in response to Mr. Tillman-Kelly's ethics complaints, which (again, according to the complaint) consisted primarily of eliminating Mr. Tillman-Kelly's job responsibilities culminating with his termination.
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> Mr. Tillman-Kelly contended that these actions violated Illinois state whistleblower protections and sought "damages included but not limited to emotional distress and humiliation and lost income and

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[1] *Tillman-Kelly v. Commissioner*, TC Memo. 2022-111, 11/21/22, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/payment-to-settle-retaliation-claim-not-excludable-from-income/7fdp0 (retrieved November 26, 2022)

> benefits." His complaint did not allege that he suffered any physical injuries, nor did he seek compensation for physical injuries.
>
> Mr. Tillman-Kelly and the Defendants settled the state court case in 2017. Under the terms of the settlement agreement, Mr. Tillman-Kelly received a payment of $230,671 in exchange for ending his suit. The settlement agreement described this payment as being for "alleged non-wage injuries, as non-economic emotional distress damages."[2]

The defendant reported the amount paid to Mr. Tillman-Kelly on a Form 1099-MISC, but the amount was not reported as income on the couple's income tax return. Not surprisingly, the IRS discovered this discrepancy and, eventually, issued a notice of deficiency to the taxpayers.

IRC §61 provides that "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived…". Thus, we start from the assumption that the entire award constitutes taxable gross income to the taxpayer.

IRC §104(a)(2) provides one possible option for excluding the payment from Mr. Tillman-Kelly's income, and this was what the taxpayers argued allowed them to exclude the payment from income. The provision provides:

> **(a) In general.** Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include--
>
> > …
> >
> > (2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness;

In addition, the flush text at the end of §104(a) concludes with the following clarification of the §104(a)(2) exclusion:

> For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1) attributable to emotional distress.

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[2] *Tillman-Kelly v. Commissioner*, TC Memo. 2022-111, 11/21/22

The opinion notes that the Court first looks at the underlying agreement to determine the nature of the claim:

> The nature of the claim is typically determined by looking to "the underlying agreement to determine whether it expressly states that the damages compensate for 'personal physical injuries or physical sickness' under § 104(a)(2)." *Rivera*, 430 F.3d at 1257; see also *Ghadiri-Asli v. Commissioner*, T.C. Memo. 2019-142, at *38, *aff'd sub nom. Najle-Rahim v. Commissioner*, No. 20-72031, 2022 WL 2869776 (9th Cir. July 21, 2022).[3]

Tax advisers who have dealt with such agreements for taxpayers will note that most often the agreement does not provide such a nice, clear indication of what the damages were in compensation for, most often running into overly broad statements of what the payment was meant to compensate for.

In such a case, the Court notes that the inquiry then turns to the intent of the *payor* in making the settlement payment:

> Should an agreement fail to answer the question, we inquire as to "the intent of the payor." *Devine v. Commissioner*, T.C. Memo. 2017-111, at *11 (quoting *Longoria v. Commissioner*, T.C. Memo. 2009-162, 2009 WL 1905040, at *7); see also *Rivera*, 430 F.3d at 1257; *Knuckles v. Commissioner*, 349 F.2d 610, 613 (10th Cir. 1965), *aff'g* T.C. Memo. 1964-33; *Ahmed v. Commissioner*, T.C. Memo. 2011-295, 2011 WL 6440130, at *3, *aff'd*, 498 F. App'x 919 (11th Cir. 2012).[4]

It is important to note that the recipient's belief about why the payment was made isn't the key here, absent evidence that the taxpayer can provide that the payor shared that view.

The opinion then goes on to describe how the court will attempt to derive the payor's intent if the agreement is ambiguous on the matter:

> The payor's intent may be discerned by taking into account "all the facts and circumstances of the case," including the amount paid, the allegations in the injured party's complaint, and the factual circumstances that led to the agreement. *Rivera*, 430 F.3d at 1257 (quoting *Allum v. Commissioner*, T.C. Memo. 2005-177, 2005 WL 1692488, at *4, *aff'd*, 231 F. App'x 550 (9th Cir. 2007)); see *Green v. Commissioner*, 507 F.3d 857, 868 (5th Cir. 2007), *aff'g* T.C. Memo. 2005-250; see also *Bent v. Commissioner*, 87 T.C. 236, 245 (1986), aff'd, 835 F.2d 67 (3d Cir. 1987). "Ultimately, the character of the

[3] *Tillman-Kelly v. Commissioner*, TC Memo. 2022-111, 11/21/22

[4] *Tillman-Kelly v. Commissioner*, TC Memo. 2022-111, 11/21/22

> payment hinges on the payor's dominant reason for making the payment." *Green*, 507 F.3d at 868. "[T]he nature of underlying claims cannot be determined from a general release [of claims] that is broad and inclusive." *Ahmed v. Commissioner*, 2011 WL 6440130, at *3.[5]

In this case, though, the court found that the agreement expressly provided the payments were not for physical injuries of a type excludable under IRC §104(a)(2).

> The settlement agreement establishes that the payment is not excludable under section 104(a)(2). The parties expressly agreed that the $230,671 payment to Mr. Tillman-Kelly was for "non-wage injuries, as non-economic emotional distress damages." The parties do not reference physical injuries or sickness in the agreement, much less tie the settlement payment to any such physical injuries or sickness.[6]

The taxpayers argued that, despite what the agreement says, the real reason for the payment was rooted in physical injuries arising from an altercation between Mr. Tillman-Kelly and another employee:

> The Tillman-Kellys respond that the retaliation claim was actually rooted in a heated altercation between Mr. Tillman-Kelly and Mr. Warner, which resulted in physical injury from the slamming of a door, and that the settlement proceeds were meant to compensate Mr. Tillman-Kelly for that injury. The Tillman-Kellys assert that their treatment of the proceeds was thus consistent with IRS Publication 4345, which states in relevant part that "proceeds you receive for emotional distress or mental anguish attributable to a personal physical injury or physical sickness are treated the same as proceeds received for Personal physical injuries or physical sickness." I.R.S. Publication 4345 (Revised Nov. 2022), *Settlements — Taxability*, at 1.[7]

The opinion, however, notes that the agreement expressly provides for other reasons for the payment:

> The settlement agreement belies the Tillman-Kellys' position. In that agreement, the parties characterized the payment as one for "emotional distress damages" and did not reference any physical injury whatsoever.[8]

[5] *Tillman-Kelly v. Commissioner*, TC Memo. 2022-111, 11/21/22

[6] *Tillman-Kelly v. Commissioner*, TC Memo. 2022-111, 11/21/22

[7] *Tillman-Kelly v. Commissioner*, TC Memo. 2022-111, 11/21/22

[8] *Tillman-Kelly v. Commissioner*, TC Memo. 2022-111, 11/21/22

As was noted earlier, the settlement agreement's language is the primary guide to the nature of the damage payment, thus the taxpayers' case effectively ends when the agreement's language clearly does not include such payments for physical injuries.

But the opinion goes on to note that even if the agreement had left some ambiguity with regard to why the payment was made, in this case the other evidence aside from the agreement was insufficient to show this altercation and the injuries arising from it are the primary motivation for the payment by the payor:

> Even if we were to expand our focus beyond the settlement agreement, the Tillman-Kellys would fare no better. As an initial matter, Mr. Tillman-Kelly's claim against the Defendants does not relate to compensation for physical injuries. The state court claim alleges violation of an Illinois whistleblower statute, describing a retaliatory campaign involving improper removal of job responsibilities and ultimately termination, not physical injury. Nor did Mr. Tillman-Kelly's complaint seek damages for physical injury, instead pursuing damages for "emotional distress and humiliation and lost income and benefits."
>
> The only clear reference in the record to any physical injury comes in Mr. Tillman-Kelly's responses to interrogatories in the state court action. In the context of a lengthy description of the events at issue and his complaints, Mr. Tillman-Kelly stated he reported to CSU ethics officials an incident in which Mr. Warner "slammed a door on [him] injuring [him]." Mr. Tillman-Kelly, however, did not identify this purported injury in response to an interrogatory asking for "the basis for any damages you claim to be entitled to, including the compensatory and punitive damages articulated in your Prayer for Relief." Nor does the record explain the precise nature or extent of Mr. Tillman-Kelly's purported physical injury from the door.[9]

Thus, the opinion concludes:

> In short, we return to the plain text of the settlement agreement that the payment was made for "alleged non-wage injuries, as non-economic emotional distress damages." This text is clear on its face, but even if there were some doubt, the nature of the state court litigation supports the conclusion that the dominant reason for the payment was to compensate for emotional distress and was altogether unrelated to physical injury.[10]

[9] *Tillman-Kelly v. Commissioner*, TC Memo. 2022-111, 11/21/22

[10] *Tillman-Kelly v. Commissioner*, TC Memo. 2022-111, 11/21/22

OPERATING AGREEMENT REVISION THAT CONTAINED §704(B) LANGUAGE TERMINATED LLC S CORPORATION STATUS

PLR 202247004, 11/25/22

Some taxpayers may prefer to use a limited liability company (LLC) as the underlying legal entity in which to form what is intended to be, for tax purposes, an S corporation. It may be due to quirks in state law (as is true in my home state of Arizona) or some other reason. But what is too often overlooked is that the LLC's operating agreement must not create a situation where there is deemed to be multiple classes of "stock" outstanding, or the LLC will not qualify as an S corporation.

This very issue forced taxpayers to pay for and seek an IRS ruling that the termination of their S corporation status was inadvertent in the ruling found at PLR 202247004.[11]

IRC §1361(b)(1) provides the following requirements for a corporation to be able to elect S status:

> (b) **Small business corporation.**
>
> > (1) **In general.** For purposes of this subchapter, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not--
> >
> > > (A) have more than 100 shareholders,
> > >
> > > (B) have as a shareholder a person (other than an estate, a trust described in subsection (c)(2), or an organization described in subsection (c)(6)) who is not an individual,
> > >
> > > (C) have a nonresident alien as a shareholder, and
> > >
> > > (D) have more than 1 class of stock.

Treasury Reg. §1.1361-1(l)(1) provides the following description of what constitutes one class of stock, looking to *rights* to distribution and liquidation proceeds:

> (l) **Classes of stock.**
>
> > (1) **General rule.** A corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in paragraph (l)(4) of this section (relating

[11] PLR 202247004, 11/25/22, https://www.irs.gov/pub/irs-wd/202247004.pdf (retrieved November 26, 2022)

> to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds.

However, such ownership classes can have different voting rights, as the regulation goes on to note:

> Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock. Thus, if all shares of stock of an S corporation have identical rights to distribution and liquidation proceeds, the corporation may have voting and nonvoting common stock, a class of stock that may vote only on certain issues, irrevocable proxy agreements, or groups of shares that differ with respect to rights to elect members of the board of directors.[12]

Treasury Reg. §1.1361-1(l)(2)(i) makes it clear that the rights provided in the governing documents are the items to consider in making this determination.

> (i) **In general.** The determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (collectively, the governing provisions).

Advisers must realize that since it is rights that are considered, the question is not *if* a differing distribution for different ownership classes has been or is likely ever to be made. Rather, the question is whether the governing documents allow for such a distribution to take place, even if it is only true if certain conditions are met.

The problem we encounter with limited liability companies is that they don't issue corporate stock, so we must treat the membership interests as if they are stock. That's not an insurmountable problem—it is possible to draft an operating agreement that provides for "units" for ownership interests and provide the necessary identical rights for each unit.

But here we run into another problem. LLCs with more than one owner are most often treated by the owners as partnerships under tax law and, in such cases, the operating agreements are drafted most often to comply with the regulations under IRC §704(b) so that allocations under the agreement can be treated as having economic effect and

[12] Treasury Reg. §1.1361-1(l)(1)

thus respected by the courts when the LLC is taxed as a partnership. Quite often the §704(b) regulations are incorporated by reference into the operating agreement.

However, those §704(b) regulations require that distributions in liquidation of an interest must be governed by the capital accounts determined under these regulations. That liquidation can very easily lead to differing amounts per unit, thus creating differing classes of "stock" being held by each equity holder under the S corporation regulations.

The §704(b) language will be found quite often in standard LLC operating agreement boilerplate text, which leads to it often being found in the operating agreements for LLCs that wish to be treated as S corporations unless the party drafting the agreement is both aware the entity plans to elect S status and is aware of the need to modify their standard agreement to contain the proper S corporation distribution language.

If the LLC has only one member the §704(b) language really isn't a problem—that owner's "units" all have identical rights in liquidation.

But once a second member is admitted to the LLC the second class of stock is now treated as issued—and the S status is terminated, with the entity reverting to being taxed as a C corporation. While the status of the LLC as a corporation isn't impacted by having more than one class of stock, it simply can no longer be an S corporation.

One unusual aspect of this letter ruling request is that it appears the entity did not have this problem initially. The ruling notes:

> The information submitted states that X was formed on Date 1 under the laws of State and elected to be treated as an S corporation effective Date 2. A and B were the sole shareholders of X as of Date 3.[13]

We can't tell from these facts if the entity was originally formed as a state law corporation, or if it was an LLC that had an agreement that properly took care of the one class of stock issue. But we do know that when the entity adopted a new operating agreement, the problematical §704(b) language made its first appearance:

> On Date 3, A and B entered into an Amended and Restated Operating Agreement that included provisions regarding partnerships. Section 5.1 of this agreement provides, in part, that X would maintain capital accounts for each member. Section 10.4 of this agreement provides, in part, that upon liquidation of X, members would distributions to the extent of their capital account balances followed by their interests in X.[14]

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[13] PLR 202247004, 11/25/22

[14] PLR 202247004, 11/25/22

The LLC later adopted a second revision to the operating agreement that also contained the problem text. However, eventually the issue was discovered, and the LLC adopted a third revised operating agreement that removed the §704(b) text and now complied with the one class of stock requirement:

> Upon discover [sic] of the effect of the partnership provisions, A and B entered into a Third Amended and Restated Operating Agreement on Date 5 to remove the requirement for the members to maintain capital accounts and to provide identical distribution and liquidation rights to the members.[15]

The problem at this point is that while the entity now qualifies to be an S corporation, its S status terminated when the first revised operating agreement was adopted. Good news is that the IRS can grant relief from inadvertent terminations under IRC §1362(f), but bad news is that obtaining that relief requires requesting and paying for a private letter ruling.

The LLC went ahead and asked for the private letter ruling. In doing so, the LLC made the following representations:

> X represents that the termination of X's S corporation election was inadvertent and not motivated by tax avoidance. X further represents that since Date 3, X and its members have filed all returns consistent with X's status as an S corporation. X also represents that since Date 3, all distributions were made to the members based on their pro rata shares of ownership of X. X and its members have agreed to make such adjustments consistent with the treatment of X as an S corporation as may be required by the Secretary.[16]

The requested relief was obtained, as the IRS ruled:

> Based solely on the facts submitted and representations made, we conclude that X's S corporation election terminated on Date 3 due to the provisions in the Amended and Restated Operating Agreement. We further conclude this termination was inadvertent under the provisions of § 1362(f). We also conclude that if X's status had not terminated on Date 3 it would have terminated on Date 4 due to the provisions in the Second Amended and Restated Operating Agreement. We conclude that X's termination on Date 4 would also have been inadvertent under the provisions of § 1362(f). Therefore, pursuant to § 1362(f), X will be treated as an S corporation effective Date 3, and thereafter, provided that X is otherwise eligible to be an S

[15] PLR 202247004, 11/25/22

[16] PLR 202247004, 11/25/22

corporation and provided that the election was not otherwise terminated.[17]

REFUND CLAIM FILED IN COURT OF CLAIMS DISMISSED AS TAXPAYER FAILED TO GIVE IRS SIX MONTHS TO PROCESS ADMINISTRATIVE CLAIM

Lofton v. United States, US Court of Claims, No. 1:22-cv-01335, 11/18/22

Since 2020 tax advisers and their clients have been a bit frustrated with how slowly the IRS processes returns, especially amended returns. But, in the case of *Lofton v. United States*,[18] the taxpayer grew impatient about the IRS delays and attempted to get the matter resolved in Court.

Unfortunately for the taxpayer, while the law allows taxpayers to pursue relief in the courts if the IRS fails to rule on their request for a refund, that law also mandates that the IRS be given six months to act on the request

IRC §6532(a)(1) provides:

> **(1) General rule.** No suit or proceeding under section 7422(a) for the recovery of any internal revenue tax, penalty, or other sum, shall be begun before the expiration of 6 months from the date of filing the claim required under such section unless the Secretary renders a decision thereon within that time, nor after the expiration of 2 years from the date of mailing by certified mail or registered mail by the Secretary to the taxpayer of a notice of the disallowance of the part of the claim to which the suit or proceeding relates.[19]

This provision is meant to balance the interests of the government and the taxpayer. The government is given six months to rule on the claim so there is a reasonable amount of time for the government to respond to the request, also reducing the burden on the courts. But the law also recognizes that the IRS will not be allowed to just hold a claim indefinitely the agency doesn't wish to approve in order to effectively avoid having to defend the denial before a court.

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[17] PLR 202247004, 11/25/22

[18] *Lofton v. United States,* US Court of Claims, No. 1:22-cv-01335, November 18, 2022, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/individual-filed-refund-suit-too-early%2c-court-finds/7fdlh

[19] *Lofton v. United States,* US Court of Claims, No. 1:22-cv-01335, November 18, 2022

In this case the facts were as follows:

> Plaintiff pro se Somona Lofton filed this calendar year 2021 federal income tax refund case against the United States on September 14, 2022. See ECF No. 1. Plaintiff alleges she filed a 2021 Form 1040-X, Amended U.S. Individual Income Tax Return, on May 18, 2022, claiming a federal income tax refund in the amount of $5,362.2 See ECF No. 1 at 2; ECF 1–2 at 20. Plaintiff seeks to challenge the IRS's "refus[al] to process [her] Amended Tax return." See ECF No. 1 at 2. Plaintiff claims the following relief: "$5,362.00 [t]ax refund amount." Id. at 3. …
>
> Plaintiff filed this tax refund suit on September 14, 2022; by the Court's calculation: 3 months and 27 days after purportedly filing her 2021 Form 1040-X.[20]

The IRS objected to this Court action, noting that the taxpayer had not given the agency six months to respond to her claim:

> Pending before the Court is defendant's motion to dismiss plaintiff's complaint for lack of subject matter jurisdiction pursuant to Rule 12(b)(1) of the Rules of the United States Court of Federal Claims (RCFC). See ECF No. 13. Specifically, defendant asserts plaintiff's complaint was filed prematurely — i.e., before the expiration of the six-month waiting period required under 26 U.S.C. § 6532(a)(1), which allows the IRS time to investigate and process tax refund claims.[21]

The opinion notes that the taxpayer concedes that the IRS had not processed her refund claim at the time she filed suit:

> In alleging the IRS has not yet processed her refund, plaintiff concedes the IRS did not issue a decision prior to her filing suit.[22]

The opinion notes that since she hadn't waited six months to file her action, the case must be dismissed:

> Because the six-month statutory waiting period had not expired at the time plaintiff filed her complaint, this Court lacks jurisdiction to adjudicate this action. See *Weston*, 2022 WL 1097361, at *1 ("[T]he failure to file a timely complaint under § 6532(a)(1) deprives the [Court of Federal Claims] of subject matter jurisdiction.") (citing

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[20] *Lofton v. United States,* US Court of Claims, No. 1:22-cv-01335, November 18, 2022

[21] *Lofton v. United States,* US Court of Claims, No. 1:22-cv-01335, November 18, 2022

[22] *Lofton v. United States,* US Court of Claims, No. 1:22-cv-01335, November 18, 2022

> cases); e.g., *Gaynor v. United States*, 150 Fed. Cl. 519, 538 (2020) (dismissing tax refund claims for lack of jurisdiction because the "requisite waiting period had not yet elapsed" when plaintiff filed the initial complaint).[23]

Somewhat amusingly, the decision was issued on the date that was exactly six months after she filed her claim with the IRS—thus, as the opinion notes, she can immediately refile the case:

> The irony is not lost on the Court that this Order of Dismissal is being issued on the precise date that Ms. Lofton's statutory six-month waiting period expires. As noted by the government, however, the jurisdictional requirements of § 6532(a) must be satisfied at the time a tax refund suit is filed. See *Gaynor*, 150 Fed. Cl. at 537–38 ("[O]ur jurisdiction is assessed at the time at which a complaint is filed — not subsequently, after a plaintiff already has filed an action. Concluding otherwise would render the statutory waiting period a dead letter."). Accordingly, plaintiff's complaint must be dismissed, albeit without prejudice. Indeed, plaintiff may refile her tax refund complaint as early as today, though she could not have so as late as yesterday.[24]

[23] *Lofton v. United States,* US Court of Claims, No. 1:22-cv-01335, November 18, 2022

[24] *Lofton v. United States,* US Court of Claims, No. 1:22-cv-01335, November 18, 2022