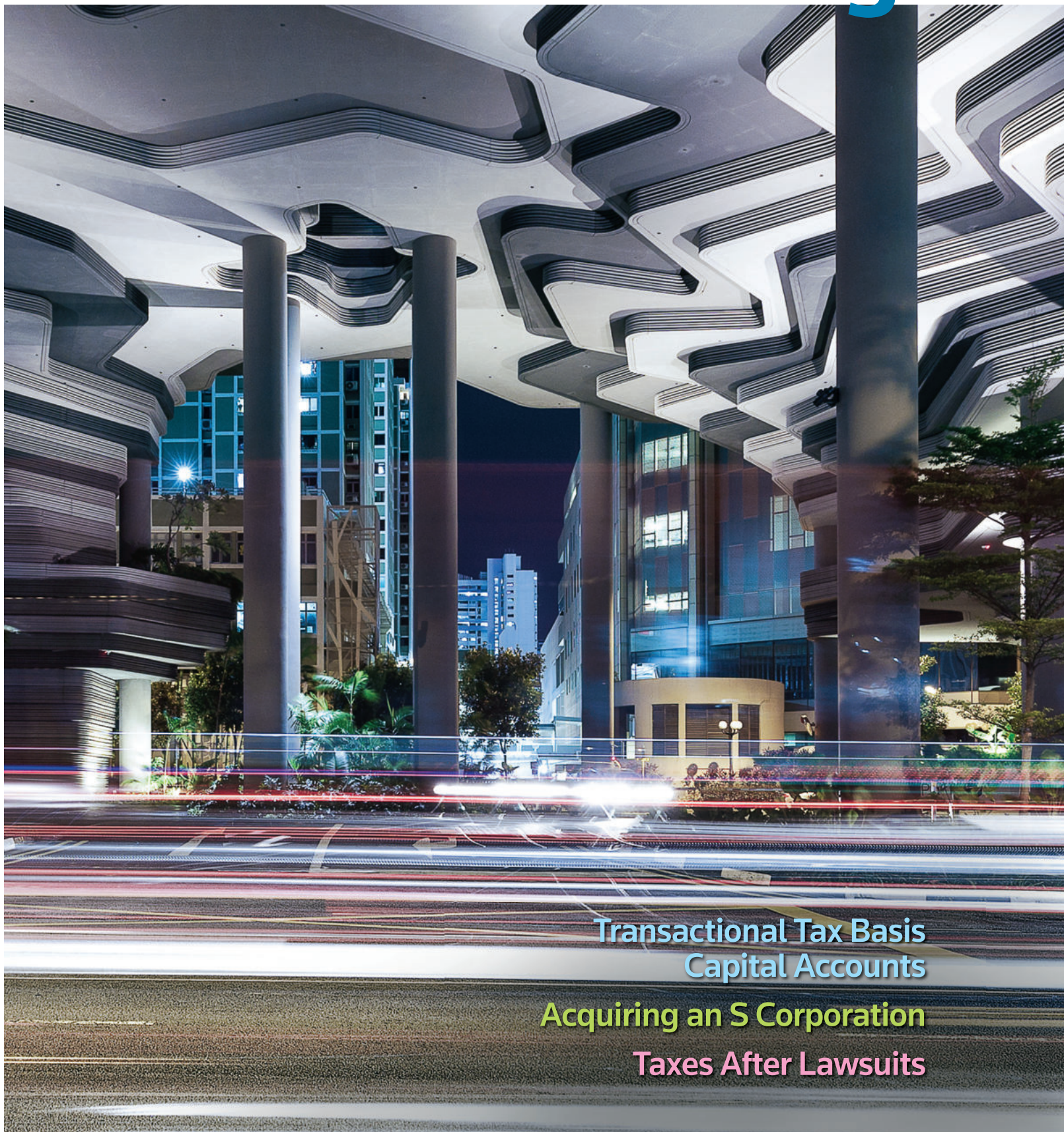


Practical Tax Strategies



Transactional Tax Basis
Capital Accounts
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Taxes After Lawsuits

Practical Tax Strategies

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ARTICLES

THE MECHANICS OF MAINTAINING TRANSACTIONAL
TAX BASIS CAPITAL ACCOUNTS **4**

JAMES R. HAMILL

COMMON TAX DILIGENCE ISSUES WHEN ACQUIRING
AN S CORPORATION **20**

DAVID ANDERS AND LAUREN POZNA

TAXES AFTER LAWSUITS: A CRYOGENIC CASE STUDY **24**

JEREMY BABENER

DEPARTMENTS

PROCEDURE **27**

Whistleblower claim survives death of whistleblower
Extended assessment period for Subpart F income omissions applies to entire tax liability
Issuance of estate tax closing letter does not preclude subsequent examination of estate tax return

COMPENSATION AND BENEFITS **32**

401(k) contribution limit increases to \$20,500 for 2021
IRS provides relief for employers and retirement plans to address COVID-related labor shortages

ACCOUNTING **34**

Court of Appeals denies claim of right deduction after trust mistakenly sold securities
IRS denies taxpayer's request to revoke election to capitalize research expenses
IRS Practice Unit on examining a reseller's UNICAP allocations

PARTNERSHIPS, S CORPORATIONS, AND LLCs **37**

IRS provides guidance on reporting carried interests
Partner could not dispute partnership-level tax adjustment

PERSONAL **39**

IRS reminds taxpayers of charitable deduction for non-itemizers

REAL ESTATE **40**

IRS guidance on tax treatment and information reporting of Homeowner Assistance Fund payments

FEATURES

IRS EXAMINATION QUESTIONS **30**

NEWSLINE **1**

TAXES AFTER LAWSUITS: A CRYOGENIC CASE STUDY

JEREMY BABENER

Focusing on litigation involving the failure of cryogenic tanks at two fertility clinics, this article discusses the taxation of lawsuit proceeds, and suggests planning to reduce such taxation, including by using structured settlements.

Cryogenic tanks at two fertility clinics failed in 2018, devastating more than a thousand would-be parents. The failures destroyed nearly 10,000 eggs and embryos at clinics in California and Ohio, prompting hundreds of claims.¹ In June 2021, a jury awarded the first verdict: \$15 million to the five plaintiffs in the first test case. Some plaintiffs are scheduled for trial, while hundreds of others have settled or soon will.

This article considers the taxation of forthcoming proceeds. In short, plaintiffs can argue that their recoveries are tax-free, though it may be an uphill battle involving politically controversial issues. A 2018 change in the law makes things more difficult, causing plaintiffs in taxable cases to be taxed on their gross, rather than net recoveries.

Plaintiff lawyers and their advisors should be thinking about (1) avoiding plaintiff taxation on legal fees and (2) using structured settlements to reduce tax rates by spreading income over many years.

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Taxation of lawsuits generally

Lawsuit proceeds are taxed based on why they were paid. By default, they are taxable. However, with limited exceptions, they are tax-free when received "on account of personal physical injuries or physical sickness." So says Section 104(a)(2) of the Internal Revenue Code.

In car accident and slip-and-fall cases, this language is easily applied. However, Section 104(a)(2) leaves much to interpret. For example, the meaning of "on account of" and "physical" evolved significantly in 2010, and in cases since, offering new opportunities for plaintiffs to reduce their taxes. In cryogenic failure cases, it is the word "personal" in Section 104(a)(2) that poses the greatest hurdle to tax-free treatment.

Are eggs person or property for tax purposes?

Lawsuit proceeds are tax-free under Section 104(a)(2) only if they compensate for a "personal" injury. Two decisions by the Tax Court tee up the "personal" issue for cryogenic failure cases.

In 1986, the Tax Court held that Section 104(a)(2) applies only to compensation received for violations of rights held "by virtue of being a person."² In 1993, the court held that

harm to personal property, like a house, is not a “personal” injury.³ The court was looking for an “injury to the person, of which bodily harm is the clearest example.”

Thus, for the cases at hand, we ask, “Is destroying a cryogenically frozen egg or embryo an injury to ‘person’ or ‘property’?” As you are probably thinking, the question relates to countless and politically controversial issues. The Tax Court ignored those issues as it addressed the question in 2015.

In 2015, the court treated Nichelle Perez’s eggs as “property” when she was paid to “donate” them to a fertility clinic. She argued that Section 104(a)(2) made her compensation tax-free because it paid for the “pain, suffering, and physical injuries she endured as part of the egg-retrieval process.”⁴ The court disagreed, finding it taxable as payment for the “performance of services.”

The court almost treated her egg donation as the sale of “property,” much like its previous treatment of blood donations.⁵ But Perez’s contract conditioned her payment “solely on how far into the egg-retrieval process she went” and not on the “quantity or the quality of the eggs retrieved.”

The Perez decision undermines the application of Section 104(a)(2) to proceeds received

in cryogenic failure cases. But there are arguments to be made. Conceivably, the IRS and courts are less likely to view eggs and embryos as “property” when extracted for the mother’s personal implantation rather than sale. Or they might distinguish unfertilized eggs in the Perez case from embryos (i.e., fertilized eggs). On this point, many would argue that the destruction of an embryo should be treated as an “injury to the person.” This is where the analysis becomes enmeshed in controversial subjects like abortion and stem cell research.

If cryogenic failure proceeds are taxable, plaintiffs may still be able to reduce their taxable amount based on the flush language of Section 104(a). That language applies the favorable treatment of Section 104(a)(2) to “the amount paid for medical care...attributable to emotional distress.” This rule is relevant in cryogenic failure cases with significant resulting medical expenses, including psychotherapy.

¹ Yan, Holly, *A Cleveland fertility clinic that lost 4,000 eggs and embryos just got hit with 2 more lawsuits*, CNN, 2/5/2020; *Jury awards \$15 million in landmark case over embryos, eggs destroyed in fertility clinic tank failure*, Washington Post, 6/11/2021.

² *Threlkeld*, 87 TC 1294 (1986), *aff’d*, 848 F.2d 81 (CA-6, 1988).

³ *Horton*, 100 TC 93 (1993).

⁴ *Perez*, 144 TC 51 (2015).

⁵ *Green*, 74 TC 1229 (1980).

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Surprising taxes on attorney fees

In 2018, the same year that the cryogenic tanks failed, Congress dramatically increased taxes on lawsuit recoveries. In general, personal injury plaintiffs lost the ability to deduct legal fees except in cases involving violations of classic civil rights or laws regulating the employment relationship. In cryogenic failure cases, neither exception applies.

Without the deduction, some lawsuit victories become financial losses. For example, a \$1 million recovery can result in \$100,000 of loss – this happens if a plaintiff has \$400,000 of nondeductible attorney fees, \$200,000 of nondeductible lawsuit costs, and \$500,000 of taxes due to a 50% tax rate. It is an extreme example, but entirely plausible. Under a similar rule, the New York Times reported on a \$1.3 million recovery in 2002 that resulted in the plaintiff's net loss of \$100,000.⁶

If an exception applied to the above example, the plaintiff would keep \$200,000 of cash rather than lose \$100,000. Note, though, that this result requires the plaintiff to report a deduction of \$600,000 – a bad strategy to avoid an audit.

⁶ Liptak, Adam, *Tax Bill Exceeds Award to Officer in Sex Bias Suit* (2002).

⁷ The author wishes to note his bias for this trust solution, on which he consults for Eastern Point Trust Company.

Whether plaintiffs face more tax or a higher risk of audit, legal fees create independent tax issues. The Plaintiff Recovery Trust is offered as a solution to both problems by Eastern Point Trust Company.⁷ Plaintiff lawyers and their advisors should consider and plan for the impact of legal fees, especially when a plaintiff might receive an IRS Form 1099-MISC reporting their full gross recovery.

Conclusion – structuring to save

Every trial lawyer knows what happens when they receive a large taxable lump sum – they pay tax at a higher rate. That is why many plaintiffs structure their recoveries and many lawyers structure their fees.

Plaintiffs in cryogenic failure cases are more likely to benefit from structuring than most. In vitro fertilization is expensive. Most likely, plaintiffs in these cases earn above-average incomes. As a result, increases in income can quickly jump them into a higher tax bracket. A structured settlement can minimize that effect, reducing their average tax rate.

For many plaintiffs, the cryogenic tank failures destroyed a hoped-for future. Recoveries will not make them whole. But it can significantly improve their financial future, especially with the right advice and planning. ■