

Taxing Terrorism Under the Federal Sovereign Immunities Act

By Robert W. Wood



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Robert W. Wood practices law with Wood LLP (<http://www.WoodLLP.com>) and is the author of *Taxation of Damage Awards and Settlement Payments*, *Qualified Settlement Funds and Section 468B*, and *Legal Guide to Independent Contractor Status*, all available at <http://www.TaxInstitute.com>. This discussion is not intended as legal advice.

In this article, Wood explores the tax treatment of compensation for the victims and their families of international terrorism.

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Fortunately, few Americans should ever need to consider litigation arising out of acts of terrorism. Apart from the heartache that prompts that litigation, those who undertake it are likely to be in for long and uncertain roads to any recovery. If they do eventually recover, the recovery may appear on the surface to be nothing like a typical personal physical injury or wrongful death case.

The parties are different, the procedures and courts are different, and the cast of characters is different. Any eventual recovery may involve asset forfeitures and bank levies, with a new breed of lawyer at the helm. And the case may involve the intricacies of foreign and U.S. banking and sovereign immunities laws.

Typically, to receive compensation, families of victims of international terrorism must obtain judgments against foreign state sponsors of terrorism. They must then identify U.S. assets of the foreign states that are not blocked or otherwise considered diplomatic property. They would then initiate attachment and execution proceedings to satisfy the judgments.

This can be involved and difficult. Often, a case will involve delicate maneuvers and disputes over

priorities, including claims of other creditors. Some of those other claims may be from other families of victims of international terrorism. What is clear is that foreign sovereign immunity precludes U.S. persons from initiating civil proceedings against foreign states.¹

Therefore, traditional state law causes of action, such as wrongful death, are unavailable. If an American is killed or injured in an act of terrorism, the case may start with a private federal cause of action for damages for death resulting from state-sponsored terrorism under 28 U.S.C. section 1605A(c), part of the Foreign Sovereign Immunities Act of 1976 (FSIA, P.L. 94-583).² But this may be the first step in a long and arduous process.

If one leaps ahead years and sees an eventual recovery, the question whether the recovery is subject to tax is hardly inconsequential. Some types of litigation recoveries receive IRS guidance and case law authorities. Yet many types of cases spawn no tax authority, and claims under the FSIA are in that category.

Of course, a fundamental precept of tax law is that recoveries in litigation are taxed according to the origin and nature of the underlying claims. Compensatory damages for wrongful death or personal physical injury should be tax free under section 104. If an underlying recovery in litigation would be excludable from the plaintiff's income under section 104, a claim against other parties to redress those wrongs should be, too.

The classic example is a claim for legal malpractice. Suppose you are injured in a car crash, but your lawyer fails to file the complaint on time, so you cannot recover. If you eventually recover from the lawyer for his malpractice, your recovery should be tax free.

Your recovery would have been tax free had you collected it from the proper party. As a result, your malpractice recovery is given the same tax-free character even though it was not the lawyer who injured you in the car crash. The same rationale should be applied to terrorism cases.

¹28 U.S.C. section 1604.

²Codified at 28 U.S.C. sections 1602, 1330, 1332, 1391(f), 1441(d), and 1602-1611.

Attachment and Execution

Under section 1610(c) of the FSIA, attachment or execution is not permitted until the court determines that a reasonable period has elapsed from the entry of a final judgment and notice has been provided. The plaintiff's recovery is likely to come about by turnover motions under section 1610(g) of the FSIA and section 201(a) of the Terrorism Risk Insurance Act of 2002 (TRIA, P.L. 107-297). However, the case generally starts with a private federal cause of action for damages for death resulting from state-sponsored terrorism under section 1605A(c) of the FSIA.

The FSIA permits a plaintiff to recover economic damages, solatium,³ and punitive damages, as well as damages for pain and suffering.⁴ The defendant may well fail to file an answer. A district court may thereafter move on to a default proceeding as provided by the FSIA.⁵ Under the FSIA, a court may enter a default judgment against a non-responding foreign state only when the "claimant establishes his claim or right to relief by evidence satisfactory to the court."

In general, the origin of the claim controls the tax treatment of a litigation recovery.⁶ The IRS and the courts ask in lieu of what were the damages awarded.⁷ The determination of the origin of the claim is factual and is made by reference to the issues raised in the complaint, issues litigated, and issues resolved in a verdict or settlement.⁸

The IRS and the courts usually view the complaint as the most persuasive evidence of the origin of the claim.⁹ Nonetheless, the IRS and the courts also look to the other documents.¹⁰

Section 104(a)(2)

Section 104(a)(2) provides an exclusion for personal physical injuries or physical sickness. The exclusion applies to damages, other than punitive damages, received (whether by suit or agreement) "on account of" personal physical injuries or

physical sickness.¹¹ In 1995 the Supreme Court in *Commissioner v. Schleier*¹² enunciated a two-prong test for excludability.

First, the taxpayer must show that "the underlying cause of action giving rise to recovery is based upon tort or tort type rights." Second, the taxpayer must establish that the award received was "on account of" personal injuries or physical sickness.¹³ But in January 2012 the regulations abandoned the requirement that a recovery be based on a tort or tort type right.¹⁴

¹¹Section 104(a)(2). TRIA permits recovery of only compensatory damages; therefore, punitive damages cannot be recovered under TRIA. See section 201(a) of TRIA ("blocked assets of that terrorist party (including the blocked assets of any agency or instrumentality of that terrorist party) shall be subject to execution or attachment in aid of execution in order to satisfy such judgment to the extent of any compensatory damages for which such terrorist party has been adjudged liable"). Accordingly, the recovery consists of only compensatory damages — pain and suffering, economic damages, and solatium.

¹²515 U.S. 323, 336 (1995).

¹³*Id.* After the Supreme Court issued its opinion in *Schleier*, Congress amended section 104(a)(2) by adding the requirement that to be excluded from gross income, any amount received must be on account of personal injuries that are *physical* or sickness that is *physical*. See Small Business Job Protection Act of 1996, P.L. 104-188, section 1605. This amendment does not otherwise change the requirements of section 104(a)(2) or the analysis in *Schleier*. Rather, it imposes an additional requirement for an amount to qualify for exclusion from gross income under section 104(a)(2). See *Hansen v. Commissioner*, T.C. Memo. 2009-87. On January 23, 2012, the phrase "tort or tort type" rights was eliminated from reg. section 1.104-1(c)(1). However, the comment to that regulation states that the phrase was used to distinguish between damages from personal injuries and damages from breach of contract cases and that it was eliminated in part because of the phrase "on account of" in the second prong of *Schleier*. It appears that the language "underlying cause of action giving rise to recovery" has been undisturbed by the regulatory elimination. Today, reg. section 1.104-1(c)(1) still requires that recovery of damages from physical injuries be related to a suit or be in lieu of a suit. See *Perez v. Commissioner*, 144 T.C. 51 (2015). Further, courts have continued to apply the first prong of *Schleier* after January 23, 2012. See *Smallwood v. United States*, No. 12-00023 (C.D. Cal. 2012); *Molina v. Commissioner*, T.C. Memo. 2013-226; *Harris v. Commissioner*, T.C. Memo. 2012-333.

¹⁴T.D. 9573 (eliminating the phrase "tort or tort type rights"). See reg. section 1.104-1(c)(2), titled "Cause of action and remedies" ("The section 104(a)(2) exclusion may apply to damages recovered for a personal physical injury or physical sickness under a statute, even if that statute does not provide for a broad range of remedies. The injury need not be defined as a tort under state or common law."); see also reg. section 1.104-1(c)(1) cmt. ("The tort-type rights test was intended to distinguish damages for personal injuries from, for example, damages for breach of contract. Since that time, however, *Commissioner v. Schleier*, 515 U.S. 323 (1995), has interpreted the statutory 'on account of' test to exclude only damages directly linked to 'personal' injuries or sickness. Furthermore, under the 1996 Act, only damages for personal physical injuries or physical sickness are excludable. These legislative and judicial developments

(Footnote continued on next page.)

³Solatium is a form of compensation for emotional rather than physical or financial harm.

⁴28 U.S.C. section 1605A(c).

⁵28 U.S.C. section 1608(e).

⁶See, e.g., *United States v. Gilmore*, 372 U.S. 39, 49 (1963); *Hart v. Commissioner*, 313 U.S. 28 (1941).

⁷See *Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944); LTR 200108029.

⁸*Robinson v. Commissioner*, 102 T.C. 116, 126 (1994), *aff'd in part and rev'd in part*, 70 F.3d 34 (5th Cir. 1995); *Raytheon*, 144 F.2d at 113; and *State Fish Corp. v. Commissioner*, 48 T.C. 465, 474 (1967); *acq.* 1968-2 G.B. 3; *mod.*, 49 T.C. 13 (1967).

⁹Rev. Rul. 85-98, 1985-2 C.B. 51.

¹⁰*Id.*

For physical injury or death by a terrorist act, it should be easy to conclude that compensatory damages should be excludable under section 104.¹⁵ As noted, U.S. persons are precluded from initiating civil proceedings against foreign states because of foreign sovereign immunity,¹⁶ and traditional state causes of action, such as wrongful death, are therefore unavailable.

The FSIA provides an exception when a foreign state commits a terrorist act or materially supports the commission of a terrorist act that results in the injury or death of a U.S. national.¹⁷ The standard for what constitutes personal physical injuries remains confused and is often the subject of dispute in the Tax Court. There are some indications that the requisite physical injury may be minor, a kind of triggering event.

For example, in LTR 201311006 the IRS determined that several individuals who appeared to have suffered relatively minor injuries in a fire, such as cuts, scrapes, bruises, or smoke inhalation, could exclude their entire recoveries from gross income.¹⁸ The letter ruling quotes the following from a conference report expressing Congress's intention that damages for loss of consortium and wrongful death attributable to physical injury be excludable:

Damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from taxable income as under present law.¹⁹

There is unlikely to be much doubt that a serious physical injury or death from a terrorist act is within the scope of section 104. In some of these cases, there may even be court findings that the decedent experienced conscious pain and suffering before death. These damages, too, should be excludable, as they would be in a wrongful death suit.

Physical Injuries and Physical Sickness

Congress amended section 104(a)(2) in 1996 by adding the word "physical." Congress reiterated that it intended for section 104(a)(2) to exclude all

damages received on account of personal physical injuries or personal physical sickness:

*If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party.*²⁰ (Emphasis added.)

In *Schleier*, the Court held that a recovery for medical expenses, lost wages, and emotional distress is excludable as long as the damages resulted from actual injuries. Thus, in LTR 200121031 the IRS treated as fully excludable a recovery received by a woman after her husband's death from asbestos-related lung cancer arising from his job as a drywall installer.

The surviving spouse asserted claims against the manufacturer for compensatory and punitive damages for loss of consortium and wrongful death. The IRS reasoned that the husband's death was the result of physical diseases from exposure to asbestos. The diseases were the proximate cause of the wife's claims, and there was a direct link between the injury and the damages.

The FSIA is the exclusive basis for subject matter jurisdiction over all civil actions against a foreign state defendant.²¹ When a valid judgment has been entered against a foreign state under the FSIA, property is immune from attachment and execution except as provided in the rules under 28 U.S.C. sections 1610 and 1611,²² which incorporate TRIA.

Under section 201(a) of TRIA, the blocked assets of the judgment-debtor or its instrumentalities are subject to attachment and execution proceedings to satisfy a judgment for which there was original jurisdiction under the FSIA. The courts have subject matter jurisdiction over post-judgment attachment and execution proceedings against property held by instrumentalities of the judgment-debtor, even when the instrumentality is not named in the judgment.²³

The FSIA provides a procedure for plaintiffs to receive damages, and TRIA gives plaintiffs a method to recover compensatory damages from those awards. Viewed in this light, a recovery should fall squarely within the framework of section 104(a)(2).

After all, section 104(a)(2) provides for excluding damages on account of personal physical injury or

have eliminated the need to base the section 104(a)(2) exclusion on tort cause of action and remedy concepts.").

¹⁵28 U.S.C. section 1605A(c).

¹⁶28 U.S.C. section 1604.

¹⁷28 U.S.C. section 1602 et seq.

¹⁸For further discussion of LTR 201311006, see Wood, "Cut or Bruise Can Yield Tax-Free Damages," *Tax Notes*, July 1, 2013, p. 79.

¹⁹H.R. Conf. Rep. No. 104-737, at 301 (1996).

²⁰*Id.*

²¹28 U.S.C. section 1602; see *Argentine Republic v. Amerada Hess Shipping Corp.*, 488 U.S. 428, 443 (1989).

²²28 U.S.C. section 1609.

²³See *Weinstein v. Islamic Republic of Iran*, 609 F.3d 43, 50 (2d Cir. 2010).

personal physical sickness “whether by suit or agreement and whether as lump sums or as periodic payments.” LTR 200942041 demonstrates that a recovery from a third party may be excludable under section 104(a)(2) when the payment represents compensatory damages for personal physical injuries or personal physical sickness.

As noted, reg. section 1.104-1(c) eliminated the tort or tort type rights requirement. Before that change, the IRS issued several private letter rulings concluding that wrongful death recoveries received from third parties on account of personal physical injuries were excludable under section 104(a)(2) if the origin of the underlying action was based in tort.²⁴

For example, in LTR 200942041 a taxpayer initiated proceedings against Entity 1 for wrongful death in year 1. A court granted summary judgment in favor of the taxpayer in year 2. The taxpayer was awarded a recovery for compensatory damages, prejudgment interest, and punitive damages in year 3.

While the award was on appeal, the taxpayer sold the rights to a portion of the award for an immediate cash payment from a third party. However, Entity 2 later passed an act to provide fair compensation to all claimants with wrongful death claims against Entity 1 through a comprehensive settlement of those claims. The act voided the taxpayer’s damage award against Entity 1.

After an agreement between Entity 1 and Entity 2, Entity 1 made a payment to Entity 2. Under the act, the taxpayer was required to file a claim to recover damages for wrongful death with the department of Entity 2. In its ruling, the IRS focused on the origin of the taxpayer’s claim. It found that the claim the taxpayer would file under department procedures sought recovery of damages for wrongful death attributable to physical injury.

Even though the act voided the taxpayer’s damage award, the IRS ruled that the taxpayer’s payment from a third party was excludable under section 104(a)(2). The IRS also concluded that the amount the taxpayer would receive from the department of Entity 2 for the wrongful death claim against Entity 1 was excludable under section 104(a)(2). LTR 200942041 is consistent with other authorities that focus on the origin of the claim

when determining whether a taxpayer may exclude his damages under section 104(a)(2).²⁵

Damages Recovered Under a Statute

Reg. section 1.104-1(c)(2) states that section 104(a)(2)’s “exclusion may apply to damages recovered for a personal physical injury or physical sickness under a statute, even if that statute does not provide for a broad range of remedies.” The IRS might look solely at the attachment and execution proceeding permitted under TRIA to determine if the recovery relates to personal physical injuries or physical sickness. Section 201(a) of TRIA states:

Notwithstanding any other provision of law, and except as provided in subsection (b), in every case in which a person has obtained a judgment against a terrorist party on a claim based upon an act of terrorism, or for which a terrorist party is not immune under section 1605(a)(7) of title 28, United States Code, the blocked assets of that terrorist party (including the blocked assets of any agency or instrumentality of that terrorist party) *shall be subject to execution or attachment in aid of execution in order to satisfy such judgment to the extent of any compensatory damages for which such terrorist party has been adjudged liable.* (Emphasis added.)

In many of these unusual cases, the recovery will be obtained from an attachment and execution of a terrorist group’s blocked assets under TRIA. In that sense, the recovery is likely to be collected as required by the FSIA to partially satisfy a judgment. A judgment awarding compensatory damages on account of personal physical injuries, physical sickness, or death is simply being collected in an unusual and arcane manner through TRIA.

Conclusion

To return to where we began, should the families of terrorism victims be able to collect damages tax free, even when they collect not in a traditional tort case but through the FSIA and TRIA? Tax law asks: What is the payment being made “on account of?” A chain of unusual legal proceedings may start with the physical injury or death.

Thereafter, one may need to follow the nuances of remedy statutes that allow claimants to pursue wrongdoers under the FSIA. In the end, however, the payment to the plaintiff is ultimately being made on account of personal physical injury or

²⁴See LTR 201024041; LTR 201025027; LTR 201022010; and LTR 201024025 (all based on the same initial litigation and subsequent act and all concluding that the payments are excludable under section 104(a)(2)).

²⁵See ILM 201045023 (“The compensatory damages that the individual receives are excluded from gross income whether the individual receives the compensation in a lump sum, periodic payments, or a factoring transaction.”); see also LTR 8831021.

death. That is pivotal, and it means that these damages — however they are collected — should be tax free.

The remaining issues should be whether interest or punitive damages are being paid. They may or may not be, depending on the specific case. Interest and punitive damages may be taxable, even if compensatory damages for the physical injury or death are not.