



June 15, 2006
Pennsylvania Personal Income Tax
No. PIT-06-007
IRA Losses – Goodwill Payment

ISSUE

Is a payment that an investment company provided Taxpayer subject to Pennsylvania Personal Income Tax when the investment company made the payment in response to Taxpayer's notification that he intended to file complaints with the Security Exchange Commission, the Pennsylvania Securities Commission and the National Association of Securities Dealers because of the investment company's actions involving his rollover Individual Retirement Account (IRA)?

CONCLUSION

Since the investment company payment covers losses in Taxpayer's IRA, the payment is subject to Pennsylvania Personal Income Tax if, at the time the investment company made the payment, Taxpayer was less than age 59 ½ or he was not retired.

FACTS

Taxpayer received a check in 2005 from the investment company as a result of a complaint he made against the investment company, the investment company's broker, and the investment company's manager. Taxpayer told the investment company that he intended to file complaints with the Security Exchange Commission, the Pennsylvania Securities Commission, and the National Association of Securities Dealers because he attributed the losses he incurred in his rollover IRA to the investment company's unsuitable investment recommendations, its investment broker's breach of fiduciary duty, and the investment company manager's failure to supervise.

The check Taxpayer received was described as being "in the interest of goodwill and not an admission of liability." The investment company issued Taxpayer a Form 1099 and reported the payment as Miscellaneous Income.

DISCUSSION

Section 302 of The Tax Reform Code of 1971 (the Pennsylvania Income Tax Law) provides that every resident and nonresident individual, estate, or trust shall pay an income tax for the privilege of receiving income in any of the following eight income classes: (i) compensation, (ii) net profits, (iii) net gains or income from the disposition of property, (iv) dividends, (v) interest, (vi) net gains or income from trusts or estates, (vii) gambling and lottery winnings other than Pennsylvania State Lottery winnings, and (viii) net gains or income derived from or in the form of rents, royalties, patents, or copyrights. Income that an individual enjoys or acquires from sources other than one of these eight classes avoids taxation.

The Pennsylvania Income Tax Law is silent in regard to whether amounts received in connection with a court judgment, lawsuit, or out-of-court settlement are taxable under any of the income classes in the law. 72 P.S. § 7303(a) (1). Because the Pennsylvania Income Tax Law does not expressly address court-awarded damages or payments received in connection with lawsuits or settlements, the Department follows the practice used by the Internal Revenue Service and the Federal courts to characterize or determine the nature of the income received from these sources.

Consequently, the Commonwealth reviews the court's judgment, the out-of-court settlement, the statutory provisions authorizing the taxpayer's claim, or any other legal basis for the action or claim to determine "in lieu of what was the settlement amount [judgment or compensation] paid?" *Leslie R. Foster v. Commissioner*, T.C. Memo 1996-276 (1996), *aff'd. per curiam*, 139 F.3d 899 (5th Cir. 1998); *Lyeth v. Hoey*, 305 U.S. 188 (1938). In *Francisco v. United States*, the Third Circuit Court used a similar analysis to determine what portion of a personal injury case settlement was subject to tax because it should be allocated to delay damages.^[1] The Court stated:

We are unable to divine a meaningful distinction between postjudgment interest and delay damages. Both compensate the plaintiff for the delay in payment of the principal - the jury's damage award.... [D]elay damages or prejudgment interest should be taxable in the same way as postjudgment interest.

Francisco v. United States, 267 F.3d 303, 316 (3d Cir. 2003).

Thus, whether the payment is made pursuant to a settlement agreement, court judgment, or other type of compromise, an analysis must be made to determine whether the payment is a substitute for income that would have been included in one of the eight classes of income subject to Pennsylvania Personal Income Tax.

The investment company's payment to Taxpayer stems from Taxpayer's having sustained losses in his rollover IRA, and the investment company's payment presumably reduces Taxpayer's IRA losses. Thus, the payment replaces the monies that Taxpayer lost in his IRA. Since contributions to an IRA are subject to Pennsylvania Personal Income Tax when made, an early IRA distribution is subject to tax only to the extent of Taxpayer's earnings in the account, and the taxable amount is determined using the cost recovery method of accounting. Under the cost recovery rule, no income is recognized with respect to distributions until the account holder has enjoyed a full recovery of his investment.

If Taxpayer was retired from full time employment and was at least age 59 ½ when he received the investment company's payment, the distribution is not subject to Pennsylvania Personal Income Tax because the State Income Tax Law does not tax distributions from old age or retirement accounts. 72 P.S. § 7301(d); 61 Pa. Code § 101.6(c)(8)(iii).

On the other hand, if the payment was received prior to Taxpayer's retirement or his having reached age 59 ½, the payment is subject to tax. The taxable portion of the payment would be determined by using the cost recovery method of accounting.

61 Pa. Code
§ 101.6(c)(8)(iii)(B).

^[1] Mr. Francisco was injured in an automobile accident, and the jury awarded him damages on account of his injuries, and the court added delay damages to the award under Pennsylvania Rule of Civil Procedure 238. While this case was on appeal, the parties executed a settlement agreement. The Internal Revenue Service argued that a portion of Mr. Francisco's settlement included delay damages which are not deductible under Section 104 of the I.R.C. Section 104 permits a deduction for damages received on account of personal injury. I.R.C. § 104(a) (2).