***Hi Life Products, Inc. v. Commissioner*, T.C. Memo. 1991-56 (1991)**

Payments made by a corporation to settle a shareholder-employee's personal injury claim are deductible as ordinary and necessary business expenses under Section 162(a) and excludable from the shareholder-employee's gross income under Section 104(a)(2) if the settlement is bona fide and based on a legitimate legal claim, even in a closely held corporation context.

Summary

Hi Life Products, Inc., a closely held corporation, paid $122,500 to its president and majority shareholder, Peter Maxwell, to settle a personal injury claim. Maxwell sustained serious injuries while operating a mixing machine at Hi Life. Hi Life deducted the payment as a business expense, and Maxwell excluded it from his income as damages for personal injuries. The IRS argued the payment was a disguised dividend and not deductible or excludable. The Tax Court held that the payment was indeed for personal injuries, deductible by Hi Life, and excludable by Maxwell, emphasizing the legitimacy of the legal claim and the reasonableness of the settlement, despite the close relationship between the parties.

Facts

Peter Maxwell, president and majority shareholder of Hi Life Products, Inc., was injured on March 9, 1977, while operating a mixing machine at Hi Life. The machine was defectively assembled, and Maxwell's sweater sleeve caught on a protruding bolt, causing severe injuries. Hi Life had excluded its officers, including Maxwell, from workers' compensation coverage to reduce premiums. Maxwell consulted an attorney who sent a demand letter to Hi Life, asserting claims based on negligence and Hi Life's failure to secure workers' compensation. Hi Life's attorney advised settlement. Hi Life's board of directors (excluding Maxwell) approved a $122,500 settlement, which was stipulated to be the reasonable value of Maxwell's injuries. Hi Life deducted this payment as a business expense, and Maxwell excluded it from his income.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Hi Life's corporate income tax and Peter and Helen Maxwell's individual income tax. Hi Life and the Maxwells petitioned the Tax Court for redetermination. The cases were consolidated.

Issue(s)

1. Whether Hi Life Products, Inc., is entitled to deduct the $122,500 payment to Peter Maxwell as an ordinary and necessary business expense under Section 162(a).
2. Whether Peter Maxwell is entitled to exclude the $122,500 payment from gross

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income as damages received on account of personal injuries under Section 104(a)(2).

Holding

1. Yes, Hi Life is entitled to deduct the $122,500 payment because it was a legitimate settlement of a personal injury claim and thus an ordinary and necessary business expense.
2. Yes, Peter Maxwell is entitled to exclude the $122,500 payment from gross income because it was received as damages on account of personal injuries.

Court's Reasoning

The court scrutinized the transaction due to the close relationship between Hi Life and Maxwell but found the settlement to be bona fide. The court reasoned that:

- Maxwell sustained genuine and serious injuries while employed by Hi Life.
- The stipulated reasonable value of the injuries was $122,500.
- Both Maxwell and Hi Life sought independent legal counsel. Maxwell's attorney presented a reasonable legal theory for recovery based on California Labor Code, particularly Hi Life's failure to secure workers' compensation for officers. The court noted, "*Attorney Pico's interpretation of Labor Code section 3351(c) was that officers and directors are considered employees of private corporations under the California Workers' Compensation Act, unless all of the shareholders are both officers and directors.*"
- Hi Life's attorney advised that settlement was reasonable given the circumstances and applicable California law.
- The court found reliance on legal counsel to be reasonable, citing *Old Town Corp. v. Commissioner*, 37 T.C. 845 (1962). The court stated, "*A taxpayer, acting in good faith with the intention of compromising a potential claim which he reasonably believes has substance, should not be denied a business deduction even if the facts finally indicate that it was unnecessary to pay the settlement.*"
- While tax considerations were a factor, the underlying transaction was grounded in a legitimate personal injury claim. The court referenced *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), stating, "*Taxpayers have the legal right to decrease taxes, or avoid them altogether, by means which the law permits. The question is whether what was done, apart from the tax motive, was the thing which the law intended.*"

Practical Implications

Hi Life Products provides guidance on the tax treatment of settlement payments in closely held corporations, particularly concerning shareholder-employees. It clarifies that:

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- Settlements of legitimate personal injury claims are deductible business expenses and excludable from income, even when paid to shareholder-employees.
- Close scrutiny is expected in related-party transactions, but bona fide settlements based on reasonable legal claims, supported by independent legal advice, will be respected.
- Tax planning is permissible, and the presence of tax motivations does not automatically invalidate an otherwise legitimate transaction.
- This case emphasizes the importance of seeking and relying on advice from legal counsel when settling potential liabilities, especially in situations involving related parties.

This ruling is relevant for tax attorneys advising closely held businesses and shareholder-employees on personal injury claims and settlement strategies, ensuring that settlements are structured to achieve favorable tax outcomes without jeopardizing their legitimacy.

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