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May 2, 2023

VIA EMAIL

Kalima Claims Administrator
P.O. Box 135035
Honolulu, Hawai'i 96801

Re: Tax Treatment of Recoveries of Kalima Class Members

Dear Claims Administrator:

You requested our opinion on the federal income tax treatment of amounts ("Settlement Payments") distributed to members of the Waiting List Subclass (the "Waiting List Plaintiffs") in satisfaction of their claims in the legal action captioned *Leona Kalima, et al. v. State of Hawai'i, et al.*, Civil No. 99-4771-12 LWC (the "Litigation"). You were appointed as the Claims Administrator to perform the claims administration process and supervise the distribution of the Settlement Payments pursuant to the Court approved Distribution Plan. This opinion letter focuses on the extent to which the Settlement Payments may be excluded from the Waiting List Plaintiffs' incomes for federal income tax purposes. This letter is organized into the following Sections: I. Facts and Assumptions; II. Issues; III. Conclusions; IV. Discussion; V. General Conditions; and Exhibit A.

I. FACTS AND ASSUMPTIONS

The documents we reviewed in preparing this letter are listed in **Exhibit A**. Our legal opinion is based on our understanding of the facts as detailed below.

A. The Land Trust and related Legislation.

In 1920, Congress enacted the Hawaiian Homes Commission Act (the "1920 Act"). The 1920 Act set aside approximately 203,500 acres in trust (the "Land Trust") to be used to rehabilitate displaced Native Hawaiian people. The 1920 Act authorized the Land Trust to *lease* land to Native Hawaiians for residential, agricultural, or pastoral purposes for $1 per year. The lease rent payment was for an improved lot with infrastructure. Beneficiaries given residential awards had to construct their own houses and

beneficiaries given agricultural and pastoral awards had to install all additional infrastructure (fences, watering systems, etc.)

When Hawai'i was formally admitted as a state in 1959, the United States retained approximately 35,000 acres, primarily for use as military bases and national parks. The balance, including the land in the Land Trust, were transferred to the government of the State of Hawai'i (the "State"), where they largely remain today. Article 12.1 of the Hawaiian Constitution adopts the 1920 Act as a provision of Hawaiian Constitutional law.

Since its inception, it appears by most accounts that the Land Trust was severely mismanaged. Among the many complaints of Native Hawaiians regarding the administration of the Land Trust was that the Land Trust took unreasonably long to consider and approve applications for residential, agricultural, and pastoral leaseholds and placed beneficiaries on a Waiting List to receive their homestead awards.

It was not uncommon for it to take a decade or more for an application for a leasehold to be considered and approved. During this time, applicants had to continue to lease property at market rates rather than enjoy the $1 per year lease rate they would enjoy if their application were approved. After decades of complaints, the Hawai'i government enacted the Native Hawaiian Judicial Trusts Relief Act, which created an *exception* from sovereign immunity for Native Hawaiians seeking redress for the mismanagement of the Land Trust.

Further legislation, the "Individual Claims Resolution Under the Hawaiian Home Lands Trust Act," (the "1991 Act") was enacted in 1991 to create formal processes for plaintiffs to bring suit regarding the Land Trust. The 1991 Act specified that sovereign immunity was waived only with regard to "actual damages." "Actual damages" is defined in the 1991 Act to *exclude* noneconomic damages and consequential damages.

C. The Litigation.

The Litigation began in 1999 as a class action on behalf of all similarly situated Native Hawaiians. The class was certified in 2000, and that certification was confirmed on appeal to the Supreme Court of Hawai'i in 2006. In 2007, the circuit court approved sub-classes of plaintiffs within the plaintiff class, including a sub-class of waiting list plaintiffs ("Waiting List Plaintiffs"). The Waiting List Plaintiffs are plaintiffs who had to pay market rents in excess of the $1 they would have paid under the 1920 Act as a result of the Land Trust's delays processing applications.

After a trial, the circuit court issued a decision in 2009 regarding the State's liability to the Waiting List Plaintiffs (the "2009 Liability Decision"). The 2009 Liability Decision found that the State breached its duties as trustee of the Land Trust and that the breaches proximately resulted in damages to the entire Waiting List subclass, of which all plaintiffs were members. Since the 2009 Liability Decision, most of the development

in the Litigation has centered on developing and approving a model for calculating the Waiting List Plaintiffs' damages.

Most of the disagreement involved the appropriate statistical method for calculating a 'typical' fair market rent paid by a plaintiff in each year. There were also disagreements about potential bases to deny plaintiffs' damages for some or all years. In 2020, the Hawai'i Supreme Court approved a methodology for calculating the Waiting List Plaintiffs' damages (the "2020 Damages Decision"). This methodology allows damages to be calculated under one of two methods.

As a default method, damages would be calculated by measuring the amount that the fair market rental value (produced through statistical analysis) of a 5,000-square-foot lot in Māʻili (selected as being a lot of *conservative-to-typical* size and value that would be leased under the 1920 Act) exceeded the $1 annual rent that would have been paid under the 1920 Act. Once a plaintiff's damages period begins, the damages are calculated for each year they were not approved for a leasehold under the 1920 Act.

The 2020 Damages Decision acknowledged that this method is not an exact calculation of the amount of additional rent paid by each Waiting List Plaintiff. Because of the length of delays, the Court found that it would not be possible for all plaintiffs to reconstruct the actual amount of rent they had paid over a potentially several-decade long wait time. Nevertheless, the Hawaiʻi Supreme Court found that exactitude is not required, and that this default method produced reasonably accurate results and could be applied consistently among all class members.

Moreover, as the alternative method, if a Waiting List Plaintiff could demonstrate that the rent they paid *exceeded* the figures produced under the default model, the 2020 Damages Decision provides that such plaintiffs are entitled to recover their demonstrated actual damages. The 2020 Damages Decision confirmed that the State had the burden of proving why a Waiting List Plaintiff should[1] not be entitled to damages for any particular year if the Waiting List Plaintiff otherwise satisfies the requirements for damages.

The 2020 Damages Decision affirms the lower courts' determination that plaintiffs are not entitled to the *present value* of previous years' additional rent (*i.e.*, adjusting for inflation), but are instead only entitled to the value of the rent using contemporaneous values for a lot with infrastructure for each relevant year. The Hawai'i Supreme Court agreed with the circuit court that increasing damages to reflect their present values effectively constitutes a payment of interest. Prejudgment interest is disallowed in litigation against the State under Hawaiian law. Moreover, under Hawaii law, interest is

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[1] This letter contains certain words and terms, such as "should" or "will," for illustrative and grammatical purposes only. Any such use of the word "should" or "will" is not intended to be read in a technical sense under the legal standards applicable to tax opinions, as defined by IRS regulations governing tax practice. This letter offers no opinion or confidence level other than that expressly described in Section III.

generally considered a consequential damage rather than an actual damage, and the 1991 Act specifically retained sovereign immunity with regard to claims for consequential damages.

As part of the decisions and appeals that resulted in the 2020 Damages Decision, the circuit court issued an order on July 26, 2017, that provided that a Claims Administrator would be appointed to oversee the calculation and administration of the Settlement Payments.

C. Construction Cost Damages.

Some Waiting List Plaintiffs made claims for reimbursement of construction costs they incurred (the “Construction Cost Damages”). Because Waiting List Plaintiffs were not able to lease their homes through the Land Trust, some purchased or rented other land for use as their homes. Many of these other properties contained buildings that were poorly built or otherwise in poor condition.

As a result, some Waiting List Plaintiffs had to incur out-of-pocket expenses to repair or rebuild the structures to make them suitable for occupancy, the Construction Cost Damages. The Construction Cost Damages would not have had to be incurred by the Waiting List Plaintiffs if they were able to lease habitable homes from the Land Trust.

D. The Settlement Agreement.

One June 2, 2022, the Waiting List Plaintiffs, through their counsel, Mr. Carl M. Varady and Mr. Thomas R. Grande, signed a settlement agreement with the Attorney General of Hawai’i, the Honorable Holly T. Shikada (the “Settlement Agreement”). The Settlement Agreement provides for a total settlement amount of $328,000,000 (the “Class Settlement Amount”), to be divided between all Waiting List Plaintiffs, their counsel, and the costs of claims administration.

The Settlement Agreement was preliminarily approved by Judge Lisa W. Cataldo on June 9, 2022 (the “Preliminary Approval”). The Preliminary Approval requires that you and the Waiting List Plaintiffs’ class counsel prepare and obtain court approval for a payment distribution plan consistent with the 2020 Damages Decision. We understand that you and the parties to the Litigation are currently developing a distribution plan and other apparatus to administer the Waiting List Plaintiffs’ claims. The distribution plan will include compensation to some Waiting List Plaintiffs for their Construction Cost Damages.

After the notice and calculations portions of the claims administration process is completed, the court will hold a hearing to provide final approvement of the Settlement Agreement. This hearing will occur on July 21, 2023. For the purposes of this opinion letter, we have assumed that the final, court-approved payment distribution plan will be

substantially identical to the draft plan provided to us. In particular, we have assumed that it will retain language similar to the following:

> Settlement payments claims made pursuant to this Payment Distribution Plan are made for "actual damages" as that term is defined in HRS § 674-2 and specifically exclude noneconomic damages, including damages for pain and suffering, personal injury, consequential damages and punitive damages pursuant to HRS § 674-17 and specifically excludes interest pursuant to *Kalima v. State of Hawai'i* [*viz.* the 2020 Damages Decision].[2]

We understand that the Class Settlement Amount will be held in a Qualified Settlement Fund to be established under Section 468B of the Internal Revenue Code[3] until distributed (the "QSF"). On July 11, 2020, the State of Hawaii enacted legislation, Act 280, to approve the Settlement Agreement and to agree to provide the Class Settlement Amount.

II. ISSUES

You have requested our opinion concerning the application of federal income tax law to Settlement Payments to the Waiting List Plaintiffs. Specifically, you have asked whether the Waiting List Plaintiffs may exclude the Settlement Payments from their respective gross incomes for federal income tax purposes.

You have also asked us whether the QSF is required to issue IRS Forms 1099 to the Waiting List Plaintiffs in connection with the Settlement Payments. For purposes of this opinion, we have assumed that the QSF will be duly qualified and properly treated as a Qualified Settlement Fund, as defined in Section 468B and the accompanying Treasury Regulations.

III. CONCLUSIONS

Section V of this opinion letter includes an explanation of the applicable federal income tax standards for legal opinions. Bearing those standards in mind, it is our opinion that the Claims Administrator has a reasonable basis to treat the Waiting List Plaintiffs' respective Settlement Payments as presumptively excludible from their respective gross incomes. It is possible that some of the Waiting List Plaintiffs may owe federal income tax on account of previously claimed tax deductions for the rent they paid, which are now being reimbursed under what is known as the tax benefit rule.

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[2] Draft Distribution Plan (Jan. 31, 2023).

[3] Except as noted to the contrary, all references to "Section" or "§" herein apply to the Internal Revenue Code of 1986, as amended ("I.R.C." or "Code"), or the Treasury Regulations promulgated thereunder.

However, neither you nor we are aware whether any Waiting List Plaintiffs claimed any tax deductions for rents previously claimed, or the amount of any such deductions. For Form 1099 reporting purposes, the Claims Administrator is generally allowed to disregard potential income tax consequences under the tax benefit rule when determining whether you are required to issue Forms 1099. Consequently, we believe that the Claims Administrator has a reasonable basis to conclude that it is not required to issue Forms 1099 to the Waiting List Plaintiffs for any amount, notwithstanding the possibility that some Waiting List Plaintiffs could owe tax as a result of the tax benefit rule. Our conclusions are based on the facts, assumptions, and analysis contained throughout this letter, and on our review of the documents listed in **Exhibit A**.

IV. DISCUSSION

A. Origin of the Claim Doctrine.

In general, the origin of the claim controls the tax treatment of a litigation recovery, whether it is received as a result of a settlement or a judgment.[4] To determine the origin of the claim, courts and the Internal Revenue Service ("IRS") ask in lieu of what the damages were awarded.[5] The determination of the origin of the claim is factual and is made by reference to the issues raised in the complaint, litigated, and resolved in a verdict or settlement.[6]

The IRS and the courts generally view the complaint as the most persuasive evidence of the origin of the claim.[7] However, the IRS and the courts also look to the other documents.[8] Here, the documents in the Litigation are clear and are in accord about the purpose and nature of the Settlement Payments.

The Litigation documents reflect that the Settlement Payments are intended to compensate Waiting List Plaintiffs for their actual damages: the additional land rent

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[4] *See, e.g.*, *United States v. Gilmore*, 372 U.S. 39, 49 (1963); *Hart v. Comm'r*, 313 U.S. 28 (1941).

[5] *See Raytheon Prod. Corp. v. Comm'r*, 144 F.2d 110, 113 (1st Cir. 1943); *cert. denied,* 323 U.S. 779 (1944); Priv. Ltr. Rul. 200108029 (Nov. 24, 2000). Throughout this letter, IRS Private Letter Rulings and other pieces of IRS written guidance are mentioned. Technically, such written guidance does not constitute precedent, although even the United States Supreme Court has cited Private Letter Rulings. *See Rowan Cos. Inc. v. United States*, 452 U.S. 247 (1981). Such rulings reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws. *See Hanover Bank v. Comm'r*, 369 U.S. 672, 686 (1962).

[6] *Robinson v. Comm'r*, 102 T.C. 116, 126 (1994), *aff'd in part, rev'd in part,* 70 F.3d 34 (5th Cir. 1995); *Raytheon Prod. Corp. v. Comm'r*, 144 F.2d 110, 113 (1st Cir. 1943); *State Fish Corp. v. Comm'r*, 48 T.C. 465, 474 (1967); *acq*. 1968-2 G.B. 3; mod., 49 T.C. 13 (1967).

[7] Rev. Rul. 85-98, 1985-2 G.B. 51 (1985).

[8] Rev. Rul. 85-98, 1985-2 G.B. 51 (1985).

they already paid on account of not receiving a leasehold under the 1920 Act that would have only required them to pay $1 of rent annually and their actual Construction Cost Damages. Indeed, the 1991 Act, the 2020 Damages Decision, and the draft payment distribution plan we have seen specifically exclude other damages, including consequential damages, non-economic damages, interest, or punitive damages.

The methodology for calculating damages approved by the Hawai'i Supreme Court in the 2020 Damages Decision is clearly intended to calculate the additional land rent paid by the Waiting List Plaintiffs on account of the delay in processing their applications under the 1920 Act. Their actual damages are calculated by determining a reasonable approximation of the land rent they likely paid in a given year, based on a statistical model, and subtracting the $1 of rent they would have paid if they had been granted a leasehold by the Land Trust.

Although this statistical model does not reproduce the exact amount of rent each plaintiff actually paid in a year, it is intended to calculate a close and plausible approximation. Accordingly, it seems clear that the Settlement Payments are intended to reimburse Waiting List Plaintiffs for their actual rental expenses and actual Construction Cost Damages that resulted from Hawai'i's unreasonable delay processing applications.

B. <u>Accessions to Wealth and Tax-Free Reimbursements</u>.

The Supreme Court has defined gross income for federal tax purposes to include "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[9] As a result of this fundamental requirement for income recognition, amounts that do not represent an accession to wealth are not taxable income to a taxpayer. For example, repayment of a loan's principal does not create taxable income to the lender, because the lender is not made wealthier by having money they previously possessed returned to them.[10]

It is settled law that a taxpayer recognizes income when he is reimbursed for personal expenses.[11] That is, when a person obtains reimbursement for a liability they created themselves, they experience an "accretion to wealth" because they are effectively spared from having to spend money that they would otherwise be obligated to spend. However, when a party reimburses another party for expenses incurred by the recipient

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[9] *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955) (holding that income for tax purposes must necessarily involve some accession to wealth).

[10] *See Meyers v. Comm'r*, T.C.M. 1968-289, *aff'd per curiam*, 435 F.2d 171 (3d Cir. 1970).

[11] See Old Colony Trust Co. v. Comm'r, 279 U.S. 716 (1929); Comm'r v. Jacobson, 3365 U.S. 28 (1949).

on behalf of the payor (and outside of the employment context), the IRS has ruled on several occasions that such a reimbursement is *not* taxable to the recipient.[12]

In such cases, the payor is merely satisfying its own liability. The recipient is only being restored to the same financial position he or she would have been in had the payor not created the liability in the first place, and is no wealthier. In order for reimbursement to be tax-free, the liability does not need to be identified by any contract or agreement as being a liability of the payor. Instead, the payor's responsibility can also derive from tort law or a sense of moral obligation.

This often occurs when the liability to the recipient was caused by the payor's mistake or negligence. Thus, for example, when a tax preparer reimburses a client for the additional tax the client owes as a result of the tax preparer's mistakes drafting the client's tax returns, the predecessor to the Tax Court ruled that the reimbursement was not taxable income to the client.[13] Although the tax preparer may not have been subject to any agreement that formally obligated him to pay the client's taxes, and the client could not be said to be paying the IRS "on behalf of" the tax preparer in any formal sense, the liability being reimbursed was nevertheless the tax preparer's fault, and the tax preparer's responsibility.

Often this type of payment arises in connection with government payments to private citizens intended to compensate the private citizens for expenses they incur providing services that the government was obligated to provide. For example, in Revenue Ruling 57-60, a local government compensated parents for transportation expenses the parents incurred transporting their children to school when government-provided school bussing was not provided. Although transporting one's children to their school is a personal expense, it is also an obligation of the government to provide transportation to schools. Therefore, the IRS ruled that the reimbursement was tax-free to the parents.

In Revenue Ruling 60-280, the IRS later clarified its reasoning in Revenue Ruling 57-60: "[T]he exclusion is based on the fact that the reimbursement is for an expense incurred on behalf of the school board which was obligated to furnish transportation to the school children." The IRS has more recently issued a similar ruling, also relating to compensating parents for transportation expenses to school, in Private Letter Ruling 201035004,[14] indicating the reasoning of the Revenue Ruling has not changed.

Under the 1920 Act, the federal government (now the State of Hawai'i) had an obligation to process applications and to provide qualifying Native Hawaiians with leases for residential, agricultural, and pastoral lands for $1 per year. Because the

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[12] *See e.g.,* Rev. Rul. 57-60, 1957-1 C.B. 25, *as modified by* Rev. Rul. 60-280, 1960-2 C.B. 12; Rev. Rul. 67-30, 1967-1 C.B. 9; Rev. Rul. 80-99, 1980-1 C.B. 10.

[13] *See Clark v. Comm'r*, 40 B.T.A. 333 (1939).

[14] September 3, 2010.

government entities failed to fulfill their obligations, Native Hawaiians had to acquire their own leases at higher, market rates, and, in some cases, pay out of pocket expenses to make their alternative housing habitable.

Therefore, the Settlement Payments reimburse Native Hawaiians for expenses (*i.e.,* the cost that the leases exceed $1 per year) and the Construction Cost Damages that were obligated under relevant law to be borne by the government. Similarly to the parents in Revenue Ruling 57-60 and its progeny, the Native Hawaiians are not being made wealthier by their Settlement Payments. They are merely being restored to the financial position they would have been had the federal and Hawaiian governments properly fulfilled their obligations under law.

C. The Tax Benefit Rule.

Notwithstanding the discussion above regarding the tax-free treatment of certain reimbursements, a reimbursement is taxable income *if* the taxpayer previously deducted the amount being reimbursed in their tax reporting *and* that deduction produced a "tax benefit" to the taxpayer (*e.g.,* reduced their tax liability for the year of deduction).[15] The principal behind this rule is that it is generally inappropriate to claim a deduction for an expense that has been reimbursed.

Therefore, if an expense is incurred and deducted, and the expense is reimbursed in a later tax year, the taxpayer must reimburse the Treasury for the tax avoided as a result of the inappropriately claimed deduction. Rather than require the taxpayer to amend the previous year's tax return to remove the deduction (which may be impossible due to the statute of limitations), Section 111 instead requires the taxpayer to treat the otherwise tax-free reimbursement as taxable income to the extent the previous deduction provided a tax benefit.

For the majority of Waiting List Plaintiffs who were seeking residential leases, the tax benefit rule is likely of little or no consequence. A lease for payment of land for a personal residence is a personal expense, and personal expenses are generally non-deductible under Section 262 of the Code. Because individuals are not allowed to deduct the rent on their land or their homes, the tax benefit rule generally would not apply to any reimbursement of rent for their land or their homes.

Nevertheless, we also understand that some of the Waiting List Plaintiffs are receiving recoveries for delays providing them agricultural or pastoral leases. Because their lease payments may be business expenses rather than personal expenses, it is possible that they may have previously deducted their rent when paid. Consequently, they are more likely to trigger the tax benefit rule, requiring them to treat part of their Settlement Payments as taxable income.

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[15] I.R.C. § 111; Treas. Reg. § 1.111-1.

Similarly, construction costs are generally considered capital expenditures that must be capitalized into the taxpayer's basis of the property. Taxpayers are disallowed from deducting capital expenditures.[16] Therefore, it seems unlikely that the Construction Cost Damages were previously deducted by Waiting List Plaintiffs.

Refunds or returns of a taxpayer's adjusted tax basis do not result in taxable gain.[17] Nevertheless, it is possible that a Waiting List Plaintiff already recovered the basis created by their construction cost expenditures, for example, through a sale of the property. Payments for properties that *exceed* the taxpayer's adjusted tax basis result in taxable gain to the taxpayer.[18] Therefore, it is possible that a Waiting List Plaintiff who receives Construction Cost Damages may have taxable gain on that payment if they have already been reimbursed for those costs through other means (*e.g.*, a sale of the property) and do not have sufficient adjusted tax basis in the property to absorb the Construction Cost Damages payment.

D. The General Welfare Exception.

The general welfare exception is an exception to gross income that originates from IRS fiat rather than from any provision of statutory or Constitutional law. Consequently, it is difficult to predict with any reasonable certainty when the IRS will conclude that a type of payment will be excluded from income under the general welfare exception. Nevertheless, certain types of payments are more likely to be treated tax-free than other types of payments.

The general welfare exception is usually traced by commentators and the IRS to a series of rulings the IRS issued in 1938 that ruled, without citing any explanation that payments under the newly enacted Social Security Act[19] would be tax-free to recipients[20]. In 1975,[21] the IRS considered its previous rulings and its authority to exclude payments from gross income without judicial or statutory basis. The IRS concluded that it was "well within its authority" to create the general welfare exclusion where Congress either explicitly *or* in the IRS assessment tacitly intended for a payment to be excluded. In the same 1975 memorandum, the IRS also asserted that its authority extended to excluding *state* payments from federal gross income if the payments were not in the nature of compensation.

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[16] I.R.C. § 263.

[17] I.R.C. § 1001(a).

[18] I.R.C. § 1001(a).

[19] P.L. 74-271.

[20] *See* Office Decision 3194; Office Decision 3229; Office Decision 3230.

[21] G.C.M. 36470.

Over the decades, the IRS has applied the general welfare exclusion to state payments to blind persons;[22] job-training program payments to unemployed and underemployed individuals to enhance employability;[23] state payments to crime victims;[24] state payments to adoptive parents for support and maintenance of their adoptive child;[25] replacement housing payments;[26] payments to workers who became unemployed mainly because of adverse impacts on their employers caused by changes in trade policy;[27] disaster payments to meet necessary expenses or serious needs that included medical, dental, housing, personal property, transportation, and funeral expenses;[28] and state credits to offset the cost of winter energy consumption.[29]

In 2005, the IRS attempted to resolve its patchwork revenue rulings into a coherent standard. It issued Revenue Ruling 2005-46[30] which clarified that in order for a payment to be excludible from income under the general welfare exception, the payment must (1) be made from government funds; (2) be for the promotion of general welfare (*i.e.*, generally be based on individual or family need); and (3) not represent compensation for the performance of services.

Of the three stated requirements, the second requirement, that the payment be based on individual or family need has arguably had the least consistent application. For example, the IRS has ruled that a payment is based on an individual or family need to include payments where there is a situational assumption of a need (rather than a specific assessment of a recipient's financial situation). For example, in Revenue Ruling 98-19[31] the IRS ruled that relocation payments to defray the expenses of moving from a flood-damaged residence to another residence qualified for the general welfare exclusion, regardless of the recipients' individual financial needs.

Congress's reaction to the general welfare exception has been equally patchwork. Rather than provide blanket approval or rejection of the IRS's authority to make exceptions to gross income, Congress instead has generally enacted new code sections to specifically correct an IRS determination or to create its own general-welfare exclusions from gross income for specific types of payments. For example, when

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[22] Rev. Rul. 54-102, 1957-1 C.B. 26.

[23] Rev. Rul. 68-38, 1968-1 C.B. 446.

[24] Rev. Rul. 74-74, 1974-1 C.B. 18.

[25] Rev. Rul. 74-153, 1974-1 C.B. 20.

[26] Rev. Rul. 74-205, 1974-1 C.B. 21.

[27] Rev. Rul. 76-229, 1976-1 C.B. 19.

[28] Rev. Rul. 76-144, 1976-1 C.B. 17.

[29] Rev. Rul. 78-170, 1978-1 C.B. 24.

[30] 2005-2 C.B. 120.

[31] 1998-1 C.B. 840.

Congress wanted to make certain social security payments taxable, it enacted Section 86 of the Code.

Similarly, Sections 139 through 139I of the Code contain Congress's patchwork of its own general welfare exceptions to gross income. The Settlement Payments to the Waiting List Plaintiffs contain many features that suggest the IRS may consider them to qualify for the general welfare exception. The Settlement Payments are paid out of government funds, and they do not represent compensation for the performance of services.

However, it is less clear whether they are based on individual or family need. There does not appear to be any financial need requirement to qualify for a leasehold under the 1920 Act. Nevertheless, the Settlement Payments are the result of the State's breaches of trust and are based on additional liability to the Waiting List Plaintiffs caused by the State's breaches of trust. In that sense, the Settlement Payments may be said to be based on a situational assumption of need, similar to the relocation payments that were approved by the IRS in Revenue Ruling 98-19.

Despite these arguments, the general welfare exception is not an exception a taxpayer can *claim*, per se. It is a relief granted (rather inconsistently) by the IRS by fiat. If the IRS were to choose not to grant a general welfare exception, it would be difficult for a taxpayer to successfully assert that the taxpayer is entitled to the exclusion. Because the IRS created the exception by fiat, it can seemingly deny it by fiat as well. Although a taxpayer could appeal any IRS determination to a court, the historical inconsistencies and poorly developed doctrines underlying the general welfare exception would likely make it difficult for a court to apply the miscellaneous IRS rulings to any particular case that is not fundamentally similar to a previous ruling.

Therefore, although we believe the Settlement Payments contain many features that make them attractive for the general welfare exception, we do not believe it would be wise for the Waiting List Plaintiffs to rely solely or principally on the general welfare exception without an IRS ruling specifically addressing the Settlement Payments. Nevertheless, because we have already concluded that the Settlement Payments are tax-free reimbursements, it should be unnecessary for the Waiting List Plaintiffs to rely solely on the general welfare exception.

E. Form 1099 Reporting.

All persons engaged in a trade or business and making payments in the course of such trade or business to another person of "fixed or determinable gains, profits, and income" that exceed $600 or more in a year are required to report such payments to the IRS and to the recipient on an IRS Form 1099-MISC, unless an exception applies.[32] Form 1099

[32] *See* I.R.C. § 6041(a).

reporting requirements also apply to payments made to attorneys that are considered paid to plaintiffs under the general rule enunciated in *Banks*.[33]

Generally, a defendant in a litigation is considered the payor with the Form 1099 reporting obligation in connection with any judgment or settlement paid by that defendant.[34] However, when settlement payments are made by a qualified settlement fund, it is generally the qualified settlement fund that is required to consider the issue of whether to issue Forms 1099 to plaintiffs.[35] This rule is consistent with Section 6041's middleman regulations, which substitute a "middle man" as the payor of a payment when the middle man exercises sufficient management or oversight functions in connection with the payment.[36]

Not all payments are payments of "fixed or determinable gains, profits, and income" for the purposes of Section 6041. As used in Section 6041, the term "gains, profits, and income" means gross *income*, and not the gross *amount* paid.[37] Income that is excludible from the recipient's income is not fixed or determinable gain, profit, or income, and is therefore not reportable on an IRS Form 1099.[38]

Accordingly, to the extent a Waiting List Plaintiff's Settlement Payment is tax-free under *either* the reimbursement authorities or the general welfare exception discussed above, the QSF should generally not be required to issue a Form 1099 to the Waiting List Plaintiff. As discussed above, it is possible that some of the Waiting List Plaintiffs previously deducted their rental payments, and therefore may owe tax under Section 111's tax benefit rule. Nevertheless, that possibility does not generally require the QSF to issue Forms 1099.

Form 1099 reporting by the QSF is only required if and to the extent that the QSF *knows* that a payment represents taxable income to a recipient. If the QSF (or other payor) does not know the extent that a payment may represent taxable income, Form 1099 reporting is not required. Consequently, the IRS has ruled on more than one occasion that a payor is not required to issue a Form 1099 when the payor does not know how much of a recipient's payment would be taxable under the tax benefit rule.[39]

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[33] *See* Treas. Reg. § 1.6045-5(f).

[34] *See* Treas. Reg. §§ 1.6041-1(f); 1.6045-5(f).

[35] *See* Treas. Reg. § 1.468B-2(l)(ii).

[36] *See* Treas. Reg. § 1.6041-1(e).

[37] *See* IRS Priv. Ltr. Rul. 200106021 (Feb. 9, 2001).

[38] *See* Treas. Reg. §§ 1.6045-5(f), *ex. 2*; 1.6041-3(e), (h), & (n); IRS Priv. Ltr. Rul. 9601035 (Jan. 5, 1996).

[39] *See, e.g.,* IRS Priv. Ltr. Rul. 9623025 (Jun. 7, 1996); IRS Priv. Ltr. Rul. 200046014 (Nov. 17, 2000).

Indeed, in Private Letter Ruling 201035004, discussed above, which specifically addresses the tax-free nature of government reimbursements for parents' transportation expenses, the IRS also discussed the government's Form 1099 reporting obligations. In the Private Letter Ruling, the IRS ruled that the reimbursement payments were includible in the recipients' incomes only to the extent that they exceeded the parents' actual transportation expenses. Because the government could not know each parents' actual transportation expenses, the IRS ruled that Form 1099 reporting was not required unless, and only to the extent, that the government had knowledge that a parents' reimbursement exceeded their actual expenses by more than $600 (the filing threshold amount).

It is not feasible for you or for the QSF to know if a Waiting List Plaintiff's actual rental expenses were less than their Settlement Payment. Under the payment structure approved in the 2020 Damages Decision, a plaintiff would only provide evidence of actual rental expenses if the expenses *exceed* the Settlement Payment calculated under the default statistical method. Moreover, the QSF would have no basis to know whether and to what extent any Waiting List Plaintiff who applied for an agricultural or pastoral lease previously deducted their lease payments, triggering the tax benefit rule.

Similarly, payors are not required to report capital recoveries on Forms 1099 when the payor does not know the recipient's adjusted tax basis, and therefore does not know how much of the payment constitutes taxable gain.[40] Because the QSF does not know the Waiting List Plaintiffs' tax basis in any substitute housing they purchased or constructed, the QSF cannot reasonably ascertain the extent, if any, that any compensation for Construction Cost Damages represents taxable gain. The QSF is not required to assume that all, or *any*, of the Construction Cost Damages payments represents taxable income to the Waiting List Plaintiffs.

Consequently, for the QSF's Form 1099 reporting obligations, the QSF is generally allowed to ignore those potential complications that could generate income tax to the recipients. Instead, the QSF is allowed to assume that all of the Settlement Payments would be tax-free under the general rule about reimbursements for non-employee expenses undertaken at the payor's behalf, discussed above, and the general rule about tax-free returns of taxpayers' adjusted tax basis. As a result, Form 1099 reporting is not required by the QSF in connection with the Settlement Payments.

If the IRS were to rule that the Settlement Payments qualified for the general welfare exception, then the analysis would even be more straightforward. However, as discussed above, we believe the general welfare exception is best employed as a secondary reason for exclusion. Regardless, under either theory, Form 1099 reporting is not required by the QSF in connection with the Settlement Payments to the Waiting List Plaintiffs.

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[40] *See,* IRS Rev. Rul. 80-22, 1980-1 C.B. 286 (1980); IRS Priv. Ltr. Rul. 9623025 (June 7, 1996).

V. GENERAL CONDITIONS

Our analysis and views herein, as qualified and limited throughout this letter, are limited solely to the issues identified in Section II. These are the only matters on which you have requested our opinion. We do not address (and therefore have no opinion on) any other tax matters or consequences arising out of, resulting from, or occurring in connection with the Litigation.

Specifically, but without limitation, we have not considered nor do we address any other matters arising under the laws of any jurisdiction (including state, local, or foreign tax consequences), or estate or gift tax consequences, or the possibility of the IRS or other taxing authorities raising other issues. No opinion should be inferred as to any other matters.

Our opinion is based on the I.R.C., Treasury Regulations, case law emanating from federal courts in the U.S. considering tax issues, and IRS rulings as they now exist. These authorities are all subject to change, and such change may be made with retroactive effect.[41] We can give no assurance that after any such change our opinion would not be different.

Furthermore, our opinions represent our reasoned legal judgment, but have no binding effect or official status of any kind. The facts, assumptions, and legal issues contained in this letter are highly complex. We cannot provide any assurances that a taxing authority, including the IRS, considering the issues would not take positions contrary to our opinion.

Should the IRS take such a contrary position and prevail on that position in a court, the tax consequences may differ materially from those set forth in our opinion. Although we believe the opinions expressed herein to be correct under existing federal income tax laws as of the date hereof, we cannot guarantee that contrary assertions by taxing authorities will not be successfully made.

We base our opinions herein on our understanding of the relevant facts and assumptions, including the information provided to us, as set forth in this letter. If this understanding is incorrect or incomplete in any respect, that could affect our opinions herein. We assume that copies of all documents presented for our review accurately reflect the originals, were executed in the form presented and on the dates set forth or as assumed herein, and represent enforceable obligations according to their terms.

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[41] *See* I.R.C. § 7805(b)(1)(C).

We undertake no responsibility to update or supplement our opinion. This letter is addressed to you, the Kalima Claims Administrator, though we understand the conclusion of this letter will be shared with the Waiting List Plaintiffs. Only you and the Waiting List Plaintiffs may rely on this opinion (or any portion thereof), and such reliance is limited to the matters specifically described herein. No other persons or entities shall be entitled to rely on the contents of this letter (or any portion thereof) without our express written consent.

We can give no guarantee that the IRS or any court would agree with the analysis or conclusions contained in this letter. Such a disagreement could result in the IRS asserting additional taxes, penalties, and interest. Sections 6662 through 6664 set forth various accuracy-related and fraud penalties connected to underpayment of tax, understatements with respect to tax items to be shown on a return, and reportable transactions.

Generally, the federal accuracy-related penalty under Section 6662(a) is 20 percent (20%) of any portion of a tax underpayment attributable to negligence or disregard of rules or regulations, or substantial understatement of income tax.[42] A return position that has at least a "reasonable basis" (as discussed below) is not attributable to negligence.[43]

An understatement of income tax is defined as the excess of the amount of tax required to be shown on the return for a taxable year over the amount of tax shown on the return, reduced by any rebate (as defined in Section 6211(b)(2)).[44] For purposes of calculating the amount of the penalty, an understatement will be reduced for all non-tax shelter items for which there is "substantial authority" (as discussed below), or that are adequately disclosed.[45]

The I.R.C. and its accompanying Treasury Regulations provide three primary standards of tax reporting, which are, from lowest to highest: reasonable basis, substantial authority, and more likely than not.[46] The reasonable basis standard, although the lowest of the three standards, is a relatively high standard of tax reporting that is significantly higher than not frivolous or not patently improper.[47] The reasonable basis standard is not satisfied by a return position that is merely arguable or merely a colorable claim.[48]

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[42] Treas. Reg. §§ 1.6662(a), 1.6664(a), 1.6662-3(a).

[43] Treas. Reg. § 1.6662-3(b).

[44] Treas. Reg. § 1.6662-3(b); I.R.C. § 6662(d)(2)(A).

[45] Treas. Reg. § 1.6662-4(a).

[46] Treas. Reg. §§ 1.6662-3(b)(3), 1.6662-4(d)(2).

[47] Treas. Reg. § 1.6662-3(b)(3).

[48] Treas. Reg. § 1.6662-3(b)(3).

Rather, if a return position is reasonably based on one or more authorities set forth in Treasury Regulations,[49] taking into account those authorities' relevance and persuasiveness, as well as subsequent developments, the return position will generally satisfy the reasonable basis standard even though it may not satisfy the substantial authority standard.[50]

The substantial authority standard is met only if the weight of authorities supporting the treatment is substantial when compared to the weight of authorities supporting contrary treatment.[51] The more likely than not standard requires that a taxpayer, after analyzing the pertinent facts and authorities in a manner prescribed in the Treasury Regulations, reasonably concludes in good faith and in reliance on that analysis that there is a greater than 50 percent (50%) likelihood that the tax treatment of the item will be upheld if challenged by the IRS.[52]

The reasonable cause and good faith exception in Section 1.6664-4 of the Treasury Regulations may provide relief from the penalty for negligence or disregard of rules or regulations, even if a return position does not satisfy the reasonable basis standard.[53] If a taxpayer's underpayment has reasonable cause, and the taxpayer acted in good faith, the 20 percent (20%) penalty may not apply.[54]

When determining if a taxpayer has reasonably relied in good faith on professional advice on the tax treatment of income or any entity, plan or arrangement, all facts and circumstances must be taken into account.[55] However, for a taxpayer's conduct to be

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[49] Treas. Reg. § 1.6662-4(d)(3)(iii). Those authorities include "applicable provisions of the Internal Revenue Code and other statutory provisions; proposed, temporary and final regulations construing such statutes; revenue rulings and revenue procedures; tax treaties and regulations thereunder, and Treasury Department and other official explanations of such treaties; court cases; congressional intent as reflected in committee reports, joint explanatory statements of managers included in conference committee reports, and floor statements made prior to enactment by one of a bill's managers; General Explanations of tax legislation prepared by the Joint Committee on Taxation (the Blue Book); private letter rulings and technical advice memoranda issued after October 31, 1976; actions on decisions and general counsel memoranda issued after March 12, 1981 (as well as general counsel memoranda published in pre-1955 volumes of the Cumulative Bulletin); Internal Revenue Service information or press releases; and notices, announcements and other administrative pronouncements published by the Service in the Internal Revenue Bulletin."

[50] Treas. Reg. § 1.6662-3(b)(3) (noting to *see* Treas. Reg. § 1.6662-4(d)(3)(ii) "for rules with respect to relevance, persuasiveness, subsequent developments, and use of a well-reasoned construction of an applicable statutory provision for purposes of the substantial understatement penalty").

[51] Treas. Reg. § 1.6662-4(d)(3).

[52] Treas. Reg. § 1.6662-4(g)(4)(i).

[53] Treas. Reg. § 1.6662-3(b)(3).

[54] I.R.C. § 6664(c); Treas. Reg. §§ 1.6662-3(b)(3), 1.6664-4(a).

[55] Treas. Reg. § 1.6664-4(c)(1).

considered sufficiently reasonable to negate an accuracy-related penalty, the Tax Court generally requires the taxpayer to prove three elements when relying on an advisor: (i) the advisor was a competent professional who had sufficient expertise to justify reliance; (ii) the taxpayer gave the advisor the necessary and accurate information; and (iii) the taxpayer actually relied in good faith on the advisor's judgment.[56]

However, for a taxpayer's conduct to be considered sufficiently reasonable to negate an accuracy-related penalty, the Tax Court generally requires the taxpayer to prove three elements when relying on an advisor: (i) the advisor was a competent professional who had sufficient expertise to justify reliance; (ii) the taxpayer gave the advisor the necessary and accurate information; and (iii) the taxpayer actually relied in good faith on the advisor's judgment.[57]

In addition, Section 6662(d)(2)(B) provides that the substantial understatement penalty will not apply to a return position for which: (i) there is or was *substantial authority* for the treatment claimed; or (ii) the relevant facts affecting the tax treatment are *adequately disclosed* in the tax return or in a statement attached to the return, and there is a *reasonable basis* for the tax treatment.

Except where the IRS has expressly permitted disclosure of a position directly on an income tax return, taxpayers with only a reasonable basis position generally must use an IRS Form 8275 Disclosure Statement in order to avoid the substantial understatement penalty.[58] Even if a Form 8275 is filed, it is possible that the IRS may not view the disclosure as sufficient to avoid a substantial understatement penalty.

We note that we are directing this opinion solely to the Kalima Claims Administrator. Although we understand that the conclusions of this opinion will be made available to the Waiting List Plaintiffs, we recommend that any such plaintiffs should obtain their own tax advice concerning the specifics of their Settlement Payments, and the extent to which such arrangements satisfy the federal income tax doctrines outlined in this letter.

[56] *Neonatology Assocs., P.A. v. Comm'r,* 115 T.C. 43, 99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

[57] *Neonatology Assocs., P.A. v. Comm'r,* 115 T.C. 43, 99 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

[58] *See* Treas. Reg. § 1.6662-4(f)(1); Rev. Proc. 2012-15, 2012-1 C.B. 369 (identifying procedures pursuant to which disclosure on a return will be deemed adequate for purposes of reducing § 6662(d)'s substantial understatement penalty).

We trust the analysis and discussion in this opinion is informative and responsive to your inquiry. Should you need us to elaborate on any point, please do not hesitate to contact us.

Very truly yours,

Wood LLP

Wood LLP

RWW:AZB:gp
AAC:008-6
Enclosure

EXHIBIT A

The following is a list of documents we considered in preparing this letter:

1. (Annotated) Opinion of the Court RE: *Leona Kalima, et al. v. State of Hawai'i, et al.*, Civil No. 99-4771-12 LWC, e-filed June 30, 2020;

2. Memo RE: Response to Email from 12-21-22 Email from Rob Wood, dated January 24, 2023;

3. Order Granting Plaintiffs' Motion to Adopt a Method to Compute Agricultural and Pastoral Damages [Filed on September 16, 2016] RE: *Leona Kalima, et al. v. State of Hawai'i, et al.*, Civil No. 99-4771-12, filed July 26, 2017;

4. Declaration of Andrew Rothstein RE: *Leona Kalima, et al. v. State of Hawai'i, et al.*, Civil No. 99-4771-12 VLC, dated August 18, 2015;

5. Trial Order RE: *Leona Kalima, et al. v. State of Hawai'i, et al.*, Civil No. 99-4771-12 VLM, dated October 6, 2014;

6. Supplemental Complaint for Waiting List Damages RE: *Leona Kalima, et al. v. State of Hawai'i, et al.*, Civil No. 99-4771-12 VLC, dated December 19, 2013;

7. Plaintiffs' Second Motion to Determine What Model Should be Used to Establish the Amount of Damage Class Members Suffered as a Result of the Braches Committed by Defendants; Declaration of Andrew Rothstein; and Exhibits 1-2 RE: *Leona Kalima, et al. v. State of Hawai'i, et al.*, Civil No. 99-4771-12 VLC, dated July 22, 2011;

8. Email Report from Andrew Rothstein to Thomas Grande RE: Residential lot values in Waianae and Waimanalo, 1960 to present, dated March 22, 2007;

9. Cover Letter and Expert Report by The Hallstrom Group, Inc. RE: *Leona Kalima, et al. v. State of Hawai'i, et al.*, Civil No. 99-4771-12 VSM, dated June 14, 2013;

10. PROPOSED – Payment Distribution Plan and Order RE: *Leona Kalima, et al. v. State of Hawai'i, et al.*, Civil No. 99-4771-12 LWC;

11. DRAFT – Order Establishing Qualified Settlement Fund Trust and Appointing QSF Administrator RE: *Leona Kalima, et al. v. State of Hawai'i, et al.*, Civil No. 99-4771-12 LWC; and

12. Settlement Agreement RE: *Leona Kalima et al. v. State of Hawai'i, et al.,* Civil No. 99-4771-12 LWC, executed June 2, 2022.