Taxability of Settlements and Judgments

By Zachary C. Warzel

The last time I checked, I was a trial lawyer, not a tax expert. Recent changes to the federal tax laws, however, have forced me to ponder Uncle Sam's tax mindset with the deranged fervor of Sigmund Freud. Nevertheless, I am not a tax lawyer, and what you are about to read is my armchair view on the current state of the federal tax laws pertaining to settlements and judgments. If you are encountering tax issues in your cases, or potential tax issues, a word to the wise: **hire a qualified tax lawyer or other tax professional** to advise you and your client. That is what I was compelled to do recently in an insurance bad faith case, and I am glad I did. What follows should not be considered tax advice, but merely a layman's primer.

The Change

If you do not know already, the tax laws changed in 2017, and not in a manner favorable to plaintiffs in certain species of cases.[1] A major change that affects the taxability of many kinds of recoveries is the ability of a recipient to deduct their attorney fees below the line from gross income. The change eradicated miscellaneous itemized deductions and deductions for investment expenses.

By way of background, in *Commissioner v. Banks*,[2] the United States Supreme Court found that contingent fees are generally recognized as part of the client's gross income. In other words, plaintiffs generally realize (and are presumed to be taxed on) 100% of the recovery, including amounts paid to their attorneys out of the gross amount received. The tax laws historically exempted (as an above the line deduction) a few types of cases from this general rule, including employment and whistleblower cases, business-related suits, and, of course, cases where the damages relate to "personal physical injuries" (see below). Importantly, Plaintiffs in non-exempted cases were able to deduct attorney fees "below the line" through miscellaneous itemized deductions, subject to some limitations.

Those miscellaneous itemized deductions have now been erased. According to one lawyer who practices in this area:

> Now there is no below-the-line deduction for legal fees for tax years 2018 through 2025. If you are not an employment plaintiff or qualified whistleblower, and you cannot find a way to position your claim as a trade or business expense or to capitalize your fees into the tax basis of a damaged asset, you get no deduction. Period. That means you are taxed on 100 percent of your recovery.[3]

So, what does this mean? By way of example, assume plaintiff is a homeowner who lost his house in a fire. He put in an insurance claim with his homeowner's insurer and the claim was unreasonably delayed, resulting in an insurance bad faith lawsuit against the carrier. While a "tort" claim, and in the nature of a "personal injury" suit, such bad faith claims are not typically considered to relate to "physical injury" or "sickness" under the modern tax code and are thus not exempt from taxation under I.R.C. 104(a)(2) (see below).

If plaintiff recovers $1,000,000 through settlement of his bad faith case and is on a one-third contingent fee agreement with his lawyers ($333,333.33), his net recovery is $666,666.66. Many would assume that plaintiff would only be taxed on the $666,666.66. Prior to the new tax law changes, plaintiff may have been able to accomplish as much through miscellaneous itemized deductions. Now, he cannot do so. Plaintiff is taxed on the full $1,000,000 **and** pays one-third of the gross amount up-front to his attorneys. Plaintiff may only receive roughly $296,666.67 out of the $1,000,000 recovery, rather than roughly $420,000 (I assume a 37% federal income tax on amounts over $500,000 for individual filers, not accounting for State income taxes).

This is clearly not good news for Mr. Plaintiff. But how does this change in the law affect the various forms of actions?

Personal Physical Injury Recoveries Are Still Safe

Perhaps most importantly for many of CTLA's members, no changes were made to the Section 104(a)(2) exemption for recoveries related to "personal physical injuries." Section 104(a)(2) provides:

(a) In general. Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 [26 USCS § 213] (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

* * *

(2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness…[4]

In *Commissioner v. Schleier*,[5] the U.S. Supreme Court established a two-prong test for determining whether a taxpayer is eligible to exclude income under Section 104(a)(2): the taxpayer must demonstrate (1) that the underlying cause of action giving rise to recovery is based upon tort or tort-type rights; and (2) that the damages were received on account of personal injuries or sickness.[6]

Personal injuries that may be excluded from gross income under Section 104(a)(2) can include harms that are tangible, intangible, physical and non-physical.[7] Intangible harms include those affecting emotions, reputation, or character.[8] "Physical injury or physical sickness" under the 1996 amendments to Section 104(a)(2) includes non-economic damages resulting from the physical injuries or sickness.[9]

Contingent fees paid out of an exempt award are not taxable, but neither can they then be deducted below the line to further diminish the plaintiff's taxable income.[10] Thus, non-physical effects that flow from physical injuries continue to fall within this exemption, including attorney fees.[11]

Of course, there are exceptions, discussed in the next section.

Punitive Damages, Interest, and Mixed Cases

Punitive damages and interest are now, and have long been, taxable to the client, even when arising out of a personal physical injury lawsuit.

Prejudgment interest is taxable, despite being an element of compensatory damages under Colorado law, because its primary purpose is to compensate for the lost time value of money and is not considered to be awarded "on account of" physical injuries or sickness by the tax authorities.[12]

Similarly, punitive damages are not excludable from gross income because they are not designed to compensate for "personal physical injuries."[13]

So be wary of reaching blanket conclusions about the taxability of personal physical injury recoveries for your clients. If you tried the case, received a judgment that included separate awards for interest and/or punitive damages, and the judgment is paid or settled, your client may face a mixed taxability situation – where some portion is excluded from gross income under Section 104(a)(2) and other portions are taxable.[14]

As a practical matter, this also means that the portion of attorney fees taken on the taxable elements of a recovery were also taxed to your client.

Insurance Bad Faith Recoveries Are in a Legal Grey Area

Some bad faith recoveries, or portions thereof, may be considered "on account of" personal physical injuries or sickness and thus exempt from inclusion in the client's gross income. But short of this, and in light of the recent repeal of miscellaneous itemized deductions, many bad faith clients will end up paying taxes on the gross amount collected, including contingent fees.

In a 2009 Private Letter Ruling from the IRS (which is not binding precedent), the IRS considered the taxability of a third-party bad faith settlement arising out of a dram shop verdict with both compensatory and punitive damage elements.[15] The insurer had rejected a pretrial settlement offer within policy limits. The tavern owner assigned his claims against his insurer, post-trial, to the injured party (*i.e.,* a *Bashor* agreement under Colorado law) and the injured party then pursued the insurer for bad faith. The bad faith case was later settled, and a satisfaction of judgment was entered in the case against the tavern.

The IRS applied the "origin of the claim" doctrine to determine whether the injured party's recovery from the insurer was taxable. According to the letter ruling:

In general, the character of amounts received as proceeds from a lawsuit or a settlement depends upon the nature of the claims, and the actual basis for the recovery. Under the "origin of the claim" doctrine, it is a "well-settled rule" that the classification of amounts received in settlement of litigation is to be determined "by the nature and basis of the action settled," and that "amounts received in compromise of a claim must be considered as having the same nature as the rights compromised (emphasis added)." *Alexander v. IRS*, 72 F.3d 938 (1st Cir. 1995). The critical inquiry is … "In lieu of what were the damages awarded?" *See Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944), cert. denied, 323 U.S. 779 (1944).[16]

The IRS determined:

In the instant case, plaintiff A's [the injured party's] recovery

> against D [insurance company] had its origin in the settlement of A's personal physical injury tort claims against B and C [tavern]. A sued D only as an assignee of C to collect on A's judgment against B and C for damages awarded in a personal physical action. But for his personal injury claim and his rights as an assignee, A would be entitled to no recovery against D. Thus, such amounts are includable in A's gross income for federal income tax purposes, except to the extent they may be excluded under section 104(a)(2) of the Code.[17]

The IRS then went on to specify which portions of the recovery were excludable under Section 104(a)(2) as amounts received "on account of" personal physical injuries:

> 1. To the extent plaintiff A receives proceeds under the Assignment Agreement of Date 5 and the final Settlement Agreement of Date 6, resulting from his settlement of personal physical injury and sickness claims arising from Incident X, including amounts in settlement of his claims for past and present medical expenses, future medical expenses, pain and suffering, and lost earnings, such amounts qualify for exclusion from A's gross income under section 104(a)(2) of the Code; and
>
> 2. To the extent plaintiff A receives proceeds under said Assignment and final Settlement Agreements resulting from his settlement of claims other than personal physical injury and sickness claims arising from Incident X, *e.g.,* punitive or other damages, such amounts are properly includable in A's gross income under section 61 of the Code.[18]

This seems relatively straightforward. But later court decisions have muddied the waters.[19]

So where does this leave the taxability of bad faith recoveries? The answer is, "I'm not too sure." The "origin of the claim" doctrine needs to be applied on a case-by-case basis. If the underlying incident giving rise to the insurance claim was in the nature of a "personal physical injury" tort, there may be an argument that a subsequent bad faith recovery is likewise excludable from gross income under Section 104(a)(2). If, on the other hand, the underlying incident giving rise to the claim is more in the nature of a sickness or disability insurance claim, it may not be excludable under Section 104(a)(2), but could be excludable under Section 104(a)(3) (pertaining to payments under accident and health insurance policies), but only if the premiums were paid by the insured with after-tax dollars. Many questions remain.

Note that the 2009 Private Letter ruling involved a post-judgment **assignment of claims** under a liability policy to the injured party prior to the lawsuit against the insurer. What about a situation where there is no assignment agreement; or where the assignment is done pre-judgment (*Nunn*); or where there is an assignment of **proceeds only** and no assignment of claims? If the insured under a third-party policy (the at-fault party who is originally sued for causing an injury) is pursuing his insurer directly for bad faith after having a judgment entered against him, can the recovery he directly obtains still be said to be "on account of" personal physical injuries or sickness? Does it qualify as payment under an accident policy pursuant to Section 104(a)(3)? What if the settlement under such scenario involves no payment directly to the at-fault insured, but rather the settlement is paid directly over to the underlying injured party to satisfy the judgment?

Answer: you need to consult a tax lawyer, not me.

There are potential solutions that a well-informed tax lawyer can provide guidance on. Consult a professional early, before your case settles or before payment of a judgment is made.

Trade or Business-Related Recoveries are Generally Still Safe

Business-related litigation expenses continued to be generally deductible under Section 162 of the Code. Section 162 dictates which expenses may be deducted as ordinary and necessary expenses of operating a trade or business.[20]

However, even in business and trade-related cases, there is a prohibition to deductibility for sexual harassment or sexual abuse-related claims where the settlement involves confidentiality – the so-called "Harvey Weinstein" amendment.[21]

Whistleblower and Discrimination Recoveries are Safe

Whistleblower or unlawful discrimination recoveries are exempted from taxation.

In 2004, Congress added section 62(a)(20) to the Code, which allows plaintiffs in cases involving unlawful discrimination to deduct fees and expenses directly against gross income in computing adjusted gross income, and not as miscellaneous itemized deductions. New Code section 62(a)(21) added the same protections for whistle blower plaintiffs. The 2017 Act did not make any changes to Code section 62(a)(20) and so, going forward, plaintiffs may continue to deduct litigation expenses related to unlawful discrimination.[22]

The 2017 Act expanded the deductibility of expenses related to such claims, with some limitations.[23]

Conclusion

Case-related tax problems give me a headache. Tax problems created by lawsuits for your clients will make their heads hurt even more. The new changes that went into effect on January 1, 2018 have made it harder for clients to escape paying taxes on the attorney fees paid to obtain a recovery. The changes have made general taxation problems in our cases even more confusing and potentially more disappointing for our clients than in the pre-Trump era.

I have begun advising clients in my bad faith cases up-front about the potential tax pitfalls, telling them that they need to speak with a tax professional, and warning them that they may be in a situation at the end of the case where they must pay taxes on the gross amount collected, including on contingent fees they pay to my firm. I have also hired tax lawyers on sizable bad faith cases since the amendments to help me and my clients navigate this tax minefield. It has been money well spent. I suggest that you do the same on cases that warrant this type of involvement and exposure to your clients. ▲▲▲

Zach Warzel of Keating Wagner Polidori Free, is one of the state's leading attorneys in the area of insurance bad faith law. For the last ten years, Zach has dedicated his practice to representing policyholders in disputes with their insurers and injured clients in complex personal injury cases. Zach serves on the Board of Directors for the Colorado Trial Lawyers Association and as a co-chair for Insurance Bad Faith Committee of CTLA. He frequently lectures and writes on case law updates and best practices in insurance law.

Endnotes:

[1] *See* Tax Cuts and Jobs Act, P.L. 115-97, available at: https://www.congress.gov/115/bills/hr1/BILLS-115hr1enr.pdf.

[2] *Commissioner v. Banks*, 543 U.S. 426 (2005).

[3] Robert W. Wood, *New Tax on Litigation Settlements, No Deduction for Legal Fees*, TAX NOTES (March 5, 2018), available at: http://www.woodllp.com/Publications/Articles/pdf/New_Tax_On_Litigation_Settlements.pdf.

[4] 26 U.S.C. § 104.

[5] *Commissioner v. Schleier*, 515 U.S. 323, 336-337 (1995).

[6] *See also Knoll v. Commissioner*, Nos. 10973-99, 5281-00, 2003 Tax Ct. Memo LEXIS 276, at *17 (T.C. Sep. 23, 2003).

[7] *See Commissioner v. Schleier*, 515 U.S. at 329 n.4.

[8] *See, e.g., Bland v. Commissioner*, T.C. Memo. 2000-98; *Knoll*, *supra*, at *23.

[9] *See* 26 C.F.R. § 1.104-1 (regulation interpreting Section 104(a)(2) to include "emotional distress attributable to a physical injury or physical sickness"). Be careful with noneconomic damages that do not flow from a physical injury or physical sickness. Pure noneconomic damage cases are likely not going to come within the Section 104(a)(2) exemption.

[10] *See Church v. Commissioner,* 80 T.C. 1104, 1110 (1983).

[11] For an excellent discussion of the roots and historical development of the modern "personal physical injury" exemption, *see* Kurt A. Leeper, *Note: Arguably Arbitrary: Taxation And The Physical Injury Requirement Of I.R.C. Section 104(a)(2)*, 55 CASE W. RES. L. REV. 1039 (2005).

[12] *See Kovacs v. Commissioner*, 100 T.C. 124 (1993), *aff'd without published opinion,* 25 F.3d 1048 (6th Cir. 1994) (prejudgment interest on wrongful death claim taxable); *Brabson v. United States*, 73 F.3d 1040, 1042 (10th Cir. 1996).

[13] *See O'Gilvie v. United States,* 519 U.S. 79, 84, 117 S. Ct. 452, 455 (1996) ("[P]unitive damages are not covered because they are an element of damages not "designed to compensate . . . victims, . . . rather they are "'punitive in nature. . ..'") (citations omitted); *see also Hawkins v. United States,* 30 F.3d 1077 (9th Cir. 1994), *cert den*. 515 US 1141(1995) (finding punitive damages received by taxpayer in bad faith suit cannot be excluded since punitive damages are not compensation for personal injuries but were awarded to punish defendant for egregious conduct).

[14] *See, e.g., Delaney v Commissioner,* 99 F.3d 20 (1st Cir. 1996), 96-2 USTC P 50576, 78 AFTR 2d 6968 (part of personal injury settlement is taxable as prejudgment interest even though settlement agreement stipulated that no interest was charged where plaintiff won verdict at trial level which included prejudgment interest and, while appeal was pending, settled case for lesser amount).

[15] IRS Private Letter Ruling 200903073 (January 16, 2009), available at: www.irs.gov/pub/irs-wd/0903073.pdf.

[16] *Id.* at 3.

[17] *Id.* at 4.

[18] *Id.* at 4.

[19] For a more in-depth discussion of this issue, *see* Robert W. Wood, *Are Insurance Bad Faith Recoveries Taxable?*, 36 ABA TAX TIMES (Nov. 18, 2016), available at: https://www.americanbar.org/groups/taxation/publications/abataxtimes_home/16nov/16nov-pp-wood-are-insurance-bad-faith-recoveries-taxable/#_ftn1.

Also see Ktsanes v. Commissioner, T.C. Summary Op. 2014-85, available at: https://www.kiplinger.com/members/links/ktl/140912/Ktsanes_v_Commissioner.pdf; (finding bad faith recovery under disability policy was not "on account" of the Bell's Palsy upon which the disability was based, but rather was on account of the insurer's breach of contract and bad faith conduct; "[P]etitioner sought compensation "on account of" the denial of his long-term disability benefits, not for any physical injuries or physical sickness."); *Watts v. Commissioner,* T.C. Memo. 2009-103 (May 18, 2009), available at: www.leagle.com/decision/intco20090518948; (finding that injured party's UIM bad faith and breach of contract settlement in class action related to anti-stacking provisions was not on account of physical injuries under Section 104(a)(2), but rather was "a settlement of a contract dispute concerning the terms of an insurance policy. . . .;" the court found, however, that "petitioner's settlement payment … was received 'through' accident or health insurance "for" personal injuries or sickness within the meaning of section 104(a)(3) and is therefore excludable, **up to the policy limits**, under that section.); IRS Private Letter Ruling 200403046 (January 16, 2004), available at: https://www.irs.gov/pub/irs-wd/0403046.pdf, (finding only portion of recovery in breach of contract and bad faith case against disability insurer that were related specifically to past and future disability benefits, where premiums were paid with after tax dollars by insured, "are excludable from B's gross income under § 104(a)(3)," and the "portion of the settlement paid on account of B's legal costs that is allocable to the benefits excludable from gross income under § 104(a)(3) is not includible in B's gross income.").

[20] Otto Shill, *Deducting Attorneys' Fees Under the Tax Cuts and Jobs Act of 2017*, JDSupra (Apr. 6, 2018), available at: www.jdsupra.com/legalnews/deducting-attorneys-fees-under-the-tax-94679/.

[21] *Id.*

[22] *Id.*

[23] *See* § 62 to the Code.