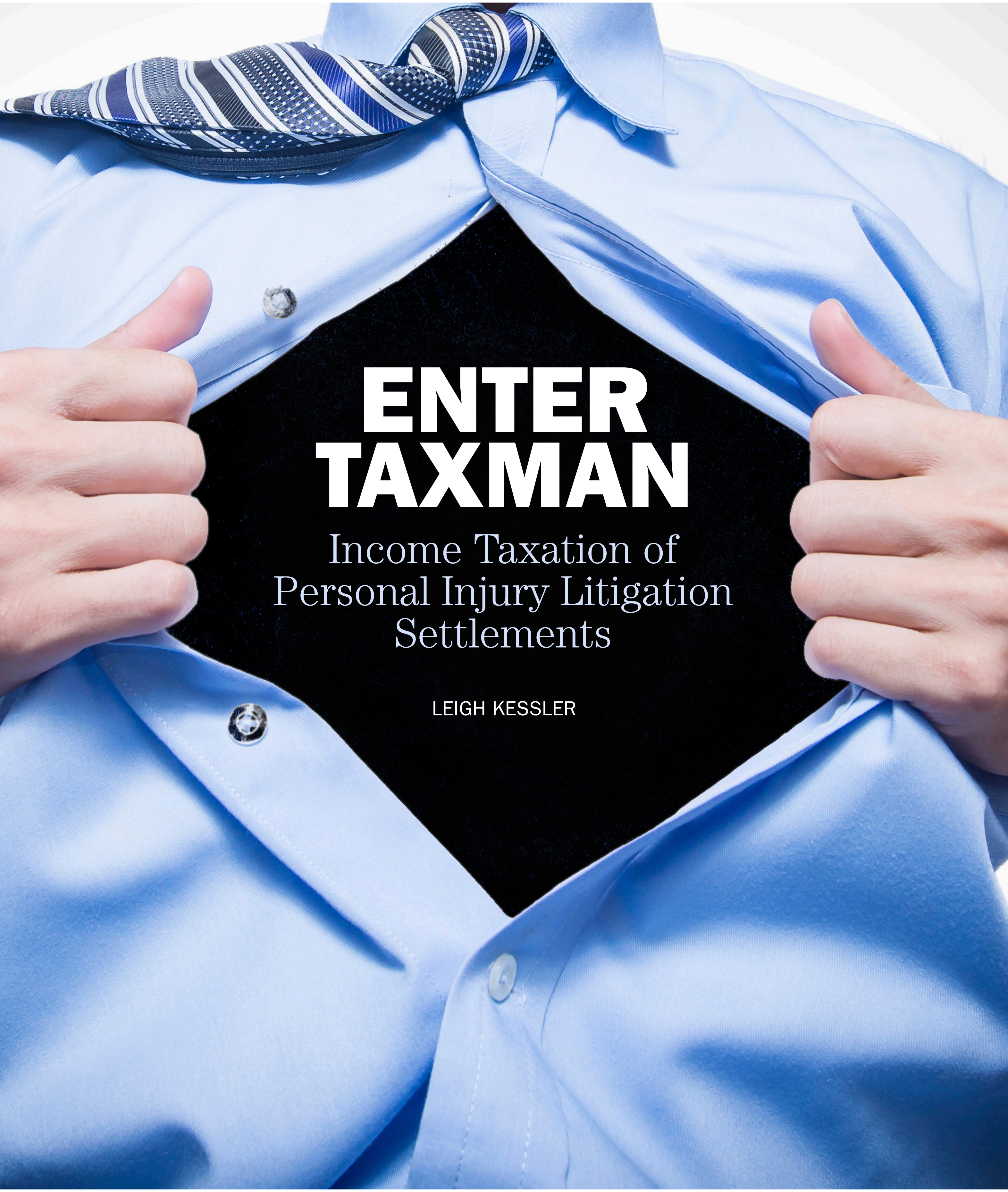

ENTER TAXMAN

Income Taxation of Personal Injury Litigation Settlements

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You represent a client in a difficult personal injury case and are close to finalizing an agreement that you believe would achieve a great result for your client. Is it time to celebrate? Not quite yet. You have to consider and address one of the things that is certain in life: TAXES. Is Uncle Sam going to get his greedy little hands on a portion of that settlement? How do you make that determination? What can you do to try to ensure clarity on the front end rather than confusion, uncertainty, and potentially more litigation (this time with the IRS) on the back end? Can you structure the settlement in a way that will minimize taxes?

Tax planning must be an early and essential consideration in the resolution of any personal injury case by settlement. Resolving a case by way of a settlement may allow you, as counsel, greater latitude and opportunity for tax planning than a court judgment would, because the tax implications can be considered by the parties and potentially addressed in the structure of any settlement.[1] If multiple claims form the basis for a settlement, the settlement agreement should detail the allocation of payments to each claim and, if possible, the manner in which they were computed. The parties should also try to reach an agreement on the proper income tax treatment of the payments, and the agreed-upon reporting should be followed by both parties. If these simple actions are taken prior to finalizing a settlement, there is an increased likelihood that the IRS will honor the intent of the parties in determining the proper taxation of any settlement. A tax professional should always be consulted, as doing so could potentially save your client substantial taxes and help avoid the stress of an unexpected tax bill.

What Personal Injury Recoveries Are Excludable From Gross Income?

Pursuant to § 61 of the Internal Revenue Code (I.R.C.), gross income includes *all income from whatever source derived*.[2] Personal injury recoveries are excluded from gross income only where specifically exempted by statute, regulation, or judicial authority. Certain specific types of recoveries, generally arising out of an injury or sickness, are usually excluded from gross income under I.R.C. § 104. These include:

- Amounts received under worker's compensation acts as compensation for personal injuries or sickness.[3]
- Amounts received through accident or health insurance for personal injuries or sickness.[4]
- Amounts received as an annuity, pension, or allowance for personal injuries or sickness that result from active service in the military.
- Amounts received by an individual as disability income for injuries directly resulting from a terrorist or military action.[5]

I.R.C. § 104(a)(2) also excludes from gross income *any* damages received for personal physical injuries or physical sickness,[6] whether resulting from judgment or agreement.[7] Payments made in a lump sum or as periodic payments are excluded from income if they are received because of a personal physical injury or physical sickness.[8] However, in nearly all situations, punitive damages will be includable in gross income.[9] Any interest on settlement payments will also be includable in gross income, as the IRS and the courts have found that interest has no relation to the underlying physical injury or physical sickness.[10] The determination of what constitutes a personal physical injury or physical sickness is the source of much contention when it comes to the taxation of personal injury settlements.

The "Origin of the Claim" Test

When does a settlement, or a portion of a settlement, result from ***personal physical injuries or physical sickness*** and therefore is excludable from the recipient's gross income?

The analysis of every settlement is fact-based, and the "origin of the claim" test will determine the tax treatment of payments in this context.[11] "The object of the origin of the claim test is to find the transaction or activity from which the taxable event proximately resulted, or the event that led to the tax dispute."[12] The origin of the claim test will also determine whether an income item must be reported as ordinary income or capital gain, whether any portion of a payment is deductible by the payor, and whether the income item must be capitalized.

Under this test, amounts received or paid in satisfaction of a claim generally must be given the same tax treatment as would have been given to what was lost and resulted in the personal injury claim. For example, if the origin of a claim was for lost wages resulting from improper discrimination, then any settlement of that claim would be taxable as ordinary income to the recipient. An exception lies wherein the origin of the claim is a personal physical injury or physical sickness. If the origin of that claim for lost wages was a motor vehicle collision in which the claimant sustained injuries such that he could not work, then any settlement for lost wages would be excludable from gross income because the origin of the claim is a *personal physical injury*. Where a recovery is made for lost wages that did not result from a personal physical injury or physical sickness, the settlement agreement should specify what portion of the payment constitutes taxable wages and what portion represents nonwage recoveries. Recoveries for taxable wages are subject to income tax, Federal Insurance Contributions Act (FICA), and Federal Unemployment Tax Act (FUTA) withholding and must be reported on Form W-2. Payments for nonwage recoveries will be reported on Form 1099 and are not subject to withholding. In this instance, it is vital that you counsel your client to pay over estimated tax that is expected to result from this payment.

What will the IRS or a court look to, factually, to determine the nature of the underlying claim that was settled?

The IRS and a court are both likely to lend significant weight to the type of underlying claim to determine whether any recovery is includable in gross income, including the nature of any suit that was filed.[13] The focus is on the type of harm caused and whether payment is made to compensate for personal physical injuries or physical sickness. It is not necessary that the underlying claim be a tort under state law. The IRS or a court will also look to:

- The intent of the payor.
- The nature and content of settlement negotiations.
- The manner in which the settlement figures were computed.
- The contents of any settlement agreement that is reached.[14]

The U.S. Tax Court has stated that the most important factor in making this determination is the language of the settlement agreement. However, the terms of the settlement agreement must be the result of an arm's-length negotiation between adverse parties.[15] It should be noted, however, that the IRS is not bound by any statements in a settlement agreement when determining taxability.[16] Counsel cannot insulate settlement payments from taxability by merely stating in the settlement agreement that they arise from a personal physical injury or physical illness. A determination of the true underlying origin of the claim will control.[17]

Most settlements based on personal injury claims, therefore, will not be subject to income tax, and the proceeds should not be reported by the recipient as income.[18] This is the case even where the payment is in satisfaction of a loss that normally would be taxable, such as lost wages. While this seems simple enough, there are nuances to this principle that must be considered. If the complaint sets forth more than one claim, the origin of the claim determination must be made as to the nature and character of *each* claim and the amount of payment allocable to each.

What constitutes a "physical injury" or "physical sickness"?

If the origin of a claim is a physical injury or physical sickness, then *all* damages resulting from that injury are excludable from income, except punitive damages. Even if damages resulting from a physical injury or physical sickness are paid to an individual who was not the injured party, they will be excludable from gross income. For example, damages for loss of consortium arising from a physical injury or physical sickness of a spouse will not be includable in the gross income of the recipient spouse.

A great deal of dispute has centered on whether emotional distress or mental anguish constitute physical injury or physical sickness and whether damages resulting therefrom are excludable from gross income. While the statute provides that all damages received as a result of physical sickness or physical injury are to be excluded from income, the statute specifically directs that emotional distress will not be treated as a physical injury or physical sickness.[19] Notably, however, the Conference Committee Report for I.R.C. § 104 indicates that the income exclusion of I.R.C. § 104(a)(2) does not apply to a recovery for emotional distress if it did not arise out of a claim for personal physical injuries or physical sickness.[20] Therefore, any recovery for emotional distress that can be shown to arise from a personal physical injury or physical sickness should be excludable from income. As a result, the IRS has taken the position that where bodily injury can be seen or documented (i.e., bleeding, bruising, etc.), this will constitute evidence of a personal physical injury and damages for resulting emotional distress related to that injury will be excluded from income.[21]

What is the result where there is a pattern of actionable behavior, such as on-the-job sexual harassment, that occurs both prior to and following an incident that results in personal physical injury to the victim?

In an IRS Private Letter Ruling, the claimant taxpayer was sexually harassed by her superior over a period of time. This began as inappropriate remarks and touching. These actions, however, initially did not result in any observable bodily harm. During the course of the harassing conduct, the victim was eventually assaulted. Early assaults caused no visible injury, only physical pain. Later assaults caused visible injuries including cuts, bruises, etc. The superior continued to assault and harass the employee. Ultimately the employee quit her job and filed suit seeking recovery for sexual harassment, battery, and intentional infliction of emotional distress. The case was settled, but the settlement contained no language allocating the payout to the particular causes of action. The IRS determined that damages received for when there was no observable bodily harm were includable in gross income, as they were not a result of personal physical injuries or physical sickness. However, damages for after the victim was assaulted and suffered observable injuries were excludable from gross income under I.R.C. §104(a)(2). The existence of an observable personal physical injury was the dividing line. Any recovery for emotional distress prior to an observable personal physical injury was not excludable from gross income. However,

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the portion of the recovery for emotional distress occurring after the observable injury was excludable because it was deemed to have been the result of the physical injury.[22]

Character of Taxation

If it is determined that all or part of a settlement is taxable, the question then focuses on the manner in which it will be taxed (i.e., as ordinary income, capital gain, return of capital, etc.). The courts and the IRS will again look to the origin of the claim to determine how the payment will be taxed, if at all. For example, if the origin of the claim is a loss of business income, any payment therefore will retain the same character and be taxed as ordinary business income. Conversely, if the loss arose from damage to a capital asset (i.e., harm to business property that has been capitalized for tax purposes), any settlement for loss of or damage to that capital asset could be taxed as a capital gain or loss or return of capital.[23]

How can you most effectively represent your client when it comes to these issues?

Always consult tax counsel as early in the process as possible. From a tax standpoint, settlements and judgments will be treated in the same way, as will lump sum payments and periodic payments. However, there is significantly more potential to maximize tax benefits in the context of a settlement than when there is a judgment after litigation. If multiple claims form the basis for a settlement, one should detail in the settlement the allocation of payments to each claim and, if possible, the manner in which they were computed. The parties should attempt to reach an agreement on the proper income reporting for the payments and document that in the settlement. If that is done, and followed by all parties, it is far more likely that the IRS will honor the intent of the parties.

Consulting with tax counsel prior to settlement also makes it possible to prepare your client for the tax ramifications of the settlement or judgment. Counsel can explain to the client the amount he or she can expect to receive after payment of taxes and make arrangements to set aside funds for the payment of estimated taxes, if necessary. This will ensure that the client will not be faced with an unexpected and hefty tax bill and the attendant consequences that go along with a large tax debt. ⊙

Endnotes

[1]It is also possible to structure a settlement agreement post-judgment, for example while an appeal or post-trial motions are pending.

[2]26 U.S.C. § 61(a) (emphasis added). All further citations to Title 26 of the U.S. Code will be cited to as I.R.C.

[3]A physical injury is not necessary to qualify for exclusion of worker's compensation claim recoveries from gross income. In addition, worker's compensation benefits usually will not be taxable regardless of the recipient. I.R.C. § 104(a)(1).

[4]However, amounts received by an employee through accident or health insurance for personal injuries or sickness, if attributable to contributions by the employer that were not includable in the gross income of the employee or paid by the employer, will be includable in gross income. I.R.C. § 104(a)(3).

[5]I.R.C. § 104(a)(1), (3), (4) and (5).

[6]Prior to enactment of the Small Business Job Protection Act of 1996, I.R.C. § 104(a)(2) excluded recoveries on account of "personal injuries or sickness" from income.

[7]I.R.C. § 104 (a)(2).

[8]*Id*.

[9]However, if punitive damages are obtained as part of a wrongful death action and only punitive damages can be awarded under the state law at issue, these punitive damages might be excludable from gross income. I.R.C. § 104(a)(2); I.R.C. §104(c).

[10]*See Brabson v. United States*, 73 F.3d 1040 (10th Cir. 1996) (statutorily mandated prejudgment interest not excludable from gross income as damages on account of personal injuries); *Chamberlain v. United States*, 401 F.3d 335 (5th Cir. 2005) (prejudgment interest not received because of personal injuries and therefore not excludable from gross income); *Rozpad v. Commissioner*, 154 F.3d 1 (1st Cir. 1998) (prejudgment interest on compensatory award in personal injury case taxable).

[11]*Ash Grove Cement Co. v. United States*, 562 F. App'x. 697 (10th Cir. 2014).

[12]*Id.* at 699 (*citing Dye v. United States*, 121 F.3d 1399, 1404 (10th Cir. 1997)).

[13]*See* Rev. Rul. 85-98, 1985-2 C.B. 51; IRS Publication 4345 ("Generally the IRS will not disturb an allocation if it is consistent with the substance of the settled claims.").

[14]*Robinson v. Commissioner*, 102 T.C. 116, 129 (1994) *aff'd in part, rev'd in part*, 70 F.3d 34 (5th Cir. 1995); *Knuckles v. Commissioner*, 349 F.2d 610 (10th Cir. 1965), *aff'g*. T.C. Memo. 1964-33.

[15]*McKay v. Commissioner*, 102 T.C. 465 (1994) *vacated and remanded*, 84 F.3d 433 (5th Cir. 1996). *But see Hess v. Commissioner*, T.C.M. 1998-240 (suggesting that payor's intent, which may be reflected in the terms of a settlement agreement, will primarily control the nature of the underlying claim that is paid).

[16]If a suit is resolved by judgment after trial, a court order may allocate payment among the claims brought. The IRS is not bound by this either, but will take this into consideration in making a determination as to taxability. *See*, I.R.S. Priv. Ltr. Rul. 84-37-084 (June 13, 1984).

[17]*See Phoenix Coal, Co. Inc. v. Commissioner*, 231 F.2d 420 (2nd Cir. 1956); *Paul v. United States*, 1972 WL 3182 (S.D. Ill. 1972); *Maryland Shipbuilding & Drydock Co. v. United States*, 409 F.2d 1363 (Ct. Cl. 1969).

[18]If the client has taken deductions for medical expenses that were a part of the settlement, the client must include in income any portion of the deducted medical expenses that provided a tax benefit in previous years. I.R.C. § 104(a).

[19]I.R.C. § 104(a).

[20]H. R. Rep. No. 104-737, at 301 n. 56 (1996) (Conf. Rep.), 1996-3 C.B. 741, 1041.

[21]*See* I.R.S. Program Manager Technical Advice 2009-035 (October 22, 2008).

[22]I.R.S. Priv. Ltr. Rul. 00-04-1022 (Oct. 13, 2000). *But see* I.R.S. Priv. Ltr. Rul. 13-11-006 (March 15, 2013), where IRS excluded from gross income settlement payment where settlement terms indicated claimants suffered personal physical injuries of cuts, bruises, or inhalation of smoke (not a visible physical injury).

[23]A number of other requirements must be met for the payment to be taxed as a capital gain/loss, which will not be detailed here. However, if those are met and the funds are taxable as a capital gain or loss, the taxpayer will get the benefit of any basis he or she may have in the property.