Taxation of Personal Injury Settlements

My paper from 2007 is still fairly current, but I suggest that the lawyer consult more recent sources:

1. The IRS's 2015 **Publication 4345**, "Settlements- Taxability."

2. DSJ CPA, **Taxes May Add Insult to Injury in a Legal Settlement.**

3. Hastings and Toscano, **To 1099 or Not 1099.**

4. Special Needs Alliance, **Tax Considerations in Personal Injury Settlements**.

***While settlement amounts from damages arising out of physical personal injury are not taxable, you still need to be aware of the "net benefit" rule for medical expenses previously deducted from income, and the possible effects of the alternative minimum tax.

Lost Wages in Personal Injury Awards Are *Not* Taxable

by Francis J. Carney, Esq.

TO THE EDITORS:

Mike Deamer's piece in the last *Utah Trial Journal* on taxation of personal injury settlements left me reeling.[1] Was he really saying that lost wages recoveries in personal injury cases are taxable?

> The following compensatory damages are not excluded from gross income and are taxable: Interest, Punitive Damages (with a limited exception), Emotional Distress or Mental Anguish (unless on account of physical injury), Employment Discrimination or Injury to Reputation, Lost Profits, Lost Wages, Loss of Personal Service, Defamation, and Discrimination based on race, color, creed, sex, national origin, etc. and Breach of Contract.[2]

Wow. He's a respected tax lawyer, and I am not a tax lawyer and only sometimes respected. If what Mike says is true, then I've been committing malpractice for twenty-eight years, because I have always advised my clients that settlements in personal injury cases were tax-free. I have read the tax code, I took taxation in law school and I thought I knew it. Now I was being told otherwise – or so I thought.

After an interesting roundtable of this issue on the UTLA listserv, I was ready for a battle of the dueling articles, but it turned out that my fight was with a straw man of my own making. For after speaking with Mike Deamer, I learned that I was misreading his article. I am not sure, but I think that the paragraph I cite comes not from Mike, but from an IRS publication – and IRS publications, as Mike pointed out in his article, can be very misleading.[3]

Mike Deamer is *not* saying that recoveries in a claim arising out of personal physical injury are subject to federal income taxation. His point – and it is a good one – is that we should not blithely assume that all "tort" recoveries are tax-free. We need to be careful how we draft our complaints, and we should not assume that cleverly-written settlement agreements will deter the IRS. We, as personal injury attorneys, have the duty to understand the basics of the taxation of awards and should know enough to understand when specialized advice is needed and when it is not.

So let me take this opportunity to restate what should be known to all personal injury lawyers: *recoveries for compensatory damages arising out of physical personal injuries are not taxable*. All damages arising out of physical injury claims are tax-free: lost wages, medical bills, loss of consortium,[4] everything. They don't even have to be reported.[5] It does not matter whether damages are received by settlement or judgment. It does not matter if the damages are allocated to lost wages or not. They are not taxable. The only exceptions

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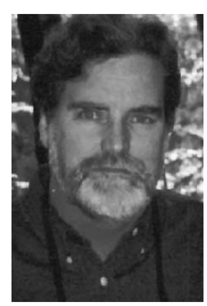

are punitive damages, medical expenses for which a deduction has already been taken (under the "tax benefit" rule),[6] and interest (pre or post-judgment).[7]

Understand that this tax treatment only applies to "personal, physical injuries" as defined in the Tax Code: anything else is likely to be taxable, such as settlements from employment claims, intentional torts without physical harm, civil rights, defamation, business disputes, contracts, and so on.

"All damages arising out of physical injury claims are tax-free... They don't even have to be reported.... The only exceptions are punitive damages, medical expenses for which a deduction has already been taken... and interest."

This is elementary, and it is not something for which you need advice from a specialist in taxation. Physical personal injury recoveries are simply not taxable. The Tax Code says so, the IRS says so, and the Supreme Court says so.

Let's start with the Internal Revenue Code. Section 104(a)(2) provides:

> Except in the case of amounts attributable to (and not in excess of) deductions allowed under Section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include:
>
> . . . .
>
> ...The amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or periodic payments) on account of personal physical injuries or physical sickness.

That is clear enough. And it has been that way since the tax code was written some eighty years ago.[8]

Then let's go to the IRS's own Revenue Rulings. Twenty years ago, Revenue Ruling 85-97 stated that the entire amount received in settlement of a suit for personal injuries, *including the part allocable to the claim for lost wages,* is excludable from gross income.[9] Nothing significant has changed since then, except that the Tax Code was amended in 1996 to make clear that punitive damages were taxable, and that the basis for the claim had to be both "personal" and "physical" in order to qualify as excludable income.

The IRS reiterates the rule in its own publication for its agents: "[t]he Service has consistently held that compensatory damages, *including lost wages,* received on account of a physical injury are excludable from gross income."[10] And, at least sometimes, the IRS even says this in its publications for taxpayers. For example, Publication 525, *Taxable and Non-Taxable Income,* 29 states, "Do not include in your income compensatory damages for personal physical injury or physical sickness."

The courts have repeatedly confirmed that all damages, including lost wages, arising out of physical injury tort claims are not taxable income. For example, in *C.I.R. v. Schleier,* 515 U.S. 323 (1995), the Supreme Court noted that in a typical personal injury case:

> the recovery for lost wages is also excludable as being on account of personal injuries, as long as the lost wages resulted from time in which the taxpayer was out of work as a result of her injuries. See, e.g., *Threlkeld v. Commissioner,* 87 T.C. 1294, 1300, 1986 WL 22061 (1986) (hypothetical surgeon who loses finger through tortious conduct may exclude any recovery for lost wages because [t]his injury will also undoubtedly cause special damages including loss of future income"), aff'd, 848 F.2d 81 (CA6 1988).

As *Threlkeld* put it, "if a taxpayer receives a damage award for a physical injury, which almost by definition is personal, the entire award is excluded from income even if all or a part of the recovery is determined with reference to the income lost because of the injury."[11] Indeed, the United States Supreme Court allows counsel to tell the jury in FELA cases that any recovery for lost future earnings will not be taxable.[12]

While some authors disagree with the concept of lost wage recoveries as being tax-free,[13] it is the law, it has been from the start, and it is likely to remain so.

So here is my message: if it is a run-of-the-mill physical injury, do not worry about income taxes. The recovery, whether it is for general damages, lost wages, wrongful death, medical expenses, loss of earning capacity, loss of consortium, is *not* subject to federal income tax. The only time that you need to worry about income taxes is if you have a non-physical injury claim: contracts, defamations, employment, civil rights, etc.[14] Do not assume that a cleverly-written settlement agreement is going to foreclose the IRS from treating some of the proceeds as taxable.[15]

I have made a challenge to everyone on the UTLA listserv, and make it again here. I am as certain as I have ever been about any legal issue that recoveries for lost wage damages arising out of physical injuries are not recoverable. To those who still disagree, I say this: prove me wrong. Prove that lost wage recoveries in the typical personal physical injury case are taxable income. If you do so, I will show up at our next annual meeting, publicly confess my ignorance, ask for forgiveness of my arrogance, and let you throw a cream pie in my face.

> *"The courts have repeatedly confirmed that all damages, including lost wages, arising out of physical injury tort claims are not taxable income."*

1. M.A. Deamer, *A Primer on Taxation of Personal Injury Settlements*, UTAH TRIAL J., Fall 2006, at 22.

2. *Id.* (emphasis added).

3. For example, Publication 4345 (cited in the Deamer article) says that emotional distress or mental anguish damages are generally taxable, which they most definitely are *not*, at least where they arise out of tort cases for personal injuries.

4. *See* H.R. CONF. REP. No. 104-737, at 300 (1996), *printed in* 1996 U.S.C.C.A.N. 1474, 1793 (stating, AIf an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as damages received on account of personal physical injuries or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim of loss of consortium due to physical injury or physical sickness of such individual's spouse are excludable from gross income.").

5. *See* IRS MARKET SEGMENT SPECIALIZATION PROGRAM, LAWSUITS AWARDS AND SETTLEMENTS (2000) (which can be downloaded at http://www.unclefed.com/SurviveIRS/MSSP/index.html).

6. These recoveries should be reported as "other income" on line 21 of Form 1040.

7. Reported as "interest income" on line 8 of Form 1040.

8. The Revenue Act of 1918 included Section 213(b)(6), the predecessor to 104(a)(2).

9. Rev. Rul. 85-97, 1985-29 I.R.B. 5, 1985-2 C.B. 50, 1985 WL 287177 (IRS RRU) (emphasis added).

10. IRS MARKET SEGMENT SPECIALIZATION PROGRAM, LAWSUITS AWARDS AND SETTLEMENTS 2-4 (2000) (emphasis added).

11. *Threlkeld*, 87 T.C. 1294, at 1300.

12. *See Norfolk & Western R.R. v. Liepeldt*, 444 U.S. 490 (1980). However, the Utah Court of Appeals disagreed, not with the idea that there is no tax for injury recoveries, but that the jury should be told about this fact. *See Davidson v. Prince*, 813 P.2d 1225 (Utah Ct. App. 1991).

13. K. Chapman, *No Pain-No Gain? Should Personal Injury Damages Keep Their Tax-Exempt Status?*, 9 U.ARK. LITTLE ROCK L.J. 407 (1987).

14. And there has been some recent relief from taxation of attorneys' fees in employment recoveries since the A Civil Rights Tax Relief" portion of the American Jobs Creation Act of 2004 was signed into law by President Bush in October 2004.

15. An obvious example is where the complaint alleges substantial punitive damages and yet the settlement agreement recites that no amounts are being paid for punitives. Needless to say, the parties cannot change a taxable settlement into a non-taxable one by drafting the settlement agreement to state that the compensation is for a physical injury. *See Hawkins v. Commissioner,* 6 B.T.A. 1023 (1927).

RESPONSE

I appreciate Frank Carney's thoughtful letter. I agree with what he has stated. The confusion arises from the IRS's use of the terms "personal injury." Some personal injury such as defamation, infliction of emotional distress, violation of civil and constitutional rights, etc., do not involve physical injury and hence recoveries for "lost wages" have been held to be taxable. However, where there are damages for "lost wages" arising out of physical injury or physical sickness, these are not taxable as described in my article. His letter actually highlights the primary thesis of my article, which is that the IRS published statements on this topic are misleading at best and wrong in many cases.

As a side note, in October 2006, the IRS requested a re-hearing on the *Murphy* case referred to in my article, before the full panel of the DC Circuit Court. The court, in an unusual move, agreed to have the original 3 member panel rehear the case themselves, before the full panel of the court considers the matter.

As a further note, the IRS in Rev. Rul. 2007-14 just issued in February 2007 held that the income tax aspects of the old 1954 Revenue Ruling (54-19, 1954-1 C.B. 179) cited in my article are now obsolete.

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