

Trial Law TIPS

Roy D. Wasson's
TIP #84

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Planning for Federal Income Tax Consequences of Personal Injury Settlements

Most trial lawyers realize that the majority of damages recoverable in a personal injury suit are not subject to federal income taxation. However, some of us oversimplify the issue and mistakenly believe that there are *no* federal income tax consequences possible in settling a personal injury case. The purpose of this TIP is to warn our readers about the potential income tax consequences from three aspects of personal injury settlements. This should help trial lawyers advise their clients concerning those tax consequences, successfully structure settlements to avoid adverse tax consequences, and protect from the possibility of later legal malpractice claims.

The three areas in which there are possible income tax consequences in a personal injury case are 1.) punitive

damages, 2.) damages for emotional distress, and 3.) the consideration paid for a confidentiality agreement. It is the taxpayer that bears the burden of proving what aspects of a personal injury settlement are non-taxable. *See Comm'r of Internal Revenue v. Schleier*, 515 U.S. 323 (1995). The starting place in meeting that burden where a tort settlement is negotiated, is the complaint and the itemization of damages set forth therein. Further, in negotiating a settlement agreement, trial lawyers should consider setting forth specific amounts of the settlement for various elements of damage.

The statute pertinent to this discussion is Section 104 of the Internal Revenue Code, which reads as follows:

§ 104. Compensation for injuries or sickness.

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

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(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;

(3) amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer);

(4) amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service, or as a disability annuity payable under the provisions of section 808 of the Foreign Service Act of 1980 [22 USCS § 4048]; and

(5) amounts received by an individual as disability income attributable to injuries incurred as a direct result of a terroristic or military action (as defined in section 692(c)(2) [IRC Sec. 692(c)(2)]).

(Emphasis added).

Punitive Damages Are Taxable Income

As can be seen from the above, the Tax Code statute itself expressly exempts punitive damages from the exclusion of personal injury recoveries from taxable income. In addition, even before Congress revised the Code to specifically reference punitive damages, the U.S. Supreme Court had held that punitive damages were taxable, holding as follows:

Petitioners punitive damages were not received “on account of” personal injuries [within the meaning of section 104 (a)(2)]; hence the gross-income exclusion provision does not apply and the damages are taxable.

(a) Although the phrase “on account of” does not unambiguously define itself, several factors prompt this Court to agree with the Government when it interprets the exclusionary provision to apply to those personal injury lawsuit damages that were awarded by reason of, or because of, the personal injuries, ***and not to punitive damages that do not compensate injury, but are private fines levied by civil juries to***

punish reprehensible conduct and to deter its future occurrence.

O’Gilvie v. United States, 519 U.S. 79, 80 (1996) (emphasis added).

Thus, our clients are subject to taxation for the punitive damages aspects of a personal injury settlement or judgment. The problem arises when we enter into a settlement that has an undifferentiated amount for all of our claims in cases involving punitive damages claim. Further, even in cases in which we negotiate a settlement that has nothing or a very small amount apportioned to a punitive damage claim, there is case law supporting a proposition that the parties’ apportionment—while given some weight—is not dispositive of the issue.

In *Bagley v. Comm’r of Internal Revenue*, 121 F.3d 393 (8th Cir. 1997), the plaintiff brought a lawsuit and was awarded both compensatory and punitive damages. While a motion for new trial was pending, the plaintiff accepted a lump sum settlement of \$1,500,000 and the parties entered into a settlement agreement stating that nothing was allocated to punitive damages. The tax court disregarded the parties’ agreement and allocated \$500,000 from the settlement as punitive damages, accessing income tax thereon. The plaintiff appealed and the Eighth Circuit affirmed, holding as follows: “when assessing the tax implications of a settlement agreement, courts should neither engage in speculation nor blind themselves to a settlement’s realities. *See Delaney v. Commissioner*, 99 F.3d 20, 23-24 (1st Cir. 1996) (court must look beyond language of settlement to determine ‘in lieu of what’ for damages paid”). *Id.* at 395.

Thus, it will help your client to take the position following a settlement that the punitive damage claim was really not that important and perhaps that the defendant was not even liable for punitive damages. If nothing else, plaintiff’s counsel should consider the tax implications when

deciding whether to proceed with a punitive damages claim at all.

Emotional Distress Damages Without Physical Injury

The next area in which tax consequences should be considered is that of damages for emotional distress. The courts have noted that the reference in Section 104 to excluding damages for “physical injuries” or “physical sickness” was an amendment to the Internal Revenue Code “to make it clear that only damages for physical injuries or sickness, and *not damages for emotional distress*, were excluded from the definition of income.” *Rivera v. Baker West, Inc.*, 430 F.3d 1253, 1256 (9th Cir. 2005). Thus, in cases involving only emotional distress damages—such as a claim for intentional infliction of emotional distress unaccompanied by physical injuries—the entire settlement or judgment amount will be taxable as income.

Our members should not despair about the ordinary personal injury case in which our clients are recovering damages for both physical injuries and emotional distress. If our clients’ emotional distress arises directly from physical injuries sustained as a result of the defendant’s wrongdoing, then those damages should be excluded from taxation because they are “on account of personal injuries.” However, our members are urged to be aware of this situation and to consider how damages claims are phrased and tort settlements are negotiated.

Portions of Settlement Paid for Confidentiality Taxable

Finally, some trial lawyers are unaware of the fact that the inclusion of a confidentiality provision in a settlement agreement will expose our clients to federal income tax liability for a portion of this settlement. This issue arose in *Amos v. Comm’r of Internal Revenue*, 2003 Tax Ct. Memo LEXIS 330 (Dec. 1, 2003), which resulted from an incident in which Chicago Bulls basketball player Dennis Rodman kicked

a cameraman during a basketball game, resulting in a personal injury suit by the cameraman.

That case settled under a confidential settlement agreement for \$200,000. The settlement agreement did not reflect how much of the settlement was being paid for the cameraman's physical injuries, and how much was being paid as consideration for his agreement that the settlement be confidential. The IRS took the position that the entire \$200,000 settlement was includible in the taxpayer's gross income, with the exception of perhaps a nominal sum of \$1. That was because the petitioner's physical injury were minimal. The settlement agreement did not apportion the amount of the payment.

The tax court held that \$80,000 of the settlement was for the confidentiality agreement, and the plaintiff was required to pay income tax on that amount. The court held as follows:

The settlement agreement does not specify the portion of the settlement amount at issue that Mr. Rodman paid petitioner on account of his claimed physical injuries and the portion of such amount that Mr. Rodman paid petitioner on account of the nonphysical injury provisions in the settlement agreement. Nonetheless, based upon our review of the entire record before us, and bearing in mind that petitioner has the burden of proving the amount of the settlement amount at issue that Mr. Rodman paid him on account of physical injuries, we find that Mr. Rodman paid petitioner \$ 120,000 of the settlement amount at issue on account of petitioner's claimed physical injuries and \$ 80,000 of that amount on account of the nonphysical injury provisions in the settlement agreement. On that record, we further find that for the year at issue petitioner is entitled under section 104(a)(2) to exclude from his gross income \$ 120,000 of the settlement amount at

issue and is required under section 61(a) to include in his gross income \$ 80,000 of that amount.

Id. at **22-23.

The message is clear: when the mediator reports that the defense has accepted your demand, write into the settlement agreement that \$500 or so of the amount is being paid for the confidentiality agreement, and the rest is for the personal injury claim. That should protect your client from a large and unexpected bill from the IRS.

Conclusion

State and Federal Law—including tax law—is so extensive and complicated that none of us ever will master all of the areas we need to know to handle every legal challenge our clients face. It is especially frustrating when federal tax laws and other obscure legal provisions outside the areas of our practice interfere with the way we negotiate settlements and otherwise handle personal injury litigation.

We will never learn everything that there is out there that may affect our clients, but all we can do is

Keep Tryin!

Roy