PERSPECTIVE
Los Angeles | Daily Journal
WEDNESDAY, MAY 3, 2023

Taxing Insurance Bad Faith Recoveries

By Robert W. Wood

Insurance bad faith litigation recoveries can be significant, in some cases dwarfing the underlying dispute. By definition, they arise out of an underlying dispute or accident. That duality can make the tax treatment of insurance bad faith recoveries especially tricky. However, it can also invite some potential tax planning. If the underlying incident was a physical injury accident, the compensatory damages should presumably be tax free.

But in a later bad faith case, does that mean that the bad faith recovery should also get the same physical injury character? Or alternatively, is the bad faith recovery likely to be viewed as punitive in nature (taxable, even if the injuries are physical)? And does it matter if the bad faith case in question is viewed as a contract dispute, or a tort case?

These questions do not have unified answers in the tax law, and as with any other case, the facts are going to matter. If the case arises out of health or disability insurance, it may be taxable or not, often depending on who paid the premiums for the policy. Sometimes, a key fact will be whether the plaintiff was adequately compensated in the underlying physical injury case. Whether the insurance company's delay exacerbated the plaintiff's medical condition is relevant to taxes too.

A common claim is that the insurance company did not proceed appropriately to pay a claim, thus causing the plaintiff additional damages. In that sense, a bad faith case may seem a little like a legal malpractice claim against a lawyer. That is, one should consider the tax treatment of the underlying case, and how the later recovery may relate back to the first.

One of the most important pieces of tax authority on this question is an IRS private letter ruling. Technically, private letter rulings are not authority on which other taxpayers can rely (they are written to one taxpayer, and technically binding only that person). As a practical matter, though, tax professionals regularly read and rely on IRS private letter rulings as good indications of how other cases for other taxpayers would come out.

In Letter Ruling 200903073 (January 16, 2009), a plaintiff had been employed as a construction worker, and in the course of his employment, was struck by a drunk driver. The drunk driver managed a tavern, and had served himself liberally while on duty.

The plaintiff was severely injured, and sued the driver/manager as well the tavern employer. A jury verdict for compensatory and punitive damages was appealed.

The insurance company for the tavern failed to settle, and the tavern had a bad faith claim, which the tavern assigned to the plaintiff. Thus, the injured plaintiff ended up with those claims. Eventually, the plaintiff settled that case, treating it as satisfying the plaintiff's underlying judgment against the tavern manager and the tavern. The IRS agreed that this bad faith money was really for the underlying personal physical injuries and therefore was tax free under Section 104, the physical injury exclusion section.

After all, the plaintiff was merely trying to collect on the plaintiff's judgment against the manager and the tavern for damages awarded on his personal physical injury claim. Quite literally, the plaintiff was only receiving money from the insurance company *because* the plaintiff was physically injured. However, the IRS noted that any punitive damages in the case would still be taxable.

As a result of this 2009 letter ruling, some taxpayers may automatically think "tax free" when they hear "bad faith." That assumption can be dangerous and lead to taxes, interest, and penalties, plus accounting and legal fees. For example, in *Ktsanes v. Commissioner*, T.C. Summ. Op 2014-85, the taxpayer worked for the Coast Community College District ("CCCD") in Orange County.

He participated in the CCCD's group long-term disability insurance plan. He developed a serious illness, and applied for long-term disability benefits. When the company rejected his claim, he filed a bad faith claim against the company and eventually settled for $65,000. He claimed that the settlement money was tax-free, but the IRS disagreed.

Under Section 104(a)(3) of the tax code, amounts received through accident or health insurance for personal injuries or sickness are excludable from income. The key qualifier is that the premiums must not have been paid by the insured's employer. Ktsanes's disability premiums were paid by his employer, so he did not qualify for tax-free treatment. His disability pay would have been taxable (his employer paid the premiums) so his bad faith recovery was too.

In *Watts v. Commissioner*, T.C. Memo. 2009-103, the taxpayer sued her automobile insurer claiming breach of contract after she sustained physical injuries in a collision with an uninsured motorist. The parties settled for an amount in excess of Watts's $50,000 policy limit. Watts excluded the settlement from his income under Section 104(a)(2), the physical injury exclusion. The IRS disallowed it entirely, arguing that the entire settlement was taxable. The Tax Court allowed the first $50,000 to be excluded, but agreed with the IRS that the excess over the policy limits was taxable income.

Another data point came in *Hauff v. Petterson*, 755 F. Supp. 2d 1138 (D. N.M. 2010). This case is not a tax case, but it is worth reading even if one is focused solely on taxes. Instead of analyzing a bad faith recovery to ascertain how it should be taxed, the court uses the tax treatment of a recovery to determine whether the insurance company acted in bad faith. The facts unfolded like this.

David Hauff filed a claim with his automobile insurer after he was injured in a collision with an uninsured motorist. Among other things, he requested lost wages. Hauff's insurance carrier agreed to pay him lost wages based on Hauff's wages *net* of the income tax that he would normally have to pay.

Hauff demanded that his lost wages be calculated based on his *gross* lost wages, and filed suit for bad faith. The court determined that the amounts received by Hauff for lost wages could be excluded from his income under Section 104 on account of personal physical injuries. Because Hauff would not have to pay tax on the amounts received from his insurer,

the court found for the insurer on summary judgment. In that sense, the court took the tax law into account and used it against the plaintiff.

In *Braden v. Commissioner*, T.C. Summ. Op. 2006-78, Braden received $30,000 from a class action settlement with his automobile insurance company related to underlying physical injury claims Braden had made against the insurance company. Braden excluded the $30,000 from his income under Section 104. The IRS disagreed, and the matter went to Tax Court.

The IRS moved for summary judgment, arguing that this amount could not be excludable under Section 104. The Tax Court, however, denied the motion, stating that the *nature* of the taxpayer's claim controlled. According to the Tax Court, the fact that this lawsuit was for breach of contract did not foreclose the possibility that his claim was for personal physical injuries.

Considering how many claims insurance companies face for putative bad faith, it is surprising that there are not more tax cases considering these settlements. Despite the relative paucity of cases, it seems reasonable to believe that there are an increasing number of bad faith settlements and judgments. Not all involve good arguments for exclusion, and sometimes the way to get to that position can require some creativity.

Indeed, Letter Ruling 200903073 involved a bad faith claim that was originally owned by the tavern policy holder. The policy owner assigned the bad faith claim to the plaintiff, which enabled him to sue the carrier. However, it was the nature of the underlying injury and the plaintiff's claim against the tavern and tavern manager that sparked the assignment. And it was the underlying injury that ultimately led to the recovery.

As with any other piece of litigation that is resolving, it generally pays to think about the tax issues before signing the settlement agreement. Settlement agreement wording does not bind the IRS or the California Franchise Tax Board. Even so, you might be surprised at how incredibly helpful tax language can be in a settlement agreement. The plaintiff will have to take a tax position on the recovery when filing taxes the following year. The more you can help set up favorable tax treatment in advance, the better.

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