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Are Insurance Bad Faith Settlements Taxable To IRS?

Are insurance bad faith litigation recoveries taxable? It depends on numerous variables. One big question is whether it can be seen as a compensatory recovery for physical injuries or physical sickness. Compensatory damages for physical injuries or physical sickness can be tax-free, and some bad faith cases can relate back to the damages. 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 an underlying physical injury case. Whether the insurance company's delay exacerbated the plaintiff's medical condition can also be relevant to taxes. A common claim is that the insurance company did not proceed appropriately to pay a claim, causing the plaintiff additional damages. The most important authority is an IRS private letter ruling. In [Letter Ruling 200903073](#), a plaintiff was a construction worker struck by a drunk driver in the course of his employment. The drunk driver managed a tavern, and had served himself liberally on duty.



The plaintiff was severely injured, and got a jury verdict against the tavern and manager, which they appealed. The tavern's insurance company failed to settle, and the tavern assigned its bad faith claim to the plaintiff in a settlement. Eventually, the plaintiff settled the bad faith claim, treating it as satisfying the plaintiff's underlying judgment against the manager and tavern. The IRS agreed that this bad faith money was *really* for the underlying physical injuries so was tax free under [Section 104](#), the physical injury exclusion section.

After all, the plaintiff was merely trying to collect the damages awarded on his personal physical injury claim. However, the IRS said that any punitive damages would still be taxable. Other bad faith recoveries aren't tax-free. In [Ktsanes v. Commissioner](#), the taxpayer had group long-term disability insurance at work. He developed a serious illness, and applied for long-term disability. When the company rejected his claim, he filed a bad faith claim. It settled for \$65,000, which Ktsanes claimed was tax-free.

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. His disability pay *would have* been taxable, so his bad faith recovery was too.

In [Watts v. Commissioner](#), 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 in excess of Watts's \$50,000 policy limit. Watts excluded the settlement under Section 104(a)(2), the physical injury exclusion. The IRS disallowed it entirely, but the Tax Court allowed the first \$50,000 to be excluded. The excess over the policy limits, the court ruled, was taxable.

In [Braden v. Commissioner](#), Braden received \$30,000 from a class action settlement with his automobile insurance company related to underlying physical injury claims he 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 Tax Court said the *nature* of his claim controlled. 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 bad faith, it is surprising that there are not more tax cases considering these settlements. Some

bad faith plaintiff's lawyers report that they routinely see clients pay taxes on the recoveries. Some plaintiffs exclude them from income, and perhaps there are few disputes.

Despite the few tax 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, but some do. And sometimes the way to get to that position can require some creativity. Letter Ruling 200903073 involved a bad faith claim originally owned by the tavern policy holder, who assigned it to the plaintiff. However, it was the nature of the underlying injury that sparked the assignment. And it was the underlying injury that ultimately led to the recovery.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.