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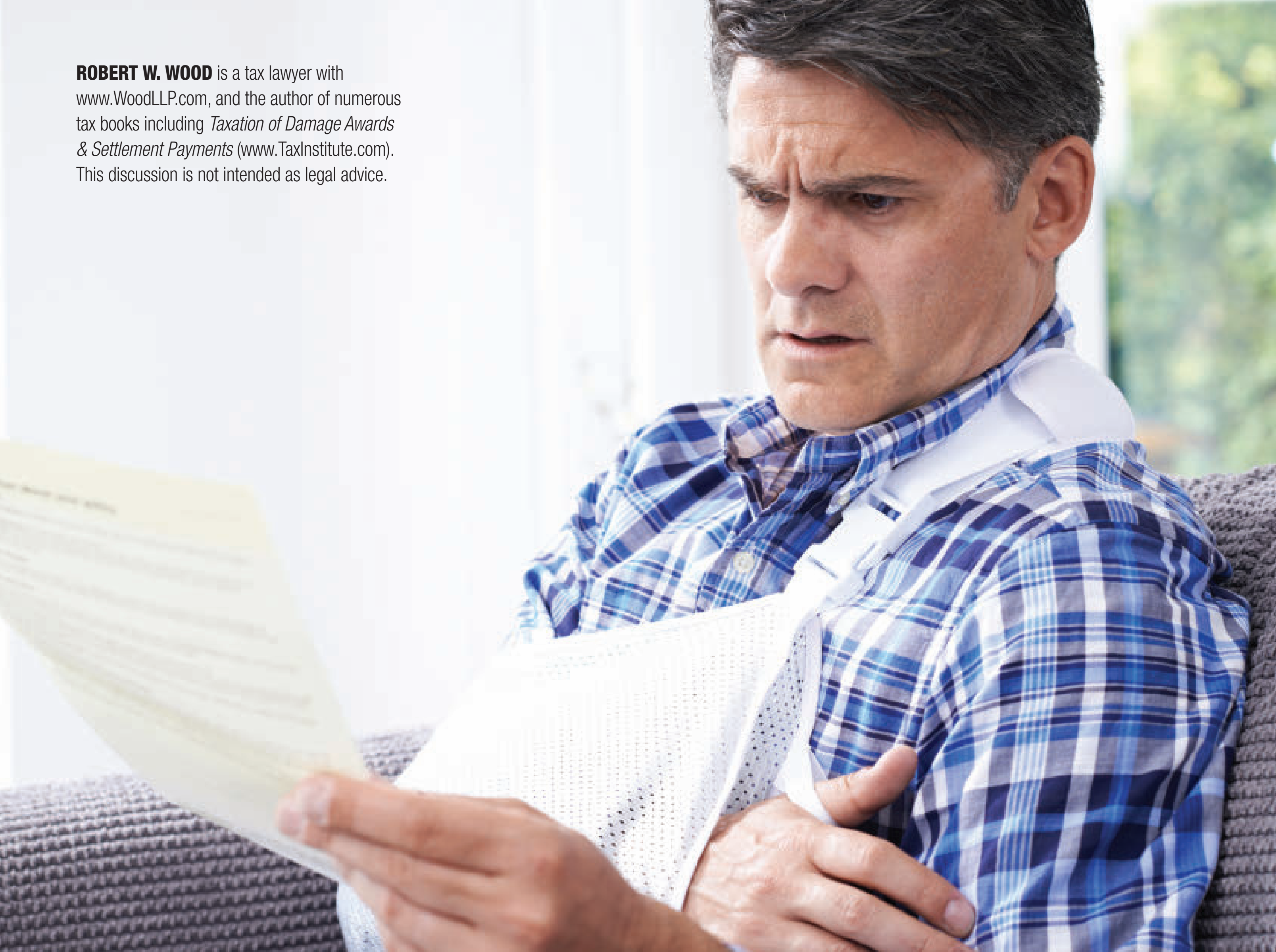

Are Insurance Bad Faith Recoveries Taxable?

BY ROBERT W. WOOD

Are insurance bad faith litigation recoveries taxable? The annoying answer is: It depends. A bad faith claim may be a tort or a contract claim, may be brought against one's own insurance carrier, or even against someone else's carrier. A common claim is that the insurance company defendant did not proceed appropriately to pay a claim, thus causing the plaintiff additional damages.

In that sense, not unlike a legal malpractice claim against a lawyer, one key question will predate the bad faith case. Most tax professionals will imagine a physical injury accident where the insurance company pays too little too late, and later must pay more for the same injuries via a bad faith claim. That is a useful—and common—example to bear in mind.

Relevant Statutory Law

The tax code states in Section 61 that, except for explicit exclusions, everything is gross income. That applies to lawsuit recoveries, whether by settlement or judgment.[1] This applies to insurance recoveries too.

Fortunately, though, there is an explicit statutory exclusion in Section 104 of the

tax code for recoveries for personal physical injuries or physical sickness. It does not apply to punitive damages. There has been great controversy over what the word "physical" means in this context. Section 1.104-1(c) of the Income Tax Regulations defines the term "damages received (whether by suit or agreement)" as "an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort-type rights, or through a settlement agreement entered into in lieu of such prosecution."

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2009 IRS Ruling

The most important guidance is an IRS private letter ruling that suggests some (but not all) bad faith recoveries are tax free.

In Letter Ruling 200903073,[2] 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 that had employed him.

The plaintiff received a jury verdict consisting of compensatory damages for his personal physical injuries, medical expenses, pain and suffering, lost earnings, plus punitive damages. After post-trial motions, the jury verdict was reduced to $X in compensatory damages and $Y in punitive damages. The defendants appealed. Prior to the judgment, the insurer for the tavern (Insurance Company) had rejected an opportunity to settle for policy limits under the tavern's policy.

Under state law, the tavern as policy holder had a cause of action against Insurance Company if it acted in bad faith in failing to settle the claim. Thus, as part of an agreement to stay the execution of the plaintiff's judgment, the tavern assigned to the plaintiff its rights to pursue a bad faith claim against Insurance Company. The assignment agreement provided that within 30 days of the termination of the litigation against Insurance Company, the judgment against the manager and the tavern (relating to plaintiff's personal injury claims) would be marked "satisfied." Eventually, the plaintiff entered into a settlement agreement calling for the insurance company to pay $Z to plaintiff and his attorneys.

Underlying Case Tax-Free

The IRS starts its analysis with the origin of the claim doctrine. Citing *Raytheon Production Corp. v. Comm'r*,[3] the IRS states that the critical inquiry is in lieu of what were the damages awarded. The plaintiff may have recovered against the insurance company, but the recovery had its origin in the case against the tavern manager and the tavern. The plaintiff was merely trying to collect on his personal physical injury claim.

"But for" the physical injury claim and assignment, the plaintiff would be receiving nothing. Quite literally, the plaintiff was only receiving money from Insurance Company *because* the plaintiff was injured. Thus, the IRS concluded that the Section 104 exclusion applied.

Interestingly, the Service noted that the exclusion would not apply to any amounts attributable to *punitive* claims. Punitive damages are always taxable.[4] Letter Ruling 200903073 expresses no opinion on allocating between compensatory and punitive damages.

Contract or Tort?

In bad faith cases, there is an underlying cause of action for which the taxpayer is seeking redress. It might be a personal physical injury action or something else. It may be viewed as a contract claim relating to the insurance policy, or as a tort claim related to Insurance Company's operations and its treatment of the plaintiff. Not surprisingly, most bad faith insurance cases relate to the mishandling of insurance claims.

Taxable Damages

When taxpayers claim that bad faith recoveries are excludable from gross income under IRC Section 104(a)(2), the personal physical injury or physical sickness almost always concerns the facts that gave rise to the insurance claim, rather than the denial of the claim itself. Put differently, relatively few bad faith claimants can assert that the insurance company actually caused them physical harm.

But some claims state that the insurance company's delays exacerbated their physical injuries and physical sickness. In that kind of case, the argument for excluding all or part of the bad faith recovery can be strong. For example, in *Ktsanes v. Comm'r*,[5] the taxpayer worked for the Coast Community College District (CCCD) in Orange County, California.

In connection with his employment, Ktsanes participated in a group long-term disability insurance program managed by Union Security. The premiums were paid by Ktsanes's employer, CCCD, and were not included in Ktsanes's income. Ktsanes developed Bell's palsy, which caused him to be unable to continue working for CCCD. He filed a claim for long-term disability with Union Security, which the insurance company denied, saying that Ktsanes was not sufficiently disabled to qualify.

Ktsanes filed a bad faith claim against Union Security. The claim was settled for $65,000. Ktsanes claimed the settlement payment was received on account of a physical sickness (the Bell's palsy), and therefore excluded it from his gross income under IRC Section 104(a)(2).

When the IRS disagreed, he argued that the group long-term disability insurance program was equivalent to a workmen's compensation payment, so was excludable under IRC Section 104(a)(1). The Tax Court rejected both arguments and found the settlement to be taxable. The Tax Court concluded that Ktsanes's damages were received "on account of" the insurance company's refusal to pay the insurance claim and not the Bell's palsy that gave rise to the insurance claim.

On the surface, this might make it difficult for bad faith recoveries to qualify under IRC Section 104(a)(2). However, the Tax Court in *Ktsanes* concludes its opinion by

suggesting that one should look through the insurance claim to the facts that gave rise to the insurance claim. The court asks how the payment would have been taxed had the insurance claim been paid without dispute.

The taxation of an undisputed payment would depend on the facts that gave rise to the insurance claim. Under IRC Section 104(a)(3), amounts received through accident or health insurance for personal injuries or sickness are excludable from gross income. The key qualifier is that the insurance premiums must not have been paid by the insured's employer as a tax-free benefit to the insured. Ktsanes's long-term disability premiums were paid by his employer, and were not included in his income.

Thus, he clearly did not qualify for tax-free treatment under Section 104(a)(3). Had his insurance claim been paid without dispute, it would have been taxable. So treating the bad faith claim as taxable made sense. However, another case decided shortly after the 2009 letter ruling is more troubling.

In *Watts v. Comm'r*,[6] 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 under IRC Section 104(a)(2).

The IRS disallowed the exclusion, and the Tax Court mostly agreed with the IRS. The Tax Court concluded that the settlement payment could be excluded under IRC Section 104(a)(3) up to the policy limits, and were taxable interest or other taxable income to the extent the settlement payment exceeded Watts's $50,000 policy limit.

Where the proceeds of bad faith cases would cause payments from insurers to be taxed differently from how the same payments would be taxed if paid by the insurer without dispute, be careful. The IRS is likely to say that the payment is taxable, and the Tax Court may agree.

Notably, though, Letter Ruling 200403046[7] ruled that legal fees allocable to disability benefits were excludable under Section 104(a)(3). The ruling involved a taxpayer who purchased disability insurance with after-tax dollars. The taxpayer was disabled on the job, but his claim was denied. The taxpayer thereafter filed suit against the insurance company, alleging bad faith and contract damages.

The taxpayer prevailed, but the insurance company appealed. The matter settled on appeal, and the taxpayer recovered attorney fees and costs. The IRS ruled that because the underlying recovery was excludable under Section 104(a)(3), the recovered attorney fees and costs were too.

Braden v. Comm'r[8] predates the 2009 letter ruling, but is interesting nonetheless. Braden received $30,000 from a class action settlement with his automobile insurance company. The action was a bad faith claim, but was related to underlying physical injury claims Braden made against the insurance company.

Braden excluded the $30,000 from his gross income under Section 104. The IRS disagreed, and the matter went to Tax Court. The IRS moved for summary judgment, but the Tax Court denied the motion, stating that the *nature* of the taxpayer's claim controlled.

Conclusion

Considering how many claims insurance companies face for alleged bad faith behavior, it is surprising that there are not more tax cases considering plaintiff recoveries. Some bad faith plaintiffs' lawyers report that they routinely see clients pay taxes on the recoveries. Some plaintiffs may exclude them from income without much thought, and perhaps there are few disputes.

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, but some do. 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 claim was later pursued by an injured plaintiff who recovered "on account of" his injuries. 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.

Do not forget the practical side of these cases. Tax language in a settlement agreement never binds the IRS, but it never hurts either.

Finally, do not forget the practical side of these cases. Tax language in a settlement agreement never binds the IRS, but it never hurts either. Where appropriate, insert tax language in settlement agreements that acknowledges that the plaintiff is being paid on account of his or her underlying personal physical injuries.

In fact, if you can manage it, also state that the plaintiff's recovery is tax-free under Section 104. And try to negate the issuance of an IRS Form 1099 to plaintiff. The tax law is clear that if a payment is excludable from income, it should not be the subject of an IRS Form 1099. Do your best to help shape the recovery and to provide the plaintiff with good documentation if there should ever be an audit. AZ AT

endnotes

1. *See Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).
2. Jan. 16, 2009.
3. 144 F.2d 110 (1st Cir. 1944), *cert denied,* 323 U.S. 779 (1944).
4. *See O'Gilvie v. U.S.*, 519 U.S. 79 (1995); *see also* IRC Section 104.
5. T.C. Summ. Op. 2014-85.
6. T.C. Memo. 2009-103.
7. Jan. 16, 2004.
8. T.C. Summ. Op. 2006-78.