Are Insurance Bad Faith Recoveries Taxable?

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Are insurance bad faith litigation recoveries taxable? The annoying answer is: it depends. This is because, although damage awards and insurance proceeds are generally considered "gross income" for tax purposes, the Internal Revenue Code ("IRC") provides an exception for damages received "on account of personal physical injuries or physical sickness" and for amounts received "through accident or health insurance … for personal injuries or sickness."[1] As discussed in this article, determining whether a particular bad faith recovery qualifies under one of these exceptions can be tricky.

Bad Faith Litigation Claims

It may be helpful to begin with a brief description of what a bad faith claim may entail. Such a claim may be a tort or a contract claim, depending on the facts and the jurisdiction. It may be brought against one's own insurance carrier or against another party's carrier.

Not surprisingly, most bad faith insurance cases relate to the mishandling of insurance claims. A common claim is that the insurance company defendant did not proceed appropriately to pay a claim, thus causing the plaintiff additional damages. Consider, for example, 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. This is a useful (and common) example to bear in mind.

Not unlike a legal malpractice claim against a lawyer, one key question will predate the bad faith case for tax purposes: what was the underlying issue (which may or may not have been litigated) that gave rise to the insurance claim?

In bad faith insurance cases, there is an underlying cause of action for which the plaintiff is seeking redress. It might be a personal physical injury action or something else. The bad faith claim may be viewed as a contract claim relating to the insurance policy, or as a tort claim related to an insurance company's operations and its treatment of the plaintiff.

The Internal Revenue Service ("IRS") has generally viewed bad faith claims as contract actions. Nevertheless, as discussed below, it is relevant to inquire into the treatment of damages that, at least in part, often relate to the original act producing the underlying insurance claim.

Relevant Statutory Law

It is a well-worn axiom that almost everything is taxable. The IRC bears this out, stating in § 61 that, except for express and explicit exclusions, everything is gross income.[2] That applies to lawsuit recoveries, whether by settlement or judgment.[3]

This applies to insurance recoveries, too. Fortunately, though, there is an explicit statutory exclusion in section 104 of the IRC for recoveries for personal physical injuries or physical sickness.[4] It does not apply to punitive damages.

There has been great controversy over what the word "physical" means in this context. § 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."

2009 IRS Letter Ruling

One of the most important authorities with respect to the tax status of bad faith recoveries is an IRS private letter ruling issued in 2009 ("2009 Letter Ruling").[5] It was a bombshell ruling when issued, and it suggests that some bad faith recoveries are tax-free. Relevant case law, on the other hand, suggests that some taxpayers may be reading the ruling too broadly.

In 2009 Letter Ruling,[6] 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, as well as 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, and lost earnings, plus punitive damages. After post-trial motions, the jury verdict was reduced as to both the compensatory damages and punitive damages. The defendants appealed.

Prior to the judgment, the insurer for the tavern 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 the insurance company if it acted in bad faith in failing to settle the claim. The tavern believed it had a cause of action against the insurance company.

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 the insurance company. The agreement between the tavern and the plaintiff provided for the assignment of all claims possessed by the tavern and the tavern manager against the insurance company related to the bad faith claims. Thus, the injured plaintiff ended up with those claims.

The assignment agreement provided that within thirty days of the termination of the litigation against the insurance company (whether by settlement or judgment), 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 a certain amount to the plaintiff and his attorneys. The settlement agreement provided that upon receipt of payment, plaintiff would cause the bad faith insurance litigation to be dismissed with prejudice, and cause the personal injury judgment against the tavern manager and the tavern to be marked as satisfied.

The IRS started its analysis in the 2009 Letter Ruling by discussing the "origin of the claim" doctrine. Citing *Raytheon Production Corp v. Commissioner*,[7] the IRS stated that the "critical inquiry" was "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 settlement of the court cases against the tavern manager and the tavern.

Indeed, the plaintiff was merely trying to collect on his judgment against the manager and the tavern for damages awarded in connection with his personal physical injury claim. "But for" the personal physical injury claim and the plaintiff's rights as an assignee, the plaintiff would be receiving nothing from the insurer for the tavern. Quite literally, the plaintiff was only receiving money from the insurance company because the plaintiff was injured.

Ultimately, the IRS concluded that the IRC § 104 exclusion applied. Interestingly, the IRS noted that the exclusion would not apply to any amounts the plaintiff received that resulted from the *punitive* claims. Punitive damages are always taxable.[8] 2009 Letter Ruling expressed no opinion on allocating the payout to the plaintiff between compensatory and punitive damages.

Recent Case Law

Perhaps as a result of the 2009 Letter Ruling, some taxpayers may think "tax free" when they hear "bad faith." The cases, however, are mixed.

Ktsanes v. Commissioner

In *Ktsanes v. Commissioner*,[9] a 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 § 104(a)(2).

When the IRS disagreed, he also argued that the group long-term disability insurance program was equivalent to a workmen's compensation payment, so was excludable under IRC § 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. The court reasoned:

> The relief that petitioner sought in his complaint was causally connected (and strongly so) to the denial by Union Security of his claim for long-term disability benefits. Although petitioner's complaint alleged that he became disabled as a result of physical injuries or sickness, this 'but for' connection is insufficient to satisfy the 'on account of' relationship discussed in *O'Gilvie* for the purposes of the exclusion under section 104(a)(2). Petitioner would not have filed his complaint if Union Security had not denied his claim but instead paid him the long-term disability payments that he sought. In other words, petitioner sought compensation 'on account of' the denial of his long-term disability benefits, not for any physical injuries or physical sickness.[10]

On the surface, this reasoning might make it difficult for bad faith recoveries to qualify under IRC § 104(a)(2). Indeed, when taxpayers claim that bad faith recoveries are excludable from gross income under IRC § 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 can claim 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 eventual bad faith recovery can be strong. In *Ktsanes*, though, the Tax Court concluded the opinion by stating that: "[t]he $65,000 that [Ktsanes] received in settlement of his suit essentially represented a substitute for what he would have received had his claim been approved. Under these circumstances, no part of that payment is excludable under any subdivision of IRC § 104(a)."[11]

This language, emphasized by its placement at the very end of the opinion, seems to contradict the court's previous language. It looks through the insurance claim to the facts that gave rise to the insurance claim. Moreover, it implicitly asks how the payment would have been taxed had the insurance claim been paid without dispute.

The taxation of an undisputed payment would surely depend on the facts that gave rise to the insurance claim. In *Ktsanes*, the court seemed bothered by IRC § 104(a)(3). Notably, Ktsanes did not raise this subsection as a basis for excluding the settlement payment from his income.

Under IRC § 104(a)(3), amounts received through accident or health insurance for personal injuries or sickness are excludable from gross income. The key qualifier, of course, is that the premiums for the insurance 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 § 104(a)(3). Had his insurance claim been paid without dispute, it would presumably have been taxable.

Read in this light, *Ktsanes* is much more easily reconciled with the other authorities on bad faith litigation. The Tax Court may have been preventing insurance payments that were income from being made tax-exempt merely because the insurance company only agreed to pay the insurance claim after litigation.

Another case decided shortly after the 2009 Letter Ruling is more troubling.

Watts v. Commissioner

In *Watts v. Commissioner,*[12] 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 § 104(a)(2).

The IRS disallowed the exclusion, asserting that the breach of contract action was not based on tort or tort-type rights. Of course, that requirement (from the *Schleier* case[13]) is now obsolete. Showing a bit of prescience, the taxpayer and the government agreed that the settlement should be analyzed under IRC § 104(a)(2).

The Tax Court took a dim view: "[t]he parties apparently believe that the interposing of a lawsuit between the insured and the insurer in this case causes the payment petitioner received from State Farm to constitute 'damages' that may be excluded from income only by satisfying the requirements of [IRC § 104(a)(2)]. We disagree."[14]

Instead, the Tax Court analyzed the settlement payment under the authorities of IRC § 104(a)(3), concerning amounts received "through" accident or health insurance "for" personal injuries or sickness. The Tax Court concluded that the settlement payment could be excluded under IRC § 104(a)(3) up to the policy limits, but were a taxable interest or other taxable income to the extent the settlement payment exceeded Watts's $50,000 policy limit.

In *Watts*, as in *Ktsanes*, the Tax Court seemed focused on making sure that in bad faith and breach of contract cases regarding insurers, IRC § 104(a)(2) did not override IRC § 104(a)(3). Where the proceeds of bad faith or breach of contract 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, taxpayers might expect the Tax Court to either refuse to apply IRC § 104(a)(2) altogether (as in *Watts*), or to construe its "on account of" language narrowly to render the subsection inapplicable (as in *Ktsanes*).

2004 IRS Letter Ruling

Notably, though, a 2004 letter ruling[15] held that legal fees allocable to disability benefits were excludable under § 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 attorneys' fees and costs. The IRS ruled that because the underlying recovery was excludable under § 104(a)(3), the recovered attorneys' fees and costs were also excludable.

Hauff v. Petterson

Although *Hauff v. Petterson*[16] is not a tax case, it is worth reading even if one is focused solely on the issue of taxes. Instead of analyzing a bad faith recovery to ascertain how it should be taxed, the court used the taxability of a recovery to determine whether an insurance company acted in bad faith.

David Hauff filed a claim with his automobile insurer after he was involved in a collision with an uninsured motorist and sustained physical injuries. Among other things, he requested compensation for lost wages. Hauff's insurance carrier agreed to pay him an amount of lost wages based on Hauff's wages *net* of the income tax that he would normally have to pay on them. Hauff demanded that his lost wages be calculated based on his *gross* lost wages, and filed suit against his insurer alleging bad faith.

The court determined that amounts received by Hauff for lost wages would be excludable from his income under IRC § 104(a)(2) as amounts received on account of a personal physical injury or physical sickness. Because Hauff would not have to pay tax on the amounts received from his insurer, the court found that the insurer was acting in good faith by only paying Hauff his *net* lost wages. As a result, the court found for the insurer on summary judgment.

Braden v. Commissioner

Braden v. Commissioner[17] 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 breach of contract bad faith claim, but was related to underlying physical injury claims Braden had made against the insurance company.

Braden excluded the $30,000 from his gross income under § 104. The IRS disagreed, and the matter went to Tax Court. The IRS moved for summary judgment, arguing that the underlying cause of action was not based on a tort or tort-like rights. Therefore, the IRS said, it could not be excludable under §104. The Tax Court denied the motion, however, stating that the *nature* of the taxpayer's claim controlled. The fact that the lawsuit was for breach of contract did not foreclose the possibility that the taxpayer's claim was for personal physical injuries.

Conclusion

Considering how many claims insurance companies face for putatively bad faith behavior, it is surprising that there are not more cases considering the tax treatment of plaintiffs' recoveries. Some bad-faith plaintiff's lawyers report that they routinely see clients paying tax on their recoveries without complaint. Conversely, some plaintiffs may exclude them from their 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. Although not all cases will involve facts giving rise to valid arguments for exclusion, attorneys should be aware that some will. Sometimes, it just takes a little analysis and creativity to get there.

Endnotes

1 IRC § 104(a)(2).

2 26 U.S.C. § 61.

3 *See* Comm'r v. Glenshaw Glass Co., 348 U.S. 426 (1955), 1955-1 C.B. 207.

4 *See* 26 U.S.C. §§ 104(a)(2), (a)(3) (stating, respectively, that gross income does not include "the amount of damages (other than punitive damages) received … on account of personal physical injuries or physical sickness" or "amounts received through accident or health insurance … for personal injuries or sickness…")

5 Technically, this ruling is not "authority," since letter rulings are non-precedential.

6 I.R.S. Priv. Ltr. Rul. 09-03-073 (Jan. 16, 2009).

7 144 F.2d 110 (1st Cir. 1944), cert denied, 323 U.S. 779 (1944).

8 *See* O'Gilvie v. United States, 519 U.S. 79 (1995); see also I.R.C. § 104.

9 T.C. Summ. Op. 2014-85.

10 *Id*. at 8.

11 *Id*. at 11.

12 T.C.M. 2009-103.

13 Comm'r v. Schleier, 515 U.S. 323 (1995).

14 T.C.M. 2009-103 at 5.

15 I.R.S. Priv. Ltr. Rul. 04-03-046 (Jan. 16, 2004).

16 755 F. Supp. 2d 1138 (D. N.M. 2010).

17 T.C. Summ. Op. 2006-78.