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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 that it depends, but perhaps this answer becomes slightly less annoying with a brief description of what a bad-faith claim may entail. It 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 sometimes 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: what was the underlying issue (which may or may not have been litigated) that gave rise to the insurance claim? 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.

2009 IRS Private Letter Ruling

The most important guidance is an IRS private letter ruling that technically is not authority, given that letter rulings are nonprecedential. It was a bombshell ruling when it was issued in 2009, and it suggests that some bad-faith recoveries are tax-free. On the other hand, there is case law to suggest that some taxpayers may be reading the ruling too broadly.

In Private Letter Ruling 200903073 (Jan. 16, 2009), the plaintiff had been struck by a drunk driver in the course of his employment and was severely injured. The drunk driver managed a tavern and had served himself liberally while on duty. The plaintiff sued the driver/manager as well as the tavern that employed him.

The plaintiff received a jury verdict consisting of punitive damages as well as compensatory damages for his personal physical injuries, medical expenses, pain and suffering, and lost earnings. 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) rejected an opportunity to settle for policy limits under the tavern's policy. Under state law, the tavern as policyholder had a cause of action against Insurance Company if it acted in bad faith in failing to settle the claim. The tavern believed it had a cause of action against Insurance Company. 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 agreement between the tavern and the plaintiff provided for the assignment of all claims possessed by the tavern and the tavern manager against Insurance Company related to the bad-faith claims. Thus, the injured plaintiff ended up with those claims.

The assignment agreement also provided that, within 30 days of the termination of the litigation against 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 Insurance Company to pay $Z to him and his attorneys. The settlement agreement provided that, upon receipt of payment, the plaintiff would cause the bad-faith insurance litigation to be dismissed with prejudice and the personal injury judgment against the tavern manager and the tavern to be marked as satisfied.

Underlying Case Tax-Free

The IRS begins its analysis in the Letter Ruling with the origin of the claim doctrine. Citing *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110 (1st Cir. 1944), *cert.*

denied, 323 U.S. 779 (1944), the IRS starts its analysis by asking why the damages were awarded. That is, in lieu of what were these damages awarded? This query is often referred to as the origin of the claim doctrine.

The plaintiff may have recovered against 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 the plaintiff's judgment against the manager and the tavern for damages awarded on 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 Insurance Company *because* the plaintiff was injured.

Thus, the IRS concluded that the IRC section 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. See *O'Gilvie v. U.S.*, 519 U.S. 79 (1995); see also I.R.C. § 104 (2002). Private Letter Ruling 200903073 expresses no opinion on allocating between compensatory and punitive damages.

Contract Versus Tort

In bad-faith insurance 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 the insurance company's operations and its treatment of the plaintiff. The IRS usually has viewed them as contract actions. Regardless, it is relevant to inquire into the treatment of damages that often relate, at least in part, to the original act producing the underlying insurance claim. Not surprisingly, most bad-faith insurance cases relate to the mishandling of insurance claims.

Taxable Damages

Indeed, when taxpayers claim that bad-faith recoveries are excludable from gross income under 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.

However, 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. For example, in *Ktsanes v. Commissioner*, T.C. Summ. Op. 2014-85, No. 21592-11S (Sept. 2, 2014), 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 on the grounds 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 section 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 and therefore excludable under section 104(a)(1). The tax court rejected both arguments and found the settlement to be taxable. The 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* [519 U.S. 79 (1996)] 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.

On the surface, this reasoning might make it difficult for bad-faith recoveries to qualify under section 104(a)(2); however, the court in *Ktsanes* concludes its opinion by finding 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).

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 seems bothered by section 104(a)(3). Notably, Ktsanes did not raise this subsection as a basis for excluding the settlement payment from his income.

Under 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 presumably would have been taxable.

Read in this light, *Ktsanes* is much more easily reconciled with the other authorities on bad-faith litigation. The court may have been preventing insurance payments that were income from tax exemption merely because the insurance company only agreed to pay the insurance claim after litigation. Another case decided shortly after the 2009 private letter ruling is more troubling.

In *Watts v. Commissioner*, T.C.M. 2009-103, No. 6056-06 (May 18, 2009), 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' $50,000 policy limit. Watts excluded the settlement under section 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 *Commissioner v. Schleier*, 515 U.S. 323 (1995)) is now obsolete. Showing a bit of prescience, the taxpayer and the government agreed that the settlement should be analyzed under section 104(a)(2); however, the court took a dim view:

> The 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.

Instead, the court analyzed the settlement payment under the authorities of section 104(a)(3) concerning amounts received "through" accident or health insurance "for" personal injuries or sickness. The court concluded that the settlement payment could be excluded under 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' $50,000 policy limit.

In *Watts*, as *Ktsanes*, the tax court seemed focused on making sure that, in bad-faith and breach of contract cases regarding insurers, section 104(a)(2) does not override section 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 court to either refuse to apply section 104(a)(2) altogether (as in *Watts*), or to construe its "on account of" language narrowly to render the subsection inapplicable (as in *Ktsanes*).

In *Braden v. Commissioner*, T.C. Summ. Op. 2006-78, No. 6736-05S (May 11, 2006), 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 section 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 and therefore could not be excludable under section 104. The court denied the motion, however, holding that the *nature* of the taxpayer's claim controlled. The fact that this 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 tax cases considering the treatment to the plaintiff. Some bad-faith plaintiff's lawyers report that they routinely see clients pay tax on the recoveries without complaint. 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 requires some creativity.

Indeed, Private Letter Ruling 200903073 involved a bad-faith claim that was originally owned by the tavern policyholder. The claim was later pursued by an injured plaintiff who recovered "on account of" his injuries. The assigned bad-faith claim enabled the plaintiff 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.

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