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THE TAX LAWYER

Insurance Legal Settlements For Bad Faith Are Often Taxed By IRS

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Some insurance payments are treated as tax-free by the IRS. For example, if you pay for car insurance and your insurance carrier later repairs your car after an accident, the amount of the repair bill is not attributed to you as income. There are special tax rules for some insurance in disasters too. For example, the tax code allows you to exclude from income amounts from insurance for temporary additional living expenses created by the loss of the your principal residence.

Insurance And Disaster Losses

But the expenses must be reasonable and necessary, such as rental payments for temporary replacement housing or replacement transportation. If the disaster that destroyed your home was a federally declared disaster, the tax code also generally allows you to treat insurance proceeds that compensate you for your personal property, such as clothing, furniture, and household goods as tax-free, if the home was your primary residence. But many types of insurance proceeds have tax implications, even in the context of a major loss. Under normal tax rules, amounts received for damage to or destruction of your property, including property insurance payments, are treated as *sales proceeds* for tax purposes.

In a sale, whether you have taxable profit or gain is based on your *tax basis* in the property sold, not its fair market value. This may seem unfair because you are only being reimbursed for what you lost. But taxes are tricky and don’t always seem fair. Thus, if you bought your property for $1 million and your insurance company pays you $1 million after it is destroyed, you should not have any gain. But if you paid $1 million years ago, and the insurance company pays you $3 million for your loss, the IRS would say you *gained* $2 million. You can usually defer paying taxes by reinvesting the proceeds under section 1033 of the tax code, subject to various technical requirements.

Taxing Insurance Lawsuits

What about a legal dispute with your insurance company? You need to consider the type of coverage and its context, personal or business. 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 tricky. However, it can also invite some potential tax planning, since in some cases, insurance bad faith recoveries are not taxed.

The primary context that has generated tax authorities about bad faith claims involves physical injury cases. In a physical injury accident, compensatory damages should be tax free under section 104 of the tax code. But in a later bad faith case, does that mean the bad faith recovery should *also* get the same physical injury treatment? Alternatively, is the bad faith recovery viewed as punitive damages (taxable, even if the injuries are physical)? These questions do not have simple answers, and the facts matter.

Bad Faith Lawsuit Claims

Many people are surprised at how the IRS taxes legal settlements is tricky, and it is safest to assume that a legal settlement is likely to be taxed. But that is not always true. For example, if a bad faith case arises out of health or disability insurance, it may be taxable or not, often depending on who paid the premiums for the policy. With a bad faith case growing out of a physical injury case, a key fact may 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.

If the insurance company did not proceed appropriately to pay a claim, did that cause the plaintiff additional damages? In IRS Private Letter Ruling 200903073, the plaintiff was 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 at work. The plaintiff was badly injured and sued the driver/manager and the tavern. There was a jury verdict for compensatory and punitive damages, which 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.

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 that it was tax-free under Section 104. The IRS said 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. 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.

Some taxpayers may automatically think "tax-free" when they hear "bad faith." That assumption can be dangerous and lead to taxes, interest, and penalties. For example, in *Ktsanes v. Commissioner*, T.C. Summ. Op 2014-85, the taxpayer worked for the Coast Community College District in Orange County. He participated in the district'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 and 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. Butt the premiums must not have been paid by the insured's employer, and Ktsanes did not qualify. His disability pay would have been taxable, 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' $50,000 policy limit. Watts excluded the settlement from his income under Section 104(a)(2), the physical injury exclusion. The Tax Court ruled that the first $50,000 was tax-free, but the excess over the policy limits was taxable.

Not all bad faith settlements involve good arguments for exclusion, and sometimes the way to get to that position can require some creativity. As with any other case that is resolving, it pays to think about the tax issues before signing the settlement agreement. Settlement agreement wording does not bind the IRS, but helpful tax language in a settlement agreement can go a long way. Insurance lawsuits and how they are taxed are tricky, be careful.