PERSPECTIVE
Los Angeles | Daily Journal
APRIL 22, 2025

Insurance payments, bad faith claims and taxes

By Robert W. Wood

Some types of 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. The same concept can apply in some other areas too. For example, with the recent wildfires, there is an understandable focus on insurance coverage.

The tax code allows taxpayers to exclude from their income amounts received from insurance for temporary additional living expenses created by the wildfire resulting from the loss of the taxpayer's principal residence. But the expenses must be reasonable and necessary, such as rental payments for temporary replacement housing or replacement transportation. If the wildfire that destroyed your home was a federally declared disaster (like recent LA fires), 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, assuming that 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 the insurance company pays you exactly that amount after it is destroyed, you should not have any gain. But if you paid $1 million some time 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.

What about litigation with an insurance company? There, you need to consider the type of coverage and its context, personal or business. Most litigation recoveries in wildfire litigation over fires that were declared federal disasters are exempt from federal tax now, but only if the money is received in 2020 through 2025 tax years. It seems likely that most lawsuits over recent LA fires are unlikely to be resolved and paid by the end of 2025. And it is not yet clear if that new tax law will be interpreted to exempt insurance payments or will be limited to litigation proceeds.

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. The primary context that has generated tax authorities about bad faith claims involves physical injury cases.

In a physical injury accident, the compensatory damages should be tax free under section 104 of the tax code. But in a later bad faith case, does that mean that the bad faith recovery should also get the same physical injury treatment? Alternatively, is the bad faith recovery likely to be viewed as punitive in nature (taxable, even if the injuries are physical)? Does it matter if the bad faith case in question is viewed as a contract dispute or a tort case?

These questions do not have unified answers in the tax law, and as with any other case, the facts are going to matter. For example, if the 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. A common claim is that the insurance company did not proceed appropriately to pay a claim, thus causing the plaintiff additional damages. In that sense, a bad faith case may seem a little like a legal malpractice claim against a lawyer. That is, one should consider the tax treatment of the underlying case, and how the later recovery may relate back to the first.

An IRS private letter ruling provides a key insight into this area. Tax professionals regularly read and rely on IRS private letter rulings as good indications of how other cases for other taxpayers would come out, even though these rulings are not technically authoritative. In Letter Ruling 200903073, the 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 at work.

The plaintiff was severely injured and sued the driver/manager and the tavern employer. 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 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 (his employer paid the premiums), 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's $50,000 policy limit. Watts excluded the settlement from his income under Section 104(a)(2), the physical injury exclusion. The IRS disallowed it entirely, arguing that the entire settlement was taxable. The Tax Court agreed that the first $50,000 was tax-free, but said the excess over the policy limits was taxable.

In *Braden v. Commissioner*, T.C. Summ. Op. 2006-78, Braden received $30,000 from a class action settlement with his automobile insurance company related to underlying physical injury claims Braden had 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 IRS moved for summary judgment, arguing that this amount could not be excludable under Section 104. The Tax Court, however, denied the motion, stating that the nature of the taxpayer's claim controlled. According to the Tax Court, 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. 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.

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