PERSPECTIVE
Los Angeles | Daily Journal
FRIDAY, JULY 15, 2016

Is Your Insurance Bad Faith Recovery Taxable? It Depends

By Robert W. Wood

Are insurance bad faith litigation recoveries taxable? It can depend on numerous variables. Does it amount to a compensatory recovery for physical injuries or physical sickness (tax-free)?

Is the recovery punitive in nature (taxable, even if the injuries are physical)? If the case arises out of health or disability insurance, it may be taxable or not, often depending on who paid the premiums for the policy. Sometimes, a key fact will be whether the plaintiff was adequately compensated in the underlying 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, not unlike a legal malpractice claim against a lawyer, one key question will predate the bad faith case.

The most important authority is an IRS private letter ruling that technically is not authority, since letter rulings are non-precedential. In Letter Ruling 200903073 (Jan. 16, 2009), 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 employer. A jury verdict for compensatory and punitive damages 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.

Thus, the injured plaintiff ended up with those claims. 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 was tax free under Section 104, the physical injury exclusion section.

After all, 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. Quite literally, 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.

As a result of this 2009 letter ruling, some taxpayers may automatically think "tax free" when they hear "bad faith." That assumption can be dangerous and lead to taxes, interest, and penalties, plus accounting and legal fees. For example, in *Ktsanes v. Commissioner*, T.C. Summ. Op 2014-85, the taxpayer worked for the Coast Community College District (CCCD) in Orange County. He participated in the CCCD's group long-term disability insurance. He developed a serious illness, and applied for long-term disability. When the company rejected his claim, he filed a bad faith claim that settled for $65,000. He claimed it 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' disability premiums were paid by his employer, so he did not qualify for tax-free treatment. 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 in excess of Watts's $50,000 policy limit. Watts excluded the settlement under Section 104(a)(2), the physical injury exclusion. The IRS disallowed it entirely, but the Tax Court allowed the first $50,000 to be excluded. The excess over the policy limits, the court ruled, was taxable.

Hauff v. Petterson, 755 F. Supp. 2d 1138 (D. N.M. 2010), is not a tax case, but is worth reading even if one is focused solely on taxes. Instead of analyzing a bad faith recovery to ascertain how it should be taxed, the court uses the taxability of a recovery to determine whether the insurance company acted in bad faith! David Hauff filed a claim with his automobile insurer after he was injured in a collision with an uninsured motorist.

Among other things, he requested lost wages. Hauff's insurance carrier agreed to pay him lost wages based on Hauff's wages *net* of the income tax that he would normally have to pay. Hauff demanded that his lost wages be calculated based on his *gross* lost wages, and filed suit for bad faith.

The court determined that amounts received by Hauff for lost wages would be excludable from his income under Section 104 on account of personal physical injuries. Because Hauff would not have to pay tax on the amounts received from his insurer, the court found for the insurer on summary judgment.

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 it could not be excludable under Section 104. The Tax Court, however, denied the motion, stating 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 his claim was for personal physical injuries.

Considering how many claims insurance companies face for putative bad faith, it is surprising that there are not more tax cases considering these settlements. Some bad faith plaintiff's lawyers report that they routinely see clients pay taxes on the recoveries. Some plaintiffs exclude them from income, 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 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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