IRS Rules Insurance Bad-Faith Recovery Is Tax Free

By Robert W. Wood

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I've long wondered about the but-for causation implicit in section 104. That simple haiku of a code section excludes from income damages or settlement payments received "on account of" personal physical injuries or physical sickness (and related emotional distress). This code section has a storied history, reaching back 90 years. For most of its tenure, section 104 was relatively uncontroversial. In the 1970s and 1980s, more and more litigants sought to exclude emotional distress and employment recoveries under its provisions. That led to IRS scrutiny and eventually to congressional action.

In 1996, Congress changed the landscape significantly to the IRS's liking, imposing a requirement that the payment be on account of *physical* injuries or *physical* sickness. Since that time, there has been no shortage of controversy about what "physical" means and how it should be proven. The courts have been thrust into the debate over what constitutes physical injury or sickness.[1]

Causal Conundrum

Even before 1996, however, a fundamental inquiry was the causal element, focusing on what we mean when we say a payment is "on account of" something. Although there is debate about what is physical, much confusion has stemmed from the "on account of" link in the statute, which precedes the requisite physical injury or physical sickness. The starting point for an analysis must be the statute, which makes the relevant nexus between the damages received and the injury. The statute excludes "damages . . . received . . . on account of personal physical injuries or physical sickness." No words in the statute require a relationship between the tortious act and the physical injuries or physical sickness for which damages are received.

In fact, the "on account of" language has required a nexus between damages and injuries since its origin in the 1918 predecessor to section 104(a)(2).[2] The same language appeared in the 1939, 1954, and 1986 codes. In 1996, Congress amended section 104(a)(2) to: (a) exclude punitive damages from the exclusion (a double negative that makes punitive damages taxable); and (b) to require that the personal injury or sickness be physical. Significantly, the 1996 amendments did not alter the "on account of" language.

Nevertheless, the 1996 legislative history focuses the "on account of" link on the nexus between the recovery and the injuries:

> If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) *that flow therefrom* are treated as payments received on account of physical injury or physical sickness *whether or not the recipient of the damages is the injured party*.[3]

There are two crucial points in that statement. First, the relevant "on account of" nexus is between damages and physical injury or sickness (that is, all damages that "flow therefrom"). In analyzing the wrongful or tortious act, Congress required the action to have its origin in a physical injury or sickness. There need not be any causal nexus between the tort and the liability.

Second, the legislative history expressly recognizes that the recipient (plaintiff) need not be the one who suffers the physical injuries. A payment can be on account of physical injury or sickness even if the plaintiff is not injured but is seeking recovery on behalf of an injured party. For example, recoveries for loss of consortium (based on physical injury to a spouse) and wrongful death qualify under section 104(a)(2).

I believe the IRS should publish guidance on its interpretation of the "physical" requirement. Quite apart from that, however, I think the "on account of" nexus requires further examination. The "on account of" question ties in to the origin of the claim doctrine.

Origin of Claim and 'On Account Of'

Recently, the IRS considered a private letter ruling that squarely raised questions on those internecine issues. In LTR 200903073,[4] a plaintiff formerly employed as a

[1]*See* Robert W. Wood, "Post-1996 Act Section 104 Cases: Where Are We Eight Years Later?" *Tax Notes*, Oct. 4, 2004, p. 68, *Doc 2004-18582*, or *2004 TNT 189-27*.

[2]*See* Revenue Act of 1918, ch. 18, section 213(b)(6).

[3]H.R. Conf. Rep. No. 104-737 at 300 (1996). (Emphasis added.)

[4]*Doc 2009-1070*, *2009 TNT 11-27*.

highway construction worker was, in the course of his employment, 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 as the tavern.

The plaintiff received a jury verdict consisting of compensatory damages for his personal physical injuries, medical expenses, pain and suffering, and lost earnings. He was also awarded punitive damages. After posttrial motions, the jury verdict was reduced to $X in compensatory damages and $Y in punitive damages. The defendants appealed.

Before the judgment was awarded, the tavern's insurer had rejected an opportunity to settle for the limits of the tavern's policy. Under state law, the tavern as a policyholder 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 execution of the plaintiff's judgment, and while the defendants' appeal was pending, the tavern assigned 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 regarding the bad-faith claims. Thus, under the assignment agreement, the injured plaintiff ended up with those claims.

The assignment agreement also provided for a stay of execution of the judgment against the assets of the tavern manager and the tavern. It further provided that the manager and the tavern would cooperate with the plaintiff in pursuing litigation against the insurance company. Finally, the assignment agreement provided that within 30 days of the termination of the litigation against the insurance company (whether by settlement or judgment), the judgment against the manager and the tavern for the plaintiff's personal injury claims would be marked ''satisfied.'' The plaintiff also entered into a contingent fee agreement with his attorneys to prosecute the bad-faith action against the insurance company.

Eventually, the plaintiff settled with the insurance company, entering into a settlement agreement calling for the insurer to pay $Z to the plaintiff and his attorneys. The settlement agreement provided that on receipt of payment, the plaintiff would cause the bad-faith insurance litigation to be dismissed with prejudice, and cause the personal injury judgment against the manager and the tavern to be marked as satisfied.

Analysis

The IRS began its analysis in LTR 200903073 with the basics of the origin of the claim doctrine and section 104 and its regulations. It then applied those basic concepts to the facts. Citing *Raytheon Production Corp. v. Commissioner*,[5] the Service said that the critical inquiry is: In lieu of what were the damages awarded? The IRS reasoned that the plaintiff may have recovered against the insurance company, but that the recovery had its origin in the settlement of the cases against the tavern manager and the tavern.

Indeed, the plaintiff sued the insurance company only as an assignee of the tavern. The plaintiff was merely trying to collect on his 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 tavern's insurer. Quite literally, the plaintiff was receiving money from the insurance company (for whatever reason the insurance company had to pay its liability to the tavern) only because the plaintiff was injured. Thus, the Service concluded that the section 104 exclusion applied.

Punitive Damages

Interestingly, the IRS carved out of the exclusion any amounts the plaintiff received under the assignment and final settlement agreements that resulted from the punitive claims. A payment for punitive damages is always taxable.[6] Just as a recovery of punitives from the tavern or the manager would have been taxable, any portion of the plaintiff's recovery received from the insurance company attributable to punitives would also be taxable.

How do you determine that amount? LTR 200903073 expresses no opinion about the proper allocation of the settlement proceeds between personal physical injury and sickness damages on one hand, and punitive damages on the other.

Malpractice and Other Recoveries

LTR 200903073 makes perfect sense in its application of the origin of the claim doctrine. Although it spent no time analyzing the ''on account of'' nexus of section 104, the IRS implicitly seemed to recognize those concepts as complementary. Those related doctrines are clearly consistent. At issue was a bad-faith claim that the insurance company may have thought it was paying on account of its shoddy claims activities. Nevertheless, the plaintiff/taxpayer received the settlement on account of *his* personal physical injuries.

Another petri dish for examining the ''on account of'' nexus is legal malpractice recoveries. Legal malpractice claims arise from wills and trusts, litigation, tax advice, real estate deals, medical malpractice cases, and so on. Many of the cases involve relatively simple acts or failures to act, such as the lawyer missing a statute of limitations or affirmatively misstepping on some issue, such as recording a lien against the wrong parcel of property.

When a legal malpractice case settles or proceeds to judgment, tax issues should be considered. Virtually all of the authority concerning those tax issues has arisen in tax malpractice actions, in which a plaintiff recovers against his attorney or accountant for poor tax advice. In general, those authorities suggest that when the plaintiff has not been enriched, but has merely been put back in

[5] 144 F.2d 110 (1st Cir. 1944), *cert. denied*, 323 U.S. 779 (1944).

[6] *See O'Gilvie v. United States*, 519 U.S. 79 (1996), *Doc 96-31894*, *96 TNT 240-1*. *See also* section 104.

the position he would have occupied were it not for the malpractice, there should be no income to the plaintiff.

The seminal case is *Clark v. Commissioner*,[7] in which the Board of Tax Appeals[8] (BTA) determined that an amount received from tax counsel as compensation for an error in preparing and filing the plaintiff's tax return was not includable in the plaintiff's gross income. The malpractice underlying *Clark* seemed open and shut. The taxpayer paid excess federal income taxes because his tax counsel negligently failed to advise him to file a separate return rather than a joint return with his wife.

This negligence caused Clark to pay approximately $20,000 more in federal income taxes than he would have paid on a separate return. Tax counsel paid the $20,000 to settle the case. Clark included that amount in his gross income but later sought a refund.

The IRS argued that the $20,000 paid by the defendant tax counsel constituted taxes paid by a third party, and, as such, that Clark had income. Although not expressed exactly as such, that sounds very much like a discharge of indebtedness theory. Clark argued that the payment constituted compensation for damages or loss caused by the malpractice and that he realized no income. In rejecting the IRS's argument, the BTA found that Clark had paid his own taxes.

In fact, in paying his taxes, Clark sustained a loss caused by the negligence of his tax counsel. The BTA determined that the $20,000 paid by tax counsel was compensation for the loss. The measure of that loss was the sum of money the taxpayer paid because of the tax lawyer's negligence. It was irrelevant that the obligation was for taxes, said the BTA.

Authorities after *Clark* continue that thread. In Rev. Rul. 57-47,[9] a tax consultant made an error in preparing and filing a taxpayer's individual income tax return. The error caused the taxpayer to pay additional tax. By the time the error was discovered, the statute of limitations for recovery of the overpayment had expired. To settle the matter, the tax consultant reimbursed the taxpayer for the additional tax. The IRS determined that the reimbursement was not income, but that the excess recovery (representing interest) was includable in her gross income.

Although *Clark*'s theory suggests that many malpractice recoveries even outside the tax arena might be tax free, the IRS has tried to limit the breadth of the *Clark* holding in a series of private letter rulings involving malpractice in tax return preparation.[10]

[7]40 B.T.A. 333 (1939).

[8]Predecessor to the U.S. Tax Court. It is a testament to the lack of authority in this area that *Clark* is still a leading (and nearly the only) case almost 70 years later.

[9]1957-1 C.B. 23.

[10]*See* LTR 9743035, *Doc 97-29235*, *97 TNT 207-11*; LTR 9833007, *Doc 98-25747*, *98 TNT 158-12*; LTR 9728052, *Doc 97-20252*, *97 TNT 134-27*; and LTR 200328003, *Doc 2003-16403*, *2003 TNT 135-16*, discussed in Wood, "Tax Treatment of Legal Malpractice Recoveries," *Tax Notes*, Feb. 12, 2007, p. 665, *Doc 2007-1715*, or *2007 TNT 30-58*.

Bad-Faith Litigation

Interestingly, the Service has not always taken the same kind of position in bad-faith insurance litigation. In most 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. But whatever happens in the underlying tort action, when it comes to bad-faith claims against insurance companies, the IRS has usually viewed them as contract actions.

Should a bad-faith insurance lawsuit be viewed as a contract claim regarding the insurance policy, or as a tort claim regarding the insurance company's operations and its treatment of the plaintiff? In either event, it is relevant to inquire into the treatment of damages that, at least in part, often relate to the original act that produced the underlying insurance claim. Not surprisingly, most bad-faith insurance cases concern the mishandling of insurance claims.

Thus, in *Braden v. Commissioner*,[11] the taxpayer received $30,000 resulting from a class action settlement with his automobile insurance company. The action was a breach of contract bad-faith claim, but it concerned underlying physical injury claims Braden had made against the insurance company. When Braden received a $30,000 settlement in the bad-faith insurance class action, he excluded it from his gross income under section 104. The IRS disagreed with that treatment, and the matter wound up in 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 that the settlement proceeds therefore could not be excludable under section 104. The Tax Court, however, denied the summary judgment request, stating that the type of lawsuit itself does not determine whether a payment can qualify under section 104. The Tax Court said it was the nature of the taxpayer's claim that controlled. That the lawsuit was for breach of contract did not foreclose the possibility that the taxpayer's claim was for personal injury.

LTR 200403046[12] is even more helpful. There, the Service ruled that legal fees allocable to disability benefits were excludable under section 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 attorney fees and costs. The IRS ruled that because the underlying recovery was excludable under section 104(a)(3), the recovered attorney fees and costs were also excludable under that provision.

Another tax case involving the treatment of insurance bad-faith claims is *Lane v. United States*.[13] The case

[11]T.C. Summ. Op. 2006-78, *Doc 2006-9276*, *2006 TNT 92-12*.

[12]*Doc 2004-1006*, *2004 TNT 12-24*.

[13]902 F. Supp. 1439 (W.D. Okla. 1995), *Doc 95-8256*, *95 TNT 171-7*.

involved a claim on an auto insurance policy for uninsured motorists. Under Oklahoma law, compensatory damages awarded for insurance bad faith do not compensate for personal injuries. Instead, they are generally treated as contract damages and, in some measure, as additional attorney fees incurred as a result of the insurer's failure to timely pay the claim. The district court in *Lane* held that the punitive damages were taxable, but it excluded tort damages for bad faith. Admittedly, the court was considering section 104 before its 1996 amendment.

Similarly, in *Wesson v. United States*,[14] the Fifth Circuit considered whether punitive damages awarded in a bad-faith case under Mississippi law were taxable. The court concluded that those damages were taxable. Again, the court was examining a recovery that preceded the 1996 amendment.

It should not be surprising that the IRS and the courts struggle with punitive damage issues. There was a historical dispute over the tax treatment of punitive damages. It was not until the Supreme Court decided *O'Gilvie* in 1996,[15] and the parallel statutory change was made in 1996, that the issue was put to rest. Even after that, however, there remains a characterization debate about when punitive damages should be considered paid.

If a case settles on appeal for a figure that is higher than the jury verdict of compensatory damages, but lower than the jury's combined award of compensatory and punitive damages, the IRS can be expected to allocate between compensatory and punitive damages for tax purposes if the parties have not done so. Even if the parties have done so, the IRS may review the allocation and alter it. However, putting punitive damages aside, LTR 200903073 strongly enunciates the notion that one should look to the situation of the taxpayer, and *why* he is receiving settlement monies, even if the payer is paying what may amount to an insurance bad-faith claim.

More Malpractice

That same kind of relationship between an underlying tort case and a later insurance bad-faith case has a parallel in the legal malpractice world. In a legal malpractice case, although the plaintiff is ostensibly recovering for the legal malpractice (which may be a tort or a contract action based on the nature of the legal work performed), there may be an underlying physical injury that was the subject of the legal work. While there is a paucity of authority, the recoveries in those situations should presumably be based on the item the plaintiff would have received but for the attorney's malpractice. That, after all, is the sine qua non of the origin of the claim doctrine.

Example: Paula Plaintiff is injured in a car accident and retains Alan Ambulance-Chaser to represent her against the driver and his insurance company. Paula loses her personal injury case because Alan fails to introduce critical evidence, carelessly misses an important court deadline, misses the statute of limitations, or commits some other grievous error. Alan's error was the *only* reason Paula failed to recover.

Paula files a legal malpractice action against Alan and settles for $400,000, an amount she might have received from the tortfeasor had Alan not erred. Instead of receiving $400,000 from the defendant for personal physical injuries, she received $400,000 from Alan or his insurance carrier.

Is the origin of Paula's claim the malpractice or the underlying personal injury? Although the complaint alleges malpractice, the malpractice relates solely to Paula's failure to recover for personal physical injuries. One should look through the malpractice claim to determine the proper tax treatment. The $400,000 payment makes Paula whole again. It is not punitive against the negligent attorney, but represents compensation Paula should have received for her injuries, and *would have* received from the driver of the car but for the negligence of the lawyer.

However, if Paula receives $150,000 in punitive damages in addition to the $400,000 malpractice recovery, Rev. Rul. 57-47 states that the $150,000 is taxable.[16] It holds that punitive damages are always taxable, a holding that was confirmed in the 1996 statutory change to section 104.

Conclusion

LTR 200903073 involves an insurance bad-faith claim that, but for the assignment to the injured plaintiff, would have been owned by the defendant tavern that was the policyholder. Yet the claim was pursued by an injured plaintiff, and he recovered ''on account of'' his injuries. The ruling is clearly correct in applying the section 104 exclusion.

It may have been the assigned insurance bad-faith claim that enabled the plaintiff to sue the carrier, but it was the nature of the underlying injury and the plaintiff's claim against the tavern and the tavern manager that sparked the insurance-claim assignment that ultimately led to the recovery. The focus on the taxpayer and *why* he is receiving the amount plainly satisfies the ''on account of'' nexus. Taxpayers who end up with bad-faith or legal malpractice recoveries should be comforted by this ruling.

[14]48 F.3d 894 (5th Cir. 1995), *Doc 95-3505*, *95 TNT 64-45*.

[15]*O'Gilvie v. United States*, 519 U.S. 79 (1996), *supra* note 6.

[16]*Id.*