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# Are Insurance Bad Faith Recoveries Taxable?

*The answer depends on a number of factors.*

BY ROBERT W. WOOD | AUGUST 1, 2016

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If you recover a judgment for bad faith damages, is the monetary recovery taxable?

The annoying answer is that it depends. This answer may be a bit less annoying with a brief description of what a bad faith cause of action may entail. It may be a tort or a contract claim, depending on the facts and the jurisdiction, though since 2012, that tort vs. contract distinction is now irrelevant to the tax treatment.

A bad faith claim is often brought against one's own insurance carrier. However, some bad faith claims are brought against someone *else's* insurance carrier. A common assertion in such disputes is that the insurance company defendant did not proceed appropriately (and timely) to pay a claim, thus causing the bad faith claimant to incur additional damages.

Those additional damages might be added physical injuries or the worsening of physical sickness. Or they might be added property damage. But there is always an initial harm that triggers the insurance company's duties.

In this sense, a bad faith claim is not unlike a legal malpractice claim against a lawyer. Thus, a key question will predate the bad faith case: what exactly was the underlying issue (which may or may not have been litigated) that gave rise to the insurance claim? Most tax professionals will start to 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. But there are other types of bad faith insurance claims too.

## PHYSICAL VS. EMOTIONAL?

We first need to distinguish between damages paid for physical injuries or physical sickness, as opposed to emotional distress. Until 1996, the tax law allowed emotional distress injuries to be tax-free. Since then, federal and California tax law provide that only damages for *physical* injuries or *physical* sickness count as tax free. The sickness part has prompted several plaintiffs in employment cases to win tax-free treatment for stress on the job that prompted a heart attack or the worsening of their pre-existing sickness (multiple sclerosis). See *Parkinson v. Comm'r*, T.C. Memo. 2010-9 (heart attack); *Domeny v. Comm'r*, T.C. Memo. 2010-142 (worsening multiple sclerosis).

But just plain emotional distress is taxable. There are still many tax disputes with the IRS and in court over the line between physical and emotional. Even the tax treatment of post-traumatic stress disorder (PTSD) recoveries is not clear. So we must address the taxation of bad faith cases in this already murky field.

## WHAT DOES THE IRS SAY?

The most important tax analysis in this area comes from the IRS via a private letter ruling that, technically speaking, is not binding authority since private letter rulings are non-precedential. Nevertheless, in 2009 the IRS suggested in a private letter ruling that some bad faith recoveries are tax free. See I.R.S. Priv. Ltr. Rul. 200903073 (Jan. 16, 2009). Needless to say, this came as a bombshell when it was issued. However, related case law, on the other hand, suggests that some taxpayers may be reading the ruling too broadly.

In Letter Ruling 200903073, 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 that had employed him.

The plaintiff received a jury verdict consisting of compensatory damages for his personal physical injuries, medical expenses, pain and suffering, lost earnings, and even punitive damages. 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 had rejected an opportunity to settle for policy limits under the tavern's policy. Under state law, the tavern as policy holder 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 just such a claim against its carrier.

In a post-verdict settlement, the parties in the personal injury case agreed to stay the execution of the plaintiff's judgment and the tavern assigned to the injured 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 of claims possessed by the tavern and the tavern manager against the insurance company related to the bad faith claims.

The assignment agreement provided that within 30 days of the termination of the bad faith litigation against the insurance company, the underlying judgment against the manager and the tavern relating to plaintiff's personal injury claims would be marked "satisfied."

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

## UNDERLYING CASE TAX FREE

The IRS began its analysis in the private 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 stated that the critical inquiry is: in lieu of what were the damages awarded? The plaintiff may have recovered against the insurance company, but the recovery had its origin in the settlement of the court case 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 that 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 the insurance company *because* the plaintiff was injured.

Thus, the IRS concluded that the Section 104 exclusion for personal injury damages applied. See 26 U.S.C. § 104. The IRS also noted that the exclusion would not apply to any amounts the plaintiff received that resulted from the *punitive* claims as damages of that nature are always taxed. See *O'Gilvie v. U.S*., 519 U.S. 79 (1995). Letter Ruling 200903073 expressed no opinion on allocating between compensatory and punitive damages.

## CONTRACT VS. 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.

When the tax law was changed in 1996 to require physical injuries or physical sickness for an exclusion, the IRS and the courts said you could only have those in a tort case, not one based on contract. That made the tort vs. contract line in bad faith cases more important. But since 2012, the tort or contract basis of the case does not impact tax treatment.

That is good, because the IRS has usually viewed bad faith claims as grounded in contract, since insurance policies are contracts. Regardless, it is relevant to inquire into the treatment of damages that, at least in part, often relate to the original act producing the underlying insurance claim.

Not surprisingly, most bad faith insurance cases relate to the mishandling of insurance claims. Those claims, in turn, often stem from underling negligence cases where a plaintiff was physically injured.

Even so, the act of bad faith in the insurance company's mishandling of the injury claim is, at least in California, a separate, independent tort all of its own. See *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566 (1973). Given this state of the law, as a starting point, a California bad faith recovery can be said to sound in tort, not contract. But we still must face the question: is the recovery taxable?

## RECENT CASES: *KTSANES, WATTS, HAUFF* AND *BRADEN*

Perhaps as a result of the 2009 letter ruling, some taxpayers have come to think "tax free" when they hear "bad faith." For example, in *Ktsanes v. Commissioner*, T.C. Summ. Op 2014-8, 2014 WL 4337231, the taxpayer worked for the Coast Community College District 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, saying 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 IRC 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, so was excludable under IRC Section 104(a)(1). The Tax Court rejected both arguments and found the settlement to be taxable, concluding that Ktsanes's damages were received "on account of" the insurance company's refusal to pay a valid claim and *not* the Bell's palsy that gave rise to it. 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 … 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." *Ktsanes*, 2014 WL 4337231 at *8.

On the surface, this reasoning might make it difficult for bad faith recoveries to qualify under IRC Section 104(a)(2). Indeed, when taxpayers claim that bad faith recoveries are excludable from gross income under IRC 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.

But some can. They may well assert 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. In *Ktsanes*, though, the Tax Court concludes the opinion by stating 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)." *Ktsanes,* 2014 WL 4337231 at *11.

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.

### SECTION 104(A)(3)

The taxation of an undisputed payment would surely depend on the facts that gave rise to the insurance claim. In *Ktsanes*, the court seemed bothered by IRC Section 104(a)(3). Notably, Ktsanes did not raise this sub-section 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. See 26 U.S.C. §104(a)(3). The key qualifier, of course, is that the premiums for the insurance 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 would presumably have been taxable.

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

### *WATTS*

In *Watts v. Commissioner*, T.C. Memo. 2009-103, 2009 WL 1391414, 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 under IRC 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 the *Schleier* case, 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 IRC Section 104(a)(2).

But the Tax 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." *Watts*, 2009 WL at 1391414 at *5.

Instead, the Tax 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 Tax Court concluded that the settlement payment could be excluded under IRC Section 104(a)(3) up to the policy limits, and were taxable to the extent the settlement payment exceeded Watts's $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, IRC Section 104(a)(2) does not override IRC 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 Tax Court to either refuse to apply IRC 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*).

Notably, though, Private Letter Ruling 200403046 ruled that legal fees allocable to disability benefits were excludable under Section 104(a)(3). See I.R.S. Priv. Ltr. Rul. 200403046 (Jan. 16, 2004). 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.

### *HAUFF*

*Hauff v. Petterson,* 755 F. Supp. 2d 1138 (D. N.M. 2010), is not a tax case. But it is worth reading even if one is focused solely on the 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 involved in a collision with an uninsured motorist and sustained physical injuries.

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

The court determined that amounts received by Hauff for lost wages would be excludable from his income under IRC Section 104(a)(2) as amounts received on account of a personal physical injury or physical sickness. Because Hauff would not have to pay tax on the amounts received from his insurer, the court found that the insurer was acting in good faith by only paying Hauff his *net* lost wages. As a result, the court found for the insurer on summary judgment.

### *BRADEN*

In *Braden v. Commissioner*, T.C. Summ. Op. 2006-78, 2006 WL283021, predates the 2009 letter ruling, but is interesting nonetheless. 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.

Therefore, the IRS said 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 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 cases that analyze the consequences 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 can require some creativity.

Indeed, Letter Ruling 200903073 involved a bad faith claim that was originally owned by the tavern policy holder. 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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