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IRS Issues New Rules For Tax-Free Legal Settlements

Which personal injury recoveries are tax-free? For almost 80 years, [Section 104](#) of the tax code has made many injury recoveries tax-free, whether you settle or go to court. Up until 1996, just about anything qualified, including emotional distress, defamation or invasion of privacy. See [Don't Fail To Consider Taxes When Settling Litigation](#).



But in 1996, the tax code was changed to say only recoveries for **physical** injuries or **physical** sickness qualify. Since then, there's been no end of litigation about the scope of this tax exclusion and just how "physical" injuries must be to count. Headaches and insomnia? Not enough. Ditto for stomachaches. See [IRS To Collect on Italian Cruise Ship Settlements](#).

The IRS hasn't issued a **formal** interpretation of the "physical" modifier but routinely argues in audits and tax cases that there must be "observable bodily harm"—think bruises or broken bones. But many injuries are internal and much physical sickness can't be observed with the naked eye. See [Are PTSD Recoveries Tax Free?](#)

Frustrated tax lawyers and accountants have repeatedly asked for regulatory guidance. Meantime, the U.S. Tax Court is clogged with taxpayer cases trying to determine what's taxed. Even National Taxpayer Advocate Nina Olson has criticized the IRS, noting that frustrated taxpayers seek answers. See [Taxpayer Advocate 2009 Annual Report to Congress](#). Unfortunately, the IRS hasn't issued regulations addressing this topic in the decade and a half since 1996.

The **only** topic the IRS addressed this time seems obscure by comparison. A 1992 Supreme Court case ruled that to be tax-free, an injury not only had to be for personal injuries or sickness but also based in tort law. [Torts](#) are civil wrongs recognized as grounds for a lawsuit like negligence, battery, etc.

Many cases denied tax-free treatment to settlements where there was no traditional tort violation. If damages were awarded under a statute providing a narrow remedy instead of the wide range typified by tort law, no tax exclusion was available. Ditto for recoveries under many state's "no-fault" statutes.

But with subsequent case law and the 1996 statutory change, in [2009](#) the IRS issued proposed regulations stating that a recovery need not be based on tort law to be tax-free. When proposed, they allowed informed taxpayers to elect to apply them immediately. The IRS has now finalized them and applied them to everyone. In effect, these final regulations allow a tax exclusion for damages awarded under no-fault statutes.

While this is a positive change, the crying need is for guidance on the "what is physical" front. Comments on the 2009 proposed regulations asked the IRS to define certain personal injuries as physical injuries and to describe when emotional distress can be attributable to physical injuries and therefore also tax-free. Sadly, on these points, the IRS is still silent.

The final rules are effective immediately but in many cases are made retroactive to 1995. See [T.D. 9573; Regulation Section 1.104-1](#).

For more, see:

[Damages Are Taxable, Even for “Political Discrimination” Says IRS](#)

[Bar Is Burned Down, Condemned, Then Taxed!](#)

[Duke Lacrosse Tax Lien Highlights How Lawsuits Are Taxed](#)

[Tax Issues in Employment Mediations](#)

[Six Tax-Wise Ways To Reduce Your Legal Bills](#)

[Tax-Free Physical Sickness Recoveries in 2010 and Beyond](#)

[Is Physical Sickness the New Emotional Distress?](#)

[Watch Your Mail For 1099s](#)

[Address Taxes When You Mediate Civil Disputes](#)

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