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IRS To Collect on Italian Cruise Ship Settlements

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One night during dinner, your cruise ship crashes into a reef. Amid the pandemonium you must climb into a lifeboat leaving all your possessions, passport, money—even your high-heeled shoes. Then the cruise line offers you $14,000 to settle. If you take it, is it taxable?

The Costa unit of Carnival Cruises is offering ***uninjured*** passengers €11,000 ($14,460) apiece to compensate them for lost baggage and psychological trauma. Costa will also reimburse passengers for their cruise, travel and medical expenses. This deal only covers those who suffered ***no physical harm***, not the roughly 100 people injured or families who lost loved ones.

Of course, there will be lawsuits. Passengers are free to pursue legal action on their own if they aren't satisfied with the deal. Two U.S. law firms are said to be launching a class-action against Costa and Carnival hoping for a considerably richer recovery per passenger.

But Is It Taxable? Maybe. Although the wreck happened in Italy, every U.S. citizen and permanent resident must report worldwide income. See New IRS Offshore Amnesty Announced: Third Time's A Charm. What's income? Generally everything.

Fortunately, damages for physical injuries (say, broken bones from an accident) are tax-free. What if you only suffer emotional injuries? Physical ***sickness*** is also tax-free but not physical symptoms caused by emotional distress—say, headaches. Neither the IRS nor Congress has clarified what's physical and what's not, so tax disputes are common.

In 2010, the U.S. Tax Court overruled an IRS decision to tax a $350,000 settlement a man received after suing his ex-employer for intentional infliction of emotional distress. See *Parkinson v. Commissioner*. Why? The distress led to a heart attack, the court said. See Tax-Free Physical Sickness Recoveries in 2010 and Beyond.

Still, the $14,000 cruise deal is ***solely*** for passengers with ***no physical injury***, which could mean it's taxable. If passengers get post-traumatic stress disorder, is PTSD physical injury for tax purposes? I argue it should be.

Property Too! What if the $14,000 covers all passenger possessions too and they were worth more? If you lost $11,000 worth of clothes, cameras, luggage and personal items you should be able to recover your basis before you have income. That could mean only the excess is taxed. What if you lost $18,000 worth of items but you accept the $14,000? You probably have no income on the settlement and perhaps can claim a $4,000 casualty loss.

Yet proof problems can be severe—who keeps receipts for personal items? For tips, see Need A Tax Receipt? How the settlement is reported to you (on IRS Forms 1099) can matter. You have more flexibility to reduce taxes if you negotiate your settlement with an eye on tax rules. The IRS isn't bound by an agreement's wording, but it can help.

For more, see:

Don't Fail To Consider Taxes When Settling Litigation

Damages Are Taxable, Even for "Political Discrimination" Says IRS

What If A Taxpayer Doesn't Have Receipts?

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]

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