INTRODUCTION

Today’s discussion provides a basic review of the taxation of tort-type damages awarded by court decision or agreed upon pursuant to a settlement agreement, including a chart summarizing the tax treatment of various damages arising from different torts. We will discuss briefly structured settlements and qualified assignments.

I. EXECUTIVE SUMMARY

Generally, under Internal Revenue Code Section 104 (“Section 104”), an individual who receives damage awards or settlements for physical sickness or physical injury arising from a physical injury tort claim will not be subject to income taxes on those damages. Prior to 1996, damage awards resulting from emotional distress claims, even absent any physical-type tort claim, were also tax-exempt. Due to 1996 legislation changes to Section 104, however, damages now must result from a physical injury tort claim to escape taxation.

II. ANALYSIS

Pursuant to Internal Revenue Code Section 61 (“Section 61”), the term taxable “gross income” is defined as “all income from whatever source derived,” with some limited exceptions. Thus, Section 61 provides the overriding general rule that any damage award or settlement...
payment will be taxable income, unless the income is subject to some statutory exemption from taxable income.

One of the exceptions from taxable gross income is compensation received as a result of personal physical injuries or physical sickness, as provided for in Section 104. Subsection 104(a)(2) exempts from taxable gross income: the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. Note that this subsection was amended in 1996 to add the word “physical” before the words “injuries” and “sickness.” Also in 1996, Proposed Regulation Section 1.104-1(c) was added to address this “physical” requirement.¹ This proposed regulation, included in part below, requires damages to arise from physical injury or physical sickness to be excluded from gross income:

Section 104(a)(2) excludes from gross income the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness. Emotional distress is not considered a physical injury or physical sickness. However, damages for emotional distress attributable to a physical injury or physical sickness are excluded from income under section 104(a)(2). Section 104(a)(2) also excludes damages not in excess of the amount paid for medical care (described in section 213(d)(1)(A) or (B)) for emotional distress. For purposes of this paragraph (c), the term damages means an amount received (other than workers’ compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution.

(Emphasis added.) Prop. Reg. Sec. 1.104-1(c).

A. Section 104 Exclusion Only Applies to Tort Claims

¹ While not technically binding, the Internal Revenue Service views proposed regulations as the Treasury’s interpretation of the Internal Revenue Code. As such, the Internal Revenue Service will use a regulation as a “sword” in enforcing the Internal Revenue Code. In contrast, a taxpayer can use a regulation as a “shield” because reliance upon a proposed regulation constitutes the taxpayer’s “reasonable basis” for taking a certain tax position.
Section 104(a)(2) requires damages to be “received (other than workmen’s compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution.”\(^2\) State law generally determines whether a cause of action is a tort.\(^3\)

Proposed Regulation Section 1.104-1(c)(2), supra, would apply the Section 104(a)(2) exclusion to “damages recovered for a physical personal injury or sickness under a statute, even if that statute does not provide for a broad range of remedies. The injury need not be defined as a tort under state or common law.”

B. The “On Account Of Personal Physical Injuries or Physical Sickness” Requirements

In light of the changes discussed above in 1996, this memorandum discusses the two requirements necessary for a damage award to escape inclusion in taxable gross income under Section 104: (1) the “on account of” requirement and (2) the “personal physical injury or physical sickness” requirement.

1. The “On Account Of” Requirement

First, damages must have been received “on account of” a personal injury to escape inclusion in taxable gross income under Section 104. In Comm. v. Schleier, a case involving age discrimination, the United States Supreme Court determined that the award a taxpayer received in a settlement was taxable because the award was not “on account of” personal injury or sickness.\(^4\) The Court explained in this case of employment discrimination that the genesis of the

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\(^2\) I.R.C. Section 104(a)(2).


back wages awarded to the taxpayer, whether his 60th birthday or his being laid off due to his age, cannot “fairly be described as a ‘personal injury’ or ‘sickness.’”

Another person aggrieved due to the physical injury or sickness of another may be able to receive damage awards or settlement payments free from income taxation. For example, in Private Letter Ruling 200121031, the IRS decided that a widow could receive settlement proceeds tax-free because her underlying causes of action, which included loss of consortium, were based on her husband’s exposure to asbestos and asbestos products, which proximately caused his subsequent diseases and death. Such a result is not surprising given the language of the Joint Committee on Taxation in its discussion of Section 104(a)(2):

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 damages received on account of personal physical injuries or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim of loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from gross income as under prior law.

(Emphasis added).

The logic of the IRS in the private letter ruling mentioned above, as buffered by the language of the Joint Committee on Taxation, can be extended to a number of various physical injury situations such that persons other than the person physically harmed may receive tax-free

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6 See also Private Letter Ruling 199952080 (1/03/2000). Please note that private letter rulings (“PLRs”) may neither be cited as precedent as they are written in response to individual requests for guidance, nor can they be relied upon by any party other than the parties to whom they are issued.
7 Comm. Report. JCS 12-96 (Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 104th Congress), Part Four (Revenue Provisions of the Small Business Job Protection Act of 1996 (H.R. 3448)), Article V (Revenue Offsets), Section 5 (“Taxation of Punitive Damages Received on Account of Personal Injury or Sickness (Sec. 1605 of the Small Business Act and Sec. 104(a)(2) of the Code), pp. 223-24 (hereinafter, this source shall be cited as the “Joint Committee Report”). See also PLR 200121031, supra.
damages, such as damages resulting from wrongful death. Likewise, if a parent suffers emotional distress as a result of witnessing an accident involving the parent’s child, then the parent’s damages arguably should be exempt from taxation.

2. The “Physical Injuries or Physical Sickness” Requirement

Second, Section 104(a)(2), as well as Proposed Regulation Section 1.104-1(c), require that an injury must be “physical” in nature in order for the resulting damages to be tax-free under Section 104.

For example, damages received on account of harm to one’s personal or professional reputation are not considered to be received “on account of personal physical injuries or physical sickness.” Before 1996, such damages were considered to have arisen from personal injury and were thus excluded from gross income. After 1996, however, damages resulting from injury to professional and personal reputation are taxable. Indeed, the Joint Committee on Taxation states, “[T]he exclusion from gross income does not apply to any damages received … based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress.”

3. Punitive Damages

Punitive damages are generally taxable because they are imposed to punish and thus do not arise “on account of” personal injury. In general, taxpayers who receive punitive damages must include these damages in their gross income even if, as suggested by the language of the statute and Joint Committee Report, the punitive damages result from physical injury or physical

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8 See, e.g., PLR 200942017 (10/16/2009), where the Service states that to the extent an award received by a taxpayer represented compensatory damages for wrongful death and associated emotional distress, that award was excludable from the taxpayer’s income under Section 104(a)(2).
9 Joint Committee Report, supra, p. 224.
sickness.\textsuperscript{11} The major exception to this rule is limited to punitive damages awarded on account of a wrongful death claim with respect to which applicable State law provides that only punitive damages may be awarded in such an action.\textsuperscript{12}

4. \textbf{Emotional Distress}

Proposed Regulation Section 1.104-1(c) also demonstrates that Congress does not consider “emotional distress”\textsuperscript{13} to be a physical injury or physical sickness.\textsuperscript{14} As a result, Congress decided that damages for emotional distress are includable in gross income.\textsuperscript{15} However, if the emotional distress is attributable to a physical injury or physical sickness, then the damages for the emotional distress also are excluded from gross income.\textsuperscript{16} Please note that one may also exclude any portion of a damage award that is a reimbursement of medical care costs relating to emotional distress, even if the emotional distress does not arise from physical injury.\textsuperscript{17}

a. \textbf{Physical v. Emotional: A Fuzzy Line}

In his article, “Tax-Free Physical Sickness Recoveries in 2010 and Beyond,” Robert W. Wood discusses the impact the elusive differences between physical sickness and emotional sickness have on emerging case law.\textsuperscript{18} Also, a 2010 Tax Court case, \textit{Domeny v. C.I.R.}, further illustrates the gray area between physical injury and emotional distress and the circular logic that

\textsuperscript{11} See Joint Committee Report, \textit{supra}, p. 223.
\textsuperscript{12} Punitive damages will not be taxable if they are awarded in wrongful death actions “with respect to which applicable State law (as in effect on September 13, 1995 and without regard to any modification after such date) provides, or has been construed to provide by a court of competent jurisdiction pursuant to a decision issued on or before September 13, 1995, that only punitive damages may be awarded in such an action.” I.R.C. Section 104(c).
\textsuperscript{13} Intended by the House Committee to include physical symptoms such as insomnia, headaches and stomach disorders which may result from such emotional distress. Joint Committee Report, \textit{supra}, n. 171.
\textsuperscript{14} Id.; I.R.C. Section 104(a); Proposed Regulation Section 1.104-1(c)(1).
\textsuperscript{15} Proposed Regulation Section 1.104-1(c)(1).
\textsuperscript{16} Id.
\textsuperscript{17} Id.
\textsuperscript{18} \textit{Tax Notes}, Vol. 128, No. 8, p. 885 (08/23/2010).
applies when determining which type of injury – physical or emotional – causes the other.\(^{19}\) In that Tax Court case, the taxpayer and the IRS disagreed over whether the taxpayer had received damages on account of physical injury or sickness. The Tax Court ultimately determined that the taxpayer received non-taxable damages on account of physical injury or sickness because the “hostile and stressful work environment” in which the taxpayer worked exacerbated her multiple sclerosis, thus causing physical injury.\(^{20}\) Such case law suggests that if damages for emotional distress are attributable to physical injury or physical sickness, the damages may avoid taxation even if the underlying claim is not based upon a traditional physical injury tort claim.

\[ \text{b. Attorney Fees} \]

Much confusion exists with respect to the treatment of attorneys fees. An example may be helpful. Consider a non-physical injury claim in which the plaintiff has agreed to pay his or her attorney 30% of any damages awarded at the end of the case. If the plaintiff is awarded $1,000 in damages, the plaintiff will pay the attorney $300. The plaintiff will then seek to deduct the $300 paid in attorneys fees on his or her income tax return.

Even if the amount paid is deductible,\(^{21}\) both the amount and effect of the deduction are limited in several ways. First, the deduction is categorized as a miscellaneous itemized deduction, which means the deduction is limited to the amount by which it exceeds two percent

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\(^{19}\) T.C. Memo 2010-9.

\(^{20}\) Id.

\(^{21}\) For example, if the source of the claim is purely personal in nature and not related to the Plaintiff’s business, the related attorneys’ fees may not be deductible. See, generally, I.R.C. Section 212. Moreover, if the award was based on physical injury and so is tax-free to the Plaintiff, then the attorneys’ fees are not deductible. See, I.R.C. Section 265. See also Bent v. C.I.R., (1986), 87 TC 236, aff’d (1987, CA3) 61 AFTR 2d 88-301, 835 F2d 67, 88-1 USTC ¶ 9101.
of the Plaintiff’s adjusted gross income. 22 Second, the deduction is subject to the itemized deduction “phase-out” rules, which means that if the Plaintiff’s adjusted gross income exceeds a specific amount, the deduction will be further limited. 23 Third, if the Plaintiff is subject to the Alternative Minimum Tax, the deduction will not be allowed at all. 24

In effect, the plaintiff, in our example above, now owes taxes on the full $1,000, even though a substantial portion of this amount was paid to an attorney. Note, however, that the American Jobs Creation Act of 2004, P.L. 108-357, provides that, if the party received the damages due to certain types of unlawful discrimination, the legal fees will not be categorized as a miscellaneous itemized deduction and, as a result, will not be subject to the above limitations.

Some taxpayers have attempted to avoid these limitations on deductions by assigning a portion of their rights in their lawsuits to their attorneys. This maneuver, however, will not be successful. Discussing two instances of employment discrimination, the United States Supreme Court held, “as a general rule, when a litigant’s recovery constitutes income, the litigant’s income includes the portion of the recovery paid to the attorney as a contingent fee.” C.I.R. v. Banks, 543 U.S. 426, 430, 125 S.Ct. 826, 829 (2005). Viewing the case in the context of an anticipatory assignment of income, the Court held that the taxpayer’s “income-generating asset” is the cause of action deriving from the plaintiff’s legal injury, an asset over which the taxpayer “retains ultimate dominion and control.” Banks at 436, 125 S.Ct. at 832. The Court declined to address claims involving statutory attorney fees. Banks at 438, 125 S.Ct. at 834.

22 I.R.C. Section 67. Note, however, that in some cases, the legal expenses may be deductible as a business expense, if the claim at issue originates from the taxpayer’s business. See, e.g., Guill v. C.I.R., 112 T.C. 325, 329 (1999). Such a deduction may only be available as a miscellaneous itemized deduction from adjusted gross income, however, for legal expenses incurred by an employee in a wrongful termination claim due to a lack of a “business connection.” See, e.g., Biehl v. C.I.R., 118 T.C. 467, 472, 478-79 (2002).
23 I.R.C. Section 68.
Please note that the deductibility of the plaintiff’s attorneys fees in a structured settlement based on a non-physical injury is a complex issue, a thorough analysis of this specific issue is outside the scope of this memorandum.

III. SUMMARY CHART

Based on the preceding analysis, the following chart provides a general summary of the tax treatment of damages resulting from various tort claims:

A. Slander/Libel
   1. Injury to Reputation Taxable
   2. Emotional Distress Taxable
   3. Punitive Damages Taxable

B. Employment Discrimination/Hostile Work Environment/Americans with Disability Act
   1. Lost Wage Income Taxable
   2. Emotional Distress Taxable
   3. Punitive Damages Taxable

C. Medical Malpractice/ Assault and Battery/ Slip and Fall
   1. Physical Injury
      1. Pain and Suffering Exempt
      2. Medical Expenses Exempt
      3. Lost Income Exempt
      4. Wrongful Death Exempt

25 Generally, but see Domeny, supra.
26 See, generally, Rev. Rul. 85-97, 1985-2 C.B. 50 (“The exclusion provided by section 104(a)(2) extends to personal injury damages allocable to lost wages.”).
2. Emotional Distress Arising from Physical Injury

   1. Medical Expenses  Exempt
   3. Punitive Damages  Taxable

IV. SETTLEMENT AGREEMENTS

A. Generally

Payments received pursuant to settlement agreements, in contrast from severance agreements, may be excluded from taxable gross income under Section 104. To benefit from the Section 104 taxable income exclusion rules, a taxpayer should ensure that his or her settlement agreement properly allocates the damage settlement between taxable and nontaxable settlement amounts.

If the parties to a settlement agreement draft the agreement to “expressly allocate[] the settlement between tort type personal injury damages and other damages, it will be respected for tax purposes to the extent that the parties entered into the agreement in an adversarial context at arm’s length and in good faith.” Moulton v. C.I.R., T.C. Memo. 2009-38.

Absent such allocation, the entire amount of the damages awarded under the settlement agreement may “result[] in the entire amount’s being presumed not to be excludable.” Pipitone v. United States, 180 F.3d 859, 864 (7th Cir. 1999), citing Wise v. C.I.R., T.C. Memo. 1998-4.

Not surprisingly, the IRS may make “a reasonable attempt … to allocate the proceeds between nonexcludable income and personal injury damages.” Field Service Advisory 2187, 1997 WL 33106702 (Sept. 23, 1997).

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27 Punitive damages are generally taxable. As discussed, supra, punitive damages are excluded from income in the rare case that punitive are awarded in a wrongful death action in which applicable state law only provides for punitive damage awards. See n. 12, supra.

28 See Greer, supra, 207 F.3d at 327, quoting Lubart v. Commissioner, 154 F.3d 539, 542 (5th Cir. 1998) (stating “[P]arties must be prohibited from creating contrived ‘settlement agreements’ to avoid taxation of the proceeds.”).
The major question the IRS and the courts will try to determine is “in lieu of what was the amount paid.” Bagley v. C.I.R., 105 T.C. 396, 406 (1995). The answer to such a question necessarily must emerge from “all of the facts surrounding the settlement.” Id. If, however, “there is no evidence on which to predicate an allocation,” a court will not make such an apportionment, presumably resulting in full taxation of the settlement proceeds.29

When considering the factual context of a settlement, the Tax Court has stated, “When damages are received pursuant to a settlement agreement, the nature of the claim that was the actual basis for settlement controls whether such damages are excludable under section 104(a)(2).”30 That said, the most important factor to be considered is “the payor’s intent in making the payment.”31 Indeed, “Although the belief of the payee is relevant…the character of the settlement payment hinges ultimately on the dominant reason of the payor in making the payment.”32 Determination of the payor’s intent may include consideration of the joint stipulation of the settlement agreement and the allegations made in the underlying complaint.33 Indeed, some commentators have suggested that a discrepancy in the manner in which the payor and recipient taxpayer record the settlement payment for tax purposes will trigger investigation by the IRS.34

B. Reporting and Withholding Requirements

31 T.C. Memo. 2009-38; see also T.C. Memo. 1998-357.
33 T.C. Memo. 1998-357. See also Alexander v. IRS, 77 AFTR 2d 96-201 (72 F3d 938) (CA1, 1995) (“[W]e take into consideration the well-settled rule that the classification of amounts received in settlement of litigation is to be determined by the nature and basis of the action settled, and the amounts received in compromise of a claim must be considered as having the same nature as the right compromised.”); Save v. C.I.R., T.C. Memo. 2009-209 at *3 (“In the absence of any express language in the agreement, the intent of the payor is the most important factor in determining the purpose of the payment.”). In Knevelbaard v. Commissioner, the Tax Court considered testimony in determining the basis of a settlement agreement. T.C. Memo. 1997-330, 11-13.
Internal Revenue Code Instructions for Form 1099 indicate that a defendant-payor will be obliged to determine the taxable nature of payments made to the plaintiff. If these payments are taxable to the plaintiff, for example, punitive damages and damages not arising from physical injury, then the defendant-payor must report such payments via Form 1099.

Under certain circumstances, for example, if the plaintiff refuses to provide his or her tax identification number to the defendant, then the defendant may also be required to “deduct and withhold from such payment a tax equal to the product of the fourth lowest rate of tax applicable under section 1(c) and such payment."35

C. Structured Settlements

Instead of making and receiving a lump-sum payment based on a tort resulting in personal injury, the parties in a settlement may agree to “structure” the settlement such that payments are made over a period of time. Each payment would be tax-free to the recipient, including the hypothetical interest within each payment. In contrast, had the recipient received a lump sum and then invested this amount, the recipient would be taxed on the income resulting from that investment. The parties to a structured settlement agreement should also be sure to not label any payment or portion thereof as interest, even if the payment would otherwise be tax-free under Section 104 as the IRS may tax the interest as ordinary income. 36

D. Qualified Assignments

If a party (the “Defendant”) becomes liable to make periodic payments as damages under a suit or a settlement agreement (the “Liability”), the Defendant can pay a third party (the “Assignee”) to assume this Liability (the “Assignment”). This payment to the Assignee (the “Payment”) will be tax-free to the Assignee if the Assignment is “qualified,” meaning that it

35 I.R.C. Section 3406(a).
meets certain conditions.\textsuperscript{37} An Assignment is “qualified” if, among other conditions, the underlying liability arises from a personal injury,\textsuperscript{38} and the recipient of the periodic payments (the “Plaintiff”) can exclude the payments from his or her gross income.\textsuperscript{39} However, the Payment to the Assignee will not be tax-free to the Assignee to the extent the Payment exceeds the Assignee’s cost of obtaining an annuity contract that is used to fund the periodic payments to the Plaintiff.\textsuperscript{40}

Economic performance will occur when payments are made to the Plaintiff, which means that the Assignee may deduct payments as they are made to the Plaintiff.\textsuperscript{41} Similarly, the Defendant will deduct the amount paid to the Assignee in the year the same year in which it so pays the Assignee.\textsuperscript{42}

\textsuperscript{37} I.R.C. Section 130(a).
\textsuperscript{38} I.R.C. Section 130(c).
\textsuperscript{39} I.R.C. Section 130(c)(2)(D).
\textsuperscript{40} See I.R.C. Sections 130(a), (d).
\textsuperscript{41} I.R.C. Section 461(h)(2)(C); I.R.C. Regulation Section 1.461-4(g)(2).