

## Come On, It's for a Personal Injury, It Shouldn't Be Taxable. Should It?

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Before I become inundated with tax returns, valuations and other litigation reports, I thought I'd take some time to remind my legal colleagues that there truly are "Tax Aspects of Personal Injury Awards." That said, how delighted I was to help I.C.L.E. with the new medium it chose for a webinar on this very topic. Who better to balance out the "Tax accountant" than the very seasoned Certified Trial Attorney, Tommie Ann Gibney Esq., of Andres & Berger? As an aside, I've personally never been a big fan of purchasing the tapes from a seminar or conference but I do encourage you to purchase this hour-and-a-half presentation offered by I.C.L.E. The webinar was strictly audio so you need not worry about the camera aspects and I believe the handouts quite insightful. Nope, this is not a paid advertisement but a suggestion from a very practical accountant. What follows are some excerpts from my portion.

Internal Revenue Code (IRC) section 61 states that all income from whatever source derived is taxable income, unless specifically excluded by another code section. The only provision which specifically addresses income

exclusions for any type of lawsuit proceeds is IRC section 104(a) (2) which excludes from income amounts paid by suit or agreement for personal injuries or sickness. Awards for nonphysical injuries are not excludable except to the extent of amounts paid for medical care attributable to emotional distress. The legislative history of The Small Business Job Protection Act signed into law in 1996, as it related to IRC section 104(a)(2), provided some useful insight into what was or was not excluded from taxable income because of "physical injuries or physical sickness." Generally, if the primary injury is physical, then all resultant damages (except for punitive damages or interest) are excludable. This is the case even if the damages are measured by lost wages. As I mentioned in an article for *The Barrister* a year or so back, the 1996 Act curtailed years of confusion and litigation by stating that awards for nonphysical injuries will be excluded but only to the extent of amounts paid for medical care attributable to emotional distress—not for the actual nonphysical injury itself (i.e. age and gender discrimination or harassment cases). Such exclusions would include medical care necessitated by a non-physical

injury (i.e. psychiatry or therapy for emotional distress resulting from a wrongful discharge, medicines for



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resulting stress, dental bills resulting from teeth grinding, etc.). However, if the primary injury is not physical, then the resultant damages are not excludable even if the action caused emotional distress, which might result in headaches, ulcers, teeth grinding, insomnia, etc. It's even interesting to note in the Conference Report that injuries resulting to other third parties are excluded if the underlying injury was physical (i.e. loss of consortium or recoveries for wrongful death).

It is now pretty much well settled that interest included in a judgment that has become final will be treated as taxable interest, not to be excluded under IRC sec 104(a)(2). Concerns develop where an out of court settlement occurs with the settlement agreement silent as to interest. IRS typically argues that some portion of the lump sum payments represents interest income taxable to the Plaintiff while the taxpayer Plaintiff will take the position that the entire settlement should be excluded under 104(a)(2) as damages received "on account of personal injuries." Even so, attorneys should consider stating in their settlements that the award is "without interest" although such a practice is certainly not decisive. While there may be an assumption there is no interest in a lump sum personal injury settlement reached before the actual trial, appreciate how easy it is for the IRS to glean an interest component from a jury verdict, which specifies compensatory damages along with stated interest computations. Structured settlements (i.e. damages awards paid in a series of periodic payments and not in a lump sum) received on account of a personal physical injury will enable the recipient to exclude the entire

amount of the periodic payments, even though such payments clearly include an interest element.

As I alluded to earlier, the water is still pretty murky on exactly what is a "physical injury"? Are ulcers? Are migraines or cluster headaches? Are strokes? Once again, reading the legislative history in the Conference Committee Reports to the 1996 law changes revealed that mere symptoms of emotional distress such as stomachaches, headaches or insomnia do not constitute physical injuries although these three examples were not meant to be all-inclusive.

A properly worded complaint or settlement agreement can certainly aid in the exclusion of the damages from gross income. In fact, not considering the tax consequences of a damages award can easily lead to a malpractice claim against the erring attorney. Regardless, I would ask my attorney colleagues to consider the following scenario: a driving instructor suffers some physical injuries when he failed to follow standard operating procedures with the company vehicle under his control. The employer terminates his employment contract for breach of their rules. The employee then sues and assume the company agrees to settle for \$100,000. The employee's attorney may artfully craft the settlement agreement to specify that the employer is paying for the personal physical injuries suffered by the employee, hoping to avoid taxation of the proceeds. Although such drafting of the settlement agreement is not conclusive, leaving it open or vague only leaves the IRS an opportunity to easily challenge such treatment. For example, the Service may claim that the \$100,000 was to

compensate the employee for the "wrongful discharge," which would make the proceeds taxable. Properly wording the initial complaint as well as the settlement agreement or even asking the Court to allocate the damage awards is the best way to help ensure favorable tax treatment. While I'm a CPA and not an attorney, I would imagine trying to substantiate the tax treatment in the initial complaint is further complicated since the plaintiff's lawyer often considers several different theories/claims at the outset of a case. Still, the IRS often relies on the initial complaint as the most persuasive in allocating damage awards (usually in their favor and not the Plaintiff's).

## **Then Came Marrita Murphy, et al, v. Internal Revenue Service, et al**

Marrita Murphy was awarded compensatory damages for emotional distress and reputation loss when she sued her former employer under the whistle blower statutes then in effect for emotional distress and physical damages resulting from her employer's retaliation and illegal treatment (or mistreatment). The initial award from an Administrative law judge and affirmed by the Department of Labor Administrative Review Board was for compensatory damages of \$70,000. \$45,000 was for "emotional distress or mental anguish" and the balance, or \$25,000, was for "injury to her professional reputation." Ms. Murphy reported and paid tax on the full amount of the award. She later filed an amended income tax return seeking refund of \$20,665. When the IRS denied her claim she sued in the U.S.

District Court for the District of Columbia in an attempt to obtain refunds for these taxes she paid on the compensatory damages for emotional distress and reputation loss. As I discussed earlier, such damages for emotional distress are not specifically excluded under section 104 and were thus considered taxable by the Service. The taxpayer plaintiff, challenging its constitutionality, argued that damages paid with regard to non-physical injuries are not “income” and also argued her award should not be taxed because she suffered from physical manifestations of her “mental” injury. The District Court rejected her plea and, after appealing, on August 22, 2006 the Court of Appeals agreed that Ms. Murphy’s damages for emotional distress were NOT “income” and, thus, were NOT taxable. The Court found an award limited to making someone “whole” for actual documented losses to physical or mental health was not taxable.

The three judge Court of Appeals decision was only binding on the IRS with similar cases in Washington DC but it was startling to the tax community as having a significant “rippling effect,” especially for any cases anticipating damage awards for “non-physical or emotional/mental injuries.” One could easily see how plaintiffs and their attorneys would likely move quickly for similar decisions in other circuits, opening up the proverbial “floodgates” for so much litigation. The Appeals Court came under tremendous pressure from various federal agencies, judiciary, the accounting and legal communities. For those who can’t easily grasp the tax significance, the cost of settlement will invariably go up when the taxing authorities want their “piece

of the pie.” Plaintiffs are willing to accept lesser “gross” awards if there are less or no income tax strings attached while, conversely, the defendant or his (her) insurer will need to come up with less money, as well. After the 1996 changes which clarified that emotional distress damages are taxable, it became that much more difficult to settle cases. We at Abo and Company, sitting on the sidelines after the Murphy decision, saw, perhaps for the first time, the plaintiff’s bar in full agreement with the defense bar.

## **What a difference a year makes**

Fast forward from the August 22, 2006 decision in Murphy to July 3, 2007. Well, in a remarkable reversal of its prior decision, the same court later accepted that any non-physical award should be fully taxable. The Department of Justice asked for a hearing en banc (I learned that this is a hearing before all the members of the Court rather than before only the panel of three judges who made the original decision). That same Court vacated its original August 2006 judgment. I’ll leave it to constitutional rights advocates or perhaps employment lawyers to argue the intrinsic merits of the government’s new arguments. For us and other tax practitioners, we’re left to follow what we initially envisioned after the 1996 tax law and before the initial Murphy decision. Of course, there is no difference in cases where the origin of the claim is a personal physical injury. The actual wording of the initial order from the Administrative Law Judge was so very critical by his use of phrases like “emotional distress or mental anguish” and “injury to professional reputation.” These words effectively

put the nail in the coffin for the argument that exclusion under section 104 (a)(2) applied by its terms, with the IRS emphatically arguing that Ms. Murphy’s injuries were not physical.

I can think of two important lessons to be learned that the Murphy verdict teaches us. First, settlement may very well be better than a verdict, giving the plaintiff taxpayer greater flexibility in structuring a settlement tax-wise. In addition, counsel can just not be concerned enough over using exacting wording in that perhaps “on account of” is not as clear as one would think (i.e. “on account of physical injury”).

## **Some Additional Thoughts on Where We Are**

Absent a specific allocation in a settlement agreement, courts (and the IRS) will look to the plaintiff’s complaint and the intention of the payor to allocate an award among various asserted claims. According to the IRS’ audit guide for Lawsuit Awards and Settlements “...many lawsuits are settled prior to a jury verdict. These settlements should be closely reviewed, and facts and circumstances should be carefully determined. The allocation among the various claims of the settlement can be challenged where the facts and circumstances indicate that the allocation does not reflect the economic substance of the settlement.”

A bona fide arm’s-length settlement agreement among adverse parties allocating specific amounts to specific claims should be honored by the IRS although they are not bound by the parties’ allocation and may challenge an unreasonable one. According to

the IRS' audit guide "...if damages have been clearly allocated to an identifiable claim in an adversarial proceeding by judge or jury, the Service will usually not challenge their character because of the impartial and objective nature of the determinations."

On a related note, plaintiffs bar as well as the defense bar should be cognizant that confidentiality provisions can also be considered taxable income. Truth be told, I was at Starbucks on a Sunday morning reading through some of the Murphy commentary when one Michael Ringold, Esq. of Danský Katz & Ringold alerted me to the Amos Case. Previously, personal injury settlements that contained confidentiality provisions were believed to be fully excluded from taxable income as with the rest of the settlement (except for an interest or punitive component) income under section 104(a)(2). Eugene Amos, a TV cameraman, was run into off-court and purposely kicked by basketball star, Dennis Rodman. Amos required medical attention but, ultimately, Mr. Amos' and Mr. Rodman's attorneys negotiated a settlement. The settlement contained a general release and included confidentiality provisions. Mr. Amos excluded the entire settlement as proceeds from a physical injury. The IRS challenged such treatment and the matter was appealed. The U.S. Tax Court, with its decision in *Amos v. Internal Revenue Service*, gave its blessing to the IRS in taxing a portion of the settlement proceeds from the physical personal injury award as attributable to the

confidentiality provision. Given the Amos decision, plaintiffs and their attorneys should be very cautious when agreeing to personal injury settlements that include confidentiality clauses. They should at least ensure that the tax issues have been considered and properly addressed if these provisions must be so included. Plaintiff lawyers are therefore well advised to commence any negotiations, right at the start, noting that such confidentiality provisions be stricken. If plaintiff attorneys can't eliminate such confidentiality clauses, then, at a minimum, they should seek to keep the language as tight as possible since defense attorneys frequently put in such clauses automatically. For more on the Amos ramifications and suggested legal strategies, I'd suggest looking to Ms. Gibney's presentation and materials from ICLE's webinar.

How's this for a scary ending? For a summary, why don't I just list the introductory bullet points retrieved directly from the IRS' special *AUDIT GUIDE FOR LAWSUIT AWARDS AND SETTLEMENTS*? I know, I know, some feel that we CPAs or your tax attorney colleagues are just overly cautious in making issues where there aren't. Hey, what follows is the IRS auditor's roadmap, not mine.

## Issues For Lawsuit Proceeds Received

1. Settlement proceeds are unreported
2. All punitive damages are taxable whether received in

relation to a physical or non-physical injury

3. Determine if any of the settlement proceeds are designated as interest, and, if so, such interest is reported as income.
4. Verify that amounts excluded from income were received in a case of personal injury. If it was not a physical injury, the only amounts excludable under IRC section 104(a)(2) are out of pocket costs for medical expenses incurred to treat emotional distress.
5. For out of court settlements for physical injury cases, determine if proper amounts were allocated between compensatory and punitive damages.
6. Verify the amount of out of pocket expenses excluded for emotional distress in a non-physical injury case (that is discrimination, fraud, etc.).
7. Verify that the taxpayer reported taxable amounts at gross rather than reporting them net of legal fees paid.
8. Allowable legal fees should be deducted on Schedule A as miscellaneous itemized deductions, unless the origin is related to a schedule C (independent contractor) or a capital transaction.
9. The legal fees deducted on Schedule A are a tax preference item for purposes of AMT (Alternative Minimum Tax).

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