The Income Tax Treatment of Economic Damages Awards

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Part 1: The Income Tax Treatment of Personal Economic Damages Awards

Financial experts are frequently asked about the tax impact of damage awards, both paid and received. The complexities of the Internal Revenue Code ("IRC") and judicial interpretations thereof make determining the taxability of receipts or payments difficult. The same is true when dealing with the taxability of economic damages awarded to plaintiffs in civil actions. Nuances in the IRC and the judicial interpretations may make it difficult for a taxpayer to determine the taxability of his or her proceeds from a litigation award of personal economic damages. Whether or not such is taxable often depends on how the award of economic damages is categorized and/or described in the awarding documents.

Introduction

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Physical Injury and Sickness Awards

Under IRC Section 61, all sources of income are taxable, regardless of how they are derived, unless excluded in another section of the Code.[1] One such exclusion is IRC Section 104(a) that provides:

(a) In general

Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include:

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) 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;

(3) amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness…

The tax status of any award of damages is based on the origin of the claim test. As stated in *Threlkeld*, "The law is well settled that the tax consequences of an award for damages depend upon the nature of the litigation and on the origin and character of the claims adjudicated, and not upon the validity of those claims."[2] Apparently, the theory excluding damage awards for personal physical injury is the absence of an "origin," i.e., physical well-being is not a taxable activity.

The exclusion of personal physical injury and sickness awards from gross income under IRC Section 104(a) applies regardless of whether the injury or sickness damages were awarded through a verdict or a settlement, and whether the award is paid out in a lump sum or periodic payments. Any portion of the settlement or verdict attributable to medical expenses that had previously been deducted under IRC Section 213 is not excluded from taxpayer's gross income under IRC Section 104(a).

Illustration:

Sam slipped on some ice on his neighbor's sidewalk and injured his back. He paid $4,000 in medical expenses for the treatment of his injury and deducted $750 of that amount after application of the AGI limitation on the deduction of medical expenses. The following year, he sued his neighbor and was awarded $11,000 in damages, including $4,000 to reimburse him for his medical expenses. Roger may exclude $10,250 of those damages; however, he must include the $750 attributable to the medical expense deduction in his gross income.

Awards for emotional losses may be excluded under IRC 104 if the losses are attributable to personal physical injuries. As stated in Regs. Section 1.104-1(c)(1):

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…for emotional distress.

Awards in personal physical injury cases are, more likely than not, paid by an insurance company. The typical process is to pay the plaintiff's attorney the award amount as well as sending a 1099 to the attorney. Normally, the attorney will then reimburse the firm for out of pocket costs and remit the fee to the firm with the balance submitted to the client.[3]

Non-Physical Damages Awards

Damages awarded for lost profits, breach of contract, employment discrimination, and other types of non-physical damages claims are includible in gross income under the origin of the claim test.

Punitive Damages Awards

Awards of punitive damages are not intended to compensate the plaintiff, but rather to punish the defendant when his/her behavior is found to be especially harmful. Accordingly, awards of punitive damages are not excluded from gross income under IRC Section 104.

There is one narrow exception under which punitive damages may qualify for this exclusion. Punitive damages awarded in a civil wrongful death action can be excluded if the applicable state law in effect on September 13, 1995, provides that only punitive damages may be awarded in such an action [Code Sec. 104(c)].

Awards of Interest

If a civil damages case is affirmed, any interest allowed by law is payable from the date the judgment under review was entered.[4] The amount the court assigns as interest is taxable as interest income[5] even if the plaintiff's underlying claim is excluded under IRC Section 104(a)(2).

If a case is settled out of court, both parties could agree to exclude interest from the settled amount. However, if no understanding of the apportionment of the award is formally written into the settlement contract, the court may allocate a portion of the proceeds as prejudgment interest.[6]

Standard and Structured Settlements

If an economic damages claim is settled out of court, the taxability of the awarded damages is not affected by a plaintiff's decision to receive the amount in a lump sum or through a payment plan. The IRS may disagree with the apportionment of the lump sum settlement even if both parties were in agreement.[7]

In personal physical injury, wrongful death, and/or workers' compensation claims, it is possible for a plaintiff to be paid through a structured settlement annuity,[8] whereby a defendant may pay an assignment company to take over his/her long term periodic payment obligation to the plaintiff.

Attorney Fees

To what extent is the legal fee deductible? If the award is wholly excludible from income under IRC Section 104(a), then Regs. Section 1.265-1(a)(1) indicates none of the legal fees are deductible. If part of the award is exempt and part not exempt, Regs. Section 1.265-1(c) indicates a reasonable proportion of the legal fee may be allocated to both exempt and non-exempt income in light of all the facts and circumstances in each case. The legal fee for non-exempt income will be included in the taxpayer's gross income along with the award and deducted as a miscellaneous itemized deduction.

In class action lawsuits (such as an employee group seeking lost wages), there is precedent that a successful member of the plaintiff group would not have to include the attorney fees as taxable income.[9]

Conclusion

The income tax consequences of a plaintiff's receipt of an award of personal economic damages may be difficult to ascertain. Generally, taxability varies based on the nature of the underlying claim (origin of the claim test), how the economic damages are apportioned, and/or whether plaintiff received the amount in a lump sum or structured settlement. This article does not provide legal or professional advice regarding the tax treatment of personal economic damages and it behooves all taxpayers to consult with knowledgeable tax professionals prior to agreeing to a settlement or award of personal economic damages.

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[1] IRC Section 61.

[2] *James E. Threlkeld, Petitioner v. Commissioner of Internal Revenue, Respondent,* 87 T.C. 1294 (1986).

[3] The specific process in any case is defined by the agreement between the attorney and the client.

[4] Rule 42 of the United States Supreme Court.

[5] IRC Section 61 (a).

[6] *Delaney v. Commissioner*, 99 F.3d 20 (1st Cir. 1996).

[7] *LeFleur v. Commissioner*, T.C. Memo 1997-312.

[8] IRC Section 130 (c).

[9] *Eirhart v. Libbey-Owens-Ford Co.*, 726 F. Supp. 700 where the judge ruled that not all the plaintiffs were part of the suit at the time, and plaintiff agreed to pay lawyer fees, each plaintiff is not required to include the attorneys' fees on their individual income taxes.

P. Dermot O'Neill, CPA, ABV, CFF, CVA, MAFF, ABAR is President of P. Dermot O'Neill, CPA PC, Glen Mills, PA. Dermot's practice concentrates in the areas of forensic accounting, litigation support, business valuation, transaction consulting, financial analysis, and income taxation. He has provided consulting and expert witness assistance in cases involving oppressed shareholders, divorce, personal injury, wrongful death, accounting malpractice, and contract and tort issues. He is an adjunct instructor, and guest lecturer, and has presented continuing professional education webinars and seminars.

Mr. O'Neill can be reached at (215) 266-0255 or by e-mail to damagres@comcast.net.

Michael D. Pakter, CPA, CFE, CA, CIRA, CDBV, CFF, MAFF, CVA, CGMA, has more than thirty-five years of experience in accounting, financial analysis, financial forensics, and investigations, including more than fifteen years of experience in economic damages and business valuation issues. Courts and arbitral bodies have recognized him as an expert in accounting, economic damages, business valuation, financial analysis, and business economics. Mr. Pakter was assisted

by Dov S. Getz, a recent graduate of the Hebrew Theological College in Skokie, Illinois

Mr. Pakter can be reached at (312) 229-1720 or by e-mail to mpakter@litcpa.com.