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Personal Injury Settlements - Taxable or Not?

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You've been injured in a car accident. Thank goodness you're OK, but you broke your arm in addition to other bangs, cuts and scrapes and your back still feels out of wack. You were out of work to recover and then find work to be more difficult. You settle the case and all the damages you suffered are reduced a an amount of money. Question - Does the government share in the damages award in the form of taxes? Well, as with all good lawyers answers, it starts with "it depends". In short, it depends on if the award you are getting are for the injury you suffered and not loss of economic benefit - such as lost wages when you were out of work that you would have had to pay taxes on had you been there. Steven Loeb, Esq. of our Tax Department explore that question in detail as a guest blogger.

Under Section 104 of the Internal Revenue Code, certain payments for physical personal injuries are excludable from gross income. In Schleier v. Commissioner, 515 U.S. 323, the United States Supreme Court adopted a two step approach which mandates that: (1) the cause of action must be based upon a tort-type action; and (2) the proceeds must be received on account of personal physical injuries or sickness.

What is difficult is that neither the IRS nor any regulations provide guidance on the term "physical injuries or physical sickness". (Don't you love the law - they give you a rule without a definition) Even in "proposed" regulations under Section 104 of the Code (IRS proposed these in 2009), there was no specific definition of "physical injury" or "sickness". The case law under Section 104 type matters is being kind "all over the place". What is interesting is that the IRS as well as taken a stand on Section 104. In LTR 200041022, the IRS ruled that damages received by a couple in a settlement with wife's employer for unwanted physical contacts *without "any observable bodily harm" were not received on account of physical injuries and were included in gross income*. There are additional Memorandums provided by the IRS which address this area of the law including ILM 2008-09001.

The case law is likewise unhelpful in many circumstances. What is important is for any attorney drafting the complaint for damages based out of a Section 104 type case where one is looking for damages resulting from bodily injury to speak with a competent tax attorney well versed in the Section 104 area of the law. Additionally, taxes are not the only source of deduction to a personal injury award. It might be appropriate to have the award paid into a Special Needs Trust so as to not be eviscerated by lifetime medical costs.