

TAXATION OF DAMAGES

I. General Rules

- A. Gross income does not include damages received for:
- (1) “Workmen’s compensation as compensation for personal injuries or sickness.” Internal Revenue Code (IRC) § 104(a)(1).
 - (2) Personal physical injuries or physical sickness. IRC § 104(a)(2).
 - (3) Personal injuries or sickness from accident or health insurance. IRC § 104(a)(4).
 - (4) Personal injuries or sickness resulting from active service in the armed forces. IRC § 104(a)(4).
 - (5) Injuries incurred as a direct result of a terrorist or military action.
- B. Gross income includes punitive damages unless the punitive damages are awarded in a wrongful death case and the only damages a person can recover are punitive damages, as determined by state law in effect on or before September 13, 1995. IRC § 104(a)(2), (c).

- C. Post judgment interest or damage award is income. IRC § 61(a)(). Prejudgment interest is included in gross income if it is an element of damages.

II. Workmen's Compensation

The Workmen's Compensation exclusion only applies to statutes which are workmen's compensation statutes and employment related injuries or sickness. Treas. Reg. 1.104-1(b). Non-employment injuries or sickness may be excluded under IRC § 105(b) to extent of medical expenses.

III. Personal Physical Injuries or Sickness

- A. This exclusion only applies to individuals. Corporations or other business entities cannot have personal injuries. IRC § 104(a)(2).
- B. Damages for emotional distress are not excludible except to the extent of amounts paid for medical care attributable to emotional distress. IRC § 104(a)(2) last two sentences. If an individual has personal physical injuries or sickness and the damages include emotional distress, then the damage award for personal physical injuries or sickness, including emotional

distress, will be excluded from gross income. House Committee Report on P.L. 104-188.

- C. Damages for personal physical injury or sickness are excluded whether the damages are received as a result of a settlement or court award. IRC § 104(a)(2). Wrongful death damages are excludible from gross income if received under a wrongful death statute. Paton, T.C. Memo 1992 – 627.
1. If the settlement agreement allocates the damages between excludible and taxable, then, in order for the IRS to honor the settlement allocation for tax purposes, the settlement agreement must be arms length and bonafide. E.E. Robinson (CA-5, 1996).
 2. If the settlement agreement fails to allocate the damages between excludible and taxable, then the courts will look to the basis of settlement (why were damages paid – for personal physical injuries or sickness or other injuries) and why the payor paid the damages. W.E. Church, 80 T.C. 1014; A.M. Metzger, 88 T.C. 834.
 3. If a jury or judge awards damages and the judge or jury allocates the damages between excludible personal

physical injuries or sickness and includible amounts, the IRS should honor the allocation. If the judge or jury fails to allocate the damage award, then the IRS and courts will examine the legal proceedings, including the petition, trial record and agreements to determine the basis and allocation of the damages between excludible and includible amounts. J.E. Threlkeld, 848 F.2d 81 (CA 6, 1988).

KEY- Allocation of damages should be contained in any settlement agreement. Judges should be educated to allocate damage awards. Perhaps questions framed to the jury could request allocation between excludible and includible damages if such an allocation does not confuse the jury or have a deterrent effect on the award.

4. Structured Settlements.

Personal injury or sickness damages which would be excluded if paid in a lump sum are also excludible if paid over a period of time or by an annuity. IRC 104(a)(2). The defendant will have income to the extent that the payments exceed the cost of the annuity or other

agreement to pay the defendant's liability. See IRC § 130 for these rules for the defendant.

IV. Condemnation

If property is condemned or under the threat of condemnation, then the amount received for the real estate will be included in the property owner's gross income to the extent the damage award exceeds the property owner's adjusted basis (usually cost plus improvements less depreciation); however, the property owner has three years to buy a property of like kind and not report the gain. If the property owner purchased a new property for less than the condemnation proceeds, then the gain is recognized on the difference between the condemnation proceeds received and the price of the new property. IRC §§ 1033(a)(2) and (g). Attorneys fees paid by the property owner for the condemnation should be added to the property owner's adjusted basis and, thus, reduce the amount of the gain. IRC §§ 263 and 1001.

V. Securities

The taxation of damages received for losses on stock or other securities (due to fraud, theft, misappropriation, churning,

overcharging commissions, unauthorized trading, etc.) depends upon the origin of the claim. For example:

1. Damages for lost dividends and/or interest will be taxed as ordinary income.
2. Damages for losses on stock or other capital asset will be treated as a recovery of basis first and the rest as a capital gain.
3. Punitive damages will be taxed as ordinary income.

Obviously, since the taxation of security related damages depends upon facts and circumstances, the damages should be allocated in a settlement agreement or by the court. See previous discussion of allocations and deductibility of attorneys fees.

Additionally, the taxation of damages for pension plan losses will depend upon whether the damages are paid to the pension plan (usually not taxed) or to the individual participant in the plan (included in income to the extent not rolled over to an IRA within 60 days).

VI. Deductibility of Attorney Fees

- A. Attorney fees to recover personal physical injuries or sickness damages are deductible if the damages are includible in gross

income. IRC § 212(1). If part of the damages are excludible from gross income, then the attorneys fees allocated to the nontaxable damages will not be deductible. IRC § 265(2).

- B. If a taxpayer receives taxable personal damages and pays attorneys fees, the taxpayer must include the entire damages in his/her gross income. *Comm. v. Banks*, U.S. S. Ct. (2005). The attorney fees for nonbusiness damages are deductible as an itemized deduction and subject to reduction as a miscellaneous itemized deduction. IRC §§ 212, 67, and 68. For example, if Josie received personal damages of \$1,000,000 and the damage payor paid \$600,000 and \$400,000 to her attorney, Josie is required to include \$1,000,000 and can deduct \$400,000 as an itemized deduction. The attorney fee deduction may be reduced by 2% of adjusted gross income and may increase the alternative minimum tax (no deduction for attorneys fees is allowed in calculating AMT). IRC §§ 55-57. However, if the damages are from “unlawful discrimination” lawsuits, the attorneys fees are deductible above the line to the extent of damages included in gross income that year and not as itemized deductions. Therefore, these attorneys fees will not be reduced

by 2% of adjusted gross income and not subject to the alternative minimum tax. Additionally, Congress may eliminate the alternative minimum tax in 2006.