

TAXATION OF PERSONAL INJURY SETTLEMENTS

- I. GENERAL RULE – NON-TAXABLE UNDER §104(a)(2)
 - a. I.R.C. §104(a)(2)
 - i. Gross Income *does not include*:
 - 1. 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
 - 2. The term “damages received (whether by suit or agreement)” means an amount received (other than workmen’s compensation) through prosecution of a legal suit or action *based upon tort or tort-type rights*, or through settlement agreement entered into in lieu of such prosecution. 26 C.F.R. §1.104-1(c)
- II. CONFIDENTIALITY AGREEMENTS
 - a. Physical injury, yet taxable – *Amos v. Comm’r*, 86 T.C.M. (CCH) 663 [the Dennis Rodman case]
 - i. Facts – Dennis Rodman kicks photographer in the groin.
 - ii. Objective Findings – no sign of trauma, limp, subjective complaints of pain.
 - iii. Confidential Settlement - \$200,000 (with liquidated damages provision for breach of confidentiality agreement of \$200,000)
 - b. Court Analysis – nature of claim was based upon tort; however, part of the consideration for the Settlement was for the confidentiality provision.
 - c. Court Holding – apportioned the \$200,000 as follows:
 - i. \$120,000 – physical injury (non-taxable)
 - ii. \$80,000 – confidentiality (taxable)
- III. NON-ECONOMIC COMPENSATORY DAMAGES WITHOUT PHYSICAL INJURY
 - a. Non physical injury, yet non-taxable – *Murphy v. I.R.S.* (D.C. Circuit) [portion of I.R.C. unconstitutional?]
 - i. Facts – whistleblower who sued for emotional distress and loss of reputation, no physical injury
 - ii. Department of Labor awarded her \$70,000 in compensatory damages for emotional distress
 - b. D.C. Circuit Holding - Murphy’s compensatory award in particular was not received “in lieu of” something normally taxed as income; nor is it within the meaning of the term “incomes” as used in the Sixteenth Amendment. Therefore, insofar as § 104(a)(2) permits the taxation of compensation for a personal injury, which compensation is unrelated to lost wages or earnings, that provision is unconstitutional.