For eighty years federal law did not impose income tax on damages or settlements “on account of” personal injuries. The applicable rationale is that a person’s ability to generate income is somewhat destroyed by injury to one’s body. Personal injury recoveries are therefore considered to be in the nature of a return of “human capital.” The logic that restoration of capital is not income came from the courts. It was promptly codified by Congress in 1918.

The 1996 Change In The Law

In 1996, Congress again reacted to the logic of the courts by clarifying the taxable nature of recoveries from personal injury litigation and by tightening up the rules. Receipts that do anything other than make the victim whole by returning personal or financial capital are now taxable. Notably, punitive damages are taxable, even if related to personal injuries, and arguably could be “damages that are awarded on account of personal injuries.”

Congress amended Section 104(a)(2) of the Internal Revenue Code after the 1995 Supreme Court decision in Commissioner v. Schleier. The new law affects personal injury recoveries received after August 20, 1996, with exceptions for those that were formally established on or before September 13, 1995, the date the bill that changed the law was first presented to the House Ways and Means Committee.

Purpose of the Change

The amendment to Section 104(a)(2) was part of the Small Business Job Protection Act of 1996. According to the Joint Explanation of Conferees on the amendment, the official purpose is to tax damage awards in employment discrimination and injury to reputation lawsuits where there is no physical injury. That same official explanation of the changes goes on to say:

Punitive damages are intended to punish the wrongdoer and are not intended to compensate the claimant (e.g., for lost wages or pain and suffering). Thus, they are a windfall to the taxpayer and appropriately should be included in taxable income. Further, including all punitive damages in taxable income provides a brightline standard which avoids prospective litigation on the tax treatment of punitive damages received in connection with a case involving a physical injury or physical sickness.

How the Change Was Accomplished

Just a few words were added to the section of the Internal Revenue Code which creates exclusions from gross income. These few added words are shown in bold italics:

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.

Section 104(a) was also amended to add these additional words to make it rather clear that “emotional distress shall not be treated as a physical injury or physical sickness.”

The Effects of the Change

Although these simple changes are not yet tested, some of the effects are quite clear. Many questions of the past have been answered. Others have not, and some new questions arise. A precise statement of the full impact of the changes is therefore difficult. However, practitioners may find a tabular display helpful as a reminder of the various personal injury damages available under either the common law or a variety of statutes. The author makes an educated guess on the ultimate position of the courts, if not the Internal Revenue Service.

As a preliminary matter, the reader should consider that most contemporary tax law commentators speak of “exclusions” to gross income, referring to the general rule that all income “from what ever source derived” is taxable by the federal government unless excluded. The tables that follow simply refer to these recoveries as either “taxable” or “nontaxable.”

Further, the phrase “on account of” has recently been construed in the context of the Internal Revenue Code by the Supreme Court in United States v. O’Givie. Whereas the petitioner in that case said the phrase meant “but-for” and that “but for the personal injury, there would be no lawsuit, and but for the lawsuit, there would be no damage,” the Supreme Court found a greater causal connection is required, consistent with the dictionary definition of the phrase “on account of.” Thus, although the phrase is not defined in the statute, it refers to those personal injury damages recovered by reason of, or because of, the injuries.

Common Law Recoveries

Here is the way the law affects a common law personal injury lawsuit, according to available authority, including the language of the amended Internal Revenue Code:

<table>
<thead>
<tr>
<th>Type of Recovery or Settlement</th>
<th>Taxable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Punitive Damages:</td>
<td></td>
</tr>
<tr>
<td>Of All Types, Even If Physical injury Is Involved</td>
<td>X</td>
</tr>
<tr>
<td>Special Wrongful Death Circumstances</td>
<td>X</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Compensatory Damages For:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Emotional Distress (or any other form of mental anguish)</td>
<td>X</td>
</tr>
<tr>
<td>Physical Manifestation of Emotional Distress</td>
<td>X</td>
</tr>
<tr>
<td>Physical Injuries Accompanied By Emotional Distress</td>
<td>X</td>
</tr>
</tbody>
</table>
Wrongful Death X
Lost Services of Injured Offspring X
Serious Emotional Distress Caused By Tortious Physical Contact Where There Is No Substantial Bodily Injury ?

Lost Wages “On Account Of” Physical Injury Or Sickness X
Lost Consortium Due To Spouse’s Physical Injury X
Bystander Claims of Negligent Infliction Of Emotional Distress X
Lost Personal, Business, Or Credit Reputation X
Wrongful Discharge And Other Common Law Employment Tort Theories Without Resulting Physical Injury Or Sickness X

Medical Expenses Incurred, Including Those Expenses Attributable To Emotional Distress X\(^{17}\)

Attorney’s Fees Associated With Nontaxable Damages X
Pre-Judgment and Post-Judgment Interest X
Interest Component of Otherwise Nontaxable Structured Settlements X
Interest Earned On Lump Sum Judgments or Settlements X

Statutory Recoveries

Most of the principles on which the above table is based also apply to the taxability of compensatory payments under various statutes listed below:

<table>
<thead>
<tr>
<th>Type of Statutory Recovery</th>
<th>Taxable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Survival(^{18})</td>
<td>X(^{18})</td>
</tr>
<tr>
<td>Worker’s Compensation Benefits</td>
<td>X(^{19})</td>
</tr>
<tr>
<td>Retaliatory Discharge Claims/ Filing For Worker’s Compensation(^{20})</td>
<td>X(^{20})</td>
</tr>
<tr>
<td>Supplemental Disability Benefits to Injured Police/Firemen</td>
<td>X(^{21})</td>
</tr>
<tr>
<td>Teachers’ Sick Leave Payments</td>
<td>X(^{22})</td>
</tr>
<tr>
<td>Certain Claims For Injury In Federal Government Active Service</td>
<td>X(^{23})</td>
</tr>
<tr>
<td>Age Discrimination In Employment Act (ADEA)(^{24})</td>
<td>X(^{24})</td>
</tr>
<tr>
<td>Scheme To Reduce Pension Benefits Under ERISA(^{26})</td>
<td>X(^{26})</td>
</tr>
<tr>
<td>Discrimination Under Civil Rights Act of 1866 (Section 1881)(^{28})</td>
<td>X(^{28})</td>
</tr>
<tr>
<td>Discrimination Under Title VII of Civil Rights Act of 1964, as amended(^{29})</td>
<td>X(^{29})</td>
</tr>
<tr>
<td>Americans With Disabilities Act of 1990, as amended(^{30})</td>
<td>X(^{30})</td>
</tr>
<tr>
<td>Fair Housing, Under Civil Rights Act of 1968(^{31})</td>
<td>X(^{31})</td>
</tr>
<tr>
<td>Fair Labor Standards Act(^{32})</td>
<td>X(^{32})</td>
</tr>
</tbody>
</table>
Deprivation of Constitutional Rights, Privileges Or Immunities\textsuperscript{33} X
Equal Pay Act of 1963 ("EPA")\textsuperscript{34} X
Texas Commission on Human Rights Act of 1983\textsuperscript{35} X

Previously, the courts found a number of recoveries under these statutes were nontaxable.

**Other Considerations**

There are at least two other aspects of the change in the law worthy of the practitioner’s special consideration. The first of these has to do with reporting taxable damages and settlements and making proper payroll tax deductions if recoveries are paid to employees. The second has to do with proper client disclosure that taxation is possible, and how that taxation may affect fees realizable by the plaintiff’s attorney under a contingent fee arrangement.

Damages or settlements subject to withholding include all wages resulting from employment, to the extent they are taxable under Section 104, including back pay, front pay, lost earnings, future earnings, and taxable benefits. This concerns income tax, FICA, Medicare, FUTA, and other state payroll taxes. Additionally, taxable recoveries are subject to Internal Revenue Service reporting under forms W-2, 1099, 2678, or 4219. There are serious penalties for failure to report and/or to withhold taxes when required by law. Such complications are beyond the scope of this article which is intended only to give the personal injury practitioner a place to begin independent research for specific needs. However, these issues are discussed comprehensively in a recent National Law Review article.\textsuperscript{36}

The same article discusses counsel’s duty to advise the client that damages or settlements are subject to income tax, and the personal injury lawyer’s need to refrain from giving tax advice to the client. The plaintiff’s lawyer must now write an engagement letter and contingent fee contract in such a way that the percentage payable to the lawyer is calculated on the gross amount before such things as income taxes, FICA, Medicare, etc. are withheld.

**Conclusion**

As a final thought, the recipient of damages or settlements for personal injury has the burden to prove that they are nontaxable.\textsuperscript{37} However, the relevant inquiry is first whether damages serve a compensatory function rather than being solely of an economic character.\textsuperscript{38} The inquiry then becomes whether proceeds are recovered on account of personal or nonpersonal injuries, not whether they compensate the taxpayer for economic loss.\textsuperscript{39} Proof of the taxable or nontaxable nature of awards or settlements is found in things showing the intent of the parties as to the assignment of damages and their apportionment to the injuries.

The question of taxability under the law is answered by proving whether the settlement amounts or damage awards, in lump sum or periodic payments, were intended to be “on account of personal physical injuries or physical sickness.” The manifestation of those intentions appears in mediation and settlement release documentation, damage studies,\textsuperscript{40} deposition testimony, trial testimony, live and superseded pleadings, jury questions and instructions, and the final judgment, agreed or adjudicated. The parties generate these documents, and the Internal Revenue Service has access to them with absolute hindsight.
ENDNOTES

1 Mr. Simpson is a partner in the Houston Litigation Section of Jackson Walker, L.L.P. He is also a CPA licensed in Texas and California (Ret.). In 1962 he was first enrolled and authorized to represent taxpayers as an “Agent” before the Internal Revenue Service under 31 CFR 10. He now has authority to represent taxpayers as an attorney before the U.S. Tax Court, the Southern District of Texas, and the Fifth Circuit.


6 Revenue Act of 1918, ch. 18, section 213(b) (6), 40 Stat. 1066.


8 See the dissent of Justice Scalia in O’Gilvie v. United States, 117 S.Ct. at 460, 463.


10 H.B. 3448.


15 O’Gilvie v. United States, 117 S.Ct. at 455.

16 This exception applies where statutes in effect on September 13, 1995, allow only the award of punitive damages. See Joint Explanation of Conferees on H.B. 3448.

17 Provided these expenses were not itemized deductions in prior years.

18 TEX. CIV. PRAC. & REM. CODE ANN. §71.021


20 TEX. LABOR CODE ANN. §451.001.


30 42 U.S.C.A. § 12101 et.seq.

31 42 U.S.C.A. 3601; 3613(c).


37 See, e.g., Taggi v. U.S., 35 F.3d 93 (2nd Cir. 1994).

39  Byrne v. Commissioner, 883 F2d 211 (3rd Cir. 1989).
41  See Rev. Rul. 85-98.
42  The U.S. Supreme Court holds that a jury must be instructed as to the taxability of a plaintiff’s recovery. Norfolk & Western Railway Co. v. Liepelt, 444 U.S. 490 (1979). However, the Texas Supreme Court holds that a jury may not be so instructed. Turner v. General Motors Corporation, 584 S.W. 2d 844 (1979).