

## Outside Counsel

# How Personal Injury Cases Are Taxed

**T**he tax treatment of personal injury settlements and verdicts is widely misunderstood, but the rule is actually simple. *All* compensatory damages attributable to a *physical* injury or sickness (e.g., broken bone, cut, bruise, medical malpractice or wrongful death) received pursuant to a settlement or verdict are tax free. Punitive damages are always taxable.

For example, if a plaintiff suffers a broken bone in an accident, and the case is settled or a verdict awards the plaintiff itemized damages for pain and suffering, medical expenses, lost wages and emotional distress, and awards the plaintiff's spouse damages for loss of services, then all such damages are tax free. They are now, and always have been, tax free. The U.S. Supreme Court, Congress, and the IRS agree on this tax treatment.

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There is a common misconception that damages for lost wages and emotional distress are always taxable, but they are treated the same as all other compensatory damages: They are tax free if attributable to a physical injury or sickness.

On the other hand, *all* compensatory damages attributable to a *nonphysical* injury or sickness (e.g., employment discrimination, intentional infliction of emotional distress, or injury to reputation) received pursuant to a settlement or verdict are taxable. For example, if a plaintiff suffers employment discrimination, and a verdict awards damages for lost wages and emotional distress, all such damages are taxable.

The determination of whether compensatory damages are tax free or taxable depends solely on whether such damages are attributable to a physical injury/sickness

or to a nonphysical injury/sickness. It does not depend on what type of compensatory damages are received.

Most cases are either exclusively physical injury (in which all compensatory damages are tax free) or exclusively nonphysical injury (in which all compensatory damages are taxable). If a case has both physical injury and nonphysical injury claims, these rules are applied separately to each claim. For example, if an employee suffers nonphysical employment discrimination at work, and the employee's boss breaks the employee's arm when the employee reports it, then all compensatory damages attributable to the employment discrimination claim are taxable, and all compensatory damages attributable to the broken arm claim are tax free.

If a physical injury or sickness claim is settled, the proceeds are tax free whether the settlement is a lump sum cash settlement or a structured settlement paid in the form of periodic payments funded by an annuity. Thus, a structured settlement makes all the annuity interest tax free.

## The Legal Authorities

The tax treatment of personal injury cases is governed by §104(a)(2) of the Internal Revenue Code. It states that “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” are tax free.

In 1985, the IRS ruled that, under §104(a)(2), “The entire amount received by an individual in settlement of a suit for personal injuries sustained in an accident, including the portion of the amount allocable to the claim for lost wages, is excludable from the individual’s gross income.” Rev. Rul. 85-97, 1985-2 C.B. 50.

In 1995, the U.S. Supreme Court confirmed that all compensatory damages attributable to a physical injury are tax free: “Assume that a taxpayer is in an automobile accident, is injured, and as a result of that injury suffers (a) medical expenses, (b) lost wages, and (c) pain, suffering, and emotional distress that cannot be measured with precision. If the taxpayer settles a resulting lawsuit for \$30,000 ... the entire \$30,000 would be excludable under §104(a)(2).” *Commissioner v. Schleier*, 515 U.S. 323, 329 (1995).

Until 1996, §104(a)(2) stated that all compensatory damages attributable to “personal injuries or sickness” were tax free. Some courts held that it even applied to nonphysical injury cases such as employment discrimination and injury to reputation.

To override those courts, in 1996, Congress added the word “physical” to make compensatory damages tax free only if attributable to “personal physical injuries or physical sickness” (e.g., broken bone, cut, bruise, medical malpractice, or wrongful death). This made damages attributable to a nonphysical injury or sickness (e.g., employment discrimination or injury to reputation) taxable, but the legislative history states that

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*all* compensatory damages attributable to a physical injury or sickness remained tax free.

This change also provides that emotional distress does not constitute a physical injury or sickness, even if it causes symptoms (e.g., insomnia, headaches or stomach disorders). There is a common misconception that this provision makes damages for emotional distress taxable in all cases. It does not. It simply prevents plaintiffs in nonphysical injury cases from claiming that their emotional distress constitutes a physical injury, which would make such damages tax free.

The legislative history explained the 1996 change:

“Under present law, gross income does not include any damages received ... on account of personal injury or sickness (section 104(a)(2)). ... [S]ome courts have held that the exclusion applies to damages in cases involving certain forms of employment discrimination and injury to reputation where there is no physical injury or sickness. ...

The House bill provides that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness [which means they are tax free] whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual’s spouse are excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from taxable income as under present law. The House bill also specifically provides that emotional distress is not considered a physical injury or physical sickness. Thus,

the exclusion from gross income does not apply to any damages received ... based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness.”

H.R. Rep. 104-737, p. 301 (conference report on Small Business Job Protection Act of 1996).

The IRS currently cites Rev. Rul. 85-97, *Schleier*, and this legislative history as controlling, and states that it “has consistently held that compensatory damages, including lost wages, received on account of a personal physical injury are excludable from gross income. ... [T]o be excludible, an emotional distress recovery must be on account of (attributed to) personal physical injuries or sickness.” *IRS Lawsuits, Awards, and Settlements Audit Techniques Guide*, p. 8-9 (2011); see also IRS Publication 525, *Taxable and Nontaxable Income*, p. 30 (2021) (“Don’t include in your income compensatory damages for personal physical injury or physical sickness. ... Emotional distress itself isn’t a physical injury or physical sickness, but damages you receive for emotional distress due to a physical injury or sickness are treated

as received for the physical injury or sickness. Don’t include them in your income. If the emotional distress is due to a personal injury that isn’t due to a physical injury or sickness (for example, unlawful discrimination or injury to reputation), you must include the damages in your income. ...”); PLR 201328022 (2013) (damages for lost wages and emotional distress attributable

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Section 104 does not define what constitutes a physical injury or sickness. In most cases, it’s clear whether the injury is physical or nonphysical, but in some cases (e.g., PTSD or some sexual harassment or abuse cases), it may not be clear, so the tax treatment may not be clear.

to a physical injury are tax free); PLR 201021016 (2010) (in wrongful death case, all compensatory damages, including heir’s emotional distress, are tax free); PLR 200121031 (2001) (in wrongful death case, all compensatory damages, including decedent’s survival claim, heir’s wrongful death claim and spouse’s loss of consortium claim, are tax free).

Section 104 does not define what constitutes a physical injury or sickness. In most cases, it’s clear whether the injury is physical or nonphysical, but in some cases (e.g., PTSD or some sexual harassment or abuse cases), it may not be clear, so the tax treatment may not be clear.

There are two minor exceptions to these tax rules. First, in a physical injury claim, damages received for medical expenses are taxable to the extent the medical expenses were previously deducted by the plaintiff. Section 104(a). But it’s very unusual for a plaintiff to have paid and deducted the medical expenses. Second, in a nonphysical injury claim, damages received are tax free to the extent of the amount (if any) plaintiff paid for medical care attributable to emotional distress that plaintiff did not previously deduct as a medical expense. *Id.*

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