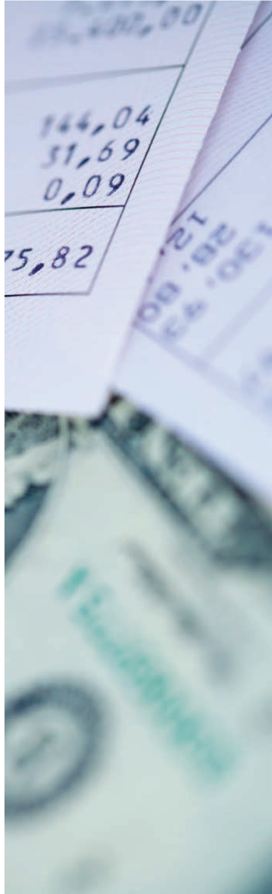
Focus: Structured Settlements

Taking medical expense deductions before and after a personal injury suit



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Whether your client is pursuing a personal injury claim, or making medical payments after receiving a settlement or award, understanding the tax relationship between personal injury damages and the medical expense deduction could save them money.

Under § 104(a)(2), damages due to physical injuries or sickness are generally received tax-free. Under § 213, medical expenses above the minimum threshold (7.5 percent of adjusted gross income) are typically deductible. The threshold will increase to 10 percent after 2012, except for a temporary waiver for the elderly.

However, taking advantage of both, when possible, requires analysis and planning. Implementation of a good tax strategy could also facilitate a settlement that would never have occurred by allowing the plaintiff to accept a lower offer while achieving an equal benefit. It is therefore in the interest of both plaintiff and defense counsel to understand these issues.

• **Already deducted.** For clients who previously deducted medical expenses and are now considering a settlement, it is best to allocate a smaller, though reasonable portion, to past medical expenses.

• **Expecting future expenses.** For clients considering a settlement, and expecting future medical expenses resulting from defendant's tortious injury, counsel should consider allocating a smaller, though reasonable portion, to future medical expenses. One might also contemplate not allocating the settlement at all, especially for a less conservative client who has not introduced information to the government relating to the expected value of future medical expenses (for example, in law suit pleadings).

• **IRS in the rearview mirror.** Clients who already received a settlement or award cannot deduct medical expenses to the extent that the settlement or award expressly included a portion for future medical expenses. When it did not, client's counsel must consider whether the IRS is likely to allocate the settlement after the fact, which the IRS asserts is within its powers.

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Receiving damages after taking medical expense deductions

Sections 104 and 213 have interlacing caveats. When assessing the excludability of damages after medical expense deductions have been taken, counsel must look to § 104's caveat. Its exclusion of damages is not available to monies "attributable to (and not in excess of) deductions allowed under section 213 ... for any prior taxable year." Damages are excludable when a defendant compensates plaintiff for medical expenses that the plaintiff previously incurred but did not deduct.

Example: Tom sustained a tortious physical injury in 2008. In 2009, Tom incurred $103,000 of medical expenses resulting from the injury, and properly deducted $100,000 pursuant to § 213 ($3,000 is 7.5 percent of his $40,000 income). In 2010, Tom will settle his case for a total of $500,000, representing past medical expenses, and pain and suffering, all of which would be excludable under § 104(a)(2) but for his prior deduction. How should Tom design his settlement to minimize his tax liability? Consider three possible scenarios.

• **Scenario 1:** If Tom's settlement expressly allocates $103,000 to past medical expenses, he will receive $100,000 of taxable income. All but $3,000 of the settlement apportioned to past medical expenses represents monies attributable to a § 213 deduction taken in a prior year. Thus, $100,000 of the settlement cannot be excluded under § 104(a)(2).

• **Scenario 2:** If Tom's settlement does not allocate at all, he will also receive $100,000 of taxable income. Though it will be unclear how much of the $500,000 is meant to compensate for past medical expenses rather than pain and suffering, the IRS will "presume" that the settlement is first attributable to Tom's past deducted medical expenses. That amount provides a "sum certain" basis to allocate after-the-fact, as opposed to the speculative value of the settlement's pain and suffering portion. This rule was established more than 30 years ago in Rev. Rul. 75-230 (1975-1 CB 93).

• **Scenario 3:** If Tom's settlement expressly allocates some reasonable value under $100,000 to previously deducted medical expenses, he will receive taxable income of that value. This settlement design, more than the other two, best minimizes Tom's tax liability. In the same revenue ruling discussed above, the Service stated that when a settlement incorporates an express allocation of medical expenses previously deducted by the taxpayer, it "will presume the correctness of the allocation to medical expenses, unless it is unreasonable in the light of all the facts."

Clearly then, when using this settlement strategy, Tom's counsel must consider what value is reasonable in light of all the facts. On the one hand, the very nature of a settlement is compromise. Thus, it is reasonable to believe that the settlement is not "fully" compensating Tom for his injury, as might occur if the case went to trial. As such, perhaps only $85,000, rather than $100,000, of Tom's settlement is "attributable to" his previously deducted medical expenses.

On the other hand, how reasonable is it that the settlement would compensate Tom for pain and suffering before substantially reimbursing him for out-of-pocket expenses? Balancing these points is a role that Tom's counsel must play in order to successfully minimize Tom's tax liability. Tom's counsel would be well advised to seek out the services of a qualified settlement planner, tax attorney or CPA.

Taking medical expense deductions after receiving damages

When assessing the future deductibility of medical expenses while designing a settlement, counsel must look to § 213 and its relevant caveat. Medical expenses are explicitly not deductible when "compensated for by insurance or otherwise."

Example: Tara sustained a tortious physical injury in 2008. In 2009, she settled her case for $500,000, all of which she properly excluded under § 104(a)(2). In 2010, she incurs $103,000 of medical expenses resulting from the injury. How much of these expenses can she deduct? The answer depends on the settlement allocation. Again, consider three scenarios.

• **Scenario A:** If Tara's settlement allocated $100,000 to future medical expenses, she cannot deduct any of her medical expenses (the last $3,000 does not surpass the 7.5 percent threshold given her $40,000 income). The $100,000 of expenses cannot be deducted because they were previously "compensated for" in the 2009 settlement.

• **Scenario B:** If Tara's settlement allocated $90,000 to future medical expenses, she can deduct $10,000 of her medical expenses. She cannot deduct those medical expenses expressly compensated for in the settlement, but can deduct those surpassing the allocated amount. The Service established this in Rev. Rul. 75-232 (1975-1 CB 94). However, the caveat set down in Rev. Rul. 75-230 likely applies. In that ruling, concerning an allocation for past medical expenses, the IRS stated that it "will presume the correctness of the allocation to medical expenses, unless it is unreasonable in the light of all the facts." Thus, Tara's ability to deduct $10,000 may depend on the reasonableness of the settlement's allocation for future medical expenses.

• **Scenario C:** If Tara's settlement did not allocate at all, it is unclear what

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1 The majority of the firm's ERISA cases are handled by Robert E. Hoskins. Experience cited herein is primarily that of Mr. Hoskins. Mr. Hoskins is a member of the South Carolina Bar. (See attorney profile, Robert E. Hoskins, www.erisaexperience.com, for specifics.)

DEDUCTIONS

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Tara can deduct, or at least what the IRS would argue she can deduct. This is because it is not clear if the IRS, in order to allow a deduction, believes there to be any minimum threshold of evidence indicating the portion of a settlement "compensating for" future medical expenses.

9th Circuit weighs in

It is clear what *is* enough, at least outside of the 9th Circuit. In Rev. Rul. 79-427 (1979-2 CB 120), the IRS ruled that a portion of an unallocated jury award could be allocated to future medical expenses based on "the best evidence available under the circumstances." In that ruling, the best evidence available was the taxpayer's hypothetical itemization of a jury's award, made when defending the amount of damages on appeal. This establishes a fairly low level of "what is enough," according to the Service.

That level appears to be too low for the 9th Circuit, which allowed the Rev. Rul. 79-427 taxpayer to take the deductions in his 1983 case, *Niles v. United States* (710 F.2d 1391 9th Circ., 1983). The court so held based on the hypothetical nature of the taxpayer's itemization, and on what it considered to be a change in IRS administrative practice.

Because Rev. Rul. 79-427 had been issued specifically based on Niles' situation, the court would "not rely on nor pass judgment on" the ruling. It refused to allow the IRS "to take advantage of a self-serving ruling," despite conceding the Service's point that it allowed Niles "a double tax benefit."

In 1997, the IRS noted the "special circumstances" of *Niles* in FSA 2187 (9/23/97), stating that Rev. Rul. 79-427 "continues to be the Service position." Thus, even those in the 9th Circuit may face an IRS holding steadfast to Rev. Rul. 79-427, although with substantial case law in taxpayers' favor.

At the same time, however, *Niles* suggests that the IRS will not attempt to allocate a portion of an unallocated lump sum to future medical expenses without some type of *Niles*-like evidence. In its decision, the 9th Circuit cited Priv. Ltr. Rul. 6510284440A, in which the IRS held that medical expenses subsequent to a settlement had not been "compensated for," for purposes of § 213, based on the settlement's lack of allocation for medical expenses.

Interestingly, the government conceded the correctness of the ruling, attempting to distinguish the Niles' case based on the existence of available evidence (i.e., Niles' hypothetical itemization). One might interpret from this concession that a taxpayer with an unallocated settlement, such as Tara, can deduct medical expenses that may have been implicitly, but not expressly compensated for. If correct, including future medical expenses in a plaintiff's pleading may have a significant downside.

Of course, such an interpretation must be made with great caution, especially in light of Rev. Rul. 75-230, which presumed that unallocated settlement monies are first attributable to previously deducted medical expenses. The IRS could attempt to apply such logic to future medical expenses, as well as past.

Settlement planning

When settling a case, plaintiff's counsel has much to consider with respect to allocating medical expenses. When the plaintiff took previous medical expense deductions, or plans to take them in the future, counsel is well advised to consider allocating a lesser, though reasonable amount, to such expenses. In the case of future medical expenses, counsel might choose to advise a less conservative client not to allocate any portion of the settlement to such expenses, in the hope that the government has not changed its position since *Niles*. Under certain scenarios, such as when government benefits are involved, these plans will need to be reconsidered.

There are of course many other tax-related aspects of a settlement to consider as well. For example, both parties can benefit from the use of a structured settlement. Section 104(a)(2)'s exclusion applies to lump sum and periodic payments alike, often allowing a plaintiff to receive both the principal and investment portions of an annuity purchased by the defendant tax-free. For many, such an exclusion would prevent increases in tax liability. On the other hand, less will be saved if a high value of medical expenses can be deducted.

Editor's note: *Babener is a 2010-11 Tax Policy Fellow in the U.S. Treasury Department's Office of Tax Policy. He is a J.D. graduate of, and a tax LL.M. candidate at, the NYU School of Law. He is also a member of the Oregon State Bar. He has spoken at settlement-related conferences on tax law, and his writings on the taxation of personal injury damages, qualified settlement funds and structured settlements are available at http://www.taxstructuring.com. The views expressed herein are those of the author and do not reflect Treasury policy. Previously published as "Taking Medical Expense Deductions Before and After a Personal Injury Settlement, Practical Tax Strategies," Practical Tax Strategies (Vol. 85, No. 2), Copyright © Jeremy Babener 2010.*

Resources

The following websites can be visited for information about settlements of personal injury suits:

- **settlepro.com** — The Settlement Professionals Inc. website has various sections on negotiating settlements, defense tactics and avoiding attorney liability. Jack Meligan, the company's president, was a founding member of the Society of Settlement Planners.
- **woodporter.com** — The Wood & Porter website provides links to relevant articles by the firm's founder Rob Wood, a nationally recognized tax attorney and author of Taxation of Damage Awards and Settlement Payments. 4th Ed. (Tax Institute, 2008).
- **s2kmblog.typepad.com** — The Beyond Structured Settlements blog provides information and analysis on structured settlement issues, written by Patrick Hindert, managing director of The Settlement Services Group, and co-author with Joseph Dehner and Daniel Hindert of Structured Settlements and Periodic Payment Judgments (Law Journal Seminars Press, 1986).
- **medivest.com** — The Medivest Benefit Advisors, Inc. website has a number of articles and posts, including guidance on the preservation of plaintiff clients' Medicare eligibility, and compliance with the Medicare Secondary Payer Act.

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