THE COLLATERAL SOURCE RULE TAX CODE BUDGET DEFICIT NEXUS: IS IT TIME TO AMEND IRS SECTION 104(a)(2)?

Lawrence R. Smith and Daniel O'Reilley SmithAmundsen LLC

The Collateral Source Rule is a common law doctrine that developed more than 150 years ago. The rule bars the admissibility of evidence at trial to show that a plaintiff's losses have been paid by other sources, such as health insurance that benefits the plaintiff or workers' compensation payments. Forty-two states have amended their laws with respect to the Collateral Source Rule as of 2009.[1] Modifications include reducing an award for medical bills by the amount of the bills that were paid by insurance as well as the standard approach of allowing a setoff in a third-party case for workers' compensation benefits paid to the plaintiff.

INTERNAL REVENUE CODE PROVISIONS

Internal Revenue Code Section 104(a)(2) states as follows:

IRS § 104 Compensation for Injuries or Sickness:

(a) In general

Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

(2) 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;

The case law that has interpreted the boundaries of the provision has made it clear that 104(a)(2) protects the personal injury plaintiff both with respect to medical bills and lost income. Punitive damages are obviously excluded and are not non-taxable. The stated rationale for not taxing personal injury awards that include reimbursement for medical expenses or lost income is the notion that the claimant has lost "human

capital" and any award is not sufficient to restore the individual to his or her pre-injury status.

Suffice it to say that the taxman has billions of dollars at stake if Section 104 of the Internal Revenue Code is amended. Not too many people are draconian enough to suggest that a plaintiff should be taxed on an award for pain and suffering or disability, but it is surprising that more attention has not been paid to the non-taxability of awards for medical bills and lost income.

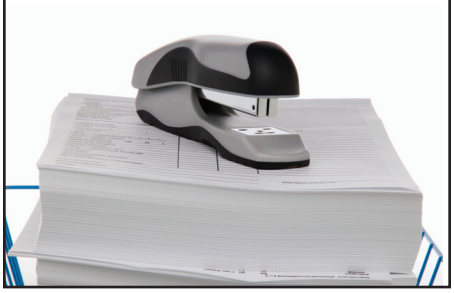
Health insurance policies may contain a subrogation provision when recovery is made on behalf of an innocent plaintiff from a responsible third party. Medical liens are often discounted as part of the settlement process. Similarly, disability policies may have subrogation provisions included within the terms of the agreement. Oftentimes, these "double recovery" payments have not been reimbursed to an employer, an employer's insurer, an employee's insurer, or the government under Medicare or Medicaid provisions in the past. As we all know now, MMSEA and SCHIP have made it very clear that Medicare will no longer foot the bill when it can rightfully be classified as a "secondary payer."

Consider the catastrophically injured plaintiff who was never able to return to work after a non-work related injury. Hypothetically, this worker has lost five years of income between the date of loss and the date of trial. In addition, economists predict another ten years of lost income in the future. Of course, if that income had been earned, it would have been subject to taxation.

In the case of a jury award for past and future medical bills, there may be a substantial difference between the amount of the medical bills placed on the "blackboard" by the plaintiff's attorney and the amount the medical providers accepted from the health insurer to resolve the claims for outstanding medical bills. Assume Medicare paid $.25 on the dollar on a $100,000 hospital bill. Medicare is entitled to a recovery of the amounts paid, but because of the Collateral Source Rule, the plaintiff gets the benefit of a jury awarding $75,000 more than the amount it took to settle or resolve the hospital bill. Should the $75,000 "windfall" be paid to the plaintiff without any taxation of the windfall?

Certainly, the proponents of the "human capital" approach do not want to see any component of a jury award subject to income tax. But, in these days, when the federal government is tax starved and some state governments are worse off than their federal government colleagues, it is surprising that we have not seen significant challenges to the non-taxability provision of IRS Section 104(a)(2).

If Medicare officials are intent on enforcing the Secondary Payor Act, it is probable that a tax conscious federal government, not to mention their underfunded state government colleagues could soon be seeking legislative changes to IRS Section 104(a)(2) that permit taxation of net economic damages such as lost income and medical bill amounts not subject to reimbursement.



Taxing awards for economic damages are logically a much easier target than taxing awards for non-economic damages like pain and suffering and disability. If plaintiffs would have paid taxes on income had it been earned, it is hard to understand why settlement proceeds or a jury award for lost income are not taxable. Presumably, awards for non-economic damages are sufficient to restore the "human capital" component in a personal injury case. Awards for future lost income are subject to the same analysis.

No one is suggesting the awards for economic damages should be taxed on a gross basis as opposed to a net basis. In fact, the suggestion is that only net awards or net settlement proceeds after payment of attorney's fees should be subject to income tax provisions. Payments for pain and suffering and disability should not be subject to tax, but benefits for past and future lost income, on a net basis, should be subject to income tax and payments for "excess" medical bills (amounts in excess of "fair payment" accepted by medical providers) should be taxed.

If Medicare officials are intent on enforcing the Secondary Payor Act, it is probable that a tax conscious federal government, not to mention their underfunded state government colleagues could soon be seeking legislative changes to IRS Section 104(a)(2) that permit taxation of net economic damages such as lost income and medical bill amounts not subject to reimbursement. This predictable tax policy change is consistent with the erosion of the Collateral Source Rule.

Philosophical reasons for the non-taxability of economic damages may well give way to the needs of the taxman. If 104(a)(2) is amended, look for the collection of state sales tax on items shipped out of state to be next.

Lawrence R. Smith, a founding partner of SmithAmundsen in Chicago, Illinois, focuses his practice on risk management consulting, case monitoring, mediation, arbitration, and implementing successful trial strategies. Having tried over 120 jury cases, his experience covers many areas including product liability, transportation, aviation, employment, insurance services, and commercial litigation.

Upon graduation from Johns Hopkins University, Dan O'Reilley joined the Defense Intelligence Agency. He spent five years working as a counter-terrorism analyst, which work included two tours in Iraq. That experience led Dan to law school at Indiana University where he writes for the Journal for Global Legal Studies and is a member of Moot Court. He is slated to graduate from Indiana University Law School in May 2012. During the Summer of 2011, Dan worked as a summer associate at SmithAmundsen LLC.

[1] Bryce Benjet, *A Review of State Law Modifying the Collateral Source Rule: Seeking Greater Fairness in Economic Damages Awards*, 76 DEF. COUNS. J. 210, 211 (2009).