

Lawsuit Settlement Wasn't Excludible from Income

The issue in this case is the taxability of a lawsuit settlement. Lawsuit settlements are not taxable if they are “on account of personal physical injuries or physical sickness.”

Debra Blum was admitted to a hospital for total left knee replacement. While there, she allegedly suffered personal injuries after being directed by an admissions clerk to sit in a wheelchair, which turned out to be broken. When Ms. Blum attempted to sit in the wheelchair, she allegedly fell on the floor and sustained significant injuries.

She hired an attorney to represent her in a suit against the hospital. While the lawsuit was pending, her attorney retired from practice. Ms. Blum retained another attorney from the same firm. The trial court ruled against Ms. Blum.

Ms. Blum then filed a malpractice suit against her former attorneys, stating there was a “breach of the standard of care”, basically claiming she would have won the lawsuit against the hospital if the attorneys had properly handled her case. The attorneys and Ms. Blum settlement for \$125,000.

Ms. Blum did not include this settlement on her income tax return. In the ensuing IRS examination and Court hearings, Ms. Blum claimed the settlement was directly tied to the physical injuries received at the hospital and therefore was nontaxable under the physical injury provision.

Tax Court ruled, and Court of Appeals affirmed, that the settlement was settling a “malpractice claim” and was not due to physical injuries Ms. Blum suffered.

Debra Jean Blum, Court of Appeals, 9th Circuit, 21-71113, June 2, 2022, (affirming TC Memo 2021-18)

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