



**Wood** LLP

# Tax Alert



**Robert W. Wood**  
THE TAX LAWYER

Oct. 10 2012 — 10:14 pm

## Are Damages For Depression Tax-Free?

Let's say your employer fires you, you plunge into a deep depression and sue. When you settle, is it taxable?

Damages for personal physical injuries are tax-free under [Section 104](#) of the tax code. So are damages for physical sickness. See [Tax-Free Wrongful Death Punitive Damages?](#)

But only **physical** injuries and **physical** sickness qualify. See [Is Physical Sickness the New Emotional Distress?](#)

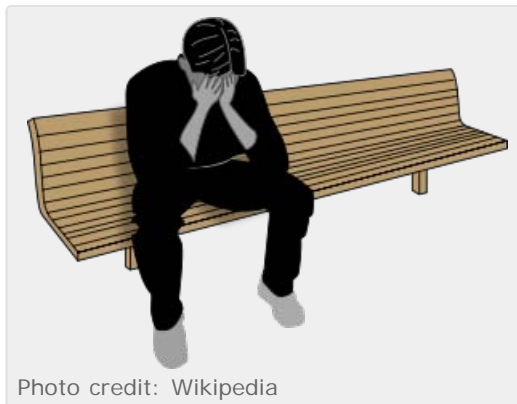


Photo credit: Wikipedia

Damages for emotional distress are taxed. Payments for emotional distress **emanating** from physical injuries or physical sickness are tax-free. Wage loss will be taxed, but if you suffered physical injuries or physical sickness from workplace harassment, maybe not. Confused?

You're not alone. Tax disputes about what's physical are common. In [Parkinson v. Commissioner](#), the [U.S. Tax Court](#) ruled that a settlement for intentional infliction of emotional distress after a heart attack at work wasn't taxable.

Is a diagnosis of depression physical, mental or both? That issue was front and center in [Blackwood v. Commissioner](#). After Julie Blackwood was fired, she relapsed into a depression she previously had overcome. Her symptoms included insomnia, oversleeping, migraines, nausea,

vomiting, weight gain, acne, and pain in her back, shoulder and neck. She resumed counseling sessions and incurred some medical expenses.

She settled for \$100,000 for “alleged damages for illness and medical expenses allegedly exacerbated by, and allegedly otherwise attributable to” her wrongful discharge. When the IRS said the payment was taxable, she argued the settlement was just like an injury accident. Her primary authority was [\*Domeny v. Commissioner\*](#), where an employment settlement for stress that exacerbated the plaintiff’s multiple sclerosis wasn’t taxed. See [Tax-Free Physical Sickness Recoveries in 2010 and Beyond](#).

But the IRS said Blackwood simply had emotional distress. She didn’t have a medical diagnosis or medical testimony detailing her physical problems. In [\*Domeny\*](#), a physician determined she was too ill to work. Blackwood only had a counselor’s letter that claimed “increased levels of anxiety and depressive symptoms.”

Blackwood may have been suffering from depression and physical symptoms from it, but her settlement wasn’t tax-free. Bottom line: one can argue whether depression is physical, mental or both. But in tax disputes, having good records and documentation can make all the difference.

Get tax advice **before** you settle. See [Address Taxes When You Mediate Civil Disputes](#). The IRS isn’t bound by settlement agreement wording but it can help enormously. So can explicitly addressing reporting on IRS Forms 1099. See [Watch Your Mail For 1099s](#). If there is a thin record of medical expenses, consider what other documents you can collect at settlement time. Don’t wait for an audit to gather them.

*Robert W. Wood practices law with [Wood LLP](#), in San Francisco. The author of more than 30 books, including *Taxation of Damage Awards & Settlement Payments* (4th Ed. 2009 with 2012 Supplement, [Tax Institute](#)), he can be reached at [Wood@WoodLLP.com](mailto:Wood@WoodLLP.com). This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*