

## Bad Settlement Agreement Wording Spells Taxes – Again

by Robert W. Wood



Robert W. Wood

Robert W. Wood is a tax lawyer with Wood LLP and the author of *Taxation of Damage Awards and Settlement Payments*, Fifth Edition, and other books available at [www.TaxInstitute.com](http://www.TaxInstitute.com).

In this article, Wood examines *Tressler* and revisits the wording of settlement agreements and the section 104

exclusion.

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Lawsuit settlements and judgments are taxed based on the origin of the claim — essentially the item for which the plaintiff is seeking to recover. The basic idea is that if you didn't have to sue but had been paid in the ordinary course of events, your taxes should be the same. Perhaps because physical well-being isn't taxed, section 104 shields damages for personal physical injuries and physical sickness. The exclusion used to be much broader. Before 1996 "personal" injury damages were tax free, so emotional distress, defamation, and many other legal injuries also produced tax-free recoveries.

That changed in 1996, and since then an injury or sickness must be physical to give rise to tax-free money. Unfortunately, in the 25 years since section 104 was amended, neither the IRS nor Treasury has said exactly what "physical" means. Some of the difficult line-drawing emanates from a footnote in

the conference committee report to the 1996 amendment that added the physical modifier.<sup>1</sup>

It states that the term "emotional distress" includes physical symptoms — such as insomnia, headaches, and stomach disorders — that may result from emotional distress. The report makes clear that all compensatory damages that flow from physical injury or physical sickness are excludable from income. It seems highly artificial, and it can depend on which words someone might use. For a time, the IRS maintained an "observable bodily harm" standard. Bruises and broken bones are physical, after all, but that doesn't necessarily mean that everything else is not.

The IRS has often said that you must have visible harm (cuts or bruises) for your injuries to be physical. But some courts have disagreed. Famously, in *Domeny*,<sup>2</sup> stress at work made a woman's preexisting multiple sclerosis worse, and that meant excludable damages. In *Parkinson*,<sup>3</sup> the plaintiff suffered a heart attack from stress at work. And even the IRS has presumed physical injuries in some cases, such as child sexual abuse and smoke inhalation. For sex abuse claims in which the victim was a minor, the IRS said it might presume that at some point those injuries were observable even if they weren't observable years later.<sup>4</sup>

That is helpful, but it is hardly a blanket statement that all damages for sexual abuse are tax free. In LTR 201311006, relatively minor injuries, such as cuts, scrapes, bruises, and smoke inhalation from a fire, allowed all victims to exclude their entire recoveries. Yet the IRS is rigid

<sup>1</sup> See H. Conf. Rept. 104-737, at 301 n.56 (1996), 1996-3 C.B. 741, 1041.

<sup>2</sup> *Domeny v. Commissioner*, T.C. Memo. 2010-9.

<sup>3</sup> *Parkinson v. Commissioner*, T.C. Memo. 2010-142.

<sup>4</sup> See ILM 200809001 and Robert W. Wood, "IRS Allows Damages Exclusion Without Proof of Physical Harm," *Tax Notes*, Mar. 31, 2008, p. 1388.

in most cases, and nowhere is that rigidity clearer than employment cases. If you sue your employer for sexual harassment involving rude comments or even fondling, that is not physical enough for the IRS. But the Tax Court has allowed some employment lawsuits partial tax-free treatment when the employee had physical sickness from the employer's conduct or the exacerbation of a preexisting illness.

Still, most taxpayers lose these tax cases, and they often lose over settlement agreement wording. *Tressler*<sup>5</sup> contains yet another reminder that the wording in legal settlement agreements is terribly important. Most legal settlements reported on tax returns are not audited. However, the actual reporting mechanics on the return and the care with which the tax return is prepared will influence the likelihood of an audit. Those things will also bear on the likely result of the audit if one occurs.

Documentation and luck may also play a part. If you are audited, you want to be able to give the IRS a settlement agreement that has optimal tax language. In the case of the always-popular section 104 exclusion for personal physical injuries or physical sickness, it is nice to have a settlement agreement that includes magic words like this: "This payment is made on account of plaintiff's alleged personal physical injuries, physical sickness, and emotional distress therefrom." In my view, it is OK to say "alleged" because the defendant does not have to admit that it caused these injuries.

However, you do want the defendant to say that it is paying the money on account of these allegations. Optimally, you also want the defendant to agree that because the damages are excludable from the plaintiff's income under section 104, the defendant will not issue a Form 1099 for the payment. The IRS instructions to Form 1099-MISC state that this type of payment should not be reported.

Of course, many payments are still reported on Form 1099 as part of the general default reaction that companies have when making payments. If the payment is \$600 or more, most businesses will issue the form. Indeed, if the

settlement agreement is not explicit on the point, someone in the defendant's accounting department is likely to send out a Form 1099 in January. Plaintiffs routinely object to Forms 1099 once issued, but if the settlement agreement does not expressly say that the form will not be issued, the odds of getting the defendant to correct it (with a corrected Form 1099 that zeroes out the income) are slim.

Some defendants will agree to helpful wording but will still issue a Form 1099 for the avoidance of doubt. Many compromises are possible, but hammering out these few lines in a settlement agreement — even if everyone is anxious to get the settlement agreement signed — is worth the time and effort to get it right. At least satisfy yourself that you have done the best you can before you agree and sign.

Dozens of examples bring this point home. As Nina Olson once observed during her long and productive tenure as the national taxpayer advocate, the Tax Court is clogged with cases about the section 104 exclusion. The IRS wins most of them, and settlement agreement wording seems to play an extraordinary part in that, perhaps even an increasing one, if that is possible.

For example, in *Blum*,<sup>6</sup> a woman sued her lawyer for allegedly botching her personal physical injury suit. As a practical matter, it appeared that Debra Blum was trying to get her lawyer to pay her money that she had failed to collect for her physical injuries because of the alleged legal malpractice. Even so, her malpractice recovery was held to be taxable.<sup>7</sup> However, the adverse result might be attributed to the settlement agreement itself, which expressly said that the settlement payment was not for her underlying physical injuries.

Determining which of several events comes first and which of several things causes or triggers another can seem quite artificial. Many of us in the real world don't know how to evaluate a mix of messy and disputed facts. The nontax lawyers who handle employment lawsuits and most other kinds of legal disputes are rarely careful (from a

<sup>5</sup>*Tressler v. Commissioner*, T.C. Summ. Op. 2021-33.

<sup>6</sup>*Blum v. Commissioner*, T.C. Memo. 2021-18.

<sup>7</sup>See Wood, "Legal Settlement Tax Worries (Revisited)," *Tax Notes Federal*, Apr. 19, 2021, p. 443.

tax viewpoint) about how they phrase claims and injuries. Lawsuit wording alleging “emotional distress with physical manifestations” or “emotional distress producing physical sickness” is common.

To the IRS, both phrases usually mean taxable damages. Thus, settlement wording seems paramount. For example, consider *Stassi*.<sup>8</sup> Cindy Stassi sued and settled with her former employer. Part of the settlement was for wages, and part was for bad treatment that allegedly triggered shingles. Stassi’s lawsuit claimed “emotional distress with physical manifestations.” She didn’t say her employer caused her shingles. Because Stassi did not file a complaint based on physical injury or sickness and the settlement agreement did not state that the payment was in lieu of damages for physical injury or physical sickness, her \$69,650 settlement was taxable.

Settlement agreement wording might even matter more than the actual claims. In an audit, strong settlement agreement wording might be enough to convince the IRS to end the audit. Conversely, poor wording may make it tough to win. In *Collins*,<sup>9</sup> Edward Collins couldn’t exclude \$85,000, even though his emotional distress resulted in physical sickness. He alleged that he had “suffered severe emotional distress and anxiety, with physical manifestations, including high blood pressure.” The case settled for \$275,000, with \$85,000 for emotional distress. Collins claimed it had been paid because of his physical sickness, but the court said he failed to persuade the court that the physical manifestations, including high blood pressure, were physical injuries or physical sickness.

*Tressler* is the latest example. Rebecca Tressler received a \$55,000 settlement payment from her former employer, Amtrak, in 2014. She paid tax on half, claiming that the other half was for personal physical injuries or physical sickness. The Tax Court held mostly for the IRS, but it did say that Tressler could exclude \$6,980, which reimbursed her for amounts she paid for psychotherapy from mid-2012 to the end of 2014. That was for medical care for emotional distress.

## Legal Woes

Tressler sued Amtrak for workplace harassment and retaliatory employment practices. Among other claims, she alleged that she had endured emotional distress, a workplace sexual assault, physical injuries from a workplace stalking incident, physical manifestations of stress caused by a hostile work environment, and an injury to her ankle sustained exiting a train while she was on duty. In her district court case, she complained of back pain, headaches, and numbness in her hand from being forced to change her seating position to avoid a passenger who was harassing her.

She alleged pain in her ankle because of management’s inadequate response. She complained of back pain, headaches, numbness, and other stress-related symptoms such as weight gain that she attributed to a hostile work environment created by Amtrak. The district court agreed that there had been a sexual assault but dismissed her case anyway, finding no evidence that Amtrak had been negligent concerning that assault. Tressler appealed, and she and Amtrak settled for \$82,500, with \$27,500 in wages reported on a Form W-2 and \$55,000 reported on a Form 1099.

The latter was to represent “settlement of Tressler’s claim for emotional distress damages related to her allegations” in the lawsuit. The settlement agreement said this was “inclusive of all claims by Tressler for any alleged damages against Amtrak, including, but not limited to, any alleged claims for physical injuries, emotional distress, attorneys’ fees, and costs.” She also had some medical claims and treatment. In fact, she was treated for post-traumatic stress disorder arising from the workplace sexual assault and her other traumatic experiences as an Amtrak employee.

Unfortunately, she failed to file a tax return for 2014, the year of the settlement. Eventually, the IRS prepared a substitute for return that included the entire \$82,500 payment in gross income and sent her a notice of deficiency. She did not disagree with the \$27,500 in wage income, but she argued that section 104(a)(2) allowed her to exclude at least half, if not all, of the \$55,000 balance.

<sup>8</sup> *Stassi v. Commissioner*, T.C. Summ. Op. 2021-5.

<sup>9</sup> *Collins v. Commissioner*, T.C. Summ. Op. 2017-74.

The settlement agreement said that the \$55,000 payment represented “settlement of Tressler’s claim for emotional distress damages related to her allegations” in the lawsuit. However, another part of the agreement said that the \$82,500 payment was “inclusive of all claims by Tressler for any alleged damages against Amtrak, including, but not limited to, any alleged claims for physical injuries, emotional distress, attorneys’ fees, and costs.”

You would think this should be enough, especially given that the Tax Court noted that her district court complaint included allegations of physical injuries. But the Tax Court said (rigidly) that the later section of the settlement agreement was general and did not state that any part of the \$55,000 payment was attributable to the settlement of a physical injury claim. The court said:

We simply cannot accept petitioner’s request to allocate the \$55,000 payment among her claims for “physical injuries, emotional distress, attorneys’ fees, and costs” when section 2.2 attributes the whole \$55,000 to her claim for emotional distress damages related to her claims in the lawsuit.

Tressler testified that she was the victim of a violent sexual assault that occurred while she was on duty at Amtrak and that Amtrak was aware of the assault. The court said her testimony was credible but that the absence from the payment provision of the settlement agreement of any reference to physical injuries represented a “conscious choice” by Tressler and Amtrak “to exclude physical injuries, including any physical injuries from the sexual assault, from the \$55,000 settlement allocation.”

If that seems harsh, it is. Most plaintiffs don’t fully understand how important this kind of language can turn out to be. Most lawyers don’t either. Besides, the whole “chicken or egg” issue about good versus bad emotional distress is hard to comprehend or even describe. Compensatory damages for personal physical injuries or physical sickness are supposed to be tax free under section 104. But exactly what injuries are “physical” is messy.

If you make claims for emotional distress, your damages are taxable. If you claim that the defendant caused you to become physically sick, those damages should be tax free. If emotional distress causes you to be physically sick, even that physical sickness does not guarantee tax-free damages. The emotional distress came first, so one can’t say that the emotional distress was the product of physical injuries or physical sickness.

In contrast, if you are physically sick or physically injured, and if your sickness or injury produces emotional distress too, those emotional distress damages should be tax free. An example would be an assault. Suppose that you are physically injured and too worried to go outside, or to work, and have difficulty dealing with others, etc. Those emotional distress damages ought to be nontaxable because they started with the physical injury.

To be sure, physical sickness is harder to pinpoint than physical injury. If you are highly stressed at work and that triggers a serious medical condition, shouldn’t all that be fair game? It will clearly matter what kind of medical condition it is and how serious and long-lasting it is. It will matter if the physical sickness comes first, producing emotional distress. Damages for the latter kind of emotional distress can be carried along with the underlying physical sickness damages. Emotional distress alone is not a physical injury or physical sickness.

Tressler argued that the payment was for emotional distress that was the product of her assault and physical injuries. The Tax Court said, “Section 2.2 of the settlement agreement allocates the \$55,000 to petitioner’s emotional distress but does not say what caused her emotional distress.” Then it went on to review her district court complaint, which repeatedly alleged that the petitioner sustained emotional distress “as well as” physical injuries. However, the Tax Court said that the portion of the complaint describing her physical injuries did not allege any associated emotional distress.

In various pleadings and documents, the court said it found nothing that referenced emotional distress attributable to physical injuries. Finally, the Tax Court considered her medical expenses, noting that damages not exceeding the amount paid for medical care for

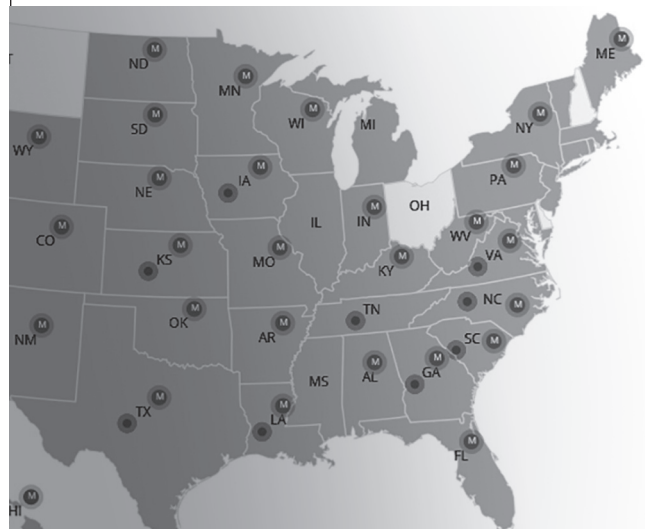
emotional distress could be excluded. Based on her records, that meant that \$6,980 of the settlement proceeds, corresponding to the \$6,980 which her psychotherapist billed, was fair game. The Tax Court acknowledged that psychotherapy is medical care for purposes of section 104(a)(2) and that the petitioner received psychotherapy to help her cope with her PTSD.

The cases suggest that to exclude a payment on account of physical sickness, the taxpayer needs evidence he made the claim. He does not necessarily have to prove that the defendant caused the sickness, but he needs to show that he claimed it. Also, he must show that the payer was aware of the claim and at least considered it in making the payment. To prove physical sickness, the taxpayer should have evidence of medical care as well as evidence that he actually claimed that the payer caused or exacerbated his condition. The more medical evidence the better.

In settlement agreements, whenever possible, be specific. The courts and the IRS should not be put in the position of determining which payments were for which claims. Moreover, when there is a scant record of medical expenses in the litigation, consider other documents you can collect at settlement time. If in settling an employment dispute you receive \$50,000 extra because your employer gave you an ulcer, is an ulcer physical injury, or is it merely a symptom of your emotional distress?

Many plaintiffs end up taking aggressive positions on their tax returns, claiming that damages of this nature are tax free. But that can be a losing battle if the defendant issues a Form 1099 for the entire settlement and if you are not well armed to explain it. If you are a plaintiff, try to get an explicit agreement with the defendant about the tax issues whenever you can. And whenever possible, get some tax advice before the settlement agreement is signed. ■

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