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Damages For Sickness Are Tax Free, But Emotional Distress Is Taxed



If you sue for damages and settle is it taxable? Usually yes, but there is an exception. Compensatory damages for personal physical injuries are tax free under [Section 104 of the tax code](#). Yet exactly what is "physical" isn't clear, and some of it seems to be semantics. If you claim the defendant caused you to become *physically sick*, those can be tax free. But if emotional distress *causes* you to be physically sick, that is taxable.

Sickness or Emotional Distress?

Some of the line-drawing comes from a footnote in the legislative history to the tax code. It says "emotional distress" includes physical symptoms, such as insomnia, headaches, and stomach disorders, which may result from such emotional distress. See [H. Conf. Rept. 104-737](#), at 301 n. 56 (1996). All compensatory damages flowing from physical injury or physical sickness are excludable from income, even in employment cases.

Worsening Symptoms Count

In [Domeny v. Commissioner](#), Ms. Domeny suffered from multiple sclerosis ("MS"). Her MS got worse because of workplace problems, including an embezzling employer. As her symptoms worsened, her physician determined that she was too ill to work. Her employer fired her, causing another spike in her MS symptoms. She settled her employment case and claimed that part of the money was tax free. The IRS disagreed, but she won in Tax Court. Her health and physical condition clearly *worsened* because of her employer's actions, which made it tax free.

In [Parkinson v. Commissioner](#), a man suffered a heart attack while at work. He reduced his hours, took medical leave, and never returned. He filed suit under the Americans with Disabilities Act ("ADA"), claiming that his employer

failed to accommodate his severe coronary artery disease. He claimed that his employer's misconduct caused him to suffer a disabling heart attack at work, rendering him unable to work. He settled and claimed that one payment was tax free. When the IRS disagreed, he went to Tax Court too.

He argued the payment was for physical injuries and physical sickness brought on by extreme emotional distress. The IRS said that it was just a taxable emotional distress recovery. The Tax Court said damages received on account of emotional distress *attributable* to physical injury or physical sickness are tax free. The court distinguished between a "symptom" and a "sign." The court called a symptom a "subjective evidence of disease of a patient's condition." In contrast, a "sign" is evidence perceptible to the examining physician. The Tax Court said the IRS was wrong to argue that one can *never* have physical injury or physical sickness in a claim for emotional distress. The court said intentional infliction of emotional distress can result in bodily harm.

Just Symptoms or Real Sickness?

Damages for many physical symptoms of emotional distress (headaches, insomnia, and stomachaches) are taxable. But ulcers, shingles, aneurysms, and strokes may all be an outgrowth of stress and it seems difficult to regard them all as 'mere symptoms of emotional distress.' Extreme emotional distress can produce a heart attack, which is not a symptom of emotional distress. The Tax Court in *Parkinson* agreed. Medical records and settlement agreement language can help materially, and with the right combination, you may be able to resolve an IRS query or audit.

Good Documentation Matters

To exclude a payment for physical sickness, you need evidence you made the claim. You don't have to *prove* the defendant *caused* your sickness, but you need to show that you *claimed* it. You need to show the defendant was aware of the claim and *considered* it in making payment. You should have evidence of medical care and evidence that you claimed the defendant caused it or made it worse.

Consider what you can collect at settlement time. A declaration from a doctor may help, and one from your attorney. Prepare what you can at the time of settlement, and do as much as you can contemporaneously. Support that you gather later is rarely as helpful. Whenever possible, settlement agreements should be specific about taxes. The IRS is likely to view everything as income unless you can prove otherwise. Try to be explicit in the settlement agreement about tax forms too, and read more about [how lawsuit settlements are taxed](#). You don't want to be surprised by [IRS Forms W-2](#) and [1099](#) arriving unexpectedly in January the year after the settlement.