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THE TAX LAWYER

How IRS Taxes Lawsuit Settlements, Sometimes Twice

Anyone pursuing legal claims cares about taxes they may have to pay when they recover. Yet determining how a settlement will be taxed can be tricky. What's more, in some cases the legal fees you pay to get a [lawsuit settlement can't be deducted](). Bizarrely, it can mean paying tax on 100%, even if 40% goes to your lawyer off the top. Some complain the rules are confiscatory, particularly since the lawyer is also paying tax on the same fees, a kind of double taxation. Yet if you are creative, there can still be [ways to deduct legal fees even under the new law.]() Ideally, of course, plaintiffs hope to pay no tax, not even on their net recovery. That's the rule for personal physical injuries like a serious auto accident. Those compensatory damages are tax free under [Section 104 of the tax code](). In employment cases, damages are usually taxable, and usually at least partially as wages, as nearly every employment case has a wage component. Employer and employee usually agree on a wage figure, and the balance goes on a Form 1099. Sometimes, there can be a tax-free portion too. Exactly what is "physical" isn't clear, and some of it seems like semantics. If you claim the defendant caused you to become *physically sick*, that sounds tax free. But it if emotional distress *causes* you to be physically sick, that sounds taxable.

The order of events and how you describe them matters to the IRS. It can seem artificial, and wording is important. Some of the line-drawing comes from a footnote in the legislative history that added the 'physical' requirement. 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 a physical injury or physical sickness are excludable from income. Even in employment cases, some plaintiffs win on the tax front. For example, 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 terminated her, causing another spike in her MS symptoms. She settled her employment case and claimed some of the money as tax free. The IRS disagreed, but Ms. Domeny

won in Tax Court. Her health and physical condition clearly worsened because of her employer's actions, so portions of her settlement were 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 lost his ADA suit, but then sued in state court for intentional infliction and invasion of privacy. His complaint alleged that the 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. 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.

Notably, the settlement agreement in *Parkinson* was not specific about the nature of the payment or its tax treatment. And it did not say anything about tax reporting. There was little evidence that medical testimony linked Parkinson's condition to the actions of the employer. Still, Parkinson beat the IRS. Damages for physical symptoms of emotional distress (headaches, insomnia, and stomachaches) might be taxable. Yet physical symptoms of

emotional distress have a limit. For example, ulcers, shingles, aneurysms, and strokes may all be an outgrowth of stress. 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. With the right combination, you may be able to resolve an IRS query or audit. To exclude a payment from income on account of physical sickness, keep evidence that the plaintiff made the claim. Keep evidence that the defendant was aware of the claim and considered it in making payment. To prove physical sickness, keep evidence of medical care and of the claim that the defendant caused or exacerbated the condition. The more medical evidence the better. Prepare what you can at the time of settlement and tax return preparation.

Whenever possible, settlement agreements should be specific about taxes. As you might expect, tax language in a settlement agreement does not bind the IRS. Even so, you might be surprised at how often the IRS pays attention in an audit if you can hand them a settlement agreement that says something explicit about taxes. It can sometimes be enough to make them walk away. Try to be explicit in the settlement agreement about tax forms too. If you are the plaintiff, you do not want to be surprised by [IRS Forms W-2](#) and [1099](#) that arrive unexpectedly around January 31st the year after you settle your case. For a summary of settlement taxes, see [Settlement Awards Post-TCJA](#).

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