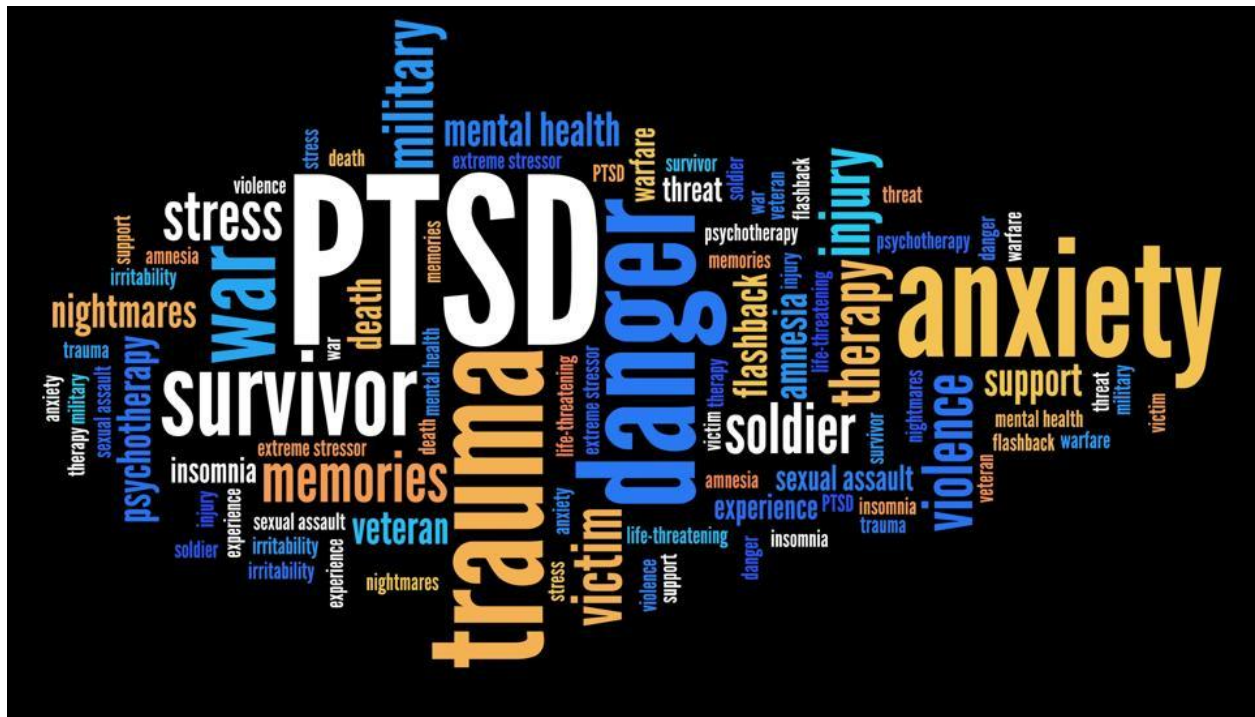


THE TAX LAWYER

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June 9, 2025



Most lawsuit [settlements are taxed](#), but there's an important exception: compensatory damages for personal physical injuries or physical sickness are tax free under Section 104 of the tax code. However, exactly what qualifies has been hotly debated for decades. Damages for *emotional* injuries are fully taxable, yet if you have emotional injuries *triggered* by physical ones, the damages for the emotional injuries are *also* tax-free. It can make [taxing emotional distress and physical sickness a kind of chicken and egg issue](#).

Settlement wording matters, as does the complaint. Adding to the confusion, exactly what is “physical” is not defined. Traditionally, the IRS likes to see observable bodily harm such as bruises, cuts or broken bones. Yet many injuries are not obvious but can be worse and take longer to heal. What example, where do sexual abuse or sexual assault fit in? It may depend on how severe it is, what evidence you have, and more. For many victims, an award of cash comes with tax worries: Can the IRS tax it?

Physical Or Emotional?

Allegations that a defendant caused a plaintiff to develop post-traumatic stress disorder occur in employment cases, wildfire and other disaster cases, personal injury claims, sexual harassment and abuse, defamation, and more. In some cases, the plaintiff claims the defendant *caused* their PTSD, and in others, that the defendant *exacerbated* pre-existing PTSD. Is an award for PTSD taxable or tax free as damages for personal physical injuries or physical sickness? There are good arguments that it is, including comments by former [President Barack Obama about PTSD](#).

However, there is no tax case yet that firmly decides one way or the other. The U.S. Tax Court upheld tax-free treatment where settlement monies are attributable to the exacerbation of a pre-existing physical condition. [In one case](#), the Tax Court concluded that a portion of the plaintiff's settlement was excludable because it was attributable to damages flowing from a cardiac event attributable to emotional distress from an alleged employment-related tort, even though the plaintiff previously had the underlying heart condition. [In another case](#), the Tax Court concluded that settlement monies

from the employer were excludable because “exposure to a hostile and stressful work environment exacerbated her MS symptoms to a point where she was unable to work.”

PTSD Changes The Brain

PTSD can be caused or exacerbated by stress, but so can heart attacks and diseases, which are physical even when they are caused or worsened by stress. Cancer, lupus, multiple sclerosis, and many other diseases may also not be apparent, but those conditions are physical and can qualify for exclusion. There is a growing medical consensus that PTSD alters the taxpayer’s brain physiology, and in a judgment or settlement, that ought to be sufficient to classify [PTSD as physical injury or physical sickness](#).

Fortunately, perhaps will finally feel some pressure on this issue. The National Structured Settlement Trade Association is the leading representative of the structured settlement industry. It deserves applause for its recent [letter to the IRS](#) that formally requests guidance from the agency on this issue.

Waiting On IRS?

Even without express IRS guidance, plaintiffs and defendants are increasingly likely to be able to agree on these issues. In settlement agreements, it is becoming common for defendants to agree that PTSD is physical injury or sickness for tax purposes. But without a published tax case that expressly states that PTSD damages qualify for exclusion, some defendants will not agree. That leaves some plaintiffs out in the cold. In any case, settlement agreement wording does not bind the IRS. A tax opinion is wise and helps protect the plaintiff, but even this is not a guarantee.