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## In Lawsuit Settlements, Most Emotional Distress Damages Are Taxable

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The tax treatment of legal settlements has spawned large volumes of tax cases, and most end up coming out in the IRS's favor, so it pays to know what you are up against. If you make claims for emotional distress, your damages are taxable. But if you claim the defendant caused you to become *physically sick*, those damages can be tax free. On the other hand, if it was emotional distress that *caused* you to be physically sick, that is taxable. It seems highly artificial, but the order of events and how you describe them matters to the IRS.

Compensation for personal physical injuries are tax free under [Section 104 of the tax code](#). Yet exactly what is "physical" isn't so clear.

Some of the line-drawing comes from a footnote in the legislative history to the tax code adding 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 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.

Medical records and settlement agreement language can help materially. 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, 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 he *claimed* it. In addition, he needs to show the defendant was aware of the claim, and at least *considered* it in making payment.

To prove physical sickness, the taxpayer should have evidence of medical care, and evidence that he actually claimed the defendant caused or exacerbated his condition. This is one of many issues in how legal recoveries are treated for tax purposes. The more medical evidence the better. Moreover, if there is a scant record of medical expenses in the litigation, consider what you can collect at settlement time. A declaration from the plaintiff can help. A declaration from a treating physician or an expert physician is appropriate, as is one from the plaintiff's attorney. And then there is the settlement agreement.

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. You don't want to be surprised by [IRS Forms W-2](#) and [1099](#) arriving unexpectedly in January the year after the settlement. You can read more about how legal [settlement awards are taxed](#).