

Tax-Free Physical Sickness or Taxable Emotional Distress?

By Robert W. Wood

Section 104 of the tax code shields damages for personal physical injuries and physical sickness, but the IRS has not defined “physical.” The IRS is rigid in most cases, and nowhere is that rigidity clearer than in 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.

And while there is no definitive tax case on point, there are good arguments that PTSD itself is physical. Still, a majority of taxpayers end up losing tax cases over settlement agreement wording. *Tressler v. Comm’r*, T.C. Summ. Op. 2021-33 (Sept. 13, 2021) contains yet another reminder that the wording in settlement agreements is *terribly* important. If you are audited, you want to be able to give the IRS a settlement agreement that has optimum tax language.

Of course, many payments still are reported on Form 1099, part of the general default reaction that most companies have when making payments. If a 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. That’s what happened to Ms. Tressler. She received a \$55,000 settlement from her former employer in 2014.

Tressler worked for Amtrak and sued for workplace harassment. 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 on duty. She complained of back pain, headaches, and numbness in her hand resulting from being forced to change her seating position to avoid a harassing passenger.

The underlying court agreed that there had been a sexual assault but dismissed her case finding no evidence that Amtrak had been negligent concerning the sexual 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 Ms. Tressler’s claim for emotional distress damages related to her allegations” in the lawsuit.

In fact, she was treated for post-traumatic stress disorder (PTSD) 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 the physical injury exclusion allowed her to exclude at least half, if not all, of the \$55,000 balance.

As noted, the settlement agreement wording said that the \$55,000 payment represented “settlement of Ms. 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 Ms. 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 since the Tax Court noted that her complaint filed in court *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. Tressler testified in Tax Court 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 Tax Court said her testimony was credible, but said 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 vs. 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” turns out to be 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.

Yet 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, have difficulty dealing with others, etc. Such emotional distress damages ought to be nontaxable, since they started with the physical injury. To be sure, physical sickness is harder to pinpoint. If you are highly stressed at work, and that triggers a serious medical condition, shouldn’t all of that be fair game? It will clearly matter what kind of medical condition it is, how serious and long-lasting. 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. In Tax Court, Tressler argued that the payment was for emotional distress that was the product of her assault and physical injuries. The complaint repeatedly alleged that petitioner sustained emotional distress “as well as” physical injuries.

However, the court said that the portion of the complaint describing her physical injuries does 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 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 \$6,980 her psychotherapist billed were fair game.

The cases suggest that to exclude a payment on account of physical sickness, the taxpayer needs evidence she made the claim. She does not necessarily have to prove that the defendant caused the sickness, but she needs to show that she claimed it. Also, he must show that the payer was aware of the claim and at least considered it in making the payment. The more medical evidence, the better. Then there is the settlement agreement. Whenever possible, settlement agreements should be specific. Many plaintiffs end up taking aggressive positions on their tax returns, claiming that damages are tax free.

But that can be a losing battle if the defendant issues a Form 1099 for the entire settlement. Whenever you can, try to get an explicit agreement with the defendant about the tax issues, and whenever possible, get some tax advice before the settlement agreement is signed.

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