The Uncertain Tax Effects of a General Release

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General releases are often used to terminate litigation and say nothing about the tax nature of the settlement payments, with unfortunate consequences. The Fifth Circuit's recent decision in *Espinoza v. Commissioner* not only illustrates the general release problem, but also speaks to the potential scope of section 104.

A general release is that most plain vanilla of settlement documents terminating litigation. Using appropriate legal wording, it may simply state that the plaintiff is accepting payment of money from the defendant in exchange for the plaintiff's release of any and all claims. The general release may state the nature of some of the plaintiff's claims, but it is predictably broad.

It will usually say something about the release extending to any and all claims, known and unknown. Most critically, from my point of view, it will say nothing at all about taxes, with one possible exception: It may say that any taxes on the settlement monies are solely the responsibility of the plaintiff. I don't view the idea that taxes are the responsibility of the plaintiff as relevant to our discussion here. That type of release is still a general release.

As a tax lawyer, I am often confronted with those documents. Fortunately, I generally can preview them before they are signed, so there may still be a chance to remedy the tax silence. Clearly, if there is a chance to draft helpful tax language within the four corners of the release before signing, lawyers should take advantage of it.

It should not be a tough sell to convince the parties — especially plaintiffs — that they are better off with explicit language. It may be more expedient for the plaintiff's lawyer and the defense lawyer not to consider any tax points. Tax provisions can breed disagreements. Typically, they can be worked out, but once in a great while the disagreements become intractable.

The litigators may not comprehend the importance of what may end up being only a few words in the settlement agreement about the tax treatment. Yet whether or not the litigators care, tax lawyers should recoil at the thought of general releases. A general release misses one of the easiest and most fundamental opportunities in the tax world for influencing how something is taxed.

Tax language in settlement agreements, as tax lawyers should know, is low-hanging fruit. It is so ripe, juicy, and easily picked that it should be impossible to leave it untouched. Axiomatically, of course, one of the key indicators of how damages are taxed is the intent of the payer.[1] How does one determine the intent of a payer? An express statement in a settlement agreement as to *why* the money is being paid can go a long way toward achieving the desired tax result. Although the tax language plainly cannot guarantee the desired tax treatment, my experience in this area is extensive and consistent.

Unquestionably, those tax provisions matter. Conversely, a general release that says nothing invites IRS scrutiny — if it does not outright scream for it. That truism was on my mind as I read the opening paragraphs of the recent Fifth Circuit decision in *Espinoza v. Commissioner*.[2]

The Fifth Circuit began by noting that this tax case involved the treatment of a settlement payment made under a general release. *Tax Notes* readers should not be surprised that an opinion with such an ominous opening is unlikely to end well.

Employment Grist

As with so many other tax cases, the settlement payment considered here arose out of an

[1]*See United States v. Burke*, 504 U.S. 229, 237 (1992); *United States v. Gilmore*, 372 U.S. 39 (1963).

[2]*Espinoza v. Commissioner*, No. 10-60778 (5th Cir. 2011), *Doc 2011-6613*, *2011 TNT 61-15*.

employment-related lawsuit. Espinoza claimed that the settlement monies she received, a $50,000 payment, should be excluded from her income under section 104 on account of her physical injuries and physical sickness. Predictably, the IRS disagreed, and the Tax Court upheld the IRS's claim.[3]

The Tax Court found that Espinoza had not met her burden of proof of showing that her payment was not income. Her underlying lawsuit was over gender, religion, and national origin discrimination, as well as retaliation for her complaints. Espinoza sought damages for back pay, mental pain and anguish, and intentional infliction of emotional distress.

Espinoza's spouse calculated her medical bills for her physical and psychological ailments that had been caused or exacerbated by the discrimination. In all, they totaled $50,000. Based on that figure, he approached his wife's lawyer, and they worked out a proposed settlement of the case for $50,000.

With the settlement in the offing, Espinoza's lawyer assured them the $50,000 would not be taxed. That advice, it turned out, would be incorrect. A settlement agreement was prepared and signed, and the defendant paid the money.

The settlement agreement and release included no tax language or even any characterization of the payment, other than general ''buying peace'' language. Espinoza received her $50,000 and then received a Form 1099-MISC reporting the payment. Espinoza's husband interacted with their accountant, explaining that the $50,000 payment was for medical expenses.

As a result, the accountant also said the money was tax free. (It is unclear from the Fifth Circuit opinion if the accountant was aware Ms. Espinoza had received a Form 1099.) In any case, the accountant prepared the return excluding the payment and filed it.

The IRS assessed a deficiency, and the matter wound up in Tax Court. Predictably, the Tax Court upheld the IRS's claim. It held that Espinoza had failed to present objective and credible evidence that the settlement proceeds were for medical expenses.

In fact, the court found that the settlement money was unallocated among multiple claims. Many of her claims were not for physical injuries or physical sickness. However, at least the Tax Court removed the penalties the IRS had assessed.

[3]*Espinoza v. Commissioner*, T.C. Memo. 2010-53, *Doc 2010-6206, 2010 TNT 55-15*.

Appealing Case

On appeal, however, *Espinoza* became a far more interesting case than one might have assumed at first glance. The appellate court reviewed the Tax Court's findings of fact for clear error.

It agreed with the Tax Court's finding that Espinoza had failed to establish that the settlement proceeds were allocable to physical injuries or physical sickness.

Commencing with the origin of the claim doctrine, the court looked first at the language of the settlement agreement itself — of course, it was a general release, saying little. The law is clear that the IRS and the courts may look behind a settlement agreement for other evidence of the reasons for a payment.[4]

Interestingly, however, the court suggested that that kind of truffle hunting should occur only when the settlement agreement is devoid of specific language.[5] In reality, of course, that can occur in any case, but if it were true, it would be yet another reason to avoid general releases.

Yet it is certainly true that the need for examining other documents is more patent with a general release. Indeed, that clearly is one of the most important messages of the *Espinoza* case. There probably would have been no tax case at all had the settlement agreement been clear on the tax point. Some will debate me, but there is no way to prove the point.

Quite frequently I see specific settlement agreements pass muster on audit or at IRS Appeals. It can sometimes even seem that the IRS is pleased to find that someone took the time to set forth the nature of the payments in the documents. As messy as it can be to look behind them, I can understand that the IRS may breathe a sigh of relief that at least the first cut of the analysis may have been done.

Nothing Settled

The Fifth Circuit agreed with the Tax Court that Espinoza had failed to prove her monies were paid on account of physical injuries or sickness. The general release clearly did not say this. The causes of action in the complaint were not much more help.

Espinoza's claims were for discrimination and retaliation. Her petition for relief had requested actual damages, back pay, mental pain and anguish, and emotional distress, both of the compensatory and exemplary variety. That also was no help to

[4]*See Bagley v. Commissioner*, 121 F.3d 393 (8th Cir. 1997), *Doc 97-23130, 97 TNT 153-8*.

[5]Citing *Green v. Commissioner*, 507 F.3d 857, 867 (5th Cir. 2007), *Doc 2007-24950, 2007 TNT 218-13*.

Espinoza in establishing that the payment was on account of her physical injuries, sickness, or medical expenses.

In that list, the only payments that might be covered by the section 104 exclusion were the payments for medical treatments for the physical manifestations of emotional distress and mental pain or anguish. Yet once again alluding to the general release, the Fifth Circuit said that nothing in the release suggested that was intended (in whole or in part) as a payment of her medical expenses.

With no language in the release referring to medical costs, Espinoza had the burden of presenting other evidence to establish that the payment was intended in lieu of damages for the costs of medical care and treatment. True, Espinoza presented evidence that she and her husband *considered* the $50,000 as reimbursement for her medical expenses. Indeed, the Fifth Circuit acknowledged that Espinoza had been ill and received medical treatment for a number of serious medical problems: enlarged lymph nodes, cirrhosis of the liver, hyperthyroidism, depression, and post-traumatic stress disorder.

Not only that, but the treatments spanned the period during and after her employment. Plainly, Espinoza attributed those significant medical problems to the harassment and retaliation she suffered. Her husband testified that they both regarded the $50,000 as payment for the medical costs.

All of that sounded good. The Fifth Circuit even agreed that testimony was probative of the payer's intent. But the court found it was insufficient to prove that intent.

In fact, the court noted that the only evidence Espinoza had presented as to the payer's intent was:

- an authorization to release her medical records to the payer from 1998;
- a certification of illness/injury submitted in 1997; and
- a doctor's supplemental statement on accident or sickness from 1999 discussing Espinoza's psychological and physical impairments that developed in response to the allegedly hostile work environment.

That, said the court, was helpful to show that the payer was aware of her medical conditions and that she was receiving medical treatments.

Yet it was not enough to show that the payer decided to pay all or any portion of the $50,000 settlement to reimburse her for her medical costs. The intended payment could just as easily have been to reimburse Espinoza for costs associated with her multiple other claims. In the end, the Fifth Circuit upheld the Tax Court, holding that no portion of the $50,000 settlement could be excluded as a payment for personal physical injuries or physical sickness.

Teachable Moment?

What does *Espinoza* reveal about the scope of section 104 and the grist of litigation? Very few cases go to trial and judgment. Most are settled. Even cases that go to verdict often end up settling on appeal.

I stress those obvious facts because it should be clear that there is rarely a final court order that says exactly what a payment is for. Put differently, just what will the IRS be able to examine to determine the genesis of a payment? The settlement agreement is the most logical place to look.[6]

Mediation briefs, pleadings, depositions, and expert reports also can be relevant. Sometimes there is more arcane evidence. For example, in *Madson v. Commissioner*,[7] the Tax Court noted that while there was no helpful settlement agreement language and no complaint, there was a ''bodily injury'' reference noted on the memo line of the check. That was pretty thin evidence and was not enough by itself to make the payment excludable under section 104, but it was at least noted.

In fact, as *Espinoza* reveals, courts often seem to lament — nearly as much as I do — that there is nothing in the settlement agreement language to reveal the intended treatment of the payment.[8] I admit that language saying ''this payment is paid on account of personal physical injuries and is therefore tax free within the meaning of Internal Revenue Code section 104'' may be self-serving. The defendant may not believe it or may have a more amorphous and multi-part intent.

But the defendant may not care, as long as the payment is deductible. If the suit is connected to the defendant's business, the deduction should be ensured. There can be nettlesome wage and withholding issues in employment disputes, but they are often solved with an allocation to wages that the IRS generally seems loath to disturb.[9]

Conclusion

It may be tempting to read *Espinoza* as yet another case in which the courts upheld the IRS in applying a narrow and unforgiving reading of the

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[6]*Knuckles v. Commissioner*, 349 F.2d 610, 613 (10th Cir. 1965), *aff'g* T.C. Memo. 1964-33.

[7]T.C. Memo. 1985-3, *later proceeding*, T.C. Memo. 1988-325 (1988).

[8]*See Allum v. Commissioner*, T.C. Memo. 2005-177, *Doc 2005-15466*, *2005 TNT 139-9*, *aff'd*, 231 Fed. Appx. 550 (9th Cir. 2007), *Doc 2007-10844*, *2007 TNT 86-16*.

[9]*Rivera v. Baker West Inc.*, 430 F.3d 1253 (9th Cir. 2005).

scope of section 104.[10] After all, Espinoza couldn't even get her reimbursed medical expenses excluded! In the same vein, Vincent couldn't get her ulcer damages excluded,[11] and Murphy couldn't get her bruxism damages excluded.[12]

In reality, of course, none of these cases is really about the scope of section 104. They all deal with causation — with why the payment was made. Put differently, they are concerned with the "on account of" part of section 104, not with the meaning of physical injuries or sickness. There is, however, one arguably unusual aspect of *Espinoza*, which I've saved for last.

The Fifth Circuit noted unexceptionally that Tax Court cases have held that payments for the physical symptoms of emotional distress are taxable.[13] Yet the Fifth Circuit said that whether damages paid for treating physical manifestations of emotional distress can be tax free is an issue of first impression in the Fifth Circuit — and indeed in its sister courts of appeal. Although the court does not reach this issue based on the lack of evidence for why the payment was made, the court seems to tilt in favor of excludability. To me, this is yet another reason — and we truly do not need any others — to avoid general releases like the plague.

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[10]*See* Robert W. Wood, "Tax-Free Physical Sickness Recoveries in 2010 and Beyond," *Tax Notes*, Aug. 23, 2010, p. 883, *Doc 2010-16739*, or *2010 TNT 165-7*.

[11]*Vincent v. Commissioner*, T.C. Memo. 2005-95, *Doc 2005-9343*, *2005 TNT 85-6*.

[12]*Murphy v. Commissioner*, 493 F.3d 170, 173 (D.C. Cir. 2007), *Doc 2007-21206*, *2007 TNT 181-6*.

[13]*See supra* note 3; *Wells v. Commissioner*, T.C. Memo. 2010-5, *Doc 2010-221*, *2010 TNT 3-10*.