Forbes

Robert W. Wood

THE TAX LAWYER

TAXES 04/01/22

Will Smith Oscars Slap Could Have Tax Impact Too

The Oscars may be over, but the repercussions of *the slap* may not be over for quite some time. Will the Academy take disciplinary action against Will Smith? Will Chris Rock change his mind and press charges? Might he even sue Will Smith? Lawsuits have been filed for less, and more than a few plaintiffs who have endured harassing conduct or assaults might be thinking about what they endured and whether they should sue. For those who sue, it turns out there can be some surprising tax issues. Legal analysts say the slap was an assault, battery, or both, and with millions of viewers who saw it, proof shouldn't be a problem. So if Chris Rock sues Will Smith and recovers, is it taxable to Chris Rock? Anyone pursuing legal claims cares about taxes when they win, but determining how a settlement will be taxed can be tricky. What's more, since 2018, in some cases the legal fees you pay to get a lawsuit settlement can't be deducted. So how much in tax will Chris Rock pay if he receives a settlement? The slap was physical, and damages for personal physical injuries like a serious auto accident are tax free under Section 104 of the tax code. But what is "physical" isn't clear.

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 emotional distress. *See* H. Conf. Rept. 104-737, at 301 n. 56 (1996). But if you start with a physical injury or physical sickness, even emotional distress damages can be excludable from income. Chris Rock was slapped, and if he suffers emotional distress from it, it should arguably be tax-free money. Even in employment cases, some plaintiffs beat the IRS. 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. But the Tax Court sided with Parkinson.

Some victims of harassment or abuse end up with PTSD, and there are good arguments that PTSD is itself physical. Although former President Obama seemed to agree, the tax code so far does not say. Plaintiffs often try to bake in a favorable tax result into their settlement agreement. 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, the IRS pays attention to the wording. In an audit, if you can hand the IRS a settlement agreement that is explicit about taxes, it might be enough to make the IRS walk away. 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.

What if you get stuck with bad wording, or even with an IRS Form 1099 for your settlements and for the legal fees? If possible, get tax advice *before* signing a settlement agreement, or even earlier when mediating your dispute. The IRS isn't bound by the parties' tax characterization, but lawsuit taxes often hinge on settlement agreement wording and the IRS often will respect it. Whatever your legal matter, the IRS rules on how lawsuit settlements are taxed can be confusing, and some seem especially unfair. Incredibly, in some cases now, there's a tax on lawsuit settlements, with legal fees that can't be deducted. That can mean paying tax on 100%, even if 40% off the top goes to your lawyer. If you have that bizarre situation, check out 12 ways to deduct legal fees under new tax law.

Check out my website.