Intricacies of Taxation of Damage Awards and Settlements

By Phyllis Horn Epstein

Damage awards and settlements may give rise unexpectedly to taxable income. For someone who has suffered injury, the realization that he or she may owe taxes on a recovery will be an unwelcome surprise. It is essential that attorneys mitigate whenever possible the imposition of tax in their settlement documents and inform clients of their reporting responsibilities. The Taxpayer Advocate Service, an independent organization within the IRS, has issued its own recommendations in this area in an attempt to reduce the high level of uncertainty in reporting damage awards and settlements.

Today, after recent amendments to the Internal Revenue Code, IRC § 104(a)(2) provides an exclusion from income for settlements or awards on account of personal physical injuries or physical sickness but not for emotional distress or punitive damages. New 2012 regulations removed the prior requirement that a claim be rooted in "tort or tort-type rights" in order to be excluded from income largely because of the statutory necessity of physical injury. Current IRC regulations at § 1.104-1(c)(2) provide that the "injury need not be defined as a tort under state or common law."

What confounds the courts and practitioners is the inverse principle that physical suffering that is the result of emotional distress does not give rise to the physical-injury income exclusion. The legislative history of IRC § 104(a) provides some clarification of what symptoms are solely manifestations of emotional distress. These include physical symptoms such as insomnia, headaches or stomach disorders, which are considered primarily emotional manifestations rather than physical harm.

Numerous courts have grappled with this question with often conflicting results. For example, in *Murphy v. Internal Revenue Service*, a federal district court case in the District of Columbia Circuit, the taxpayer suffered an array of physical symptoms arising out of an employment-related claim. The court held that the damage recovery was taxable because the symptoms were manifestations of emotional distress rather than physical injury. Subsequently, the U.S. Tax Court reached a contrary result in *Domeny v. Commissioner*, T.C. Memo. 2010-9, concluding that the taxpayer's claims for employment discrimination were "on account of" a physical injury, as the hostile work environment exacerbated the plaintiff's condition of multiple sclerosis.

In the tax court case of *Parkinson v. Commissioner*, T.C. Memo. 2010-142, the taxpayer's damage recovery for claims of emotional distress and invasion of privacy in an employment context was excluded from income. In that case the taxpayer suffered a heart attack as a result of his employer's conduct. Contrary to most of the prior cases, the tax court wrote that it is "self-evident that a heart attack and its physical aftereffects constitute physical injury or sickness."

The IRS ruled in *PLR 200041022* that damages from a claim for sexual harassment may be excluded from income only if the harassment involves "observable bodily harms" as opposed to emotional distress manifested by physical symptoms. A review of these circuit court and tax court decisions leads to the conclusion that an employment-related claim may result in income exclusion if the conduct complained of results in a sufficiently serious physical impact — something at least as traumatic as a heart attack.

In *PLR 200041022*, the Taxpayer Advocate Service articulated this standard for physical injury: "… [W]e believe that direct unwanted or uninvited physical contact resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under § 104(a) (2)." The taxpayer in *PLR 201311006* demonstrated sufficient physical injury "because … she either suffered a cut, scrape, bruise, or other physical injury in the Incident, or inhaled thick smoke and, as a result, suffered smoke inhalation during the Incident."

In the more recent tax court case of *Blackwood v. Commissioner*, T.C. Memo. 2012-190, the petitioner complained of insomnia, excessive sleeping, migraines, nausea, vomiting, weight gain, acne and pains in her back, shoulder and neck that she claimed were caused by her depression brought on by her wrongful termination from employment. The court found that these "symptoms" of depression were not the primary underlying cause of action and therefore her recovery was included in income. The *Blackwood* court distinguished *Domeny* (see above) because of "the level of physical injury or physical sickness" that made it impossible for the petitioner to continue working.

In the tax court case of *Sharp v. Commissioner*, T.C. Memo. 2013-290, an employee at the University of Northern Iowa brought a claim against the university for conduct leading to her departure, all of which resulted in clinical depression, anxiety disorder and post-traumatic stress disorder. The settlement agreement with the university stated that it was a payment for emotional distress only. The court stated: "On the basis of the weight we apply to this express language, we find that the parties intended the settlement proceeds to exclude damages for physical injuries." Moreover, as in *Blackwood*, the court held that the petitioner "failed to provide sufficient evidence

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to make her case that her physical manifestations amount to physical injuries."

Although decided after the new regulations went into effect, the court still required that the taxpayer satisfy the two-prong test enunciated by the U.S. Supreme Court in *Commissioner v. Schleier*, that is: "A taxpayer must show that the underlying cause of action giving rise to the recovery is based on tort or tort-type rights … [and a] taxpayer must also demonstrate he or she received the damages on account of his or her personal physical injuries or physical sickness."

The Taxpayer Advocate Service 2013 Annual Report to Congress informs us that in 2013, in six cases reviewed where a taxpayer challenged the inclusion of a damage award in income, the service won in each case. The report continues: "The National Taxpayer Advocate has previously recommended a legislative change that would clarify the tax treatment of court awards and settlements by permitting taxpayers to exclude any payments received as a settlement or judgment for mental anguish, emotional distress, or pain and suffering." Such a change would eliminate the necessity for analysis over whether a physical injury was primarily a manifestation of emotional distress or whether the emotional distress was a manifestation of the physical injury.

Allocation of Damage Awards

Since damages flowing from physical injury will not be included in income, the question arises whether all damages are excludable once there is a physical injury component of the settlement. By way of clarification, the House Report to the Small Business Job Protection Act of 1996 provided: "... [I]f an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party." H.R. Rep. No. 104-737.

It is possible to conclude from this language and from the Supreme Court's hypothetical in *Schleier* that all damages, including lost wages and emotional distress damages, provided they relate to physical harm as a primary injury, can be excluded from income. The *Schleier* hypothetical reads as follows:

> Consideration of a typical recovery in a personal injury case illustrates the usual meaning of "on account of personal injuries." Assume that a taxpayer is in an automobile accident, is injured, and as a result of that injury suffers (a) medical expenses, (b) lost wages, and (c) pain, suffering, and emotional distress that cannot be measured with precision. If the taxpayer settles a resulting lawsuit for $30,000 (and if the taxpayer has not previously deducted her medical expenses, see § 104(a)), the entire $30,000 would be excludable under § 104(a)(2). The medical expenses for injuries arising out of the accident clearly constitute damages received "on account of personal injuries." Similarly, the portion of the settlement intended to compensate for pain and suffering constitutes damages "on account of personal injury." Finally, the recovery for lost wages is also excludable as being "on account of personal injuries," as long as the lost wages resulted from time in which the taxpayer was out of work as a result of her injuries. … The critical point this hypothetical illustrates is that each element of the settlement is recoverable not simply because the taxpayer received a tort settlement, but rather because each element of the settlement satisfies the requirement set forth in § 104(a)(2) (and in all of the other subsections of § 104(a)) that the damages were received "on account of personal injuries or sickness."

As the Supreme Court's hypothetical suggests, parties will often terminate litigation with a general full and final release of all claims upon payment of the settlement amount. As a general rule and contrary to the *Schleier* hypothetical, if there is no allocation in a settlement document among compensatory damages, punitive damages

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or emotional-distress damages, the IRS will consider the entire amount taxable.

Upon review, the courts may allocate damages on the basis of the intent of the payor, the underlying litigation and pleadings, the realities of the settlement and other facts and circumstances. As a general rule, an allocation of damages set out in a settlement agreement will be accepted by the IRS, provided it is entered into in good faith, at arm's length and in the context of an adversarial proceeding. The tax court disregarded the allocation of a settlement agreement on an Age Discrimination on Employment Act claim on the grounds that the allocation was an affront to the realities of the settlement. The parties allocated the entire settlement to pain and suffering from physical injury and nothing to lost wages. It became evident to the court that the employer had considered the lost-wages portion of the claim at approximately $400,000 and therefore the allocation of the entire settlement to physical pain and suffering was entirely arbitrary and unsupported.

In *Smallwood v. U.S.*, a California district court case, the petitioner brought a claim for gender discrimination, harassment for race and gender, race discrimination, retaliation and sex discrimination. In her pleadings she alleged physical injuries as a result of acts of discrimination. The court accepted the petitioner's evidence of physical injuries, which were extensive, including vertigo, excessive vomiting, dizziness, hair loss, dehydration, viral/bacterial infections, post-trauma stress and low blood pressure. Petitioner, however, failed to demonstrate that the majority of her recovery could be allocated to physical injuries and therefore the entire amount was included in her income.

Many lawsuits are commenced with numerous alternate claims or counts, some of which may be economic and some sounding in tort either for personal injuries or emotional distress. A general settlement without specific allocation among those various claims will likely result in the entire award being taxable when some might be excluded from income. Taxpayers are cautioned when signing a final release of litigation either to avoid the standard "settlement of any and all claims" language or supplement that language with an allocation of the damage award to claims that require the recognition of income and those that do not. As stated above, the IRS will not be bound by any settlement agreement to which it is not a party and may challenge an allocation "where the facts and circumstances indicate that the allocation does not reflect the economic substance of the settlement." An allocation that appears to be entirely tax motivated will be disregarded. In *Kathleen S. Simpson, et vir. v. Commissioner*, 141 T.C. No. 10 (2013), the tax court reiterated the principle: "If we cannot find evidence of the parties' express intent in the settlement agreement specifying the purpose of the compensation, we look to the payor's intent."

Caution should also be taken where a taxable recovery may be characterized as Federal Insurance Contribution Act (FICA) wages. In a 2013 case for damages relating to lost wages, the 2nd U.S. Circuit Court of Appeals, in *Gerstenbluth v. Credit Suisse Securities (USA) LLC, Internal Revenue Service*, held that the nature of the claim is determinative of the issue of whether the

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damages are FICA wages or simply taxable damages. The plaintiff argued that the settlement was for the purpose of dropping a lawsuit rather than reimbursement for lost wages. The court held otherwise to avoid an inconsistent outcome that would find a settlement not subject to withholding and a court award subject to FICA. No designation was made in the settlement documents, yet the plaintiff did receive a form W-2 from his former employer. The court commented:

> To be sure, without a negotiated tax classification stated in a settlement agreement and reflected in the settlement amount, the defendant — especially an employer or former employer — may have little incentive to treat a payment as anything other than FICA-taxable wages: an error in making a non-wage classification creates unnecessary and undesirable exposure for the employer in light of FICA's withholding requirements.

For the purpose of tax certainty, attention to settlement documents is critical.

Taxation of Contingent-Fee Awards

The U.S. Supreme Court, in *Commissioner v. Banks*, enunciated the general reporting rule on contingency fee arrangements. The client is taxed on the entire amount of a litigation settlement or award, including the portion attributable to the attorney's contingent fee. The rationale is the anticipatory assignment of income doctrine, which prevents a taxpayer from diverting income to a third party or creditor without reporting the income. Because the client has ownership over the litigation and the attorney serves as the client's agent, it is consistent to hold the client as taxable owner of the entire proceeds. The client may then take a deduction for the amount of attorney's fee paid as a miscellaneous itemized deduction; however, in many instances the Alternative Minimum Tax will negate any benefit from the deduction. The inclusion of income is subject to a few exceptions. For example, in some large opt-out class actions the attorneys' fee recovery from a large pooled fund is not charged against the individual litigants. *PLR 200906010* and *PLR 200906012*. The net result may be that the portion of a recovery attributable to an attorney's contingent fee is taxed twice — first to the litigant and then to the attorney. ⚖

Editor's note: The full text of this article, as submitted and with footnotes, is available on the PBA website along with the contents of this issue of the magazine, posted for members-only access at www.pabar.org/members/lawyerhome.asp.

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