
A Properly Worded Settlement May Avoid Tax

By Kenneth S. Wear, Christine M. Green / Jul 09, 2018

Last week, the US Tax Court issued a summary opinion holding that a taxpayer could not exclude settlement proceeds from gross income because the settlement agreement failed to contain any reference to physical injuries.¹ Had the settlement agreement done so, the taxpayer likely could have excluded the settlement proceeds (or at least a portion thereof) from gross income and from tax.

The taxpayer entered into a settlement agreement with her employer over claims that the taxpayer was the subject of discrimination and a hostile work environment. The taxpayer had been separated from her co-workers, not granted bereavement leave, and reprimanded by her supervisor for “discourteous behavior”. Following this, the taxpayer began having physical symptoms of shortness of breath and heart problems. She sought medical attention and was found to have a severely elevated white blood cell count. The doctors prescribed her various medications and placed her on medical leave. Before filing the claim with the Equal Employment Opportunity Office (the “EEO”), the taxpayer filed a grievance stating that she was intimidated enough by her supervisor to affect her health as evidenced by having to be placed on medications. Despite the reference in her grievance to her health being affected, the EEO claim did not refer to any personal physical injuries or sickness, and the negotiated settlement agreement simply stated that the agreement was a full settlement of all claims under the EEO complaint.

Under section 104(a)(2) of the Internal Revenue Code², damages received on account of personal physical injuries or physical sickness are excluded from gross income and, therefore, not taxable. In general, emotional distress is not treated as a physical injury or physical sickness;³ however, damages for emotional distress attributable to a physical injury or physical sickness are excludable to the extent of the amount paid for medical care for such emotional distress.⁴ For tax purposes, the nature of the claim that was the basis for the settlement determines whether or not settlement proceeds are excludable under section 104(a)(2). The IRS and courts determine the nature of the claim by reference to the terms of the settlement agreement. Here, the US Tax Court found no reference to physical injuries or sickness in the settlement agreement. Although the settlement agreement referenced the EEO complaint, the complaint also did not reference physical injuries or sickness. The taxpayer testified that in conversations with EEO attorneys, there was a mention that the settlement was to compensate her for personal physical sickness, but the US Tax Court held that she did not satisfy the burden of proving that the settlement proceeds were to compensate her for physical sickness.

Based on the facts presented in the opinion, it appears that the taxpayer certainly had a basis for arguing that the proceeds were for physical sickness or for the medical costs of treating emotional distress related to physical sickness. If the settlement agreement had referenced physical injuries, the taxpayer may have been able to exclude the proceeds from her taxable income. Accordingly, in cases where a plaintiff suffers physical injuries or sickness, the plaintiff and the plaintiff’s counsel should negotiate for the settlement agreement to reference physical injuries or sickness. Doing so may help to avoid having the settlement proceeds unnecessarily subject to income tax.

For questions or more information, please contact Christine M. Green, Kenneth S. Wear or another member of Clark Hill’s Corporate Business Unit or Tax and Estate Planning Business Unit.

[1] *Zinger et ux. v. Comm’r*, T.C. Summary Opinion 2018-33, Docket No. 13096-16S (Filed July 2, 2018).

[2] Unless otherwise provided, all “section” references are to the Internal Revenue Code of 1986, as amended.

[3] Section 104(a) (flush language).

[4] *Id.*; Treasury Regulations section 1.104-1(c)(1).