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Damages Are Taxable, Even for “Political Discrimination” Says IRS

It may sound silly to think of suing because you don't like someone's politics, but some do it. In fact, politically motivated hiring decisions can be unlawful. So said Thelma Ruffin when she and others sued the City of Chicago for repeatedly turning down their job applications. She joined a class action and eventually received a \$12,500 settlement.

Was it Taxable? Thelma said no, the IRS said yes, and it went to Tax Court. See [Ruffin v. Commissioner](#). There, Thelma argued that the settlement payment:

1. Wasn't wages. After all, she never worked for the City—they kept rejecting her!
2. Was for the City's violations of the law; and
3. Was for political discrimination and as such shouldn't be taxed.

Still, the Tax Court had to agree with the IRS. About the only way a payment can be excluded from income is if it is made for physical injuries



or physical sickness. Thelma didn't even make that argument. That made the money taxable whether it was wages or not.

If you sue for physical injuries like a slip and fall or car accident, your damages are tax-free (except for punitive damages and interest). The tax-free treatment applies even if you sought lost wages because you couldn't work after your injuries. Before 1996, "personal" damages were tax-free, including emotional distress, defamation, etc. But since 1996, your injury must be "physical."

What's Physical? Neither the IRS nor Congress has made it clear. If you sue for sexual harassment involving rude comments or even fondling, that's not physical enough for the IRS. Symptoms of emotional distress are also not "physical." The law draws a distinction between money you receive for physical symptoms of emotional distress (like headaches and stomachaches) and physical injuries or sickness.

Physical symptoms caused by emotional distress—say, headaches—are generally taxable, but it's fuzzy and much litigated. In 2010, the [Tax Court](#) overruled an IRS decision to tax a \$350,000 settlement a Maryland man received after suing his ex-employer for intentional infliction of emotional distress. See [Parkinson v. Commissioner](#). Why? The distress arguably led to a real disease—a heart attack—the court said. Note, too, that payments for medical treatment, including counseling, aren't taxable.

How You Settle Matters. It can be tempting to just bring your dispute to an end and to let the tax chips fall where they may. But before you resolve it, consider the tax aspects. You have more flexibility to reduce taxes if you settle, especially if you negotiate with an eye on the tax rules.

A settlement agreement might say all the cash was for a (nontaxable) physical injury, while a court verdict might attribute some of it to taxable punitive damages or interest. The IRS isn't bound by an agreement's wording, but it can help.

For more, see:

[Don't Fail To Consider Taxes When Settling Litigation](#)

[10 Things to Know About Taxes on Damages](#)

[Tax-Free Physical Sickness Recoveries in 2010 and Beyond](#)

[Is Post-Traumatic Stress Disorder Physical Injury for Tax Purposes?](#)

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