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THE TAX LAWYER

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### Who Wins in Sharon Stone v. Maid Face-Off?

Whether John Travolta or Sharon Stone, it's hard not to turn your head when you hear salacious allegations, regardless of whether they're true. The winners are invariably tabloid and magazine purveyors, not to mention anyone who gets paid for their story. The IRS often wins too.

Sharon Stone's ex-nanny Erlinda T. Elemen has sued her for verbal abuse over the nanny's Filipino heritage and religious beliefs. See [Sharon Stone sued by former nanny](#). The National Domestic Worker Alliance has rallied behind her, claiming domestics have little legal protection. See [Domestic Workers Shocked by Sharon Stone's Alleged Abuse of Nanny](#). Proposed bills—like California's [Domestic Worker's Bill of Rights](#)—could change that.



(Image credit: AFP/Getty Images via @daylife)

But if Stone's maid recovers, she may be surprised at her tax bill. It's often unclear what cases generate tax bills and how the plaintiff's income is measured. Would the maid be taxed on her net recovery **after** lawyer fees or the gross **including lawyer fees**?

**Tax-Free?** Under [Section 104](#) of the tax code, damages for personal physical injuries and physical sickness are tax-free. However, the injury must be “physical.” The IRS says that means observable. See [Tax-Free Physical Sickness Recoveries in 2010 and Beyond](#). Stone’s maid suing for verbal abuse is not physical enough for the IRS.

Suppose your employer gives you an ulcer. Is an ulcer **physical** (tax-free) or merely a **symptom of your emotional distress** (taxable)? Many plaintiffs end up taking aggressive positions on their tax returns, claiming damages of this nature as tax-free.

Taxpayers routinely argue in U.S. Tax Court that their damages are sufficiently physical to be tax-free. These lines are not clear and the IRS usually wins. See [Symptoms of Emotional Distress vs. Sickness: Sheep From Goats](#).

**Beware Attorney Fees!** If you have a contingent fee lawyer, you’ll usually be treated as receiving 100% of the recovery even if the defendant pays your lawyer’s fee directly. If your case is fully nontaxable (say an auto accident in which you’re injured), that won’t cause any tax problems. But if your recovery is taxable, beware. See [10 Things To Know About Taxes On Damages](#).

**Example:** You settle a suit for intentional infliction of emotional distress against your neighbor for \$100,000. Your lawyer keeps \$40,000. You might think you’d have \$60,000 of income. Instead, you’ll have \$100,000 of income, followed by a \$40,000 miscellaneous itemized deduction. You’ll be subject to numerous limitations, including the alternative minimum tax (AMT) that can whittle your deduction down to nothing.

That’s why many clients say they are paying tax on lawyer’s fees they never received. See [Attorney Fee Deduction Problems Remain](#). With high legal fees and costs and the AMT, some clients actually **lose** money after tax by winning a lawsuit. See [Spina v. Forest Preserve Dist. of Cook County](#). There are some routes out of this mess, but get some professional help and be careful.

If she recovers, Stone’s maid is likely to face at least some of these issues.

For more, see:

[AMT Problems For Attorney Fees Remain](#)

[10 Things To Know About Taxes On Damages](#)

[Baldwin v. Costner Suit May Come Down To Taxes](#)

[Acquitting John Edwards, \\$2M; Deducting His Legal Fees, Priceless](#)

[IRS Wants \\$5 Million From Singer R. Kelly](#)

[Dionne Warwick Proves IRS Tax Liens Can Be Wrong](#)

[Crocodile Tears For Paul Hogan Tax Travails](#)

[Kan Kim Kardashian Deduct Her Kampaign Expenses?](#)

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