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Avoid General Releases Without Tax Language

by Robert W. Wood

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In this article, Wood examines court cases in which settlement agreement wording was vital, suggesting that an express statement in a settlement agreement about why the money is being paid can be essential in achieving a desired tax result.

This discussion is not intended as legal advice.

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As a tax lawyer, when I use the term "general release," I refer to that most plain vanilla of settlement documents terminating litigation. In appropriate legal verbiage, it may simply say that the plaintiff is accepting payment of money from the defendant in exchange for the plaintiff's release of "any and all claims." A general release may recite the nature of some of the plaintiff's claims, but it is predictably broad.

It will usually say something about the release extending to "any and all claims, known and unknown, whether asserted or not." Most critically from my point of view, I consider a "general release" to say nothing about taxes, with one possible exception: It might say that any taxes on the settlement monies are solely the responsibility of the plaintiff. I don't view "taxes are on the plaintiff" as relevant to this discussion since I still view the release as a general one.

Fortunately, I often see agreements before they are signed, when there may still be a chance to remedy the tax silence. If there is a chance to draft helpful tax language in the release before signing, one should take advantage of it. It should not be a tough sell to convince the parties — especially plaintiffs — that they are better off with explicit tax language.

Of course, tax provisions can breed disagreements, but they can usually be worked out. It often surprises plaintiffs and lawyers how important a few words in the settlement agreement can be for tax purposes. A general release misses a fundamental opportunity for influencing how something is taxed.

One of the key indicators of how damages are taxed is the intent of the payer.[1] How does one determine the intent of a payer? An express statement in a settlement agreement addressing why the money is being paid can go a long way toward achieving a desired tax result — although tax language plainly cannot guarantee a particular tax treatment.

Payment Intent Language

Unquestionably, tax provisions matter. Conversely, a general release that says nothing invites — if not outright screams for — IRS scrutiny. For example, consider the Fifth Circuit decision in *Espinoza*.[2] This case involved the treatment of a settlement payment made under a general release. The settlement payment arose from an employment-related lawsuit.

Isidra Elizabeth Espinoza claimed that the settlement monies she received, a $50,000 payment, should be excluded from her income under section 104 on account of her physical injuries and physical sickness. Predictably, the IRS

[1] *See United States v. Burke*, 504 U.S. 229, 237 (1992); *United States v. Gilmore*, 372 U.S. 39 (1963).

[2] *Espinoza v. Commissioner*, 636 F.3d 747 (5th Cir. 2011).

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disagreed, and the Tax Court upheld the IRS.[3] The Tax Court found that Espinoza had not met her burden of proof showing that her payment wasn't income.

Her underlying lawsuit was over discrimination based on gender, religion, and national origin, as well as retaliation for her complaints. Espinoza sought damages for back pay, mental pain and anguish, and intentional infliction of emotional distress. Espinoza's spouse calculated her medical bills for her physical and psychological ailments that had been caused or exacerbated by the discrimination. In all, they totaled $50,000.

Based on this figure, Espinoza's husband approached his wife's lawyer, and they worked out a proposed settlement for $50,000. With this settlement in the offing, Espinoza's lawyer assured them the $50,000 would not be taxed. This advice turned out to be incorrect. A settlement agreement was prepared and signed, and the defendant paid the money.

The settlement agreement and release included no tax language or characterization of the payment, other than general "buying peace" language. Espinoza received her $50,000 and a Form 1099-MISC reporting the payment. Espinoza's husband (again) interacted with their accountant, explaining that the $50,000 payment was for medical expenses.

As a result, the accountant, too, said the money was tax free. It is unclear from the Fifth Circuit opinion whether the accountant was aware Espinoza had received a Form 1099. In any event, the accountant prepared the return excluding the payment and filed it. The IRS assessed a deficiency, and the matter wound up in the Tax Court.

Unsurprisingly, the Tax Court upheld the IRS. It ruled that Espinoza had failed to present objective and credible evidence that the proceeds were for medical expenses. The court found that several claims were alleged during the dispute and the settlement money was not allocated among them. Many of her claims were not for physical injuries or physical sickness. However, the Tax Court at least removed the penalties the IRS had assessed.

Appealing Case

On appeal, this became a more interesting case. The appellate court reviewed the Tax Court's findings of fact for clear error. It treated the Tax Court's finding that Espinoza had failed to establish that the settlement proceeds were allocable to physical injuries or physical sickness as a finding of fact.

Commencing with the origin of the claim doctrine, the court looked first at the language of the settlement agreement. Of course, this was a general release, saying little. The law is clear that the IRS and the courts may look behind a settlement agreement for other evidence of the reasons for a payment.[4] Interestingly, the court suggested that those queries should occur only when the settlement agreement is devoid of specific language.[5]

If that were true, it would be yet another reason to avoid general releases. In reality, courts can examine the underlying facts and allegations to consider the reasonableness of a taxpayer's claimed position even when there is specific allocation language. Yet it is certainly true that the need for examining other documents is more patent with a general release. Indeed, that is one of the most important lessons of *Espinoza*. There would likely have been no tax case at all had the settlement agreement been clear on the tax point.[6]

I frequently see settlement agreements that are specific enough to pass muster on audit or at IRS Appeals. No one wants to be audited, or even to get a letter or notice from the IRS asking about a legal settlement they received. Some tax audits about legal settlements start with a long list of the documents requested, such as the demand letter, complaint, settlement agreement, discovery documents, medical records, and so on.

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[3] *Espinoza v. Commissioner*, T.C. Memo. 2010-53 (2010).

[4] *See Bagley v. Commissioner*, 121 F.3d 393 (8th Cir. 1997).

[5] Citing *Green v. Commissioner*, 507 F.3d 857, 867 (5th Cir. 2007).

[6] *See, e.g.*, *NCA Argyle LP v. Commissioner*, T.C. Memo. 2020-56 (an express allocation to a tax-favorable claim was "respected" by the Tax Court because the settlement payment was made "by adversarial parties negotiating at arm's length" and because the amount of the express allocation "was within the reasonable range" of the value of that claim).

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However, in a surprising number of cases, the first document the IRS asks for is the settlement agreement. If the settlement agreement says what specific claims the payments are for, and ideally even how they are to be taxed, the IRS may say "thank you," and conclude the audit. It can sometimes even seem that the IRS is pleased to find that someone took the time to set forth the nature of the payment in the documents.

But this is not always the case. The IRS (and later the courts) always have the right to look behind the settlement agreement to make their own determinations about what the case was about and if the tax issues line up. But you might be surprised at how frequently a settlement agreement alone that is clear about taxes does the trick. As messy as it can be to look behind settlement agreements at everything else, perhaps the IRS may breathe a sigh of relief that a more detailed investigation is not necessary.

Providing the Reason for a Payment

The Fifth Circuit agreed with the Tax Court that Espinoza had failed to prove her monies were paid on account of physical injuries or sickness. The general release clearly didn't say this. The causes of action in the complaint were not helpful either. Espinoza's claims were for discrimination and retaliation. Her prayer for relief had requested actual damages and back pay, citing mental pain and anguish, and emotional distress, both compensatory and exemplary.

These claims did not help Espinoza establish that the payment was on account of her physical injuries, sickness, or medical expenses. In this list, the only payments that might be covered by the section 104 exclusion were the payments for medical treatments for the physical manifestations of emotional distress, mental pain, or anguish. Yet once again alluding to the general release, the Fifth Circuit said that nothing in the release suggested this was intended (in whole or in part) as a payment for her medical expenses.

With no language in the release averring medical costs, Espinoza had the burden of presenting other evidence to establish that the payment was intended in lieu of damages for the costs of medical care and treatment. Espinoza presented evidence that she and her husband considered the $50,000 as a reimbursement for her medical expenses. Indeed, the Fifth Circuit acknowledged that Espinoza had been ill and had received medical treatment for a panoply of serious medical problems: enlarged lymph nodes, cirrhosis of the liver, hyperthyroidism, depression, and post-traumatic stress disorder.

Not only that, but these treatments spanned the time during and after her employment. Espinoza attributed these significant medical problems to the harassment and retaliation she suffered. Her husband testified that they both regarded the $50,000 as payment for the medical costs. All of that sounded good. The Fifth Circuit even agreed that this testimony was probative of the payer's intent.

But the court found that it was insufficient to prove that it was the defendant-payer's intent. The court noted that the only evidence Espinoza presented regarding the payer's intent was (1) an authorization to release her medical records to the payer from 1998; (2) a certification of illness or injury submitted in 1997; and (3) a doctor's supplemental statement on accident or sickness from 1999 discussing Espinoza's psychological and physical impairments that developed in response to the allegedly hostile work environment.

The court said this was helpful to show that the payer was aware of her medical conditions and that she was receiving medical treatments. Yet it was not enough to show that the payer decided to pay all or any portion of the $50,000 settlement to reimburse her for the medical costs. The intended payment could just as easily have been to reimburse Espinoza for costs associated with her multiple other claims. In the end, the Fifth Circuit upheld the Tax Court, ruling that no portion of the $50,000 settlement could be excluded for personal physical injuries or physical sickness.

Painful Lessons

Very few cases go to trial and judgment. Most cases are settled, and even cases that go to verdict often settle on appeal. I stress these obvious facts because it should be clear that there is rarely a final court order that says exactly what a payment is for. Put differently, what will the IRS be able to examine to determine the genesis of a payment?

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The settlement agreement is the most logical place to look.[7] Mediation briefs, pleadings, depositions, and expert reports can also be relevant. Sometimes there is more arcane evidence. For example, in *Madson*,[8] the Tax Court noted that while there was no helpful settlement agreement language and no complaint, there was a "bodily injury" reference noted on the memo line of the check. That was pretty thin evidence, and it was not enough to make the payment excludable under section 104, but it was at least noted.

As *Espinoza* reveals, courts often seem to lament that there is nothing in the settlement agreement language to show the intended treatment of the payment.[9] Language saying "this payment is paid on account of alleged personal physical injuries" may be self-serving. Negating the issuance of a Form 1099 is also important. Adding that the payment "is excludable under section 104 of the Internal Revenue Code" helps if you can get it. Defendants may reject language suggesting that they made a legal conclusion or are providing tax advice to a plaintiff.

Plainly, a defendant may have a more amorphous and multifaceted intent, and many cases have multiple elements. There are often significant wage and withholding issues in employment disputes, but they are usually solved with an allocation to wages that the IRS generally seems reluctant to disturb.[10] Physical injury language can often be massaged so the defendant is comfortable. The defendant may care primarily about having the case resolved and being able to deduct the payment.

If the lawsuit is connected to the defendant's business, particularly if the dispute does not involve claims involving capital assets owned by the plaintiff, the defendant's deduction should be noncontroversial. However, special tax rules apply if the case is for sexual abuse or sexual harassment and the plaintiff has agreed to a confidentiality provision. The so-called Harvey Weinstein provision took effect in 2018 with the addition of new section 162(q):

> (q) PAYMENTS RELATED TO SEXUAL HARASSMENT AND SEXUAL ABUSE. — No deduction shall be allowed under this chapter for — (1) any settlement or payment related to sexual harassment or sexual abuse if such settlement or payment is subject to a nondisclosure agreement, or (2) attorney's fees related to such a settlement or payment.

It is unclear how effective the provision has been. Some defendants expressly allocate a modest payment to the sexual harassment or abuse claims, arguing the rest is deductible.[11] Others use a separate agreement about confidentiality so they can argue that the settlement agreement itself does not include it. How the IRS would react to this is unclear.

Settlement Wording Matters

There are many tax cases in which settlement language turns out to be critical. In *Collins*,[12] Edward Collins alleged that he had "suffered severe emotional distress and anxiety, with physical manifestations, including high blood pressure." The case settled for $275,000, with $85,000 for emotional distress. Collins claimed it had been paid because of his physical sickness, but the court said:

> While there may be some ambiguity as to what the parties to the term sheet intended to encompass within the meaning of the term "emotional distress", petitioner has failed to persuade us that the physical manifestations, including high blood pressure, that he may have suffered amount to physical injuries or physical sickness within the meaning of section 104(a).

The complaint and settlement agreement both referred to the damages as being for emotional distress. His emotional distress may have had

[7] *Knuckles v. Commissioner*, 349 F.2d 610, 613 (10th Cir. 1965), *aff'g* T.C. Memo. 1964-33.

[8] *Madson v. Commissioner*, T.C. Memo. 1985-3 (1985), later proceeding, T.C. Memo. 1988-325 (1988).

[9] *See Allum v. Commissioner*, T.C. Memo. 2005-177, *aff'd*, 231 Fed. Appx. 550 (9th Cir. 2007).

[10] *Rivera v. Baker West Inc.*, 430 F.3d 1253 (9th Cir. 2005).

[11] Robert W. Wood, "(Still) Writing Off Confidential Sexual Harassment Settlements?" *Tax Notes Federal*, Feb. 24, 2020, p. 1301.

[12] *Collins v. Commissioner*, T.C. Summ. Op. 2017-74.

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physical symptoms or consequences, but the emotional distress came first. It might have been different if the settlement language said otherwise. In fact, consider the practical side: Good settlement wording may have given Collins a tax return filing position. Indeed, it might have also been enough to survive an audit.

Worse Than Neutral Wording

I try to avoid settlement agreements that say nothing about taxes. A generic settlement agreement misses a wonderful opportunity to try to shape and optimize the tax result. Besides, addressing the tax issues in the settlement agreement also helps to avoid unpleasant tax reporting surprises when unexpected Forms 1099 arrive early in the year following the settlement.

However, even worse than saying nothing about taxes would be a settlement agreement that is affirmatively hurtful about taxes. A good example is *Blum*.[13] Debra Jean Blum received a $125,000 settlement from a lawyer who botched her personal physical injury suit. Had she recovered in the original injury suit, that money would clearly have been tax free.

Instead, she sued her lawyer for flubbing the suit and received a Form 1099 for her legal malpractice settlement. She did not report it on her tax return, was audited, and went to Tax Court. The mess started when Blum was in the hospital for a knee replacement. While there, she was injured in a wheelchair accident.

She hired a lawyer and sued the hospital for negligence, but her case was dismissed. When she sued her lawyers for malpractice, she was trying to get the money that she would have collected in her hospital negligence case. There was a pretty good tax argument that she was only collecting money from her lawyer that would have been tax free from the defendant if not for the lawyer's negligence, so this money should not be taxed.

However, the settlement agreement said it was only for alleged legal malpractice, and explicitly was not for any personal physical injuries. In short, it did the exact opposite of what would have been helpful tax language. As a result, even though she was physically injured and was seeking compensation for her physical injury, her legal malpractice settlement was taxed.

Settlement agreement wording is important. I would argue that it is essential if you want to avoid trouble. It does not bind the IRS or the government, but it can still go a long way. Perhaps the judge in *Blum* felt hamstrung by a settlement agreement with very firm language saying that the recovery was not for personal physical injuries. In the end, I think the extraordinarily bad settlement agreement was fatal to her tax position.

Conclusion

Missed opportunities are always lamentable. That is true with settlement agreement wording that can spell the difference between a good tax result and a bad one. *Espinoza* is one of many cases in which the courts uphold the IRS in applying a narrow and unforgiving reading of the scope of section 104.[14] Indeed, Espinoza was not even able to get her reimbursed medical expenses excluded from her income. Whenever possible, try to include specific and helpful tax language in settlement agreements. ■

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[13] *Blum v. Commissioner*, T.C. Memo. 2021-18.

[14] *See* Robert W. Wood, "Tax-Free Physical Sickness Recoveries in 2010 and Beyond," *Tax Notes*, Aug. 23, 2010, p. 883.

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