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How IRS Taxes Legal Settlements And Legal Fees Surprises Plaintiffs



The tax treatment of litigation damages is varied and complex. Even worse, in some cases, [legal fees can't be deducted](#). That can mean paying tax on 100%, even if 40% off the top goes to your lawyer, unless you qualify for one of the [ways to deduct legal fees under new tax law](#). The rule for compensatory

damages for personal physical injuries, like a serious auto accident, is supposed to be easy. There, the compensatory damages should be tax free under [Section 104 of the tax code](#).

In employment cases, damages are usually taxable, and usually at least partially as wages. Nearly every employment case has a wage component. In most employment settlements, employer and employee agree on a wage figure subject to withholding, and the balance goes on a Form 1099. Sometimes, there can be a tax-free portion too. Exactly what is "physical" isn't so clear, and some of it seems like semantics. If you make claims for emotional distress, your damages are taxable.

Some of the line-drawing comes from a footnote in the legislative history to the tax code adding the 'physical' requirement. It says "emotional distress" includes physical symptoms, such as insomnia, headaches, and stomach disorders, which may result from such emotional distress. See [H. Conf. Rept. 104-737](#), at 301 n. 56 (1996). All compensatory damages flowing from a physical injury or physical sickness are excludable from income.

Even in employment cases, some plaintiffs win on the tax front. For example, in [Domeny v. Commissioner](#), Ms. Domeny suffered from multiple sclerosis ("MS"). Her MS got worse because of workplace problems, including an embezzling employer. As her symptoms worsened, her physician determined that she was too ill to work. Her employer terminated her, causing another spike in her MS symptoms. She settled her employment case and claimed some of the money as tax free. The IRS disagreed, but Ms. Domeny won in Tax Court. Her health and physical condition clearly worsened because of her employer's actions, so portions of her settlement were tax free.

In [*Parkinson v. Commissioner*](#), a man suffered a heart attack while at work. He reduced his hours, took medical leave, and never returned. He filed suit under the Americans with Disabilities Act (“ADA”), claiming that his employer failed to accommodate his severe coronary artery disease. He lost his ADA suit, but then sued in state court for intentional infliction and invasion of privacy.

His complaint alleged that the employer’s misconduct caused him to suffer a disabling heart attack at work, rendering him unable to work. He settled and claimed that one payment was tax free. When the IRS disagreed, he went to Tax Court. He argued the payment was for physical injuries and physical sickness brought on by extreme emotional distress. The IRS said that it was just a taxable emotional distress recovery. But the court said intentional infliction of emotional distress can result in bodily harm.

In the end, Parkinson beat the IRS. Damages for physical symptoms of emotional distress (headaches, insomnia, and stomachaches) might be taxable, yet physical symptoms of emotional distress have a limit. For example, ulcers, shingles, aneurysms, and strokes may all be an outgrowth of stress. It seems difficult to regard them all as ‘mere symptoms of emotional distress.’ Extreme emotional distress can produce a heart attack, which is not a symptom of emotional distress. The Tax Court in *Parkinson* agreed.

To prove physical sickness, the taxpayer should have evidence of medical care, and evidence that he actually claimed the defendant caused or exacerbated his condition. Whenever possible, settlement agreements should be specific about taxes. Tax language in a settlement agreement does not bind the IRS. Even so, you might be surprised at how often the IRS pays attention in an audit if you can hand them a settlement agreement that says something explicit about taxes. It can sometimes be enough to make them walk away.

Of course, the IRS is likely to view everything as income unless you can prove otherwise. But there's another reason to be explicit, so each client knows that to expect. That is, try to be explicit in the settlement agreement about tax forms too. If you are the plaintiff, you do not want to be surprised by [IRS Forms W-2](#) and [1099](#) that arrive unexpectedly around January 31st the year after you settle your case. That can ruin your day, and maybe even your tax return.

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