

# PTSD Can Reduce Settlement Tax - But Not Always

By Robert W. Wood

Allegations that a defendant caused a plaintiff to develop post-traumatic stress disorder arise in employment cases, fire loss and other disasters, assorted personal injury claims, sexual harassment and abuse, defamation, etc. In some cases, the plaintiff claims not that the defendant caused PTSD, but rather that the defendant *exacerbated* pre-existing PTSD. In any of these contexts, is an award for PTSD taxable, or is it tax free as damages for personal physical injuries or physical sickness?

The tax law distinguishes between physical injuries and physical sickness and emotional distress. Damages for physical injuries or physical sickness can be excluded under Section 104 of the tax code, while emotional distress is generally taxable. Yet even emotional distress can be excludable if the emotional distress emanates from physical injuries or physical sickness. There is considerable awkward line-drawing, so tax disputes between taxpayers and the IRS (and between plaintiffs and defendants) are common.

Still, the Tax Court has upheld an exclusion where settlement monies are attributable to the exacerbation of a pre-existing physical condition. In one case, the Tax Court concluded that a portion of the plaintiff's settlement payment was excludable because it was attributable to damages flowing from a cardiac event attributable to emotional distress from an alleged employment-related tort, even though the plaintiff previously had the underlying heart condition. See *Parkinson v. Comm'r*, T.C. Memo. 2010-142. In another case, the Tax Court concluded that settlement monies from the employer were excludable because "exposure to a hostile and stressful work environment exacerbated her MS symptoms to a point where she was unable to work." See *Domeny v. Comm'r*, T.C. Memo. 2010-9 (holding that a recovery for the exacerbation of a taxpayer's multiple sclerosis by stress is a tax-free recovery for the exacerbation of a physical injury or physical sickness).

Where does PTSD fall on the physical or emotional spectrum? PTSD can be caused or exacerbated by stress, but so can heart attacks and diseases, which are physical even when they are caused or worsened by stress. Cancer, lupus, multiple sclerosis, and many other diseases may also not be apparent, but those conditions are physical and can qualify for exclusion. PTSD can also be seen with medical equipment. See Justin Berton, "PTSD Leaves Physical Footprints on the Brain," S.F. Chron. (July 27, 2008), available at <http://www.sfgate.com/health/article/PTSD-leaves-physical-footprints-on-the-brain-3275618.php>. There is a growing medical consensus that PTSD alters the taxpayer's brain physiology, and in a judgment or settlement, that ought to be sufficient to classify it as a physical injury or physical sickness.

In settlement agreements, it is becoming common for defendants to agree that PTSD is physical injury or sickness for tax purposes. But there appears to be no published tax case that expressly states that PTSD damages qualify for exclusion. The recent case of *Estate of Roman J. Finnegan, Deceased, Kevin C. Tankersley, Personal Representative, and Lynnette Finnegan, et al. v. Commissioner of Internal Revenue*, T.C. Memo 2024-42 (Apr. 10, 2024), might at first seem to address this.

Like many other tax cases that the Tax Court is regularly asked to decide, this one primarily regards the character of the underlying litigation, the nature of the damages that were requested, what the defendant was ultimately paying for when the case settled, and how those damages should be treated under the tax law, in tax parlance, the "origin of the claim."

In *Estate of Finnegan*, the Tax Court considered whether Section 104 shielded a \$25M settlement from income and held that it did not. However, by reaching its conclusion under the origin of the claim analysis, the Tax Court avoided addressing the physical or emotional classification of PTSD. In fact, this case serves as a reminder of what taxpayers need to show for an exclusion.

The status of PTSD was ultimately not addressed in the Tax Court's decision. The taxpayer was instead hamstrung by the more basic issues of how the litigation claims were framed, the origin of the claims that were litigated, and how the settlement agreement was written. All those points went in favor of the IRS, whether the Finnegans had PTSD or not.

## Bad Facts?

*Estate of Finnegan* arose from the death of a child at age 14. Mrs. Finnegan was the child's mother, and Mr. Finnegan, now deceased, was the child's stepfather. Mrs. Finnegan also had three other children, also taxpayers in the tax dispute, who were being raised in the Finnegan household. The state was not alleged to be responsible for the child's death so the child's death did not play into the Section 104(a)(2) exclusion issue.

The Finnegans were accused of neglecting and abusing the child, and criminal charges were filed against them. Two of their other children were removed from their home and put in foster care. The criminal charges were eventually dismissed, and the children were returned to the Finnegans, but the family sued state employees for violating their civil rights by removing the children and bringing criminal charges. If their goal was to support a PTSD allocation and exclusion, the Finnegans' missteps began early.

Their First Amended Complaint listed civil rights violations, but it did not allege any damages for PTSD or reference that any of the parties had or had been diagnosed with PTSD. Nor did the Finnegans reference having PTSD in their response to the defendants' motion to dismiss the First Amended Complaint. PTSD was referenced in only one of the family members' interrogatories and depositions.

The case went to trial, but without any emphasis on alleged physical injuries or physical sickness. The *voir dire* questions concerned alleged violations of the plaintiffs' civil rights under the First, Fourth, and Fourteenth Amendments and informed potential jurors that they "may be asked to award compensation for mental and emotional suffering." The plaintiffs' preliminary statement and the district court judge's summary of the issues likewise frame the case as centering on whether the defendants violated the plaintiffs' civil rights.

Even the plaintiffs' counsel at trial described their case as asserting civil rights claims. Of 31 jury instructions, *not one* mentioned PTSD or any physical injury or physical

sickness. The jury awarded the plaintiffs compensatory damages totaling \$31.5 million, with amounts specifically awarded for violations of each plaintiff's constitutional rights. The jury verdict did not mention PTSD or physical injury or physical sickness.

Only Roman (the stepfather) had a known PTSD diagnosis at the time of the district court litigation and execution of the Settlement Agreement. Across 14 witnesses' testimonies, Roman's PTSD was referenced only once. Punitive damages were requested but not awarded. The Tax Court's analysis paints a weak picture for PTSD being a significant component of the claims alleged.

#### Appeal

The case was appealed to the Seventh Circuit and settled for \$25 million in 2017 before the Seventh Circuit reached a decision. The Settlement Agreement did not reference PTSD or physical injuries, except in the broad release language that generally released every possible claim that could have been alleged. Of the \$25 million settlement, Roman (the stepfather) received \$3,563,351.24; Lynnette (the mother) received \$3,147,830.24; and the three living siblings, Tabitha, Katelynn, and Johnathon, received amounts ranging from \$1,613,205.08 to \$2,074,956.35, all figures being net of legal fees and expenses.

None of the five plaintiffs reported *any* of their settlement as income, and when an IRS audit commenced, it did not start off well. The Finnegan's responded to the IRS that the violation of constitutional rights under the First, Fourth, and Fourteenth Amendments should be considered a *personal* injury. Of course, Section 104(a)(2) requires personal *physical* injuries or *physical* sickness for an exclusion, so their argument fell flat.

Then, about a year after the IRS audit commenced, the Finnegan's said the settlement was to compensate them for their PTSD, which they said is a *physical* injury or *physical* sickness under Section 104(a)(2). This was too little too late and did not fit the facts. It was clear based on the litigation documents and the Finnegan's medical histories that only one of them was diagnosed with PTSD before the 2017 settlement. How could the defendants be compensating the other four for a physical condition with which they had never been diagnosed and which had never alleged prior to settlement?

The Finnegan's solution was to commission an expert report by a doctor over a year into the tax audit that diagnosed *each* family member with PTSD. It concluded that "[t]he traumatic events experienced by the family meet the criteria of [Criterion] A of the DSM-5 criteria for PTSD of a threat to life or self-integrity." This later evidence did not convince the IRS, and eventually the matter wound up in Tax Court. The Tax Court examined the nature of the claims that led to the settlement, finding that the lawsuit primarily addressed violations of civil rights, not personal physical injuries or physical sickness.

The Settlement Agreement and related documents *did not specify* that the damages were awarded for physical injuries or sickness, but rather for the alleged violation of constitutional rights. For damages to be excludable, the court said, there must be a direct causal link between the legal action and the physical injury or sickness. This case was all about the alleged infringement of civil rights, so the recovery was taxable.

#### Damages for PTSD

Regarding whether damages for PTSD are excludable, the Tax Court noted in footnote that "we need not answer whether PTSD is, in fact, a physical injury or physical sickness." *Finnegan* at \*34, n.5. If *Finnegan* tells us anything, it is that the documentation matters. The litigation documents—complaint, verdict, discovery, etc.—are highly relevant. The Finnegan's settled post-verdict, and a case settling at that stage is always harder from a tax viewpoint unless good characterization language and favorable allocations are present in the verdict and settlement documents. Whether before or after a verdict, settlement agreement wording is key.

As to the substantive question of whether PTSD is more like a broken leg than mere emotional distress, there are strong arguments. Recognizing PTSD as a physical injury for purposes of Section 104 would mean that *emotional* distress damages *arising from* PTSD would also be tax-free. For a more complete discussion of the PTSD issue, see Robert W. Wood, "President Obama and PTSD," Vol. 154, No. 10, Tax Notes (March 6, 2017), p. 1297.

#### Conclusion

PTSD shares key characteristics with other medical conditions that clearly qualify as physical sickness for the Section 104 exclusion. With many maladies, the harm occurs inside the body and may not be visible to the untrained eye. Heart disease, cancer, COVID, stroke, chronic lower respiratory disease, Alzheimer's disease, diabetes, nephritis, and liver disease, represented *nine* out of the ten leading causes of death in the United States in 2022.

According to the CDC's National Center for Health Statistics, they accounted for every one of the ten leading causes of death *except* unintentional injury, and no one would doubt that they are physical injuries or physical sickness. The scientific and medical community verifies that PTSD is observably physical, and that should be sufficient for PTSD to be treated as physical for tax purposes, provided that the defendant is paying for those claims.

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