

Settlement Agreements Without Tax Language Ask For Trouble

By Robert W. Wood

Almost every settlement includes a full release of claims, with the plaintiff compensated for relinquishing all rights. A release may recite some of the plaintiff's claims, but it is predictably broad. It might say any taxes on the settlement are solely the plaintiff's responsibility, but should it say more?

If there is a chance to add tax language to the release before signing, take advantage of it. It should not be a tough sell to convince the parties—especially plaintiffs—that they are better off. Tax disagreements can usually be worked out, and a few words can matter and help with taxes later.

Conversely, a release that says nothing can invite IRS scrutiny. Consider *Isidra Elizabeth Espinoza v. Commissioner*, 636 F.3d 747 (5th Cir. 2011). This tax case involved the treatment of a settlement payment made under a general release. The settlement arose out of an employment-related lawsuit, but there was good background evidence the payment was for medical expense reimbursement.

Ms. Espinoza claimed it should be excluded from her income under Section 104 on account of her physical injuries and physical sickness. The IRS disagreed, and the Tax Court upheld the IRS, finding that she had not met her burden of showing that her payment wasn't income. *Espinoza v. Commissioner*, T.C. Memo 2010-53 (2010). Her underlying lawsuit was over discrimination and retaliation, but when the parties totaled her medical bills, they totaled \$50,000.

And that was the amount of the entire payment. She had other claims, but the deal was for medical expenses, right? She and her lawyer "knew" it would not be taxed. Unfortunately, the settlement agreement was silent. Then—as most defendants do routinely unless the settlement agreement expressly says otherwise—the defendant issued her a Form 1099.

Her accountant, too, said the money was tax free, but the IRS disagreed, and the matter wound up in Tax Court. It ruled that Espinoza had failed to present objective and credible evidence that the proceeds were for medical expenses. After all, the settlement agreement covered everything. The court removed the IRS penalties, but the tax bill remained.

Appealing 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 for physical injuries or physical sickness as a finding of fact. The court looked first at the general release. The Fifth Circuit agreed that Mrs. Espinoza had failed to prove her monies were paid for medical expenses.

Her settlement agreement didn't say this was meant as a payment of her medical expenses. The court acknowledged that she had been ill and had received medical treatment for serious medical problems: enlarged lymph nodes, cirrhosis of the liver, hyperthyroidism, depression and

post-traumatic stress disorder. And these treatments spanned the time during and after her employment.

But none of this was enough to carry her burden of showing that the defendant paid the \$50,000 to reimburse her for her medical expenses. There would probably have never been a tax case if the settlement agreement had been clear on the tax point. *See, e.g., NCA Argyle LP v. Comm'r*, T.C. Memo. 2020-56. No one wants to be audited, or even to get a letter or notice from the IRS asking about a legal settlement they received. A few tax audits start with a long list of documents requested, such as the demand letter, complaint, settlement agreement, discovery documents, medical records.

But often, the first document the IRS asks for in an audit is the settlement agreement itself. If the settlement agreement says what specific claims the payments are for and ideally how they should be taxed, the IRS may say thank you, and conclude the audit. The IRS and the state have the right to look behind the settlement agreement for what the case was about, but you might be surprised at how frequently a settlement agreement alone does the trick.

Painful Lessons

Most cases are settled, and even cases that go to verdict often settle on appeal. There is rarely a final court order that says what a payment is for. So how does the IRS determine the genesis of a payment? The settlement agreement is the most logical place to look. *Knuckles v. Commissioner*, 349 F.2d 610, 613 (10th Cir. 1965), *aff'd* T.C. Memo. 1964-33.

Mediation briefs, pleadings, depositions and expert reports can be relevant, and sometimes there is more arcane evidence. In *Madson v. Commissioner*, there was no helpful settlement agreement language and no complaint, but there was a "bodily injury" reference on the memo line of the check. T.C. Memo 1985-3 (1985), later proceeding, T.C. Memo 1988-325 (1988). That was not enough to make the payment excludable under section 104.

Courts in tax cases often lament settlement agreements that are silent. *See Allum v. Commissioner*, T.C. Memo. 2005-177, *aff'd*, 231 Fed. Appx. 550 (9th Cir. 2007). Language that "this payment is paid on account of alleged personal physical injuries" may be self-serving, but it can sure help. Negating the issuance of a Form 1099 does too, if you can get it. Of course, many cases have multiple elements. In employment cases, there are wage and withholding issues which can be solved with allocations that the IRS generally is reluctant to disturb. *Rivera v. Bake West Inc.*, 430 F.3d 1253 (9th Cir. 2005).

With physical injury language, the language can often be massaged so the defendant is comfortable. Many defendants care primarily about resolving the case, being able to deduct the payment, and not being on the hook for any tax flubs the plaintiff makes. If the suit is connected to the defendant's business, a tax deduction should be non-controversial.

However, if the case is for sexual abuse or sexual harassment and includes a confidentiality provision, section 162(q) of the tax code says that both the settlement payment *and* the legal fees the defendant paid to defend the case *cannot* be deducted. Some defendants allocate a modest payment to the sexual harassment or abuse claims, and argue the rest is deductible. Others use a separate agreement about confidentiality to argue the settlement agreement itself does not include it. How the IRS would react is unclear.

Settlement Wording Matters

Settlement language turns out to be critical in many tax cases. In *Collins v. Commissioner*, Mr. Collins alleged that he had "suffered severe emotional distress and anxiety, with physical manifestations, including high blood pressure." T.C. Summary Opinion 2017-74. The case settled for \$275,000, with \$85,000 for emotional distress. Mr. Collins claimed it had been paid because of his physical sickness, but the court said no. It might have been different if the settlement language said otherwise.

A generic settlement agreement misses a wonderful opportunity to try to shape the tax result. Addressing the tax issues also helps avoid tax reporting surprises when unexpected Forms 1099 arrive early the year after the settlement. However, even worse than saying nothing about taxes is a settlement agreement that is affirmatively *hurtful* about taxes. A good example is *Blum v. Commissioner*. T.C. Memo. 2021-18.

Debra 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. She received an IRS Form 1099 for her settlement, did not report it, and wound up in Tax Court.

There was a good tax argument that she was only collecting money from her lawyer that would have been tax free. 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 essentially seeking compensation for her physical injury, her legal malpractice settlement was taxed.

Conclusion

Settlement agreement wording is important and can be essential if you want to avoid tax trouble. It does not bind the IRS or the state, but it still goes a long way. Missed opportunities are lamentable, and that is true with wording that can spell the difference between a good and bad tax result. Whenever possible, try to include specific and helpful tax language in settlement agreements.

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