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**The magnitude of the Internal Revenue Service's (IRS's) ability to tax is far-reaching and targets "income from whatever source derived unless otherwise excluded by the Internal Revenue Code."[1] Significantly, one such exclusion from income is provided by the Internal Revenue Code (IRC) §104(a) in the context of the treatment of proceeds resulting from lawsuits and settlements. However, this exclusion is specifically limited to excluding only those damages which are paid out on account of a judgment or settlement derived from physical injuries or sickness. Thus, it is not difficult to understand that drafting tax-savvy settlement agreements is key to achieving the intended allocation of proceeds.**

# Tax-Savvy Drafting of Settlement Agreements Can Save You Money

By Mary Lundstedt, Esq. & Justin Liberatore

Recently, in *Beckett v. Commissioner*, the Tax Court ruled that a portion of an amount paid to Taxpayer pursuant to a settlement agreement resulting from an employment discrimination lawsuit was excludible from income (i.e., not taxable) because the settlement agreement clearly indicated that a portion was due to physical injury.[2] The case is an important reminder that even when the nature of a lawsuit itself (here, employment discrimination) would generally result in taxable proceeds, where the origin of the claim also has a physical component involving physical injuries or sickness, the clear language of a settlement agreement can direct which proceeds are actually payment due to physical injury—i.e., not taxable. In this case, the Tax Court determined that the plain language of the settlement agreement indicated that one-third of the settlement was for personal physical injury/sickness—satisfying the IRC §104(a)(2) exclusion.

## Background

In this case, Taxpayer claimed that she was wrongfully terminated in violation of the Americans with Disabilities Act of 1990 and that her employer failed to reasonably accommodate her epilepsy and the resulting complications. In April of 2015, Taxpayer settled her employment discrimination lawsuit for a total of $28,000. The Tax Court described the breakdown of the payment as described in the settlement agreement, as follows:

*"(1) $1,000, less withholding for payroll taxes, for backpay, which was reported on a Form W-2, Wage and Tax Statement, issued to petitioner; (2) $19,000 for claims of emotional distress, pain and suffering, physical distress, and damages, which was reported on a Form 1099-MISC, Miscellaneous Income, issued to petitioner; and (3) $8,000 for attorney's fees [. . .].[3]"*

The Tax Court noted that Taxpayer asked the judge presiding over the lawsuit whether the portion in the settlement agreement totally $19,000 would be taxable. The judge told

her that it would not be taxable because the lawsuit was based on her health issues. As such, Taxpayer filed her Form 1040, *U.S. Individual Income Tax Return*, for tax year 2015 and did not report the $19,000 from the settlement.[4]

The IRS subsequently issued Taxpayer a notice of deficiency contending that the $19,000 settlement proceeds were taxable. Taxpayer brought the matter to Tax Court.

## Analysis

Generally, gross income is considered to be income from any source that is not exempted by another section of the IRC.[5] However, the IRC contains a section in which damages from personal injury suits are precluded from taxation, and are not computed as a part of taxpayer's gross income.[6] While other parts of settlements are taxable, such as payments for lost wages and attorneys' fees, which are deductible as expenses on income taxes, the IRC specifically excludes damages from personal injury or sickness from qualifying as part of gross income. [7]

The Tax Court emphasized that when considering damages received from a settlement, "the nature of the claim that was the actual basis for settlement controls whether such amounts are excludable under section 104(a)(2)."[8] Noting that this is a factual inquiry, the Tax Court explained that the settlement agreement is viewed along with all of the facts and circumstances and that the "key" to this factual inquiry is the payor's intent in creating the agreement.[9]

In this case, the Tax Court noted that  Taxpayer's settlement amount of $19,000 was paid for emotional distress, pain and suffering, physical distress and damages.[10] As such, the Tax Court determined that the payment clearly qualifies as a legal settlement for damages in lieu of a legal suit or action. Thus, the Tax Court turned its focus to the answering the question as to whether any of the amount was received for physical injury or sickness.

According to the Tax Court, there must be a direct causal link between the damages received and the physical injury for such damages to be covered under the exemption in IRC §104(a)(2).[11] Allocations set forth in settlements between excluded and non-excluded damages are generally respected if they are the product of adversarial parties negotiating at arms length and in good faith. Any further allocation is done based on the intent of the payor to allocate those funds between excluded and non-excluded damages.[12]

The Tax Court clarified that damages received as the result of a wrongful termination action are not usually exempted under IRC §104(a)(2), because such damages are not usually received for physical injury or sickness. However, in this case Taxpayer's claim was based partly on her physical injuries, and the settlement agreement reflected this fact. The Tax Court reiterated that the settlement agreement clearly indicated that a portion of the settlement was paid partly for physical damages and distress. The Tax Court had no trouble concluding that the payor intended part of the monetary damages to compensate for physical injuries and distress. Moreover, there was credible testimony that Taxpayer suffered physical injures as a result of failure to receive reasonable accommodations.

While there were damages for physical distress and injuries, the settlement was not paid solely for this reason, so the Tax Court had to make the determination as to what percentage of the settlement was nontaxable. Using prior case law that was analogous to Taxpayer's claims, the Tax Court determined that when the agreement is silent as to the intention of allocation of the payments to different claims, the Tax Court would step in and use the language of the settlement in order to determine what portion, if any, is nontaxable.13 Using the settlement language, the Tax Court determined that:

*"The agreement in the instant case explicitly allocates the settlement amount among backpay, attorney's fees, and compensatory damages. [Taxpayer's] settlement agreement further identifies three bases for the $19,000 settlement payment: "emotional distress", "pain and suffering", and "physical distress and damages". We have no reason to believe that this express allocation was not the result of adversarial, arm's-length, and*

*good-faith negotiations, or that it is incongruous with the "economic realities" of [Taxpayer's] underlying claims. Accordingly, we conclude that one third of [Taxpayer's] $19,000 settlement payment is excluded from income under section 104(a)(2).*[14]"

## Conclusion

The taxation of settlement proceeds should always be forefront in the minds of the parties during the settlement process. Readers should remember that even when the nature of a lawsuit itself would generally result in taxable proceeds, if there is also a claim therein which asserts a physical component involving physical injuries or sickness, a carefully drafted settlement agreement can clearly direct which proceeds are payment due to physical injury or sickness—ultimately excluding that amount from taxation.

Our attorneys at Frost Law are particularly cognizant of tax issues in the context of settlement agreements and highly experienced in drafting language that achieves the parties' goals.

**If you need help with any tax issues, please contact our tax team at 410-862-2806 or fill out our online form.**

**Footnotes**

1. IRC §61(a).
2. *Beckett v. Commissioner*, No. 2104-18S., T.C. Summary Opinion 2020-19.
3. *Id*. at 3.
4. Taxpayer also did not report the $8,000 for attorney's fees, but the IRS conceded that while it was indeed includible income, it was also deductible from gross income under IRC §62(a)(20).
5. *Commissioner v. Glenshaw Glass Co*., 348 U.S. 426, 429-430 (1955).
6. *Perez v. Commissioner*, 144 T.C. 51, 58 (2015).
7. *Id*.
8. Beckett at 7; see also, *United States v. Burke* 504 U.S. at 236-237 (1992).
9. Beckett at 7.
10. *Id*. at 8.
11. *Id*. at 8; see also *Lindsey v. Commissioner*, 422 F.3d at 688.
12. *Id*. Aa 8; see also *Bagley v. Commissioner*, 105 T.C. 396, 406 (1995), aff'd, 121 F.3d 393 (8th Cir. 1997).
13. *Id*. at 9; see also *Domney v. Commissioner*, T.C. Memo. 2010-9 (2010).
14. *Id*. at 11.

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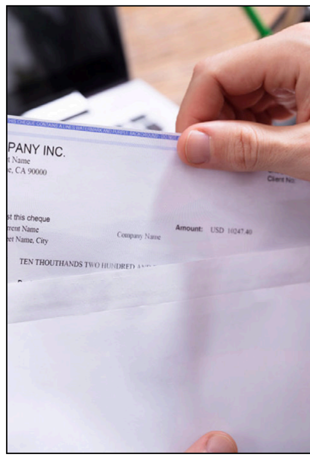


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