

Discrimination Settlements—Income Tax Considerations

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This article reviews the general rules related to taxation of discrimination settlement awards and how federal statutory changes affect negotiation and drafting of the settlement agreement.

Proper consideration of income taxes is an essential part of any unlawful discrimination settlement. Recent legislation, including the Tax Cuts and Jobs Act (TCJA),¹ places new attention on the taxation of the award and related counsel's fees.² This article reviews the general rules related to taxation of the settlement award and how the 1996 statutory changes affect negotiation and drafting of the settlement agreement.

A brief discussion of the prior rules will help provide context for the analysis. A successful plaintiff in an unlawful discrimination case (e.g., discrimination on account of age, race, sex, or employment) receives a settlement award for

various damages including back pay, liquidated damages, punitive damages, or damages for mental distress. The plaintiff-taxpayer often elects not to report the award as taxable income. However, gross income is broadly and liberally construed to include all income from whatever source.³ Section 104(a)(2) excludes from income damages received on account of personal injuries, whether by suit or by agreement.⁴ In *Schleier*,⁵ an age discrimination case, the Supreme Court held that a recovery is excludable under the prior Section 104(a)(2) if two requirements were met:

First, the taxpayer must demonstrate that the underlying cause of action

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giving rise to the recovery is “based upon tort or tort type rights”; and second, the taxpayer must show that the damages were received “on account of personal injuries or sickness.”⁶

The Court held that the ADEA settlement did not meet either of those requirements because it provided only for the recovery of lost wages and liquidated damages.

Prior to 1996, the statute provided a broad exemption for discrimination awards and did not require physical injury; therefore, many tort-type recoveries were held sufficient for exclusion under Section 104(a)(2).⁷ In 1996, the statute was changed to require physical injury. The statute exempts from gross income “the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.”⁸ The statute was also amended to provide a limited exclusion for payments for emotional distress limited to related medical expenses.⁹

Physical Injury or Physical Illness

The statutory changes require personal physical injury or physical sickness and

clarify that emotional distress will not rise to the required level. The House Conference Report classifies symptoms such as insomnia, headaches, and stomach disorders within the definition of emotional distress.¹⁰

In *Stadnyk*,¹¹ the taxpayer cancelled payment on a personal check related to the purchase of an automobile. The bank incorrectly stamped the check “NSF” and returned the check to the seller, who then filed a criminal complaint. The taxpayer was arrested and detained in the local jail, and although she did not suffer any physical injury, she did suffer emotional distress.¹² Although Mrs. Stadnyk’s claims arose in tort or tort-type rights arising out of her false arrest and detention, she could not prove that her damages were sustained on account of personal physical injuries or physical sickness under the 1996 amendments.¹³

The Sixth Circuit stated that “a false imprisonment claim may cause a physical injury, such as an injured wrist, as a result of being handcuffed. But the mere fact that false imprisonment involves a physical act—restraining the victim’s freedom—does not mean that the victim is necessarily physically injured as a result of that physical act.”¹⁴ The Sixth Circuit further stated that “the Supreme Court has construed the ‘on account of’ phrase to require a direct causal link be-

tween the physical injury and the damages recovery in order to qualify for the income exclusion.”¹⁵ The damages must “be awarded by reason of, or because of a personal physical injury.”¹⁶ In *Stadnyk*, had the litigation and settlement agreement been framed to include discussion of the physical elements and an allocation to the physical injury, perhaps the result would have been different.

Importance of the Settlement Agreement

There does not appear to be any bright-line test for how much physical injury is needed to meet the threshold requirement. The underlying claims and settlement must sufficiently focus on this important element.

Intent of Payor

The Tax Court views the intent of the payor in making the payment as the primary inquiry under Section 104(a)(2).¹⁷ In *Maciujec*,¹⁸ amounts received by a former employee of Home Depot in settlement of a discrimination suit were taxable and not excluded under Section 104(a)(2) on account of personal physical injury or physical sickness. The taxpayer alleged various forms of harassment, retaliation, and wrongful termination and that the company failed to accommodate

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¹ P.L. 115-97, 131 Stat. 2054.

² See Section 67(g) (the TCJA suspends miscellaneous itemized deductions until 2026); see also Section 162(q) (the TCJA has also placed new requirements on the payor in cases relating to sexual harassment or sexual abuse; no deduction is allowed if the settlement includes a nondisclosure agreement).

³ Section 61(a); see also *Schleier*, 515 U.S. 323, 327-28 (1995).

⁴ Section 104(a)(2), amended by Small Business and Job Protection Act of 1996, P.L. 104-188, 110 Stat. 1755.

⁵ 515 U.S. 323 (1995).

⁶ 515 U.S. at 337.

⁷ See, e.g., *Fabry*, 223 F.3d 1261, 86 AFTR2d 2000-5672 (CA-11, 2000) (discussing case law prior to the 1996 amendment and that malicious prosecution, abuse of process, harm to reputation, false imprisonment, defamation, and assault and battery, not resulting in physical injury, may all have the statutory prerequisites for exclusion).

⁸ Section 104(a)(2).

⁹ Section 104(a)(6)(B) (“emotional distress shall not be treated as a physical injury or as a physical sickness. The preceding sentence shall not

apply to an amount of damages not in excess of the amount paid for medical care . . . attributable to emotional distress.”)

¹⁰ H. Conf. Rep. 104-737 at 301 n.56 (1996), 1996-3 CB 741, 1041 n.56; see *Shultz*, TCM 2003-173 (emotional distress also includes mental anguish, humiliation and embarrassment).

¹¹ 367 F. App’x 586, 105 AFTR2d 2010-1130 (CA-6, 2010).

¹² *Id.* at 588.

¹³ *Id.* at 593-94 (The Sixth Circuit explained that under Kentucky law, the tort of false imprisonment is in large part a “mental” one and the taxpayer testified that she did not suffer any physical injury as a result of her arrest and detention).

¹⁴ *Id.* at 593.

¹⁵ *Id.* at 593 (citing *Schleier*, 515 U.S. at 329-31).

¹⁶ *Id.* at 593 (citing *O’Gilvie v. United States*, 519 U.S. 79, 83 (1996)).

¹⁷ See *Bent*, 87 TC 236, 244 (1986); *Glynn*, 76 TC 116, 120 (1981); *Amos*, TCM 2003-329.

¹⁸ TCM Summ. Op. 2017-49.

¹⁹ *Id.*

²⁰ *Id.*

²¹ TCM Summ. Op. 2004-60.

²² *Id.*

²³ *Shultz*, TCM 2003-173.

²⁴ *Beckett*, TC Summ. Op. 2020-19 (citing *Bagley*, 105 TC 396, 406 (1995), *aff’d*, 121 F.3d 393 (CA-8, 1997)).

²⁵ See *Schoeneman*, TCM 2000-161; *Robinson*, 102 TC 116, 129 (1994) (stating that “this Court will not blindly accept the terms contained in a settlement agreement,” especially when those terms are tax motivated), *aff’d. in part, rev’d. in part, and remanded on other grounds*, 70 F.3d 34 (CA-5, 1995).

²⁶ See *Stadnyk*, 367 F. App’x at 593 (citing *Schleier*, 515 U.S. at 329-31); see also *Beckett*, TC Summ. Op. 2020-19 (citing *Lindsey*, 422 F.3d 684, 688 (CA-8, 2005)).

²⁷ TCM 2017-111.

²⁸ *Id.*

²⁹ *Id.*

³⁰ See *Longoria*, TCM 2009-162; *Shultz*, TCM 2003-173; *Seay*, 58 TC 32 (1972) (the Internal Revenue Service maintained that the petitioner failed to show what portion of the settlement was paid for personal injury).

³¹ TCM 2009-162.

³² TCM 2003-329.

her physical disability. She also claimed that a coworker had committed battery and unwanted and offensive physical touching and physical contact.¹⁹ Each of the causes of action included an allegation of emotional distress. However, the complaint did not allege that she suffered any physical injury or physical sickness as a result of the conduct of Home Depot or its employees, nor was any medical treatment or medical costs incurred. The settlement agreement failed to allocate payment to any particular cause of action.

The taxpayer claimed on her tax return that she had suffered "sexual abuse injuries" at Home Depot and therefore considered the payment non-taxable. However, the settlement payment was taxable because there were no allegations that she suffered any physical injury or physical sickness. The complaint focused on her loss of income, wages, other pecuniary losses, mental anguish, embarrassment, humiliation, and emotional distress.²⁰ Here, the taxpayer may have suffered physical injury as a result of the battery described in the complaint, but there was insufficient evidence of such injury in the complaint and in the settlement agreement which both focused on the emotional distress.

In *Murray*,²¹ the taxpayer was employed by May Department Stores Company and injured her right thumb and index finger while she was apprehending a shoplifter. She filed a discrimination lawsuit, alleging sexual harassment and wrongful termination. The complaint included claims for discrimination, wrongful termination, and emotional harm and severe mental anguish, but did not include any claim for the physical injury. In a later arbitration submission, no mention was made of the physical injury to the taxpayer's hand. The case was generally described as a sexual harassment and hostile work environment case, and there was limited mention of the physical injury. Similarly, the settlement agreement recited her claims for financial loss, emotional distress, discrimination, and wrongful termination. The court stated that the provision relating to the hand injury was inserted as part of an overall settlement to pre-

vent future lawsuits, and not as a primary underlying claim supporting the payment.²² Therefore, the taxpayer was not compensated for any physical injury. The entire settlement payment was required to be reported in her gross income under Section 61(a).

Documentation

The record and settlement agreement must support a finding of physical injury and that payment was made on account thereof.²³ The underlying complaint and settlement agreement must fully document the physical injury. Additionally, "[a]n allocation in a settlement agreement between excludable and nonexcludable damages is generally binding for tax purposes if the agreement was entered into by the parties in an adversarial relationship at arm's length and in good faith."²⁴ However,

retaliation. However, the complaint did not allege physical injury.

The court stressed that the nature of the claim provides the foundation for determining the taxation of the damages received under the settlement agreement. The payor's intent is determined by taking into account all facts and circumstances, and the allegations included within the complaint. A general release, including a broad variety of claims, is not determinative.²⁹

In reviewing the settlement agreement and claims, the court held that the award was paid on account of discrimination and sexual harassment, not on account of physical injury or physical sickness. Therefore, the payments were not excluded under Section 104(a)(2). Perhaps had more attention been given to the physical components of the complaint, the result might have been different. Evidence of

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purely tax motivated agreements will not be respected.²⁵ As described above, the taxpayer must document a link between the damages and the physical injury.²⁶

Unfortunately for many taxpayers, the documents do not properly present the physical injury as a predicate for the related compensation. Both the complaint and settlement agreement should clearly describe both. In *Devine*,²⁷ the taxpayer's spouse was a member of the National Guard and received a monetary settlement related to allegations of sexual harassment and reprisal. Neither the complaint nor the agreement referred to any physical injury or physical sickness. The taxpayer's spouse was the target of continued sexual harassment and gender discrimination.²⁸ She informed her supervisor that she was pregnant, yet she was ordered to work in an area exposed to toxic chemicals and developed a rash allegedly due to the exposure. She was denied leave to receive medical treatment. She also reported other misconduct, including inappropriate advances, a forceful violent hug, and

medical treatment for a rash allegedly caused by exposure to toxic chemicals would appear to be the type of physical injury encompassed within the exclusion; the "violent" hug which hurt her might also have been sufficient. The documents failed to show that the payment was based on the physical injury. As described below, bifurcation of the award may be possible.

Bifurcation of Award

An allocation of the award may be made in the agreement. Many cases mention that the pleadings and settlement agreement failed to allocate the award among the various injuries. Although the cases analyzed below discuss or involve such allocation, clear guidance is lacking.³⁰

In *Longoria*,³¹ a police officer was injured due to workplace discrimination and retaliation. The court stated that the release and settlement agreement did not appropriately describe and allocate any portion of the payment to the physical injuries he received, and exclusion was therefore denied.

In *Amos*,³² the taxpayer was kicked in the groin by Dennis Rodman at a Chicago Bulls basketball game. The tax-

payer was taken to the local county medical center complaining of shooting pain to his neck. Shortly thereafter, the taxpayer filed a police report claiming assault. A settlement was reached, and a general release was issued. The release also included confidentiality and non-disparagement provisions.

The Tax Court stated that the nature of the claim and settlement controls whether the damages are excludable under Section 104(a)(2).³³ Where the settlement agreement is not clear, the intent of the payor is critical to the determination.³⁴ The *Amos* court stated “whether the settlement payment is excludable from gross income under section 104(a)(2) depends on the nature and character of the claim asserted, and not upon the validity of that claim.”³⁵

On its face, this appeared to be a clear case of physical injury. Nevertheless, the court bifurcated the award. The IRS asserted that only a nominal amount should be applied to the physical injury because the taxpayer failed to introduce sufficient evidence regarding the extent of the physical injuries. The Tax Court rejected the IRS position and stated that it is well established that the nature and character of the claim under Section 104(a)(2) is the ultimate determinant of the taxability. The court found that the dominant reason for paying the settlement amount at issue was petitioner’s physical injuries as a result of the incident.

Although the Tax Court found that Mr. Rodman’s payment was a settlement of the physical injury, the court nevertheless bifurcated the payment to both the physical injury claim and the confidentiality provisions. The court did not provide any guidance as to the method it employed in order to bifurcate the payment. Perhaps a better result might have been reached if the settlement agreement provided an allocation to the various claims.

In *Simpson*,³⁶ the Tax Court bifurcated an award based upon the allegations contained in the complaint. The complaint and settlement highlighted employment discrimination and emotional distress, but also contained evidence of physical injuries and mental anguish.³⁷ The taxpayer worked for Sears and became ill due to her work. The suit was generally based on employment discrimination, but it was accompanied by illness and disability claims related to her work conditions. The taxpayer alleged that her physical exertion resulted in injuries to her shoulders, left knee, and neck, and that she developed irritable bowel syndrome and fibromyalgia as a result of her work environment and conditions. She also suffered clinical depression and emotional distress.

Payments for mental anguish and related symptoms, such as depression and insomnia, headaches, and stomach unrest are excluded from the definition of physical injury.³⁸ Nevertheless, the taxpayer suffered more intense and objective

injuries, and the Tax Court allocated 10% of her recovery to the physical injury.³⁹ The decision is important to the extent that the author found only a few cases that included bifurcation of the award to physical injuries in the context of employment discrimination. The court, *sua sponte*, allocated the award, and perhaps additional amounts might have been excluded from income had the settlement agreement and complaint been more precise and included an allocation of the award.⁴⁰

Similarly, in *Domeny*,⁴¹ the Tax Court determined that 50% of the settlement payment was for the exacerbation of existing physical illness. Ms. Domeny suffered from MS and her conditions were worsened due to various workplace factors. The settlement agreement discussed various causes of action but failed to allocate any specific amount to each.⁴² The court looked to the intent of the payor and found that the employer intended to compensate the petitioner for acute physical illness exacerbated by the hostile and stressful work environment. In its determination of such intent, the court stated “an inference can be drawn, however, from the terms of the settlement agreement.”⁴³

The court was influenced by the manner in which the employer agreed to pay the settlement compensation. The agreement specified that one quarter was reflected as employee compensation and was included in the employee’s W-2, one quarter was paid directly to the em-

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³³ See, e.g., *U.S. v. Burke*, 504 U.S. 229 (1992); *Knuckles*, 349 F.2d 610, 613 (CA-10, 1965).

³⁴ *Knuckles*, 349 F.2d at 613; see also *Agar*, 290 F.2d 283, 284 (CA-2, 1961).

³⁵ *Amos*, TCM 2003-329 (citing *Bent*, 87 TC 236, 244 (1986), *aff’d*, 835 F.2d 67 (CA-3, 1987); *Glynn*, 76 TC 116, 119 (1981); *Seay*, 58 TC 32, 37 (1972)).

³⁶ 141 TC 331 (2013).

³⁷ *Id.* at 334-37.

³⁸ H. Conf. Rep. 104-737 at 301 n.56 (1996), 1996-3 CB 741, 1041 n.56.

³⁹ *Simpson*, 141 TC at 347.

⁴⁰ See also *Beckett*, TC Summ. Op. 2020-19.

⁴¹ TCM 2010-9.

⁴² *Id.* The causes of action include: “(a) any and all rights and claims relating to or in any manner arising from the . . . [petitioner’s] employment or the termination of her employment; (b) any and all rights and claims arising under the California Fair Employment and Housing Act; (c) any and all claims arising under the Civil Rights Act of

1964; (d) any and all rights and claims arising under the Americans with Disabilities Act; (e) any and all rights and claims arising [under] the Age Discrimination in Employment Act of 1967; (f) any and all rights and claims arising under the Family and Medical Leave Act or the California Family Rights Act; (g) any and all claims for violation of the Fair Labor Standards Act, the California Labor Code, or the California Wage Orders; and (h) any and all claims for breach of contract, breach of the covenant of good faith and fair dealing, invasion of privacy, infliction of emotional distress, defamation and misrepresentation.”

⁴³ *Id.*

⁴⁴ Section 61; see *Miller*, TCM 2001-55 (Judge Beghe stated “[b]oth the Court of Appeals for the Ninth Circuit and this Court have consistently held that contingent fees paid to recover a claim to income are not excluded in computing the gross income from the recovery. . . .”); but cf. *Domeny*, TCM 2010-9 (where the attorney was paid separately and said payment was not included in the taxpayer’s income); see also *Maciuc-*

jec, TC Summ. Op. 2017-49 (where the IRS conceded that legal fees paid separately to Petitioner’s counsel were deductible. Perhaps the IRS conceded due to the statutory changes under the American Jobs Creation Act of 2004, P.L. 108-357, 118 Stat. 1418, which modified Section 62(a) and Section 62(e)); see also *Beckett*, TC Summ. Op. 2020-19, at n.1.

⁴⁵ Section 265(a)(1).

⁴⁶ Section 62(a)(20); Section 62(e)(1)-(18) (unlawful discrimination is very broadly defined to include federal, state, and local claims); see *Beckett*, TC Summ. Op. 2020-19 (the IRS conceded that petitioner’s attorney’s fees were “deductible as an adjustment to gross income, pursuant to section 62(a)(20)”).

⁴⁷ *Beckett*, TC Summ. Op. 2020-19.

⁴⁸ Section 6662(a); Section 6662(b); Section 6662(d).

⁴⁹ Section 6662(d)(1).

⁵⁰ Section 6662(d)(2)(B); Reg. 1.6662-4(f).

ployee's attorney, and the balance was issued to the employee and reflected on a Form 1099-MISC reflecting non-employee compensation. The court found that the differing payments and reporting were evidence that the payment was partially due to the physical illness and allocated the payments reflected on Form 1099-MISC to physical injury.

Legal Fees

A detailed discussion of legal fees and settlements is beyond the scope of this article. Legal fees often represent a material portion of a settlement award and many cases discuss the deductibility of legal fees.

The Tax Cuts and Jobs Act, signed into law in 2017, suspended miscellaneous itemized deductions until 2026. After sunset in 2026, the value of this deduction is offset by the 2% adjusted gross income limitation and by the alternative minimum tax. Several comments are helpful:

1. Legal fees paid as part of the settlement are included in income under Section 61.⁴⁴
2. If the award is exempt under Section 104(a)(2), then no deduction will be allowed for the accompanying legal fees; but no deduction would be needed.⁴⁵
3. Legal fees paid in employment discrimination and civil rights cases may be deducted "above the line" to arrive at adjusted gross income.⁴⁶
4. Otherwise, no portion of the legal fee will be deductible as a miscella-

neous itemized deduction until 2026, even though the entire award is taxable.

Penalties

The Internal Revenue Service has requested the imposition of penalties in almost every case, even those cases involving physical injury.⁴⁷ The Tax Court frequently upholds the Internal Revenue

tax professional and therefore reasonably relied on such advice.

Although beyond the scope of this article, penalties may be avoided where a taxpayer acted with substantial authority, or in good faith with reasonable cause, or where there was a reasonable basis and adequate disclosure.⁵⁰ Whether a taxpayer may rely on the exclusion provided in Section 104(a)(2) is a question of fact as documented by the set-

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Service in allowing accuracy related penalties for improperly addressing the Section 104(a)(2) exclusion. The Internal Revenue Code imposes a 20% penalty on the portion of an underpayment which is attributable to negligence or to a substantial understatement of tax.⁴⁸ Negligence includes a failure to make a reasonable attempt to comply and includes carelessness or disregard. A substantial understatement exists if it exceeds the greater of \$5,000 or 10% of the tax required to be shown on the return.⁴⁹ Taxpayers frequently assert that they were relying on the advice of their accountant or attorney in claiming the exemption. Such reliance is often found to be insufficient without documentary evidence that the taxpayer provided all the information to a competent

tlement agreement and underlying complaint. Although the Internal Revenue Service is not always successful in recovering penalties, they almost always assert them in these cases. It is therefore important to obtain competent tax counsel and address the burden of proof needed to avoid penalties in the event that the recovery is ultimately determined to be taxable.

Conclusion

More attention to the tax consequences must be made when drafting the complaint and settlement agreement involving a claim of unlawful discrimination. The attorney should be careful to include information that supports a direct link between the damages received and the physical injury or illness suffered. ●