

## Settlement for Emotional Distress is Taxable

### Cross References

- *Montes*, U.S. Tax Court, June 29, 2023

Settlement proceeds from lawsuits are generally taxable. There is one exception under IRC section 104(a)(2), which excludes from gross income “any damages other than punitive damages received whether by suit or agreement and whether as lump sums or as periodic payment on account of personal, physical injuries or physical sickness.” For a taxpayer to fall within this exclusion, he or she must show that there is a direct causal link between the damages and the personal injuries sustained. When a taxpayer settles a lawsuit, the court looks at the nature of the claim that was the basis of the settlement.

The taxpayer in this case was a pioneer for women in the San Francisco Fire Department. She was one of the few women to pass the exam to get into the Fire Academy. There were only a handful of women admitted to the Fire Academy and she was one of only about half that were able to finish their training.

In 2016 she received a coveted assignment to a firehouse in downtown San Francisco. Firefighters have to live together and work as a team. Their job requires physical skill and bravery to perform. She was part of this team, but many of the male members did not welcome her as a woman in their ranks.

The truck unit she was assigned to had the job of securing the roof of a burning building, venting gases to allow suppression of the fire. It was extremely dangerous work and required members of the team to be able to trust each other and work together.

In a short period of time, some of the male firefighters began making disparaging comments about her, sabotaged her equipment, and made it difficult for her to speedily respond to calls. She was ostracized within the firehouse, and the situation eventually escalated into members of her team doing disgusting and extremely unsanitary things to her personal property.

She complained up the chain of command, which only served to increase the harassment she was suffering from. Her complaints eventually were leaked out into the local press and her name became locally known as somebody who was making complaints about the conditions of her employment.

In 2017, she filed a lawsuit in federal court to put an end to the harassment, and in June of 2018, that lawsuit was settled. One of those terms was a payment to the taxpayer of \$382,797.70. The agreement also provided for her attorney’s fees.

When she went to a CPA to file her tax return, the CPA told her that she did not have to report the money, so it was not included on her 2018 tax return. The IRS disagreed and issued a Notice of Deficiency.

The court stated the settlement agreement states the payment ... “will be considered and treated as general damages for personal injury, including allegations of emotional injury. This amount will not be considered or treated as back wages.”

Two paragraphs latter, it states: “The parties understand and agree that the settlement amount is inclusive of all of plaintiff’s claimed general damages, including emotional distress, special damages, and attorney’s fees and costs.”

The court stated the complaint itself stresses that no physical injuries were alleged. The first claim for relief was for sex discrimination. The second for retaliation under California law. The third for sex discrimination under federal law. The fourth for retaliation under federal law. The fifth, the failure on the part of the Fire Department to prevent discrimination against the taxpayer. And the sixth, the intentional infliction of emotional distress.

There are no allegations of physical injury to the taxpayer in the complaint. In the summary of the complaint it states: “She has lost compensation for which she would have been entitled. She has suffered from emotional distress, embarrassment, and humiliation and her prospects for career advancement have been diminished.”

The court stated that IRC section 104(a) specifically commands that “emotional distress shall not be treated as a physical injury or physical sickness” and case law tells us that emotional distress includes symptoms such as insomnia, headaches, and stomach problems that result from such severe emotional distress. (T.C. Memo. 2008-87)

The tax court judge said: “While I have noted in previous opinions about the crumbling barrier between psychiatry and neurology, where the Code itself assumes a dualist view of mind and body, we must assume such a view as well when we apply the Code to the facts of the particular case. I can’t fault [the taxpayer] for the position that she took, but [IRC section 104] says that this payment has to be included in her taxable income.”