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U.S. Tax Court Decision Shows Importance of Carefully Drafting Settlement Agreements

By William Hays Weissman

In *Sharp v. Commissioner*,¹ the United States Tax Court once again demonstrated the importance of carefully crafting settlement agreements and reaffirmed that emotional distress damages are taxable income to the recipient.

Background Facts

The petitioner was a professor at the University of Northern Iowa. She alleged that after she reported missing equipment, the university demoted her to a secretarial position in the Dean's Office. She subsequently took a leave of absence, and then sought reinstatement as a professor at the university. After reinstatement, she again filed a report of missing equipment, which led to a yearlong grievance dispute between her and another faculty member. She alleged her colleagues and supervisors were hostile to her and impeded her advancement and, therefore, her work life caused stress that ultimately led her to leave the university. She alleged she developed muscle tension and migraine headaches, became afraid to go to the university, developed a fear of people, had nightmares and was eventually hospitalized for depression and diagnosed with severe clinical depression, anxiety disorder and post-traumatic stress disorder. She did not return to work.

The petitioner brought a worker's compensation claim and a separate action for gross negligence asserting that several colleagues had conspired to force her to quit her job. She eventually entered into a settlement agreement with the university under which the university agreed to pay her settlement proceeds of \$210,000 in three \$70,000 installments. The settlement agreement stated that the proceeds were for "emotional distress damages only." She received the first \$70,000 in 2010, but instead of reporting it as income, attached a statement to her income tax return asserting that the income was exempt as a personal physical injury under Internal Revenue Code section 104(a)(2). The IRS determined the payment was taxable and issued her an assessment. She then filed a petition with the Tax Court. The issues before the Tax Court were whether the \$70,000 paid in 2010 qualified as income, and if so, whether the failure to report the income qualified for an accuracy-related penalty.

¹ *Sharp v. Commissioner*, TC Memo 2013-290.

Tax Court's Analysis

The petitioner argued that the payment was excluded as compensation received under a statute in the nature of a workers' compensation, citing to the Iowa Worker's Compensation Act (IWCA). The IRS countered that the petitioner failed to prove that the settlement was paid in exchange for her settling a claim under the IWCA. The Tax Court agreed.

It began by noting the basic rule that what the parties intended to compromise by entering into the settlement agreement is a question of fact that must be determined by reference to the agreement's express language. If the agreement fails to contain an express intent, the court must look at whether the payor in fact intended to settle a claim brought under a statute in the nature of a workers' compensation statute. The Tax Court found that the petitioner's settlement agreement did "not indicate that the parties intended petitioner to receive the settlement proceeds in exchange for her settling a claim under the IWCA." The only reference in the settlement agreement to a workers' compensation claim was a single reference to the agreement being conditioned on the petitioner "settling her 'W.C. claim.'" The Tax Court held that a "sole vague reference is insufficient to prove that the university paid petitioner the settlement proceeds in exchange for her settling a claim under the IWCA."

The Tax Court further held that there was "scant evidence" in the record to support her contention, noting that it could not "bridge the logical gap between the evidence petitioner offered of her IWCA claims and a finding that the university paid the settlement proceeds in exchange for petitioner's settling an IWCA claim." Rather, the Tax Court noted that "the record does not reflect that the IWCA claims were the only claims the university could have considered when entering into the settlement agreement." Thus, other claims brought against the university could have been considered in settling her claims, which would have been attributable to non-IWCA claims. The court stated: "[w]ithout this missing link we are unable to conclude how much, if any, of the settlement proceeds may have been paid in exchange for petitioner's settling an IWCA claim."

The petitioner also argued that the payment was excludable from income as a payment on account of her emotional distress attributable to a physical injury or physical sickness. The Tax Court rejected this argument, noting again that she failed to prove that the university paid her the settlement proceeds on account of her physical injuries or physical sickness when the settlement agreement expressly states that the university would pay the settlement proceeds to the petitioner for emotional distress damages only.

The Tax Court also pointed out that even if it could accept her evidence of a linkage, the petitioner still failed to demonstrate that her emotional distress resulted from a personal physical injury, citing several cases holding that emotional distress, even when coupled with physical manifestations, is an insufficient basis on which a taxpayer may exclude settlement proceeds from gross income.

Lessons for Employers

While this case arose in the context of a plaintiff's failure to report income to the IRS, it provides several important lessons for employers.

- Do not assume a general settlement without clear intent or allocation will be respected by the IRS or the courts.
- Clearly express the intent of the parties in a written settlement agreement.
- Carefully allocate the amounts to be paid for each kinds of damage for all claims being settled (including wages for claims for back pay, emotional distress on claims for harassment or discrimination, liquidated damages or other penalties provided by statute, attorney's fees, etc.).
- Properly report all payments to the extent required, which includes reporting emotional distress damages as income on an IRS Form 1099-MISC, box 3 (other income).

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