If You "Don't Give Tax Advice," Start by Asking About Physical Injuries at Intake
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Litigators like to warn that they don't give tax advice. That's too bad; the decisions that lead to big savings happen early on, when it's still unclear whether it's worth paying for a specialist's time. Fortunately, when it comes to the biggest savings of all—the exclusion for settlements attributable to personal physical injuries—good habits are easy to learn. A lot of taxes could be saved if plaintiff's attorneys simply asked a few extra questions at intake.

First, the black letter law. Under IRC § 104(a)(2), taxpayers can exclude amounts received as damages "on account of personal physical injuries or physical sickness." Emotional distress can also be excluded, up to "the amount paid for medical care." Emotional distress includes physical symptoms (e.g., insomnia, headaches, stomach disorders) which result from emotional distress. However, emotional distress is treated like physical injuries—fully excludable—to the extent attributable to physical injury or sickness. There are also cases[1] where the plaintiff could exclude damages for physical and emotional harms caused by the defendant's exacerbation of an existing physical disease.

To show that payments are excludable, the plaintiff must show that the alleged injuries were the "origin of the claim." The determination hinges on the payor's dominant reason for making the payment. The court first looks to the language of the settlement agreement. This is less reliable if the tax allocation was not entered into by the parties in an adversarial relationship at arm's length and in good faith, or where the settlement agreement lacks express language of purpose. The court also looks to any other facts that may reveal the payor's intent, including the complaint, the evidence at trial, the judgment, the amount paid, and the factual circumstances that led to the agreement.[2]

So why not always allocate everything to physical injuries? The limiting factor is evidence—meaning the settlement agreement and other documents in your dispute, plus records of mental health expenses. To help the client generate this evidence, conversations about these injuries should happen at client intake. Genuine injuries go undocumented if nobody asks. Some questions to ask:

- Did the defendant physically injure the plaintiff? (Some harms are subtle: in a case alleging that a fire destroyed a home, the plaintiff may have suffered smoke inhalation.)

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[1] Domeny v. Comm'r, T.C. Memo 2010-9 (workplace hostility exacerbated plaintiff's multiple sclerosis); Parkinson v. Comm'r, T.C. Memo 2010-142 (workplace stress contributed to heart attack).
[2] See Green v. Comm'r, 507 F.3d 857 (5th Cir. 2007); Beckett v. Comm'r, T.C. Summ. Op. 2020-19.

- Did the plaintiff suffer emotional harm, and incur costs for medical care as a result? (These days, who among us doesn't turn to a therapist after a workplace conflict?)
- Did the plaintiff suffer a pre-existing physical disease, and did the defendant exacerbate this? (If so, get professional tax advice; this is a nuanced legal theory.)

These rules for allocating tax-free treatment to payments amount to one of the most generous loopholes in tax law. They give plaintiffs and their attorneys significant power over how their damages will be taxed. A few dynamics lead to this result.

First, although the rule purports to be about the past injury, in fact it rests heavily on the content of today's settlement. As a general rule, taxpayers shouldn't be able to influence the tax treatment of a past event. But a settlement might be paid to compensate for something which never happened, or to spare the parties the burden of learning what happened. To cure this uncertainty, courts could have decided to be more skeptical of settlements than of judgments. However, as one court has noted, "To reach the unestablished merits of a case in our Court punishes those parties who settle rather than litigate, which isn't in anyone's interest."[3]

Second, although the rule purports to focus on the payor's intent, in practice decisions by the plaintiff control how that intent will look. Defendants decide which claims to accept, but only after the plaintiff first identifies his claims, drafts his complaint, submits his mediation demand, or proposes settlement terms.

Third, although courts claim to prefer tax allocations reached while other key terms are being negotiated,[4] in practice raising tax early actually invites cooperation. In the heat of negotiation, defendants are often willing to cooperate over tax allocations, because it is one of the few ways a defendant can enrich the plaintiff at someone else's expense.[5] As a result, litigators should know that when they treat the tax conversation as a tool to close the gap in sticky negotiations, they are also falling in line with the Tax Court's preferred timing.

Giving tax advice may feel uncomfortable. It may also feel like charity; your client's tax savings won't increase your contingency fee. Still, the possibility of avoiding taxes that can exceed 50% can turn a mediocre deal into a great one, and make the difference between four stars and five on Yelp. If you don't want to give tax advice, consider asking a few tax-motivated questions.

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[3] *Cavanaugh v. Comm'r*, T.C. Memo 2012-324, at n.6.

[4] See *Hess v. Comm'r*, T.C. Memo 1998-240 (rejecting allocation to personal injury, noting that, "[w]hile the underlying litigation was certainly adversarial, the parties were no longer adversaries after they agreed on a settlement in principle").

[5] There are constraints on defendants' generosity—if the IRS concluded that too much was allocated from wages to physical injury, the defendant would be on the hook for unpaid withholding taxes.