Are Damages for Exacerbation of Depression Tax Free?

By Robert W. Wood

Robert W. Wood practices law with Wood LLP in San Francisco (http://www.woodllp.com) and is the author of Taxation of Damage Awards and Settlement Payments (2009 with 2012 supplement), Qualified Settlement Funds and Section 468B (2009), and Legal Guide to Independent Contractor Status (2010), all available at http://www.taxinstitute.com. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

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We know that damages for personal physical injuries are tax free, but what about damages for physical sickness? In 2010 two remarkable Tax Court cases addressed this question: Domeny v. Commissioner and Parkinson v. Commissioner. Both suggest an enlightened reading of the section 104 exclusion that recognizes it excludes both types of damages.

In Domeny, an employee with multiple sclerosis (MS) experienced workplace conditions that exacerbated her disease. She experienced vertigo, shooting leg pain, numbness in both feet, burning behind her eyes, and extreme fatigue. Domeny was fired, received a settlement, and claimed that the non-wage portion was excludable from her income. The Tax Court agreed, despite less than precise language in the settlement agreement and the issuance of a Form 1099 reporting the payment.

In Parkinson, the taxpayer experienced stress in the chief supervisor of a medical center’s ultrasound and vascular lab. He suffered a heart attack while at work in 1998 and thereafter reduced his workweek from 70 hours to 40. In 2000 he took medical leave and never returned. He sued under various claims alleging that the defendants’ misconduct caused him to suffer another disabling heart attack on the job that rendered him unable to work.

Parkinson settled for $350,000, was paid $250,000 in 2004, $34,000 in 2005, and $33,000 each in 2006 and 2007. The settlement agreement said the payment was for “noneconomic damages and not as wages or other income.” The only payment at issue in the Tax Court was the $34,000 payment in 2005.

Parkinson argued that the payment was for physical injuries and physical sickness brought on by extreme emotional distress. The IRS said it was for emotional distress, pure and simple. Tax Court Judge Michael B. Thornton stated:

"It would seem self-evident that a heart attack and its physical after effects constitute physical injury or sickness rather than mere subjective sensations or symptoms of emotional distress. Indeed, at trial respondent’s counsel conceded that the petitioner did “suffer some physical injury,” stating that he “suffered several heart attacks.” Respondent contends, however, that petitioner received no amount of the settlement payment on account of his asserted physical injuries or sickness because “his causes of action did not reflect that assertion.” Clearly, however, petitioner’s state court complaint did reflect, extensively, his assertions of physical injuries and sickness."

The Tax Court even stated that the IRS was wrong that one can never have physical injury or physical sickness damages when a suit is for intentional infliction of emotional distress. Now, another

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3 Parkinson, T.C. Memo. 2010-142.
Tax Court case, Blackwood v. Commissioner, undercuts these two pivotal decisions. The question is by how much.

A. Background

For nearly a century, the code has excluded from income some payments for injuries and sickness. Whether by settlement or judgment and whether in a lump sum or over time, those payments are tax free. But since 1996, to be excludable, the damages must be for personal physical injuries or personal physical sickness.

Although the “physical” modifier added 16 years ago was a sea change, no rulings or regulations have tackled this topic. The IRS’s failure to provide guidance on those questions has become a flash point. However, most practitioners are aware that the IRS has generally required an overt manifestation of physical injuries and “observable bodily harm” for an exclusion to be available.

Despite its focus on observable bodily harm, the IRS said it would presume there were personal physical injuries in at least some cases. In an important 2008 ruling, the IRS excluded a recovery for sexual molestation even though payment was made years later when no observable bodily harm could be shown. More generally, the Service seems to recognize that sometimes physical and emotional injuries may be inextricably entwined.

Physical injuries and physical sickness are both physical in nature but are quite different. In most cases of physical sickness, there is no striking or other physical event triggering the illness. The word “injuries” is thus a misnomer in most cases of physical sickness.

B. Domeny

In Domeny, the taxpayer was diagnosed with MS in 1996. Mindful of her condition, and having disclosed it to her new employer, she began working at Pacific Autism Center For Education (PACE) in 2000. PACE offered an environment in which she could do community development, fundraising, and grant writing without spending too much time on her feet.

But in November 2004, embezzlement by a PACE executive and the stresses related to those events caused Domeny’s MS to flare up. As the months elapsed, she was tense and worried and her symptoms grew worse. She had vertigo, shooting pain in both legs, difficulty walking because of numbness in her feet, burning behind her eyes, and extreme fatigue. On March 8, 2005, her doctor pronounced her too ill to work and ordered her to stay home.

PACE abruptly fired her, triggering additional physical ailments. She contacted a lawyer who negotiated a settlement before filing suit. The settlement agreement listed a raft of causes of action, including disability, age discrimination, civil rights, Family and Medical Leave Act violations, and infliction of emotional distress. The settlement agreement awarded $8,187.50 in pay, $8,187.50 in attorney fees, and $16,933 in damages.

The sole question in the Tax Court was whether the $16,933 was excludable from income. The Tax Court found it clear that Domeny’s exposure to a hostile and stressful work environment exacerbated...
Although Domeny’s presentation had been thorough, Blackwood’s was not. Blackwood’s counselor did not testify in the Tax Court. She wrote about her patient’s treatment but said nothing about any specific physical symptoms of her depression. Blackwood testified that her insomnia, hypersonmia, migraines, nausea, weight gain, acne, and back, shoulder, and neck pain were attributable to her depression. However, no other evidence was submitted to prove that she suffered from these or other physical injuries.

Judge Robert P. Ruwe found these facts distinguishable from those present in Domeny. Qualitatively and quantitatively, Blackwood’s evidence did not show the level of physical injury or physical sickness present in Domeny. Moreover, of the eight symptoms Blackwood mentioned in her testimony, five were similar to the list of emotional distress symptoms specifically mentioned in the 1996 legislative history to section 104(a).12

In addition, in Domeny a physician had determined that she was too ill to work. Blackwood had no such determination and only presented a counselor’s letter that said she had “increased levels of anxiety and depressive symptoms.” Blackwood may have been suffering from depression and she may even have had some physical symptoms from it. However, they did not qualify under section 104, the court ruled.

The court seemed to have an easy time drawing the line between Domeny and the Blackwood facts. Nevertheless, because Blackwood had some similarities to the Domeny case and because her CPA had advised her that the payment was not taxable, the court declined to impose penalties.

D. Teachable Moment?

What do the Domeny, Parkinson, and Blackwood decisions teach us? It seems possible to draw different lessons from these cases, but here are the lessons they give me.

1. The facts and your proof matter. To exclude a payment on account of physical sickness, you need evidence that you really made the claim, that the payer was aware of it, and that the payer at least considered your claims in making the payment.

2. You must show you had a demonstrable sickness. You need not have a medical diagnosis that you suffer from MS or had a heart attack. But you need some kind of medical diagnosis. Blackwood
did not even have a clinical diagnosis of depression, although the court seemed to believe that she did. The more physical your medical diagnosis is, the better.

3. Obtain and be prepared to present evidence of medical care. In *Blackwood*, there was no medical documentation, no linking of the symptoms to the diagnosis, and nothing too far beyond the “headaches, stomachaches, and insomnia” famously noted in the act’s 1996 legislative history. Keep evidence that you were claiming the payer caused your condition or caused it to worsen.

4. Be as explicit as you can in the settlement agreement. The courts and the IRS are ill-equipped to determine which payments were for which claims. You miss a huge opportunity if you are not specific in your settlement agreement. If an express allocation in a settlement agreement is reasonable and has a rationale, the IRS frequently will accept it.

5. Be reasonable in your allocation. In allocating which payments are for which claims, don’t go overboard. In an employment dispute, don’t allocate $10 to wages. And in an intentional infliction of emotional distress case, don’t allocate 90 percent of a recovery to physical injuries or physical sickness. Don’t pick a figure you cannot support.

6. Collect good documentation contemporaneously. Especially if there is a thin record of medical expenses, consider what other documents you can collect at settlement time. A letter from the plaintiff’s attorney saying why the physical sickness claims were strong may help. A letter from a treating physician or an expert physician may help. Declarations signed under penalties of perjury may be more persuasive than letters. Prepare what you can at the time of the settlement or, at the latest, at tax return time. Do as much as you can contemporaneously. Don’t wait for an audit to gather supporting documentation.