

What's Excludable?

Despite Amendment, IRC Sec. 104 Leaves Some Questions Unanswered

BY ROBERT W. WOOD, ESQ

Internal Revenue Code

Sec. 104 excludes from income damages for personal physical injuries or physical sickness. Sound simple? Hardly. Tax advisers have long lamented the lack of clarity surrounding this provision, even though it's been in the tax law since the 1930s.

In 1996, largely in response to plaintiffs in employment cases excluding emotional distress damages, Congress amended Sec. 104 to require "physical," as opposed to merely "personal," injuries. However, the statute does not define "physical."

The IRS position, as determined through private letter rulings and case law, is that you need demonstrable physical harm—cuts, bruises, broken bones—that were sustained in a physical battery. Taxpayers usually favor an expanded interpretation that includes physical sickness. After all, the statute excludes from income damages for physical injuries or physical sickness. Yet, ambiguity reigns.

Distinguishing between mere symptoms of emotional distress (no exclusion) and physical sickness (excludable) isn't easy, though, which leaves taxpayers with a tough choice: forgo claiming the exclusion or claim it and fight about it later.

RECENT CASES

The Supreme Court in *Commissioner v. Schleier* [(515 US at 323, 337 (1995))] said that to qualify for the exclusion, a taxpayer must establish that prosecution or settlement of an underlying claim is based on tort or tort type rights, and that the receipt of damages is on account of personal physical injuries or physical sickness.

Many courts make it tougher still. In *Lindsey v. Commissioner* [T.C. Memo 2004-113, aff'd by 422 F.3d 684 (8th Cir. 2005)], the Eighth Circuit ruled that to satisfy the second criterion set forth in *Schleier*, you must show a direct causal link between the damages recovered and the physical injuries or physical sickness in question.

In this case, Lindsey suffered from

hypertension and stress-related symptoms, including insomnia, fatigue and occasional indigestion. The Eighth Circuit ruled that these were symptoms of emotional distress, not physical sickness. Plus, the court stated that the defendant knew nothing about any physical sickness or physical injury claims. The court found no direct causal link between the payment and Lindsey's maladies.

SICKNESS VS. SYMPTOMS OF EMOTIONAL DISTRESS

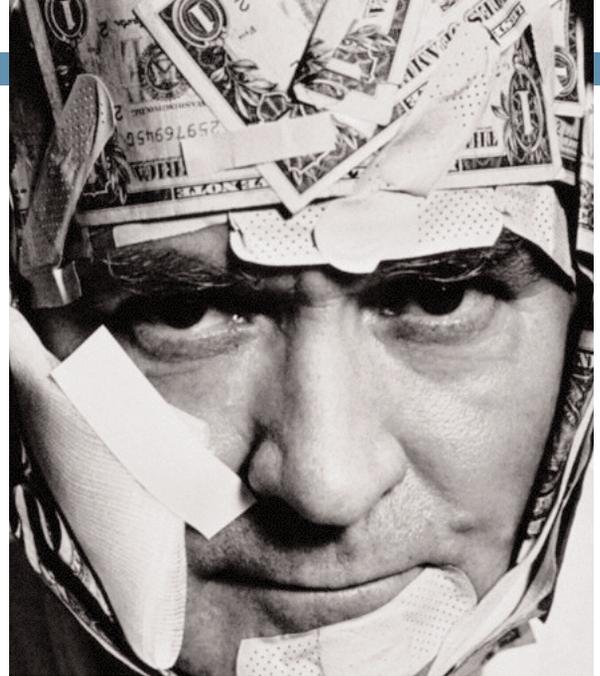
In *Mummy v. Commissioner* [T.C. Summ. Op. 2005-129], a woman sued her employer for sexual harassment, requesting \$500,000 in compensatory damages and \$500,000 in punitive damages. The case settled for \$12,000, which Mummy did not report.

Predictably, the Tax Court concluded that Mummy's recovery was not excludable.

Mummy alleged that she suffered anxiety, embarrassment and humiliation from the harassment, and pain from a pinch. Still, no physical injuries or physical sickness, said the court. Turning to the language of the release, the court found no help for Mummy there, noting that it was a general release with no tax allocation.

How do you distinguish between symptoms of emotional distress, which do not give rise to any exclusion, and damages paid for physical sickness that do? After all these years, there still is not much to review except the legislative history to the 1996 Act, which states that damages for symptoms of emotional distress do not give rise to an exclusion.

The three examples given in the act are headaches, insomnia and stomach aches, which are said to be symptoms of emotional distress [H. Rpt. 104-586, H.R. 3448, Sec. 1605, 96 TNT 101-11]. This list is not comprehensive, but indicates the types of relatively minor inconveniences that may have some physical component, but do not constitute physical injuries or



physical sickness.

At the same time, every physical injury may not start with a physical blow. Suppose a defendant takes a swing at the plaintiff, who dodges the blow, but in doing so leaps into oncoming traffic? Surely, the damages flowing from what is probably an assault under state law should be excludable.

Or suppose a defendant defamed a plaintiff by calling him a child abuser. The plaintiff is so mortified he suffers a stroke and has significant medical expenses and wage loss. The stroke does not produce bruising or broken bones, though in some cases it may have demonstrable effects, such as paralysis. Whether this recovery is excludable depends on whom you ask.

The IRS focus on battery and observable bodily harm ignores "physical sickness." Yet, in Private Letter Ruling 200121031, the IRS addressed damages for a disease, finding a recovery against an asbestos manufacturer to be excludable, even though there was no physical contact with the plaintiff.

In this ruling, the taxpayer's husband was diagnosed with lung cancer after years of installing drywall. The taxpayer and her husband sued for personal injuries and loss of consortium. When the husband died, the wife added claims, including for wrongful death.

When the case settled, the IRS ruled that it was fully excludable. After all, the husband contracted a physical disease from exposure to asbestos, and that was the proximate cause of the lawsuit. While there was no physical contact or touching between the taxpayer's husband and the manufacturers, Letter Ruling 200121031 upholds the exclusion.

PRONE TO INJURY?

In *Bond v. Commissioner* [T.C. Memo.

2005-251], the taxpayer suffered from various maladies. She had carpal tunnel syndrome and needed surgery. At a later date, she tripped in her office. She filed workers' compensation claims for both injuries. Later, she suffered from depression and was hospitalized. She then filed a discrimination claim with the U.S. Equal Employment Opportunity Commission. Her case settled for \$25,000. Despite a Form W-2, Bond did not report it.

The court easily dismissed her arguments that Sec. 104 applied. The settlement agreement excluded her pending workers' comp claims, thus, she could hardly argue her work-related injuries were covered by the settlement. The court also rejected her claim that emotional distress (depression) awards were excludable.

BAD SHOPPING DAY

Jacqueline and Theodore Major Green v. Commissioner [T.C. Memo. 2006-39] involved a shopping cart incident in a grocery store parking lot. A shopper ran her cart into Green, who then sued. The injury forced Green to change positions at the GM plant where she worked. Two years

later, she sustained injuries at work that rendered her unable to work. She began receiving Social Security benefits and filed for workers' comp.

Green obtained a default judgment for \$166,000 in her lawsuit, but the defendant filed for bankruptcy. The Greens then claimed a casualty loss on their tax return for the judgment they couldn't recover. The court didn't waste much time denying the taxpayers' claims.

Finally, there's *Charles E. Bradley v. Commissioner* [T.C. Memo 2005-223 (2005)]. Bradley was an investment banker and executive whose business endeavors left him embroiled in numerous lawsuits, none of which alleged any personal injuries. The lawsuits surrounded contract violations from the sale and/or purchase of various stocks and options.

The basic question was whether or not any portion of a large settlement

could be considered paid for personal physical injuries.

The Tax Court concluded that there was no evidence any personal physical injury claim was made and no evidence that any portion of the settlement was so intended.

CONCLUSION

The IRS has been silent as to what constitutes personal physical injuries or physical sickness. Given the lack of regulations, combined with a terse IRC section, it is likely we will continue to see controversy under Sec. 104. **CPA**

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