

Cut or Bruise Can Yield Tax-Free Damages

By Robert W. Wood



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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.

A cut or bruise may be the classic indicator of physical injuries and be enough to trigger the section 104 exclusion. Since the statute is clear that related emotional distress damages are then excludable, a cut or bruise can be an important threshold. As Wood explains, a recent ruling suggests a reasoned approach to section 104 determinations, one that may place less emphasis on the degree of physical harm suffered.

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The section 104 exclusion for compensation for injuries or sickness has been part of federal income tax law for nearly 100 years yet has always been controversial, perhaps because there are not many exclusions from income in the tax code. The tax treatment of compensatory payments is contentious in part because plaintiffs who recover a settlement or judgment naturally want to conserve it rather than have it reduced by taxes. Damages for personal physical injuries are tax free. The code also excludes damages for physical sickness even though they have never been the subject of voluminous authority.

The exclusion applies regardless of whether the payment is occasioned by settlement or judgment, and regardless of whether it is paid in a lump sum or over time. Since 1996, however, the exclusion is

premised on the damages being received on account of personal *physical* injuries or personal *physical* sickness. The insertion of the “physical” modifier 17 years ago was a drastic shift in policy, and since then taxpayers and the government have debated what should be considered physical for purposes of the exclusion.

With the focus on the meaning of physical, perhaps there has been little need to distinguish between injuries and sickness. Although there is no regulatory guidance on the subject, most practitioners are aware that the IRS has generally required (as in the so-called “bruise ruling”)¹ an overt manifestation of physical injuries and “observable bodily harm” for the exclusion to be available.

However, in an important 2008 memorandum, the IRS enunciated an exception to this rule. The Service said it would assume there were personal physical injuries from a sexual molestation even though payment was made many years later when no observable bodily harm could be shown.² That conclusion may seem so obvious that no ruling would need to enunciate it. Nevertheless, it was a bold, innovative, and important position for the IRS to take at that time.

Physical injuries and physical sickness may both be physical, but they are arguably quite different in result and in their source. In most cases of physical sickness, there has been no striking or other physical event to trigger the physical sickness. In that sense and others, “injuries” may be a misnomer.

¹LTR 200041022: “We believe that direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under section 104(a)(2).”

²ILM 200809001:

C has alleged that Entity’s agent(s) X caused physical injury through Tort while he was a minor under the care of X. . . . Because of the passage of time and because C was a minor when the Tort allegedly occurred, C may have difficulty establishing the extent of his physical injuries. Under these circumstances, it is reasonable for the Service to presume that the settlement compensated C for personal physical injuries, and that all damages for emotional distress were attributable to the physical injuries.

See also discussion in Robert W. Wood, “IRS Allows Damages Exclusion Without Proof of Physical Harm,” *Tax Notes*, Mar. 31, 2008, p. 1388.

In a 2001 ruling,³ the sickness was life-threatening and clearly physical, yet did not involve bruises or broken bones. The taxpayer was awarded damages from asbestos manufacturers for her husband's death as a result of lung cancer, a disease generally associated with the inhalation of asbestos fibers.

Reasoning that the husband contracted a physical disease from exposure to asbestos and that it was the proximate cause of the circumstances giving rise to the taxpayer's claims, the Service excluded the wife's recovery. The IRS did not make clear whether it viewed the payments as being on account of personal physical injuries or personal physical sickness. The Service's failure to provide guidance on this question has become a flash point for some.⁴

The discussion regarding what is physical and whether emotional distress flows from a physical injury (or sickness) can be dizzying. In the bruise ruling, once there was bruising in a sexual assault (termed the "first pain incident"), all emotional distress damages thereafter were also tax free. In the real world, of course, damages are rarely parsed into those leading up to an assault and those that come afterward.

Emotional distress damages are even less likely to be divided into those emanating from an assault and those emanating from verbal abuse. The issue is further complicated by the fact that in almost all cases, the damages are paid long after the incidents. The tax issues are often addressed even later.

Threshold Cuts?

Earlier this year, the IRS issued an important ruling that confirms and arguably expands the scope of the section 104 exclusion.⁵ It involved victims of what appears to have been a mass tort. The class of people that were paid damages included those who were injured in the conflagration, close relatives of those who were killed, and the estates of the deceased victims.

On behalf of the victims, a law firm entered into a joint prosecution agreement with the plaintiffs

and then pursued claims against the responsible parties for compensation. Eventually, legislation was passed that had the effect of superseding the lawsuit. Monies were to be paid to the victims, and the ruling considers the tax treatment of those payments.

The facts of the ruling indicate that each victim suffered a cut, scrape, bruise, or other visible physical injury in the incident, or suffered smoke inhalation during the fire. Some victims were subjected to both.

Apart from the injured parties who were paid, each additional payee was a close relative (spouse, parent, child, or sibling) or the estate of a person killed in the incident. Victims and surviving family members entered into a joint prosecution agreement to pursue claims for damages, and the agreement detailed how the plaintiffs would divide any recoveries. However, disputes broke out, and eventually the plaintiffs arbitrated how funds would be distributed.

Everyone agreed to a settlement that revised the formula for allocating recoveries. Monies were transferred from the defendants to an escrow account so that amounts could be divided and paid to the claimants. Once the legislation became effective, the plaintiffs and defendants in the lawsuit filed a stipulated dismissal.

The victims were required to file a claim with a government agency to recover damages for the claims of wrongful death and physical injury. The escrow fund distributed amounts received, plus interest according to the agreed allocation formula, as amended by the settlement agreement.

Each of the victims received damages resulting from a cut, scrape, bruise, or other physical injury, or from smoke inhalation. Each sustained a personal physical injury or physical sickness as a result of the incident. Therefore, the IRS concluded that all the damages were excludable under section 104(a)(2).

Sensible Conclusion

Is this enough for an exclusion? Clearly it is and should be. So is there anything remarkable in this ruling? In a sense, not really. Obviously it is the right result. The incident that was the subject of the lawsuit and legislation was plainly catastrophic. There were deaths, physical injuries, and smoke inhalation.

The legal process involved a joint prosecution agreement against what was apparently a public body and public officials. The taxpayer that applied for the ruling may have been the law firm representing the plaintiffs under the joint prosecution agreement or the fund (qualified settlement fund or otherwise) set up to administer and disburse the monies. There was even a dispute about how the

³LTR 200121031.

⁴See Nina Olson, "National Taxpayer Advocate 2009 Annual Report to Congress," at 356 (Dec. 31, 2009):

Since the amendment of IRC section 104(a)(2) in 1996, the scientific and medical community has demonstrated that mental illnesses can have associated physical symptoms. Accordingly, conditions like depression or anxiety are a physical injury or sickness and damages and payments received on account of this sickness should be excluded from income. Including these damages in gross income ignores the physical manifestations of mental anguish, emotional distress, and pain and suffering.

⁵LTR 201311006.

money would be divided. That dispute led to a settlement agreement following a mediation.

The IRS kept to its long-standing position that the exclusion from income requires physical injuries or physical sickness with observable bodily harm. After the 1996 change to section 104, the Service often repeated the observable bodily harm mantra. It does so again in this ruling, and the revised statute should clearly apply.

New Era of Excludability?

For years now, we have been admonished to allocate and apportion damages between taxable and nontaxable. In the bruise ruling, the IRS said that the damages, including those from emotional distress, attributable to events leading up to the first pain incident were taxable. After the first pain incident, damages could be nontaxable.

Thus, the first pain incident rule did not sweep *all* of the damages into the tax-free category. The first pain incident acted as a temporal dividing line between taxable and nontaxable. In contrast, in the 2013 ruling, the IRS showed no sign that it wants to allocate or apportion the damages.

As long as a victim had a cut, scrape, or bruise, or presumably anything else that could be observed — and smoke inhalation might not even be observable — that is enough for an exclusion of all the damages. This is where the ruling departs — quite appropriately, in my view — from what might have been expected. The IRS is taking the appropriate and logical view that, in some cases, there is no need to bother with artificially dividing the damages.

The event that led to the payments in the 2013 ruling was a terrible fire in which some individuals died. We can probably assume that some of the victims may have only sustained cuts or scrapes or suffered from smoke inhalation, but all the harm resulted from the same terrible incident. It can surely be assumed that the people who escaped with their lives will be forever scarred in an emotional sense even if their physical cuts or marks heal quickly.

In short, the 2013 ruling suggests that the IRS is considering each victim more as a whole and less as artificially divided physical and mental or emotional parts. The ruling stands for the proposition that the emotional distress damages need not be apportioned between: (1) those associated with (or produced by) a cut, scrape, bruise, or smoke inhalation; and (2) emotional distress damages not produced by a cut, scrape, or bruise but rather by being at the horrific event.

It is noteworthy that the ruling is signed by Michael J. Montemurro, IRS branch chief, who also authored the 2008 memorandum and the bruise ruling. Montemurro provides an important voice of

clarity on section 104. These rulings chart a careful but quite appropriate expansion of the scope of the statute as applied to the real world. Tax practitioners dealing with plaintiffs (and their lawyers who are often less sensitive to these tax issues) should all be grateful.

Wrongful Imprisonment Too

In another piece of administrative guidance that deserves rereading, the IRS ruled that payments made to an individual after several years of unlawful incarceration were excludable from gross income.⁶ When the ruling was released, I urged a cautious reading of it.⁷ Many advisers seemed to believe it said that all wrongful imprisonment recoveries were now always tax free.

Although the guidance certainly does not say that all wrongful imprisonment recoveries are tax free, it also may be broader than I thought. To be fair, it is unclear whether the exclusion only applies to damages for *physical injuries and physical sickness* the individual received or whether the recovery must be divided between its constituent elements, if indeed there were any such elements. Perhaps it is intentionally ambiguous.

In the real world, after all, one may receive damages for being wrongfully imprisoned and not have to divide the dollars into categories. The IRS said that the wrongfully imprisoned individual can exclude from income all compensatory damages for physical injuries and physical sickness (including damages received for economic losses flowing from the physical injury or physical sickness). It is unclear if being wrongfully imprisoned is itself a kind of physical injury. In any case, the IRS does not allocate the compensatory payment among the wrongfully imprisoned individual's possible claims.

Interest and Punitive Damages

The IRS does mention in the 2010 ruling that no punitive damages were awarded, so that tax issue is also covered. Since 1996 (if not before), all punitive damages constitute income. Curiously, the tax treatment of interest is not expressly addressed in the 2013 ruling. Although awards to victims are increased by an interest factor, the ruling does not expressly state whether the interest is taxable.

My guess is that the interest accrual is being accorded tax-free treatment because the award money was situated in a qualified settlement fund in which 100 percent of the amounts paid out to victims were treated as damages, with no amount being regarded as interest in the hands of victims.

⁶ILM 201045023.

⁷Wood, "Tax-Free Wrongful Imprisonment Recoveries," *Tax Notes*, Feb. 21, 2011, p. 961.

That is consistent with the qualified settlement fund authorities.⁸ It represents another advantage to using those funds to administer and distribute litigation proceeds.⁹

No Forms 1099

The 2013 ruling also addresses information reporting and Forms 1099. Such reports are generally required for payments of \$600 or more made in the course of a trade or business. However, damages excluded from gross income under section 104(a)(2) are not income and therefore need not be reported. Thus, the ruling concludes that the payer of the damages to each victim is not required to issue a Form 1099 for the distributions.¹⁰

The ruling even considers victims who might be nonresident alien individuals. In those cases, section 1441(a) generally requires withholding equal to 30 percent of the income. However, damages that

are excluded from a recipient's gross income under section 104(a)(2) are also not subject to withholding under section 1441. Since the ruling concludes that each victim is entitled to the section 104 exclusion for the entire payment, any payment to a nonresident alien is also not subject to withholding.

Conclusion

On the surface, the IRS simply recited an obviously correct conclusion in the 2013 ruling. Victims who were physically hurt (and doubtlessly psychologically injured) in a fire shouldn't pay tax on their recoveries, nor should the families of those who died. A second look reveals that this is a more important ruling.

It suggests that dividing recoveries between tax free and taxable — between emotional distress caused by the physical injuries and the rest of the emotional distress — is not always necessary. Just as he did in the 2008 guidance that paved the way for many sex abuse victims to exclude damages for sex abuse despite lacking the normally mandatory cut, scrape, or bruise, Mr. Montemurro has again molded section 104 administrative authority for the better. Bravo.

⁸See LTR 200819013; LTR 200712005; LTR 200704004, discussed in Wood, *Qualified Settlement Funds and Section 468B*, para. 9.4[E] (2009 with 2012 supplement).

⁹See Wood, *supra* note 7.

¹⁰See section 6041.

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