

## Taxing Emotional Distress Damages: Now What? Settlement Wording!

by Robert W. Wood



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In this article, Wood revisits the distinction between physical and emotional damages in employment cases and beyond after the 1996 amendment to section 104.

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It has long been true that section 104 is a fertile hotbed for taxpayer disputes, especially in employment settlements. More than once, esteemed and former National Taxpayer Advocate Nina Olson lamented how the lack of guidance and cloudy “physical vs. emotional” line-drawing have clogged the Tax Court and IRS machinery with disputes. Most employment plaintiffs and prospective plaintiffs believe the stress and other conditions of their workplaces have adversely affected their health.

They may be right, but that doesn’t mean the money they receive can be viewed as tax-free. The issue can be a big one in the vast numbers of employment cases filed and eventually resolved every year. The same is true in the legions of quietly threatened cases that are mediated or otherwise resolved outside any court filing. Of course, the battleground isn’t limited to employment cases, although the dichotomy between compensation for services and

something else may be most obvious in that context.

There are plenty of non-employment cases in which the line between taxable and not taxable also looms large. Section 104 was amended in 1996 to require that for compensatory damages to be excludable, they must be for physical injuries or physical sickness. There is no doubt that the targets of that statutory change were the legions of employment plaintiffs with emotional distress claims. Nearly every employment case before and since then has wage claims and emotional distress claims.

Yet in the 25 years that have elapsed since section 104 was amended, neither the IRS nor Treasury has said exactly what “physical” means. For a time, the IRS maintained an “observable bodily harm” standard. Bruises and broken bones are physical, after all, but that doesn’t necessarily mean that everything else is not. For sex abuse claims in which the target was a minor, the IRS even said it might *presume* that at some point, those injuries were observable, even if they weren’t observable years later.<sup>1</sup>

In ILM 200809001, given the passage of time and nature of the abuse, the IRS presumed there were physical injuries and that the emotional distress resulted from those injuries. Ergo, the recovery was tax-free. In LTR 201311006, relatively minor injuries, such as cuts, scrapes, bruises, and smoke inhalation from a fire, allowed victims to exclude their entire recoveries. Indeed, it was never made clear just how observable a harm must be in the first place.

Suppose that someone — inside or outside the employment context — gives you \_\_\_\_ [fill in the

<sup>1</sup> See Robert W. Wood, “IRS Allows Damages Exclusion Without Proof of Physical Harm,” *Tax Notes*, Mar. 31, 2008, p. 1388.

blank with a *serious disease*] that you can see only with a microscope. You sue and receive compensatory damages from the defendant for giving you that disease. Surely that should qualify as tax-free. Some physical repercussions of the disease that you have now or can expect later should persuade even the IRS.

Significantly, the 1996 change to section 104 made clear that whether the chicken or egg comes first matters. Emotional distress damages on their own are clearly taxable. A critical footnote in the conference committee report states that emotional distress includes physical symptoms, such as insomnia, headaches, and stomach disorders, which may result from that emotional distress.<sup>2</sup> Thus, those physical symptoms aren't generally considered physical injuries for section 104(a)(2).

The conference committee report makes clear that all compensatory damages that flow from a physical injury or physical sickness are excludable from income.<sup>3</sup> That is true even if the recipient of the damages isn't the injured party.<sup>4</sup> Examples include damages for loss of consortium resulting from the physical injury or physical sickness of a spouse.

Pleadings — or demand letters and mediation briefs — clearly matter. Inartful wording can haunt you. If you make claims for emotional distress, your damages are taxable. If you claim that the defendant caused you to become physically *sick*, those damages should be tax-free. But if you sue for emotional distress that causes you to be physically sick, the IRS and some courts might say that even physical sickness damages may not be tax-free in that case.

What causes what can seem artificial. Many of us in the real world don't really know what comes first and how to evaluate a mix of messy and disputed facts. Thus, settlement wording seems paramount. For a recent example, consider *Stassi*.<sup>5</sup> The taxpayer, Cindy Stassi, sued and settled with her former employer. Part of the settlement was wages and part was for bad treatment that allegedly triggered shingles. Predictably, the IRS

said the recovery was taxable. Stassi's lawsuit claimed "emotional distress with physical manifestations." She didn't say her employer *caused* her shingles. *Stassi* is a summary opinion so it isn't precedential. But even in telling Ms. Stassi that her recovery was all taxable, the court handed plaintiffs and lawyers a playbook by saying:

Because petitioner wife did not file a complaint based on physical injury or sickness and the settlement agreement did not state that the payment was in lieu of damages for physical injury or physical sickness, the \$69,650 settlement payment is not excludable pursuant to section 104(a)(2).

This is just one judge out of many on the Tax Court, and the memo opinion (it bears repeating) is not precedential. Still, it is a tough test in the conjunctive for whoever is held to this high bar. To my mind, settlement wording might matter more than the claims. In *Collins*,<sup>6</sup> the taxpayer, Edward Collins, couldn't exclude \$85,000 even though his emotional distress resulted in physical sickness. He alleged that he had "suffered severe emotional distress and anxiety, with physical manifestations, including high blood pressure." The case settled for \$275,000, with \$85,000 for emotional distress. Collins claimed it had been paid because of his physical sickness, but the court said:

while there may be some ambiguity as to what the parties to the term sheet intended to encompass within the meaning of the term "emotional distress", petitioner has failed to persuade us that the physical manifestations, including high blood pressure, that he may have suffered amount to physical injuries or physical sickness within the meaning of section 104(a).

The complaint and settlement agreement both referred to the damages as being for emotional distress. His emotional distress may have had physical symptoms or consequences, but the emotional distress came first. It might have been

<sup>2</sup> See H. Rept. 104-737, at 301 n.56 (1996).

<sup>3</sup> *Id.* at 301.

<sup>4</sup> *Id.*

<sup>5</sup> *Stassi v. Commissioner*, T.C. Summ. Op. 2021-5.

<sup>6</sup> *Collins v. Commissioner*, T.C. Summ. Op. 2017-74.

different if the settlement language said otherwise.

Consider the practical side. Good settlement wording might not only give you a tax return filing position but also be enough to survive an audit. The IRS sometimes sees the settlement agreement and says, “OK.”

### Physical Sickness

The most flexible cases on these issues were *Domeny*<sup>7</sup> and *Parkinson*.<sup>8</sup> But since those cases were decided in 2010, it hasn’t necessarily been easier for taxpayers who face scrutiny in the absence of great documents. In *Domeny*,<sup>9</sup> the taxpayer, Julie Domeny, suffered from multiple sclerosis, the symptoms of which were exacerbated by workplace problems. Workplace stress, including the taxpayer’s discovery that the director of her company was embezzling funds, aggravated her MS symptoms.

Her physician determined that she was too ill to work and that she shouldn’t work for several weeks. The employer terminated her, causing another spike in her MS symptoms. The Tax Court found it clear that Domeny’s exposure to a hostile and stressful work environment had exacerbated her MS symptoms. Her health and physical condition grew worse.

In *Parkinson*,<sup>10</sup> the taxpayer worked long hours under stressful conditions as the chief supervisor of a medical center’s ultrasound and vascular lab. Ronald Parkinson suffered a heart attack while at work in 1998 and thereafter reduced his workweek from 70 hours to 40 hours. In 2000 he took medical leave and never returned to work. Parkinson filed suit under the Americans With Disabilities Act, claiming that the medical center failed to accommodate his severe coronary artery disease.

Parkinson’s suit included counts against two employees of the medical center for intentional infliction of emotional distress and invasion of privacy. The district court dismissed his ADA,

intentional infliction, and invasion of privacy claims. Parkinson appealed to the Fourth Circuit, which affirmed. He then asked for Supreme Court review. Parkinson also filed suit in Maryland state court, claiming intentional infliction and invasion of privacy.

The complaint alleged that the defendants’ extreme and outrageous misconduct caused him to suffer another disabling heart attack at work, rendering him unable to work. The case settled for \$350,000 “as noneconomic damages and not as wages or other income.” It was paid in installments: \$250,000 in 2004, \$34,000 in 2005, and \$33,000 in each 2006 and 2007. The 2004, 2006, and 2007 payments were not before the court, nor was it clear how they were treated for tax purposes.

Parkinson argued that the 2005 payment was for physical injuries and physical sickness brought on by extreme emotional distress. The IRS argued that it was an emotional distress recovery. Unfortunately, the settlement agreement stated only that the payments were meant as “noneconomic damages and not as wages or other income.” The Tax Court consulted the Maryland authorities about the meaning of “noneconomic damages.”

### Physical Symptoms

Physical symptoms of emotional distress might be physical in nature, but that does not make the related damages tax-free. The *Parkinson* court noted that damages received on account of emotional distress attributable to a physical injury or physical sickness are excludable.<sup>11</sup> The court addressed what is meant by a “symptom,” calling it “subjective evidence of disease of a patient’s condition.”<sup>12</sup>

In contrast, a “sign” is evidence perceptible to the examining physician. The Tax Court stated:

It would seem self-evident that a heart attack and its physical aftereffects

<sup>7</sup> *Domeny v. Commissioner*, T.C. Memo. 2010-9.

<sup>8</sup> *Parkinson v. Commissioner*, T.C. Memo. 2010-142.

<sup>9</sup> For a more extensive discussion of *Domeny*, see Wood, “Is Physical Sickness the New Emotional Distress?” *Tax Notes*, Feb. 22, 2010, p. 977.

<sup>10</sup> T.C. Memo. 2010-142.

<sup>11</sup> *Id.* at 301 (“Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness.”).

<sup>12</sup> See *Sloane-Dorland Annotated Medical-Legal Dictionary* 496 (supp. 1992).

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.<sup>13</sup>

The Tax Court in *Parkinson* even stated that the IRS was wrong to argue that one can never have physical injury or physical sickness in a case brought under the tort of intentional infliction of emotional distress. The court referred to Maryland authorities and the Restatement of Torts, noting that intentional infliction of emotional distress can result in bodily harm.

The settlement agreement in *Parkinson* was (from a tax viewpoint) poorly drafted. It wasn't specific about either the nature of the intended payment or its tax treatment, much less saying anything about tax reporting. Moreover, Parkinson's underlying lawsuit was primarily about intentional infliction of emotional distress.

There was little evidence that medical testimony linked Parkinson's condition to the actions of the employer, but perhaps physical symptoms of emotional distress have a limit. Extreme emotional distress can produce a heart attack, which isn't a symptom of emotional distress. Without good wording, though, you still may be sunk.

Despite the taxpayer victories in *Domeny* and *Parkinson*, most taxpayers lose in Tax Court. In *Lindsey*,<sup>14</sup> the taxpayer, Paul S. Lindsey Jr., sued for tortious interference with contracts. His doctor testified that during the tortious events (occurring over two years), Lindsey suffered from hypertension and stress-related symptoms,

including periodic impotency, insomnia, fatigue, occasional indigestion, and urinary incontinence.

A bad work environment produced emotional distress and eventually physical sickness, so the Tax Court held that it was taxable. The Eighth Circuit agreed. In *Sanford*,<sup>15</sup> the Tax Court considered physical symptoms, including asthma, sleep deprivation, skin irritation, appetite loss, severe headaches, and depression. The Tax Court agreed with the IRS that these were simply manifestations of emotional distress.<sup>16</sup>

### Post-Traumatic Stress Disorder

PTSD afflicts many Americans,<sup>17</sup> yet its tax treatment remains unclear. There is strong medical evidence that PTSD is physical<sup>18</sup> and should be for tax purposes too. Then-President Obama almost said as much in 2016.<sup>19</sup> Olson has also expressed the view that PTSD damages should be tax-free.<sup>20</sup>

*Sullivan*<sup>21</sup> too suggests that PTSD damages should be tax-free. John Sullivan received payments from the Department of Veterans Affairs for disabilities resulting from his service in Vietnam, including PTSD. Sullivan attempted to amend his tax returns to exclude his disability payments. The court balked based on the statute of limitations, but it didn't dispute that disability

<sup>15</sup> *Sanford v. Commissioner*, T.C. Memo. 2008-158.

<sup>16</sup> See also *Prinster v. Commissioner*, T.C. Summ. Op. 2009-99. See also *Molina v. Commissioner*, T.C. Memo. 2013-226; and *Gutierrez v. Commissioner*, T.C. Memo. 2011-263, in which the Tax Court easily ruled for the IRS on emotional distress recoveries despite some physical claims. See also Wood, "Taxing Physical Sickness, Workers' Compensation, and PTSD," *Tax Notes*, Feb. 24, 2014, p. 857.

<sup>17</sup> See Alexandra Wolfe, "A Psychiatrist's Quest to Understand PTSD," *The Wall Street Journal*, Jan. 6, 2017.

<sup>18</sup> See Wood, "President Obama and Damages for PTSD," *Tax Notes*, Mar. 6, 2017, p. 1297; Wood, "Taxing Post-Traumatic Stress Disorder," *Tax Notes*, July 7, 2014, p. 89.

<sup>19</sup> CNN, "Presidential Town Hall: America's Military and the Commander and Chief," CNN Press Room (Sept. 28, 2016).

<sup>20</sup> See Olson, "National Taxpayer Advocate 2009 Annual Report to Congress," at 355-356 (Dec. 31, 2009); see also Olson, "National Taxpayer Advocate 2013 Annual Report to Congress," at 2 (Dec. 31, 2013) ("Since the amendment of 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.").

<sup>21</sup> *Sullivan v. United States*, 46 Fed. Cl. 480 (2000).

<sup>13</sup> *Parkinson*, T.C. Memo. 2010-142.

<sup>14</sup> *Lindsey v. Commissioner*, 422 F.3d 684 (8th Cir. 2005).



payments for PTSD are excludable from income under section 104(a)(4).<sup>22</sup>

### Depression

Depression is arguably a physical sickness, so if you sue someone for giving you depression, should section 104 apply? How you phrase your claim and your settlement agreement will matter. In *Blackwood*,<sup>23</sup> Julie Blackwood trained hospital personnel to use a computer data entry program for the collection of patient information upon a patient's admission to the hospital.

Following the admission of her son to the hospital, Blackwood observed a hospital nurse taking her son's medical history without using the data entry program. Blackwood later used the system to access her son's medical records (which was a violation of the law), and she was dismissed. As a result, she relapsed into depression, which she previously had overcome.

Her symptoms included insomnia, oversleeping, migraines, nausea, vomiting, weight gain, acne, and pain in her back, shoulder, and neck. Claiming wrongful termination, she settled for \$100,000. The settlement agreement stated that the payment was for "alleged damages for illness and medical expenses allegedly exacerbated by, and allegedly otherwise attributable to" her wrongful discharge. The IRS said she had symptoms of emotional distress, so the money was taxable, and the Tax Court agreed.

The recent *Stassi* case<sup>24</sup> reminds me of *Maciujec*.<sup>25</sup> In that case, the Tax Court held in favor of the IRS because neither the taxpayer's complaint nor the taxpayer's settlement agreement mentioned that the taxpayer, Liudmela Oksana Maciujec, had suffered from physical injuries and physical sickness. The settlement agreement said the payment was for compensatory damages including emotional distress. The settlement agreement stated that the

taxpayer "has not sought medical treatment or incurred medical costs . . . as a result of the claims asserted in this lawsuit."<sup>26</sup>

In reaching its holding in *Maciujec*, the Tax Court reiterated that the taxpayer must show that the "settlement payment was in lieu of damages for a physical injury or physical sickness." The Tax Court said:

Petitioner contends that the damages that she received for emotional distress are attributable to a physical injury (battery) arising during her employment at Home Depot. We disagree.

The complaint that petitioner filed against Home Depot does not include an allegation that she suffered any physical injury or physical sickness as a result of the conduct of Home Depot or its employees. The complaint states that as a proximate result of the actions underlying the complaint petitioner suffered "loss of income, wages and other pecuniary losses" and "mental anguish, embarrassment, humiliation, and emotional distress."

*Although petitioner may have suffered physically as a result of the battery described in the complaint, there is no indication in the settlement agreement or in the record as a whole that she was compensated for a physical injury or physical sickness, or emotional distress attributable thereto. Petitioner does not claim that any portion of the settlement payment served to reimburse her for amounts paid for medical care attributable to emotional distress.*<sup>27</sup> [Emphasis added.]

### Conclusion

The cases suggest that to exclude a payment on account of physical sickness, the taxpayer needs evidence of making the claim. The taxpayer doesn't have to *prove* that the defendant caused the sickness but should hopefully be able to show it was claimed and that the payer was aware of the

<sup>22</sup> See also *Kiourtsis v. Commissioner*, T.C. Memo. 1996-53 (in which disability compensation for PTSD appears to be excludable).

<sup>23</sup> *Blackwood v. Commissioner*, T.C. Memo. 2012-190, superseded by regulation as stated in *Perez v. Commissioner*, 144 T.C. 51 (2015); see also Wood, "Are Damages for Exacerbation of Depression Tax Free?" *Tax Notes*, Sept. 3, 2012, p. 1211.

<sup>24</sup> *Stassi*, T.C. Summ. Op. 2021-5.

<sup>25</sup> *Maciujec v. Commissioner*, T.C. Summ. Op. 2017-49.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

claim and at least considered it in making the payment. To prove physical sickness, the taxpayer should have evidence of medical care and evidence of actually claiming that the payer caused or exacerbated the condition.

The more medical evidence, the better, but the settlement agreement may be the most important thing of all. Settlement agreements should be specific, so the IRS and the courts aren't asked to determine which payments were for which claims. When there is a scant record, consider what other documents you can collect at settlement time.

With the right combination, you may be able to quickly resolve an IRS query or audit. You might even do that with good settlement wording and a less than stellar complaint. Without either one, you may be out of luck. ■

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