

## Taxing Post-Traumatic Stress Disorder

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>. Wood gratefully acknowledges the assistance of Carol H. Wang of Wood LLP in preparing this article.

In this article, Wood discusses the tax consequences of litigation recoveries based on claims for post-traumatic stress disorder.

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Post-traumatic stress disorder can develop after trauma involving physical harm or the threat of physical harm. It is said to change and damage a person's natural fight-or-flight response to perceptions of danger.<sup>1</sup> Those changes may manifest themselves in flashbacks, insomnia, headaches, depression, and stomach disorders.

Studies say approximately 25 percent of the 2.6 million returning post-9/11 veterans from Afghanistan and Iraq have been diagnosed with PTSD.<sup>2</sup> It has also been diagnosed in victims of child abuse and workplace injury. PTSD sufferers may endure life-changing difficulties with normal daily tasks, alienation from family and friends, and an inability

<sup>1</sup>National Institute of Mental Health, "What Is Post-Traumatic Stress Disorder (PTSD)?" available at <http://www.nimh.nih.gov/health/topics/post-traumatic-stress-disorder-ptsd/index.shtml>.

<sup>2</sup>Florida Center for Investigative Reporting, "Returning Iraq and Afghan War Vets Find Little Government Support, Investigation Finds" (Aug. 26, 2013).

to perform work. The Social Security Administration has ruled that some PTSD sufferers are disabled.<sup>3</sup>

Their condition may be exacerbated by medical malpractice, and they may encounter discrimination in the workplace. Any of these circumstances can lead to legal disputes and lawsuits. The tax treatment of settlement payments for PTSD has thus become an increasingly relevant question.

### Tax Treatment of PTSD

Section 104 excludes from income the proceeds of legal settlements and judgments in personal physical injury cases. Before 1996 even recoveries for purely emotional distress could be tax free. Congress amended section 104 in that year to restrict the exclusion to damages for personal physical injuries and physical sickness.<sup>4</sup>

Although the IRS has not defined the physical requirement, it has emphasized that physical injuries must be observable. PTSD involves physical and emotional trauma and manifests itself in physical sickness and emotional distress. Nevertheless, some nontax courts have determined that PTSD is an emotional injury, not a physical one.<sup>5</sup> This may suggest that the tax law should follow.

Still, recoveries on account of PTSD injuries may be tax free in some cases even without proof of physical injury. After all, section 104(a)(1) excludes amounts received under workers' compensation acts. Moreover, section 104(a)(4) excludes amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces. Neither of those subsections requires the injuries or sickness to be physical as in section 104(a)(2). More generally, however, there are also strong arguments for treating PTSD recoveries outside those two subsections as on account of physical injuries or physical sickness within section 104(a)(2).

<sup>3</sup>*Laskowski v. Department of Veteran Affairs*, No. 3:10-cv-600, at 17 (M.D. Pa. Jan. 16, 2013); see also Social Security Administration, "Apply Online for Social Security Benefits," available at <http://www.socialsecurity.gov/applyfordisability/#a0=0>.

<sup>4</sup>Small Business Job Protection Act, P.L. 104-188, section 1605.

<sup>5</sup>See *Curtis v. DOJ*, 342 Fed. Appx. 610 (2009); *Parker Drilling Offshore United States LLC v. Campbell*, 323 Fed. Appx. 330 (2009).

### Science and the Courts

The IRS has stated in private letter rulings and argued in cases that for an injury to be physical, there must be “observable bodily harm” such as broken bones, cuts, or bruises.<sup>6</sup> For individuals who develop PTSD after physical injuries, including veterans who have lost limbs or sight from small arms, mortar fire, or explosions from improvised explosive devices, their case for tax-free recovery of personal physical injury seems beyond question. But for those who develop PTSD without sustaining physical injuries, perhaps veterans who suffer emotional trauma from witnessing the deaths of fellow soldiers, their illness may not be observably physical.

Nonetheless, scientific developments in brain imaging suggest that PTSD is observable bodily harm. The physical structure of the brain is altered by PTSD just as the physical structure of the heart is altered by a heart attack. Advances in magnetic resonance imaging allow neurologists to examine the brain at 1 millimeter resolution, in color and in 3-D, enabling detections in small changes in brain activity.<sup>7</sup>

With this technology, researchers can now survey the human brain more thoroughly than with conventional X-ray or CT scans. The data reveal the physical damage of PTSD in several ways. First, the images reflect demonstrably higher levels of cortisol as physically observable as a bruise.<sup>8</sup>

Cortisol is a steroid hormone that plays a key role to direct urgent physiological and metabolic processes. It also regulates the processes that bring the body back to normal. It is well documented that individuals with PTSD generally have altered cortisol levels.<sup>9</sup>

For example, child abuse victims with PTSD experience enhanced cortisol activity in response to exposure to traumatic reminders.<sup>10</sup> Moreover, PTSD sufferers exhibit a diminished hippocampus, and this, too, is quite observable. Like a shrunken limb, this part of the PTSD sufferer’s brain is noticeably smaller.

The hippocampus is the part of the brain that plays a major role in short-term memory and emo-

tions. Studies comparing hippocampus size in those with and without PTSD demonstrate upward of a 20 percent reduction in size because of PTSD.<sup>11</sup> Patients suffering from PTSD also show altered activity in the amygdala and insular cortex.<sup>12</sup> Scientific studies suggest that the amygdala supports emotional memory. The insular cortex inhibits the amygdala, regulating negative emotion.

In PTSD patients, the insular cortex shows hypoactivity. Further, the amygdala shows hyperactivity, which leads to reduced effectiveness of the brain’s fear conditioning.<sup>13</sup> All those effects are observable with the use of the requisite equipment.

Of course, outward manifestations of PTSD are often all too apparent.<sup>14</sup> In a study by researchers at the University of Pittsburgh and the University of Michigan, children subjected to emotional abuse from their parents exhibit similar symptoms as children subject to physical abuse. Those symptoms include depression and increased risk of aggressive behavior.<sup>15</sup>

In her 2009 annual report to Congress, National Taxpayer Advocate Nina Olson stated clearly that PTSD and other mental disorders are indeed physical injuries under section 104.<sup>16</sup> The taxpayer advocate may not be the IRS commissioner, but her position is nevertheless important. Congress has required the commissioner to establish formal procedures to consider the advocate’s recommendation.<sup>17</sup>

<sup>11</sup>M.W. Gilbertson et al., “Smaller Hippocampal Volume Predicts Pathologic Vulnerability to Psychological Trauma,” 5 *Nat. Neuroscience* 1242 (2002).

<sup>12</sup>The amygdala, located in the temporal lobes of the brain, helps process memory and emotional reactions. The insular cortex, located within the lateral sulcus of the brain, regulates a person’s perception, motor control, self-awareness, and cognitive functioning. See Amit Etkin and Tor Wager, “Functional Neuroimaging of Anxiety: A Meta-Analysis of Emotional Processing in PTSD, Social Anxiety Disorder, and Specific Phobia,” 164 *Am. J. Psychiatry* 1476 (2007).

<sup>13</sup>Michael Koenigs and Jordan Grafman, “Post-Traumatic Stress Disorder: The Role of Medial Prefrontal Cortex and Amygdala,” 15 *Neuroscientist* 540 (2009).

<sup>14</sup>These include depression, withdrawal, moodiness, and unpredictable temperament.

<sup>15</sup>Andrea Petersen, “Study Says Yelling Is as Hurtful as Hitting,” *The Wall Street Journal*, Sept. 4, 2013.

<sup>16</sup>National Taxpayer Advocate 2009 Annual Report to Congress, at 355-356 (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.”).

<sup>17</sup>*Id.* at 2.

<sup>6</sup>See LTR 200041022.

<sup>7</sup>See Justin Berton, “PTSD Leaves Physical Footprints on the Brain,” *San Francisco Chronicle*, July 27, 2008.

<sup>8</sup>Eileen Delaney, “The Relationship Between Traumatic Stress, PTSD and Cortisol,” Naval Center for Combat & Operational Stress Control (May 14, 2013) (citing B.M. Elzinga et al., “Higher Cortisol Levels Following Exposure to Traumatic Reminders in Abuse-Related PTSD,” 28 *Neuropsychopharmacology* 1656 (2003)).

<sup>9</sup>The hypothalamus links the nervous system to the endocrine system. It controls body temperature, hunger, thirst, fatigue, and sleep.

<sup>10</sup>See *supra* note 8.

The departments of Treasury, Labor, and Health and Human Services have also recognized that the line between emotional and physical injury is increasingly tenuous. In 2013 those departments issued final regulations so that mental health or substance use disorder benefits equal medical and surgical benefits. Section 9812 required “processes, strategies, evidentiary standards, and other factors used by the plan or issuer” to be “comparable to, and be applied no more stringently for, mental health or substance use disorder benefits than for medical surgical benefits.”<sup>18</sup>

Nontax courts have also held that PTSD is a physical injury. In *City of Norman v. Helm*,<sup>19</sup> the taxpayer was a firefighter who suffered from PTSD after responding to an emergency in which two young boys were suffocating in the trunk of a car. The taxpayer argued that PTSD “causes physiological changes in the brain itself, [and] therefore it is a physical injury.”

Although the Oklahoma court of appeals eventually concluded that the injuries were not excludable, the trial court and the appeals panel both recognized that “there is evidence the [PTSD] is accompanied by changes to the claimant’s brain (prefrontal cortex, the amygdala and the hippocampus). The court therefore finds that PTSD is a physical injury to the brain.”

Further, in *Werline v. CSX Transportation Inc.*,<sup>20</sup> the court recognized that the plaintiff suffered both physical and emotional injuries from PTSD. It so concluded even though the case was pled as one for negligent infliction of emotional distress. The court observed that there is “no recognizable clean-cut [line] that would allow the Court to partition off” emotional injuries from physical injuries affiliated with PTSD.

Perhaps encouraged by this recognition of PTSD as a physical injury, a professor brought a case alleging that he was unlawfully fired because of PTSD injuries resulting from being held captive in Rwanda in 2010.<sup>21</sup> His complaint argues that PTSD is a physical illness that alters neurochemical functioning.

### Emotional Distress From PTSD

Recognition that PTSD is a physical injury means that emotional distress damages arising from PTSD should also be tax free. The legislative history to the 1996 amendment to section 104(a)(2) states that the

section does not apply to any emotional distress recovery to the extent that it did not arise out of a claim for personal physical injuries or physical sickness. However, the exclusion *does* apply to damages received based on a claim of emotional distress that is on account of personal physical injury or physical sickness.<sup>22</sup>

The IRS does not dispute the tag-along status of emotional distress recoveries. In LTR 200041022, often called the “bruise ruling,” the IRS ruled that emotional distress injuries sustained *after* physical injury are tax free.

### PTSD Triggers Physical Signs

Some courts have held that payments for symptoms such as insomnia, headaches, and stomach disorders are taxable.<sup>23</sup> However, the courts have recognized that those symptoms may arise as a result of physical sickness or physical injury and can be characterized as “objective indications of a disease” rather than merely “subjective sensations.”<sup>24</sup> As such, payments on their account can be tax free.

In *Parkinson v. Commissioner*,<sup>25</sup> the taxpayer suffered a heart attack because of stresses at his job. In determining the tax treatment of the recovery, the Tax Court distinguished between *symptoms* of emotional distress and *signs* of emotional distress. Symptoms are “subjective evidence of a disease or a patient’s condition.”

In contrast, signs are evidence perceptible to the examining physician. Damages for the former are taxable; damages for the latter are tax free. Mr. Parkinson suffered a heart attack at work and brought suit for intentional infliction of emotional distress.

The IRS argued that the settlement was not excludable because the claim was for emotional distress. Nonetheless, the Tax Court sensibly viewed a heart attack as a sign and not merely a symptom of emotional distress. The court explained that a heart attack’s physical effects are clearly diagnosable by examining physicians.

<sup>22</sup>PMTA 2009-035; see also *Commissioner v. Schleier*, 515 U.S. 323 (1995).

<sup>23</sup>See *Sanford v. Commissioner*, T.C. Memo. 2008-158; see also *Blackwood v. Commissioner*, T.C. Memo. 2012-190 (holding that payments for depression symptoms of insomnia, oversleeping, migraines, nausea, and vomiting were for emotional distress and not excludable from income); *Murphy v. IRS*, 493 F.3d 170 (D.C. Cir. 2007) (in which the District of Columbia Circuit considered sleeplessness, stomachaches, and headaches “minor and transitory” and did not exclude payments for those symptoms).

<sup>24</sup>*Parkinson v. Commissioner*, T.C. Memo. 2010-142.

<sup>25</sup>*Id.*

<sup>18</sup>T.D. 9640.

<sup>19</sup>Okla. Civ. App. 106 (2012).

<sup>20</sup>U.S. Dist. LEXIS 137028, at 10 (2010).

<sup>21</sup>Plaintiff’s Complaint, *Erlinder v. Janus*, State of Minnesota, District Court, Second Judicial District, County of Ramsey (2014).



Interestingly, PTSD and its aftereffects can now be diagnosed by physicians. As with a heart attack, PTSD triggers entrenched physical (and mental) changes documented by MRI technology. In the language of the Tax Court in *Parkinson*, the effects of PTSD are signs, not symptoms. They therefore give rise to damages that should be excludable.

In another important case, *Domeny v. Commissioner*,<sup>26</sup> Ms. Domeny's multiple sclerosis (MS) was exacerbated by stressful conditions on the job. Her symptoms of MS included shooting pain, fatigue, burning eyes, vertigo, and light-headedness. The Tax Court concluded that the settlement was excludable because it was for physical illness.

Notably, Ms. Domeny was not physically touched or injured, and it was clear that the stressors were emotional. Even so, the court sensibly held her damages to be tax free. Whether her damages were for physical injuries (and related emotional distress) or physical sickness (and related emotional distress) may be semantics.

Since section 104 excludes both, the distinction is unimportant. Similarly, whether PTSD represents physical injury or physical sickness, it is physical. That means any accompanying emotional distress damages should also be tax free.

### Workers' Compensation

Given the increasing acceptance of PTSD in medical communities and its increasing recognition by the public, PTSD also figures in workers' compensation claims. Payments for PTSD as a workers' compensation claim should be tax free regardless of whether one views the injury as physical or emotional. Under section 104(a)(1), payments received under workers' compensation acts are excluded from income regardless of whether the personal injury was physical.

An increasing number of states are altering their workers' compensation laws to include benefits for PTSD. For example, Minnesota passed a bill that added PTSD to the list of covered occupational diseases under workers' compensation, and Minnesota's governor signed it into law.<sup>27</sup> Some of those developments are the result of specific incidents.

In Minnesota's case, the legislative effort may be traced to the 2005 Red Lake High School shooting, in which a 16-year-old killed seven people at the school and wounded five others before taking his own life. One of the teachers suffered PTSD injuries but was denied workers' compensation because PTSD was not on the list of covered diseases. Similarly, after the Sandy Hook Elementary School

shooting, the Connecticut legislature passed a bill to add PTSD as a listed condition covered by workers' compensation.<sup>28</sup>

### Armed Forces Pensions

Even after 1996, workers' compensation payments are tax free by statute and have no "physical" requirement. Similarly, under section 104(a)(4), payments received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces are tax free. For example, in *Sullivan v. United States*,<sup>29</sup> the taxpayer received payments from the Department of Veterans Affairs.

The payments were for disabilities, including PTSD, resulting from his service in Vietnam. The court did not dispute that those disability payments for PTSD were excludable under section 104(a)(4). Thus, the IRS agreed to some adjustments in tax credits for those disability payments.

### Conclusion

PTSD sufferers face many challenges. In some cases, their physical and mental condition precludes ever living a normal life. Even a person who may look entirely normal may be permanently debilitated. The same is true with many diseases of the body that may not be apparent to an observer until their late stages.

The scientific community has verified that PTSD is devastatingly genuine. It is observably physical in signs, symptoms, and effects. This should be sufficient for a PTSD diagnosis to be treated similarly to a medical report of a heart attack. A payment on account of either should be tax free regardless of whether the payment comes through workers' compensation, a pension, or in an employment dispute.

By statute, tax-free treatment already applies to payments for PTSD under workers' compensation and as pension payments for active services in the armed forces. Outside those two statutory cases, there should be parallel treatment for PTSD damages more generally. As Olson has put it, "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."<sup>30</sup>

<sup>28</sup>Fred Hosier, "State to Add Post Traumatic Stress Disorder to Workers' Comp Coverage," *Safety News Alert* (May 20, 2013).

<sup>29</sup>46 Fed. Cl. 480 (2000).

<sup>30</sup>See *supra* note 16, at 356.

<sup>26</sup>T.C. Memo. 2010-9.

<sup>27</sup>"Workers' Compensation Bill Passes," *Compact* (May 2013).