What Litigation Recoveries Are Excludable as 'Physical'?

By Robert W. Wood

As most tax practitioners know, section 104 provides an exclusion for personal injury recoveries. This provision was radically changed in 1996 by the insertion of only a couple of words. To obtain an exclusion from income under section 104, since August 20, 1996, the personal injury or illness must be "physical." The code does not specify what "physical" means. The legislative history is less than helpful, but makes it apparent that emotional distress recoveries and employment litigation in general were particular targets. The legislative history goes on to state that headaches, insomnia, and stomachaches are not physical. Yet beyond this, there has been little guidance.

Another change to section 104 in 1996 relates to reimbursements for medical expenses. Even though the "physical" modifier was added, if a plaintiff has reimbursed medical expenses (and these may merely be for emotional injuries such as psychiatrist bills), a reimbursement of these expenses will be excludable even though there was no "physical" injury. Of course, it will be necessary to be able to show that the plaintiff had not previously deducted these medical expenses. Finally, one other 1996 change to section 104 was to make clear that all punitive damages are now taxable.

What is 'Physical'?

Given the importance of the term "physical injuries" and "physical illness," one would think that there would be stacks of authority explaining it. Given that tax cases take years to wend their way through the IRS administrative process and then through the courts, one would have assumed that at least there would be regulations or IRS notices or announcements indicating the Service's view of what constitutes physical injuries or physical illness.

In that regard, while IRS regulations may take years to percolate through the administrative process, there is a variety of IRS vehicles such as notices and announcements that can be issued quite quickly when and if the IRS wants to give guidance on a particular point.

Many tax lawyers and accountants (and probably a much larger number of plaintiffs' lawyers and defense counsel) are frustrated that the IRS has been silent over the last five years regarding what this "physical" requirement really means. As in other grey areas, taxpayers are entitled to read a statute, read the legislative history, and try to achieve a result in accordance with the expressed views of either the IRS or Congress, while at the same time keeping in mind what is best for them. Thus, this silence has allowed some taxpayers to take positions that it is unlikely the IRS would find persuasive. At the same time, it is enormously inefficient and potentially risky for taxpayers to go too far. It is therefore important to know just what the IRS thinks about this.

It is well known that private letter rulings (LTRs) are not published authority (and not so considered for many purposes under the tax law). For example, LTRs cannot be cited as legal precedent. They are issued to just one taxpayer — the one who applies for the ruling. This rule seems to be breaking down somewhat. For example, the Supreme Court cited LTRs in *Rowan Companies v. U.S.*, 452 U.S. 247 (1981). Still, they do not, technically, constitute authority.

The second point about LTRs is that most taxpayers do not want to apply for one unless they are sure they will get a favorable ruling. In most areas where there is some controversy, LTRs are not issued. This is because the IRS does not want to go out on a limb, and also because taxpayers do not want to expose themselves by asking a question to which they may not know the answer. This may seem paradoxical, but taxpayers do not typically ask unless they know how the IRS will rule. Otherwise, if the IRS does not give the taxpayer the sought-for answer, it is customary to find this out just before the IRS gives its adverse ruling, and withdraw the ruling request. Of course, since, in the process, the taxpayer has revealed his or her identity, the taxpayer will also be concerned whether the IRS may follow up on the matter in the audit process.

Some Guidance?

Despite all these caveats, tax practitioners still look to LTRs for the Service's general position on matters. A recent LTR gives some indication about the scope of the "physical" injury requirement and is therefore highly interesting. LTR 200041022, *Doc 2000-26382 (6 original pages), 2000 TNT 201-10,* deals with the difficult topic of when a taxpayer receives damages for assault, but there is no observable bodily harm. This LTR concludes that the damages a couple received under a settlement agreement with the wife's employer that are allocable to her employer's unwanted physical contacts without any "observable bodily harm" were not within the section 104 exclusion.

Interestingly, the same LTR, however, concludes that the damages she received for pain, suffering, emotional distress, and reimbursement of medical expenses that are allocable to the period beginning with the first physical injury are properly excludable. Of course, allocated punitive damages would be includable in income and the ruling so holds.

The facts in the ruling are somewhat reminiscent of many sexual harassment cases. The wife was employed as a full-time driver. Her employer began making suggestive and lewd remarks to her, and also began touching her. According to the ruling, those physical contacts did not leave any "observable bodily harm." However, while the wife was on road trip with the superior, he physically assaulted her, causing her extreme pain. The employer also assaulted her on other occasions, causing physical injury. He later physically and sexually assaulted her.

The wife quit her job and filed a suit alleging sex discrimination and reprisal, battery, and intentional infliction of emotional distress. The complaint also requested leave to amend to add a claim for punitive damages for her common-law claims. The employer

settled the case, and there was no express allocation of the proceeds in the settlement agreement. As an aside, this was truly bad tax planning.

Under these facts, the Service in LTR 200041022 concluded that the damages that the wife received for her employer's unwanted physical contacts without any observable bodily harm were not received on account of personal physical injuries or physical sickness. These amounts were, therefore, taxable. The damages received for pain, suffering, emotional distress, and reimbursement of medical expenses after the first assault, however, were excludable under section 104 because they were attributable to and linked to physical injuries.

Bifurcate, Bifurcate, Bifurcate!

The exact amount of physical consequences that is required under the amended version of section 104 has been a troublesome enigma ever since August 20, 1996, when this new, and supposedly clear, statute was passed. Why the IRS has not come forward with regulations or even a notice of some sort on this topic is unclear. Discussions with various personnel at the IRS and the Treasury Department indicate that there may be some disagreements within the government. After all, different people even in the government can have differing views.

Nevertheless, tax practitioners can easily get frustrated that there is little guidance. However, it is uncertain that the IRS and the Treasury got it right in LTR 200041022 in their attempt to draw the line between the various incidents of sexual harassment and touching that left no "observable bodily harm," and the various assaults that began with what they term the "first pain incident." Although the ruling seems cogent enough, the truth is that very often it is difficult to separate exactly what does and does not cause trauma as well as identify the type of trauma.

After reviewing the two-part analysis required by *Commissioner v. Schleier,* 515 U.S. 323, *Doc 95-5972 (27 pages), 95 TNT 116-8* (1995), the Service in this LTR examines the first unwanted and uninvited physical contacts with the wife before the first pain incident. It noted that these unwanted and uninvited physical contacts did not result in any observable harms such as bruises, cuts, etc., to the wife's body, nor did they cause pain to her. This latter reference to the alternative of causing pain may offer the possibility of an exclusion even where there are no "observable harms."

In addition, the LTR goes on to state that the ruling request did not represent that the medical attention the wife received after the first pain incident for headaches and digestive problems was related to events that occurred with or before that incident. Once again, the IRS seems to be leaving open the door for a nexus between the various incidents that often lead up to a sexual harassment claim. Thus, says the ruling, any damages the taxpayers received for events occurring before the first pain incident were not received on account of personal physical injuries or physical sickness under section 104(a)(2).

The LTR does note that according to the representations submitted, the wife suffered severe physical injuries within a relatively short period of time commencing after the first physical injury. Thus, the ruling bifurcates the factual incidents into these two time frames. At and after the first physical injury, there was pain, suffering, emotional distress, and reimbursement of medical expenses under the settlement agreement that were properly allocable to physical injury. Because these were attributable to and connected with the physical injuries that the wife suffered, they were within the ambit of section 104.

Lessons to Be Learned

LTR 200041022 is instructive in its attempt to segregate the various incidents that occurred in this particular factual setting, and to distinguish between them for purposes of analyzing the tax result to be applied to each element of the settlement payment. Although this LTR certainly does not have all the answers, it does demonstrate that the Service is attempting to provide the kind of guidance taxpayers truly need in this volatile area.

Obviously, this LTR confirms that the IRS will be looking for a physical touching, one that sets off a physical injury or physical illness. Personally, I believe a distinction between a case in which the taxpayer is touched and injured as a result, compared with a taxpayer who is not touched but injured in the same way, is artificial. The statute itself, section 104 as amended in 1996, does not make this distinction. At the same time, it is unsurprising that the IRS is taking this view. It is a line that at least seems drawable.

Conversely, consider a taxpayer who is subjected to heaps of verbal abuse and threatening conduct, such as a knife pointed at the taxpayer's throat or eyes, and then has a heart attack, stroke, or even a less serious illness or injury. Should it matter that there was no physical touching? We will clearly see litigation on this issue. I believe it is likely that the IRS will be proven wrong if it takes the position that a taxpayer who is not touched cannot be physically injured within the meaning of the revised statute. Time, however, will tell.

For the time being, at least the issuance of LTR 200041022 should give some guidance to taxpayers on how strict the IRS will be. Not only does this authority make it doubly important to keep up to date in this area, even if you are a litigator, but it makes it doubly important also to negotiate over and include provisions in the settlement agreement that expressly deal with tax consequences, and in the vast majority of cases, to retain tax counsel to assist in this effort.

Robert W. Wood practices law with Robert W. Wood Professional Corporation in San Francisco. He is the author of *Taxation of Damage Awards and Settlement Payments* (2d ed 1998), published by Tax Institute (info@taxinstitute.com).