

lawyer dealing with the nitty-gritty of clients and the government, I come at this issue from a somewhat different perspective.

### Riding an Injured Pig's Back

Jensen mentions *Tax Notes'* 2004-2005 exchange of letters dealing with recoveries for alienation of affections. That was an important (albeit protracted) dialogue about whether there must be a personal physical injury (or death) to which an alienation of affections (or emotional distress) recovery must be appended in order for the latter to qualify for exclusion. Rightly or wrongly, history seems to have taught us that the piggyback theory probably prevails. That is, one probably cannot have an excludable alienation of affections recovery (under section 104) without someone being physically injured or killed.

The primacy of the claim (and the tax-free recovery for that underlying injury) is what carries along the causally related (though not necessarily itself physical) alienation recovery. I don't know if this is right. But I think both the IRS and most tax advisers follow this piggyback idea and so advise their clients. The case law since 1996 hasn't dealt with alienation of affections, but the legislative history to the 1996 act seems to support the piggyback theory.<sup>2</sup>

In any event, as a practical matter, I think it will be hard for taxpayers in the real world to make a stand-alone argument regarding alienation of affections, at least under section 104. One might try to argue fundamental notions of what constitutes income. Yet that is likely to be a tough road to hoe. One sounds (especially if uttering the now nearly banned name of *Murphy*) like a tax protestor.

Yet I do think there are cases in which one should have good arguments for an exclusion, statutory or not. Jensen surely is right that one need not analyze section 104 if one is convinced something simply isn't income to begin with. You don't need an exclusion unless there is something to exclude.

I too was disappointed to see the Service "obsolete" the confinement rulings<sup>3</sup> that had confirmed tax-free treatment to recoveries for violation of civil or personal rights. To me, those rulings all made (and still make) sense. As Jensen argues, one can look to nonstatutory

## Wood Praises Article on Taxability Of Personal Rights Compensation

To the Editor:

I am writing to compliment — actually, to heap accolades on — Prof. Erik Jensen's article, "The Receipt of Cash for Losses of Personal Rights,"<sup>1</sup> Jensen eloquently highlights an area of doctrinal confusion. While I think Prof. Jensen is right on the money, as a practicing tax

<sup>1</sup>See Erik Jensen, "The Receipt of Cash for Losses of Personal Rights," *Tax Notes*, Jan. 4, 2010, p. 103, *Doc 2009-27321*, or *2010 TNT 4-9*, at p. 104, note 12.

<sup>2</sup>See H.R. Conf. Rep. No. 104-737, 104th Cong., 2d Sess., 301 (1996): "Damages (other than punitive damages) received by an individual on account of a claim of loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income."

<sup>3</sup>Rev. Rul. 55-132, 1955-1 C.B. 213; Rev. Rul. 56-462, 1956-2 C.B. 20; Rev. Rul. 56-518, 1956-2 C.B. 25; Rev. Rul. 58-370, 1958-2 C.B. 14; all obsoleted by Rev. Rul. 2007-14, 2007-12 IRB 747, *Doc 2007-4230*, *2007 TNT 34-15*.

possibilities, including the general welfare exception. However, as the general welfare exception can apply only to certain governmental payments,<sup>4</sup> recoveries for civil or personal rights from nongovernmental entities would have to look elsewhere.

That brings us to the heart of Jensen's argument: that the amendments to section 104(a)(2) do not themselves mandate the Service "obsoleting" the confinement rulings. As the Service didn't originally refer to section 104 (or its predecessor statute) in the confinement rulings,<sup>5</sup> perhaps Jensen is right that there was no reason (at least under section 104) for the Service to obsolete them after 1996. However, I had understood that the Service *did* expressly consider the 1996 amendments to wipe away the theory of those rulings.<sup>6</sup>

### False Imprisonment and Metaphysics of Harm

Most of my contact with the obsoleted confinement authorities comes from examining how recoveries for wrongful imprisonment should be treated post-1996. I have argued they should be tax-free, even if the jailers leave no bruises.<sup>7</sup> To be deprived of your right to move about is physical by its very nature and observably so. The unlawful context of such imprisonment creates an injury. Under piggyback nomenclature, the injury caused by unlawful confinement can lead to emotional distress.

### Healing the Bruise

Of course, the "bruise ruling"<sup>8</sup> suggests there must be a physical striking of the plaintiff and observable bodily harm for an award to be excludible under section 104. Headaches, stomachaches, and insomnia, commonly experienced by those in stressful situations, are not sufficiently physical to give rise to an exclusion. But the deprivation of an individual's physical liberty might be *presumed* to cause a personal physical injury.

The Tax Court had an opportunity to address this in *Stadnyk v. Commissioner*, although axiomatically, bad facts make bad law.<sup>9</sup> Mrs. Stadnyk placed a stop payment order on a check she wrote for a car purchase. Because her bank erroneously stamped the check "NSF" (insuffi-

cient funds), Mrs. Stadnyk was arrested and detained for eight hours. She sued for such false imprisonment and received a \$50,000 settlement.

The Tax Court distinguished physical restraint from physical injury, finding this false imprisonment to be *without* personal physical injury. Broadly stating that physical restraint and physical detention are *never* physical injuries, the *Stadnyk* court found injury from false imprisonment to be largely mental. That meant taxable.

*Stadnyk* is only a memorandum case, and thus non-precedential.<sup>10</sup> It involved a few hours of confinement by gentle jailors, not a decade of hard time. Thus, the Tax Court understandably failed to address the physicality of unlawful confinement.

### Presumed Innocent

Occasionally, the Service has issued enlightened guidance addressing the post-1996 physical injury requirement. For example, ILM 200809001 (Nov. 27, 2007), *Doc 2008-4372*, 2008 TNT 42-21 (deftly written by Mike Montemurro) is very helpful, ruling that in certain limited circumstances, physical injuries (or observable bodily harm evidencing them) can be *presumed*. It describes a sex abuse recovery from an organization that failed to prevent the abuse. Substantial time elapsed between the alleged tort and the settlement. The plaintiff still struggled with the trauma from the tort, though the continuing trauma was entirely psychological in nature.

Because of the passage of time, the legal memorandum acknowledges the difficulty the plaintiff would have in establishing his physical injuries. The legal memorandum concludes that the Service can *presume* the settlement was for personal physical injuries, and the damages for emotional distress were attributable to the physical injuries. That meant all the damages were excludable under section 104.<sup>11</sup> Of course, the Service stopped short of saying that the section 104 exclusion could apply *even if there was no personal physical injury*.

However, it was willing to *presume* there was observable bodily harm. The Service might reasonably apply this same analysis to (serious long-term cases of) false imprisonment. Just as ILM 200809001 presumes physical harm despite the passage of time, so the Service might presume physical harm to an individual imprisoned for many years, on account of unlawful confinement alone.

### Remembrance of Things Murphy

All of this brings me back to *Murphy*.<sup>12</sup> I agree with Jensen that we should not forget *Murphy*. Not even *Murphy I*,<sup>13</sup> which as Jensen says, we are supposed to

<sup>4</sup>See Robert W. Wood, "Updating General Welfare Exception Authorities," *Tax Notes*, June 22, 2009, p. 1443, *Doc 2009-11813*, or 2009 TNT 118-6.

<sup>5</sup>See, e.g., Rev. Rul. 55-132: Payments "received by a 'Prisoner of War' from the United States Government are in the nature of reimbursement for the loss of personal rights and are not includible in the gross income of such individual for Federal income tax purposes."

<sup>6</sup>See Wood, "Are False Imprisonment Recoveries Taxable?" *Tax Notes*, Apr. 21, 2008, p. 279, *Doc 2008-7149*, or 2008 TNT 78-28, at p. 287, note 86, where I wrote that although the IRS does not publish reasons for an obsolescence, I understand from IRS personnel who were involved in this obsolescence that the IRS considered the rulings no longer valid in light of the 1996 changes to section 104.

<sup>7</sup>*Id.* at 279; and Wood, "Why False Imprisonment Recoveries Should Not Be Taxable," *Tax Notes*, June 8, 2009, p. 1217, *Doc 2009-10767*, or 2009 TNT 108-10.

<sup>8</sup>LTR 200041022 (July 17, 2000), *Doc 2000-26382*, 2000 TNT 201-10.

<sup>9</sup>T.C. Memo. 2008-289, *Doc 2008-27001*, 2008 TNT 247-10.

<sup>10</sup>See *Nico v. Commissioner*, 67 T.C. 647, 654 (1977), *aff'd in part, rev'd in part on other grounds*, 565 F.2d 1234 (2d Cir. 1977).

<sup>11</sup>For further discussion, see Wood, "IRS Allows Damages Exclusion Without Proof of Physical Harm," *Tax Notes*, Mar. 31, 2008, p. 1388, *Doc 2008-5734*, or 2008 TNT 63-31.

<sup>12</sup>493 F.3d 170 (D.C. Cir. 2007), *Doc 2007-15777*, 2007 TNT 129-4.

<sup>13</sup>460 F.3d 79 (D.C. Cir. 2006), *vacated*, 493 F.3d 170 (D.C. Cir. 2007).

pretend never happened. (Chief Judge Douglas H. Ginsburg surely would appreciate our collective amnesia.) But it is hardly surprising that *Murphy* seems taboo.

I routinely deal with litigants and with the Service regarding the tax treatment of varied settlements and judgments. I do not like to bring up *Murphy*, and when it is mentioned by others, I try to steer the conversation away. After all, the name elicits eye-rolls, sighs, and other reactions you don't want in a serious tax discussion. Referring to human capital and other personal rights buzzwords seems to generate whispers of "tax protestor."

Even mentioning personal rights is risky. Talk of physical injury is safer, and the more obviously physical the situation the better. The "I was physically injured" argument will always be more persuasive — and more verifiably true — than the "this made me physically sick" argument. Yet section 104 excludes recoveries for physical sickness too. Most physical sickness doesn't start with a physical trauma, but that doesn't mean it is not physical.

*Murphy* was brilliantly argued by David K. Colapinto, a D.C. employment (not a tax!) lawyer. Murphy's dental records proved she had suffered permanent damage to her teeth. In addition to dictionary authorities, she cited federal court decisions ruling that substantial physical problems caused by emotional distress are considered physical injuries or physical sickness.

For example, in *Walters v. Mintec/International*,<sup>14</sup> the Third Circuit allowed a plaintiff to recover for physical harm caused by emotional disturbance from an accident. The court based its decision on the Restatement of Torts, which requires physical harm for damages to be available. Long continued nausea or headaches may amount to physical illness, which the Restatement of Torts classifies as bodily harm.<sup>15</sup>

National Taxpayer Advocate Nina Olson acknowledged the plight of bewildered plaintiffs in her latest (2009) report to Congress delivered in January 2010.<sup>16</sup> The report noted that Mrs. Stadnyk (like many plaintiffs) was led to believe her case was physical enough to merit being excludable from income. With 6 percent of the tax cases reviewed by the Taxpayer Advocate Service involving asserted exclusions under section 104, the report suggested these controversies may be reaching epidemic proportions. With understatement, Olson concluded that many questions remain as to how "physical" is to be defined.

Olson certainly isn't afraid to utter the *Murphy* name. Noting the case's continuing controversy, her report came right out and asked for an amendment to section 104 to make emotional distress recoveries tax free. She took on the physical elements of depression and other disorders, using scientific data to back her up. Many mental health professionals acknowledge the biological cause of mental disorders, and acknowledge that many mental disorders show up as physical symptoms, she concluded.

Apart from the lamentably disparate treatment similarly situated taxpayers receive at the hands of the currently confused rules, Olson suggested the tax law conflicts with Congress's intent and public policy. Mental health parity legislation passed in 2008 generally requires health insurance plans that offer both medical/surgical benefits and mental health/substance abuse benefits to provide parity in treatment limitations and financial requirements.<sup>17</sup> That is one signpost of Congress' intent (after the 1996 amendments to section 104) that mental suffering is treated on a par with physical suffering.

As a practitioner, I prefer the "easy" case of an exoneree who is physically injured on one or more occasions while wrongfully in long-term custody. In long-term incarceration cases, one usually need not scrutinize the facts to find such incidents. That simply makes the taxpayer's and the government's jobs clearer when it comes tax return or audit time.

The purist's fact pattern involving a deprivation of civil liberties without physical injury or physical sickness may be more academic than real. The taxable treatment of Mrs. Stadnyk's settlement arguably makes sense, for she was confined for mere hours. Plus, she expressly *admitted* she was not injured or even roughed up.

As to the larger questions Jensen raises, I believe he is right that there may be extrastatutory arguments, and that they may be compelling. Yet they will be very difficult for many people to accept. Now that the Service has dispensed with the tort or tort-type rights portion of the section 104 equation,<sup>18</sup> there should be a somewhat broader chance for an exclusion. For me, ILM 200809001 with its statute-triggering presumption of physical harm offers a brighter path that may light the way for excluding recoveries for serious deprivations of personal liberty.

Very truly yours,

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<sup>14</sup>758 F.2d 73 (3d Cir. 1985).

<sup>15</sup>See *Restatement (2d) of Torts*, section 436A, Comment C (1965), quoted in *Walters v. Mintec/International*, 758 F.2d 73, at 1985 U.S. App. Lexis 29782, p. 6.

<sup>16</sup>*Doc 2010-174, 2010 TNT 4-19.*

<sup>17</sup>See P.L. No. 110-343, Division C sections 511 and 512, 122 Stat. 3765, 3881 (2008).

<sup>18</sup>See recent proposed regulations, 74 *Fed. Reg.* 47,152, under section 104.