

## Getting Physical: Emotional Distress and Physical Sickness

By Robert W. Wood

Robert W. Wood practices law with Wood & Porter, San Francisco (<http://www.woodporter.com>), and is the author of *Taxation of Damage Awards and Settlement Payments* (3d Ed. Tax Institute 2005 with 2008 update), and *Legal Guide to Independent Contractor Status* (4th Ed. Tax Institute 2007), both 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.

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If you receive a settlement or damage payment for physical symptoms of emotional distress, your award is taxable income. Conversely, if you receive an award on account of physical injuries or physical sickness, it is tax free. So states section 104. It has long been clear that the IRS focuses primarily on physical injuries and doesn't believe you've had a physical injury unless it causes "observable bodily harm." To the IRS, that means bruising or broken bones.

Thus, if you are hit over the head, producing bruising and a concussion, all damages flowing from that injury (including wage loss) should be tax free. The only payments that would be taxable would be any interest or punitive damages. In contrast, if there was no physical touching, but you nonetheless have physical problems, how do you know if a settlement is taxable or tax free?

Unfortunately, you don't, although you can usually assume the IRS will rule against you. Nevertheless, the IRS recently considered a clergy sex abuse case, in which a minor was sexually abused, and many years later, received a settlement as an adult. The IRS said it would *presume* there had once been observable bodily harm, allowing the settlement to be tax free.

This is about the only piece of taxpayer-friendly advice from the Service on the topic, however. Indeed, the reference in section 104(a)(2) to "physical sickness" accounting for a nontaxable damage award has been generally disregarded by the IRS. Suppose you experience asthma, sleep deprivation, skin irritation, appetite loss, severe headaches, and depression? Are these mere symptoms of emotional distress (taxable), or are they themselves physical sickness (tax free)? Suppose you develop ulcers, hypertension, heart conditions, or shingles? Sadly, these situations do arise.

As a tax adviser, it is more than a little frustrating not to be able to give clients clear guidance about the tax treatment of settlements in those situations. Plaintiffs receiving settlements must find it even more frustrating not to be able to find clear guidance from a tax professional, or even from the IRS.

### What Prompted Payment?

At its root, the tax quandary revolves around whether the damages are received “on account of” a physical sickness or physical injuries. Alternatively, are the damages for emotional distress and related physical symptoms? The issue first arose in 1996, when Congress changed section 104 to require “physical” injuries or sickness for damages to be excluded. Before that, *any* injury or sickness (including emotional distress) was enough.

Neither Congress nor the IRS has explained just what “physical” means, although the IRS has said informally that it expects to see “observable bodily harm.” The legislative history to the amendment that inserted the “physical” modifier makes it clear that mere symptoms of emotional distress (such as headaches, insomnia, and stomachaches) are not excludable. The long debate regarding this phrase is mentioned in the legislative history as a mere footnote. It seems probable that the footnote was meant to be illustrative, and was not meant to suggest that anything beyond headaches, insomnia, and stomachaches produce a tax-free recovery.

So, causation and semantics matter. The question may be whether you were paid *for* your physical injuries or physical sickness, or *for* your emotional distress, even if the emotional distress produces physical symptoms. But how do you determine if you are being paid “for” (or, as the tax code phrases it, “on account of”) your ulcer, or if you are being paid on account of your emotional distress which *caused* your ulcer?

What you receive in litigation should (at least in part) depend on what you request. The nature of a cause of action is certainly relevant. In *Commissioner v. Schleier*,<sup>1</sup> the Supreme Court said that to exclude your damages, you must meet two requirements. First, the underlying cause of action must be based on tort or tort-type rights. Second, the payment must be made “on account of” personal physical injuries or physical sickness. The second requirement turns out to be overly formalistic, at least as it has been applied.

### Bruised and Battered Taxpayers!

Many taxpayers don’t manifest sufficient observable bodily harm to convince the Service or the courts that any part of their settlement is excludable. In fact, they can get bruised and battered in their tax cases. Like the IRS, the Tax Court has been harsh and formalistic. A good example is the recent case of *Joyce M. Sanford v. Commissioner*.<sup>2</sup>

Sanford pursued an Equal Employment Opportunity Commission (EEOC) complaint against the U.S. Postal Service for discrimination (race, national origin, sex, religion, color, age) and for sexual harassment. The EEOC ruled in her favor, and the Postal Service issued a decision awarding her \$7,662 in past medical expenses and transportation, \$14,033 for benefits (leave without pay) and \$12,000 in nonpecuniary compensatory dam-

ages. The Postal Service paid these amounts (a total of \$33,695) in 2003. The EEOC also ordered the Postal Service to pay \$16,602 to Sanford’s attorney under a law requiring discriminators to pay attorney fees.

Unsatisfied, Sanford appealed, asking for additional compensatory damages. The EEOC then ruled that she had suffered emotional distress due to the sexual harassment and the Postal Service’s failure to address it. The EEOC concluded that she had experienced physical symptoms due to the psychiatric problems the harassment created. Sanford’s physical symptoms included intensification of her asthma, sleep deprivation, skin irritation, appetite loss, severe headaches, and depression.

The EEOC awarded additional damages, totaling \$115,000 in nonpecuniary damages, \$33,542 in future pecuniary losses, \$7,662 for medical expenses, and \$14,033 for annual leave, sick leave, and leave without pay. The EEOC again awarded reasonable attorney fees. Because the Postal Service had already paid the amounts awarded in 2003, the Postal Service paid the difference in 2004.

### Fees and Reporting

The EEOC twice determined (in 2002 and in the 2004 appeal) that Sanford was entitled to reasonable attorney fees under the applicable fee-shifting regulation. Based on those rulings, the Postal Service paid \$16,602 in attorney fees in 2003, and \$4,686 in attorney fees in 2004. On her 2003 federal income tax return, Sanford reported \$14,033 of “other income” attributable to her dispute (the amount awarded for sick leave and leave without pay). She did not report the rest of the damages (for past medical expenses and nonpecuniary compensatory damages) or the \$16,602 in lawyer fees. For 2004 Sanford did not report any of the amounts from the EEOC appeal, claiming it all as excludable.

The IRS asserted that everything Sanford received in 2003 and 2004 was taxable income, so Sanford and the Service faced off in the Tax Court. In addition to contesting the substantive issues, the IRS asserted accuracy-related penalties which the Tax Court also evaluated.

### Test for Excludability

The Tax Court began its analysis with a recitation of the maxim that gross income is broadly construed, and that *Schleier* established the test for excludability. For damages to be excludable, the underlying cause of action must be based in tort or tort-type rights, and proceeds must be received on account of personal physical injuries or physical sickness. The IRS had already conceded that Sanford’s underlying cause of action was based on tort or tort-type rights. Thus, the first prong of the *Schleier* test was satisfied.

The sole remaining question was whether Sanford’s damages were received on account of personal physical injuries or physical sickness. On this point, the Tax Court said it found the language of the EEOC and Postal Service determinations “compelling.” Indeed, the Tax Court said those orders themselves made it clear that none of the award was predicated on personal physical injury or physical sickness.

<sup>1</sup>515 U.S. 323 (1995), *Doc* 95-5972, 95 *TNT* 116-8.

<sup>2</sup>T.C. Memo. 2008-158 (June 23, 2008), *Doc* 2008-13911, 2008 *TNT* 122-11.

True, said the Tax Court, the EEOC decision acknowledged that the sexual harassment caused Sanford emotional distress. Moreover, the court even agreed that such distress *manifested itself* in physical symptoms such as asthma, sleep deprivation, skin irritation, appetite loss, severe headaches, and depression. Yet, the Tax Court said those physical symptoms were not the *basis* of the award.

Sanford sought and was awarded relief for sexual harassment, discrimination based on sex, and the failure of the Postal Service to take appropriate corrective action. The Tax Court found Sanford was simply not compensated for the physical symptoms she experienced. One can't help asking if it matters whether the EEOC *considered* the severity of the employer's treatment, or the severity of the plaintiff's reaction in making the award "for emotional distress."

It may be reasonable to assume that they did. Moreover, in some cases there will be evidence that *in fact* such points were considered. *Sanford* does not discuss those possibilities. However, the Tax Court judge seems hostile enough to the entire area that it likely would not have mattered even if this had been considered.

### Medical Expenses

The Tax Court then turned to Sanford's medical expenses, acknowledging that even though damages for emotional distress are generally not excludable, there is an exception for amounts paid for medical care (even medical care for emotional distress). The Tax Court noted that a reimbursement for medical expenses must be included in income when received if a deduction was claimed for the medical expenses in a prior year.<sup>3</sup> Conversely, when no deduction was previously claimed, the amount is excludable.

Placing the burden of proof on the taxpayer, the Tax Court admonished Sanford that she had failed to introduce evidence the medical expenses were not deducted in a prior tax year. Therefore, the court ruled that she could not exclude from her income any portion of the reimbursement for medical expenses.

### Attorney Fees

Regarding attorney fees, the Tax Court cited the rule announced in *Commissioner v. Banks*<sup>4</sup> that attorney fees generally represent gross income to the plaintiff. Interestingly, however, the Tax Court then said this general rule applied whether or not the attorney fees were paid under a fee-shifting statute. The Tax Court cited several pre-*Banks* cases for this proposition, including *Sinyard v. Commissioner*.<sup>5</sup> The only post-*Banks* case the court mentioned was *Green v. Commissioner*.<sup>6</sup>

Because *Banks* left open the fee-shifting question, the Tax Court had to get a little creative to deny Sanford's claim. The Tax Court noted that the Postal Service had paid \$16,602 in attorney fees in 2003, and \$4,686 in attorney fees in 2004. Both amounts were paid directly to

the taxpayer's attorney, and both amounts were ordered by the EEOC under applicable law. The Tax Court therefore had no choice but to acknowledge that those amounts were paid under a fee-shifting statute.

Citing *Sinyard*, however, the court said that, despite the fee-shifting nature of the payment, the legal fees nevertheless constituted income. The Tax Court's discussion on this point is minimal, with no mention of the fact that the Supreme Court in *Banks* expressly decided *not* to address the fee-shifting statute. The Tax Court does not discuss any cases that would have allowed it to exclude these legal fees from Sanford's income. There is a paucity of authority on this fee-shifting issue, but it is hardly as clear as the Tax Court suggests.

### Accuracy-Related Penalty

If any further evidence of the Tax Court's hostility in Sanford's case was necessary, the court's discussion on the accuracy-related penalty should remove all doubts. Despite the continually murky status of this area of the tax law, the Tax Court concluded that Sanford was not diligent in seeking out the law and the correct treatment. Although she testified that she had sought tax advice from H&R Block, the Tax Court said it was unclear exactly what advice she received and what advice she relied on.

Again placing the burden of proof on Sanford, the Tax Court imposed a full measure of penalties.

### Nature of an Award

It seems far fetched to expect plaintiffs (or their counsel) in employment litigation to suddenly start praying for damages that are new and different. Surely they will continue to ask for money damages. Moreover, it seems unlikely that they will start asking for money *expressly* for *particular* items of physical sickness or physical injury arising out of prohibited acts such as sexual harassment and various forms of discrimination.

It is not even clear to me that such a prayer for relief would be permitted as a matter of substantive (federal or state) employment law or local court rules or procedures. Yet if *Sanford* tells us anything, it is that the *specific wording* in an award is highly important, perhaps paramount, to the tax treatment.

That was one of the major lessons from *Murphy v. IRS*,<sup>7</sup> which involved a whistleblower whose employer blacklisted her after she complained about environmental hazards. She submitted evidence in an administrative hearing that she had mental and physical injuries from the blacklisting, including bruxism (teeth-grinding) that left her with permanent dental damage. The administrative law judge determined that she had other physical manifestations of stress, including anxiety attacks, shortness of breath, and dizziness.

The wording of her damage award, however, was for "emotional distress or mental anguish" and "injury to reputation," so she had to pay tax. In a widely watched second opinion (after the first *Murphy* opinion was vacated), the D.C. Circuit refused to connect the dots, and

<sup>3</sup>See reg. section 1.213-1(g)(1).

<sup>4</sup>543 U.S. 426 (2005), *Doc 2005-1418*, 2005 TNT 15-10.

<sup>5</sup>268 F.3d 756 (9th Cir. 2001), *Doc 2001-24862*, 2001 TNT 188-11.

<sup>6</sup>T.C. Memo. 2007-39 (2007), *Doc 2007-4397*, 2007 TNT 35-9.

<sup>7</sup>*Murphy v. IRS*, 493 F.3d 170 (D.C. Cir. 2007), *cert. denied*, 128 S. Ct. 2050 (2008).

simply ruled Murphy's payment was not on account of "physical sickness or injury."

In the second *Murphy* opinion, Chief Judge Ginsburg was riveted to the *specific wording* of the arbitration decision in the underlying whistle-blower case. It had awarded Murphy damages for "emotional distress." The order *did not* say she was receiving money for bruxism.

Yet, the court seemed to acknowledge (or assume) that Murphy did indeed suffer bruxism. Plus, the court seemed to acknowledge (or assume) that her bruxism qualified as a physical injury, or at least physical sickness. Nevertheless, because the award was not *expressly stated to be for that malady*, the court would not hold the payment to be within the section 104 exclusion. And people say tax lawyers are overly formulistic and literal!

### More Than Semantics

In the wake of the *Murphy* case, I contended that one of the legacies of *Murphy* was likely to be a renewed focus on specific wording, both in orders and even in settlement agreements.<sup>8</sup> Sometimes, something is what you call it. Although the IRS and the courts are clearly not bound by settlement agreement language, the fact remains that such language is considered.

In light of cases like *Murphy* and *Sanford*, in which the court goes to great lengths to examine the specific language with a microscope, lawyers may wonder whether specific language *favorable* to the plaintiff would be equally compelling. A reader of the *Sanford* decision can sense the court's underlying hostility to this taxpayer, and to taxpayers like her, throughout the opinion. The unstated but palpable undercurrent seems to be that taxpayers say everything is physical, but really little is.

The Tax Court and the IRS occasionally sound like former Sen. Phil Gramm, who famously remarked that we're a "nation of whiners."<sup>9</sup> If that's so, some of the blame rests with the Service for not even revising its section 104 regulations, which continue to predate the 1996 statutory change.

Many tax professionals find the distinction between damages for physical sickness or physical injuries and damages for mere symptoms of emotional distress a fuzzy one. The IRS uses its unofficial "observable bodily harm" position (from private rulings) as a kind of Maginot Line. History buffs will recall that the Maginot Line was supposed to be highly defended and clearly demarcated, laid out with military precision. Yet, it turned out to be more chimera than real.

Shouldn't the IRS at least *attempt* to draw this critical distinction? Is it any wonder that taxpayers also find this to be an amorphous line? Taking a charitable view of the Tax Court (which is not easy to do if you've just read the *Sanford* case), one could argue that the court had little choice but to rule as it did in *Sanford*. Perhaps that is

particularly true concerning the section 104 exclusion regarding a specific award for "emotional distress."

Like Judge Ginsburg in the second *Murphy* opinion, the Tax Court may be unwilling to take notice of the specific items of damage considered. The EEOC, court, or arbitration panel in question might have evaluated the physical symptoms of emotional distress, and may have even considered them as damages for physical sickness. Yet even on such items as medical expenses, and particularly attorney fees and penalties, the Tax Court in *Sanford* seems gratuitously harsh.

The court looks myopically at what the award says. This interpretation suggests that a plaintiff in a body cast may still be out of luck if the award is attributed to "emotional distress." That, of course, would be absurd.

### Causation and Taxes

It was clear even before *Sanford* and *Murphy* that the wording of a court order or administrative order is key. Because the courts in those cases concluded that the taxpayers did not carry their burden of showing the recovery was "on account of" physical injury or sickness, it is worth asking what *would* have worked. Notes? Pleadings? A transcript? Surely the language of the order itself should not be the only reference point.

After all, the IRS has long maintained that it is not bound by characterizations in court orders or settlement agreements.<sup>10</sup> That rule should work both ways. Still, the "on account of" phrase continues to be enigmatic, and given its manifest importance, this is disturbing.

What if the evidence in *Murphy* showed that the judge awarded money to Murphy because of her bruxism, and acknowledged that the bruxism was caused by the emotional distress, which was caused by the defendants? If the judge's order so stated, or if there was a transcript in which the judge's reasoning was clear, that might be enough for excludability, even though the order ultimately stated that the payment is "for emotional distress."

As I read it, section 104 makes the relevant nexus between the damages and the injury. The statute does not require a relationship between the tortious act and the physical injuries or physical sickness for which damages are received. The statutory "on account of" language has required a nexus between damages and injuries since its origin in the 1918 predecessor to section 104(a)(2).<sup>11</sup> The same language appeared in the 1939 code, the 1954 code, and the 1986 code.

In 1996 Congress amended section 104(a)(2) to except punitive damages from the statute so that punitive damages are always taxable, and require the personal injury or sickness to be physical. The 1996 amendments did not alter the "on account of" language, although the

<sup>8</sup>See Robert W. Wood, "Waiting to Exhale: *Murphy* Part Deux and Taxing Damage Awards," *Tax Notes*, July 23, 2007, p. 265, Doc 2007-16168, or 2007 TNT 142-29.

<sup>9</sup>See Hill and Patrice, "McCain Adviser Talks of 'Mental Recession,'" *The Washington Times* (July 9, 2008) available at <http://www.washtimes.com/news/2008/jul/09/mccain-adviser-addresses-mental-recession>.

<sup>10</sup>See *Robinson v. Commissioner*, 102 T.C. 116 (1994), Doc 94-1439, 94 TNT 23-18, *aff'd in part rev'd in part*, 70 F.3d 34 (5th Cir. 1995), Doc 95-10932, 95 TNT 238-7; *McKay v. Commissioner*, 102 T.C. 465 (1994), Doc 94-3399, 94 TNT 60-9, *vacated on other grounds*, 84 F.3d 433 (5th Cir. 1996), Doc 96-13888, 96 TNT 92-7; *Brown v. United States*, 890 F.2d 1329, 1342 (5th Cir. 1989).

<sup>11</sup>Revenue Act of 1918, ch. 18, section 213(b)(6).

legislative history attempts to elucidate the “on account of” nexus between the recovery and the injuries.

Much often turns on the relationship between the harm and the recovery, and medical evidence is important. The Tax Court has found that uncorroborated testimony about exacerbation of harm is not enough to support an exclusion, suggesting that corroborated testimony might be treated differently.<sup>12</sup> Although exact wording may be more important than the intent of the payer and other traditional reference points, mere wording should not be the only consideration.

Besides, counsel often draft court orders for judges to sign. Plaintiffs’ counsel already include battery claims in employment cases on appropriate facts. Given that most cases are settled and do not go to verdict or administrative ruling, the settlement process is likely to become more tax-centric, with increased attention to exactly what documents say. Unlike most cases, *Murphy* and *Sanford* both went to judgment (or its administrative equivalent). Settlement by its very nature offers vastly more tax flexibility.

Courts applying the two-tier *Schleier* test may find that a recovery fails the first requirement because it was not based on tort or tort-type rights.<sup>13</sup> However, the IRS often concedes the first point, as it did in *Sanford*. Moreover, courts often do not make clear whether the taxpayer failed the first or the second prong of the *Schleier* test.

For example, in *Johnson v. United States*,<sup>14</sup> a guard at a juvenile detention center suffered injuries while restraining an inmate. The guard sued under the Americans with Disabilities Act after his employer failed to accommodate his physical limitations resulting from the incident. The court found the claim to be tort-based, but concluded that the recovery was not on account of personal physical injuries or physical sickness. The court found the link between the discrimination-based discharge and the work-related injuries was simply too tenuous to support an exclusion. A better link between the discharge and the injuries might yield a different result.

### Murphy’s Law

Murphy argued that the legislative history to the 1996 amendment separated transitory symptoms from serious and permanent physical injuries and physical sickness. Murphy’s ailments were not minor and transitory symptoms of emotional distress, like headaches, upset stomach, and sleeplessness. Those inconveniences are not permanent; they eventually go away.

This broaches the territory of one of the great unspoken phrases of the tax law: “physical sickness,” an epigram that receives no attention in the literature or case

law.<sup>15</sup> If a bright line cannot be drawn between physical injuries and mere symptoms of emotional distress, the line is even fuzzier when it comes to physical sickness. Murphy pointed to her physician’s testimony that she experienced “somatic” and “body” injuries “as a result of [the defendant’s] blacklisting.” She also cited the American Heritage Dictionary, which defines “somatic” as “relating to, or affecting the body, especially as distinguished from a body part, the mind or the environment.”

Murphy’s dental records also proved she suffered permanent damage to her teeth. That sure sounds physical. Quite apart from rudimentary sources like dictionaries, Murphy cited federal court decisions showing that substantial physical problems caused by emotional distress are considered physical injuries or physical sickness. For example, in *Walters v. Mintec/International*,<sup>16</sup> the Third Circuit allowed a plaintiff to recover for physical harm caused by the emotional disturbance of an accident. The court based its decision on the Restatement of Torts, which requires physical harm for damages to be available, and which notes that “long continued nausea or headaches may amount to physical illness, which is bodily harm.”<sup>17</sup>

In *Payne v. General Motors Corp.*,<sup>18</sup> an employee sued an employer under Title VII and for negligent infliction of emotional distress. The employee suffered from constant exhaustion and fatigue, diagnosed as resulting from depression. The court held this constituted “physical injuries,” a prerequisite to an action for negligent infliction of emotional distress under Kansas law.

It is unclear how to evaluate whether a particular medical problem is a mere symptom of emotional distress (taxable) or a physical sickness or physical injury in its own right (excludable). Presumably, the IRS will someday propose regulations saying that in their view, bruising or the equivalent must be observable for there to be a physical injury. However, the statute says damages paid on account of physical *sickness* are excludable, too.

Many physical sicknesses do not involve bruising or other outward manifestations of harm, unless EKGs, blood work visible with a microscope, X-rays, etc., are included. The term “physical” as it modifies “sickness” may simply mean that the sickness can’t be “mental” and still give rise to an exclusion. Physical (as opposed to mental) sickness can be perceived by someone, even if that someone is a medical professional with special skills and equipment.

### Conclusion

*Sanford* and *Murphy* suggest that the wording of an order or settlement agreement should particularize the physical sickness and physical injuries for which an award is being made. Put differently, *Sanford* and *Murphy*

<sup>12</sup>See *Prasil v. Commissioner*, T.C. Memo. 2003-100 (2003), *Doc* 2003-9085, 2003 TNT 69-39.

<sup>13</sup>See *Tamberella v. Commissioner*, T.C. Memo. 2004-47, *Doc* 2004-4540, 2004 TNT 43-12, *aff’d*, 139 Fed. Appx. 319 (2d Cir. 2005), *Doc* 2005-15534, 2005 TNT 140-11.

<sup>14</sup>76 Fed. Appx. 873 (10th Cir. 2003), *Doc* 2003-19761, 2003 TNT 172-6, *cert. denied*, 542 U.S. 925 (2004).

<sup>15</sup>See Wood, “Physical Sickness and the Section 104 Exclusion,” *Tax Notes*, Jan. 3, 2005, p. 121, *Doc* 2004-24100, or 2005 TNT 2-41.

<sup>16</sup>758 F.2d 73 (3d Cir. 1985).

<sup>17</sup>See Restatement (Second) of Torts section 436A, comment (1965), *quoted in Walters v. Mintec/International*, 758 F.2d 73, 78 (3d Cir. 1985).

<sup>18</sup>731 F. Supp. 1465, 1474-1475 (D. Kan. 1990).

## TAX PRACTICE

seem to say that a payment may not be for personal physical injuries or physical sickness unless it expressly says it is. When appropriate, my advice is to be as specific as possible.

In fact, if you expect to claim that an award is excludable, perhaps you should insist that the settlement language specifically says that the defendant is paying for the personal physical injuries or physical sickness. In many cases, it may be inappropriate to lump the entire award into such a category, but bifurcation is often an answer. Had the relevant documents (or the settlement agreement) in *Sanford* awarded something specifically for asthma, sleep deprivation, skin irritation, appetite loss,

severe headaches, and depression, I think it would be hard for the Tax Court — even a hostile Tax Court — to explain these away as “mere symptoms of emotional distress.”

If a settlement agreement includes express recitations of the physical injuries or sickness for which money is being paid, and if there is underlying factual support, wouldn't the payment be made “on account of” physical injuries or physical sickness? Arguably, both *Sanford* and *Murphy* would have come out very differently if a few words had been changed. Although that may suggest planning opportunities, it is also disturbing.