

Are Damages for Exacerbation of Depression Tax Free?

By Robert W. Wood



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<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.

In the endless controversies over the scope of the section 104 personal physical injury exclusion, *Domeny* and *Parkinson* established that damages attributable to the onset or exacerbation of medical conditions can be physical sickness and can qualify. More recently, *Blackwood* makes clear that depression may not be enough and that details and documentation matter. Wood examines these cases and suggests a post-*Blackwood* approach.

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We know that damages for personal physical injuries are tax free, but what about damages for physical sickness? In 2010 two remarkable Tax Court cases addressed this question: *Domeny v. Commissioner*¹ and *Parkinson v. Commissioner*.² Both suggest an enlightened reading of the section 104 exclusion that recognizes it excludes both types of damages.

In *Domeny*, an employee with multiple sclerosis (MS) experienced workplace conditions that exacerbated her disease. She experienced vertigo, shooting leg pain, numbness in both feet, burning behind her eyes, and extreme fatigue. Domeny was fired,

received a settlement, and claimed that the non-wage portion was excludable from her income. The Tax Court agreed, despite less than precise language in the settlement agreement and the issuance of a Form 1099 reporting the payment.

In *Parkinson*, the taxpayer experienced stress as the chief supervisor of a medical center's ultrasound and vascular lab. He suffered a heart attack while at work in 1998 and thereafter reduced his workweek from 70 hours to 40. In 2000 he took medical leave and never returned. He sued under various claims alleging that the defendants' misconduct caused him to suffer another disabling heart attack on the job that rendered him unable to work.

Parkinson settled for \$350,000, was paid \$250,000 in 2004, \$34,000 in 2005, and \$33,000 each in 2006 and 2007. The settlement agreement said the payment was for "noneconomic damages and not as wages or other income." The only payment at issue in the Tax Court was the \$34,000 payment in 2005.

Parkinson argued that the payment was for physical injuries and physical sickness brought on by extreme emotional distress. The IRS said it was for emotional distress, pure and simple. Tax Court Judge Michael B. Thornton stated:

It would seem self-evident that a heart attack and its physical after effects 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.³

The Tax Court even stated that the IRS was wrong that one can never have physical injury or physical sickness damages when a suit is for intentional infliction of emotional distress. Now, another

¹T.C. Memo. 2010-9, Doc 2010-787, 2010 TNT 9-9.

²T.C. Memo. 2010-142, Doc 2010-14364, 2010 TNT 124-12.

³*Parkinson*, T.C. Memo. 2010-142.

Tax Court case, *Blackwood v. Commissioner*,⁴ undercuts these two pivotal decisions. The question is by how much.

A. Background

For nearly a century, the code has excluded from income some payments for injuries and sickness. Whether by settlement or judgment and whether in a lump sum or over time, those payments are tax free. But since 1996, to be excludable, the damages must be for personal *physical* injuries or personal *physical* sickness.

Although the "physical" modifier added 16 years ago was a sea change, no rulings or regulations have tackled this topic. The IRS's failure to provide guidance on those questions has become a flash point.⁵ However, most practitioners are aware that the IRS has generally required an overt manifestation of physical injuries and "observable bodily harm" for an exclusion to be available.⁶

Despite its focus on observable bodily harm, the IRS said it would presume there were personal physical injuries in at least some cases. In an important 2008 ruling, the IRS excluded a recovery for sexual molestation even though payment was made years later when no observable bodily harm could be shown.⁷ More generally, the Service seems to recognize that sometimes physical and emotional injuries may be inextricably entwined.⁸

⁴T.C. Memo. 2012-190, *Doc* 2012-14672, 2012 TNT 134-12.

⁵See Nina Olson, "National Taxpayer Advocate 2009 Annual Report to Congress," at 356 (Dec. 31, 2009), *Doc* 2010-174, 2010 TNT 4-19. "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."

⁶See LTR 200041022, *Doc* 2000-26382, 2000 TNT 201-10. "We believe that direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under section 104(a)(2)."

⁷See CCA 200809001, *Doc* 2008-4372, 2008 TNT 42-21. "C has alleged that Entity's agent(s) X caused physical injury through Tort while he was a minor under the care of X. . . . Because of the passage of time and because C was a minor when the Tort allegedly occurred, C may have difficulty establishing the extent of his physical injuries. Under these circumstances, it is reasonable for the Service to presume that the settlement compensated C for personal physical injuries, and that all damages for emotional distress were attributable to the physical injuries." See also discussion in Robert W. 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.

⁸See comments of Michael Montemurro, branch 1 chief, IRS Office of Associate Chief Counsel (Income Tax and Accounting),

(Footnote continued in next column.)

Physical injuries and physical sickness are both physical in nature but are quite different. In most cases of physical sickness, there is no striking or other physical event triggering the illness. The word "injuries" is thus a misnomer in most cases of physical sickness.⁹

B. Domeny

In *Domeny*,¹⁰ the taxpayer was diagnosed with MS in 1996. Mindful of her condition, and having disclosed it to her new employer, she began working at Pacific Autism Center For Education (PACE) in 2000. PACE offered an environment in which she could do community development, fundraising, and grant writing without spending too much time on her feet.

But in November 2004, embezzlement by a PACE executive and the stresses related to those events caused Domeny's MS to flare up. As the months elapsed, she was tense and worried and her symptoms grew worse. She had vertigo, shooting pain in both legs, difficulty walking because of numbness in her feet, burning behind her eyes, and extreme fatigue. On March 8, 2005, her doctor pronounced her too ill to work and ordered her to stay home.

PACE abruptly fired her, triggering additional physical ailments. She contacted a lawyer who negotiated a settlement before filing suit. The settlement agreement listed a raft of causes of action, including disability, age discrimination, civil rights, Family and Medical Leave Act violations, and infliction of emotional distress. The settlement agreement awarded \$8,187.50 in pay, \$8,187.50 in attorney fees, and \$16,933 in damages.

The sole question in the Tax Court was whether the \$16,933 was excludable from income. The Tax Court found it clear that Domeny's exposure to a hostile and stressful work environment exacerbated

Public Hearing on Proposed Regulations, 26 CFR Part 301, "Damages Received on Account of Personal Physical Injuries or Physical Sickness" (REG-127270-06), Feb. 23, 2010, *Doc* 2010-4501, 2010 TNT 41-15: "I mean I don't know that the Service has ever gone to court on litigation, you know, I know the Service doesn't ever go to court on litigation, [regarding] anybody who's been falsely imprisoned or anyone who's suffered any sex abuse, as far as asserted in a courtroom that those kinds of damages are taxable, I mean whatever the pure technical answers may be," at 10, *Doc* 2010-4501, 2010 TNT 41-15.

⁹In LTR 200121031, *Doc* 2001-15011, 2001 TNT 103-10, the taxpayer received damages from asbestos manufacturers after her husband's death from lung cancer. The disease was associated with the husband's inhalation of asbestos fibers. Reasoning that the husband contracted a physical disease from exposure to asbestos and that that triggered the taxpayer's claims, the IRS excluded the wife's recovery. Whether for personal physical injuries or personal physical sickness, it was clearly excludable.

¹⁰For more extensive discussion of *Domeny*, see Wood, "Is Physical Sickness the Next Emotional Distress?" *Tax Notes*, Feb. 22, 2010, p. 977, *Doc* 2010-2454, or 2010 TNT 37-11.

her MS and made her unable to work. Despite less than clear drafting in the settlement agreement, the court inferred from the fact that the settlement was segregated into three distinct payments, and three different reporting treatments, that PACE was aware that part of Domeny's recovery may not have been taxable.

PACE had issued a Form 1099-MISC for the \$16,933 payment, and many section 104 cases have said that a Form 1099 means the payer thought reported payment was taxable.¹¹ Nevertheless, the court noted that Domeny had advised PACE of her illness, and therefore concluded that PACE must have taken her physical sickness into account. Linking sickness to injury, the court held the payment to be for physical illness and therefore excludable.

C. Blackwood

In *Blackwood*, Julie Blackwood was a trainer for Siemens who was assigned to a Charleston, S.C. hospital. She trained hospital personnel in a Siemens computer program used for patient medical information. But when her own son was admitted to the hospital, she saw the program was not being used. She accessed his medical records in violation of HIPAA and was thereafter terminated.

She was represented by her attorney father and claimed wrongful termination. She reached a \$100,000 settlement with Siemens in advance of litigation. Her 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. Siemens issued a Form 1099-MISC for the payment.

Blackwood had previously suffered from depression and relapsed as a result of her termination. It caused her to suffer insomnia and hypersomnia, and to experience migraines, nausea, vomiting, weight gain, acne, and pain in her back, shoulder, and neck. She resumed counseling sessions and incurred medical expenses. She did not report the \$100,000 as income.

When the IRS treated the payment as taxable, Blackwood argued that it was excludable, primarily based on *Domeny*. She argued that the exacerbation of her depression symptoms as a result of her termination qualified as a physical injury or physical sickness. The IRS countered that she simply had symptoms of emotional distress, which produced a taxable recovery.

¹¹See *Burns v. United States*, 76 F.3d 384 (9th Cir. 1996), Doc 96-5624, 96 TNT 39-55; *Peebles v. Commissioner*, T.C. Summ. Op. 2006-61, Doc 2006-7527, 2006 TNT 76-5; and *Vaughn v. Commissioner*, T.C. Memo. 1992-317, aff'd without published opinion, 15 F.3d 1095 (9th Cir. 1993).

Although Domeny's presentation had been thorough, Blackwood's was not. Blackwood's counselor did not testify in the Tax Court. She wrote about her patient's treatment but said nothing about any specific physical symptoms of her depression. Blackwood testified that her insomnia, hypersomnia, migraines, nausea, weight gain, acne, and back, shoulder, and neck pain were attributable to her depression. However, no other evidence was submitted to prove that she suffered from these or other physical injuries.

Judge Robert P. Ruwe found these facts distinguishable from those present in *Domeny*. Qualitatively and quantitatively, Blackwood's evidence did not show the level of physical injury or physical sickness present in *Domeny*. Moreover, of the eight symptoms Blackwood mentioned in her testimony, five were similar to the list of emotional distress symptoms specifically mentioned in the 1996 legislative history to section 104(a).¹²

In addition, in *Domeny* a physician had determined that she was too ill to work. Blackwood had no such determination and only presented a counselor's letter that said she had "increased levels of anxiety and depressive symptoms." Blackwood may have been suffering from depression and she may even have had some physical symptoms from it. However, they did not qualify under section 104, the court ruled.

The court seemed to have an easy time drawing the line between *Domeny* and the *Blackwood* facts. Nevertheless, because Blackwood had some similarities to the *Domeny* case and because her CPA had advised her that the payment was not taxable, the court declined to impose penalties.

D. Teachable Moment?

What do the *Domeny*, *Parkinson*, and *Blackwood* decisions teach us? It seems possible to draw different lessons from these cases, but here are the lessons they give me.

1. The facts and your proof matter. To exclude a payment on account of physical sickness, you need evidence that you really made the claim, that the payer was aware of it, and that the payer at least considered your claims in making the payment.

2. You must show you had a demonstrable sickness. You need not have a medical diagnosis that you suffer from MS or had a heart attack. But you need some kind of medical diagnosis. Blackwood

¹²When section 104 was amended in 1996, the conference committee report noted that symptoms of emotional distress such as insomnia, headaches, and stomachaches were not physical injuries or physical sickness. See H.R. Conf. Rept. No 104-737 (1996).

did not even have a clinical diagnosis of depression, although the court seemed to believe that she did. The more physical your medical diagnosis is, the better.

3. Obtain and be prepared to present evidence of medical care. In *Blackwood*, there was no medical documentation, no linking of the symptoms to the diagnosis, and nothing too far beyond the "headaches, stomachaches, and insomnia" famously noted in the act's 1996 legislative history. Keep evidence that you were claiming the payer caused your condition or caused it to worsen.

4. Be as explicit as you can in the settlement agreement. The courts and the IRS are ill-equipped to determine which payments were for which claims. You miss a huge opportunity if you are not specific in your settlement agreement. If an express allocation in a settlement agreement is reasonable and has a rationale, the IRS frequently will accept it.

5. Be reasonable in your allocation. In allocating which payments are for which claims, don't go overboard. In an employment dispute, don't allocate \$10 to wages. And in an intentional infliction of emotional distress case, don't allocate 90 percent of a recovery to physical injuries or physical sickness. Don't pick a figure you cannot support.

6. Collect good documentation contemporaneously. Especially if there is a thin record of medical expenses, consider what other documents you can collect at settlement time. A letter from the plaintiff's attorney saying why the physical sickness claims were strong may help. A letter from a treating physician or an expert physician may help. Declarations signed under penalties of perjury may be more persuasive than letters. Prepare what you can at the time of the settlement or, at the latest, at tax return time. Do as much as you can contemporaneously. Don't wait for an audit to gather supporting documentation.