Bruises, Settlements, and the Proposed 104 Regs

By Robert W. Wood

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Section 104 is brief, yet important. To plaintiffs in all manner of lawsuits, it usually represents the only possibility that their recovery will be tax free. Once in a while (in the case of some claims against the government) the general welfare exception might conceivably apply.[1] Also, some lawsuits relate to capital assets, and a recovery might constitute a recoupment of basis, with any excess as capital gain.[2]

In the bulk of litigation, however, section 104 alone offers hope. In a way, this is unfortunate, because the hope is often short-lived. Many a plaintiff has read something somewhere or listened to someone say that some recoveries for personal injuries are tax free. Usually, they take that to heart. Surely their recovery must be tax free. After all, they were injured!

I am not making light of anyone's injury, nor of bona fide advice that qualified professionals give based on an understanding of the facts and the law. This is an area in which reasonable minds can and do differ. Even something as fundamental as whether a physical battery is required to set off a chain of events leading to excludable damages for physical injuries or physical sickness is unclear.

As a frequent adviser to litigants (both plaintiffs and defendants), their litigation counsel, their tax counsel, and their accountants, I share their frustration. Sometimes, getting bad news is better than getting no news at all. Yet until very recently, the section 104 regulations had remained unaltered for decades, despite the sea change effected by the 1996 Act.

Clearly, the release of proposed regulations in September 2009 was welcome.[3] Yet it was also a disappointment. After a 13-year gestation period, the proposed regulations do not attempt to define physical injury, physical sickness — or for that matter — physical.

This is disturbing. Even the D.C. Circuit in the now-famous *Murphy* case was faced with the argument that the regulations said one thing and the statute another, Judge Robert H. Ginsburg had to rule that the statute (not the old regulations) controlled.[4] Short of regulations (temporary, proposed, or final), the IRS has other vehicles at its disposal — including notices, announcements, and other items of that ilk — yet it has been almost miserly about issuing them.

The object, it would seem, is to get information in the hands of the taxpayers and their advisers. The proposed regulations issued in September 2009 target the 1996 Act statutory changes.[5] They state that it is not necessary to satisfy the first test enunciated in *Commissioner v. Schleier*.[6] They also state that it is no longer relevant whether the remedial scheme under which the damages were awarded is tort-like in scope.

In effect, the proposed regulations say they are reversing the result in *United States v. Burke*.[7] According to the preamble, after *Burke*, the *Schleier* court sought to verify the presence of tort or tort-type rights in an effort to ensure that the damages were paid for *personal* injuries. Since the 1996 Act (post-*Schleier*) made clear that the injury must be *physical* (which by definition must be personal), the proposed regulations take the view that there is no need for the first part of the *Schleier* test.

Significantly, although the proposed regulations are proposed to apply to damages received after they are published as final regulations, taxpayers are allowed to apply these proposed regulations currently, generally for damages received after August 20, 1996. Claims for refund for those tax years may even be allowed. That may all make sense. It is a positive change, one that is liberalizing for at least the arguably small group of taxpayers who are tripped up by the first *Schleier* test.

Most taxpayers, however, stumble on the second prong of the *Schleier* test, not the first. Unfortunately, the proposed regulations do not seek to explain what constitutes a physical injury or a physical sickness. So instead of many new answers, we have a steady stream of cases.

It is a mixed lot, generally uninspiring to read. I have tried on several prior occasions to collect the post-1996 cases dealing with section 104.[8] I offer here the latest entrants.

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[1] *See* Robert W. Wood, "Updating General Welfare Exception Authorities," *Tax Notes*, June 22, 2009, p. 1443, *Doc 2009-11813*, or *2009 TNT 118-6*; and Wood and Richard C. Morris, "The General Welfare Exception to Gross Income," *Tax Notes*, Oct. 10, 2005, p. 203, *Doc 2005-20172*, or *2005 TNT 191-34*.

[2] *See* Wood, "Securities Lawsuit Recoveries: Capital Gain or Ordinary Income?" *Tax Notes*, Aug. 15, 2005, p. 767, *Doc 2005-16770*, or *2005 TNT 152-26*; and Wood, "Litigation Settlements, Sales and Exchanges, and Section 1234A," *Tax Notes*, Nov. 7, 2005, p. 776, *Doc 2005-22208*, or *2005 TNT 212-50*.

[3] *See* prop. reg. section 127270-06, *Doc 2009-20411, 2009 TNT 176-6*.

[4] *See Marrita Murphy et al. v. IRS*, 460 F.3d 79, 83 (D.C. Cir. 2006), *Doc 2006-15916*, *2006 TNT 163-6*.

[5] *See* prop. reg. section 12720-06.

[6] 515 U.S. 323 (1995).

[7] 504 U.S. 229 (1992).

[8] *See* Wood, "Post-1986 Act Section 104 Cases: Where Are We Eight Years Later?" *Tax Notes*, Oct. 4, 2004, p. 68, *Doc 2004-18582*, or *2004 TNT 189-27*; and Wood, "Damage Awards: Sickness, Causation, and More," *Tax Notes*, June 12, 2006, p. 1233, *Doc 2006-10655*, or *2006 TNT 113-22*.

Bruises That Didn't Measure Up

In *Justin W. Hansen v. Commissioner*,[9] the taxpayer (Hansen) worked at a Martin Marietta mine in Nebraska. His supervisor assaulted him, throwing him to the ground and pushing his face into limestone powder. The Tax Court referred to this as the mine assault, from which Hansen sustained some bruises.

Later, the same supervisor came to Hansen's home and assaulted him there. In this home assault, Hansen sustained more bruises, plus a small cut on his foot. He called the police, and the matter escalated with his employer. Hansen complained to the Mine Safety and Health Administration and asked a Nebraska court for a harassment protection order. A few days later, Martin Marietta terminated Hansen, stating he was unable to communicate with fellow employees.

Hansen filed a discrimination claim under the Federal Mine Safety and Health Act of 1977, which generally prohibits firing or discriminating against a worker for complaining of safety violations. He sought reinstatement as well as all monies and benefits he would have received had he had not been terminated. Hansen received an order from an administrative law judge granting him temporary reinstatement.

Eventually, however, Hansen and his employer entered into a global settlement in which he received $120,000. The settlement agreement was explicit that $20,000 was back wages to be reported on a Form W-2. The other $100,000 was for "emotional distress and attorney's fees."

Not surprisingly, Martin Marietta reported the $20,000 as wages and issued a Form 1099 for the $100,000. Hansen included the $20,000 wage payment on his 2004 tax return, but not the $100,000 for emotional distress and legal fees. The Service issued a notice of deficiency. In Tax Court, Judge Carolyn P. Chiechi started with *Commissioner v. Schleier*[10] and a discussion of the 1996 changes to section 104.

Despite the language of the settlement agreement, Hansen argued that the parties intended the $100,000 award for emotional distress and legal fees not to be taxable. To support that position, Hansen pointed out that he had sustained bruises in both the mine assault and the home assault. At the time of the settlement, his only remaining claims were for those bruises, he contended.

Yet the settlement agreement itself contradicted that position. Indeed, it was clear that Hansen was asserting claims against the company, and those claims had teeth. With clear cause-and-effect analysis, Judge Chiechi noted:

> Although petitioner had sustained some bruises as a result of the mine assault and the home assault by Mr. Fleischman, none of the claims that petitioner asserted in those complaints and that grievance and that are disclosed by the record in this case was for damages on account of those bruises or any other alleged personal physical injuries or physical sickness.[11]

Further, the settlement agreement was clear that Martin Marietta was being released from all claims forming the basis of the Mine Safety and Health Administration complaints, a Nebraska complaint, and a union grievance.

This seemed to be an easy case for the government even though Hansen was actually bruised. Ironically, the prevalence of the "bruise" ruling (and its informal moniker) can mislead taxpayers and their counsel (and even tax advisers).[12] One might think that as long as there are bruises or other manifestations of observable bodily harm, an exclusion under section 104 should be appropriate (for at least part of the recovery).

Of course, that is not enough. Judge Chiechi made it clear that the payment must be *for* those bruises. Hansen's settlement agreement was inadequate even to make that argument. It stated that the disputed $100,000 was for emotional distress and attorney fees. The bruises, physical injuries, or physical sickness is simply not mentioned.

Toward the end of the opinion, as a nail in the coffin, the Tax Court noted that the issuance of a Form 1099-MISC for the $100,000 further contradicted Hansen's position. The instructions to that form state that damages for nonphysical injuries or sickness should be reported. Interestingly, the court did not mention the converse, that excludable recoveries should not be reported. Yet because a Form 1099 was prepared here (and indeed was required by the settlement agreement), the court took that as further evidence that the award was taxable. The Tax Court evidently raised this Form 1099-MISC point on its own, saying it was taking judicial notice of the form's instructions.

Sickness and Causation

The Tax Court took another recent trip into section 104 lore in *Jon E. Hellesen v. Commissioner*.[13] Judge Juan F. Vasquez was faced with a settlement involving claims by Hellesen and his wife against State Farm. Both spouses worked for State Farm. Hellesen was a claims adjuster and his wife was an attorney.

Both were evidently fired, although the circumstances are unclear from the Tax Court's memorandum decision. They both sued, but virtually all the allegations seemed to relate to Hellesen rather than his wife. The couple alleged sexual harassment and discrimination (mostly of Hellesen, it appears), tortious discharge in violation of public policy, negligence, negligent misrepresentation, fraud, and so on. The couple alleged they suffered extreme and severe emotional distress, including lack of concentration, loss of self-esteem, embarrassment, anxiety, humiliation, and stress.

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[9]T.C. Memo. 2009-87, *Doc 2009-9580*, *2009 TNT 80-9*.

[10]515 U.S. 323 (1995), *Doc 95-5972*, *95 TNT 116-8*.

[11]*See Hansen*, T.C. Memo. 2009-87, at 16.

[12]*See* LTR 200041022 (July 17, 2000), *Doc 2000-26382*, *2000 TNT 201-10*.

[13]T.C. Memo. 2009-143, *Doc 2009-13919*, *2009 TNT 116-9*.

Notably, the couple did not ask for damages resulting from physical injuries or sickness from emotional distress. Hellesen claimed he was the victim of sexual harassment, causing him to pace and feel upset, nervous, and stressed. He maintained he had physical problems as a result of his termination, including escalations in chest pain, an aching pain and loss of sensitivity on the right side of his forehead, increased blood pressure, weight loss, an upset stomach, irregular bowel movements, headaches, and emotional instability.

Hellesen had a single appointment with two different physicians regarding his physical ailments. He did not provide proof of costs incurred in seeing those physicians, nor did he prove that he had paid for any medical care. The doctor Hellesen saw for chest pains instructed him to reduce his stress level and did not diagnose a heart problem or prescribe any medication.

The other doctor (to whom Hellesen complained of pain and loss of sensitivity over his right eye), appears to have offered no advice. Hellesen told him the area over his right eye was weakened, and that when he had stress or upset feelings, they lodged in that area. In his deposition, Hellesen could not recall whether this doctor made a diagnosis. He was referred to another doctor for this condition but did not pursue the referral.

At trial Hellesen said that in 1994 (while still working at State Farm), a blood vessel had burst in his head. Hellesen said a doctor had diagnosed a condition in his head, and that this condition had not improved. He began having an upset stomach while working at State Farm, and after his termination became more emotional, with a daily upset stomach. Hellesen lost approximately 20 pounds following his termination by State Farm.

Hellesen Settlement

In 1997 Hellesen and his wife settled with State Farm for $550,000, less a $3,000 arbitration fee. They received a check for $273,500 (net of attorney fees), and State Farm reported it on a Form 1099-MISC. However, Hellesen did not report the payment. The settlement agreement contained general release language and said that the couple was receiving the payment for:

> all obligations by Defendants to CLAIMANTS including, without limitation, severance pay, sick pay, and other wages or benefits, and general damages for personal physical injuries and sickness, including medical costs and treatment incurred therein, as well as emotional injuries arising from Claimants' alleged personal physical injuries and sickness from alleged sexual harassment, wrongful termination and retaliation and all other statutory, tort, contract, or other claims of any kind.[14]

The settlement agreement also contained a recital, indicating that Hellesen and his wife:

> claim they suffered personal physical injuries and sickness, including, but not limited to, medical injuries, costs and treatment, resulting from being subjected to sexual harassment, wrongful termination and retaliation caused by Defendant, resulting in physical disabilities.[15]

As Judge Vasquez points out, the settlement agreement did not allocate any portion of the amount among these various claims. Moreover, physical injuries or sickness were not alleged in the complaint. The settlement agreement said all claims were being released, but there was no allocation between them.

The court noted that when there is no express language accomplishing an allocation in a settlement agreement, it will look to the intent of the payer based on all the facts and circumstances. All the facts (and all the documents) pointed toward the entire recovery being taxable. The Tax Court acknowledged that Hellesen had stated his impression that, in reaching a settlement, State Farm was very concerned about his physical injuries.

Yet Hellesen did not present any evidence in support of his impression, so the Tax Court rejected what it referred to as his self-serving testimony. Further, finding no explanation for Hellesen's failure to report the income (or for his late return filing), the Tax Court sustained the imposition of additions to tax under section 6651(a)(1).

Raccoon Bites and Other Injuries

In *Emblez Longoria v. Commissioner*,[16] the Tax Court (Judge David Gustafson) considered the tax treatment of a discrimination award. The complaint did not mention physical injuries, but there was no question the plaintiff had suffered some in this case.

There was physical injury, and probably physical sickness to boot. Longoria was a New Jersey state trooper who claimed he suffered racial discrimination and physical injuries. In 1988, while at the state police academy, he was singled out to participate in a wrestling training exercise. He was injured when his weapon struck his ribcage. He sustained bruised ribs and experienced severe pain.

On another occasion, an instructor purposely blocked a gas chamber doorway during a training session, causing Longoria to inhale a noxious chemical agent and suffer gagging and burning in his lungs. Longoria was also singled out during swimming exercises. He was required to swim extra laps while physically exhausted, which sickened him.

In 1989, while a trooper, Longoria encountered a suspect and called for backup. Because his superiors ignored the request (another alleged act of discrimination), he proceeded himself, injuring his back when the suspect resisted arrest. Another time (in retaliation for his complaints), fellow troopers put all of Longoria's gear high up in his locker so that it fell on him (injuring his back) when he opened the locker.

Longoria also alleged incidents of substandard duty because of his minority status. Sent out to investigate a wild raccoon sighting, he was bitten or scratched by the rabid animal. He had to undergo painful rabies shots, causing swelling, nausea, and flu-like symptoms.

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[14] *Id.* at 6.

[15] *Id.* at 5.

[16] T.C. Memo. 2009-162, *Doc 2009-15184, 2009 TNT 126-16*.

Finally, Longoria sustained injuries when his patrol vehicle caught fire. This incident allegedly occurred because other officers discriminated against him, giving him a substandard vehicle with high mileage. Although he escaped the fire, Longoria suffered smoke inhalation. After this recitation of the physical incidents, the Tax Court dropped a footnote in which it mentioned an auto accident, allegedly related to the discrimination, in which Longoria injured his back.

This, it must be acknowledged, is a long and detailed list. As a result of the various injuries, Longoria sometimes sought medical attention and sometimes required time off. He was allowed sick leave with pay, and the state paid all his medical bills. He suffered no lost wages or out-of-pocket medical expenses as a result of any of these injuries.

Longoria filed an Equal Employment Opportunity Commission complaint as well as a complaint in federal court. In both complaints Longoria requested damages, but never for physical injuries or physical sickness. In the voluminous materials, the court notes, the only enumeration of damages is Longoria's statement that, as a result of the unlawful retaliation:

> he has suffered loss of income; loss of fringe benefits (including but not limited to medical benefits, dental benefits, and pension benefits); loss of seniority in higher positions; severe mental anguish; anxiety; stomach problems; sleep disorder; stress; diminution of the quality of his life and other hedonistic injury.[17]

During settlement negotiations, Longoria's attorney brought his physical injuries to the state's attention. Yet no evidence was offered in Tax Court to show that the physical injuries were ever mentioned in writing during the pendency of the suit. Eventually (in 2005), Longoria signed a settlement agreement calling for him to be paid $156,667 for ''all claims and rights which he may have against'' the state.

There was no allocation of this amount, and the state issued him a Form 1099-MISC reflecting the settlement. It was clear that the amount was not lost wages, given that Longoria never experienced wage loss. Longoria evidently confirmed this wage point with his lawyer. When Longoria asked more generally about the tax consequences of the award, he took his lawyer's advice and went to see a tax professional.

The CPA Longoria hired told him he could exclude his recovery, but that he had to report it on his return with a statement about what it was, listing it as nontaxable. Longoria didn't pay tax on the recovery and wound up in Tax Court. Interestingly, the CPA testified in Tax Court that Longoria had not given him the settlement agreement or anything from the underlying case, while Longoria said he had. The court found the CPA's recollection more credible, so it concluded that Longoria did not present the CPA with any paperwork related to the lawsuit or the settlement.

Based on all this, the court easily concluded that the entire recovery was taxable income. Although the settlement may have resolved *all* of Longoria's claims, and although Longoria may have had physical injury and sickness, there was simply no indication that the state was paying anything for physical injuries or sickness. The settlement agreement was silent about what claims the money was meant to satisfy.

This was a discrimination, retaliation, and civil rights case. The damages Longoria claimed were primarily for loss of income, loss of fringe benefits, and loss of seniority in higher positions. Plainly, none of these are physical. To Judge Gustafson, the alleged injuries all arose from the emotional distress Longoria suffered and the symptoms of that distress. There was simply nothing to suggest Longoria was being paid because of the physical injuries, no matter how physical they may have been.

Here, the Tax Court is worth quoting at length, not only about the evidence presented to it, but also about the odd turn of events Longoria tried to orchestrate posttrial:

> Although Mr. Longoria gave credible testimony at trial about other injuries that were plainly physical — e.g., bruised ribs, smoke inhalation, animal bite, and back injury — none of these injuries was alleged in Mr. Longoria's complaint, and we cannot find that the State of New Jersey agreed to settle because of them. While the settlement agreement does state that the settlement ''releases all claims including those of which * * * [the State of New Jersey] is not aware,'' it was Mr. Longoria's burden to prove some discernible allocation between the emotional distress-type damages that were pleaded in the State court complaint and the physical injuries about which he testified at the trial in this case. Mr. Longoria did not carry that burden. Without much explanation, Mr. Longoria's posttrial brief asks us to allocate one-third of the $156,667 settlement award to physical injuries and two-thirds to non-physical injuries, punitive damages, and costs. Without an evidentiary basis for such an allocation, we decline to adopt Mr. Longoria's allocation or to attempt any other.[18]

Other statements by the Tax Court are equally telling about its thoroughness and its inquiry into causation:

> While we find Mr. Longoria's testimony to be sincere and find that he suffered discrimination from his employer that apparently led to several physical injuries, the determinative issue is whether the State of New Jersey intended to compensate Mr. Longoria for his physical injuries when it paid him the settlement award. On the basis of the record before us, we cannot find that the State of New Jersey placed any importance on Mr. Longoria's physical injuries.[19]

Finally, with admirable patience, the court said:

[17] *Id.* at 9.

[18] *Id.* at 20.

[19] *Id.* at 21-22.

> Even assuming that recovery was potentially available in the State court lawsuit for Mr. Longoria's physical injuries, Mr. Longoria did not present any witness from the State of New Jersey to testify as to its intent, nor did he present any other evidence from which we might infer the State's actual intent. . . . Mr. Longoria did not establish that he received the $156,667 settlement award, or any identifiable part thereof, from the State of New Jersey on account of personal physical injuries or physical sickness.[20]

Still, the court was satisfied that Longoria had reasonable cause and therefore should not be penalized for his good-faith reliance on what the court characterized as "poor advice from a CPA."[21]

Bruising Loans?

Judge Gustafson faced another section 104 argument in *James W. and Mattie M. Johnson v. Commissioner*.[22] The Johnsons sued a mortgage company over an attempted foreclosure. Johnson received a $25,000 settlement from the mortgage company, which he claimed was excludable from income.

The settlement agreement did not list any of Johnson's claims but merely said it was settling claims that were filed in the action. Johnson did not offer into evidence, in the pleadings in the underlying case or in the record, any information about the nature of his claims, his damages, or the relief sought. In fact, Johnson testified in Tax Court that he understood the suit to be one for breach of contract.

Moreover, Johnson did not allege or present any evidence in Tax Court showing that he or his wife suffered actual physical injuries for which the mortgage company intended to compensate them. In fact, he only offered evidence that the underlying case was for breach of contract. Obviously, therefore, the court concluded that the $25,000 was not excludable under section 104.

The court also had to address attorney fees, because $3,500 of the $25,000 was paid to the lawyer. Citing *Commissioner v. Banks*,[23] the court concluded that the Johnsons could deduct those attorney fees only as a miscellaneous itemized deduction.

Hypertension, Diabetes, Etc.

In *Paul J. and Allen C. Prinster v. Commissioner*,[24] Judge Joel Gerber faced taxpayer arguments that a wrongful termination recovery was excludable under section 104. Paul Prinster was fired and suffered mental distress. He also experienced hyperlipidemia, hypertension, and other ailments, believing them to be caused by his mental distress. Prinster sued and settled for $76,500, of which $28,716.50 was paid directly to his lawyer.

The employer issued Forms 1099-MISC to Prinster and his lawyer. Prinster's lawyer told him this 2005 settlement was not taxable because it was attributable to personal injuries. Prinster filed his tax return on that basis and later landed in Tax Court.

Noting that wrongful termination in California is a tort claim, the Tax Court concluded that Prinster had satisfied the first *Schleier* hurdle. However, the court concluded that Prinster's ailments were not the type contemplated by section 104(a)(2). Although Prinster contended he had physical sickness in the form of headaches, vomiting, diarrhea, hypertension, hyperlipidemia, and diabetes, the court found these to be symptoms related to his emotional distress rather than physical sickness.

Moreover, the Tax Court found that Prinster did not sufficiently show that his ailments resulted from his termination. Indeed, the court commented that the record reflected that Prinster had already been suffering from hyperlipidemia. The record also suggested that Prinster's posttermination symptoms could have been the product of his diet and lifestyle. The court therefore found that the record failed to establish the cause of Prinster's sickness.

Turning to physical injuries, the court also concluded that Prinster failed to demonstrate the payments were for physical injuries. A sealed portion of the record stated that the payments were "for alleged emotional and related physical injuries."[25] Yet there was no specificity of any amount that could be allocated to either. In the absence thereof, the court held the entire payment to be taxable.

Regarding the physical sickness point, the court referred to its decision in *Lindsey v. Commissioner*.[26] In that decision, the taxpayer suffered from hypertension and stress-related symptoms, and the Tax Court held those symptoms to be related to emotional distress rather than to physical sickness. The court evidently considered Prinster's claims to be similar.

Although the Tax Court stopped short of saying that these claims were not themselves sickness, Prinster failed to connect the dots. Moreover, noting that section 104 provides an exclusion for medical expenses, the court stated that Prinster had not even submitted any proof of medical care expenses.

Harassment Does Not Equal Bruises

Finally, in our dubious hit parade of cases, we have *Hartford and Josephine Shelton v. Commissioner*,[27] in which Judge Joseph Robert Goeke of the Tax Court had to rule on a sexual harassment award and its impact under section 104. Josephine Shelton, an employee of Dial Corp., was harassed by her supervisor. When Shelton complained, she received menial labor and undesirable assignments in retaliation.

As a result of the harassment, Shelton developed severe emotional problems and sought medical help. She began to take antidepressants and other medication to deal with the physical effects of her harassment (and had continued to do so at the time of the Tax Court trial). The

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[20] *Id.* at 23-24.
[21] *Id.* at 30.
[22] T.C. Memo. 2009-156, *Doc 2009-14857*, *2009 TNT 123-6*.
[23] 543 U.S. 426 (2005), *Doc 2005-1418*, *2005 TNT 15-10*.
[24] T.C. Summ. Op. 2009-99, *Doc 2009-14983*, *2009 TNT 124-47*.
[25] *Id.* at 9.
[26] T.C. Memo. 2004-113, *Doc 2004-10134*, *2004 TNT 92-13*, *aff'd*, 422 F.3d 684 (8th Cir. 2005), *Doc 2005-18306*, *2005 TNT 171-51*.
[27] T.C. Memo. 2009-116, *Doc 2009-11892*, *2009 TNT 99-7*.

Equal Employment Opportunity Commission determined that there was sexual discrimination and harassment, and it eventually entered into a consent decree with Dial.

As a claimant in the eligible group of class members, Shelton had to sign a release form discharging Dial from liability for all past instances of sexual harassment. The release stated that the settlement proceeds were for emotional pain, suffering, inconvenience, mental anguish, loss of enjoyment of life, and nonpecuniary losses. It did not include provisions describing their tax treatment. Shelton signed a release and received $123,500 in 2004, for which she was issued a Form 1099-MISC.

Shelton contacted the IRS to determine if the payment was taxable. Based on those discussions, she understood that it was not. Shelton went to a tax return preparer who similarly said he did not think the payment was taxable. Accordingly, Shelton did not include it on her return.

In Tax Court, Judge Goeke had an easy time concluding that although Shelton may have suffered physical injury as a result of her sexual harassment, her settlement payment was not excludable under section 104. The settlement agreement itself said that the money was for emotional pain, suffering, inconvenience, and mental anguish. Physical injury was not mentioned. Shelton may have received settlement proceeds and she may have even been injured, said the court, but she did not receive the settlement proceeds on account of personal physical injury or sickness.

As some consolation, Shelton was not saddled with penalties. She was found to have acted reasonably and in good faith in checking with the IRS and in relying on her return preparer.

Conclusions

It is hard to think of a code section that gives people more fits than section 104. That was true before 1996, and in a somewhat different way, it has been even truer thereafter. Thirteen years after section 104 was amended, confusion is still rampant.

Although section 104 is a simple code section, the situations in which it is called into play are not. Many taxpayers can be forgiven for not understanding its nuances. That is particularly true for failures to appreciate the nature of the causal nexus that must be shown for the statute to apply.

One of the more unfortunate but frequent problems I see may be a simple hangover from pre-1996 law. Many a taxpayer, and many a trial lawyer, dashes off language in a settlement agreement about money being for emotional distress. They somehow think this will make the recovery tax free. The IRS and the Tax Court must get tired of these cases.

Indisputably, if there is no physical injury or physical sickness, you should not say there is. But in the hurly-burly of real-life cases, there are often many things going on. After all, in some of the cases discussed above, there *was* physical injury, physical sickness, or both. Why then was there no exclusion?

The answer may come in several parts. First, the taxpayer must have complained of the right thing. The plaintiff doesn't necessarily have to be thinking about tax issues when he files a complaint (although that certainly helps). However, it will be odd if he first mentions his bruised or broken arm in the settlement documents. Be reasonable.

That applies to the causes of action too. A demand letter to the defendant that complains of many things (including physical injuries or sickness) may be better (in terms of later tax flexibility) than a federal court complaint brought under a statute that entitles the plaintiff only to wages. Again, be reasonable.

Regarding causes of action, the new proposed regulations[28] are certainly liberalizing, making it unimportant whether the remedial scheme under which the damages are awarded is tort-like in scope. No longer, they say, must we assure ourselves that the suit is a tort suit or even one for tort-type rights. Of course, to be excludable, the damages must still be payable on account of personal physical injuries or physical sickness. That is where the rubber meets the road. It remains to be seen just how significant this liberalizing change will prove to be, although its practical effect seems limited.

Finally, when the time comes to settle, make the settlement agreement explicit. Be thoughtful, accurate, and complete in trying to divvy up a settlement. A general release with no tax language should pass from our scene.

In fact, it is amazing to think that taxpayers and their counsel believe that a settlement in a case that might be a smidgen physical and mostly taxable will somehow be made completely tax free by a failure to allocate. The reverse is more likely true.

Despite the many other problems the taxpayers had in the bevy of recent cases I've considered here, they were all hoist by their own petard. With the exception of the suit against the mortgage company (*Johnson*), most of these cases might even have been resolved at the audit or IRS Appeals level had the settlement agreement been specific and allocated a reasonable (not greedy) piece to the physical injury/sickness elements of the case. I say this even if there might have been a lack of specificity about the precise forum and the precise nature of the claims presented. If the facts are messy and if the parties specifically allocated the payments and were reasonable, that may be enough for the IRS to accept.

There was a brief upheaval over *Murphy*, its constitutional hockey game, and its not-so-palatable personal equity aftertaste. Yet I believe its most lasting lesson is much more basic: A recovery for ''emotional distress'' that caused bruxism is taxable, while a recovery ''for bruxism and emotional distress arising from it'' might not be.

Today, more than ever, explicit allocations and bona fide, bargained-over indications of the payer's intent are very important.

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[28]*See* prop. reg. section 12720-06, note 3 *supra*.