

IRS Allows Damages Exclusion Without Proof of Physical Harm

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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Yes, you read the headline correctly. It has been 12 years since section 104 was amended in small but momentous ways. In 1996 Congress amended this formerly simple and straightforward personal injury exclusion by inserting the word “physical” in two key places. Since that amendment, to get tax-free damages or tax-free settlement payments, the payment must be on account of personal *physical* injuries or *physical* sickness.

Since then, there’s been no shortage of debate about just how one should define the “physical” modifier.¹ Sadly, the IRS has not seen fit to amend its regulations under section 104. Thus, although a dozen years have elapsed since Congress amended section 104 to insert the “physical” modifier, there is no official pronouncement (in regulations or anywhere else) about exactly what the IRS thinks of this exclusion.

Given the importance of the phrase “physical injuries or physical sickness,” one would think there would be ample authority explaining it. Nevertheless, there are no regulations (or IRS notices or announcements) stating the IRS view of what constitutes physical injuries or physical illness. Although IRS regulations also often take years to work their way through the IRS and Treasury administrative process, some IRS vehicles (especially notices and announcements) can be issued quickly when (and if) the IRS wants to give guidance on a particular point.

In Terrorem Effect

The lack of regulatory action and the lack of published rulings on this point is maddening. Congress sought to amend section 104 in 1996 precisely because it perceived (perhaps correctly) that the section 104 exclusion had become an exclusion as big as the great outdoors. As employment litigation flourished in the ’70s and ’80s, it was becoming increasingly common in employment cases for many settlements to be largely (if not entirely)

¹See Robert W. Wood, “Post-1996 Act Section 104 Cases: Where Are We Eight Years Later?” *Tax Notes*, Oct. 4, 2004, p. 68, Doc 2004-18582, 2004 TNT 189-27; Wood, “Damage Awards: Sickness, Causation, and More,” *Tax Notes*, June 12, 2006, p. 1233, Doc 2006-10655, 2006 TNT 113-22.

characterized as “emotional distress” damages. Congress attempted to draw a bright line between taxable and tax free by imposing the physical moniker. Since then, the IRS has doubtless done its best on an *ad hoc* basis to apply the law.

Of course, most readers are aware that the IRS view of what constitutes a physical injury requires adherence to a high standard. Attempting to draw its own bright line, the IRS has announced in various private letter rulings that for something to constitute a physical injury, we have to be able to see it or, more exactly, to see its fruits. A battery doesn’t give rise to excludable damages, it would seem, unless the battery produces observable bodily harm. Bruises, cuts, and broken bones are observable.

This theory is given its most eloquent and most cited voice in LTR 200041022, *Doc 2000-26382, 2000 TNT 201-10*, which has come to be known as the “bruise ruling.”

Bruise Ruling

LTR 200041022 deals with the thorny topic of when a taxpayer receives damages for assault when there is no “observable bodily harm.” The ruling concludes that the damages a couple received under a settlement agreement with the wife’s employer that are allocable to her employer’s unwanted physical contacts *without* any observable bodily harm were *not* within the section 104 exclusion.

Interestingly, the same ruling concludes that the damages she received for pain, suffering, emotional distress, and reimbursement of medical expenses that are allocable to the period beginning with the first physical injury are properly excludable. Thus, this oft-cited ruling attempts to parse the physical from the nonphysical. Of course, damages allocable to punitive damages would be includable in income (and the ruling so holds).

The wife was employed as a full-time driver. Her employer began making suggestive and lewd remarks to her, and also began physically touching her. According to the ruling, those physical contacts did not leave any observable bodily harm. However, while on one road trip, the superior physically assaulted the taxpayer, causing her extreme pain. The employer assaulted her on other occasions, causing physical injury. He later physically and sexually assaulted her.

The plaintiff then quit her job and filed a suit asserting sex discrimination and reprisal, battery, and intentional infliction of emotional distress. The complaint also requested leave to amend to add a claim for punitive damages for her common-law claims. The employer settled the case, but there was no express allocation of the proceeds in the settlement agreement.

Under these facts, LTR 200041022 concludes that damages the plaintiff received for unwanted physical contacts without any observable bodily harm were not received on account of personal physical injuries or physical sickness. However, the damages received for pain, suffering, emotional distress, and reimbursement of medical expenses *after* the first assault were excludable under section 104 because they were attributable to physical injuries. LTR 200041022 tries to draw a line separating the various incidents of sexual harassment and touching that

left no observable bodily harm from the physical altercations that the ruling defines as the “First Pain Incident.”

Real World?

Although this ruling is cogent and well written, in the real world it is often difficult to determine exactly what causes trauma (and what *type* of trauma). After reviewing the two-part analysis required by *Commissioner v. Schleier*, 515 U.S. 323, *Doc 95-5972, 95 TNT 116-8* (1995), the IRS in this letter ruling examined the first unwanted and uninvited physical contacts with the plaintiff before the First Pain Incident. The IRS notes that these unwanted and uninvited physical contacts did not result in any observable harms (such as bruises, cuts, and so on) to the plaintiff’s body, nor did they cause the plaintiff pain.

This latter reference to the *alternative* of causing the plaintiff pain seems to offer the early possibility of an exclusion even when there are no observable harms. One can have pain, after all, without observable bodily harm. If the pain emanates from a physical touching (consider, for example, the kick to the groin administered by Dennis Rodman in *Amos v. Commissioner*²), one arguably should have an exclusion whether or not you can see the source of the pain.

The ruling goes on to state that it was not represented that the medical expenses that the plaintiff received after the First Pain Incident (for headaches and digestive problems) were related to events that occurred with or before that incident. Once again, the IRS seems to be leaving the door open for a nexus between the various incidents that often lead up to a sexual harassment claim. Yet, any damages the plaintiff received for events occurring *before* the First Pain Incident are not received on account of personal physical injuries or physical sickness under section 104(a)(2).

The ruling does note that according to the representations submitted, the plaintiff suffered severe physical injuries within a relatively short period after the first physical injury. The ruling splits the factual incidents into these two time frames. On occurrence of and after the first physical injury, there was pain, suffering, emotional distress, and reimbursement of medical expenses that were properly allocable to physical injury. Because these were attributable to (and linked to) physical injuries, they were within the scope of section 104.

New Era?

It cannot be gainsaid that bright lines have their place in the tax law. Indeed, perhaps the tax law needs more of them. Yet, there are many (including me) who find this particular bright line an entirely inappropriate one. After all, there are plenty of physical injuries that leave lasting scars but not physical bruises or broken bones.

As but one example, it seems hard to argue that rape is not physical, and yet it is quite possible for a rape victim not to be outwardly bruised or cut. Nevertheless, few would presumably have the temerity to argue that a rape does not produce physical injuries. And what of a wrongful imprisonment case? If wrongful imprisonment compels an unfortunate victim to spend years locked

²T.C. Memo. 2003-329, *Doc 2003-25600, 2003 TNT 231-8*.

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unjustly behind bars before he is exonerated, surely the act of wrongful incarceration is entirely physical.

In the past, the IRS had ruled recoveries for wrongful imprisonment to be tax free.³ A deprivation of civil rights seems inherently physical, whether or not one bears outward bruises or scars. Yet, it is unclear if the IRS agrees.

Physical Sickness?

Then there is the whole physical sickness debate. It has long been unnerving that almost all of the authorities under section 104 focus on the “physical injury” wing of this exclusion.⁴ That is odd, since the “or physical sickness” wing of section 104 is equally important. Even if the IRS wanted to maintain a rigid “we must be able to see it” policy regarding physical *injury* damages, one could make a principled distinction when it comes to physical *sickness* damages. So many physical sicknesses, after all, bear no outward signs.

Should the tax law allow a taxpayer an exclusion for damages for leprosy, but not allow a taxpayer an exclusion for damages for autism, ulcers, or any other malady that did not result in bruises, broken bones, or some other overt manifestations of harm? In attempting to winnow the taxable from the tax free, one might have to inquire *how* one must be able to see a physical injury or sickness.

Must one be able to see it with the naked eye? With a microscope? With an electron microscope? Is it sufficient if *someone* can see it, or must the IRS be able to see it too? Such gradations of visibility surely could result in arbitrary (and thus unjust — and conceivably even unconstitutional) tax distinctions.

Fading Bruises?

Against this backdrop, I was delighted to read the IRS’s recent discourse on section 104 in ILM 200809001.⁵ This is an important piece of guidance. Interestingly, it was also written by Michael Montemurro, who wrote the bruise ruling eight years ago. He thoughtfully revisits the observable bodily harm standard on at least one fact pattern.

ILM 200809001 gives few facts about the situation on which it rules. The lack of factual detail is probably a good thing, leading to a broader application of the principles enunciated in this ruling. Although I don’t have any personal knowledge of the specific facts involved, the ruling seems to describe a sex abuse recovery from an organization for allowing (or failing to prevent) sex abuse in the past. However, it could probably apply to many other types of tort cases.

In the ILM, a settlement payment is made to settle tort claims asserted against an organization that allegedly

caused physical injury to the plaintiff, who was a minor at the time of the injuries. The ILM says that a substantial amount of time elapsed since the alleged tort occurred. The ILM also says that the plaintiff alleges that he continues to struggle with the trauma resulting from the alleged tort.

We are not told if that continuing trauma is mental or physical, but for the ILM to make sense, I believe we can assume that the continuing trauma is entirely mental or psychological in nature. Thus, we cannot see it. However, the ILM says that because of the passage of time, and because the plaintiff was a minor when the tort was allegedly committed, the plaintiff “may have difficulty establishing the extent of his physical injuries.”

As such, the ILM concludes that “it is reasonable for the Service to presume that the settlement compensated [the plaintiff] for personal physical injuries, and that all damages for emotional distress were attributable to the physical injuries.” The ILM adds that in those circumstances, it is reasonable for the IRS to believe that *all* the damages paid to settle such a claim are excludable from income under section 104. As a corollary, no information report (Form 1099) is required.

Scope of the ILM

The significance of this ILM probably cannot be over-emphasized. Whether the underlying facts prompting this legal memorandum were a clergy sex abuse case or any one of many other horrible situations, the result seems just, appropriate, and administrable. True, there is no bright line here.

The question is not whether the IRS standards require one to show observable bodily harm. From what we know, the IRS does require that. (It is arguably not yet clear if the IRS can reasonably draw that bright line, particularly given that it has not done so in regulations.) Yet, whatever may be said about the legal status of the lack of prevailing published standards under post-1996 section 104, the IRS has now (helpfully and appropriately) altered its stance. It has said that, in appropriate cases, it is *reasonable* to *presume* that observable bodily harm existed.

When the years have elapsed and it is no longer possible to expect someone to show observable bodily harm, the IRS is willing to assume that the damages were physical in the first instance. It is too soon to say whether this important ILM will be seen as watering down the observable bodily harm rationale. It can perhaps be read as admitting of the possibility that the observable bodily harm standard the IRS has informally adopted is too tough.

Indeed, note that the ILM does not state that the plaintiff/taxpayer must show that the injuries in the now long-elapsed years were in fact physical. There seems to be no standard requiring photos, medical records, or other evidence from the past. Instead, it says that in some situations it is reasonable to assume the injuries. That, in my opinion, is reasonable, appropriate, and most welcome.

But, questions may abound. How important is the passage of time? How important is the fact of the

³See Rev. Ruls. 58-370, 1958-2 C.B. 14, and 56-518, 1956-2 C.B. 25. However, the IRS recently obsoleted these rulings. See Rev. Rul. 2007-14, 2007-12 IRB 747, Doc 2007-4230, 2007 TNT 34-15.

⁴See Wood, “Ulcers and the Physical Injury/Physical Sickness Exclusion,” *Tax Notes*, June 20, 2005, p. 1529, Doc 2005-13042, 2005 TNT 115-33; Wood, “Physical Sickness and the Section 104 Exclusion,” *Tax Notes*, Jan. 3, 2005, p. 121, Doc 2004-24100, 2005 TNT 2-41.

⁵Doc 2008-4372, 2008 TNT 42-21.

plaintiff's minority status at the time of the tort? It is probably good that the ILM does not attempt to answer all the questions.

When read narrowly, all it does — and appropriately so — is admit that there are clearly cases in which a rigid application of the observable bodily harm theory is entirely inappropriate. Bravo for that!