Damage Awards: Sickness, Causation, and More

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Tax advisers have long lamented the lack of clarity surrounding the application of code section 104. That was always disturbing, but it has become significantly more bothersome now that 10 years have passed since the statute was amended. In 1996 largely in response to perceived abuses in the employment arena, Congress amended section 104 to require "physical" (as opposed to merely personal) injuries. The statute does not define physical, but how difficult would it be to do so?

Not too difficult, I submit. If I'm right, it means the IRS is missing a huge opportunity to cuff many wayward taxpayers about the head. Olivia Newton-John defined at least a little piece of a generation with "Getting Physical," so why can't the IRS?

Like it or not, 10 years later there is still virtually no certainty surrounding the application of section 104.[1] The IRS's position (in private letter rulings and case law) is that you must show demonstrable physical harm (cuts, bruises, broken bones) having their genesis in a physical battery. Taxpayer positions, however, usually favor an expanded interpretation that includes physical sickness.

That taxpayer fixation on physical sickness hardly seems a stretch, for the statute states expressly that an exclusion is allowed for damages for physical injuries *or* physical sickness. The latter is hardly ever precipitated by physical blows and often involves no outward manifestations of harm equivalent to broken bones or bruises. Yet, ambiguity reigns.

Because the case law is tremendously fact-specific, and given that there are no regulations, taxpayers face a difficult choice. They can either forgo claiming the exclusion or they can claim it and fight about it later. Not only is the IRS fairly hostile to the entire issue, but the Tax Court has become so too, no doubt tired of a seemingly never-ending stream of cases. I'll cover the past year's cases in this article.

Eye of the Beholder?

Just what a payment represents often depends on whom you ask. The Tax Court's decision in *Lindsey v. Commissioner*[2] is interesting from several perspectives, not the least of which is that it straddles the period surrounding the 1996 statutory change. Lindsey was the controlling owner, chairman, and CEO of Empire Gas Corp. (a propane retailer). Lindsay received a $2 million settlement from his company. The settlement agreement said the payment was attributable to his claims for tortious interference with contracts, for injury to Lindsey's personal and professional reputation, and to his claims for emotional distress, humiliation, and embarrassment related to the termination of an acquisition.

The background of the mess involved Lindsey's negotiation with Synergy, under which Synergy was to acquire a large share of the propane retailer for approximately $100 million. It turned out that there were other negotiations afoot, and Lindsey ultimately lost out. Lindsay obtained a temporary restraining order enjoining Synergy from acquiring the other target company. The parties eventually reached a settlement that was captioned a "termination agreement," under which Lindsey's company (Empire) was to receive a cash payment of $15 million or $20 million, depending on other events.

The crucial provision of the agreement involved a payment of $2 million to Lindsey personally. The termination agreement indicated that Lindsey was expected to sign a written general release in exchange for $2 million. The termination agreement included references to Lindsey's tortious interference claims and various items of damage, including emotional distress, humiliation, and injury to personal and professional reputation. However, that same provision of the termination agreement said Lindsey would be obligated to perform such consulting services to which the parties might agree.

When it came time for filing Lindsey's tax return, he excluded the entire $2 million from his income based on an asserted section 104 claim. The IRS assessed a tax liability of approximately $725,000, plus interest and penalties, and Lindsey petitioned the Tax Court. He argued that the section 104 exclusion applied to the symptoms he suffered, which included fatigue, indigestion, and insomnia. The Tax Court said that even if Lindsey suffered in those respects, none of that constituted physical injury or physical sickness.

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[1]For a summary of the post-1996 act case law, see Wood, "Post-1996 Act Section 104 Cases: Where Are We Eight Years Later?" *Tax Notes*, Oct. 4, 2004, p. 68.

[2]T.C. Memo. 2004-113, *aff'd*, 422 F.3d 684, *Doc 2005-18306*, *2005 TNT 171-51* (8th Cir. 2005).

Significantly, Lindsey had not communicated any complaints of physical injury or sickness to the payer or any of its various representatives during settlement negotiations. That meant the payer was completely unaware of those claims, making it inconceivable (according to the court) that Lindsey's alleged injuries or sickness could have been the basis for any portion of the settlement payment.

Getting Physical

On appeal to the Eighth Circuit, Lindsey argued that the pre-1996 version of section 104 applied to the payment (which was made in 1996). Lindsey also argued that the Tax Court was wrong in finding that damages for his physical sickness were not excludable under section 104. The effective date issue was cut and dried, with the Tax Court noting that the statutory language change to section 104 (imposing the "physical" modifier) was effective for amounts received after August 20, 1996. Lindsey's payment came after that date.

Far more interesting is the appellate court's treatment of the physical injury/physical sickness question. The Eighth Circuit noted that the standard established by the Supreme Court in *Schleier* had to be followed.[3] That standard requires a taxpayer to establish both that prosecution or settlement of an underlying claim must be based on tort or tort-type rights and that the receipt of damages must be on account of personal physical injuries or physical sickness.

However, the Eighth Circuit noted that to satisfy the second criterion, the taxpayer must show a direct causal link between the damages recovered and the physical injuries or physical sickness in question. That direct causal link requirement necessitates a fact-based analysis of the damages awarded. The appellate court referred to the testimony of Lindsey's physician, who testified that during the settlement negotiations from 1995 through 1997 Lindsey suffered from hypertension and stress-related symptoms, including periodic impotency, insomnia, fatigue, occasional indigestion, and urinary incontinence.

Those symptoms, the Eighth Circuit found, related to emotional distress, not to physical sickness. The court cited no authority for that proposition. More significantly, however, the court said the payer (with whom Lindsey was negotiating) *knew nothing* about any physical sickness or physical injury claims. The intent of the payer is important. Further, quite apart from the payer's view, the court found no direct causal link between the payment and the maladies of which Lindsey complained. Although the court does not expressly allude to the intent of the payer, it is clear that the reference to the payer's awareness (or in this case, *lack* of awareness) underscores the importance of the payer's intent.

Finally, the court said ominously that Lindsey "opted to take an all or nothing approach, claiming the entire $2 million is physical sickness settlement damages and is excludable." Although the settlement agreement said Lindsey had various claims, even noting that he might be obligated to perform consulting services, the court was particularly influenced by the fact that there was no allocation between taxable and nontaxable. I take that as dramatically underscoring the importance (and validity) of allocations. Having a court refer to an all-or-nothing approach seems self-explanatory: You should allocate.

Suing Yourself

One of the interesting issues implicitly raised by the decision in *Lindsey* (although not explicitly discussed), is just how important it was to the case that Lindsey was receiving a *personal* settlement arising out of a dispute between his business and another business. After all, the dispute was between two companies, yet Lindsey personally received a chunk of the money.

The case reminds me of *Maxwell*,[4] in which a clever taxpayer was able to cause his wholly owned corporation to pay (and deduct) a personal injury settlement to himself. In the years at issue, the recovery did not have to be attributable to a physical injury to be excludable. When Maxwell received the settlement, he did not include it in income. The Tax Court upheld that treatment, in part because Maxwell hired independent counsel separate and apart from his (wholly owned) company's counsel. That suggests that respecting the separate status and identity of the entity, even if the plaintiff owns 100 percent of the defendant, can be critical.

In *Lindsey*, I doubt that the payer cared all that much (or perhaps at all) whether the extra $2 million the settlement agreement allocated to Lindsey personally was actually paid to him personally. My guess is that the payer would have been equally happy (or more likely equally *unhappy*) to have that $2 million payment made to Lindsey's company. All the defendant wanted was a complete release. Reading between the lines, I expect it was Lindsey who wanted the $2 million paid to him personally.

Sickness vs. Symptoms of Emotional Distress

In *Mumy v. Commissioner*,[5] the taxpayers were a married couple. The wife was a secretary in a body shop and the husband was a factory worker. Both were employed by DaimlerChrysler. The wife suffered sexual harassment, which included harassing comments and being pinched, and that resulted in her experiencing anxiety and humiliation. The wife brought a suit for harassment under Ohio state law, requesting $500,000 in compensatory damages and $500,000 in punitive damages.

Evidently those requests were somewhat beyond the pale, because the case settled for only $12,000. The wife accepted $11,500 from DaimlerChrysler and $500 went directly to her lawyer. The settlement agreement noted that she had various claims for harassment and that the settlement was only to buy peace. The settlement agreement specifically called for the issuance of an IRS Form 1099 and said the taxpayer would hold DaimlerChrysler harmless regarding any withholding or employment tax

[3]515 U.S. 323 at 337, *Doc 95-5972*, *95 TNT 116-8* (1995).

[4]95 T.C. 107 (1990).

[5]T.C. Summ. Op. 2005-129, *Doc 2005-17777*, *2005 TNT 164-8*.

issues. Mrs. Mumy did not report the amount despite the issuance of the Form 1099, and the matter wound up in Tax Court.

Predictably, the Tax Court first disposed of the section 104 argument, concluding that since 1996, physical injury or sickness is required for an exclusion, and Mrs. Mumy's 2002 recovery did not qualify. The payment was simply not on account of personal physical injuries or sickness. The Tax Court even sounded a little amused when it noted that Mrs. Mumy alleged that she suffered anxiety, embarrassment, and humiliation from the harassment, and pain from the pinch. The court concluded, however, that mental anguish, humiliation, and embarrassment are simply not personal physical injuries or physical sickness, but are instead akin to emotional distress. Anxiety is simply a part of that.

Turning to the language of the release, the court also found no help for Mumy there, noting that a general release with no tax allocation would not help the plaintiff. Moreover, the intent of the payer (as discerned by the court from the trial testimony and the agreement), suggested that DaimlerChrysler merely wanted to settle all claims, whatever they were. Moreover, DaimlerChrysler specifically referenced the issuance of Forms 1099 and insisted on indemnity from the plaintiff for any withholding, income, or employment taxes. All of that suggested that DaimlerChrysler did not think it was paying personal physical injury damages.

Mumy is a simple case, but it does raise the question of how one distinguishes between mere symptoms of emotional distress (which do not give rise to any exclusion from income) and damages paid for physical sickness (which do). After all these years, there still is not much to review except the legislative history to the 1996 act. That legislative history says that damages for symptoms of emotional distress do not give rise to an exclusion. The three examples given are headaches, insomnia, and stomachaches, which are said to merely be symptoms of emotional distress.[6] That list is surely not meant to be comprehensive, but rather to indicate the types of relatively minor inconveniences that may still have some physical component but simply do not rise to the level of physical injuries or physical sickness.

Line Dancing

At the same time, just where does one draw the line? If one accepts the notion that every physical injury does not start off with a physical blow, just how does one evaluate the circumstances? Suppose the defendant takes a swing at the plaintiff, the plaintiff dodges the blow, but in the process of dodging the blow, leaps into oncoming traffic?

Surely here all damages flowing from what is probably an assault under state law should be excludable (except for the obviously taxable items such as interest and punitive damages, if any). There is good but-for causation here. However, there is no physical blow struck by the defendant from which the injuries emanate.

Take another case without a physical blow. Suppose the defendant defames the plaintiff (calling him a child abuser). The plaintiff is so mortified by the accusation that he suffers a stroke, and thereafter has significant medical and wage loss expense. The stroke does not produce bruising or broken bones, although in some cases it may have demonstrable effects (such as paralysis). There has certainly been good but-for causation, and one would think the plaintiff would be able to recover against the defendant on those facts. Whether the recovery would be excludable would probably depend on whom you ask. It is debatable whether the sickness arises out of symptoms of emotional distress or whether there is simply accompanying emotional distress after the understandable reaction to a demonstrable harm.

All of this focus on battery and observable bodily harm should, I think, reinvite an examination of just what the ''physical sickness'' wing of section 104 can mean. The IRS addressed the topic of physical sickness when the taxpayer received damages as a result of a disease, but there was no physical contact with the plaintiff. In LTR 200121031, *Doc 2001-15011*, *2001 TNT 103-10*, the IRS found that a recovery against an asbestos manufacturer was excludable under section 104.

After working 33 years installing drywall, the taxpayer's husband was diagnosed with cancer of the lining of the lung, a disease generally associated with inhalation of asbestos fibers. The taxpayer and her husband filed an action in state court against several defendants engaged in the business of producing asbestos, including research, manufacturing, labeling, selling, installing, repairing, packaging, and advertising of asbestos. The taxpayer and her husband alleged that as a result of exposure to asbestos, the husband contracted and suffered asbestos-related lung cancer and other asbestos-related lung disease. The taxpayer and her husband sought to recover damages for personal injuries and loss of consortium because of those diseases.

The husband died, and the taxpayer amended her pleading to add a survival action, a wrongful death action, and a loss of consortium claim. The plaintiffs alleged that decedent's exposure to asbestos and asbestos-containing products was the proximate cause of the diseases causing his death. In the following year, the taxpayer settled the case for a substantial sum.

The total settlement was apportioned as follows:

- to the survival action, and of this amount 100 percent to economic damages;
- to the existing loss of consortium claim, and of this amount 100 percent to noneconomic damages; and
- to the wrongful death action of the heirs, and of this amount 20 percent to economic damages and 80 percent to noneconomic damages.

The taxpayer sought a ruling on whether the economic and noneconomic damages as allocated in the settlement agreement to the survival action, the wrongful death action, and the loss of consortium claim were excludable from gross income under section 104(a)(2) ''as damages received on account of personal physical injuries or physical sickness.''

In allowing the taxpayer to exclude all of the damages, the IRS tested the taxpayer's claim under the *Schleier* test.

[6]*See* H.R. Rep. 104-586, on section 1605 of H.R. 3448, *Doc 96-15083*, *96 TNT 101-11*.

The IRS stated:

> The Supreme Court has stated section 104(a)(2) and the accompanying regulations allow a taxpayer to exclude from gross income the proceeds of a settlement when two requirements are met: First, the taxpayer must prove the cause of action giving rise to the recovery is based upon tort or tort type rights, and second, the taxpayer must demonstrate the tortfeasor paid the proceeds on account of personal injuries or sickness. *Schleier*, 515 U.S. at 337. If the taxpayer fails either requirement, section 104(a)(2) will not allow exclusion of the disputed amounts from the taxpayer's gross income. *Schleier*, 515 U.S. at 333-334.

The IRS concluded that the:

> Husband contracted *physical diseases* from exposure to asbestos. These diseases were the proximate cause of the circumstances giving rise to Taxpayer's loss of consortium claim, survival action and wrongful death action. Because there exists a direct link between the physical injury suffered and the damages recovered, Taxpayer may exclude from gross income any economic damages compensating for such injury. These would include damages received for the survival action, loss of consortium and wrongful death of Taxpayer's spouse.
>
> Based on the facts and representations made, we conclude Taxpayer may exclude from gross income . . . the entire amounts received in settlement of her claims against the manufacturers.

Note that there was no physical contact or touching between the taxpayer's husband and the manufacturers. LTR 200121031 is instructive in its application of section 104(a)(2) to physical sickness as distinguished from physical injury.

Bad Publicity

In *Goode v. Commissioner*,[7] the taxpayer was the general counsel of the Washington, D.C., Department of Human Resources. After an investigating series by *The Washington Post* created bad publicity for his department, the taxpayer did the unexpected. He pointed the finger at his bosses and filed a suit against the city. He claimed that his civil rights had been violated and that there was a violation of the city's whistle-blower's act. His complaint expressed a veritable rainbow of emotional problems, from humiliation and embarrassment to damage to his reputation

Interestingly, Goode never served his complaint on the city, proclaiming that it would disrupt settlement negotiations. That's right, Goode was settling his case before even serving his claim. In fact, he settled within months after filing. His settlement agreement designated $103,000 for ''claims and out-of-pocket'' expenses. Of course, the city could not have known of the particulars of his claims because he never served the complaint. Nonetheless, the agreement contained a clause that characterized that amount as section 104(a)(2) damages, saying that it was nontaxable.

Goode filed his return based on the settlement's characterization, and the IRS took issue. At trial, Goode argued that as a result of ''repeated, vehement verbal assaults'' by the deputy mayor, he suffered from debilitating physical ailments, including migraines, stomachaches, and hand numbness. Even though those ailments probably wouldn't constitute personal physical injury or physical sickness, the court never reached the question because it didn't believe Goode's self-serving testimony.

The Tax Court said that express allocations are generally accorded conclusive effect for tax purposes.[8] However, the court found that the settlement agreement in this case was not the result of adversarial arm's-length negotiations, and the court refused to give it effect. The court noted that it was ''incongruous with the economic realities'' of the underlying claims.[9] The record was devoid of any indication of physical injury or physical sickness.

Prone to Injury?

Bad publicity isn't the only reason employers are getting sued these days. Sometimes employers find that their employees are more than a little prone to injuries. In *Bond v. Commissioner*,[10] the taxpayer worked for Ivy Tech college, and she suffered from all sorts of maladies. She was diagnosed with carpal tunnel syndrome and had surgery to correct it. Then she tripped over some boxes at her office, causing her back injuries. She filed workers' compensation claims for those two problems. Later, she suffered from depression and was hospitalized.

As if her physical and mental problems weren't enough, Bond filed a claim with the Equal Employment Opportunity Commission alleging discrimination. Notably, that claim was filed before all of the above injuries. The parties settled, and Ivy Tech paid Bond $25,000 to release her claims and leave her job. It provided her with a Form W-2 (for her wages) but not a Form 1099 (for the settlement). Yet, Bond did not report any of the award, claiming that section 104 excluded the income.

The court easily dismissed her arguments. First, it noted that the settlement agreement excluded all claims for injury for which she had pending workers' compensation claims. Thus, she could hardly argue that her work-related injuries were covered by the settlement agreement. Then, the court rejected her claim that emotional distress (that is, her depression) awards were excludable.

Grasping at straws, Bond suggested that because the defendant did not send her a Form 1099, she did not have to report the award. At that point in the opinion, the court made a noteworthy comment, stating that her nonreceipt of a Form 1099 required by the settlement agreement did not convert her taxable award into a nontaxable one. That

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[7] T.C. Memo. 2006-48, *Doc 2006-5466*, *2006 TNT 55-5*.

[8] *See Fono v. Commissioner*, 79 T.C. 680, 693-694 (1982), *aff'd without published opinion*, 749 F.2d 37 (9th Cir. 1984).

[9] *See Bagley v. Commissioner*, 105 T.C. 396, 406-410, *Doc 95-11034*, *95 TNT 241-12* (1995).

[10] T.C. Memo. 2005-251, *Doc 2005-22075*, *2005 TNT 210-16*.

is incontrovertible, of course, yet it is also important. In my experience, the nonreceipt of a Form 1099 (or for that matter, an incorrect Form 1099) is common. I always advocate being clear in settlement agreements about what the parties believe each element of the case constitutes for tax purposes. I often believe the recovery should be split between several different categories depending on the facts. The parties should also be clear what Forms W-2 and 1099 will be issued. Then they should follow through.

Withholding Disputes

Section 104 disputes are not exclusively limited to personal physical injury or physical sickness. It is common for parties with arguable section 104 claims to fight over amounts withheld. Of course, withholding should be moot if the recovery is really excludable under section 104.

Rivera v. Baker West[11] is an interesting tax case for what it is not. *Rivera* is not a case in which the taxpayer was fighting the IRS. Rivera was suing another private taxpayer — his employer, Baker West — for discrimination and wrongful termination. Before trial, the parties reached a settlement in which Baker West agreed to pay Rivera $40,000 ''less all lawfully required withholdings.''

Much to Rivera's chagrin, when the check arrived, it was for only $25,000. He cashed the check, but contrary to his settlement agreement, he did not dismiss his suit. Instead, he filed a motion to order the defendant to remit to him the amount it had withheld for taxes. The district court dismissed his motion, and not to be deterred, Rivera appealed to the Ninth Circuit, arguing that his damages were paid based on personal physical injury or physical sickness.

Rivera didn't win (not by a long shot), but at least he had his day in court. The appeals court noted that the settlement agreement was silent regarding the claims on which Baker West was paying. Looking to the intent of the payer, the court found that the withholding of taxes suggested that Baker intended the payment to constitute severance pay.

Undeterred, Rivera then argued that even if section 104 didn't apply, Baker should not have withheld because the payment represented back pay. The court gave little credence to Rivera's argument, noting that employment taxes are payable on all wages, even if no employer-employee relationship exists at the time of payment.[12]

The case reminds me of *Redfield v. Insurance Company of North America*,[13] another disaster in which a plaintiff, on receiving the check that was supposed to end the litigation, refused to sign a satisfaction judgment. Here, it was the former employer who sued, trying to force the plaintiff to sign. The employer had withheld, and the plaintiff hadn't expected that, so the case came down to whether withholding on a wrongful termination case was appropriate.

For an answer, the case went to the district court and then to the Ninth Circuit. Such uncertainty and added expense are almost always avoidable. Imagine how unhappy you would be with your lawyer if you ended a long legal battle by paying out a settlement, and then started *another* long legal battle over whether withholding had been proper?

Front Pay

Given that back pay is taxable wages, is front pay taxable too? That question was raised in *Hurley v. Commissioner*.[14] The taxpayer was a correctional officer. He injured his back at work and underwent surgery to replace several disks. He received a lump sum workers' compensation award after the workers' compensation board determined that he had sustained a 30 percent permanent disability.

After his recovery, Hurley returned to work full-time in spite of his 30 percent permanent disability. He performed the same duties and worked the same hours as he did before his injury. Yet, Hurley took the position on his return that 30 percent of his salary could be excluded from his gross income because of his disability. He contended that his tax return preparer as well as his work colleagues advised him that this was an accepted practice among disabled law enforcement officers.

Hurley found support in section 104(a)(1), which provides that gross income does not include amounts received under workers' compensation acts as compensation for personal injury or sickness. After finding that Hurley was no longer receiving any workers' compensation, the Tax Court had little trouble holding that Hurley could not exclude 30 percent of his regular compensation.

What is interesting about *Hurley* is that the taxpayer testified that this type of exclusion was common practice among his law enforcement colleagues. Surely the IRS would be peeved if that were a widespread practice, or even a widely held belief. Of course, it is hard to believe that this practice could have any vitality, given that the IRS routinely matches Forms W-2 to amounts listed on returns. In any case, the court found Hurley's testimony credible and did not apply any penalties.

Origin of the Claim

A review of recent cases feels incomplete without at least a cursory discussion of the origin of the claim doctrine. The Supreme Court has repeatedly held that the origin of the claim controls the tax treatment of any recovery, whether received under a settlement or judgment.[15] The recovery should be taxed in the same manner as the item for which it is intended to substitute.[16] Under

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[11] 403 F.3d 1253, *Doc 2005-25068*, *2005 TNT 239-11* (9th Cir. 2005).

[12] Reg. section 31.3121(a)-(1)(I); *Gerbec v. United States*, 164 F.3d 1015, 1026, *Doc 1999-2311*, *1999 TNT 11-26* (6th Cir. 1999) (''We conclude that it would be improper to exempt Plaintiffs from mandatory FICA taxes merely because they were not employees of [their company] at the time the payments were made and because the payments were not in return for actual services rendered.''). *See also* IRS Information Letter 2006-0023.

[13] 940 F.2d 542 (9th Cir. 1991).

[14] T.C. Summ. Op. 2005-125, *Doc 2005-17374*, *2005 TNT 158-5*.

[15] *United States v. Gilmore*, 372 U.S. 39 (1963); *United States v. Patrick*, 372 U.S. 53 (1963). *See also Hort v. Commissioner*, 313 U.S. 28 (1941).

[16] *Id. See also Knowland v. Commissioner*, 29 B.T.A. 618 (1933).

the origin of the claim doctrine, the crucial inquiry is: In lieu of what were the damages awarded?[17]

LTR 200551008[18] reinforces the origin of the claim doctrine. The taxpayer structured a settlement after sustaining injuries in a car accident. The defendant assigned his obligation to make the structured payments to an insurance company. A few years later the insurance company stopped making the structured payments. Many others also found themselves without their structured payments from the same insurance company.

A class-action lawsuit was brought and settled. The taxpayer was able to recover all of the amounts that were due. The IRS ruled that if the original structured payments were excludable under section 104(a)(2), the amounts recovered from the class action would also be excludable.[19] Notably, the taxpayer expected to receive additional amounts as compensatory damages. Those amounts were not excludable.

Bad Shopping Day

Jacqueline and Theodore Major Green v. Commissioner[20] is an atypical section 104 case. I'm not sure if it is more noteworthy for its unique story than for the taxpayer's lackluster claim. At a minimum, it proves that some taxpayers are indomitably ingenious, even if stupid.

Mrs. Green sustained injuries in 1989 when she was struck in a grocery store parking lot by a shopping cart being pushed by Rachel Perez. She filed a complaint against Perez. The injury forced Green to change positions at the GM plant where she worked. Two years later, she sustained additional injuries, this time at the GM plant, rendering her unable to work. She filed for, and received, Social Security benefits. She also filed for workers' compensation.

In 1996 Green obtained a default judgment for $166,000 against Perez, who promptly filed for bankruptcy. On their 1997 return, the Greens claimed a casualty loss for the default judgment they couldn't recover. They divided the loss into 15 pieces and claimed a net operating loss for one piece in 1997. Moreover, they also claimed that Mrs. Green's Social Security benefits were not taxable because they were in lieu of workers' compensation, which can be excludable under section 104.

The story gets better. Although the Greens' return position, if taken by many taxpayers, could have been considered bizarrely aggressive (if not downright unlawful), for the Greens, it was inexcusable. From the time of the shopping cart incident until the time of the return filing, Mr. Green was employed as an IRS tax auditor, and his duties included examining federal income tax returns. Yikes.

The court didn't waste much time denying all of the taxpayers' claims. It noted that Social Security benefits were taxable under section 86.[21] Although section 104(a)(1) excludes amounts received for workers' compensation for personal injuries or sickness, social security is not in the nature of workers' compensation.[22]

The court then quickly dismissed the taxpayers' casualty loss and NOL claim. It noted that the Greens were not in a trade or business, or even engaged in making investments. Mrs. Green's injuries were incurred while shopping for groceries. Clearly, that is not sufficient to claim a loss under section 165 or to carry forward a loss under section 172. Just to be clear, the court further noted that the taxpayers had no basis in their default judgment and thus could not claim a section 166 worthless debt deduction.

Outside the Complaint

Finally, let's turn to *Charles E. and Noel K. Bradley v. Commissioner*.[23] That voluminous case, involving a pro se taxpayer and a $12 million settlement payment, makes for fun reading. The basic question was whether any amount of the large settlement could be considered paid for personal physical injury damages excludable under section 104. It is hard to imagine a more thorough trouncing of a taxpayer. The Tax Court basically concluded that there was no evidence that any personal physical injury claim was made in the underlying litigation and no evidence that any portion of the settlement payment was intended to be paid for those damages. Checkmate.

Although there was considerable procedural hoopla in *Bradley*, it brings up an important point: Just how much *outside* the confines of the complaint can be brought in to support a tax allocation? Put differently, despite the lack of a stated claim in a complaint, are there circumstances in which it is nevertheless justifiable to allocate some portion of the settlement consideration to a claim that is not expressly asserted? That question may seem rhetorical, but I do not think it is.

It is axiomatic that the complaint sets forth the gravamen of the claims and that it will be the first document (and the most important document) the IRS or the courts will examine in seeking to determine the tax character of a payment. Yet, while the complaint frames the case, it is possible for other facts and other claims to creep in as the case progresses, and for the settlement agreement to vary from the complaint. Some courts have said that the express language of the settlement agreement is the most important factor in determining the intent of the payer.[24] The intent of the payer is of vital importance and ranks

[17]*Raytheon Production Corp. v. Commissioner*, 144 F.2d 110 (1st Cir. 1944).

[18]*Doc 2005-25818*, *2005 TNT 247-16*.

[19]The ruling cites *Sanders v. Commissioner*, 225 F.2d 629 (10th Cir. 1955), and *Sanger v. Commissioner*, 323 F.2d 913, 916 (9th Cir. 1963).

[20]T.C. Memo. 2006-39, *Doc 2006-4577*, *2006 TNT 47-13*.

[21]*Reimels v. Commissioner*, 123 T.C. 245, 247-248, *Doc 2004-17272*, *2004 TNT 167-3* (2004), *aff'd*, 436 F.3d 344, *Doc 2006-1910*, *2006 TNT 22-8* (2d Cir. 2006).

[22]*See* 42 U.S.C. section 423(d)(1)(A); *see also Norris v. Commissioner*, T.C. Memo. 2001-152, *aff'd*, 46 Fed. Appx. 582, *Doc 2002-23108*, *2002 TNT 198-6* (9th Cir. 2002).

[23]T.C. Memo. 2005-223, *Doc 2005-19729*, *2005 TNT 186-7*.

[24]*See Glynn v. Commissioner*, 76 T.C. 116 (1981) *aff'd without published opinion*, 676 F.2d 1013 (3d Cir. 1988); *see also Metzger v. Commissioner*, 88 T.C. 834 (1987), *aff'd without published opinion*, 845 F.2d 1013 (3d Cir. 1988).

right up there with the claims stated in the complaint in probative value on tax issues.[25]

For example, although the IRS may understandably be skeptical of tax allocations when the complaint does not plainly set forth each claim making up that allocation, there can be reasons for that. For example, an S corporation may bring a lawsuit that is in effect on behalf of itself as well as its sole owner. When it comes to negotiating a release, the defense lawyer may insist not only on a release from the plaintiff S corporation, but also on a release from the nominally nonplaintiff individual shareholder as well. Surely, that mere signature requirement does not manifest the existence of claims asserted by the individual.

However, it is worth examining whether there are really claims that the shareholder is pursuing or would pursue that the corporation cannot. Similarly, plaintiffs' counsel will sometimes be available to give their reasons why a particular claim was filed in a specific way. For example, the plaintiffs' lawyer may have reasons why the individual shareholder in the above S corporation example was not named as an individual plaintiff, even though the individual has claims too.

Sometimes there are tactical reasons and evidentiary reasons behind such a decision. Perhaps the individual plaintiff will be added right before trial, as a means of preventing the defense from doing as much potentially damaging discovery involving the individual plaintiff. In any event, in appropriate cases a taxpayer's counsel should marshal the evidence of those considerations because they may be needed later in the event of a tax dispute.

There are also cases in which there is no issue as to the identity of the plaintiffs, but rather questions about the gravamen of the claim. One famous case on that point is *Paton v. Commissioner*,[26] in which a woman who received a settlement from her deceased husband's employer was allowed to exclude the settlement even though no lawsuit was ever filed, and she merely *hinted* at a tort suit. Her husband committed suicide after stressful incidents at work. Her attorney wrote the employer asking for ''help'' for the widow.

That plainly was not a demand letter and really only hinted that legal action might follow if help from the employer was not forthcoming. The settlement was held to be nontaxable under section 104 primarily on the testimony of her attorney that the opaquely implied claim for wrongful death was a valid one, and that it *would have resulted* in an excludable judgment had it been litigated.

That is a curious kind of but-for causation. It seems to recognize that even when claims are not *asserted*, a payment can be attributed to disposing of them *before* that assertion is made. The rationale of *Paton* hardly seems limited to the context of wrongful death actions. Its rationale and holding may be applicable in other contexts in which litigation is a reasonable option but is not overtly threatened. That, it seems to me, could extend the circumstances in which some claims on behalf of some plaintiffs are manifested, and others are not.

When it comes to settlement time, all claims come out in the wash and must be released. That is the time to consider the full panoply of claims one is releasing and to consider the status of each party who might sign. The complaint with its framing of issues and parties is still enormously important to the tax consequences. Yet, the apparent preeminence of the complaint does not mean that claims that are only *implicitly* made (a la *Paton*) are irrelevant. Similarly, it does not mean that in appropriate cases parties who were not originally named in a complaint, but who *would have been* added later, are irrelevant.

Conclusion

Tax practitioners are becoming more frustrated that the IRS has been silent as to exactly what constitutes personal physical injuries or physical sickness. There is good reason for that because it has been 10 years since section 104 was — to allude to current baseball drama — put on steroids. As in other gray areas of the tax law, taxpayers are entitled to read the statute and legislative history to attempt to achieve a favorable result. Of course, that reading is not without limits.

Plainly, the lack of IRS guidance has enabled (as Dr. Phil might say) some taxpayers to take aggressive positions. Many of the taxpayers whose cases are described in this article went too far. Yet, from a taxpayer's perspective, it may be inefficient to fail to claim an exclusion to which one may be entitled. Determining entitlement to the exclusion is the enigma.

It is likely that we will continue to see controversy under section 104. The lack of regulations (combined with a terse — if not haiku-like — code section) empowers many taxpayers to test the waters. What is perhaps most surprising is that this empowerment comes in the face of the IRS's notorious litigating strength in section 104 cases. Simply put, the IRS has been winning most of its cases in this area.

The skeptic in me thinks that the IRS's victorious public facade belies the fact that most taxpayers (who paradoxically often have stronger cases than those who go to trial) are settling privately. In any event, I can't imagine that the IRS wouldn't want more clarity in this area. Until that clarity is provided, even taxpayers with relatively weak cases may decide to pay their money and take their chances.

[25]*See Knuckles v. Commissioner*, 349 F.2d 610, 613 (10th Cir. 1965), regarding the importance of the intent of the payer.

[26]T.C. Memo. 1992-627.