WHAT LITIGATION RECOVERIES ARE EXCLUDABLE AS "PHYSICAL?": IRS FINALLY WEIGHS IN WITH SOME GUIDANCE IN PRIVATE LETTER RULING[1]

By Robert W. Wood

As most readers know, Section 104 of the Internal Revenue Code provides an exclusion for personal injury recoveries. As most readers also know, this Code provision was radically changed in 1996 by the insertion of only a couple of words. Since August 20, 1996, to obtain an exclusion from income under Section 104, the personal injury or illness must be "physical." The Code does not specify what "physical" means. The legislative history is less than helpful, but makes it apparent that emotional distress recoveries (and employment litigation in general) were particular targets. The legislative history goes on to state that headaches, insomnia and stomachaches are not physical. Yet beyond this, there has been little guidance.

Another change to Section 104 in 1996 relates to reimbursements for medical expenses. Even though the "physical" modifier was added, if a plaintiff has reimbursed medical expenses (and these may merely be for emotional injuries such as psychiatrist bills), a reimbursement of these expenses will be excludable even though there was no "physical" injury. Of course, it will be necessary to be able to show that the plaintiff had not previously deducted these medical expenses. Finally, one other change to Section 104 in 1996 was to make clear that all punitive damages are now taxable.

What is "Physical"?

Given the importance of the term "physical injuries" and "physical illness," one would think that there would be stacks of authority explaining it. Given that tax cases take years to wend their way through the IRS administrative process and then through the courts, one would have assumed that at least there would be regulations (or IRS notices or announcements) stating the IRS view of what constitutes physical injuries or physical illness. Indeed, although IRS regulations also often take years to work their way through the IRS and Treasury administrative process, there are a variety of IRS vehicles ("Notices" and "Announcements" especially) that can be issued quite quickly when (and if) the IRS wants to give guidance on a particular point.

Many tax lawyers and accountants (and probably a much larger number of plaintiffs' lawyers and defense counsel) are frustrated that the IRS has been silent over the last five years just what this "physical" requirement really means. As in other grey areas, taxpayers are entitled to read a statute, read the legislative history, and try to give effect to the IRS or Congressional change, while at the same time keeping in mind what is best for them. Thus, this silence has allowed some taxpayers to take positions that it is unlikely the IRS would find appealing. At the same time, it is enormously inefficient (and potentially risky) for taxpayers to go too far. It is therefore important to know just what the IRS thinks about this.

IRS letter rulings are not published authority (and not so considered for many purposes under the tax law). For example, IRS letter rulings cannot be cited as legal precedent. They are issued only to one taxpayer — the one who applies for the ruling. Although this rule is breaking down somewhat (in fact, the Supreme Court has cited letter rulings!), they still do not technically constitute authority. (On Supreme Court citations, see Rowan Companies v. U.S., 452 U.S. 247 (1981).)

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The second point about letter rulings is that most taxpayers do not want to apply for a letter ruling unless they are sure they will get it. In most areas where there is some controversy, letter rulings are not issued. This is both because the IRS does not want to go out on a limb, and because taxpayers do not want to expose themselves by asking a question to which they may not know the answer. This may seem paradoxical, but you do not typically ask for a ruling unless you know how the IRS will rule. Otherwise, if the IRS does not give you the answer you want, it is customary to find this out just before the IRS gives its adverse ruling, and withdraw your ruling request. Of course, since you have identified who you are, then you will be concerned whether the IRS may follow-up on the matter in the audit process.

Some Guidance?

Despite all these comments about private letter rulings, tax lawyers still look to private letter rulings for the IRS' general position on matters. A recent private letter ruling gives some indication about the scope of the "physical" injury requirement and is therefore highly interesting. IRS Letter Ruling, No. 200041022 (July 17, 2000), Tax Analysts Doc. No. 2000-26382, 2000 TNT 201-10, deals with the thorny topic of when a taxpayer receives damages for assault, but there is no observable bodily harm. This 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, however, 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. Of course, damages allocable to punitive damages would be includable in income (and the ruling so holds).

The facts in the ruling are somewhat reminiscent of many sexual harassment cases. 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 with him, the superior physically assaulted her, 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, and there was no express allocation of the proceeds in the settlement agreement (this, all our readers know, is truly bad tax planning!).

Under these facts, the IRS in Letter Ruling 200041022 concluded that the damages that the plaintiff received for her employer's unwanted physical contacts without any observable bodily harm were not received on account of personal physical injuries or physical sickness. Thus, these amounts were taxable. The damages received for pain, suffering, emotional distress, and reimbursement of medical expenses after the first assault, however, were excludable under Section 104 because they were attributable to and linked to physical injuries.

Bifurcate, Bifurcate, Bifurcate!

The exact amount of physical consequences that is required under the amended version of Section 104 has been a troublesome enigma ever since August 20, 1996, when this new (and supposedly clear) statute was passed. Just why the IRS has not come forward with regulations (or even a

notice of some sort) on this topic is not clear (at least not to me). My own discussions with various personnel at the Service and the Treasury Department suggest that there may be some disagreements going on there. Different people even in the government, after all, can have differing views.

Nevertheless, it is frustrating that there is little guidance. Of course, I'm not sure they have got it right in Letter Ruling 200041022 when they try to draw the line between the various incidents of sexual harassment and touching that left no "observable bodily harm," and the various assaults (that they term beginning with the "First Pain Incident"). Although the ruling seems cogent enough, the truth is that very often it is difficult to separate exactly what causes trauma (and what type of trauma) and what does not.

After reviewing the two-part analysis required by Commissioner v. Schleier, 515 U.S. 323 (1995), the Service in this letter ruling examines the first unwanted and uninvited physical contacts with the plaintiff prior to the First Pain Incident, noting that these unwanted and uninvited physical contacts did not result in any observable harms (e.g., bruises, cuts, etc.) to plaintiff's body, nor did they cause plaintiff pain. This latter reference to the alternative of causing the plaintiff pain may offer the possibility of an exclusion even where there are no "observable harms."

Furthermore, the ruling goes on to state that it was not represented that the medical that the plaintiff received after the First Pain Incident (for headaches and digestive problems) were related to events that occurred with or prior to that incident. Once again, the Service seems to be leaving open the door for a nexus between the various incidents that often lead up to a sexual harassment claim. Thus, says the ruling, any damages the plaintiff received for events occurring prior to 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 did suffer severe physical injuries within a relatively short period of time commencing after the first physical injury. Thus, the ruling bifurcates the factual incidents into these two time frames. At and after the first physical injury, there was pain, suffering, emotional distress and reimbursement of medical expenses under the settlement agreement that were properly allocable to physical injury. Because these were attributable to (and linked to) the physical injuries that the plaintiff suffered, they were within the scope of Section 104.

Lessons to be Learned

Letter Ruling 200041022 is instructive in its attempt to bifurcate the various incidents that occurred in this particular factual setting, and to distinguish between them for purposes of analyzing the tax result to be applied to each element of the settlement payment. Although this letter ruling certainly does not have all the answers (and it is, after all, only a letter ruling), it does demonstrate that the Service is making some attempt to provide the kind of guidance taxpayers truly need in this volatile area.

Probably the most obvious point to note about this letter ruling is that it confirms that the IRS will be looking for a physical touching (a touching that sets off a physical injury or physical illness). Personally, I believe a distinction between a case in which the plaintiff is touched and then injured as a result, compared with the plaintiff who is not touched but injured in the same way, is artificial. The statute itself (Section 104 as amended in 1996) does not make this distinction. At the same time, I'm not surprised that the IRS is taking this view. It is a line that at least seems drawable.

On the other hand, consider the plaintiff who is subjected to heaps of verbal abuse and threatening conduct (such as a knife pointed at the plaintiff's throat or eyes) who then has a heart attack or stroke (or even a less serious illness or injury). Should it matter that there was no physical touching? We will clearly see litigation on this issue. I believe that eventually (although this is only my belief) that the IRS will be proven wrong if it takes the position that the plaintiff who is not touched cannot be physically injured within the meaning of the revised statute. Time, however, will tell.

For the time being, at least the issuance of Letter Ruling 200041022 should give some guidance to taxpayers on how strict the IRS will be. Not only does this authority make it doubly important to keep up to date in this area (even if you are a litigator), but it makes it doubly important also to negotiate over and include provisions in the settlement agreement that expressly deal with tax consequences, and in the vast majority of cases, to retain tax counsel to assist in this effort.