Viewpoint

The Case for Excluding Discrimination, Harassment Recoveries Under Section 104

BY ROBERT W. WOOD

This will be a controversial article. It is about a controversial subject, and I know there are at least some people who disagree with my viewpoint. The topic is excludability under Section 104 of the Internal Revenue Code. It is a very brief code section that has been with us (in one iteration or another) for most of the history of our Tax Code. In fact, the thrust of what is now Section 104 has been in the Internal Revenue Code since 1918. Despite this longevity, it continues to spawn confusion.

That there is confusion is hardly surprising. After all, the Internal Revenue Service has been all but silent on the appropriate interpretation of this provision. This lack of guidance is particularly notable given the changes wrought to Section 104 by the Small Business Job Protection Act of 1996. Apart from modifications to that code section that do not concern us here (for example, concerning punitive damages), the 1996 law amended Section 104 to require physical injuries or physical sickness in order to give rise to excludability. The key modifier was the appearance of the word "physical" twice in the statute. That was a huge change.

I have been considering this question since 1996 when the law was amended. Although there have been a few glosses over the intervening years, in the form of a few private letter rulings from the IRS and a few cases in the Tax Court, there are no regulations on the topic (proposed, temporary, or otherwise). Likewise, there are no revenue rulings, no notices, no announcements, no information releases. You get the idea. Apart from a few private letter rulings, we know very little. We just get crumbs.

The background to the 1996 act is clear. The IRS and Congress were concerned that a spate of cases had accorded tax-favored treatment to discrimination and other non-physical recoveries, primarily arising in employment litigation. The case law had been pretty favorable and Section 104 was wide open, particularly to employment lawyers who used excludability for tax purposes to bring plaintiff and defendant closer together. "Emotional distress damages," often being the plaintiffs' lawyer throw-away argument, had become the sine qua non for tax-free money.

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Put simply, the 1996 "physical" qualifier was meant to tax emotional distress recoveries. The conference committee report to the 1996 act makes clear that the physical requirement is a threshold. Yet once the threshold is reached, a kind of floodgate opens, carrying emotional distress damages emanating from the physical injury or sickness along too.

Moreover, all damages that flow from a physical injury or physical sickness are excludable, even if the recipient of the damages is not the injured party.[1] The examples used in the conference committee report include damages received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of that person's spouse. The loss of consortium damages are still tax-free.

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Similarly, with physical injury or physical sickness being the triggering event, even emotional distress damages that flow from the physical sickness or physical injury are excludable, despite the generally less-favored nature of emotional distress recoveries.

Virtually every observer noted after the passage of the 1996 act that this new law elevates the underlying and initial harm to extreme importance. If there is a personal physical injury, such as a battery, and that battery produces various physical harms as well as emotional distress, the entire recovery (including emotional distress damages) should be excludable.

What Is Physical? Unfortunately, nowhere in the tax code or regulations is the word "physical" defined. Aside from the limited guidance contained in the 1996 act's legislative history, we have little inkling of this term. Given the importance of this term, that is not good.

Likewise, we have very little indication what the IRS (or even the courts) think about causation and Section 104, though the IRS seems continually to be querying whether a payment is truly made "on account of" physical injury or sickness.

Although I consider myself reasonably knowledgeable about the status of this area of the law, I am continually surprised by commentary, and particularly by fact patterns, that make me think in new ways about the scope of Section 104, both the elusive concept of what

[1] See House Report No. 104-737, p. 301 (1996); 1996-3 C.B. 741, 1041.

is "physical," and the causation element embedded in the term "on account of" in Section 104. Here are a few examples of that concern.

Conventional wisdom suggests that a recovery for a purely non-physical injury will be excludable only if it piggybacks on a physical injury. Regrettably, that seems to be what the courts are saying, and it is obviously what the IRS is saying.

Yet physical sickness recoveries are excludable under Section 104 as well. After all, that is what the statute says.

The IRS has generally (if not uniformly) mandated physical contact causing observable bodily harm.[2] Private Letter Ruling 200041022 is the so-called "bruise" ruling dealing with a sexual harassment fact pattern. Apart from lewd behavior and dirty jokes, the letter ruling recites a series of physical contacts with the taxpayer which did not leave any observable bodily harm. Then, the facts get more involved, and the taxpayer is physically assaulted, causing her extreme pain. Unlike the less extreme physical contacts, this physical assault leaves her with bruises and other observable harm.

The ruling goes through a detailed analysis of the course of events and the recovery, bifurcating the recovery between those elements attributable to harms prior to the "first pain incident" (that produced the observable bodily harm), and those occurring thereafter. Only those damages received for the physical injuries attributable to the observable bodily harm are excludable.

This focus on physical contact causing observable bodily harm is unfortunate, if not downright wrong. Mandating physical contact causing observable bodily harm effectively eviscerates the second but equally important wing of Section 104(a)(2), which excludes damages paid on account of physical sickness. Although the physical injury part of Section 104(a) may receive all the attention, damages paid on account of physical sickness are equally excludable.

'On Account of' What? I believe much of the confusion about this tax concept has stemmed from the "on account of" link in the statute, which is to precede the requisite physical injury or physical sickness. The starting point for an analysis of the phrase "on account of" must be the statute.

As I read it, Section 104 makes the relevant nexus that between the damages received and the injury. The statute excludes "damages . . . received . . . on account of personal physical injuries or physical sickness." No words in the statute require a relationship between the tortious act and the physical injuries or physical sickness for which damages are received.

In fact, the "on account of" language has required a nexus between damages and injuries since its origin in the 1918 predecessor to Section 104(a)(2).[3] The same language appeared in the 1939 code, the 1954 code, and the 1986 code.

In 1996, Congress amended Section 104(a)(2) to accomplish two (and only two) goals: (1) to exclude punitive damages from the statute so punitive damages are always taxable, and (2) to require that the personal injury or sickness be physical. Significantly, the 1996 amendments did not alter the "on account of" language.

The legislative history to the 1996 act attempts to elucidate the "on account of" link that serves as the nexus between the recovery and the injuries. According to the legislative history, "If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party."[4]

There are two crucial points in this statement. First, the relevant "on account of" nexus is between damages and a physical injury or sickness (i.e., all damages that "flow therefrom"). In analyzing the wrongful or tortious act, Congress required that the action have its origin in a physical injury or sickness. There need not be any causal nexus between the tort and the injury.

Second, the legislative history expressly recognizes that the recipient (plaintiff) need not be the one who suffers the physical injuries. A payment can be "on account of" physical injuries or sickness even if the plaintiff is not injured, but recovers on behalf of an injured party. Examples include recoveries for loss of consortium (based on physical injury to a spouse) and wrongful death. Both of these qualify under Section 104(a)(2).

Example of 'on Account of.' Some examples may help clarify this morass. Suppose a plaintiff sues for racial discrimination (and related torts) that prevented a promotion. The promotion would have taken the plaintiff from his policeman job to a managerial job where he would not have walked a beat. He is injured on the job and recovers more in his discrimination case because of it. What tax result?

Strict "but for" causation would suggest that the plaintiff recovered for his job-related physical injury because of the discrimination. While this injury meets the second part of the test announced in *Schleier v. Commissioner*,[5] does it meet the first? The Supreme Court there suggested that not only must the damages be paid on account of personal physical injuries, but that the action must also be based in tort.

Here, perhaps we do not have enough facts to know what tax result would apply. I believe the recovery should be allocated between taxable wage and nonwage amounts for the discrimination, and nontaxable amounts for the injury.

That is what should happen, at least in my opinion. Yet I suspect the IRS would disagree.

If the IRS did acknowledge that on this fact pattern there should be some kind of allocation for the physical injury, they might well suggest that this amount should be limited by the amount of damages that would be available in a worker's compensation claim.

The recovery here should (in my view) be allocated, and the arguably excludable portion should not be so limited. Of course, how clear the tort claims are in the complaint would be an important factor.

To take another fact pattern, suppose a plaintiff sues for discrimination and failure to accommodate disabilities in the workplace, which allegedly caused additional and/or more severe illness. Is the recovery here excludable or not?

[2] See Private Letter Ruling 200041022.
[3] See Revenue Act of 1918, chapter 18, Section 213(b)(6).
[4] House Conference Report No. 104-737, at 300 (1996).
[5] 515 U.S. 323 (1995).

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Perhaps it would be simple to allocate between the physical and non-physical elements of the case. Again, this may be the proper (and most practical) result. However, when one adds into the mix the notion that one must have the proper tort-based cause of action too, visions blur.

The Tax Court has tried to enunciate the principles of *Schleier*, stating that there must be both a tort-based cause of action and a payment on account of personal physical injuries. Yet a great deal will often turn on the relationship between the harm and the recovery; medical evidence will be important.

Recently, the Tax Court found that uncorroborated testimony about exacerbation of harm is not enough to support an exclusion.[6] That suggests that corroborated testimony might be treated differently.

Most of the Tax Court cases so far dealing with the post-1996 act version of Section 104 in the employment arena have held the recoveries to be taxable.

In fact, one can argue that some cases will not even make it to Tax Court if there is good evidence not only of a physical injury or physical sickness, but also evidence of a reasonable allocation of the monies. Tying the numbers to something in the litigation, and ensuring that the overall amount allocated to Section 104 damages is reasonable in an absolute sense, will go a long way toward helping to alleviate these problems.

More Physical Triggers. Returning to the loss of consortium situation, suppose we have a loss of consortium claim brought (as a stand-alone lawsuit) by the spouse of a plaintiff in an employment case. Assume that the employee is fired, brings a claim against his employer, and ultimately resolves it for a pure wage settlement. However, also assume that the employee is so upset that there is a loss of consortium, hence leading to his spouse's separate claim. Is the spouse's recovery on her own claim entitled to exclusion?

I suppose the loss of consortium claim is by its very nature physical. The spouse in my example suffers a physical loss, even if the events causing her spouse to be alienated are purely contractual and/or purely emotional in nature, thus not invoking Section 104 at all. I expect this is an academic question, as I have never seen a claim quite like this.

Maybe the spouse's recovery is excludable, and maybe not. At least one academic has argued that even if Section 104 does not apply, the recovery may be excludable under a general no-accretion-to-wealth theory.[6] Much as I would like to believe it, and no matter how attractive I find these arguments, if it is excludable I expect it is only excludable under Section 104.

Claims and Evidence. Most of the Tax Court cases so far dealing with the post-1996 act version of Section 104 in the employment arena have held the recoveries to be taxable. The cases have looked not merely to whether there is observable bodily harm (though the Tax Court does seem to suggest that this is necessary), but rather to the underlying tort nature of the case. In cases of sex discrimination, racial discrimination, age discrimination, and so on, the IRS and the Tax Court have looked to see whether there is an underlying tort cause of action.

The Tax Court in particular has generally cited *Schleier* for the proposition that for a recovery to be excludable, there must be an underlying cause of action based upon tort or tort-type rights, and the resulting damages must be recovered on account of personal physical injuries or physical sickness.

In some cases, the courts have tried to give a taxpayer the benefit of the doubt, first analyzing the tort nature of the case, and, although concluding that there was no tort action, going on to analyze whether there was a personal physical injury or physical sickness within the meaning of the statute. Put differently, perhaps the courts are trying to avoid the case being appealed.

In any event, *Oyelola v. Commissioner*,[7] is a good example. In *Oyelola*, the Tax Court considered a race discrimination recovery. The court went through its usual two-step *Schleier* analysis, and concluded that the race discrimination recovery did not involve an underlying tort cause of action. Therefore, the court found that Section 104 could not apply.

However, the court went on to say that even if the cause of action was based on tort or tort-type rights, the resulting recovery was not paid on account of personal physical injuries or sickness. The Tax Court gave the same analysis in *Cates v. Commissioner*.[8]

There are other discrimination cases, and wrongful termination cases, that can be added to this list. Unfortunately, taxpayers have not fared well.[9] In many of these cases, the taxpayer sues under a discrimination statute that the Tax Court determines is not tort-based or even tort-like.[10] In other cases, the taxpayer may be able to circumvent the first hurdle (finding that the tort cause of action applies), but fails in proving that the recovery was for personal physical injury or physical sickness.

For example, in *Reid v. Commissioner*,[11] Reid was employed by Chevron as a cashier at a gas station. Reid alleged that he injured his shoulder by lifting a five-pound bucket of ice. He filed for workers' compensation benefits, but his claim was denied and he was terminated. He later sued Chevron for wrongful discharge. When his case settled, he did not include it in income, taking the position that it was excludable under Section 104. The court acknowledged that there might be an ancillary cause of action based upon tort or tort-type rights, but concluded that the recovery here was not for personal physical injuries or physical sickness.

[6] See *Prasil v. Commissioner*, T.C. Memo 2003-100 (2003).
[6] See Jensen, "Are Recoveries for Non-physical Injuries Automatically Taxable?," *Tax Notes*, Dec. 6, 2004, p. 1439.

[7] T.C. Summary Opinion 2004-28 (2004).
[8] T.C. Summary Opinion 2003-15 (2003).
[9] See *Tamberella v. Commissioner*, T.C. Memo 2004-47 (2004).
[10] See *Tamberella*.
[11] T.C. Summary Opinion 2002-55 (2002).

Also consider *Tritz v. Commissioner*.[12] That case concerned an employee of Amdahl. During his first two years as an employee, he was treated for carpal tunnel syndrome. A year later, Tritz was terminated from Amdahl as part of a reduction in force. Like other persons so terminated, Tritz had to sign a release to get a severance package. Although Tritz received a Form W-2, he backed out a portion of this severance payment on his return, arguing that it was for personal physical injury or physical sickness. The Tax Court disagreed.

Perhaps to a greater extent than with other recoveries, there is a natural tendency for sexual harassment cases to be treated somewhat differently. After all, in many of these cases, there is some physical touching. However, one must remember the IRS's rather narrow view and the bifurcation of the recovery which the IRS accomplishes in its "bruise" ruling, P.L.R. 200041022. The same can be said for Americans With Disabilities Act recoveries (or recoveries based on similar state laws). There has not been a great deal of authority, but some of that suggests that taxpayers must focus on proof of their physical injuries or sickness and proof of the reasons for the payment.

Consider *Johnson v. United States*.[13] There the court found that a guard at a juvenile detention center who suffered injuries while restraining an inmate could not exclude his recovery from his income. He brought suit under the ADA after his employer failed to accommodate his physical limitations resulting from the incident.

The court found that the claim was tort-based, but that his recovery was on account of unlawful termination, rather than on account of personal physical injuries or physical sickness. The 10th Circuit Court of Appeals said that the link between the discrimination-based discharge and the work-related injuries was simply too tenuous to support exclusion under Section 104.

What About Physical Sickness? One of the most fundamental issues under Section 104 is the lack of authority concerning a recovery for physical sickness. Although Section 104 states that a recovery is excludable if it is paid either on account of physical injuries or physical sickness, almost no attention has been devoted to the latter concept. Part of the confusion may emanate from the change to Section 104 effected in 1996 with the addition of the "physical" moniker.

Even though Section 104 had included the injuries or sickness dichotomy prior to that time, it is common knowledge that the physical modifier was meant to stem the tide of tax-tree emotional distress recoveries. That is why the legislative history to the 1996 act is replete with statements about mere physical symptoms of emotional distress. The now-famous footnote to the committee report mentions stomachaches, headaches, and insomnia as illustrations of this problem, mere symptoms of emotional distress that are not meant to be excludable.

Perhaps because of the difficulty of determining when something is a physical symptom of emotional distress and when it is actually a physical sickness, virtually no one talks about this problem. Although there is no litmus test, I expect that some of us engage in a kind of backroom doctoring, evaluating the plaintiff's health and seeking to determine if this plaintiff has serious physical sickness, something that is not merely physical symptoms of emotional distress. But how can we know what brings something on?

What if we have doctors' reports saying that, hands down, the defendant's conduct caused this heart condition? I have actually seen cases like this, and it is not my place to dispute what an expert says. In some cases (as, for example, where a case is settling on appeal) it will be clear that the court and the jury paid a great deal of attention to such expert testimony. Failing to accord Section 104 treatment for such monies merely because there has been no physical injury seems silly.

After all, there has been physical sickness. Determining whether the payment is made "on account of" that physical sickness may be hard to do. But with a simple "but for" analysis, if there is a tort-like cause of action (or at least a tort-like cause of action is among the various causes of action asserted by the plaintiff), and if a payment (or part of it) is made by reason of the physical sickness caused by the defendant, then it seems to me the exclusion should apply.

In the real world, the scope of the physical sickness exclusion should be of far greater practical impact than the physical injury exclusion. And yet we know very little. It is axiomatic that the physical sickness element of Section 104 has received almost no attention from the IRS or the courts.

There is at least a ray of light. In P.L.R. 200121031, the service ruled that Section 104(a)(2) applies to damages received for a physical sickness that did not involve any battery or unwanted touching. The taxpayer was awarded damages arising from her deceased husband's death from lung cancer, a physical disease. The disease was associated with the husband's inhalation of asbestos fibers, and the taxpayer received a settlement from asbestos manufacturers.

While it is not clear from this ruling, it is likely that the manufacturer did not directly cause the husband to inhale the asbestos and contract the disease. That suggests there is more to this ruling than meets the eye. It may suggest that the "on account of" link is not quite as close to classic "but for" causation as some would have us believe.

In any case, the IRS allowed the wife to exclude the recovery under Section 104(a)(2). The service reasoned that: (i) the husband contracted a physical disease from exposure to asbestos, and (ii) the "diseases were the proximate cause of the circumstances giving rise to" the taxpayer's claims.

The service's reference to "circumstances giving rise to" claims is consistent with the origin of the claim analysis in the 1996 legislative history. In fact, the service quotes from the 1996 legislative history to support its analysis. The service ruled that "[b]ecause 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."[14]

Conclusion. I believe the scope and interpretation of Section 104 deserves far more attention from the service than it is receiving, but I believe the physical sickness issue should be at the very top of the list.

[12] T.C. Summary Opinion 2001-76 (2001).

[13] 76 Fed. App. 873 (10th Cir. 2003), *cert. denied* 124 S. Ct. 2888 (2004).

[14] P.L.R. 200121031.

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