Symptoms Of Emotional Distress Vs. Sickness: Sheep From Goats?

By Robert W. Wood[1]

I. INTRODUCTION

If you receive a settlement or damage payment for physical symptoms of emotional distress, your award is taxable income. Conversely, if you receive an award on account of physical injuries or physical sickness, it is tax-free. So states Internal Revenue Code ("IRC") §104. It has long been clear that the IRS focuses primarily on physical injuries, and doesn't believe you've had a physical injury unless it causes "observable bodily harm." To the IRS, that means bruising or broken bones.

Thus, if you are hit over the head producing bruising and a concussion, all damages flowing from that injury (including wage loss) should be tax-free. The only payments that would be taxable would be any interest or punitive damages.

In contrast, if there was no physical touching, but you nonetheless have physical problems, how do you know if a settlement is taxable or tax-free? Unfortunately, you don't, although you can usually assume the IRS will rule against you.

Nevertheless, the IRS recently considered a clergy sex abuse case, where a minor was sexually abused, and many years later, received a settlement as an adult. The IRS said it would *presume* there had once been observable bodily harm, allowing the settlement to be tax-free.

Regrettably, though, this is about the only piece of taxpayer-friendly advice from the IRS on this topic. Indeed, the IRS has generally chosen to disregard the "or physical sickness" phrase in §104. Increasingly, that's become a real problem.

Suppose you experience asthma, sleep deprivation, skin irritation, appetite loss, severe headaches, and depression? Are these mere symptoms of emotional distress (taxable), or are they themselves physical sickness (tax-free)? Suppose you develop ulcers, hypertension, heart conditions, or shingles? Sadly, these situations do arise.

As a tax advisor, it is more than a little frustrating not to be able to give clients clear guidance about the tax treatment of settlements in these situations. Plaintiffs receiving settlements must find it even more frustrating not to be able to find clear guidance from a tax professional, or even from the IRS.

II. ASK WHAT PROMPTED PAYMENT?

At its root, the tax quandary revolves around this question: are you receiving damages "on account of" your physical sickness or physical injuries? Alternatively, are you receiving damages for emotional distress, and physical symptoms thereof? The issue first arose in 1996, when Congress changed §104 to require "physical" injuries or sickness for an exclusion. Before that, ***any*** injury or sickness (including emotional distress) was enough.

Sadly, neither Congress nor the IRS has seen fit to say just what "physical" means, although the IRS has said informally that it expects to see "observable bodily harm."

The legislative history to the law which inserted the "physical" modifier makes it clear that mere symptoms of emotional distress (such as headaches, insomnia and stomachaches) are not excludable. There has long been debate about this phrase in the legislative history—which literally appears in a mere footnote. It seems probable that the footnote was meant to be illustrative, and was not meant to suggest that anything beyond headaches, insomnia and stomachaches produce a tax-free recovery.

So, causation and semantics matter. The question may be whether you were paid ***for*** your physical injuries or physical sickness, or ***for*** your emotional distress, even if the emotional distress produces physical symptoms. Yet, how do you determine if you are being paid "for" (or, as the tax code phrases it, "on account of") your ulcer, or if you are being paid on account of your emotional distress which ***caused*** your ulcer?

What you receive in litigation should (at least in part) depend on what you request. The nature of a cause of action is certainly relevant. Yet, there is confusion there too. So far, what qualifies as excludable from income under §104 as personal physical injuries (or sickness) damages is tested under *Commissioner v. Schleier.*[2]

In that case, the Supreme Court said that to exclude your damages, you must meet two requirements. First, the underlying cause of action must be based on tort or tort-type rights. Second, the payment must be made "on account of" personal physical injuries or physical sickness. The second requirement turns out to be awfully formulistic, at least as it has been applied.

III. BRUISED AND BATTERED TAXPAYERS!

Many taxpayers don't manifest sufficient observable bodily harm to convince the IRS or the courts that any part of their settlement is excludable. In fact, they can get bruised

and battered in their tax cases. Like the IRS, the Tax Court has been harsh and formulistic. A good example is the recent Tax Court case of *Joyce M. Sanford v. Commissioner.*[3]

Ms. Sanford pursued an EEOC complaint against the U.S. Postal Service for discrimination (race, national origin, sex, religion, color, age) and for sexual harassment. The EEOC ruled in her favor, and the Postal Service issued a decision awarding her $7,662 in past medical expenses and transportation, $14,033 for benefits (leave without pay) and $12,000 in non-pecuniary compensatory damages. The Postal Service paid these amounts (a total of $33,695) in 2003. The EEOC also ordered the Postal Service to pay $16,602 to Sanford's attorney under a law requiring discriminators to pay attorneys' fees.

Unsatisfied, Sanford appealed, asking for additional compensatory damages. The EEOC then ruled she had suffered emotional distress due to the sexual harassment and the Postal Service's failure to address it. The EEOC concluded she had experienced physical symptoms due to the psychiatric problems the harassment created. Her physical symptoms included intensification of her asthma, sleep deprivation, skin irritation, appetite loss, severe headaches and depression.

The EEOC awarded her additional damages, totaling $115,000 in non-pecuniary damages, $33,542 in future pecuniary losses, $7,662 for medical expenses, and $14,033 for annual leave, sick leave and leave without pay. The EEOC again awarded reasonable attorneys' fees. Because the Postal Service had already paid the amounts awarded in 2003, the Postal Service paid the difference in 2004.

IV. FEES AND REPORTING

The EEOC twice determined (in 2002 and in the 2004 appeal) that Sanford was entitled to reasonable attorneys' fees pursuant to the applicable fee-shifting regulation. Based on that ruling, the Postal Service paid $16,602 in attorney's fees in 2003, and $4,686 in attorney's fees in 2004. These amounts went to Sanford's lawyer, not to her.

On her 2003 federal income tax return, Sanford reported $14,033 of "other income" attributable to her dispute (the amount awarded for sick leave and leave without pay). She did not report the rest of the damages (for past medical expenses and non-pecuniary compensatory damages), nor the $16,602 in lawyers' fees. For 2004, Sanford did not report any of the amounts from the EEOC appeal, claiming it all as excludable.

The IRS asserted that everything Sanford received in 2003 and 2004 was taxable income, so Sanford and the IRS faced off in Tax Court. Significantly, in addition to the substantive issues, the IRS asserted accuracy-related penalties, so the Tax Court evaluated penalties too.

V. TEST FOR EXCLUDABILITY

The Tax Court began its analysis with a recitation of the maxim that gross income is broadly construed, and that *Schleier* established the test for excludability. For damages to be excludable, the underlying cause of action must be based in tort or tort-type rights, and proceeds must be received on account of personal physical injuries or physical sickness. Significantly, the IRS had conceded that Sanford's underlying cause of action was based on tort or tort-type rights. That meant the first of prong of the *Schleier* test was satisfied.

The sole remaining question was whether Sanford's damages were received on account of personal physical injuries or physical sickness. On this point, the Tax Court said it found the language of the EEOC and Postal Service decisions and orders "compelling." Indeed, the Tax Court said the *orders themselves* made it clear that *none* of the award was predicated on personal physical injury or physical sickness.

True, said the Tax Court, the EEOC decision acknowledged that the sexual harassment caused Sanford emotional distress. Moreover, the court even acknowledged that such distress *manifested itself* in physical symptoms such as asthma, sleep deprivation, skin irritation, appetite loss, severe headaches, and depression. Yet, the Tax Court said these physical symptoms were not the *basis* of the award.

Sanford sought and was awarded relief for sexual harassment, discrimination based on sex, and the failure of the Postal Service to take appropriate corrective action. The Tax Court found Sanford was simply not compensated *for* the physical symptoms she experienced. One can't help wondering if it matters whether the EEOC considered the severity of the employer's treatment, or the severity of the plaintiff's reaction in making the award "for emotional distress."

It may be reasonable to assume that they did. Moreover, in some cases there will be evidence that, in fact, such points were considered. The *Sanford* case does not discuss these possibilities. However, the Tax Court Judge seems hostile enough to the entire area that it likely would not have mattered even if this had been considered.

VI. MEDICAL EXPENSES, TOO

The Tax Court then turned to Sanford's medical expenses, acknowledging that even though damages for emotional distress are generally not excludable, there is an exception for amounts paid for medical care (even medical care for emotional distress). The Tax Court noted that a reimbursement for medical expenses must be included in income when received if a deduction was claimed for the medical expenses in a prior year.[4] Conversely, where no deduction was previously claimed, the amount is excludable.

Placing the burden of proof on the taxpayer, the Tax Court admonished that Ms. Sanford had failed to introduce evidence that she had not deducted the medical expenses in a prior taxable year. The Tax Court put the burden of proof on Ms. Sanford. The Tax Court therefore ruled that she could not exclude from her income any portion of the reimbursement for medical expenses.

VII. ATTORNEYS' FEES

Regarding attorneys' fees, the Tax Court recited the rule announced in *Banks*[5] that attorneys' fees generally represent gross income to the plaintiff. Interestingly, though, the Tax Court then said this general rule applied regardless of whether the attorneys' fees were paid pursuant to a fee-shifting statute! The Tax Court cited a number of pre-*Banks* cases for this proposition, including *Sinyard v. Commissioner.*[6] The only post-*Banks* case the court cited is *Green v. Commissioner.*[7]

Since *Banks* left open the fee-shifting question, the Tax Court had to get a little creative to crush this taxpayer. The Tax Court noted that the Postal Service had paid $16,602 in attorney's fees in 2003, and $4,686 in attorneys' fees in 2004. Both amounts were paid directly to the taxpayer's attorney, and both amounts were ordered by the EEOC pursuant to applicable law. The Tax Court therefore had no choice but to acknowledge that these amounts were paid pursuant to a fee-shifting statute.

Citing *Sinyard,* however, the court said that, notwithstanding the fee-shifting nature of the payment, the legal fees nevertheless constituted income. The Tax Court's discussion on this point is spartan, with no mention of the fact that the Supreme Court in *Banks* expressly determined ***not*** to address the fee-shifting statute point. The Tax Court does not discuss any cases that would have allowed it to exclude these legal fees from Sanford's income. There is a paucity of authority on this fee shifting issue, but it is hardly as clear as the Tax Court suggests.

VIII. ACCURACY-RELATED PENALTY

If taxpayers needed any further message about the Tax Court's hostility in this case, its discussion on the accuracy-related penalty should remove all doubts. Notwithstanding the continually murky status of this area of the tax law, the Tax Court concluded that this taxpayer was not diligent in seeking out the law and the correct treatment. Although Ms. Sanford testified that she had sought tax advice from H&R Block, the Tax Court said it was unclear exactly what advice she received, and what advice she relied upon.

Again, placing the burden of proof on Sanford, the Tax Court slapped her with a full measure of penalties.

IX. NATURE OF AN AWARD

It seems unlikely that plaintiffs in employment litigation (or their counsel) will suddenly start praying for damages that are new and different. Surely, they will continue to ask for money damages. Moreover, it seems unlikely that they will start asking for money ***expressly*** for ***particular*** items of physical sickness or physical injury arising out of prohibited acts such as sexual harassment and various forms of discrimination.

Indeed, it is not even clear to me that such a prayer for relief would be permitted as a matter of substantive (federal or state) employment law or local court rules or procedures. Yet, if *Sanford* tells us anything, it is that the ***specific wording*** in an award is highly important, perhaps paramount, to the tax treatment.

That was one of the major lessons from the last gasp of the *Murphy* case.[8] *Murphy* involved a whistleblower whose employer blacklisted her after she complained about environmental hazards. She submitted evidence in an administrative hearing that she had mental and physical injuries from the blacklisting, including bruxism that left her with permanent tooth damage. The administrative law judge determined that she had other physical manifestations of stress, including anxiety attacks, shortness of breath, dizziness, etc.

Yet, the wording of her damage reward was for "emotional distress or mental anguish" and "injury to reputation." So, she had to pay tax. In a widely watched second opinion (after the first *Murphy* opinion was vacated), the D.C. Circuit refused to connect the dots, and simply ruled Murphy's payment was not on account of "physical sickness or injury."

In the second *Murphy* opinion, Chief Judge Ginsburg was riveted to the *specific wording* of the arbitration decision in the underlying whistleblower case. It had awarded Murphy damages for "emotional distress." The order *did not* say she was receiving money for "bruxism."

Yet, the court seemed to acknowledge (or assume) that Murphy did indeed suffer bruxism. Plus, the court seemed to acknowledge (or assume) that her bruxism qualified as physical injuries, or at least physical sickness. Nevertheless, because the award was not *expressly stated to be for that malady,* the court would not hold the payment to be within the §104 exclusion.

Boy, and people say tax lawyers are overly formulistic and literal!

X. MORE THAN SEMANTICS

In the wake of the *Murphy* case, I opined that one of the lasting lessons of *Murphy* was likely to be a renewed focus on specific wording, both in orders and even in settlement agreements.[9] Sometimes, something is what you call it.

Although the IRS and the courts are clearly not bound by settlement agreement language, the fact remains that such language is considered.

Particularly in cases like *Murphy* and *Sanford*, where the court goes to great lengths to examine the specific language with a microscope, one must wonder. Wouldn't specific language that was ***favorable*** to the plaintiff be equally compelling? In *Sanford*, one senses the court's underlying hostility to this taxpayer, and/or to taxpayers like her, throughout the opinion. The unstated, but palpable, undercurrent seems to be that taxpayers say everything is physical, but really very little is.

The Tax Court and the IRS occasionally sound like former Senator Phil Gramm, who famously remarked that we're a "nation of whiners."[10] If that's so, some of the blame rests with the IRS. Enormous uncertainty remains. The IRS has not even seen fit to revise its regulations under §104, which continue to predate the 1996 statutory change, despite the passage of 12 years!

Many tax professionals find the line between damages for physical sickness or physical injuries (on the one hand) and damages for mere symptoms of emotional distress (on the other) a fuzzy one. The IRS uses its unofficial "observable bodily harm" position (from private rulings) as a kind of Maginot line. History buffs will recall that the Maginot line was supposed to be highly defended and clearly demarcated, laid out with military precision. Yet, it turned out to be more chimera than real.

Here, shouldn't the IRS at least *attempt* to draw this critical distinction? Is it any wonder that taxpayers also find this to be an amorphous line? Taking a charitable view of the Tax Court (which is not easy to do if you've just read the *Sanford* case), one could argue that the Tax Court has little choice but to rule as it did in *Sanford*. Perhaps that is particularly so as concerns the §104 exclusion for a specific award for "emotional distress."

Like Judge Ginsburg in the second *Murphy* opinion, the Tax Court may be unwilling to take notice of the specific items of damage considered. Sure, the EEOC, court, or arbitration panel in question might have evaluated the physical symptoms of emotional distress. They might even have looked at such items as damages for physical sickness, depending on how one views this chicken or egg conundrum.

Yet, even on such items as medical expenses, and particularly attorney's fees and penalties, the court in *Sanford* seems gratuitously harsh. The court looks myopically at what the award says. Such attention to the mere words may suggest that even if you are in a body cast, if your award says "emotional distress," you may be out of luck. That would be absurd.

XI. CAUSATION AND TAXES

It was clear even before *Sanford* and *Murphy* that the wording of a court order or administrative order is key. Since the courts in *Murphy* and *Sanford* concluded that the taxpayers there did not carry their burden of showing the recovery was "on account of" physical injury/sickness, it is worth asking what ***would*** have worked. Notes? Pleadings? A transcript? Surely the language of the order itself should not be the only reference point.

After all, the IRS has long taken the position that it is not bound by characterizations in court orders or settlement agreements.[11] That rule should work both ways. Yet, the "on account of" phrase continues to be enigmatic, and given its manifest importance, this is disturbing. What if the evidence in *Murphy* showed that the judge awarded money to Murphy because of her bruxism, and acknowledged that the bruxism was caused by the emotional distress, which was caused by the defendants? If the judge's order so stated, or if there was a transcript in which the judge's reasoning was clear, that might be enough for excludability even though the order ultimately stated that the payment is "for emotional distress."

As I read it, §104 makes the relevant nexus between the damages and the injury. The statute does not require a relationship between the tortious act and the physical injuries or physical sickness for which damages are received. The statutory "on account of" language has required a nexus between damages and injuries since its origin in the 1918 predecessor to §104(a)(2).[12] The same language appeared in the 1939 Code, the 1954 Code and the 1986 Code.

In 1996, Congress amended §104(a)(2) to: (1) exclude punitive damages from the statute so punitive damages are always taxable, and (2) require the personal injury or sickness to be physical. Significantly, the 1996 amendments did not alter the "on account of" language, although the legislative history attempts to elucidate the "on account of" nexus between the recovery and the injuries.

Often, a great deal will turn on the relationship between the harm and the recovery, and medical evidence will be important. The Tax Court has found uncorroborated testimony about exacerbation of harm is not enough to support an exclusion, suggesting that corroborated testimony might be treated differently.[13] Although exact wording may be more important than the intent of the payor and other traditional reference points, mere wording should not be the only consideration.

Besides, counsel often draft court orders for judges to sign. Plaintiffs' counsel already include battery claims in employment cases on appropriate facts. Given that the vast majority of cases are settled and do not go to verdict or administrative ruling, the settlement process is likely to become more tax-centric, with increased attention to exactly what documents say. Unlike most cases, *Murphy* and *Sanford* both went to judgment (or its administrative equivalent). Settlement by its very nature offers vastly more tax flexibility.

Courts applying the two-tier *Schleier* test may find that a recovery fails the first requirement, because it was not based on tort or tort-type rights.[14] However, the IRS often

concedes the first point, as it did in *Sanford.* Moreover, courts often do not make clear whether the taxpayer failed the first or the second prong of the *Schleier* test.

For example, in *Johnson v. United States,*[15] a guard at a juvenile detention center suffered injuries while restraining an inmate. The guard sued under the Americans with Disabilities Act after his employer failed to accommodate his physical limitations resulting from the incident. The court found the claim to be tort-based, but concluded that the recovery was not on account of personal physical injuries or physical sickness. The court found the link between the discrimination-based discharge and the work-related injuries was simply too tenuous to support an exclusion. A better link between the discharge and the injuries might yield a different result.

XII. MURPHY'S LAW

Murphy argued that the legislative history to the 1996 amendment separated transitory symptoms from serious and permanent physical injuries and physical sickness. Murphy's were not minor and transitory symptoms of emotional distress, like headaches, upset stomach and sleeplessness. Those inconveniences are not permanent, and they eventually go away.

This broaches the territory of one of the great unspoken phrases of the tax law: "physical sickness," an epigram that receives no attention in the literature or case law.[16] If one cannot draw a bright line between physical injuries and mere symptoms of emotional distress, the line is even fuzzier when it comes to physical sickness. Murphy pointed to her physician's testimony that she experienced "somatic" and "body" injuries "as a result of [the defendant's] blacklisting." She also cited the American Heritage Dictionary, which defines "somatic" as "relating to, or affecting the body, especially as distinguished from a body part, the mind or the environment."

Besides, Murphy's dental records proved she suffered permanent damage to her teeth. That sure sounds physical. Quite apart from rudimentary sources like dictionaries, Murphy cited federal court decisions showing that substantial physical problems caused by emotional distress are considered physical injuries or physical sickness. For example, in *Walters v. Mintec/International,*[17] the Third Circuit allowed a plaintiff to recover for physical harm caused by the emotional disturbance of an accident. The court based its decision on the Restatement of Torts, which requires physical harm for damages to be available, and which notes that "long continued nausea or headaches may amount to physical illness, which is bodily harm."[18]

In *Payne v. General Motors Corp*[19] an employee sued an employer under Title VII and for negligent infliction of emotional distress. The employee suffered from constant exhaustion and fatigue, diagnosed as resulting from depression. The court held this constituted "physical injuries," a prerequisite to an action for negligent infliction of emotional distress under Kansas law.

It is unclear how one evaluates whether a particular medical problem is a mere symptom of emotional distress (taxable) or a physical sickness or physical injury in its own right (excludable). Presumably, the IRS will someday propose regulations saying that in their view, one must be able to observe bruising or the equivalent for there to be a physical injury. Yet, the statute says damages paid on account of "physical *sickness*" are excludable too.

Many physical sicknesses do not involve bruising or other outward manifestations of harm, unless one includes EKGs, blood work visible with a microscope, X-rays, etc. The term "physical" as it modifies "sickness" may simply mean that the sickness can't be "mental" and still give rise to an exclusion. Physical (as opposed to mental) sickness can be perceived by someone, even if that someone is a medical professional with special skills and equipment.

XIII. CONCLUSION

Sanford and *Murphy* suggest that the wording of an order or settlement agreement should particularize the physical sickness and physical injuries for which an award is being made. Put differently, *Sanford* and *Murphy* suggest that a payment may not be for personal physical injuries or physical sickness *unless* it *expressly* says it is. Where appropriate, my advice is to be as specific as possible.

In fact, if you expect to claim an award is excludable, perhaps you should insist the settlement language specifically says that the defendant is paying *for* the personal physical injuries or physical sickness. In many cases, it may be inappropriate to lump the *entire* award into such a category, but bifurcation is often an answer. Had the relevant documents (or the settlement agreement) in *Sanford* awarded something specifically for asthma, sleep deprivation, skin irritation, appetite loss, severe headaches and depression, I think it would be hard for the Tax Court—even a hostile Tax Court—to explain these away as "mere symptoms of emotional distress."

If a settlement agreement includes express recitations of the physical injuries/sickness for which money is being paid, and if there is underlying factual support, wouldn't the payment be made "on account of" physical injuries or physical sickness? Arguably, both *Sanford* and *Murphy* would have come out very differently with a few words of difference. Although that may suggest planning opportunities, it is also disturbing.

ENDNOTES

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2. *Commissioner v. Schleier,* 515 U.S. 323 (1995).

3. *Joyce M. Sanford v. Commissioner,* T.C. Memo 2008–158 (June 23, 2008).

4. *See* Treas. Reg. §1.213–1(g)(1).

5. *Commissioner v. Banks,* 543 U.S. 426 (2005).

6. *Sinyard v. Commissioner,* 268 F.3d 756 (9th Cir. 2001).

7. *Green v. Commissioner,* T.C. Memo 2007–39 (2007).

8. *Murphy v. IRS,* 493 F.3d 170 (D.C. Cir. 2007), *cert. denied,* 128 S. Ct. 2050 (2008).

9. *See* Wood, "Waiting to Exhale: Murphy Part Deux and Taxing Damage Awards," Vol. 116, No. 4, *Tax Notes* (July 23, 2007), p. 265.

10. *See* Hill, Patrice, "McCain adviser talks of 'mental recession,'" *The Washington Times* (July 9, 2008) *available at* http://www.washtimes.com/news/2008/jul/09/mccain-adviser-addresses-mental-recession.

11. *See Robinson v. Commissioner,* 102 T.C. 116 (1994), *aff'd in part rev'd in part,* 70 F.3d 34 (5th Cir. 1995); *McKay v. Commissioner,* 102 T.C. 465 (1994), *vacated on other grounds,* 84 F.3d 433 (5th Cir. 1996); *Brown v. U.S.,* 890 F.2d 1329, 1342 (5th Cir. 1989).

12. See Revenue Act of 1918, ch. 18, §213(b)(6).

13. *See Prasil v. Commissioner,* T.C. Memo 2003–100 (2003).

14. *See Tamberella v. Commissioner,* T.C. Memo. 2004–47, *aff'd.* 139 Fed. Appx. 319 (2d Cir. 2005).

15. *Johnson v. United States,* 76 Fed. Appx. 873 (10th Cir. 2003), *cert. denied,* 542 U.S. 925 (2004).

16. *See* Wood, "*Physical Sickness and the Section 104 Exclusion,*" Vol. 106, No. 1, *Tax Notes* (January 3, 2005), p. 121.

17. *Walters v. Mintec/International,* 758 F.2d 73 (3d Cir. 1985).

18. *See* Restatement (Second) of Torts § 436A, comment c (1965), quoted in *Walters v. Mintec/International,* 758 F.2d 73, 78 (3d. Cir. 1985).

19. *Payne v. General Motors Corp.,* 731 F. Supp. 1465, 1474–75 (D. Kan. 1990).