Ulcers and the Physical Injury/Physical Sickness Exclusion

By Robert W. Wood

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I have often lamented the fact that the taxation of damage awards is clouded, particularly when it comes to the scope of section 104. Since 1996, when Congress amended that exclusion to specify that a payment for personal injuries or sickness must be ''physical,'' there has been speculation about how far the IRS and the courts would go. To date, the IRS has said almost nothing about its view of section 104 (no regulations, no rulings, no notices), and the courts have decided a fairly unappetizing array of cases interpreting its scope.

The courts have generally adopted a two-tier approach based on the Supreme Court's decision in *Schleier*,[1] requiring that:

- the underlying cause of action must be based on tort or tort-type rights; and
- the proceeds must be received on account of ''personal physical injuries'' or ''physical sickness.''

That approach has led to many plaintiffs being out of luck when seeking to apply the section 104 exclusion outside the archetypal auto accident (or other physical injury) case. That has been particularly true in the employment context, where perceived abuses led to the 1996 statutory change. Since the 1996 change to section 104, taxpayers have generally not fared well. In many of those cases, a court seeking to apply the two-tier test has found that the recovery simply does not meet the first requirement because it was not based on tort or tort-type rights.

For example, the Tax Court so concluded in *Tamberella v. Commissioner*,[2] a case involving the tax treatment of a recovery arising out of a discrimination statute, that cause of action was not tort-based or tort-like. In many cases, the court may not make it clear whether the taxpayer has failed the first or the second *Schleier* test. Either failure is fatal.

For example, in *Johnson v. United States*,[3] the Tax Court found that a guard at a juvenile detention center who suffered injuries while restraining an inmate and who sued his employer could not exclude his recovery from income. The guard brought suit under the Americans with Disabilities Act after his employer failed to accommodate his physical limitations resulting from the incident. Here, the court found that the claim was tort-based, but concluded that the recovery was not for personal physical injuries or physical sickness. Instead, the court found the recovery to be because of unlawful termination, and that, said the court, did not give rise to an exclusion.

Interestingly, in *Johnson* the Tenth Circuit Court of Appeals said the link between the discrimination-based discharge and the work-related injuries was too tenuous to support an exclusion under section 104. That suggests that a better link between the discharge and the injuries might yield a different result. That sounds similar to the Tax Court's recent statement in *Prasil v. Commissioner*.[4] In *Prasil* the Tax Court found that uncorroborated testimony about exacerbation of harm was not enough to support an exclusion. That suggests that corroborated testimony might be treated differently.

To some extent, that may be a question of degree. In *Reid v. Commissioner*,[5] Reid was employed as a cashier at a Chevron gas station. He alleged that he injured his shoulder by lifting a bucket of ice. He filed for workers' compensation benefits, but his claim was denied and he was terminated. Reid later sued for wrongful discharge. When his case was settled, he did not include the settlement in income, arguing that it was excludable under section 104. The Tax Court acknowledged that there might be an ancillary cause of action based on tort or tort-type rights, but concluded that the recovery was not for personal physical injuries or physical sickness.

In so many of those cases, the IRS and the courts seem to be looking for the substance of the case and the reason the defendant paid the amount. Language in a settlement agreement can be helpful in securing the desired tax treatment when the underlying facts of the case and the pleadings support the tax language. When they seem unconnected, the IRS and the courts may view the assertions made in settlement agreements about tax treatment to a plaintiff as inherently suspect.

Significant Recent Case

One of the most interesting recent cases exploring the scope of section 104 — particularly the ''on account of'' nexus requirement — is *Nancy J. Vincent v. Commissioner*.[6] *Vincent* involved an employee of a trust company. She was diagnosed with serious ulcers in 1993. Vincent was advised that high stress would exacerbate her condition, and therefore requested a four-day workweek. The trust company accommodated the schedule.

The taxpayer and the trust company then began having problems. In 1994 the company disciplined the taxpayer. Some months later, Vincent received an unfavorable performance appraisal. In 1995 she was placed on six months probation and was returned to her five-day work schedule. Shortly thereafter, the taxpayer had several doctor reports advising her not to work a full five-day workweek. The taxpayer stayed out of work and was terminated by the company.

[1]*Schleier v. Commissioner*, 515 U.S. 323, *Doc 95-5972*, *95 TNT 116-8* (1995).

[2]T.C. Memo. 2004-47, *Doc 2004-4540*, *2004 TNT 43-12*.

[3]76 Fed.App. 873, *Doc 2003-19761*, *2003 TNT 172-6* (10th Cir. 2003), *cert. denied* 124 S.Ct. 2888 (2004).

[4]T.C. Memo. 2003-100, *Doc 2003-9085*, *2003 TNT 69-39*.

[5]T.C. Summ. Op. 2002-55, *Doc 2002-12459*, *2002 TNT 100-12*.

[6]T.C. Memo. 2005-95, *Doc 2005-9343*, *2005 TNT 85-6*.

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In the resulting lawsuit against the trust company and other defendants, the taxpayer asserted causes of action under federal and state laws, including intentional infliction of emotional distress. The Tax Court spent considerable time going through the detailed procedural aspects of the lawsuit. Among other allegations, Vincent alleged that she had a disability (ulcers) within the meaning of California's Fair Employment and Housing Act (FEHA), that the trust company knew of her condition, and that the trust company had wrongfully terminated her. As a direct and proximate result, she alleged, she suffered lost wages and emotional distress. She did not allege in the FEHA case that the trust company had either caused or exacerbated her ulcers. That, as we'll see below, turned out to be an important fact in the case.

After various procedural wranglings (including the dismissal of some claims), the taxpayer went to trial and recovered a verdict. After the trial, the jury was given a special verdict form that asked whether the plaintiff's ulcer substantially limited a major life activity, whether the defendant knew that the plaintiff was disabled because of her ulcer, and so on. Notably, although the special verdict form asked questions about the various events and communications leading up to the termination, none of the questions inquired whether any of the ulcer conditions were caused — or even exacerbated — by the defendant. The jury awarded $400,000 in damages without specifying the general or special damages to which they related. On motion by the taxpayer's attorney, the court awarded $184,350.76 in attorney fees and costs under a statutory fee provision, California Govt. Code section 12965(b).

Both parties appealed. The case settled pending appeal for a lump sum of $510,000. The settlement agreement reflected at least some tax sensitivity on the part of the plaintiff. Under the settlement agreement, the taxpayer received $30,000 in 1997 for back wages and fringe benefits, $30,000 in 1998 for back wages and fringe benefits, $12,000 in 1997 for attorney fees, $198,000 in 1998 for attorney fees, and $240,000 in 1998 for personal injuries and emotional distress arising from the ulcer. The taxpayer reported the $30,000 in her 1998 income but did not report in 1998 the $198,000 for attorney fees or the $240,000 denominated for personal injuries and emotional distress. (The taxpayer's 1997 tax year was not before the court.)

Scope of Section 104

The major issue addressed in *Vincent* is whether any of those amounts was paid on account of personal physical injuries or physical sickness. Applying the two-tier test set forth in *Schleier*, the Tax Court addressed only the second element of that test. The IRS had conceded that the taxpayer had satisfied the first part of the *Schleier* test. The question was whether any part of the $240,000 that the settlement agreement attributed to "personal injuries and emotional distress" qualified for exclusion.

The Tax Court started by reciting that it is not bound by settlement agreements and is in fact free to disregard them. For that proposition, the court cited *Robinson v. Commissioner*.[7] The court also noted that the intent of the payer is extremely important. For that proposition, the court cited *Knuckles v. Commissioner*.[8] The court sought to divine that intent, noting that the parties could have entered into a settlement only as to causes of action that were before the trial court.

That suggests, as seems appropriate, that taxing authorities and courts will endeavor to look behind the settlement to the causes of action remaining extant at the time of the settlement. The taxpayer argued that as a threshold, the settlement agreement should itself be determinative. The taxpayer (too) relied on *Robinson v. Commissioner*.[9]

Suggesting that it was paying attention to the language of the agreement, the *Vincent* court did note that even the settlement agreement itself did not use the word "physical," instead stating that the $240,000 was attributable to "personal injuries and emotional distress." Of course, the substance rather than semantics should control the tax consequences of the payment. Yet that comment suggests one should use the correct wording from the statute.

Beyond mere semantics, though, the *Vincent* court said that a review of the special verdict form shows that the jury did not consider any claim by the taxpayer for personal physical injuries as a basis for a damage award. The court once again reviewed the special verdict form and the questions that were put to the jury.

Nowhere on that special verdict form was the jury asked whether the trust company's actions caused, or even exacerbated, the ulcer. The medical condition of the taxpayer was discussed at length in the lawsuit, including photographs of her ulcer and so forth. However, the evidence was used only to establish that she was disabled. The evidence did not speak to *how* that disability occurred; the jury was not asked to conclude whether the trust company caused or exacerbated those ulcers. The court therefore found that the jury verdict underlying the settlement did not support any apportionment of the settlement to personal physical injury damages.

In discussing the adversarial nature of negotiations on settlement agreements (particularly on tax provisions in settlement agreements), the *Vincent* court found that once the settlement amount was negotiated, and once significant provisions of the settlement agreement were discussed, the negotiation regarding characterization of the proceeds ceased to be adversarial. The taxpayer wanted a large tax exclusion, and the trust company apparently did not object to that goal as long as it secured indemnity for any adverse tax consequences to it arising from the settlement. The trust company had an interest only in resolving the matter and avoiding any future tax consequences.

Once those concerns were met, the trust company didn't care how the settlement proceeds were classified.

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[7]102 T.C. 116, *Doc 94-1439*, *94 TNT 23-18* (1994), *aff'd in part and rev'd in part* 70 F.3d 34, *Doc 95-10932*, *95 TNT 238-7* (5th Cir. 1995).

[8]349 F.2d 610 (10th Cir. 1965).

[9]*Supra* note 7.

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Suggesting that there may have been something nefarious going on, the Tax Court noted in a footnote that the total amount of the court judgment was $584,350.76 (including attorney fees), and that the case was settled for $510,000. The difference between $584,350.76 and $510,000 was $74,350.76, almost exactly 30 percent of $240,000 (approximating the petitioner's expected tax benefit from the settlement as it was structured).

The court also looked to the wage calculations, noting that the jury had awarded a total of $400,000, but the taxpayer had allocated only $60,000 for past and future lost wages. The taxpayer reduced the tax on that $60,000 even further by splitting it between two tax years. Perhaps the taxpayer seemed to be playing it a little too cute.

Indeed, implicit in the opinion is the notion that there was an arm's-length pretense about the negotiations, but that did not disguise the reality of the underlying lawsuit, which was clearly a discrimination action rather than one arising from personal physical injuries. The court therefore found that none of the settlement proceeds could be excluded. I think the Tax Court would have reacted differently had Vincent claimed her ulcers were caused or exacerbated by the defendant. The Tax Court found that the jury was never asked to consider those points. Although having those causation or exacerbation issues in the case might not have taken the case out of the employment milieu, it would, I suspect, have allowed the court to get over the ''on account of'' hurdle in section 104.

Problems of Proof

The road to a section 104 exclusion is often wrought with proof problems. The taxpayer must be prepared to show (even though he may never be asked to show it) that he suffered physical injuries or physical sickness and that there was a causal nexus between the events set in motion by the defendant and that physical injury or physical sickness. In some cases, the plaintiff might be able to demonstrate only that he *claimed* that causal connection, not that it existed.

Take *Henderson v. Commissioner*.[10] In that case, the Tax Court found that, absent a showing of personal physical injuries or physical sickness, recoveries for injury to reputation are fully taxable. The case involved alleged injury to reputation arising out of a credit card reporting gaffe. The Tax Court was satisfied that Henderson had met the first prong of the *Schleier* test but concluded that Henderson failed to prove that any portion of his recovery was on account of personal physical injuries or physical sickness. *Witcher*[11] is to the same effect.

Another example involving problems of proof is *Tritz v. Commissioner*.[12] There the Tax Court found that payments were not excludable despite allegations about carpal tunnel syndrome. Mr. Tritz was terminated by Amdahl as part of a reduction in force. Like other terminated employees, he received a severance package.

[10]T.C. Memo. 2003-168, *Doc 2003-14014*, *2003 TNT 111-12*.
[11]T.C. Memo. 2002-292, *Doc 2002-26347*, *2002 TNT 229-6*.
[12]T.C. Summ. Op. 2001-76, *Doc 2001-15770*, *2001 TNT 108-12*.

Although Tritz's package was the same as other employees, he backed out a portion of the severance payment (despite a Form W-2) and attached a note to his tax return explaining that this portion was nontaxable because of his physical injuries and sickness. The Tax Court disagreed, concluding that the entire severance package was made in exchange for his general release. No portion of the settlement amount was for personal physical injuries or physical sickness.

Attorney Fees

The second part of the *Vincent* case dealt with the tax treatment of attorney fees. Vincent had a contingent-fee agreement with her lawyer, stating that the lawyer would receive a specific percentage of any recovery. However, the contingent-fee agreement stated that the attorney would receive the contingent recovery unless there was a fee-shifting statute in effect. Here, there was an applicable fee-shifting statute, and there was even a court award of fees. The Tax Court therefore duly noted that the tax treatment of attorney fees in fee-shifting statute cases had not been presented to the Supreme Court in *Banks*.

The court stated that if the attorney fees had been received under the contingent-fee agreement rather than the statute, *Banks* would control.[13] Because *Banks* did not cover the fee-shifting statute, the court turned to the authority concerning fee-shifting statutes. In *Sinyard v. Commissioner*,[14] the taxpayer signed a contingent-fee agreement similar to the one Vincent signed. The settlement agreement apportioned some of the settlement amount to pay the attorney fees and costs under the fee-shifting provisions. In effect, the *Sinyard* court treated the obligation to pay fees as decisive, even if it turns out that the fee-shifting statute was in effect. Surprisingly, with little analysis, the Tax Court found that the presence of the fee-shifting statute did not save Vincent.

The taxpayer had an alternative argument. The taxpayer argued that a California state decision, *Flannery v. Prentiss*,[15] made the awarded attorney fees the property of the lawyer, not the client. Apparently not considering the *Flannery* argument seriously, the Tax Court stated that it was not bound by state law classifications as to the ownership of income.[16]

The Tax Court said that any contingent fees would be income under *Banks* and that the taxpayer could not escape that outcome by arguing that because her fees and costs were awarded by a court under a fee-shifting provision, that income is properly attributable to her attorney. Again, the court cited *Sinyard*. The court stated that it was not presented with (and did not address) the question whether the taxpayer would have been taxed on the attorney fees paid if she had been represented by a nonprofit legal foundation.

[13]*See Commissioner v. Banks*, 125 S. Ct. 826, *Doc 2005-1418*, *2005 TNT 15-10* (2005).
[14]268 F.3d 756, *Doc 2001-24862*, *2001 TNT 188-11* (9th Cir. 2001).
[15]26 Cal.4th 572 (2001).
[16]For that proposition, the court cited *Burnet v. Harmel*, 287 U.S. 103 (1932).

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Conclusion

The Tax Court in *Vincent* seems to viciously attack the argument that the presence of a statutory fee-shifting provision should alter the treatment of attorney fees. The Tax Court does not even refer to the specific guidance on statutory fee-shifting provisions the Supreme Court noted at the end of the *Banks* decision. I have previously characterized that guidance at the end of the *Banks* opinion as a road map.

There, the Supreme Court stated that the plaintiff might not have gross income measured by attorney fees when there was a statutory fee-shifting provision and either: a court award of attorney fees, a contingent-fee agreement that provided that the lawyer would receive all fees either as statutory fees or in lieu of statutory fees, or a settlement agreement that similarly provided that all fees were being paid to the lawyer in lieu of statutory fees to which the lawyer would be entitled.

It does seem that Vincent did not follow that path in settling her case (of course, the Supreme Court had not yet then rendered *Banks*, so no one could follow the path until it was created). Still, it would have been nice for the Tax Court to pay attention to what the Supreme Court advised. It is troubling that it did not.

We can expect to see more cases like *Vincent*, in which causation and proof of causation are examined to determine the applicability of section 104. Given the Tax Court's conclusion in *Vincent* that the jury was never asked if the defendant caused or exacerbated Vincent's ulcer, maybe the section 104 holding is not so odd. But the fee issue is troubling. We can expect to see more cases in which statutory fee arguments are raised.

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