

## Post-1996 Act Section 104 Cases: Where Are We Eight Years Later?

By Robert W. Wood

Robert W. Wood practices law with Robert W. Wood, PC, in San Francisco (<http://www.rwwpc.com>). He is the author of 29 books, including *Taxation of Damage Awards and Settlement Payments* (published by the Tax Institute and available at <http://www.amazon.com> and <http://www.taxinstitute.com>).

Section 104 of the Internal Revenue Code of 1986 dates back to a similar provision in the 1939 Internal Revenue Code.<sup>1</sup> It provides a specific statutory exclusion for personal injury damages. The rationale of this section is presumably that a taxpayer should not be subject to taxation on the receipt of monetary damages that are merely intended to make the taxpayer whole — that is, a recovery in this context is akin to a tax-free return of “personal” capital.

The major issue facing taxpayers, the IRS, and the courts in the area of personal injury recoveries is what constitutes a personal injury. For many years, the courts generally applied the notion that a recovery may relate to personal injuries excludable under section 104 if it is based on tort or tort-type rights. During the 1980s and early 1990s, the case law in this area exploded. The courts gave considerable breadth to section 104’s exclusion, extending coverage of the provision to awards that do not relate to physical injuries or physical sickness.

For example, several courts held that damages for injury to professional reputation were tax-free.<sup>2</sup> Moreover, the Tax Court and the First Circuit held that damages for deprivation of the right to free speech were excludable from income.<sup>3</sup> In *Byrne v. Commissioner*,<sup>4</sup> the Third Circuit held that a portion of the damages paid to an employee who claimed to have been wrongfully discharged were tax-free under section 104(a)(2). Only six years later, the IRS convinced the Supreme Court in *Commissioner v. Schleier*<sup>5</sup> that damages for age discrimination were taxable, signaling a major change in the scope of section 104.

The IRS prevailed on Congress to amend section 104 in the Small Business Job Protection Act of 1996 (the 1996 act). Signed by President Clinton on August 20, 1996, this law restricts section 104(a)(2) to exclude only damages for physical injuries or physical sickness as opposed to merely personal injuries or sickness. Now, eight years

after the statute was changed, there have been some cases decided that help to clarify this area of the tax law.

### What ‘Physical’ Means

The conference committee report to the 1996 act makes clear that all damages that flow from physical injuries or physical sickness are excludable, even if the recipient of the damages is not the injured party. 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 injuries or physical sickness of that person’s spouse. Those damages for loss of consortium are still excludable under section 104.

However, the situation with emotional-distress causes of action is less clear. According to the conference committee report to the 1996 act, section 104 no longer applies to any damages received, other than for medical expenses, in the context of nonphysical injuries such as employment discrimination or injury to reputation. On the other hand, the conference committee report recognizes that all damages received on account of physical injuries or physical sickness are excludable. Thus, exclusion under section 104 is still appropriate for any damages that are based on a claim of emotional distress attributable to physical injuries or physical sickness.

Unfortunately, nowhere in the code or the accompanying Treasury regulations is the meaning of the term “physical injuries or physical sickness” defined. Even the legislative history to the 1996 amendments to section 104(a)(2) is less than helpful. Given the importance of the term, it is reasonable to assume that the IRS, or perhaps the judiciary, would provide guidance on the meaning of the term “physical injuries or physical sickness.”

The IRS is particularly culpable in that lack of guidance. Optimally, it should issue proposed or temporary regulations. Short of that, an IRS notice or announcement, both of which are easier to issue than regulations, would at least break what has been an eight-year silence by the IRS. Admittedly, anything written by the IRS would offer only an IRS statement of its view of what constitutes physical injuries or physical sickness. Still, guidance is needed.

Most tax practitioners are frustrated that the IRS has been silent as to what constitutes physical injuries or physical sickness. As in other gray areas of the tax law, taxpayers can read the statute and the legislative history to try to achieve a favorable result. Of course, that reading is not without limits. The lack of guidance has allowed some taxpayers to take aggressive positions. Although it is inefficient and risky for taxpayers to go too far, it is also inefficient to fail to claim an exclusion that one is entitled to.

Tax practitioners still look to letter rulings — despite all their caveats — for guidance as to the IRS’s general position on matters. Because we know little about the IRS’s thoughts on the meaning of physical injuries or physical sickness, letter rulings can at least provide some practical guidance. LTR 200041022<sup>6</sup> deals with the difficult topic of a taxpayer who receives damages for sexual

<sup>1</sup>Internal Revenue Code of 1939, section 22(b)(5).

<sup>2</sup>*Miller v. Commissioner*, 93 T.C. 330 (1989), *rev’d and remanded* 914 F.2d 586 (4th Cir. 1990), *on remand* T.C. Memo. 1993-49, *supp.* T.C. Memo. 1993-588, 93 TNT 32-24, *aff’d* 60 F.3d 823, *Doc* 95-7392, 95 TNT 148-48 (4th Cir. 1995); *Threlkeld v. Commissioner*, 848 F.2d 81 (6th Cir. 1988).

<sup>3</sup>*Bent v. Commissioner*, 87 T.C. 236 (1986), *aff’d* 835 F.2d 67 (3d Cir. 1988).

<sup>4</sup>90 T.C. 1000 (1988), *rev’d and remanded* 883 F.2d 211 (3d Cir. 1989).

<sup>5</sup>15 U.S. 323, *Doc* 95-5972, 95 TNT 116-8 (1995).

<sup>6</sup>*Doc* 2000-26382, 2000 TNT 201-10.

harassment and assault, both before and after there is any observable bodily harm. This letter ruling concludes that the damages a taxpayer received that were allocable to unwanted physical contacts without any "observable bodily harm" did not constitute physical injury or physical sickness under section 104(a)(2).

The ruling goes so far as to say, "The term 'personal physical injuries' is not defined in either section 104(a)(2) or the legislative history of the 1996 Act. However, direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under section 104(a)(2)."

The facts in LTR 200041022 are reminiscent of many sexual harassment cases. The taxpayer was employed as a full-time driver. Her employer began making suggestive and lewd remarks to her and also began touching her inappropriately. According to the ruling, those physical contacts left no observable bodily harm. However, while the taxpayer was on one road trip with her employer he physically assaulted her, causing her extreme pain. The employer also physically assaulted her on other occasions, causing physical injury. He later physically and sexually assaulted her.

The taxpayer quit her job and filed a suit alleging sex discrimination and reprisal (including sexual harassment), battery, and intentional infliction of emotional distress. The employer settled the case, but there was no express allocation of proceeds in the settlement agreement. Clearly, this was less than ideal tax planning, because a failure to include a tax allocation in a settlement agreement is a missed opportunity.<sup>7</sup>

Under those facts, the IRS concluded that the damages the taxpayer received from her employer's unwanted physical contacts that resulted in no observable bodily harm were not received on account of personal physical injuries or physical sickness. Those amounts were therefore taxable. However, the damages received for pain, suffering, emotional distress, and reimbursement of medical expenses after the first assault were excludable under section 104(a)(2) because they were attributable to physical injuries.

### Case Law So Far

The amount and extent of physical consequences required under the post-1996 incarnation of section 104(a)(2) have been unclear for almost a decade. It is high time for the IRS to give us some guidance in this area; taxpayers and revenue agents both deserve better. In the absence of IRS guidance, there have been several cases that are noteworthy and that at least tell us something about the scope of post-1996 act section 104. Organized by the nature of the claim, the rest of this column summarizes the case law so far.

<sup>7</sup>See *Robinson v. Commissioner*, 102 T.C. 116, Doc 94-1439, 94 TNT 23-18 (1994), *aff'd in part and rev'd in part on another issue* 70 F.3d 34, Doc 95-10932, 95 TNT 238-7 (5th Cir. 1995), *cert. denied* 519 U.S. 824 (1996).

### Emotional Distress

Under the current incarnation of section 104, for an emotional distress recovery to be excludable, it generally must be received on account of personal physical injuries or sickness.<sup>8</sup> A footnote in the conference committee report to the 1996 act states that the term "emotional distress" includes physical symptoms such as insomnia, headaches, and stomach disorders, which may result from the emotional distress.

The conference committee report states that section 104(a)(2) does not apply to any emotional distress recovery, to the extent it did not arise out of a claim for personal physical injuries or physical sickness. Because all damages received on account of personal physical injuries or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to personal physical injuries or physical sickness.<sup>9</sup>

So far, it does not appear that the courts will be terribly expansive here. In *Emerson v. Commissioner*,<sup>10</sup> the Tax Court found that a tort recovery for emotional distress was not excludable under section 104(a)(2) because the recovery was not received on account of personal physical injuries. In 1994 the taxpayer was an independent contractor for ProGuard Inc. Sometime before 1998 Emerson stopped working for ProGuard. The taxpayer filed a complaint alleging intentional infliction of emotional distress, and ProGuard settled the matter after mediation. On his 1998 tax return the taxpayer failed to include any portion of the settlement proceeds as gross income.

The IRS issued a notice of deficiency, and the matter wound up in Tax Court. The court found for the IRS, holding that the settlement was not paid on account of personal physical injuries or physical sickness. Accordingly, the entire amount of the settlement was found to be taxable as nonemployee compensation. Similarly, in *Witcher v. Commissioner*,<sup>11</sup> the Tax Court held that a tort recovery for emotional distress and defamation was not excludable under section 104(a)(2) because it was not received on account of personal physical injuries or physical sickness.<sup>12</sup>

### Injury to Reputation

The law concerning the tax treatment of recoveries for injury to reputation has long been contentious. Although defamation is clearly a traditional tort under common law, the IRS has always sought to tax defamation recoveries. Based on the 1996 changes to section 104, recoveries

<sup>8</sup>The one exception to this general rule is that reimbursed medical expenses regarding emotional distress are excludable even absent physical injuries or sickness. See section 104(a). See also *Prasil v. Commissioner*, T.C. Memo. 2003-100, Doc 2003-9085, 2003 TNT 69-39.

<sup>9</sup>The amendments made by the 1996 act are generally effective for recoveries received after August 20, 1996. However, a grandfather provision applies to some recoveries.

<sup>10</sup>T.C. Memo. 2003-82, Doc 2003-7295, 2003 TNT 55-7.

<sup>11</sup>T.C. Memo. 2002-292, Doc 2002-26347, 2002 TNT 229-6.

<sup>12</sup>See also *Gantea v. Commissioner*, T.C. Summ. Op. 2003-55, Doc 2003-12489, 2003 TNT 97-14 (holding the same).

for injury to reputation are generally fully taxable under section 61(a). Even so, if the recovery is received on account of personal physical injuries or physical sickness, or otherwise falls within the rubric of another of section 104's exclusionary provisions, it should be excludable.

In *Henderson v. Commissioner*,<sup>13</sup> the Tax Court found that absent a showing of personal physical injuries or physical sickness, recoveries for injury to reputation are fully taxable. In 1997 Henderson used a credit card issued by Morgan Stanley to pay for a motel room. After an argument with the motel owner, Henderson became dissatisfied. He promptly paid the credit card balance and canceled it. Thereafter, the motel charged Henderson additional amounts. Morgan Stanley honored the charges and billed Henderson, who refused to pay.

Not surprisingly, Morgan Stanley reported Henderson to the major credit reporting agencies. Henderson sued Morgan Stanley, alleging injury to reputation. The parties agreed to settle the matter for \$5,000. On his 1999 tax return, Henderson excluded that recovery from income. The IRS issued a deficiency notice asserting Henderson was taxable on the recovery.

The Tax Court agreed with the IRS. As has become the norm, the court cited *Schleier*,<sup>14</sup> for the proposition that for a recovery to be excludable under section 104(a)(2): (1) the underlying cause of action must be based on tort or tort-type rights and (2) the resulting damages must be recovered on account of personal injuries or sickness. Although the Tax Court did not say so in this instance, for recoveries after August 20, 1996, the effective date of the 1996 act, the second prong of the *Schleier* test has generally been read to require that the personal injuries or sickness be physical in nature.<sup>15</sup>

The Tax Court was satisfied that Henderson met the first prong of the *Schleier*<sup>16</sup> test, but it concluded that Henderson failed to prove any portion of the recovery was on account of personal physical injuries or physical sickness. Accordingly, the entire recovery was found to be taxable. Similarly, in *Witcher v. Commissioner*,<sup>17</sup> the Tax Court held a tort recovery for defamation and emotional distress was not excludable under section 104(a)(2) because it was not received on account of personal physical injuries or physical sickness.<sup>18</sup>

### Alienation of Affection and Loss of Consortium

Although alienation of affections is clearly a traditional tort under common law, based on the 1996 changes

to section 104, recoveries for alienation of affections are generally fully taxable under section 61(a). Even so, if the recovery is received on account of personal physical injuries or physical sickness, or otherwise falls within the rubric of another of section 104's exclusionary provisions, it should be excludable.

Loss of consortium recoveries, on the other hand, will generally be excludable, as long as the loss of consortium claim is linked to another person's physical injury or death.

For example, in LTR 200121031<sup>19</sup> the IRS ruled that a recovery for loss of consortium and wrongful death was excludable under section 104(a)(2). The ruling involved a widow whose husband died from cancer after being exposed to asbestos fibers for a prolonged period. Citing *Schleier*,<sup>20</sup> the IRS noted that the underlying causes of action for loss of consortium and wrongful death were based on tort or tort-type rights, and the resulting damages were recovered on account of personal physical injuries or physical sickness. The IRS went on to note that there was a direct causal link between the deceased husband's inhalation of toxic asbestos fibers and the widow's claims for loss of consortium and wrongful death. Accordingly, the recovery was excludable under section 104(a)(2).

### Wrongful Death

The legislative history of section 104 makes it clear that damages, other than punitive damages, received on account of a claim of wrongful death are excludable from income.<sup>21</sup> Apart from cases involving punitive damages, this type of case is unlikely to cause significant controversy. Although post-1996 act cases involving wrongful death actions have been slow in surfacing, there is one letter ruling involving a wrongful death action.

In LTR 200029020<sup>22</sup> the IRS ruled that a settlement received by an estate as compensation for a wrongful death action was excludable from gross income under section 104(a)(2). The ruling involved a decedent who sustained fatal physical injuries in an automobile accident. The decedent's survivors obtained a wrongful death settlement from the tortfeasor's insurance company.

The IRS noted that section 104(a)(2) provides that gross income does not include damages received, whether by suit or agreement and whether as lump sums or as periodic payments, on account of personal physical injuries or physical sickness. Accordingly, the IRS ruled that because the recovery resulted from the decedent's fatal physical injuries, it was excludable under section 104(a)(2).

### Sex Discrimination

The controversy over the tax treatment of sex discrimination recoveries came to a head in the early 1990s. In

<sup>13</sup>T.C. Memo. 2003-168, Doc 2003-14014, 2003 TNT 111-12.

<sup>14</sup>Supra note 5.

<sup>15</sup>*Oyelola v. Commissioner*, T.C. Summ. Op. 2004-28, Doc 2004-5381, 2004 TNT 50-17; *Venable v. Commissioner*, T.C. Memo. 2003-240, Doc 2003-18653, 2003 TNT 157-5; *Shultz v. Commissioner*, T.C. Memo. 2003-173, Doc 2003-14203, 2003 TNT 113-9; *Henderson*, supra note 13; *Prasil*, supra note 8.

<sup>16</sup>Supra note 5. See also Wood, "Scope of Personal Injury Exclusion Still Clouded," *Tax Notes*, Dec. 28, 1998, p. 1675; Wood, "Schleier Strikes Taxpayers Three Times," *Tax Notes*, July 24, 1995, p. 475.

<sup>17</sup>Supra note 11.

<sup>18</sup>See also *Cotterell v. Commissioner*, T.C. Summ. Op. 2003-145, Doc 2003-21618, 2003 TNT 191-18 (holding the same).

<sup>19</sup>Doc 2001-15011, 2001 TNT 103-10.

<sup>20</sup>Supra note 5.

<sup>21</sup>H.R. Conf. Rep. No. 104-737, 104th Cong., 2d Sess., 301 (1996).

<sup>22</sup>Doc 2000-19640, 2000 TNT 142-16.

*United States v. Burke*,<sup>23</sup> the Supreme Court found sex discrimination recoveries to be taxable, but seemed to leave room for some recoveries to be excludable.

Unfortunately, after the 1996 changes to section 104, most sex discrimination recoveries are now fully taxable. LTR 200303003<sup>24</sup> is indicative of the IRS's current view on sex discrimination recoveries. In that letter ruling, the IRS ruled that settlement proceeds in a sex discrimination recovery are taxable. The letter ruling involves a class of employees that filed a class-action employment discrimination complaint against a federal agency. The class alleged that the agency discriminated against it through disparate treatment based on race and gender in hiring practices, performance evaluations, initiation of disciplinary proceedings, and other related allegations.

The class sought equitable relief including back pay, reinstatement, other lost compensation, and attorney fees. The class signed a settlement agreement releasing its claims in exchange for a monetary award. The agreement made no reference to emotional distress and stated that all payments made "represent compensatory damages and not wages."

The IRS stated that the underlying cause of action was not based on tort or tort-type rights, and it determined that the damages were not received on account of personal physical injuries or physical sickness. The IRS went on to note that the underlying cause of action was based on economic rights, such as the denial of promotions and awards, rather than tort-type rights. Although the complaint alleged emotional distress, the IRS found there was no evidence of physical injuries, sickness, or medical expenses related to emotional distress. Accordingly, the IRS determined that the recovery was not excludable under section 104.

To say that the Tax Court has found sex discrimination recoveries taxable would be an understatement.<sup>25</sup> Although the facts vary from case to case, the ultimate result and the underlying rationale have become almost boilerplate.

The court generally cites *Schleier*<sup>26</sup> for the proposition that for a recovery to be excludable under section 104(a)(2): the underlying cause of action must be based on tort or tort-type rights and the resulting damages must be recovered on account of personal injuries or sickness. For recoveries after the effective date of the 1996

act, the second prong of the *Schleier* test has been held to require that the personal injuries or sickness be physical in nature.<sup>27</sup>

In each of these sex discrimination cases, the Tax Court essentially determines 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 physical sickness. Accordingly, in each case the recovery is found not to be excludable from gross income under section 104(a)(2) because sex discrimination alone does not constitute a personal physical injury or physical sickness. Sexual harassment cases can yield a different tax result (at least in some situations), as described below.

### Age Discrimination

The tax treatment of age discrimination recoveries, like the tax treatment of sex discrimination recoveries, has followed a tortured path. Under federal law, those claims are typically brought under the Age Discrimination in Employment Act (ADEA). Many state laws include similar acts regarding a prohibition on age discrimination. The tax treatment of ADEA recoveries was finally resolved by *Schleier*,<sup>28</sup> in which the Supreme Court ruled that a recovery under the ADEA constitutes taxable income.

In *Schleier*, the Supreme Court relied on *Burke*, invoking two independent requirements that a taxpayer must meet before a recovery may be excluded under section 104(a)(2): "that the underlying cause of action was 'based upon tort or tort type rights,' and that the damages were received 'on account of personal injuries or sickness.'" The Supreme Court ultimately concluded that *Schleier* had not satisfied either of those requirements, and, accordingly, was not entitled to exclude the liquidated-damages portion of his recovery under the pre-1996 incarnation of section 104. For recoveries after August 20, 1996, the effective date of the 1996 act, the second prong of the *Schleier* test should be read to require that the personal injuries or sickness be physical in nature.<sup>29</sup>

Although age discrimination cases that opine on the post-1996 version of section 104(a)(2) have been slow in rising to the top, it is a safe bet that they will not change the underlying taxable nature of age discrimination recoveries.

### Racial Discrimination

After the 1996 changes to section 104, racial discrimination recoveries are generally fully taxable. In *Oyelola v. Commissioner*,<sup>30</sup> the Tax Court held that a taxpayer was not entitled to exclude a racial discrimination recovery from gross income. The court found that the taxpayer failed to prove that the recovery was received on account of personal physical injuries or physical sickness.

<sup>27</sup>*Oyelola*, *supra* note 15; *Venable*, *supra* note 15; *Shaltz*, *supra* note 15; *Henderson*, *supra* note 13; *Prasil*, *supra* note 8.

<sup>28</sup>*Supra* note 5.

<sup>29</sup>*Oyelola*, *supra* note 15; *Venable*, *supra* note 15; *Shaltz*, *supra* note 15; *Henderson*, *supra* note 13; *Prasil*, *supra* note 8.

<sup>30</sup>*Supra* note 15.

<sup>23</sup>504 U.S. 229 (1992), *on remand* 969 F.2d 218 (6th Cir. 1992). See also Wood, "Section 104 Cases Continue to Merit Attention," *Tax Notes*, Nov. 24, 1997, p. 983.

<sup>24</sup>Doc 2003-1563, 2003 TNT 13-66.

<sup>25</sup>*Nield v. Commissioner*, T.C. Summ. Op. 2002-110, Doc 2002-19836, 2002 TNT 167-7; *Oyelola*, *supra* note 15; *Medina v. Commissioner*, T.C. Summ. Op. 2003-148, Doc 2003-22027, 2003 TNT 195-8; *Dorroh v. Commissioner*, T.C. Summ. Op. 2003-93, Doc 2003-17056, 2003 TNT 139-71; *Montgomery v. Commissioner*, T.C. Memo. 2003-64, Doc 2003-5845, 2003 TNT 44-7; *Cates v. Commissioner*, T.C. Summ. Op. 2003-15, Doc 2003-5507, 2003 TNT 41-39; *Porter v. Commissioner*, T.C. Summ. Op. 2003-14, Doc 2003-5128, 2003 TNT 38-6.

<sup>26</sup>*Supra* note 5.

The court cited *Schleier*<sup>31</sup> for the proposition that for a recovery to be excludable under section 104(a)(2): the underlying cause of action must be based on tort or tort-type rights and the resulting damages must be recovered on account of personal injuries or sickness. The Tax Court also noted that for recoveries after the effective date of the 1996 act, the second prong of the *Schleier* test should be read to require that the personal injuries or sickness be physical in nature.<sup>32</sup>

The Tax Court essentially determined 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. Accordingly, the court found the recovery not to be excludable because racial discrimination alone does not constitute a personal physical injury. Instead, the court found the recovery to be fully taxable under section 61(a).

In *Cates v. Commissioner*,<sup>33</sup> the Tax Court reached a similar conclusion — that racial discrimination recoveries are includable in income if they are not received on account of personal physical injuries or physical sickness.

### Wrongful Termination

Suits for wrongful termination have blossomed in recent years. Instead of claiming race, sex, or age discrimination under one of the relevant federal or state statutes, plaintiffs in employment contexts often choose to proceed under a wrongful termination cause of action. Much like other employment recoveries, after the 1996 changes to section 104, wrongful termination recoveries are generally fully taxable.

In *Tamberella v. Commissioner*,<sup>34</sup> the Tax Court held that an individual may not exclude the proceeds of a wrongful termination recovery under section 104. The taxpayer in *Tamberella* worked for ATC-Vancom from 1994 to 1996. In 1996 his boss moved in with him and his live-in girlfriend. After a couple of months, his boss moved out and took Tamberella's girlfriend with him. Soon after, Tamberella was diagnosed with mental illness and was committed to a hospital for treatment. It would probably be an understatement to say that there was more than a little bad blood between Tamberella and his boss, so it was no real surprise to Tamberella when he was terminated by ATC. He filed suit for wrongful termination and the parties settled.

The settlement was allocated by the parties as part back wages, with the remainder representing the amount paid to Tamberella for his general release of claims against the company. The agreement specified whether some or all of the non-back-pay portion was taxable to Tamberella. ATC reported that amount as nonemployee compensation, but Tamberella excluded it from gross income under section 104(a)(2). The discrepancy evidently piqued the IRS's interest, and it issued Tamberella a deficiency notice.

The Tax Court noted that the settlement failed to allocate any portion of the recovery to personal physical injuries. Citing *Schleier*,<sup>35</sup> the Tax Court determined that even if there was an ancillary cause of action based on tort or tort-type rights, the resulting recovery was not paid on account of personal physical injuries. Accordingly, the recovery was found not to be excludable from gross income under section 104(a)(2) because wrongful termination alone does not constitute a personal physical injury or physical sickness. The court found the recovery to be fully taxable under section 61(a).<sup>36</sup>

In a similar case, the Tax Court in *Reid v. Commissioner*<sup>37</sup> held that a tort recovery from wrongful discharge was not excludable under section 104(a)(2) because it was not received on account of personal physical injuries or physical sickness. Reid was employed by Chevron Corp. as a cashier at one of its Florida gas stations. Reid alleged that sometime in 1995 he was injured lifting a five-pound bucket of ice. Shortly thereafter he filed for workers' compensation benefits. But his claim was denied and he was terminated. Reid sued Chevron for wrongful discharge. The case settled in 1998 for \$5,000.

On his 1998 tax return, Reid failed to claim any portion of the settlement payment as income. The IRS issued a notice of deficiency, and the matter ended up in Tax Court. Not surprisingly, the court noted that the settlement failed to allocate any portion of the recovery to personal physical injuries or physical sickness.

Citing *Schleier*,<sup>38</sup> the Tax Court determined that even if there was an ancillary cause of action based on tort or tort-type rights, the resulting recovery was not paid on account of personal physical injuries or physical sickness. Accordingly, the recovery was found not to be excludable from gross income under section 104(a)(2) because wrongful termination alone does not constitute a personal physical injury. The court found the recovery to be fully taxable under section 61(a).<sup>39</sup>

In *Tritz v. Commissioner*,<sup>40</sup> the Tax Court held that payments a couple received from a former employer were not excludable under section 104(a)(2) because payments concerning termination of employment do not constitute a recovery on account of personal physical injuries or physical sickness. From 1994 through 1997 Richard Tritz was employed by Amdahl Corp. as an application systems engineer. During the first two years of his employment with Amdahl, he was diagnosed with and treated for carpal tunnel syndrome.

In 1997 Amdahl decided to reduce its workforce. It provided all terminated employees with a severance package, but required that they sign a general release

<sup>31</sup>Supra note 5.

<sup>32</sup>Venable, supra note 15; Shultz, supra note 15; Henderson, supra note 13; Prasil, supra note 8.

<sup>33</sup>Supra note 25.

<sup>34</sup>T.C. Memo. 2004-47, Doc 2004-4540, 2004 TNT 43-12.

<sup>35</sup>Supra note 5.

<sup>36</sup>See also Medina, supra note 25 (holding that wrongful termination recoveries are not excludable under section 104(a)(2)).

<sup>37</sup>T.C. Summ. Op. 2002-55, Doc 2002-12459, 2002 TNT 100-12.

<sup>38</sup>Supra note 5.

<sup>39</sup>See also Medina, supra note 25 (holding that wrongful termination recoveries are not excludable under section 104(a)(2)).

<sup>40</sup>T.C. Summ. Op. 2001-76, Doc 2001-15770, 2001 TNT 108-12.

before checks were issued. Tritz signed a release in 1997, and Amdahl issued him a W-2 for the entire amount of the severance payment.

On his 1997 federal income tax return, Tritz backed out a portion of the severance payment. Tritz attached a note to his return explaining that that portion of the severance payment was allegedly nontaxable because it concerned claims for personal injury, emotional distress, workers' compensation, ERISA violations, discrimination, and civil rights violations.

The IRS did not agree with Tritz's allocation and issued a notice of deficiency. The Tax Court found for the IRS, noting that the entire severance payment was made in exchange for the execution of the general release Tritz signed in connection with the termination of his employment. Because no portion of the settlement amount was received on account of personal physical injuries or physical sickness, the entire amount was found to be taxable.

### Sexual Harassment

After the 1996 changes to section 104, most sexual harassment recoveries became fully taxable under the general rule of section 61(a). Even so, the IRS itself has recognized that when there is physical touching and resulting physical injuries, sexual harassment recoveries can be excluded under section 104.<sup>41</sup>

In *Prasil v. Commissioner*,<sup>42</sup> the Tax Court found that a settlement payment arising out of a sexual harassment lawsuit was not excludable under section 104(a)(2). In filing her 1999 tax return, the taxpayer excluded a sexual harassment recovery from her former employer. The settlement agreement that accompanied the payment failed to allocate the settlement amount and included a general release. In 2001 the IRS issued a deficiency notice. The taxpayer's former employer reported the entire settlement amount to the IRS on Form 1099.

Citing *Schleier*,<sup>43</sup> the Tax Court determined 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 physical sickness. Accordingly, the recovery was found not to be excludable from gross income under section 104(a)(2) because sexual harassment alone does not constitute a personal physical injury. The court found the recovery to be fully taxable under section 61(a).

It is worth noting that the court also dismissed Prasil's uncorroborated testimony that the harassment caused or worsened various illnesses that she suffered from. The court noted that the settlement documents failed to allocate any portion of the payment to physical injury or to refer to any physical sickness.

A similar result was reached in *Shaltz v. Commissioner*,<sup>44</sup> in which a sexual harassment recovery was held to constitute taxable income. The Tax Court found section 104(a)(2) to be inapplicable because the taxpayer failed to

establish that damages recovered for mental anguish, humiliation, embarrassment, and loss of economic advantages constituted amounts received on account of personal physical injuries or physical sickness.

Instead, the Tax Court found that the payments were taxable under section 61(a), which is construed broadly to reach any accession to wealth.<sup>45</sup> The Tax court also noted that exclusions from gross income, on the other hand, are construed narrowly.<sup>46</sup>

### ADA

In *Johnson v. United States*,<sup>47</sup> a guard at a juvenile detention center who suffered injuries while restraining an inmate was not permitted to exclude damages he recovered in a suit brought under the Americans With Disabilities Act after his employer failed to accommodate his physical limitations that resulted from the incident. The court found that Johnson's recovery was on account of unlawful termination rather than personal physical injuries or physical sickness.

The court cited *Schleier*<sup>48</sup> for the proposition that for a recovery to be excludable under section 104(a)(2): (1) the underlying cause of action must be based on tort or tort-type rights and (2) the resulting damages must be recovered on account of personal injuries or sickness. Of course, for recoveries after August 20, 1996, the effective date of the 1996 act, the second prong of the *Schleier* test has generally been read to require that the personal injuries or sickness be physical in nature.<sup>49</sup>

The Tenth Circuit in *Johnson* determined that while the cause of action was based on tort or tort-type rights, the resulting recovery was not paid on account of personal physical injuries. Thus, the court found the recovery not to be excludable from gross income under section 104(a)(2) because discrimination under the ADA alone does not constitute a personal physical injury or physical sickness. Ultimately, the court concluded that the link between Johnson's discrimination-based discharge and his work-related injuries was too tenuous to support exclusion under section 104. The court found the recovery to be fully taxable under section 61(a).

### Where Do We Go From Here?

Section 104(a)(2) now excludes from gross income only amounts received on account of personal physical injuries or physical sickness. In fact, section 104(a)(2) excludes from its ambit emotional distress recoveries, except when coupled with personal physical injuries or physical sickness.<sup>50</sup>

We still have no regulations (proposed, temporary, or otherwise) under section 104 as amended, nor do we have any administrative guidance. There has been some

<sup>41</sup>See LTR 200041022, discussed above.

<sup>42</sup>*Supra* note 8.

<sup>43</sup>*Supra* note 5.

<sup>44</sup>*Supra* note 15.

<sup>45</sup>*Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955).

<sup>46</sup>*Id.*; *Schleier*, *supra* note 5; *Burke*, *supra* note 23.

<sup>47</sup>76 Fed. Appx. 873, Doc 2003-19761, 2003 TNT 172-6 (10th Cir. 2003).

<sup>48</sup>*Supra* note 5.

<sup>49</sup>*Oyelola*, *supra* note 15; *Venable*, *supra* note 15; *Shaltz*, *supra* note 15; *Henderson*, *supra* note 13.

<sup>50</sup>See section 1605 of the 1996 act, 110 Stat. 1838.

case law, but so far primarily Tax Court cases and most of the cases have not been terribly interesting.

Still, many of these cases suggest that where there are multiple causes of action (as there often are) and there is some recovery that can be attributed to physical injuries or physical sickness, that portion of the award can still qualify for exclusion under section 104, notwithstanding the changes made to section 104 by the 1996 act.

The Service itself suggests bifurcation of awards in LTR 200041022.<sup>51</sup> The Tax Court has suggested that in

---

<sup>51</sup>See *Doc 2000-26382, 2000 TNT 201-10* (in which the IRS ruled that “direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under section 104(a)(2).” See also Wood, “Were Sex Abuse Payments for Physical Injuries or Sickness?” *Tax Notes*, July 5, 2004, p. 56.

some cases, the link between the injuries or illness of the plaintiff and the defendant’s conduct will be sufficient to support some exclusion.<sup>52</sup>

Much of the future of section 104 would seem to revolve around causation. Yet there are even more fundamental issues remaining, issues that have not even been touched on by the IRS or the courts. No one seems to be interpreting the “physical sickness” wing of section 104. The case law so far has ignored this alternative part of the exclusion. I expect that makes the IRS happy, because it is my impression that the IRS would generally like to ignore that portion of the statute. If the “or physical sickness” wing of the statute is to have any meaning — as it should — someone will have to pay attention to it soon.

---

<sup>52</sup>See *Johnson, supra* note 47.

### TAX NOTES WANTS YOU!

*Tax Notes* has a voracious appetite when it comes to high-quality analysis, commentary, and practice articles. We publish more and better articles than anyone else, and we are always looking for more.

Do you have some thoughts on the pending international/corporate tax reform bills? Tax shelters? Federal budget woes? Recent IRS guidance? Important court decisions? Maybe you’ve read a revenue ruling

that has flown under the radar screen but is full of traps for the unwary.

If you think what you have to say about any federal tax matter might be of interest to the nation’s tax policymakers, academics, and leading practitioners, please send your pieces to us at [taxnotes@tax.org](mailto:taxnotes@tax.org).

Remember, people pay attention to what appears in *Tax Notes*.