It's All About the Proof

By Robert W. Wood

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Sometimes I sound like a broken record even to me. In effect since 1996, section 104 of the tax code excludes from income settlements or judgments attributable to personal physical injuries or physical sickness. For 70 years before that, this provision excluded personal injury recoveries, whether or not they were physical. But since 1996, defamation, emotional distress, etc., are no longer tax free. Some settlements today fall clearly on either side of the taxable vs. nontaxable line.

Yet, in a large number of cases, I find myself lapsing into the familiar. Damages for emotional distress are clearly taxable now, I explain helplessly, unless the emotional distress arises out of physical sickness or physical injury. If the emotional distress emanates from the physical (and not the other way around), the share of damages fairly allocable to the emotional distress will also be tax free.

For those untutored in the nuances of the tax law, it is understandable that this may sound like blather, a distinction without a difference. To some, these metaphysical musings seem to invite proactive planning. Often, however, the opportunity for meaningful planning may already have passed by the time I start my broken record. The IRS is usually skeptical about the applicability of the section 104 exclusion, and the Tax Court usually agrees with the IRS.

The Tax Court has shown time and time again that it has the patience of Job when analyzing just why a payment is being made. The Tax Court is quite rigorous, and it sometimes seems (at the IRS's urging) to virtually relitigate the underlying case on the way to figuring out what to tax. Often, a considerable portion of the record in the underlying litigation requires review.

Sometimes (to switch Biblical metaphors), a Solomonic allocation in a settlement agreement between taxable and nontaxable amounts may be indicated. Yet the better time to do that is before the settlement agreement is signed. At that point, one can at least argue that the parties have bargained over the allocation (and sometimes the parties really *do* bargain over those issues). In that way, the final settlement agreement reflects the intent of the payer, one of the key indicators of tax treatment.

Documentation Is Key

The Tax Court routinely gets into the nitty-gritty details of who did what when, and why amounts are paid. The Tax Court may be able to divine those facts from the record. But the Tax Court has shown it is not too inclined to do this when the taxpayer has not made an attempt to do so. Indeed, frequently taxpayers find that they are hoisted by their own petard. That was clearly the case in *Richard S. Moulton, Jr. v. Commissioner*.[1]

This case involved a $65,000 payment received after a 2003 mediation between Moulton and his former employer. Moulton had been fired by Morrell Corp. in 2000 and brought a claim against it. After a series of unfortunate events (including alleged threats of violence), the matter eventually settled in 2003. The settlement agreement reflected the dismissal of restraining orders against Moulton, and the payment of $65,000. The settlement agreement characterized this as a payment "to enhance his employment opportunities, maintain his health insurance, and/or enhance his ability to relocate."

The settlement agreement expressly said that this $65,000 payment would be subject to all applicable state and federal taxes. Part of the settlement agreement included a release of all claims. Morrell Corp. withheld taxes on the payment, issuing Moulton a Form W-2. He nevertheless did not report the amount as income and eventually wound up in Tax Court.

Moulton argued that the payment was excludable under section 104, claiming that the payment was for injuries he suffered because of his wrongful termination and subsequent defamation, including injury to his health. The Tax Court went through the predictable litany of section 104 authorities, describing the 1996 change to the statute in detail, and proceeding to the two-pronged test established in *Commissioner v. Schleier*.[2]

Poor Record

The court concluded that the first prong of the *Schleier* test was met, because this was a payment for tort or tort-type rights. Turning to the second prong of the *Schleier* test, the court asked if these proceeds were received on account of personal physical injuries or physical sickness. Predictably, the Tax Court stepped methodically through the documents from the underlying case. The settlement agreement did not contain any express allocation to specific injuries or harm.

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[1]T.C. Memo. 2009-38 (Feb. 18, 2009), *Doc 2009-3630, 2009 TNT 31-8*.

[2]515 U.S. 323 (1995), *Doc 95-5972, 95 TNT 116-8*.

The agreement did not acknowledge that there was a wrongful termination, but it suggested that the termination *might* have been questionable. Moreover, it was clear from the language of the settlement agreement that the $65,000 payment was to provide for enhanced employment opportunities, to maintain Moulton's health insurance, and to give him the ability to relocate. The settlement agreement so stated. To the Tax Court, that sure sounded like severance. Severance, of course, constitutes wages.

The court also noted the express language in the settlement agreement about the $65,000 payment being subject to all applicable state and federal taxes. Taken together (said the court), this (and the circumstances) made clear that the payment was a severance payment subject to tax as wages. It is unclear how much (if at all) Moulton may have argued about his personal physical injuries in his Tax Court trial. The opinion notes that in 2005 (two years *after* the settlement) the taxpayer received medical treatment for sleeping problems that he attributed to depression.

In 2006 Moulton also received medical treatment for elevated blood-sugar levels, which the taxpayer attributed to increased stress and emotional issues over the prior several years. The Tax Court took those into account, noting that, to the extent he suffered those items, the mere fact that he *attributed* them to stress from his job termination and its aftermath was not enough. Those conditions, said the court, fall within the category of symptoms of emotional distress. The symptoms may be physical, but they are not treated as a physical injury or physical sickness under section 104. Of course, this was also long after the settlement.

The court specifically noted the 1996 legislative history to the effect that ''the term emotional distress includes symptoms (e.g., insomnia, headaches, and stomach disorders) which may result from such emotional distress.''[3] Although the Tax Court acknowledged that there was some evidence that Moulton was actually treated by a psychologist before, during, and after the year in question, the court found no substantiation in the record of any actual expenditures for medical care. Consequently, the Tax Court found that Moulton had not demonstrated eligibility for the section 104 exclusion for any portion of his recovery.

Finally, the Tax Court imposed accuracy-related penalties under section 6662(a). The court noted that Moulton failed to include any portion of the $65,000 settlement in his income. Not only that, but it did not appear that Moulton engaged in any investigation of the merits of his tax claim. That is, he didn't hire a tax professional, and there was no evidence that he pursued any other avenue to educate himself about section 104. Given that his settlement agreement said the $65,000 payment was subject to all applicable taxes, Moulton should have been on notice there were tax issues here. Besides, he even received a Form W-2.

[3]*See* H. Conf. Rep. No. 104-737, 1996-3 C.B. at 1041.

Consider the Record!

Moulton is hardly a benchmark case. Indeed, it is unexceptional. The problem is that there have been so many others like it.[4] Those cases may help to warn other taxpayers. Considering the number of taxpayers who end up fighting over section 104 issues, taxpayers and their advisers should be cataloguing those cases.

Warning seems needed, for despite the frequency of these cases, significant confusion remains. There is confusion not only among taxpayers, but even among tax advisers. The physical vs. nonphysical line is clearly not as bright as the IRS or Congress wanted to make it. Nevertheless, Moulton didn't have much of a tax case. The line is not as ambiguous as taxpayers might think.

Pain Redux

Another recent example is *Carranza v. Commissioner*.[5] This case concerned a settlement payment from another wrongful termination action. Here again the taxpayer did not report the settlement as income. Yet at least this taxpayer had a few more physical elements present.

Mr. Carranza worked for a manufacturing company for 25 years. His job pressure led to anxiety and hypertension, which may have caused a central arterial occlusion and loss of sight in his left eye during 1999. He also developed a hematoma in his leg, affecting nerves and muscles, eventually making it difficult for him to walk. He became unable to walk up or down stairs, and he could not function effectively in his supervisory position.

Thus, in 2001, on his doctor's advice, he was assigned lighter job responsibilities. He was not able to meet his job responsibilities and was apparently also subjected to comments about his physical condition. In 2002 he was fired, and his anxiety thereafter became severe. He was in the care of three different psychiatrists, and because of his mental and physical condition, he was unable to obtain another job.

After Carranza was dismissed, his wife negotiated a severance agreement with the company under which he was paid $1,000 per week for 19 weeks. At about the same time, Carranza contacted a lawyer and filed suit. The complaint sought damages for violations of the California Fair Employment and Housing Act, including disability discrimination, age discrimination, wrongful termination in violation of public policy, and breach of an implied contract because of wrongful termination of employment.

The complaint alleged that Carranza was disabled because of his medical conditions of vascular embolic disease, hypertension, and glaucoma. He alleged that he

[4]For summaries of many cases, see Robert W. Wood, ''Getting Physical: Emotional Distress and Physical Sickness,'' *Tax Notes*, Oct. 20, 2008, p. 281, *Doc 2008-19673*, or *2008 TNT 204-27*; Wood, ''Recent Damage Awards Decisions,'' *Tax Notes*, Sept. 5, 2005, p. 1129, *Doc 2005-18117*, or *2005 TNT 169-15*; and Wood, ''Post-1996 Act Section 104 Cases: Where Are We Eight Years Later?'' *Tax Notes*, Oct. 4, 2004, p. 68, *Doc 2004-18582*, or *2004 TNT 189-27*.

[5]T.C. Sum. Op. 2009-28, *Doc 2009-4300, 2009 TNT 37-18*.

had been suffering from those conditions since June 1999. He also alleged that he was disabled because of the hematoma in his left leg.

Carranza sought damages for medical expenses, general damages for emotional distress and mental suffering, exemplary and punitive damages, and attorney fees. Carranza applied for disability payments from the Social Security Administration and began receiving disability pay. He also filed a worker's compensation claim with the state of California, receiving a separate $49,000 settlement.

In 2003 Carranza settled his suit against the company for $162,500. Of this amount, $97,500 was paid directly to Carranza for ''personal injury in the form of emotional distress damages.'' The remaining $65,000 was paid directly to his attorney. The settlement agreement said that a Form 1099-MISC would issue for the $97,500 settlement ''for personal injury in the form of emotional distress damages.'' The settlement agreement also called for a Form 1099 for $65,000 for the lawyers' fee to be issued solely to the attorney.

Carranza's tax return preparer concluded that the $97,500 settlement was excludable from Carranza's income under section 104. Likewise, his return also did not report the attorney fees.

Hard Lessons

The Tax Court reviewed the facts, the basics of section 104, and the nature of Carranza's claims. Considering the two-pronged Schleier test, the Tax Court noted that there was no problem in satisfying the first tort or tort-type rights element of the *Schleier* case. It was the second part that was the problem. Indeed, the court noted that although Carranza had sued his employer, he did *not* seek damages for physical disability caused by his working conditions.

Instead, he sought damages for emotional distress and mental suffering. Correspondingly, the settlement he received was also for emotional distress damages. The court seemed to take no glee in noting that, in considering the tax treatment of litigation recoveries, courts generally first look to the express language of a settlement agreement.[6] Carranza's settlement agreement expressly attributed his settlement to emotional distress and mental suffering.

Plus, he did not even allege in his complaint that his working conditions caused him physical injury. The court noted that there was some evidence in the record that *might* support a finding that his working conditions were a contributing factor to some of his physical problems. Yet clearly that was not the focus of the investigation.

Finding itself hamstrung by the facts and by the express language of the settlement agreement, the Tax Court said that ''with such compelling and explicit language,'' the payment simply was not excludable. The settlement plainly was not paid on account of physical injury. Turning to the attorney fees question, the court noted the Supreme Court decision in *Commissioner v. Banks*.[7] Until the *Banks* case there had been considerable differences in the treatment of attorney fees.

Yet the Supreme Court in *Banks* ruled that the attorney fees would be gross income to the plaintiff. Unfortunately, given that Carranza's settlement occurred in 2003 (before the enactment of the above-the-line deduction for employment cases), poor Mr. Carranza had to include the attorney fees in his income. Then, he could only deduct them as a miscellaneous itemized deduction. Apart from the 2 percent threshold, Carranza faced the application of the alternative minimum tax.

Finally, the court turned to the potential applicability of accuracy-related penalties, and the taxpayer's reliance on his return preparer. The Tax Court concluded that the preparer was a competent professional with sufficient expertise to prepare the return, and that it was reasonable for Carranza to rely on his preparer. Unlike Mr. Moulton who had not bothered to investigate the tax law at all, Carranza had at least tried. The Tax Court therefore held that Carranza was not liable for accuracy-related penalties.

Wording and Proof

This has become an unfortunate area. To be sure, there are some taxpayers who push the envelope, who make section 104 claims that are ridiculous. Yet there are many more taxpayers, those like Mr. Carranza, who unwittingly enter the fray. So often, as evidently occurred in his case, the clients tend to think of the recovery in a generalized fashion. This is understandable. They consider the injuries or illnesses to which they have been subjected, and the package of payments with which they may be provided in the end.

There may be some degree to which they see their recovery through rose-colored glasses, often encouraged by their non-tax counsel. Yet often, it is not so easy to say expressly what they are asking for. That appears to be critical. It is crucial to examine not only what they are *asking* for, but what they are *awarded*. Exact wording is terribly important, especially in settlement agreements.

Mr. Carranza's settlement agreement was less than artful. Exactly what did the plaintiff and defendant mean when they wrote that the settlement payment was for ''personal injury in the form of emotional distress damages''? Surely personal and physical are not the same, or we would have had no 1996 amendments to section 104.

Emotional distress damages without more are taxable. Had the parties even wanted to give lip service to the notion that those settlement funds were for physical injuries, physical sickness, and emotional distress arising from such, they would have said so.

***Murphy*'s Legacy**

Recall one of the lasting lessons of the *Murphy*[8] case. When the smoke finally cleared on the second *Murphy* opinion, we learned that if a recovery is for ''emotional distress'' it is taxable even if bruxism is present. Conversely, we learned that if the recovery was for bruxism

[6]*See Rivera v. Baker West, Inc.*, 430 F.3d 1253 (9th Cir. 2005), *Doc 2005-25068, 2005 TNT 239-11* (9th Cir. 2005).

[7]543 U.S. 426 (2005).

[8]*Murphy v. IRS*, 493 F.3d 170 (D.C. Cir. 2007), *Doc 2007-15777, 2007 TNT 129-4.*

itself, it is probably excludable. In the now infamous first *Murphy* opinion, Chief Judge Ginsburg ruled that the income tax (at least as it was applied to Murphy's recovery) was unconstitutional.[9] Ginsburg concluded that Congress could not legitimately differentiate between injuries to reputation and injuries to one's person.

That case caused more than a few observers to recall that Judge Ginsburg likely would have been sitting on the U.S. Supreme Court if he had not admitted to having smoked marijuana.[10] In any event, Judge Ginsburg vacated his first decision and set the *Murphy* case for reargument.[11] The second time around, with virtually no discussion (and certainly no admission that there was anything amiss in his first opinion), Judge Ginsburg focused intently on the language of the arbitration award that gave Ms. Murphy money for ''emotional distress.''

Whether or not Murphy suffered bruxism (she did), and whether or not bruxism is physical (the court seemed to admit that it was), that wasn't *why* she received her award. Murphy's award, the arbitration decision document clearly stated, was for emotional distress. The D.C. Circuit (in its second Judge Ginsburg opinion) acknowledged that the stated *reason* a payment is made is terribly important to its tax character.

A payment for bruxism presumably would be tax free. Conversely, a recovery for emotional distress *accompanied by bruxism* would not. Bruxism may by itself be a physical sickness or even a physical injury. Yet, if it is a byproduct of emotional distress, it is evidently not a physical injury or physical sickness.

'On Account of' What?

Judge Ginsburg in his redo of *Murphy* focuses on the ''on account of'' phrase that appears in section 104(a)(2). To put the importance of this phrase in context, the statute says you can exclude from your income damages you receive only if they are paid to you ''on account of'' personal physical injuries or physical sickness. The critical inquiry, wrote Judge Ginsburg in *Murphy,* is when something is paid ''on account of'' the enumerated items. Judge Ginsburg noted that Murphy no doubt suffered physical problems.

Yet Judge Ginsburg referred to a written record which enunciated that the Labor Board awarded Murphy compensation *only* for mental pain and anguish and for injury to professional reputation. Sure, noted Judge Ginsburg, the record showed that there *were* physical ailments, and that the board may have even *considered* them. He simply could not say the board had *actually* awarded Murphy damages *because* of her bruxism and other physical manifestations of stress.[12]

Nevertheless, Murphy noted that both the administrative law judge and the arbitration board in her case expressly cited the portion of her psychologist's testimony establishing her physical injuries. She therefore argued that the board relied on those physical injuries in determining her damages. That does seem like a reasonable inference. Even so, the *Murphy* opinion refuses to connect the dots.

In an odd concluding paragraph on this point, Judge Ginsburg stated that ''at best the Board and the ALJ may have considered her physical injuries . . . but her physical injuries themselves were not the reason for the award.''[13] Quoting the U.S. Supreme Court, Ginsburg concludes: ''Murphy's damages were not 'awarded by reason of, or because of [physical] personal injuries.'''[14] This ''on account of'' language (to which the court in *Murphy* adheres like a barnacle) appears in *O'Gilvie*.

O'Gilvie was a case evaluating the tax treatment of punitive damages awarded for the wrongful death of a woman. The jury awarded both compensatory and punitive damages, and there was never any question about the excludability of the compensatory damages. The Supreme Court held that punitive damages are taxable, representing a windfall to the plaintiff.[15] The Court failed to advance the ''on account of'' debate with its meanderings into causation.

Causation

If the evidence in *Murphy* had shown that the ALJ awarded money to Murphy *because* of her bruxism, the tax result could have been different. If the ALJ had acknowledged that the bruxism was caused by the emotional distress, which was caused by the defendants, that would be ideal. If the judge's order so stated, or if there was a transcript in which the judge's reasoning was clear, even though the judge ultimately stated in his order that the payment was ''for emotional distress,'' this record should arguably be enough for excludability.

Indeed, because the court in *Murphy* concluded that Murphy did not carry her burden of showing that her recovery was ''on account of'' physical injury/sickness, it is worth asking what *would* have worked. Notes, pleadings, and a transcript should all be relevant. Surely the language of the order itself should not be the only reference point.

The IRS has long maintained that it is not bound by characterizations in court orders or settlement agreements.[16] That rule should work both ways.

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[9]460 F.3d 79 (D.C. Cir. 2006), *Doc 2006-15916, 2006 TNT 163-6*.

[10]*See* Brian Duff and Donald Baer, ''Up in Smoke: The Undoing of a High Court Nominee,'' *U.S. News & World Report*, Nov. 16, 1987.

[11]For further history, see Wood, ''Tax-Free Damages: Murphy's Law Opens Floodgates,'' *Tax Notes*, Sept. 4, 2006, p. 850, *Doc 2006-16362*, or *2006 TNT 172-37*; and Wood, ''Waiting to Exhale: *Murphy* Part Deux and Taxing Damage Awards,'' *Tax Notes*, July 23, 2007, p. 265, *Doc 2007-16168*, or *2007 TNT 142-29*.

[12]*Murphy*, see note 8 *supra*.

[13]*Id.* at 176.

[14]*Id.*, citing *O'Gilvie v. United States*, 519 U.S. at 79, 83 (1996), *Doc 96-31894, 96 TNT 240-1*.

[15]Contemporaneously, Congress also made this point clear in the 1996 changes to section 104.

[16]*See Robinson v. Commissioner*, 102 T.C. 116 (1994), *Doc 94-1439, 94 TNT 23-18*, *aff'd in part and rev'd in part*, 70 F.3d 34 (5th Cir. 1995), *Doc 95-10932, 95 TNT 238-7*; *McKay v. Commissioner*, 102 T.C. 465 (1994), *Doc 94-3399*, *94 TNT 60-9*, *vacated on other grounds*, 84 F.3d 433, *Doc 96-13888, 96 TNT 92-7* (5th Cir. 1996); *Brown v. United States*, 890 F.2d 1329, 1342 (5th Cir. 1989).

Yet the ''on account of'' phrase continues to be enigmatic, and given its manifest importance, this is disturbing. The *Murphy* court says *O'Gilvie*[17] makes the exclusion available only for personal physical injury damages awarded by reason of, or because of, the personal physical injuries. *Murphy* cites *O'Gilvie* for the notion that something stronger than but-for causation is required. These gradations of ''why'' a payment is made are troubling.

In fact, they conjure up notions of the provisions in the code focusing on a ''principal'' purpose, which recognize that there are generally multiple reasons for things. 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).[18] The same language appeared in the 1939 code, the 1954 code, and the 1986 code. 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. 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.[19]

'On Account' vs. 'Physical'

In analyzing a wrongful or tortious act, Congress required that the action have its *origin* in a physical injury or sickness. 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.[20]

Of course, we still need to know what is physical. If the IRS will not define the term in regulations, then taxpayers must do the best they can. Murphy pointed both to her physician's testimony that she had experienced ''somatic'' and ''body'' injuries ''as a result of [the defendant's] blacklisting.'' She also pointed to 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.'' She submitted dental records which proved she had suffered permanent damage to her teeth.

That sure sounds physical. Quite apart from rudimentary sources like dictionaries, Murphy cited several federal court decisions showing that for various purposes, substantial physical problems caused by emotional distress are *indeed* considered physical injuries or physical sickness.[21] There is little guidance, and reasonable minds can and do differ on what qualifies.

The IRS itself often looks to medical records and other evidence to see how sick or how injured the taxpayer/plaintiff really was. In my practical experience, Murphy was right to focus on what is physical. At many levels, the IRS does this too.

Wordsmithing and Proof

Language is important, but so is proof. In some cases, the plaintiff might be able to demonstrate only that he *claimed* this causal connection, not that it actually existed. For example, in *Henderson v. Commissioner*,[22] the taxpayer failed to prove that any portion of his recovery was paid on account of personal physical injuries or physical sickness.[23] Similarly, in *Tritz v. Commissioner*,[24] the Tax Court found that payments were not excludable notwithstanding allegations about carpal tunnel syndrome.

It sometimes seems that the IRS and the courts focus intensely — and perhaps a bit too much — on what the parties have said in their settlement agreement. Suppose we have a recovery emanating from employment claims, with wages paid separately, with the bulk of the recovery being for emotional distress and reputation-like injuries. If there are physical injuries or there is physical sickness (such as bruxism), should it matter if the parties have said the defendant caused the bruxism, or if the parties have said the defendant caused emotional distress that caused the bruxism? Should it matter exactly how the settlement agreement is worded?

Clearly it does matter, but it is interesting to contemplate if it *should* matter, or at least if it should matter as much as it appears to. Congress drew its line, and the legislative history to the 1996 change is clear that physical symptoms of emotional distress are not tax free. The IRS and the Tax Court have done their best to interpret the facts and the language of settlement agreements to give meaning to this important distinction. In the rough and tumble of real life, however, how real this distinction is, and how one can separate the sheep from the goats, remains debatable.

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[17]519 U.S. at 454.

[18]*See* Revenue Act of 1918, ch. 18, section 213(b)(6).

[19]H.R. Conf. Rep. No. 104-737, at 300 (1996).

[20]*See Paton v. Commissioner*, T.C. Memo. 1992-627 (wrongful death), and LTR 200121031, *Doc 2001-15011, 2001 TNT 103-10* (wrongful death and loss of consortium).

[21]*Walters v. Mintec/International*, 758 F.2d 73 (3d Cir. 1985), and *Payne v. General Motors Corp*. 731 F. Supp. 1465, 1474-1475 (D. Kan. 1990).

[22]T.C. Memo. 2003-168, *Doc 2003-14014, 2003 TNT 111-12*.

[23]*See also Witcher v. Commissioner*, T.C. Memo. 2002-292, *Doc 2002-26347, 2002 TNT 229-6*.

[24]T.C. Summ. Op. 2001-76, *Doc 2001-15770, 2001 TNT 108-12*.