

## Is Physical Sickness the New Emotional Distress?

By Robert W. Wood

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In this article, the author comments on the impetus for excluding physical sickness recoveries from income, noting the Tax Court's *Domeny* decision as a bellwether of change. He concludes that the ruling will expand section 104.

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"You make me sick," may be a familiar refrain on TV sitcoms. It can even figure into playful banter between spouses. Yet the phrase seems to be cropping up in earnest more and more frequently in litigation.

The notion that conduct has a causal link to sickness — real sickness, not merely being upset — is becoming more and more accepted. In her latest report to Congress in January 2010, National Taxpayer Advocate Nina Olson made this a point. She has argued for parity between the taxation of emotional and physical injuries.<sup>1</sup> She even asked Congress to amend section 104 to make emotional distress recoveries tax-free.<sup>2</sup>

This is no emotional appeal. The national taxpayer advocate uses scientific data to back up her views that there are decidedly physical elements of depression and other disorders. Many medical health professionals now acknowledge the biological causes of mental disorders. They also acknowledge that many mental disorders show up as physical symptoms.<sup>3</sup>

<sup>1</sup>See National Taxpayer Advocate, "2009 Annual Report To Congress," Dec. 31, 2009, p. 351 et seq., *Doc 2010-174*, 2010 TNT 4-19.

<sup>2</sup>*Id.* at 352.

<sup>3</sup>See National Institutes of Health, "The Science of Mental Illness," available at <http://science.education.nih.gov/> (Footnote continued in next column.)

Moreover, Olson suggests that present tax law conflicts with public policy and even with expressed congressional intent. The national taxpayer advocate refers to mental health parity legislation passed in 2008 specifying nondiscrimination. A group health plan that provides both medical or surgical benefits and mental health or substance use disorder benefits cannot apply any financial requirement or treatment limitation to mental health or substance use disorder benefits that is more restrictive than the predominant financial requirement or treatment limitation of that type applied to most medical or surgical benefits.<sup>4</sup>

In other words, there should be no discrimination or distinction between physical and mental illness. Olson argues that this recent expression of congressional intent conflicts with the 1996 version of section 104.

### Proving Sickness

Axiomatically, sometimes things are exactly what you call them. This is often proven true regarding the tax treatment of settlement payments. Optimally, the settlement agreement should clearly state *why* the payment is being made.<sup>5</sup> The IRS and the courts are not bound by such language, or by any tax characterization in the agreement, but they do consider it.<sup>6</sup>

Thus, the agreement should not only say *why* the payment is being made, but should also address the tax treatment of the item. That is particularly true when asserting that the settlement is tax-free under section 104. On the latter point, the issuance of a Form 1099 should be negated since if a payment is truly excludable under section 104, it should not be subject to Form 1099 reporting.<sup>7</sup> At a minimum, however, the agreement should identify the nature of the payment.

Of course, merely reciting the nature of a payment does not make the recitation accurate. Such a recitation also does not preclude the IRS (or another agency) from piercing the language of the settlement agreement to

supplements/nih5/mental/guide/info-mental-b.htm; Nancy C. Andreasen, "The Broken Brain: The Biological Revolution in Psychiatry," 277 (1984).

<sup>4</sup>See P.L. 110-343, Div. C, sections 511-512, 122 Stat. 3765, 3881 (2008).

<sup>5</sup>See *Pipitone v. United States*, 180 F.3d 859, 863 (7th Cir. 1999), *Doc 1999-20743*, 1999 TNT 116-5.

<sup>6</sup>See, e.g., *Taggi v. United States*, 835 F. Supp. 744 (S.D.N.Y. 1993), *Doc 93-72817*, 93 TNT 94-58, *aff'd*, 35 F.3d 93 (2d Cir. 1994), *Doc 94-3296*, 94 TNT 57-9; see also *Robinson v. Commissioner*, 102 T.C. 116 (1994), *Doc 94-1439*, 94 TNT 23-18, *aff'd in part, rev'd in part on other grounds*, 70 F.3d 34 (5th Cir. 1995), *Doc 95-10932*, 95 TNT 238-7; *Bradley v. Commissioner*, T.C. Memo. 2005-223, *Doc 2005-19729*, 2005 TNT 186-7, *aff'd by unpublished op.*, 209 Fed. Appx. 40 (2d Cir. 2006), *Doc 2006-25332*, 2006 TNT 245-7.

<sup>7</sup>See Form 1099-MISC instructions (2010), p. 4.

investigate further. Yet it is nearly always a starting point.<sup>8</sup> Sometimes it is the ending point, too.<sup>9</sup> In most cases, in all types of litigation, therefore, the parties should try to agree on language characterizing the nature of payments.

Much litigation involves not one claim, but many. There may be multiple payments made to resolve multiple claims. That is why it is often appropriate (and sometimes necessary) to allocate a gross settlement payment among multiple claims, sprinkling dollar amounts among several categories. Armed with the facts, the discovery responses and pleadings, it is normally possible to develop a range of alternatives for such an allocation.

Optimally, this is done before (or as a part of) settlement negotiations. Sometimes I've had to do it after a settlement, and sometimes at tax time the year *after* the settlement. There are still principled ways to allocate a recovery after the fact, but it is always better to do so *before* the settlement is finalized.

### Recognizing Sickness

The recent Tax Court decision in *Julie Leigh Domeny v. Commissioner*<sup>10</sup> is an important new development that helps to expand and clarify the scope of the section 104 exclusion. Like most section 104 cases these days, *Domeny* arose out of an employment dispute. Domeny commenced working for Pacific Autism Center for Education (PACE) in 2000. Four years before that, she was diagnosed with multiple sclerosis (MS).

At the onset of her MS, she had a variety of physical problems, including numbness, fatigue, lightheadedness, vertigo, and sometimes a burning sensation behind her eyes. Because of side effects from the prescribed treatment, she chose to manage her symptoms without medication. In fact, one reason she took the job with PACE postdiagnosis was that the position there offered her the chance to work where she would not spend much time on her feet.

Her work involved community development, fundraising, and writing grants, and she felt a symbiosis between autism and her own MS. In 2004, however, under PACE's new executive director, Domeny experienced a variety of workplace problems. They caused her MS symptoms to flare up. In November of 2004, she learned that the director of PACE was embezzling funds from the personal accounts of PACE students.

Domeny complained to PACE's board and was assured they would handle it. Understandably, she felt tension and worry as the weeks wore on. She was upset to be raising funds for PACE knowing that those funds were being embezzled.

Over the next few months, Domeny advised her superiors of the unhealthy work environment on several occasions. She noted her continuing stress over the embezzlement and over the organization's failure to act. She continued to have elevated stress and experienced an intensification of her MS symptoms.

Finally, on March 8, 2005, she visited her primary care physician. He determined that she was too ill to work because of her MS symptoms, and that she should not return until after March 21, 2005. Her symptoms at that point included vertigo, shooting pain in both legs, difficulty walking because of numbness in both feet, a burning sensation behind her eyes, and extreme fatigue.

Domeny's physician notified PACE of his diagnosis by facsimile on March 8, 2005, instructing that she should stay home until at least March 21, 2005. PACE's executive director called Domeny immediately after receipt of the fax and terminated her as of March 15, 2005. After that call, Domeny's physical MS symptoms started "spiking," including shooting pain up her legs, fatigue, burning eyes, spinning head, vertigo, and lightheadedness.

Domeny contacted a lawyer who negotiated a settlement without filing suit. The settlement agreement was entitled "Severance Agreement and Release of Claims," and noted that she had various potential causes of action or legal rights. The catalog of these legal rights included claims for termination of employment; rights under the California Fair Employment and Housing Act; rights under the Civil Rights Act of 1964, the Americans with Disabilities Act, the Age Discrimination in Employment Act, the Family and Medical Leave Act or the California Family Rights Act, the Fair Labor Standards Act, and the California Labor Code or California Wage Orders; and any claims for breach of contract, breach of the covenant of good faith and fair dealing, invasion of privacy, infliction of emotional distress, defamation, and misrepresentation.

The settlement agreement awarded a total of \$33,308, and specified the following categories:

- \$8,187.50 as compensation to Domeny, that would be reported as compensation (but paid to her lawyer);
- A second \$8,187.50, also paid to her attorney; and
- \$16,933 (paid directly to Domeny).

Domeny did not attend the negotiations between PACE's lawyer and her own lawyer. When she received her \$16,933 settlement, she understood it was to compensate her for physical injuries that occurred in a hostile work environment that PACE allowed to exist over an extended period. Domeny's intense MS symptoms continued to prevent her from working until sometime in 2006.

### Connecting the Dots

Domeny reported the first \$8,187.50 as compensation income and reported and deducted the legal fees. She excluded the \$16,933 from income. The sole question in the case was whether the \$16,933 settlement was excludable under section 104.

The Tax Court found it clear that Domeny's exposure to a hostile and stressful work environment had exacerbated her MS symptoms. The settlement agreement contained a blanket release of all claims, and the payments

<sup>8</sup>See Wood, "Tax Treatment of Settlements and Judgments," *Tax Notes*, May 31, 2004, p. 1134, *Doc 2004-11040*, or *2004 TNT 101-27*.

<sup>9</sup>See *McKay v. Commissioner*, 102 T.C. 396 (1995), *vacated on other grounds*, 84 F.3d 433 (5th Cir. 1996); and *Threlkeld v. Commissioner*, 87 T.C. 1294 (1986).

<sup>10</sup>T.C. Memo. 6975-08 (Jan. 13, 2010), *Doc 2010-787*, *2010 TNT 9-9*.

were divided up, but there was no specific or express statement of the payer's intent in making the payments. Did PACE intend to pay Domeny for physical sickness?

Despite the lack of an express statement on this point, Judge Gerber of the Tax Court said an inference could be drawn from the terms of the settlement agreement. Indeed, the manner in which PACE agreed to pay out the settlement revealed a recognition of Domeny's claim and condition. The \$33,308 settlement was segregated into three distinct payments.

One payment of \$8,187.50 was reflected as employee compensation due to Domeny, which PACE agreed to pay directly to her attorney. Domeny reported that exact amount as wage compensation on her 2005 federal income tax return.

A second \$8,187.50 was also sent directly to her attorney, and PACE issued no Form 1099 or Form W-2 to Domeny for that amount. The remaining \$16,933 was paid to Domeny directly, with no withholding. However, PACE did issue a Form 1099-MISC reflecting this payment as "non-employee compensation."

### Tax Reporting Inferences

Judge Gerber found that the differing tax and reporting treatments of these three payments demonstrated that PACE was aware that at least part of Domeny's recovery may have been excludable as compensation for physical illness. Coupled with that inference, the Tax Court was influenced by the fact that Domeny had advised PACE of her illness *before* her employment was terminated. Judge Gerber also found it likely that her attorney represented her circumstances to PACE in the course of settlement negotiations.

In short, it appeared that PACE must have taken her physical sickness into account. Indeed, Domeny had made no other claim. To the Tax Court, that meant it was reasonable to believe that PACE intended to compensate Domeny for her acute physical illness caused by her hostile and stressful work environment. To the Tax Court, this taxpayer demonstrated that her work environment exacerbated her existing physical illness.

There's been much talk of causation in tax cases, and yet this case was about PACE making Domeny's health worse, not making it bad to begin with. Yet in a footnote, the court noted that "it is of no consequence that Petitioner had the MS condition before the flare-up caused by her hostile work environment."<sup>11</sup> Judge Gerber was satisfied that the *only* reason Domeny received the \$16,933 payment was to compensate her for her physical injuries as manifested in her physical illness.

This may be a mere question of semantics, but Judge Gerber appears to have concluded that the payment was for "physical illness" which is a physical injury within the meaning of section 104(a)(2). Surely it is a small step to conclude that, in fact, the taxpayer's payment was made on account of her physical sickness, which would be no less excludable under section 104(a)(2).

<sup>11</sup>*Id.*, at n. 7.

### More Cases

It may be difficult for clients to see the forest for the trees. It is also hard to examine one's own circumstances dispassionately. There are, after all, many other tax cases in which section 104 has been examined in the context of employment claims. In some of these, there are serious physical events or physical consequences befalling the plaintiffs.

Yet in most section 104 cases, it is difficult for plaintiffs to convince the IRS or the Tax Court that they were paid on account of personal physical injuries or personal physical sickness. Take *Justin W. Hansen v. Commissioner*.<sup>12</sup> Hansen was a mineworker who was assaulted by his supervisor.

The supervisor threw Hansen to the ground and pushed his face into limestone powder. Later, the supervisor came to Hansen's home and assaulted him there too, bruising him and producing a small cut on Hansen's foot. Hansen called the police and filed a complaint with the Mine Safety and Health Administration. A few days later, Martin Marietta, which operated the mine, fired him.

Hansen went to a lawyer. When he received a settlement of \$120,000, it appeared Hansen had a pretty good case that some (or all) of the payment should be excludable under section 104. The settlement agreement allocated \$20,000 to back wages (on a Form W-2) and the other \$100,000 to "emotional distress and attorneys' fees." Hansen didn't report the \$100,000 and landed in Tax Court.

Despite some convincing physical facts, the Tax Court (Judge Chiechi) concluded that the \$100,000 payment was for "emotional distress and legal fees" just as the settlement agreement said it was. The Tax Court even noted that Martin Marietta had issued a Form 1099-MISC for the \$100,000, further confirming (in the Tax Court's eyes) that the payer viewed the payment as taxable. (Judge Chiechi's observation on the Form 1099 stands in contrast to Judge Gerber's in *Domeny*.)

### Physical Effects?

In many tax cases involving section 104, there is little or no physical injury, no assault, and no bruising. It often looks as if a taxpayer who is claiming some kind of sickness is really just claiming emotional distress. Consider *Jon E. Helleesen v. Commissioner*.<sup>13</sup> Mr. and Mrs. Helleesen were both State Farm employees and both were fired.

Both claimed they suffered extreme and severe emotional distress, including lack of concentration, loss of self-esteem, embarrassment, anxiety, humiliation, and stress. Mr. Helleesen also claimed physical problems as a result of his termination. They included escalations in chest pain, aching pain and loss of sensitivity on the right side of his forehead, increased blood pressure, weight loss, upset stomach, irregular bowel movements, headaches, and emotional instability. He had one appointment

<sup>12</sup>T.C. Memo. 2009-87, *Doc* 2009-9580, 2009 TNT 80-9.

<sup>13</sup>T.C. Memo. 2009-143, *Doc* 2009-13919, 2009 TNT 116-9.

each with two different physicians but did not provide a diagnosis or even proof of medical expense.

Judge Vasquez of the Tax Court methodically reviewed the catalog of events and conditions and clearly did not think much was going on that was too serious. Yet Judge Vasquez seems to hang his hat primarily on the settlement agreement itself, noting that the agreement did not allocate any portion of the amount among these claims. Further, Judge Vasquez noted, physical injuries or sickness were not even alleged in the complaint. Not surprisingly, the Tax Court found section 104 inapplicable.

In *Marion J. Wells*,<sup>14</sup> the court considered the aftermath of an employment dispute over alleged gender discrimination. The taxpayer claimed that the discrimination led to her depression. However, the settlement agreement had ascribed the payment to “emotional distress due to depression.” The settlement agreement specified that a Form 1099 would be issued and it was. The Tax Court (Chief Special Trial Judge Panuthos) determined (on the government’s motion for summary judgment) that there was no material issue of fact and that the payment simply was not excludable.

In *Emblez Longoria v. Commissioner*,<sup>15</sup> a New Jersey state trooper claimed racial discrimination and physical injuries. Longoria faced several physical incidents, including being forced during a training exercise to inhale noxious chemical agents that he said caused burning in his lungs. He was also singled out to swim extra laps in the pool, which he claimed sickened him.

More seriously, Longoria’s requests for backup to help with a suspect were ignored. As a result, he injured his back when a suspect resisted arrest. Finally, at one point, other troopers piled gear in his locker. Longoria claimed he was injured when he opened the locker, dislodging its contents.

What about Longoria’s settlement agreement? It was woefully plain, releasing everything but providing no tax allocation. He was paid a lump sum of \$156,667 and received a Form 1099. Trying to exclude the payment, he landed in Tax Court.

The Tax Court opinion is well reasoned and thorough, and seems to reflect some misgivings. Judge Gustafson noted that Longoria clearly experienced various physical incidents. He even had some physical injuries. The problem was that none of these injuries was alleged in his complaint.

The court simply found that it could not agree that the state of New Jersey had agreed to settle *because* of any of these physical claims. Given that Longoria had the burden of proving what damages were paid on account of physical injuries or physical sickness, the court felt compelled to treat the entire amount as taxable.

### Cause and Effect

The Tax Court’s Judge Gerber (who wrote the *Domeny* opinion) decided differently in *Paul J. and Allen C. Prinster*

*v. Commissioner*.<sup>16</sup> Paul Prinster was fired and suffered mental distress. He claimed that his hypertension, hyperlipidemia, and other ailments were caused by his mental distress. He received a \$76,500 settlement and claimed it was not income, despite receiving a Form 1099.

Judge Gerber found that Prinster did not sufficiently show that his ailments resulted from his termination. In fact, Judge Gerber commented that the record showed he had *already* been suffering from hyperlipidemia, and that any other symptoms could have been the product of his diet and lifestyle. He simply failed to meet his burden of proof. The settlement was therefore taxable.

*Prinster* is a clear departure from *Domeny*. Judge Gerber discerns the former to be an employment dispute, not unlike the kind that often produces emotional distress and even physical ailments. The judge finds a fundamental lack of diligence, however, on the part of the plaintiff from complaint to diagnosis.

In contrast, *Domeny* involved patently serious illness and demonstrable causation. True, PACE did not *cause* the MS, but it clearly exacerbated it. PACE’s actions clearly aggravated Domeny’s symptoms. Moreover, the symptoms did not indicate emotional distress; they were symptoms of physical illness that were substantial enough to constitute a physical injury.

It was Judge Goeke who reached the “no exclusion” holding in *Hartford and Josephine Shelton v. Commissioner*.<sup>17</sup> Shelton had been employed by Dial Corp. and suffered sexual harassment. As a result of the harassment, she developed severe emotional problems and sought medical help.

Shelton took antidepressants and other medication. She filed a claim with the Equal Employment Opportunity Commission and eventually signed a release under which she received \$123,500. She was issued a Form 1099 for the entire amount but claimed it was all excludable under section 104.

Judge Goeke ruled that although Shelton may have suffered physical injury as a result of her sexual harassment, her settlement payment was not excludable. (Interestingly, Judge Goeke refers to physical injury, not physical sickness.) The settlement agreement itself said that the money was for emotional pain, suffering, inconvenience, and mental anguish. Physical injury was not mentioned.

### Is It Soup Yet?

We all like bright lines. For this reason, the “observable bodily harm” standard developed by the IRS in the wake of the 1996 statutory change is understandable. It may even be a convenient line. Yet it has not worked very well, and it is unjust.

Anyone wanting to argue the administrative efficiency of the “observable bodily harm” standard may want to review the Tax Court’s collected cases over the last few

<sup>14</sup>T.C. Memo. 2010-5, *Doc 2010-221*, 2010 TNT 3-10.

<sup>15</sup>T.C. Memo. 2009-162, *Doc 2009-15184*, 2009 TNT 126-16.

<sup>16</sup>T.C. Summ. Op. 2009-99, *Doc 2009-14983*, 2009 TNT 124-47.

<sup>17</sup>T.C. Memo. 2009-116, *Doc 2009-11892*, 2009 TNT 99-7.

years,<sup>18</sup> or even the current docket. As the National Taxpayer Advocate has pointed out, there are a huge number of these section 104 cases. That can't be efficient. The Tax Court judges have to deal with these cases. They are very repetitive, seem to put the court in a no-win position, and must be frustrating to handle.

Yet most Americans have an excuse for continuing to litigate the murky scope of the exclusion provided by section 104. Perhaps dedicated tax professionals may be chargeable with the knowledge that the Service expects observable bodily harm for an exclusion. However, most people still don't know this. It is not easy to articulate what is and isn't excludable even if you've read everything issued by the IRS and the Tax Court.

The Service hasn't exactly done a great job with its regulations. The section 104 regs were unchanged from 1970 (long before the 1996 statutory change) to 2009. Finally in 2009, proposed regulations were issued but still failed to include *any* information about what "physical" means, what "physical sickness" means, or the causal link that needs to be shown.<sup>19</sup> That is a shame.

Of course, the IRS has issued many private letter rulings. One of the most notable is the bruise ruling.<sup>20</sup> In that instance, the Service laid down its approach to bifurcating damages in a serious sexual assault and harassment case arising in the employment context. Yet neither that ruling nor any since has discussed the tougher case, in which physical sickness is arguably caused by or exacerbated by the defendant. (The *Domeny* case is clearly correct, and I hope the IRS embraces it.)

I say "arguably" in the preceding paragraph because in most litigation there is a settlement, not a judgment. Rarely is there a judicial finding that the defendant actually caused the harm. It may be quite clear that the plaintiff *says* so and that the defendant denies it. Yet if most cases settle, it follows that there is usually no definitive causal finding of who did what to whom.

<sup>18</sup>See Wood, "Post-1996 Section 104 Cases: Where Are We Eight Years Later?" *Tax Notes*, Oct. 4, 2004, p. 68, *Doc 2004-18582*, or *2004 TNT 189-27*.

<sup>19</sup>See REG-127270-06, 2009-42 IRB 534, *Doc 2009-20411*, 2009 *TNT 176-6*.

<sup>20</sup>LTR 200041002 (July 17, 2000), *Doc 2000-26382*, 2000 *TNT 201-10*.

The settlement agreement (even one that is properly specific as to the nature of the payment and its character for tax purposes) will usually be clear that the defendant is not admitting anything. When a defendant is willing to pay for fear that it will be found to have caused a condition, that ought to be all the causation that is needed.

The IRS has appropriately presumed observable bodily harm in some circumstances, but that alone does not fix the problem. Although the Service took a laudable position in a 2008 legal memorandum (presuming observable bodily harm in a sex abuse case at least on particular facts),<sup>21</sup> it didn't say anything about physical sickness.

Just what is physical sickness, anyway? Is it physical illness? Is it physical illness giving rise to physical injury? Should the semantics matter?

Of course, the statute is clear that it excludes from income damages paid on account of physical injuries *or* physical sickness. Judge Gerber seems right to use the preferred nomenclature, finding that the \$16,933 payment to *Domeny* "was to compensate her for her physical injuries." Yet through much of the opinion, he uses the term "physical illness," presumably a synonym for physical sickness.

Most of the tax cases that have raised the physical sickness aspect of section 104 have been lackluster. In contrast, *Domeny* is a bell ringer. Excluding the payment, Judge Gerber ruled that the taxpayer "has shown that her work environment exacerbated her existing physical illness," despite the lack of specific wording in the settlement agreement.

### Conclusion

Judge Gerber's decision in *Domeny* is an important and commendable one, and his reasoning and conclusions are surely correct. As Olsen points out, we seem to be learning more all the time about the nexus between physical and mental, between action and illness.

Of course there may be some taxpayers who will claim they were "made sick" and who may exaggerate those claims. However, that is not a reason to deny the righteous the appropriate tax treatment for their recoveries.

<sup>21</sup>CCA 200809001 (Nov. 27, 2007), *Doc 2008-4372*, 2008 *TNT 42-21*.

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