recent tax case expands "SICKNESS" EXCLUSION

By Robert W. Wood

"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 mere upset—is becoming more and more accepted. In her latest report to Congress in January 2010, U.S. Taxpayer Advocate Nina Olson made this a point. She has argued for parity between the taxation of emotional and physical injuries.[1] She even asks Congress to amend Section 104 to make emotional distress recoveries tax-free.[2]

This is no emotional appeal. The 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.[3]

Moreover, Olson suggests that present tax law conflicts with public policy and even with expressed Congressional intent. The Taxpayer Advocate refers to mental health parity legislation passed in 2008 which generally requires parity from heath insurance plans that offer medical/surgical benefits as well as mental health/substance abuse benefits. Such plans are specifically now required to provide parity in treatment limitations and financial requirements.[4]

In other words, there should be no discrimination or distinction between physical and mental. Olson argues that this recent expression of Congressional intent recognizes the equal status of physical and mental illness. Plainly, she says, that conflicts with the 1996 version of Section 104.

Proving Sickness

Axiomatically, sometimes things are exactly what you call them. This is often proven true concerning the tax treatment of settlement payments. Optimally, you want a clear statement in the settlement agreement as to *why* the payment is being made.[5] The IRS and the courts are not bound by such language, or by any tax characterization included, but they do consider it.[6]

Thus, you may want not only to say *why* the payment is being made, but to go on to say something about the tax treatment of the item. That is particularly true if you will assert it is tax-free under Section 104. On the latter point, you may want to specifically negate the issue of a Form 1099. After all, if a payment is truly excludable under Section 104, it should not be subject to a Form 1099 reporting.[7] At a minimum, however, you certainly want to 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 foreclose the IRS (or another agency) from going behind the language of the settlement agreement to investigate further. Yet it is nearly always a starting point.[8] Sometimes it is the ending point too.[9] In the vast majority of cases, in all types of litigation, therefore, you should try to agree on such language.

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 downright 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 prior to (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 can still be 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*[10] is an important new case helping 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, light-headedness, vertigo, and sometimes a burning sensation behind her eyes. Due to side effects from the prescribed treatment, she chose to manage her symptoms without medications. In fact, one reason she took the job with PACE post-diagnosis was that her position there offered her the chance to work in an environment where she would not spend much time on her feet.

Her work involved community development, fundraising, and writing grants, and she felt a certain symbiosis between autism and her own MS. But in 2004, and under PACE's new executive director, Domeny experienced a variety of workplace problems. They caused her MS symptoms to flare up. Then 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, through, she felt tension and worry as the weeks wore on. It was upsetting 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 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 due to 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, giving instructions that she should stay home until at least March 21, 2005. PACE's executive director called Domeny immediately thereafter, and he 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 about her discharge, and her lawyer was able to negotiate 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, 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 which 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. In fact, it reached a point where she was unable to work. Her doctor confirmed it. Domeny had notified her employer of her condition, and a short time later, she was fired.

She then met with a lawyer, and the lawyer and PACE's lawyer worked out a settlement. The settlement agreement contained a blanket release of all claims, and the payments were divided up. However, there was no specific or express statement of the payor's intent in making the payments. Did PACE intend to pay Domeny for physical sickness?

Despite 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 was issued 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 her recovery may not have been subject to tax due to 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."[11] 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 very 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).

More Cases

It may be difficult for clients to see the forest for the trees. It is also difficult 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 some pretty significant physical events or physical consequences befalling 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.*[12] Hansen was a mineworker who was assaulted by his supervisor.

Hansen's supervisor threw him 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, you might think Hansen had a pretty good case that some (or all) of it 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 having some pretty good physical facts, the Tax Court (Judge Chiechi) had an easy time concluding that this 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 payor 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. Hellesen v. Commissioner.*[13] Mr. and Mrs. Hellesen 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. Hellesen also claimed physical problems as a result of his termination. They included escalations in chest pain and aching pain and loss of sensitivity on the right side of his forehead, increased blood pressure, weight loss, upset stomach, irregular bowel movement, headaches, and emotional instability. He had one appointment 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 too 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 settlement agreement did not allocate any portion of the amount among these claims. Furthermore, 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*,[14] 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) had an easy time concluding (on the government's motion for summary judgment) that there was no material issue of fact, and that this payment simply was not excludable.

In *Emblez Longoria v. Commissioner*,[15]a New Jersey State trooper claimed racial discrimination and physical injuries. Longoria faced several physical incidents, including being forced to inhale noxious chemical agents during a training exercise that he said caused burning in his lungs. He was also singled out for extra laps of the swimming 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 notes 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 to prove 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 decided the *Domeny* case) came out differently in *Paul J. and Allen C. Prinster v. Commissioner.*[16] 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 despite receiving a Form 1099, claimed it was not income.

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 carry his burden of proof. The settlement was therefore taxable.

Prinster is a nice contrast with *Domeny*. Judge Gerber discerns the former to be an employment dispute, not unlike the kinds of disputes that often produce emotional distress and even physical ailments. But there was a fundamental lack of follow through, 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 caused the uptick in Domeny's symptoms. Moreover, they were not symptoms of 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.*[17] 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.

She took anti-depressants and other medication. She filed a claim with the EEOC, 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 had an easy time with this one. He concluded 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 it as 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 bright line "observable bodily harm" standard may want to review the Tax Court's collected cases over the last few years.[18] For that matter, you could even look at the court's current docket. As the 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 even easy to articulate what is and isn't excludable, even if you read all that the Service and the Tax Court issues.

On that topic, the Service hasn't exactly done a great job with its regulations. The Section 104 regulations were unchanged from 1970 (long before the 1996 statutory change) to 2009. Finally in 2009, proposed regulations were issued.[19] Yet even after this hiatus of 13 years after the 1996 sea change, the 2009 regulatory iteration failed to include *any* information about what *physical* means, about what physical *sickness* means, or about the causal link that needs to be shown. That is a shame.

Of course, the Service has issued many private letter rulings. One of the most notable is the bruise ruling, Letter Ruling 200041002.[20] There, the Service lays down its (arguably) sensible 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, where 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 (which they do), it follows that in most cases there is no definitive causal finding of who did what to whom.

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. One can read the situation as involving a defendant willing to pay something for fear that it *will* be found to have caused it. That ought to be all the causation one needs.

The Service has (appropriately) presumed observable bodily harm in some circumstances, but that alone does not fix the problem. Indeed, as laudable as the Service was in Chief Counsel Advice 200809001[21] (presuming observable bodily harm in a sex abuse case at least on particular facts), it doesn'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 quite 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 expressly raised the physical sickness wing of Section 104 have been lackluster. In contrast, *Domeny* is a bell ringer. Excluding the payment, Judge Gerber says that the taxpayer "has shown that her work environment exacerbated her existing physical illness." Despite the lack of specific wording in the settlement agreement, that, he ruled, was the reason for the defendant's payment.

Conclusion

Judge Gerber's decision in *Domeny* is an important and laudable one. The facts presented in the case have the ring of truth, and Judge Gerber's reasoning and conclusions are surely correct. As Taxpayer Advocate Nina 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 such claims. However, that is not a reason to deny the righteous the appropriate tax treatment for their recoveries.

endnotes

1. See *National Taxpayer Advocate*, 2009 Annual Report To Congress, Dec. 31, 2009, p. 351 *et seq.*, Doc 2010-174 or 2010 TNT 4-19.
2. See *id.* at 352.
3. See National Institutes of Health (NIH), *The Science of Mental Illness*, available at **http://science.education.nih.gov/supplements/nih5/mental/guide/info-mental-b.htm**; Nancy C. Andreasen, *The Broken Brain: The Biological Revolution in Psychiatry 277* (1984).
4. See Pub. Law No. 110-343, Div. C, §§ 511-512, 122 Stat. 3765, 3881 (2008).
5. See *Pipitone v. U.S.*, 180 F.3d 859, 863 (7th Cir. 1999).
6. See, *e.g. Taggi v. U.S.*, 835 F. Supp. 744 (S.D.N.Y. 1993), *aff'd*, 35 F.3d 93 (2d Cir. 1994); *see also Robinson v. Comm'r*, 102 T.C. 116 (1994), *aff'd in part, rev'd in part on other grounds*, 70 F.3d 34 (5th Cir. 1995); *Bradley v. Comm'r*, T.C. Memo 2005-223, *aff'd by unpublished op.*, 209 Fed. Appx. 40 (2d Cir. 2006).
7. See Form 1099-MISC instructions.
8. See Wood, *Tax Treatment of Settlements and Judgments*, Vol. 103, No. 9, Tax Notes (May 31, 2004), p. 1134.
9. See *McKay v. Comm'r*, 102 T.C. 396 (1995), vacated on other grounds, 84 F.3d 433 (5th Cir. 1996); and *Threlkeld v. Comm'r*, 87 T.C. 1294 (1986).
10. T.C. Memo 6975-08 (Jan. 13, 2010).
11. See Tax Court Op., at n. 7.
12. T.C. Memo 2009-87, Doc. 2009-9580, 2009 TNT 80-9.
13. T.C. Memo 2009-143, Doc. 2009-13919, 2009 TNT 116-9.
14. T.C. Memo 2010-5 (2010).
15. T.C. Memo 2009-162, Doc. 2009-15184, 2009 TNT 126-16.
16. T.C. Sum. Op. 2009-99, Doc. 2009-14983, 2009 TNT 124-47.
17. T.C. Memo 2009-116, Doc. 2009-11892, 2009 TNT 99-7.
18. See Wood, *Post-1996 Section 104 Cases: Where Are We Eight Years Later?*, Tax Notes (Oct. 4, 2004) p. 68.
19. See REG-127270-06; 2009-42 IRB 534; Doc 2009-20411 or 2009 TNT 176-6.
20. July 17, 2000.
21. Nov. 27, 2007.

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