

Taxing Emotional Distress and Physical Sickness: Chicken or Egg?

by Robert W. Wood



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In this article, Wood explains how emotional distress claims can complicate the tax treatment of compensatory damages awarded for physical injury.

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The tax treatment of litigation damages is varied and can be complex. However, compensatory damages for personal physical injuries are supposed to be easy. They are tax free under section 104 of the tax code. But exactly what injuries are “physical” turns out to be messy.

If you make claims for emotional distress, your damages are taxable. If you claim that the defendant caused you to become physically sick, those damages should be tax free. Yet if emotional distress *causes* you to be physically sick, even that physical sickness will not spell tax-free damages.

In contrast, if you are physically sick or physically injured, and your sickness or injury produces emotional distress too, those emotional distress damages should be tax free. Confused yet? It seems highly artificial, and it can depend on which words someone might use.

In the real world, of course, these lines are hard to draw, and sometimes can seem contrived. A recent example of the importance of these distinctions (and of getting the wording just right) appears in *Collins*.¹

Collins

Edward Collins received a gross settlement of \$275,000 from his employer, but the Tax Court held that he could not exclude \$85,000 from his income. It was not tax free, even though his emotional distress resulted in physical sickness. Collins sued his employer for workplace discrimination and retaliation.

One of his allegations was that he had “suffered severe emotional distress and anxiety, with physical manifestations, including high blood pressure.” The case was settled for \$275,000, of which \$90,000 was allocated to legal fees, \$15,000 to reimbursement of his unpaid medical expenses, \$85,000 to emotional distress, and \$85,000 as wages subject to withholding.

For the \$85,000 allocated to “emotional distress,” Collins claimed that it had been paid because of his physical sickness. The court said:

While there may be some ambiguity as to what the parties to the term sheet intended to encompass within the meaning of the term “emotional distress”, petitioner has failed to persuade us that the physical manifestations, including high blood pressure, that he may have suffered amount to physical injuries or physical sickness within the meaning of section 104(a).

Unfortunately, both the complaint and settlement agreement referred to the damages as

¹ *Collins v. Commissioner*, T.C. Summ. Op. 2017-74.

being for emotional distress. Collins's emotional distress might have had physical symptoms or consequences, but the emotional distress came first. It might have been different if the settlement language said otherwise.

It also might have been different if his physical sickness came first, *producing* emotional distress. Damages for the latter kind of emotional distress can be carried along with the underlying physical sickness damages. Emotional distress alone is not a physical injury or physical sickness.

Some of this difficult line-drawing emanates from a critical footnote in the conference committee report (to the 1996 amendment that added the "physical" modifier). It states that the term "emotional distress" includes physical symptoms — such as insomnia, headaches, and stomach disorders — that may result from such emotional distress.² The conference committee report makes clear that all compensatory damages that flow from physical injury or physical sickness are excludable from income.

That is so even if the recipient of the damages is not the injured party. Examples include damages for loss of consortium due to the physical injury or physical sickness of a spouse. There is voluminous case law in which taxpayers with employment recoveries have failed to prevail in excluding any portion of their recoveries from income. However, the tax law took a more flexible trend in *Domeny*³ and *Parkinson*.⁴

Demonstrable Physical Sickness

In *Domeny*,⁵ Julie Domeny suffered from multiple sclerosis (MS), the symptoms of which were exacerbated by workplace problems. Workplace stress, including the taxpayer's discovery that the director of her company was embezzling funds, aggravated her MS symptoms. As her symptoms worsened, her physician determined that she was too ill to work and should not work for several weeks.

The employer terminated Domeny, causing another spike in her MS symptoms. The Tax Court found it clear that Domeny's exposure to a hostile and stressful work environment had exacerbated her MS symptoms. Her health and physical condition clearly worsened because of her employer's actions.

In *Collins*, The Tax Court took another step consistent with *Domeny* by distinguishing *Parkinson*.⁶ In that case, Ronald Parkinson had worked long hours under stressful conditions as the chief supervisor of a medical center's ultrasound and vascular lab. Parkinson had a heart attack while at work in 1998, thereafter reducing the hours he worked each week from 70 to 40. In 2000 he took medical leave and never returned to work.

Parkinson filed a lawsuit under the Americans with Disabilities Act (ADA), claiming that the medical center failed to accommodate his severe coronary artery disease. His complaint included counts against two medical center employees for intentional infliction of emotional distress and invasion of privacy. The district court dismissed his ADA, intentional infliction, and invasion of privacy claims.

Parkinson appealed to the Fourth Circuit, which affirmed. He then asked for Supreme Court review. Parkinson also filed suit in Maryland state court, claiming intentional infliction and invasion of privacy. The complaint alleged that the defendants' extreme and outrageous misconduct caused him to suffer another disabling heart attack at work, rendering him unable to work.

The case settled for \$350,000 "as noneconomic damages and not as wages or other income." It was paid in installments: \$250,000 in 2004, \$34,000 in 2005, and \$33,000 each in 2006 and 2007. The 2004, 2006, and 2007 payments were not before the court, nor was it clear how they were treated for tax purposes.

Parkinson argued that the 2005 payment was for physical injuries and physical sickness brought on by extreme emotional distress. The IRS argued that it was an emotional distress recovery. Unfortunately, the settlement agreement

² See H. Conf. Rept. 104-737, at 301 n.56 (1996), 1996-3 C.B. 741, 1041.

³ *Domeny v. Commissioner*, T.C. Memo. 2010-9.

⁴ *Parkinson v. Commissioner*, T.C. Memo. 2010-142.

⁵ For a more extensive discussion of this case, see Robert W. Wood, "Is Physical Sickness the Next Emotional Distress?" *Tax Notes*, Feb. 22, 2010, p. 977.

⁶ *Parkinson*, T.C. Memo. 2010-142; see also *Save v. Commissioner*, T.C. Memo. 2009-209.

stated only that the payments were meant as “noneconomic damages and not as wages or other income.” The Tax Court consulted the Maryland authorities about the meaning of “noneconomic damages.”

Physical Symptoms of What?

Physical symptoms of emotional distress might be physical in nature, but that does not make damages for those symptoms tax free. However, the *Parkinson* court noted that damages received on account of emotional distress attributable to a physical injury or physical sickness are excludable.⁷ The court then addressed what is meant by a “symptom,” calling it “subjective evidence of disease of a patient’s condition.”⁸

In contrast, a “sign” is evidence perceptible to the examining physician. The Tax Court stated that:

It would seem self-evident that a heart attack and its physical aftereffects constitute physical injury or sickness rather than mere subjective sensations or symptoms of emotional distress. Indeed, at trial respondent’s counsel conceded that the petitioner did “suffer some physical injury,” stating that he “suffered several heart attacks.” Respondent contends, however, that petitioner received no amount of the settlement payment on account of his asserted physical injuries or sickness because “his causes of action did not reflect that assertion.” Clearly, however, petitioner’s state court complaint did reflect, extensively, his assertions of physical injuries and sickness.⁹

The Tax Court in *Parkinson* even stated that the IRS was wrong to argue that one can never have physical injury or physical sickness in a case brought under the tort of intentional infliction of

emotional distress. The court referred to Maryland authorities and the Restatement of Torts, noting that intentional infliction of emotional distress can result in bodily harm.

It is notable that the settlement agreement in *Parkinson* was (from a tax viewpoint) poorly drafted. It was neither specific about the nature of the intended payment nor its tax treatment, much less saying anything about tax reporting. Moreover, *Parkinson*’s underlying lawsuit was primarily about intentional infliction of emotional distress. There was little evidence that medical testimony linked *Parkinson*’s condition to the employer’s actions.

Nevertheless, the Tax Court seemed determined to allow a significant taxpayer victory. Damages for physical symptoms of emotional distress (headaches, insomnia, and stomachaches) might be taxable.¹⁰ But physical symptoms of emotional distress have a limit. For example, ulcers, shingles, aneurysms, and strokes may all be outgrowths of stress. Yet it seems difficult to regard them all as “mere symptoms of emotional distress.” Extreme emotional distress can produce a heart attack, which is plainly not a symptom of emotional distress. The Tax Court so held in *Parkinson*.

Mental or Physical

What about depression? In *Blackwood*,¹¹ the Tax Court was asked to decide whether depression was physical, mental, or both. Julie Blackwood trained hospital personnel to use a computer data entry program for the collection of patient information upon a patient’s admission to the hospital. The information so collected was to be used by other medical personnel when making decisions regarding the patient’s subsequent medical care.

Following the admission of her son to the hospital, Blackwood observed a nurse taking her son’s medical history without using the data entry program, and knew immediately that the nurse failed to ask all the questions the program required. Blackwood later used the system to

⁷ *Parkinson* at 301 (“Because all damages received on account of physical injury 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 a physical injury or physical sickness.”).

⁸ See Sloane-Dorland *Annotated Medical-Legal Dictionary* 496 (Supp. 1992).

⁹ *Parkinson v. Commissioner*, T.C. Memo. 2010-142.

¹⁰ H. Conf. Rep. 104-737, at 301, n.56 (1996).

¹¹ *Blackwood v. Commissioner*, T.C. Memo. 2012-190, superseded by regulation as stated in *Perez v. Commissioner*, 144 T.C. 51 (Jan. 22, 2015); see also Wood, “Are Damages for Exacerbation of Depression Tax Free?” *Tax Notes*, Sept. 3, 2012, p. 1211.

access her son's medical records (which was a violation of the law), and she was dismissed.

Thus, Blackwood relapsed into the depression she had previously overcome. Her symptoms included insomnia, oversleeping, migraines, nausea, vomiting, weight gain, acne, and pain in her back, shoulder, and neck. She resumed counseling sessions and incurred medical expenses. Claiming wrongful termination, she settled for \$100,000.

Blackwood's settlement agreement stated that the payment was for "alleged damages for illness and medical expenses allegedly exacerbated by, and allegedly otherwise attributable to" her wrongful discharge. When the IRS said the payment was taxable, she took her case to Tax Court, arguing *Domeny*. The exacerbation of her depression qualified as a physical injury or sickness, Blackwood claimed.

Predictably, the IRS said she simply had symptoms of emotional distress, so the money was taxable. Unlike in *Domeny*, Blackwood had neither a medical diagnosis, nor medical testimony detailing her physical problems. Her symptoms were also not as serious as those in *Domeny*. Blackwood only had a letter from her counselor that claimed "increased levels of anxiety and depressive symptoms." That was not enough.

Post-Traumatic Stress Disorder

The Department of Veterans Affairs' National Center for Post-Traumatic Stress Disorder estimates that 7.8 percent of Americans will experience post-traumatic stress disorder (PTSD) at some point in their lives.¹² Apart from military and emergency service applications, PTSD claims are now appearing in employment and other litigation.

The tax treatment of PTSD recoveries remains unclear, although there are strong arguments that PTSD is physical and should be regarded as such for tax purposes.

President Obama was asked about post-traumatic stress disorder during a September 2016 CNN presidential town hall concerning national security, foreign policy, and veteran issues affecting the U.S. military. Obama said:

I have instructed the Joint Chiefs and up and down the chain of command that they have a responsibility to destigmatize mental health issues and issues of PTSD and help to explain to everybody in all of the units under their command that there's nothing weak about asking for help. If you break your leg, you're going to go to a doctor to get that leg healed. If, as a consequence of the extraordinary stress and pain that you are witnessing, typically, in a battlefield, something inside you feels like it's wounded, it's just like a physical injury. You've got to go get help. And there's nothing weak about that. That's strong. And that is what will allow you then to continue to — with your service and there shouldn't be a stigma against it.¹³

Although the IRS and Tax Court have not directly faced the PTSD tax question, National Taxpayer Advocate Nina Olson has expressed the view that PTSD damages should be tax free.¹⁴ Although it is hardly definitive, *Sullivan*¹⁵ suggests that PTSD damages should be tax free. John Sullivan received payments from the Department of Veterans Affairs for disabilities, including PTSD, resulting from his service during the Vietnam War. After his disability rating was adjusted upward, Sullivan attempted to amend previous tax returns to exclude more of his disability payments. The court balked based on the statute of limitations issue. However, it did not dispute that disability payments for PTSD are excludable from income under section 104(a)(4).¹⁶

Whether more garden-variety damage (rather than disability) payments for PTSD are tax free

¹³ CNN Presidential Town Hall, "America's Military and the Commander and Chief," CNN Press Room (Sept. 28, 2016).

¹⁴ See Nina Olson, "National Taxpayer Advocate 2009 Annual Report to Congress," at 355-356 (Dec. 31, 2009); see also Olson, "National Taxpayer Advocate 2013 Annual Report to Congress," at 2 (Dec. 31, 2013) ("Since the amendment of IRC section 104(a)(2) in 1996, the scientific and medical community has demonstrated that mental illnesses can have associated physical symptoms. Accordingly, conditions like depression or anxiety are a physical injury or sickness and damages and payments received on account of this sickness should be excluded from income. Including these damages in gross income ignores the physical manifestations of mental anguish, emotional distress, and pain and suffering.").

¹⁵ *Sullivan v. United States*, 46 Fed. Cl. 480 (Fed. Cl. 2000).

¹⁶ See also *Kiourtsis v. Commissioner*, T.C. Memo. 1996-53 (in which disability compensation for PTSD appears to be excludable).

¹² See Alexandra Wolfe, "A Psychiatrist's Quest to Understand PTSD," *The Wall Street Journal*, Jan. 6, 2017.

can still be debated. But there is strong medical evidence that PTSD is physical, and demonstrably so.¹⁷

Medical Evidence and Settlement Language

There is no question that medical records and settlement agreement language can help taxpayers materially. With the right combination, you might be able to quickly resolve an IRS query or audit. Without it, you might have no chance.

In *Molina*,¹⁸ the Tax Court denied any exclusion. In 2004 and 2005, Jose Molina began to suffer from peptic ulcers, gastric and intestinal problems, and stomach pain attributable to long hours at work, lack of proper staffing, and racial discrimination. His medical tests were inconclusive on whether he had any peptic ulcers.

When Molina excluded his recovery, he cited *Domeny*. However, the court distinguished *Domeny*, in which there had been credible evidence that the taxpayer was physically ill, and she had informed her employer of that fact. Also, consider *Gutierrez*,¹⁹ involving a vineyard worker who was subjected to gender discrimination, harassment, wage violations, lack of meal or break periods, exposure to pesticides, and more. When Antonia Gutierrez settled for \$35,000, the settlement agreement said it was for emotional distress damages and attorney fees. There was evidence that Gutierrez suffered respiratory damage, constant headaches, loss of vision, and more. Nevertheless, the IRS and Tax Court said it was taxable.

Notably, Gutierrez did not speak English. There was some question as to who translated, what that person said, and whether Gutierrez had understood the settlement agreement. Noting that the settlement agreement was general and just said “emotional distress,” the Tax Court agreed with the IRS.

In *Sanford*,²⁰ the Tax Court considered physical symptoms including asthma, sleep deprivation, skin irritation, appetite loss, severe headaches, and depression. The Tax Court agreed with the IRS that these were simply manifestations of emotional distress. That meant the damages were awarded for the emotional trauma, not for the physical symptoms.

In *Prinster*,²¹ the Tax Court held that a settlement for hypertension, hyperlipidemia, and other ailments was not excludable. The court in *Prinster* simply noted that the taxpayer had not sufficiently shown that his ailments resulted from his work conditions or termination.

Key Elements

The cases suggest that to exclude a payment on account of physical sickness, the taxpayer needs evidence he made the claim. He does not necessarily have to *prove* that the defendant caused the sickness, but he needs to show that he claimed it. Also, he must show that the payer was aware of the claim and at least considered it in making the payment.

To prove physical sickness, the taxpayer should have evidence of medical care as well as evidence that he actually claimed that the payer caused or exacerbated his condition. The more medical evidence, the better.

Then there is the settlement agreement. Whenever possible, settlement agreements should be specific. The courts and IRS should not be put in the position of determining which payments were for which claims. Moreover, when there is a scant record of medical expenses in the litigation, consider other documents you can collect at settlement time.

A declaration from the plaintiff’s attorney stating why the physical sickness claims were strong may help. A declaration from a treating physician or an expert physician could also help. Prepare what you can at the time of settlement or, at the latest, at tax return time. Do as much as you can contemporaneously. Support that is gathered later is rarely as helpful. ■

¹⁷ See Wood, “President Obama and Damages for PTSD,” *Tax Notes*, Mar. 6, 2017, p. 1297; Wood, “Taxing Post-Traumatic Stress Disorder,” *Tax Notes*, July 7, 2014, p. 89.

¹⁸ *Molina v. Commissioner*, T.C. Memo. 2013-226; see also Wood, “Taxing Physical Sickness, Workers’ Compensation, and PTSD,” *Tax Notes*, Feb. 24, 2014, p. 857.

¹⁹ *Gutierrez v. Commissioner*, T.C. Memo. 2011-263.

²⁰ *Sanford v. Commissioner*, T.C. Memo. 2008-158.

²¹ *Prinster v. Commissioner*, T.C. Summ. Op. 2009-99.