

## Taxing Physical Sickness, Workers' Compensation, and PTSD

By Robert W. Wood



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<http://www.taxinstitute.com>. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Wood discusses the confusing distinctions between physical and emotional injuries in post-1996 legal settlements. He considers several recent cases demonstrating the subtle overlap between emotional and physical injuries, and surveys how the courts have reached different conclusions on the issue.

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Section 104 has long excluded from gross income the proceeds of many legal settlements and judgments in personal injury cases. An increase in employment litigation in the 1980s and 1990s led to an abundance of tax-free emotional distress settlements. In 1996, that prompted the biggest ever statutory curtailment of section 104. The provision was amended to clarify that the exclusion applies only to recoveries for *physical* injuries and sickness, not emotional distress.

The primary target of the amendment was employment settlements in which the plaintiff suffered emotional distress but no physical injuries. Nevertheless, the legislative history makes clear that if emotional distress results from physical injuries or sickness, damages for emotional distress are also tax free. There has been a paucity of guidance on

the subject. Although the “physical” modifier was added 18 years ago, no published rulings or regulations have tackled this topic.<sup>1</sup>

For years, the IRS required an overt manifestation of physical injuries and observable bodily harm for an exclusion to be available.<sup>2</sup> But, the Service has also said that it would presume personal physical injury in some cases. For example, in an important 2008 ruling, the IRS excluded a recovery for sexual molestation even though payment was made years later when no observable bodily harm could be shown.<sup>3</sup>

More generally, the Service seems to recognize that physical and emotional injuries may sometimes be inextricably entwined.<sup>4</sup> That brings us to the

<sup>1</sup>See Nina Olson, “National Taxpayer Advocate 2009 Annual Report to Congress,” at 356 (Dec. 31, 2009):

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.

<sup>2</sup>See LTR 200041022 (“we believe that direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under section 104(a)(2)”).

<sup>3</sup>See CCA 200809001, in which the IRS stated the following: C has alleged that Entity’s agent(s) X caused physical injury through Tort while he was a minor under the care of X. . . . Because of the passage of time and because C was a minor when the Tort allegedly occurred, C may have difficulty establishing the extent of his physical injuries. Under these circumstances, it is reasonable for the Service to presume that the settlement compensated C for personal physical injuries, and that all damages for emotional distress were attributable to the physical injuries.

See also discussion in Robert W. Wood, “IRS Allows Damages Exclusion Without Proof of Physical Harm,” *Tax Notes*, Mar. 31, 2008, p. 1388.

<sup>4</sup>See comments of Michael Montemurro, branch 1 chief, IRS Office of Associate Chief Counsel (Income Tax and Accounting), Public Hearing on Proposed Regulations, 26 CFR Part 301, “Damages Received on Account of Personal Physical Injuries or Physical Sickness” (REG-127270-06), at 10 (Feb. 23, 2010). Montemurro said the following:

I mean I don’t know that the Service has ever gone to court on litigation, you know, I know the Service doesn’t ever go to court on litigation, [regarding] anybody who’s

(Footnote continued on next page.)

important case law developments. Many taxpayers still slog it out in audits, before IRS Appeals, and in the Tax Court.

### *Domeny and Parkinson*

Among the most important post-1996 cases on the scope of section 104 were *Domeny v. Commissioner*<sup>5</sup> and *Parkinson v. Commissioner*<sup>6</sup> in 2010. In the latter case, Ronald Parkinson experienced stress at work and suffered a heart attack. After first reducing his workweek, he took medical leave but never returned to work afterward.

The taxpayer alleged that the employer's misconduct caused him to suffer a disabling heart attack. The settlement agreement referred to the settlement amount as "noneconomic damages" and not as "wages or other income." The IRS said the proceeds were for emotional distress and therefore were taxable, so Parkinson appealed to the Tax Court.

He argued that the settlement was for physical injuries and sickness brought on by extreme emotional distress. Noting that Parkinson's state court complaint made extensive assertions of physical injuries and sickness, the Tax Court held that the payment was tax free. Importantly, the court pointed out that a plaintiff can be entitled to physical injury or sickness damages even if a suit is for intentional infliction of emotional distress.

In *Domeny*, the taxpayer had multiple sclerosis and disclosed it to her new employer, the Pacific Autism Center for Education (PACE). Later, embezzlement by an executive and related stresses caused Julie Domeny's condition to flare up. She had vertigo, shooting pains in both legs, difficulty walking because of numbness in her feet, burning behind her eyes, and extreme fatigue.

When her doctor ordered her to stay home, PACE fired her, triggering additional physical ailments. She contacted a lawyer who negotiated a pre-suit settlement. It listed causes of action for disability and age discrimination, civil rights infractions, Family and Medical Leave Act violations, and infliction of emotional distress.

Domeny paid tax on the wage part of her settlement but not on the balance, which the IRS argued was taxable damages for emotional distress. The Tax Court agreed with Domeny that the bulk of the recovery should be treated as tax free. Linking

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been falsely imprisoned or anyone who's suffered any sex abuse, as far as asserted in a courtroom that those kinds of damages are taxable, I mean whatever the pure technical answers may be.

<sup>5</sup>T.C. Memo. 2010-9. For a more extensive discussion of *Domeny*, see Wood, "Is Physical Sickness the Next Emotional Distress?" *Tax Notes*, Feb. 22, 2010, p. 977.

<sup>6</sup>T.C. Memo. 2010-142.

physical sickness to physical injury, the court held the payment to be for physical illness and therefore excludable.

### *Blackwood and Other Cases*

Since *Domeny* and *Parkinson*, more taxpayers are probably claiming section 104 exclusions based on physical sickness arising from employment. Clients tend not to appreciate the distinction between symptoms of emotional distress and those of physical sickness. Lawyers and tax advisers have trouble, too. Moreover, some claims may be genuine and yet not supported by adequate documentary evidence.

In *M. Blackwood et ux. v. Commissioner*,<sup>7</sup> the Tax Court was asked to decide whether a diagnosis of depression should be considered physical, mental, or both. Julie Blackwood trained hospital personnel to use a computer data entry program for the collection of patient information at the time of the patient's admission to the hospital. The information collected by the system was to be used by other medical personnel when making decisions regarding the patient's subsequent medical care at the hospital.

Following the admission of her son to the hospital, the taxpayer observed the hospital 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 required by the program. The taxpayer later used the system to access her son's medical records, which was a violation of the law and she was dismissed.

As a result, she relapsed into the depression she previously had 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. She did not report the \$100,000 as income. When the IRS said the payment was taxable, she took her case to the Tax Court.

Blackwood argued that the settlement was tax free because it was for physical injury or sickness. Her primary authority was *Domeny*. The exacerbation of her depression qualified as a physical injury

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<sup>7</sup>T.C. Memo. 2012-190. For a more detailed discussion of *Blackwood*, see Wood, "Are Damages for Exacerbation of Depression Tax Free?" *Tax Notes*, Sept. 3, 2012, p. 1211.

or sickness, she claimed. Nonetheless, the IRS said she simply had symptoms of emotional distress, so the money was taxable.

Unlike *Domeny*, Blackwood did not have a medical diagnosis and did not have medical testimony detailing her physical problems. Further, her symptoms were not as serious as those *Domeny* suffered. The Tax Court held that Blackwood's own testimony attributing her symptoms to her depression was not sufficient and ruled against the taxpayer. In *Domeny*, a physician determined that the taxpayer was too ill to work. Blackwood only had a letter from her counselor that claimed "increased levels of anxiety and depressive symptoms."

In *Molina et ux. v. Commissioner*,<sup>8</sup> the Tax Court denied any exclusion. Jose Molina started working for Clearing House Payments Co. in 1980. In 2004 and 2005 he began to suffer from peptic ulcers, gastric and intestinal problems, and stomach pain attributable to long hours, lack of proper staffing, and racial discrimination. But, his medical tests were inconclusive on whether he had any peptic ulcers.

In 2005 Molina notified his supervisors of insufficient staffing and its effect on employee morale and health. In 2007 he filed a lawsuit claiming that Clearing House had created a hostile work environment, discriminated against him, and retaliated for his reporting of the discrimination. Molina also alleged that he was the victim of assault and "serious and significant emotional and physical distress."

Molina settled his case for \$700,000 less applicable withholdings, to be paid in three installments. Clearing House attributed the first payment of \$77,000 to attorney fees and the second and third payments of \$373,000 and \$250,000, respectively, to wages and other taxable benefits. The settlement agreement did not allocate any specific payments for claims of physical sickness, physical injuries, physical distress, or emotional distress.

Molina filed his return with a statement asserting that the settlement proceeds should be excluded. The IRS issued a notice of deficiency. The Tax Court noted that the settlement agreement did not attribute any portion of the settlement payment to physical sickness, physical injuries, physical distress, or emotional distress. The court concluded that Molina failed to prove that Clearing House intended to compensate him for his physical injuries or sickness.

Molina argued that his peptic ulcers and gastric and intestinal problems were the result of being overworked and of racial discrimination by his

supervisors. Molina cited *Domeny*, but that case was distinguishable because *Domeny* had offered credible evidence proving she was physically ill and she informed her employer of that fact. In contrast, Molina did not offer credible evidence to support that he was physically ill or that he had even informed Clearing House of his alleged illness. Molina was only able to provide the court with a letter from his doctor stating that he believed Molina's symptoms may have been attributable to his stress at work. Thus, no amount could be excluded.

### *Simpson and Workers' Compensation*

In *Simpson et vir v. Commissioner*,<sup>9</sup> the Tax Court held that a portion — albeit a small portion — of an employment settlement was for personal physical injuries or sickness and therefore was excludable. Yet, much of the case deals with workers' compensation issues. Kathleen Simpson began working for Sears in 1972, and by the late 1990s, she was managing a Sears store in Fairfield, California.

Her store was difficult to manage and had an inexperienced staff. That meant long hours and strenuous physical activities that caused Simpson to injure her shoulders, left knee, and neck. Exhausted, she lost 25 pounds and even considered suicide.

She sought treatment and was diagnosed with clinical depression, irritable bowel syndrome, and fibromyalgia. In March 2002 Simpson approached the human resources department at Sears about her work-related sickness. On the advice of her doctor, she asked to transfer to another position.

She asked again in June, and by August, Sears had terminated her. She continued to suffer from depression and work-related physical injuries and remained unemployed for one year. She sued in state court, claiming employment discrimination under California's Fair Employment and Housing Act (FEHA) and that she was entitled to compensation for physical injuries.

After the state court dismissed all but one of her claims, her attorney concluded that she would be unable to get a settlement from Sears on her remaining FEHA claim. However, her attorney learned that she was eligible for workers' compensation benefits under California law.

Simpson eventually settled, releasing Sears from all claims including, but not limited to, those asserted in the FEHA lawsuit. Nevertheless, the settlement agreement was silent regarding her possible workers' compensation claims. The agreement broke down the settlement as \$12,500 for lost wages and employment benefits; \$98,000 for emotional

<sup>8</sup>T.C. Memo. 2013-226.

<sup>9</sup>141 T.C. No. 10 (2013).

distress and physical and mental disability; and \$152,000 for attorney fees and court costs.

Her attorney claimed that the \$98,000 was for emotional distress and physical and mental disabilities from work-related injuries covered by workers' compensation. He attributed 10 to 20 percent of the \$98,000 to her work-related physical illness and disabilities. Even so, neither Simpson nor Sears submitted the settlement agreement to the California Workers' Compensation Appeals Board for approval as required under state law.

Simpson reported the \$12,500 payment but excluded the remaining \$250,000, arguing that it was excludable as a workers' compensation payment under section 104(a)(1). In the alternative, she contended that up to 20 percent of the \$98,000 allocated to emotional distress and physical and mental disabilities was excludable under section 104(a)(2).

Finally, all of the legal fees and costs, Simpson claimed, were deductible above-the-line. The IRS argued that only \$113,985.60 was deductible because that was the amount paid to her attorney. The balance was reimbursed costs.

### Not Workers' Compensation

The Tax Court first noted that the settlement agreement did not specify whether the payment was for Simpson's FEHA claims, workers' compensation claims, or both. Although the agreement did not expressly include her workers' compensation claim, the court said it was clearly intended to be treated as covered. A portion of the settlement was for work-related physical injuries and sickness, the court found.

However, to be excludable under section 104(a)(1), the payment must be made "under a workers' compensation act or under a statute in the nature of a workers' compensation act that provides compensation to employees for occupational personal injuries or sickness."<sup>10</sup> Operative state law required the parties to seek state approval of any release, and they failed to do so.

For that reason, the \$250,000 payment was not technically workers' compensation, whatever the parties thought. According to California state law, the settlement agreement was not valid for settlement of her workers' compensation claims, so the \$250,000 did not qualify under section 104(a)(1). Nevertheless, the court agreed with Simpson's alternative claim that 10 percent of the \$98,000 was for personal physical injuries or sickness and therefore excludable under section 104(a)(2).

Finally, turning to the issue of attorney fees, the court concluded that the entire \$152,000 was de-

ductible above-the-line as Simpson claimed. The court rejected the Service's recommendation to limit the deduction to \$113,985.60 (that is, the amount paid to the attorney), finding that the attorney's testimony and overall facts of the case showed that the remaining \$38,014.40 was used to reimburse Simpson for the court costs she incurred.

### Not So Sharp

In *Sharp v. Commissioner*,<sup>11</sup> the Tax Court held that a professor's settlement for emotional damages was fully taxable and that penalties applied. Linda Sharp was a professor at the University of Northern Iowa. After she reported missing equipment, she was demoted to a secretarial position.

Sharp took a leave of absence to teach in a local public school. She successfully sought reinstatement as a professor, but shortly after resuming her position, she again reported missing equipment. This led to a dispute between Sharp and another faculty member.

The stress the dispute created in Sharp's work life ultimately led her to leave the university. She developed muscle tension and migraines, suffered from nightmares, and feared people and going to the university. Eventually hospitalized, she was diagnosed with severe clinical depression, an anxiety disorder, and post-traumatic stress disorder.

Sharp brought several legal actions, including a workers' compensation claim. A second claim sought damages for her colleagues' gross negligence, which involved several people allegedly conspiring to force Sharp to quit her job. She settled for \$210,000 — paid in three \$70,000 installments — characterized as for emotional distress damages only.

She did not report the first \$70,000 installment but attached a statement to her return explaining that she was excluding the settlement proceeds under section 104(a)(2). When the IRS disagreed with her claim, she argued in court that either she received the damages under a state statute in the nature of a workers' compensation law, or in the alternative, the damages were for emotional distress attributable to physical injury or sickness. The court rejected both arguments.

According to the court, the workers' compensation point turned on intent. What Sharp and the university intended to compromise on was a question of fact. If that was unclear, the court noted, it had to look to whether the university intended to settle a claim brought under a statute in the nature of a workers' compensation act.

<sup>10</sup>*Id.* at 19.

<sup>11</sup>T.C. Memo. 2013-290.

A vague reference was insufficient to prove that the university was paying for workers' compensation. Although Sharp had brought two Iowa workers' compensation claims, that did not mean the payment was made for those claims. The court said it could not bridge the gap between the evidence she offered regarding her claims and a finding that the university had paid the settlement proceeds in exchange for settlement of Sharp's workers' compensation claim. The court also rejected Sharp's physical sickness or injury argument because the settlement agreement stated that the university was paying for emotional distress damages only.

Almost gratuitously, the court went on to say that even apart from that language, Sharp had failed to provide sufficient evidence that her physical manifestations of emotional distress amounted to physical injuries.

### And Then There Were Penalties

In many section 104 cases, the Tax Court seems to recognize the tough spot plaintiffs are in when the line between physical sickness and symptoms of emotional distress is blurred. Even tax advisers have difficulty with these issues. In *Sharp*, however, the IRS was firm and so was the Tax Court.

Sharp argued that she qualified for an exception to the substantial understatement accuracy-related penalty either because she qualified under section 6662(d)(2)(B)(ii) or because she reasonably relied on her attorney. The court disagreed with both of these assertions and found that the penalty applied. Regarding the section 6662(d)(2)(B)(ii) claim, the court said Sharp did not establish that the \$70,000 in settlement proceeds arose from settling a workers' compensation claim or that it was attributable to physical injuries or sickness.

Sharp never showed that the relevant authorities supported her position because she failed to establish that they applied to her facts. Reliance on the advice of an attorney could have constituted reasonable cause and good faith if she had proved by a preponderance of evidence that she: (1) reasonably believed her attorney was a competent tax adviser with sufficient expertise to justify reliance; (2) provided necessary and accurate information to her attorney; and (3) relied in good faith on the attorney's judgment.<sup>12</sup> Sharp's argument that she relied on her attorney failed, the court said. It was difficult to imagine how Sharp, a professional,

accomplished woman, could reasonably rely on an attorney whose tax advice was so contrary to the established body of case law.

### Small Lessons

It would be nice if we could say these controversies are at an end and if we could say what is taxable and what is not. Sadly, the mess will continue, as will misinformation. Some lawyers do not even know that emotional distress recoveries are taxable.

Beyond the obvious cases, the issue often boils down to documents. A detailed medical record can help significantly even if it describes something that sounds like symptoms of emotional distress. In a car accident or slip-and-fall case, a plaintiff who has an extensive medical record with high medical expenses is likely to recover more than an equally injured plaintiff who toughs it out with no treatment.

The right language in a settlement agreement can also help. Documenting who really paid for what can be difficult later. Nevertheless, lawyers, clients, and tax preparers need to think more creatively about this. Sometimes, providing tax language in a settlement is impossible, or it is already too late to do so because the settlement agreement is signed by the time the tax attorney becomes involved.

That does not mean counsel can do nothing. What about declarations from the lawyers involved in the case or from medical personnel who treated the plaintiff? Statements might also be obtained from a mediator, co-workers, or even family members. Attorneys may also want to cull the discovery documents and briefs in the case to collect all the helpful items. It is possible that none of these will be conclusive, but all of them can help.

Finally, if you have a workers' compensation issue, be careful about state law. Many plaintiffs' lawyers try to avoid workers' compensation because of its low limits. That is true in accident and employment cases. Nevertheless, for a workplace injury or illness, workers' compensation can help from a tax viewpoint. In *Simpson*, it seems to have resolved the tax issue entirely.

The section 104(a)(1) claim in *Simpson* may have succeeded with better settlement language regarding the workers' compensation claim or if the taxpayer and her attorneys had complied with the California procedures. The case offers a lesson not only for the lawyers drafting settlement agreements, but also for tax attorneys in general. If you contend that a payment resolves a claim, follow the rules and be consistent.

<sup>12</sup>*Neonatology Associates PA v. Commissioner*, 115 T.C. 43 (2000).