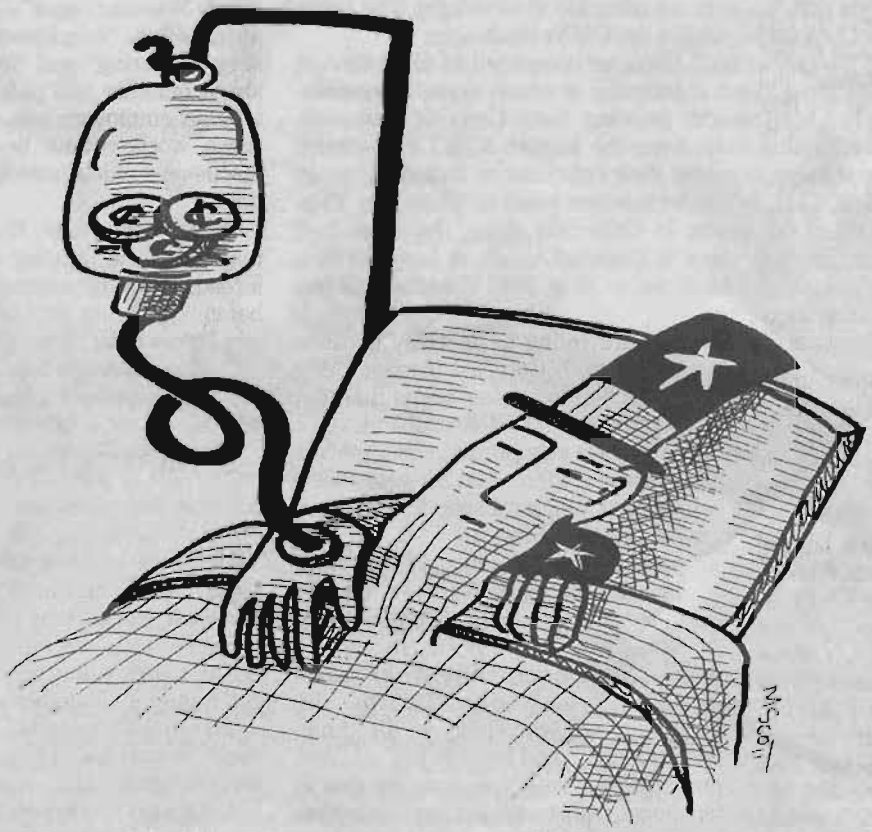
An Ulcer Does Not Provide For Exclusion From Income

By Robert W. Wood



Ever since 1996, when Congress amended Section 104 of the Internal Revenue Code to specify that a payment for personal injuries or sickness must be "physical," there has been speculation about what that means.

To date, the IRS has said almost nothing (no regulations, no rulings, no notices), and the courts have faced an unappetizing array of cases interpreting the scope of Section 104. The courts have generally adopted a two-tier approach based on the Supreme Court's decision in *Schleier v. Commissioner*, 515 U.S. 323 (1995), requiring that, for an exclusion from income, the underlying cause of action must be based on tort or tort-type rights, and the proceeds must be received on account of "personal physical injuries" or "physical sickness."

Many plaintiffs are out of luck when seeking to apply the Section 104 exclusion outside of the archetypal auto accident (or other physical injury) case. This has been particularly true in the employment context. For example, *Tamberella v. Commissioner*, T.C. Memo 2004-47 (2004), involved a recovery on a discrimination statute. The Tax Court determined that this cause of action was not tort-based or tort-like.

Similarly, in *Johnson v. United States*, 76 Fed.App. 873 (2003), certiorari denied, 124 S.Ct. 2888 (2004), a guard at a juvenile detention center suffered injuries while restraining an inmate. The guard lump sum of $510,000.

The major issue in *Vincent* was whether any amount was paid on account of personal physical injuries or physical sickness. The Tax Court recited that it is not bound by settlement agreements and is free to disregard them. Suggesting that physical injury or physical sickness. In some cases, the plaintiff might be able to demonstrate only that he or she claimed this causal connection, not that it existed.

The second part of the *Vincent* case deals with the tax treatment of attorney fees. Vincent's contingent fee agreement with her lawyer stated that the attorney

TAX LAW

The court ... found that the jury verdict underlying the settlement did not support any apportionment of the settlement to personal physical injury damages.

brought suit under the Americans with Disabilities Act after his employer failed to accommodate his physical limitations resulting from the incident.

The 10th U.S. Circuit Court of Appeals found the recovery to be on account of unlawful termination, and that did not give rise to an exclusion. The link between the discrimination-based discharge and the work-related injuries was simply too tenuous to support an exclusion under Section 104. Likewise, in *Prasil v. Commissioner*, T.C. Memo 2003-100 (2003), the Tax Court found that uncorroborated testimony about exacerbation of harm was not enough to support an exclusion.

One of the most interesting recent cases is *Nancy J. Vincent v. Commissioner*, T.C. Memo 2005-95. *Vincent* involved an employee of a trust company who was diagnosed with ulcers. After being advised that high stress would exacerbate her condition, she went on a four-day work week. Later, the company returned her to a five-day schedule. Several doctors advised her not to work a five-day week. She stayed out of work and was fired.

She sued, asserting federal and state claims, including intentional infliction of emotional distress. She alleged that her ulcers were a disability under California's Fair Employment and Housing Act, that the trust company knew of her condition and had wrongfully terminated her. She did not allege that the company had either caused or exacerbated her ulcers.

After trial, the jury awarded $400,000 in damages, and the court awarded $184,350.76 in attorney fees and costs pursuant to a statutory fee provision. The special verdict form asked questions, not whether the ulcer condition was caused (or even exacerbated) by the defendant. The case settled pending appeal for a it is paying attention to the language of the agreement, the court notes that even the settlement agreement itself does not use the word "physical," instead stating that the $240,000 was attributable to "personal injuries and emotional distress." While substance rather than semantics should control tax consequences, this suggests one should use the correct wording from the statute.

Beyond mere semantics, the special verdict form shows that the jury did not consider any claim for personal physical injuries. Nowhere was the jury asked whether the company's actions caused, or even exacerbated, the ulcer. The plaintiff's medical condition was discussed at length in the lawsuit, but only to establish she was disabled, not how that disability occurred. The court, therefore, found that the jury verdict underlying the settlement did not support any apportionment of the settlement to personal physical injury damages.

The court found that once the settlement amount was negotiated, the negotiation as to characterization of the proceeds ceased to be adversarial. The taxpayer wanted a large tax exclusion, and the trust company did not object, as long as the trust company secured indemnity for any adverse tax consequences to it. Perhaps this taxpayer seemed to be playing it a little too cute.

Indeed, implicit in the opinion is the notion that there was an arms-length pretense about the negotiations, but this did not disguise the reality of the underlying lawsuit, which was clearly a discrimination action rather than one arising from personal physical injuries.

The road to a Section 104 exclusion is often wrought with proof problems. The taxpayer must be prepared to show there was a causal nexus between the events set in motion by the defendant and this with her lawyer stated that the attorney would receive a contingent recovery unless there was a statutory fee shifting statute in effect. Here there was an applicable fee shifting statute, and there was even a court award of fees. The Tax Court therefore duly noted that the tax treatment of attorney fees in fee shifting statute cases had not been presented to the Supreme Court in *Banks*. See *Commissioner v. Banks*, 125 S.Ct. 826 (2005).

Because *Banks* did not address fee shifting statutes, the court turned to *Sinyard v. Commissioner*, 268 F.3d 756 (2001), finding that any contingent fees would be income, and that the taxpayer could not escape this outcome by arguing that her fees and costs were awarded by a court pursuant to a fee shifting provision.

The taxpayer even argued that a state decision, *Flannery v. Prentiss*, 26 Cal.4th 572 (2001), made the attorney fees that were awarded the property of the lawyer, not the client. Apparently not taking the *Flannery* argument seriously, the Tax Court simply stated that it was not bound by state law classifications as to the ownership of income. For this proposition, the court cited *Burnet v. Harmel*, 287 U.S. 103 (1932).

The Tax Court in *Vincent* attacks the argument that a statutory fee shifting provision, and/or of state law regarding fee ownership, are relevant to taxes. The Tax Court does not even refer to the Supreme Court's guidance that a plaintiff might not have gross income measured by attorney fees where there was a statutory fee shifting provision and either:

- A court award of attorney fees.
- A contingent fee agreement providing that the lawyer would receive all fees either as statutory fees or in lieu of statutory fees.
- A settlement agreement similarly providing that all fees were being paid to the lawyer in lieu of statutory fees to which the lawyer would be entitled. In any case, we can expect more cases like *Vincent*, in which causation and proof of causation are examined to determine the applicability of Section 104, plus more cases in which statutory fee arguments are raised.

Robert W. Wood, of Robert W. Wood P.C. in San Francisco, is the author of "Taxation of Damage Awards and Settlement Payments" (3d Ed. 2005).