

Physical Sickness and The Section 104 Exclusion

To the Editor:

I am writing concerning the clever and thought-provoking piece by Erik Jensen, "Are Recoveries for Nonphysical Injuries Automatically Taxable?" *Tax Notes*, Dec. 6, 2004, p. 1439. Prof. Jensen begins his article by noting that virtually none of his academic colleagues agree with his views. He also attributes a few thoughts to me.

I agree with Prof. Jensen to a far greater extent than his colleagues do. Jensen starts his article by referring to a recent article of mine, "Post-1996 Act Section 104 Cases: Where Are We Eight Years Later?" *Tax Notes*, Oct. 4, 2004, p. 68. Jensen says that he thinks "Wood buys into the conventional wisdom that, after the amendment, a recovery for a nonphysical personal injury is taxable, period, unless it can somehow be tied to a physical injury." Jensen *supra* at 1439.

I admit I probably sound like I buy into the conventional wisdom that a recovery for a purely nonphysical injury will be excludable only if it piggybacks on a physical injury. Regrettably, that seems to be what the courts are saying, and it is obviously what the Internal Revenue Service is saying. Thus, my practical experience leaves me less optimistic about this topic than I used to be.

Prof. Jensen expressly notes in his piece that he will refer only to "injuries, dropping any reference to sickness." As a result, he doesn't talk about how physical sickness cases will be examined, which is a topic I find much more interesting than the largely theoretical question Prof. Jensen raises about an excludable recovery (for alienation of affections) that is not tied to a physical injury. I think the important point is that physical sickness recoveries are excludable under section 104 as well. After all, that is what the statute says.

The IRS has generally (if not uniformly) mandated physical contact causing observable bodily harm. See LTR 200041022, *Doc 2000-26382*, *2000 TNT 201-10*. That is unfortunate, if not downright wrong. Mandating physical contact causing observable bodily harm would eviscerate the second but equally important wing of section 104(a)(2), which excludes damages paid on account of physical sickness. While the physical injury part of section 104(a) may receive all the attention, damages paid on account of physical sickness are equally excludable.

I believe much of the confusion has stemmed from the "on account of" link in the statute, which precedes the requisite physical injury or physical sickness. The starting point for an analysis of the phrase "on account of" must be the statute, which makes the relevant nexus that between the damages received and the injury. The statute

excludes "damages . . . received . . . on account of personal physical injuries or physical sickness." No words in the statute require a relationship between the tortious act and the physical injuries or physical sickness for which damages are received.

In fact, the "on account of" language has required a nexus between damages and injuries since its origin in the 1918 predecessor to section 104(a)(2). See Revenue Act of 1918, ch. 18, section 213(b)(6). The same language appeared in the 1939 code, the 1954 code, and the 1986 code. In 1996, Congress amended section 104(a)(2) to accomplish two (and only two) goals: to exclude punitive damages from the statute and to require that the personal injury or sickness be physical. Significantly, the 1996 amendments did not alter the "on account of" language.

The 1996 legislative history focuses the "on account of" link on the nexus between the recovery and the injuries. According to the legislative history:

If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. (Emphasis added.)

H.R. Conf. Rep. No. 104-737 at 300 (1996). There are two crucial points in that statement. First, the relevant "on account of" nexus is between damages and a physical injury or sickness (that is, all damages that "flow therefrom"). In analyzing the wrongful or tortious act, Congress required that the action have its origin in a physical injury or sickness. There need not be any causal nexus between the tort and the injury.

Second, the legislative history expressly recognizes that the recipient (plaintiff) need not be the one who suffers the physical injuries. A payment can be "on account of" physical injury or sickness even if the plaintiff is not injured, but recovers on behalf of an injured party. For example, recoveries for loss of consortium (based on physical injury to a spouse) and wrongful death qualify under section 104(a)(2).

I suppose it is this element of Prof. Jensen's argument that I don't really understand. Suppose we have a loss of consortium claim brought (as a stand-alone lawsuit) by the spouse of a plaintiff in an employment case. Assume that the employee is fired, resolves his claim against his employer for a pure wage settlement, but the employee is so upset there is a loss of consortium, hence leading to his wife's separate claim. Is the wife's recovery on her own claim entitled to exclusion?

I suppose the loss of consortium claim is by its very nature physical. The wife in my example suffers a physical loss, even if the events causing her spouse to be alienated are purely contractual or purely emotional in

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nature, thus not invoking section 104. I expect that is an academic question, as I've never seen a claim quite like this.

Maybe the wife's recovery is excludable, and maybe not. If it is excludable, I expect it would be so only under section 104, and not under the general no-accretion-to-wealth theory Prof. Jensen describes. Indeed, I don't find it all that surprising that a 1974 revenue ruling mentioning two family rights claims (alienation of affections and surrender of custody of a child) would conclude that there is no taxable income, and that in so concluding, that it would not mention section 104 as then in effect. See Jensen *supra* at 1440. That was an entirely different era. Much as I'd like to believe it, and no matter how attractive I find Jensen's arguments, I am hard-pressed to find much vim or vigor in a non-section 104 based exclusion for nonphysical injury. The recovery of basis point Prof. Jensen mentions (for example, involving the loss of an asset) is a wholly separate issue.

Returning to the physical sickness issue, which is of much greater practical import in the real world, it is axiomatic that the physical sickness element has received almost no attention from the IRS or the courts. However, there is at least a ray of light. In LTR 200121031, *Doc 2001-15011*, *2001 TNT 103-10*, the IRS ruled that section 104(a)(2) applies to damages received for a physical sickness that did not involve any battery or unwanted touching. The taxpayer was awarded damages arising from her deceased husband's death from lung cancer, a physical disease. The disease was associated with the husband's inhalation of asbestos fibers, and the taxpayer received a settlement from asbestos manufacturers.

While it is not clear from that ruling, it is likely that the manufacturer did not directly cause the husband to inhale the asbestos and contract the disease. That suggests there is more to this ruling than meets the eye. In any case, the IRS allowed the wife to exclude the recovery under section 104(a)(2). The IRS reasoned that the husband contracted a physical disease from exposure to asbestos and the "diseases were the proximate cause of the circumstances giving rise to" the taxpayer's claims.

The IRS's reference to "*circumstances giving rise to*" claims is consistent with the origin of the claim analysis in the 1996 legislative history. In fact, the IRS quotes from the 1996 legislative history to support its analysis. The IRS ruled that: "Because there exists a direct link between the *physical injury* suffered and the *damages recovered*, Taxpayer may exclude from gross income any economic damages compensating for such injury." (LTR 200121031, emphasis added.)

I hope that the scope of section 104 receives more attention from the IRS, but I believe the physical sickness issue should be at the very top of the list.

Very truly yours,

Rob Wood
Robert W. Wood PC
San Francisco
<http://www.rwwpc.com>
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