

## Tax-Free Physical Sickness Recoveries in 2010 and Beyond

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Section 104 excludes from income damages for personal physical injuries and physical sickness, yet there has been little focus on the latter. Wood points to two 2010 Tax Court decisions, *Parkinson* and *Domeny*, that signal an appropriately expanded scope to the exclusion.

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We know that damages for personal physical injuries are tax free, but are damages for physical sickness? For roughly 80 years, the tax code has excluded payments for personal injuries and sickness. That was true regardless of whether the payment was by settlement or judgment, and whether paid in a lump sum or over time. Section 104 clearly provides for that exclusion. But since 1996, the damages must be for personal *physical* injuries or personal *physical* sickness to be excludable.

Taxpayers and the government focused on what should be considered "physical." Since the physical modifier injected 14 years ago was a sea change, that focus is understandable. With the spotlight on what is physical and with no regulations to address it, perhaps there has been little need to distinguish between injuries and sickness.

Most practitioners are aware that the IRS has generally required an overt manifestation of physical injuries and "observable bodily harm" for an exclusion to be available.<sup>1</sup> However, in an important 2008 ruling, the Service

<sup>1</sup>See LTR 200041022 (July 17, 2000), *Doc 2000-26382*, 2000 TNT 201-10: "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)."

said it would assume there were personal physical injuries from a sexual molestation even though payment was made many years later when no observable bodily harm could be shown.<sup>2</sup> That conclusion may seem so obvious that no ruling would need to enunciate it. In fact, however, it was a bold, innovative, and important position for the Service to take.

Physical injuries and physical sickness may both be physical, but they are quite different. In most cases of physical sickness there has been no striking or other physical event to trigger the physical sickness. In that sense and others, it seems that "injuries" is a misnomer when describing most cases of physical sickness.

It is clear from LTR 200121031 that sickness is physical yet may not involve bruises or broken bones.<sup>3</sup> In that ruling the taxpayer was awarded damages from asbestos manufacturers owing to her husband's death from lung cancer. That physical disease was associated with the husband's inhalation of asbestos fibers. Reasoning that the husband contracted a physical disease from exposure to asbestos and that it was the proximate cause of the circumstances giving rise to the taxpayer's claims, the IRS excluded the wife's recovery. The IRS has not made clear in such a case whether it views the payments as being on account of personal physical injuries or personal physical sickness. The Service's failure to provide guidance on those questions has become a flashpoint for some.<sup>4</sup>

<sup>2</sup>See CCA 200809001 (Nov. 27, 2008), *Doc 2008-4372*, 2008 TNT 42-21:

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, *Doc 2008-5734*, or 2008 TNT 63-31.

<sup>3</sup>*Doc 2001-15011*, 2001 TNT 103-10.

<sup>4</sup>See Nina Olson, "National Taxpayer Advocate 2009 Annual Report to Congress," p. 356, *Doc 2010-174*, 2010 TNT 4-19:

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.

## Two New Cases

Two cases decided in 2010 should sharpen our focus on physical sickness recoveries. In *Ronald W. Parkinson v. Commissioner*,<sup>5</sup> the taxpayer worked long hours under stressful conditions as the chief supervisor of a medical center's ultrasound and vascular lab. He suffered a heart attack while at work in 1998, and thereafter reduced his work week from 70 to 40 hours. In 2000 he took medical leave and never returned.

The taxpayer filed suit in federal district court under the Americans With Disabilities Act (ADA), claiming the medical center failed to accommodate his severe coronary artery disease. His suit 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.

He 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 Parkinson 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.

As to the \$34,000 payment in 2005, Parkinson argued the payment was for physical injuries and physical sickness brought on by extreme emotional distress. Unfortunately, the settlement agreement stated only that the payments were meant as "noneconomic damages and not as wages or other income." The Tax Court considered the Maryland authorities about the meaning of "noneconomic damages."

Predictably, the IRS said this was an emotional distress recovery, pure and simple. The legislative history to section 104 makes clear that emotional distress is simply not a physical injury or physical sickness. Symptoms of emotional distress are not either.<sup>6</sup> Physical symptoms of emotional distress might be physical, but they are not physical injuries or physical sickness. However, the Tax Court also considered significant the portion of the legislative history providing that damages received on account of emotional distress that are *attributable to* a physical injury or physical sickness are excludable.<sup>7</sup>

The Tax Court then addressed what is meant by a "symptom," calling it "subjective evidence of disease of a

patient's condition."<sup>8</sup> In contrast a "sign" is evidence perceptible to the examining physician. But were the problems Parkinson experienced signs or symptoms?

Speaking for the Tax Court, Judge Thornton stated simply:

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.<sup>9</sup>

The Tax Court even went so far as to say that the IRS was wrong 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.

## Wordsmithing

Few tax lawyers reading *Parkinson* would be satisfied with the language of the settlement agreement. Surely no tax lawyer was involved in drafting it! Had a tax lawyer been involved, he doubtlessly would have included language using the "on account of personal injury/physical sickness" language, perhaps even stating, "and therefore excludable under section 104 of the Internal Revenue Code."

A statement that a payment is for "noneconomic damages" is not very specific and hardly invokes the section 104 exclusion. Yet the Tax Court dug deep to smooth over that sizable flub. The court noted that the intent of the payer is important. Even with a general release, the settlement payment would be excludable if the medical center intended it to compensate Parkinson for his alleged physical injuries or physical sickness. But did it here?

The Tax Court thought so. Parkinson's physical injuries were the overriding focus of his state court complaint, leading the Tax Court to conclude: "We have no doubt that those physical injuries figured prominently among the 'noneconomic damages' for which the settlement payment was made."<sup>10</sup>

Nonetheless, the Tax Court said that Parkinson had not established that this settlement payment was *only* for physical injuries or physical sickness. After all, Parkinson's state court complaint included claims for psychological injuries, too. The court said that those claims of

<sup>5</sup>T.C. Memo. 2010-142, Doc 2010-14364, 2010 TNT 124-12.

<sup>6</sup>See House Conference Report 104-737, p. 301, note 56 (1996): "It is intended that the term emotional distress includes symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress."

<sup>7</sup>*Id.* 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."

<sup>8</sup>See *Sloane-Dorland Annotated Medical-Legal Dictionary* 496 (sup. 1992).

<sup>9</sup>*Parkinson*, T.C. Memo. 2010-142.

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

psychological injury seemed less fully described in the complaint than the claims for physical injuries. That may have suggested that the physical part of the case and the resulting damages were stronger.

Finding no clear guidance, the Tax Court took the Solomonic approach: 50/50. It had to allocate the payment based on the best evidence available, and there wasn't much. Splitting the baby, the court held that one half of the settlement payment was made on account of Parkinson's emotional distress, and the other was on account of his personal physical injuries and physical sickness.

### Important Lessons

One can read the *Parkinson* case as either a glass half-full or a glass half-empty. To me, *Parkinson* is decidedly half-full if not full to the brim. I say this because:

1. The settlement agreement was very poorly drafted. It was not specific either about the nature of the intended payment or its tax treatment, much less saying anything about tax reporting! We are again reminded that we must be vigilant in settlement agreements.
2. Parkinson's underlying lawsuit was primarily about intentional infliction of emotional distress. Lawsuits for emotional distress traditionally produce taxable damages, no matter what. That is apparently changing, and that is big news indeed.
3. There was little actual evidence (at least reflected in the Tax Court opinion) that medical testimony linked Parkinson's condition to the actions of the employer. Still, the court took a broad view of what was going on in the underlying suit and didn't hold Parkinson's feet to the fire. That is a significant taxpayer victory.

Can one discern the line between physical manifestations (or mere symptoms) of emotional distress and signs that cause the physical injuries or physical sickness itself? It can be a thin, even rhetorical, line. The key to that line in the sand is the 1996 act's legislative history, which disallows tax-free treatment when apparently physical symptoms of emotional distress — headaches, insomnia, and stomachaches — result from the initial emotional distress.<sup>11</sup>

Yet surely there are other physical symptoms of emotional distress that would be caught within that rule. Even if the concept of mere symptoms of emotional distress includes more than headaches, insomnia, and stomachaches (the famous triumvirate enumerated in the footnote), it is surely finite. Mere physical symptoms of emotional distress have a limit.

For example, ulcers, shingles, aneurisms, and strokes may all be an outgrowth of stress, but they are clearly not mere symptoms of emotional distress. Also, one could have extreme emotional distress (caused intentionally or otherwise) that produces a heart attack, which is not a symptom of emotional distress. Those are signs of emo-

tional distress that appear to be qualitatively different. The Tax Court says so in *Parkinson*.

### Take Two

It is worth revisiting the Tax Court's earlier 2010 bombshell and contrasting it with *Parkinson*. In *Julie Leigh Domeny v. Commissioner*,<sup>12</sup> the taxpayer commenced working for Pacific Autism Center for Education (PACE) in 2000. She had been diagnosed with multiple sclerosis (MS) in 1996, causing numbness, fatigue, lightheadedness, vertigo, and burning behind her eyes. PACE offered an environment where she would do community development, fundraising, and grants, and would not spend much time on her feet.

But in November 2004 embezzlement in the executive suite made Domeny's MS flare up. As the months elapsed she felt tension and worry, her symptoms grew worse, and on March 8, 2005, her doctor pronounced her too ill to work. She had vertigo, shooting pain in both legs, difficulty walking because of numbness in both feet, burning behind her eyes, and extreme fatigue. Domeny's doctor ordered her to stay home until at least March 21, 2005, but PACE promptly fired her.

That triggered additional physical ailments. Domeny contacted a lawyer who negotiated a settlement before filing suit. The settlement agreement listed a raft of causes of action, including disability, age discrimination, civil rights, the Family and Medical Leave Act, the California Family Rights Act, the Fair Labor Standards Act, invasion of privacy, infliction of emotional distress, defamation, misrepresentation, and more. The settlement agreement awarded \$8,187.50 as compensation, \$8,187.50 in attorney fees, and \$16,933 as damages.

Domeny reported the first \$8,187.50 as compensation, reported and deducted the \$8,187.50 in legal fees, and excluded the \$16,933 from income. The sole question in Tax Court was whether the \$16,933 was excludable. The Tax Court found it clear that Domeny's exposure to a hostile and stressful work environment exacerbated her MS symptoms and made her unable to work. Her doctor confirmed it, and she notified her employer but was promptly fired.

Unfortunately, her settlement agreement contained no express statement of the payer's intent in making the payments. Once again, a poorly drafted settlement agreement lands a taxpayer in court, while a more deftly drafted one would probably have satisfied an auditor. Despite the bad drafting, however, the Tax Court drew an inference from the fact that the \$33,308 settlement was segregated into three distinct payments.

However, PACE did issue a Form 1099-MISC reflecting the \$16,933 payment as nonemployee compensation. Most section 104 cases have said a Form 1099 means the payer thought it was taxable.<sup>13</sup> In fact some of the cases have cited the issuance of a Form 1099 as evidence that

<sup>12</sup>T.C. Memo. 2010-9, *Doc 2010-787*, 2010 TNT 9-9. For more extensive discussion of *Domeny*, see Wood, "Is Physical Sickness the Next Emotional Distress?" *Tax Notes*, Feb. 22, 2010, p. 977, *Doc 2010-2454*, or 2010 TNT 37-11.

<sup>13</sup>See *Burns v. United States*, 76 F.3d 384 (9th Cir. 1996).

<sup>11</sup>House Conference Report 104-737, p. 301, note 56 (1996).

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the payer thought the payment was income.<sup>14</sup> If that were not so, the argument goes, the payer would not have issued the Form 1099. Conversely, some courts have noted that the failure to issue a Form 1099 does not make a payment tax free.<sup>15</sup>

Of course, one can argue that a defendant's failure to issue a Form 1099 is at least some evidence of its intent. Failing to issue a Form 1099 is more consistent with damages excludable under section 104 than it is with taxable amounts. The IRS instructions to Form 1099-MISC make this point clear: If the payment is excludable you are not supposed to issue a Form 1099.<sup>16</sup>

However, Judge Gerber found the different tax and reporting treatments demonstrated that PACE was aware that at least part of Domy's recovery may not have been subject to tax because of the physical illness exclusion. That is a lenient standard, one many plaintiffs could meet. Noting that Domy had advised PACE of her illness before she was fired, the court concluded that PACE must have taken her physical sickness into account. Linking sickness to injury, the court held the payment to be for "physical illness," which is a physical injury within the meaning of section 104(a)(2).

Interestingly, the Tax Court concluded that her payments were for personal physical injuries. Yet a more common-sense nomenclature would be to report Domy's problems as physical manifestations of her physical sickness. Whether the result is labeled as personal physical injuries or personal physical sickness, her health and physical condition worsened because of the employer's actions.

The vast majority of cases do not have compelling facts or convincing proof. Therefore, in *Mumy v. Commissioner*,<sup>17</sup> the Tax Court sounded amused when it noted that Mumy alleged that she suffered anxiety, embarrassment, and humiliation from the harassment, and pain from an employer's pinch. The court concluded that mental anguish, humiliation, anxiety, and embarrassment are simply not personal physical injuries or physical sickness.<sup>18</sup>

In nontax law, physical problems caused by emotional distress can constitute physical injuries or physical sickness. Ongoing nausea or headaches can amount to physical illness and bodily harm, and even long-term mental

disturbance may be classified as illness.<sup>19</sup> Therefore, in *Walters v. Mintec/International*<sup>20</sup> the plaintiff recovered for physical harm caused by emotional distress from an accident. In *Payne v. General Motors Corp.*<sup>21</sup> the court held that constant exhaustion and fatigue from depression constituted physical injuries, a prerequisite to an action for negligent infliction of emotional distress under Kansas law.

Because there is little guidance, and reasonable minds can differ on what qualifies, the IRS often looks to medical records and other evidence to see how sick or injured the plaintiff really was. Even so, it is unclear how one evaluates whether a particular medical problem is a mere symptom of emotional distress (taxable) or a physical sickness or physical injury in its own right (excludable). Yet there is a fundamental difference between physical sickness and physical injury.

As it modifies "sickness" in the statute, the term "physical" may simply mean that the sickness cannot be mental. Physical sickness can be perceived. Yet until *Domy* and *Parkinson*, the courts had generally not been flexible. For example, in *Lindsey v. Commissioner*,<sup>22</sup> Lindsey's physician testified that during settlement negotiations from 1995 through 1997, Lindsey suffered from hypertension and stress-related symptoms, including periodic impotency, insomnia, fatigue, occasional indigestion, and urinary incontinence.

Citing no authority, the Eighth Circuit found those to be symptoms of emotional distress, not physical sickness. Many other cases stand for the proposition that mental anguish, humiliation, and embarrassment are not personal physical injuries or physical sickness, but are akin to emotional distress.<sup>23</sup> But exactly where you draw the line isn't clear.

### Conclusion

The *Domy* and *Parkinson* cases seem appropriate in logic and result, and instruct us that:

1. The facts matter and your proof of the facts matter. To exclude a payment on account of physical sickness, you need evidence that you really made the claim and that the payer was aware of it, and at least considered the claims in making the payment.
2. Proving that you were struck isn't part of physical sickness, but proving that you had demonstrable sickness is. You'll need evidence of medical care, and evidence that you were claiming the payer caused your condition or caused it to worsen.
3. The courts and the IRS shouldn't be put in the position of trying to figure out which payments were for which claims. Spend the time to nail down

<sup>14</sup>See *Peebles v. Commissioner*, T.C. Summ. Op. 2006-61 (2006); *Vaughn v. Commissioner*, T.C. Memo. 1992-317 (1992), *aff'd. without published opinion*, 15 F.3d 1095 (9th Cir. 1993).

<sup>15</sup>See *Bond v. Commissioner*, T.C. Memo. 2005-251 (2005), *Doc* 2005-22075, 2005 TNT 210-16.

<sup>16</sup>See Instructions for Form 1099-MISC (2010), which state that a payer should "not report damages (other than punitive damages) . . . received on account of personal physical injuries or physical sickness [or] damages received on account of emotional distress due to physical injuries or physical sickness." See p. 4.

<sup>17</sup>T.C. Summ. Op. 2005-129 (2005), *Doc* 2005-17777, 2005 TNT 164-8.

<sup>18</sup>See Wood, "Physical Sickness and the Section 104 Exclusion," *Tax Notes*, Jan. 3, 2005, p. 121, *Doc* 2004-24100, or 2005 TNT 2-41.

<sup>19</sup>See Restatement (2d) of Torts section 436A, Comment C (1965), quoted in *Walters v. Mintec/International*, 758 F.2d 73 at 1985 U.S. App. Lexis 29782, p. 6.

<sup>20</sup>758 F.2d 73 (3d Cir. 1985).

<sup>21</sup>731 F. Supp. 1465, 1474-1475 (D. Kan. 1990).

<sup>22</sup>T.C. Memo. 2004-113, *aff'd*, 422 F.3d 684 (8th Cir. 2005), *Doc* 2005-18306, 2005 TNT 171-51.

<sup>23</sup>*Mumy v. Commissioner*, *supra* note 17.

as much as you can in the settlement agreement. Very frequently the IRS will accept an explicit allocation and will not go behind it.

4. Be reasonable. If you are allocating which payments are for which claims, do not go overboard. Don't allocate \$10 to wages in an employment dispute. Don't allocate 90 percent of a recovery in an intentional infliction of emotional distress case to physical injuries or physical sickness.

5. When there isn't much of a record of medical expenses and discovery in the litigation, consider

what other documents you can collect at settlement time. A letter from the plaintiff's attorney saying why the physical sickness claims were strong may help. A letter from a treating physician or an expert physician may help. Declarations may be even more persuasive than letters. Prepare what you can at the time of the settlement, or at the latest, at tax return time. Do as much as you can contemporaneously. Don't wait for an audit to gather those things.