

Tax Court Rules \$25 Million Lawsuit Settlement Is Taxable Despite PTSD

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In this article, Wood and Brown examine a recent Tax Court decision and argue that awards for post-traumatic stress disorder should be excludable as damages for personal physical injuries or physical sickness under section 104.

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It has become commonplace for plaintiffs in a variety of litigations to allege defendants caused them to develop post-traumatic stress disorder. PTSD claims arise in employment cases, fire loss and other disaster cases, assorted personal injury

claims, sexual harassment and abuse cases, defamation cases, and so on. The contexts are myriad, as are the relative strengths and weaknesses of the claims.

In some cases, the plaintiff alleges not that the defendant caused the onset of PTSD but rather that the defendant exacerbated the plaintiff's preexisting PTSD. In those contexts, is an award for PTSD taxable as income, or is it excludable as damages for personal physical injuries or physical sickness under section 104? We believe the case for excluding those damages from income is strong.

Tax law distinguishes physical injuries and physical sickness from emotional distress; damages for physical injuries and physical sickness can be excluded under section 104(a)(2), but emotional distress is generally taxable. However, stark dichotomies are often difficult to draw, and the physical/emotional distinction here is no exception. Moreover, emotional distress damages may be excludable — but only if the emotional distress results from physical injuries or physical sickness. Because of the awkward line drawing, tax disputes, including in the Tax Court, are common.

Where does PTSD fall on the physical/emotional spectrum? Although PTSD can be caused or exacerbated by stress, so can physical conditions like heart attacks, which qualify for exclusion under section 104(a)(2) — even when caused or exacerbated by emotional distress.¹ PTSD may not be visible on the body's surface like a cut or a bruise, but it may be visible with medical equipment.² Cancer, lupus, multiple sclerosis, and many other diseases may also not be visibly

¹ See *Parkinson v. Commissioner*, T.C. Memo. 2010-142.

² See Justin Berton, "PTSD Leaves Physical Footprints on the Brain," *S.F. Gate*, July 27, 2008.

apparent, requiring special equipment or tests to observe. Yet those conditions are physical enough to qualify for exclusion.³

PTSD has some connection to the brain, but that alone does not make it emotional distress. Plainly, brain injuries, brain cancer, and infections that affect the brain are more than simply emotional distress. There is a growing medical consensus that PTSD alters a person's brain physiology; and in a judgment or settlement, that ought to be enough to classify it as a physical injury or physical sickness.

We have seen the IRS in audits and appeals agree that PTSD can constitute physical sickness enabling an exclusion, but there appears to be no tax case that expressly states this. At first glance, the recent case of *Estate of Finnegan*⁴ might appear to resolve the point, but further inspection reveals it does not. Like so many other cases the Tax Court is regularly asked to decide, this one primarily regards the character of the underlying litigation, the nature of the damages requested, what the defendant ultimately paid when the case settled, and how the damages should be treated under the tax law — in tax parlance, the origin of the claim.

In *Estate of Finnegan*, the Tax Court considered whether section 104 shielded a \$25 million settlement from income and ultimately held that it did not. By reaching its conclusion under the origin of the claim analysis, the Tax Court avoided addressing the physical or emotional classification of PTSD. Consequently, we do not think this decision hurts taxpayers who have a better settlement agreement and a better connection in their litigation record between the defendant's conduct, their litigation claims, and their damages.

In fact, this case may serve as a reminder of what taxpayers need to show for an exclusion. The physical/emotional status of PTSD is the most interesting part of the Finnegans' tax position. Yet it was ultimately moot and not even addressed in the Tax Court's decision. The taxpayers were instead hamstrung by the more basic issues of

how the litigation claims were framed, the origin of the litigated claims, and how the settlement agreement was written. All those points went in the IRS's favor, whether the Finnegans may have had PTSD or not.

Facts and Litigation

Estate of Finnegan arose from the death of a child at age 14. Lynnette Finnegan was the child's mother, and Roman Finnegan, now deceased, was the child's stepfather. Lynnette had three other children — also taxpayers in the tax dispute — who were being raised in the Finnegan household. Death is a physical injury, but the state, which was a defendant in the matter, was not alleged to be responsible for the child's death. Therefore, the child's death did not play into the section 104(a)(2) exclusion analysis.⁵

Following the child's death, the Finnegans were accused of neglecting and abusing the child, and criminal charges were filed against them. Two of Lynnette's other children were removed from the Finnegan home and put in foster care. The criminal charges were eventually dismissed, and the children were returned to the Finnegans. But the family struck back in a long and difficult lawsuit. The suit was brought against state employees for violations of the Finnegans' civil rights through the improper removal of the two children from their home and the pursuit of criminal charges against Lynnette and Roman.

If the Finnegans' goal was to support a PTSD allocation and exclusion, their missteps began early. Their first amended complaint listed several civil rights violations. However, it did not allege any damages for PTSD or mention that any of the parties had, or had been diagnosed with, PTSD. Nor did the Finnegans reference having PTSD in their response to the defendants' motion to dismiss the first amended complaint. PTSD was referenced in only one of the family members' interrogatories and depositions.

The case went to trial without any notable emphasis on alleged physical injuries or physical

³ See *Domeny v. Commissioner*, T.C. Memo. 2010-9 (holding that a recovery for the exacerbation of a taxpayer's multiple sclerosis by stress is a tax-free recovery for the exacerbation of a physical injury or physical sickness).

⁴ *Estate of Finnegan v. Commissioner*, T.C. Memo. 2024-42.

⁵ See, e.g., *Blum v. Commissioner*, T.C. Memo. 2021-18, at *7-8 (citing *Doyle v. Commissioner*, T.C. Memo. 2019-8, at *11), *aff'd* No. 21-71113, (9th Cir. June 2, 2022) (requiring that for damages to be "on account of" a physical injury under section 104(a)(2), there must be a direct causal link between the actions giving rise to the damages and the personal physical injury or physical sickness).

sickness. The voir dire questions concerned alleged violations of the plaintiffs' "civil rights under the First, Fourth, and 14th Amendments to the United States Constitution" and informed the potential jurors that the jury "may be asked to award compensation for mental and emotional suffering."

The plaintiffs' preliminary statement and the district court's summary of the issues presented likewise framed the litigation as centering on whether the defendants violated the plaintiffs' civil rights — specifically their rights under the First, Fourth, and 14th amendments. Even the plaintiffs' counsel at trial described their case as asserting "civil rights claims." Of the 31 jury instructions, not one mentioned PTSD or any physical injury or physical sickness.

The jury awarded the plaintiffs compensatory damages totaling \$31.5 million, with amounts specifically awarded for violations of each plaintiff's constitutional rights. The jury verdict did not mention PTSD specifically, nor physical injury or physical sickness generally. Of the plaintiffs, only Roman had a known diagnosis of PTSD at the time of the district court litigation. Moreover, in the subsequent execution of the settlement agreement and across 14 witnesses' testimonies, Roman's PTSD was referenced only once.

Punitive damages were requested but not awarded. The Tax Court's opinion goes into detail, parsing seemingly all the substantive pleadings and statements made during trial. The Tax Court's analysis paints a weak picture of PTSD being a significant component of the claims the Finnegans alleged.

The case was appealed to the Seventh Circuit and settled for \$25 million in 2017 before the court reached a decision. The settlement agreement did not reference PTSD or physical injuries, except in the likely boilerplate, broad release language that generally released every possible claim that could have been alleged. Of the \$25 million settlement, Roman received roughly \$3.56 million; Lynnette \$3.15 million; and the three living siblings,

Tabitha, Katelynn, and Johnathon, amounts ranging from \$1.6 million to \$2.1 million, all figures being net of legal fees and expenses.⁶

The five plaintiffs did not report any of their settlement proceeds as income, and when an IRS audit was launched, it did not start well. For example, the Finnegans responded to the IRS by saying the violation of their constitutional rights under the First, Fourth, and 14th amendments should be considered personal injuries. Before 1996, section 104(a)(2) allowed taxpayers to exclude recoveries received for personal injuries. However, by the time the Finnegans' audit commenced, it had already been two decades since section 104(a)(2) was amended to limit its exclusion to amounts received on account of personal physical injuries or physical sickness.

About a year after the Finnegans' audit began — likely after realizing their civil rights argument was based on outdated law and therefore dead in the water — they pivoted to the argument that they could exclude the payments under the current version of section 104(a)(2). The Finnegans based this on the theory that the settlement was to compensate them for their PTSD, which, unlike constitutional violations, is a physical injury or physical sickness under section 104(a)(2).

The suddenness of the Finnegans' pivot was not lost on the IRS or the Tax Court and likely did not help their efforts to show that their characterization of the settlement as a recovery for PTSD was bona fide.

The underlying facts of the litigation also did not help the Finnegans. It was clear based on the litigation documents and the family's medical history that only one of them had been diagnosed

⁶ Plaintiffs must report their income tax based on the gross amount of legal recoveries, including portions paid for legal fees and expenses. *Commissioner v. Banks*, 543 U.S. 426 (2005). Thus, the Tax Court's reference to the Finnegans' recovery in net figures is noteworthy. Still, they would likely not have difficulty deducting their 2017 legal fees and expenses against their gross recovery and effectively owing tax only on their net recoveries. Their 2017 recovery was before section 67(g) went into effect for 2018-2025, suspending (disallowing) all miscellaneous itemized deductions for those years. Most nonbusiness taxpayers in litigation not involving their employment deduct legal fees and expenses under section 212, and a nonbusiness plaintiff's section 212 deduction is often categorized as a miscellaneous itemized deduction and therefore suspended. The Finnegans' emphasis on civil rights claims would likely help them qualify their section 212 deduction as an above-the-line deduction, avoiding characterization as a miscellaneous itemized deduction and suspension under section 67(g) even if it were to somehow apply to 2017 deductions. See section 62(a)(20) and (e).

with PTSD before the 2017 settlement. How could the defendants be compensating the other four family members for a physical condition with which they had never been diagnosed and which they never alleged they had before settlement?⁷

The Finnegan's solution was to commission an expert report by a doctor — over a year into the tax audit — that diagnosed each family member with PTSD. It concluded that “the traumatic events experienced by the family meet the criteria of [Criterion] A of the DSM-5 criteria for PTSD of a threat to life or self-integrity.” This later evidence did not convince the IRS, and eventually the matter wound up in the Tax Court. The Tax Court examined the nature of the claims that led to the settlement, finding that the lawsuit primarily addressed violations of civil rights, not personal physical injuries or physical sickness.

The court noted that the settlement agreement and related documents did not specify that the damages were awarded for physical injuries or sickness, but rather for the alleged violation of constitutional rights.⁸ Despite the origin of the claim analysis largely resolving the case, the Tax Court did include additional, uncontroversial discussion about section 104(a)(2). The court went through the history of section 104(a)(2), noting that “emotional distress includes symptoms (e.g., insomnia, headaches, stomach disorders) which may result from emotional distress.”⁹ Reg. section 1.104-1(c)(1) further explains that “emotional distress is not considered a physical injury or physical sickness” unless it is “attributable to a physical injury or physical sickness.”

For damages to be excludable under section 104(a)(2), the court said, there must be a direct causal link between the legal action and the

physical injury or sickness. Emotional distress alone, without a physical component, does not qualify. Having dispensed with the usual summary of the relevant rules, the Tax Court returned to the origin of the claim analysis.

Because the damages were not on account of personal physical injuries or physical sickness but were instead related to the alleged infringement of civil rights, the recovery was taxable. Consequently, the question of whether damages for PTSD are within the section 104 exclusion was not answered, with the Tax Court noting in the footnote that “we need not answer whether PTSD is, in fact, a physical injury or physical sickness.”¹⁰

Are Damages for PTSD Excludable?

If *Finnegan* tells us anything, it is that documentation matters. Litigation documents — complaint, verdict, discovery, etc. — are all highly relevant. Of course, the Finnegan's settled post-verdict, and by definition, a case settling at that stage is always harder from a tax viewpoint unless good characterization language and favorable allocations are already present in the verdict documents, which was clearly not the case for the Finnegan's. Whether before or after a verdict, settlement agreement wording is key. Perhaps it should not be as pivotal as it is, but history shows that it clearly matters enormously.¹¹

Regarding the substantive question of whether PTSD is more like a broken leg than mere emotional distress, there arguably should be no doubt. On September 28, 2016, in a CNN presidential town hall concerning veterans, national security, and foreign policy issues affecting the U.S. military, then-President Obama was asked about PTSD. He said:

The first is I have instructed the Joint Chiefs and up and down the chain of command that they have a responsibility

⁷ See *French v. Commissioner*, T.C. Summ. Op. 2018-36 (holding that a trial court's award was taxable, even when plaintiff's stress created by defendant's conduct at issue in the trial caused plaintiff to be admitted to a hospital intensive care unit, suffer two pulmonary embolisms, die twice as a result of the pulmonary embolisms before being resuscitated by hospital staff, and be placed in a medically induced coma for several days, when the existence of these clearly physical injuries were not made known to the trial court or jury to preserve plaintiff's medical privacy).

⁸ See, e.g., *Green v. Commissioner*, 507 F.3d 857, 868 (5th Cir. 2007) (“Ultimately, the character of the payment hinges on the payor's dominant reason for making the payment.”); cf. *Pipitone v. United States*, 180 F.3d 859, 864 (7th Cir. 1999) (“The existence of an agreement that contains a release of undisclosed or potential claims is not sufficient evidence standing on its own to demonstrate that the amounts paid under the agreement are eligible for exclusion under section 104(a)(2).”).

⁹ H. Conf. Rept. 104-737, at 301 n.56 (1996).

¹⁰ *Finnegan*, T.C. Memo. 2024-42 at *34, n.5.

¹¹ See, e.g., *NCA Argyle LP v. Commissioner*, T.C. Memo. 2020-56; *McKay v. Commissioner*, 102 T.C. 465, 482 (1994), *vacated on other grounds*, 84 F.3d 433 (5th Cir. 1996). See also Robert W. Wood, “Taxes and Settlement Agreement Wording Underscored Again,” *Tax Notes Federal*, Aug. 9, 2021, p. 947; Wood, “IRS Tax on Legal Settlements Depends on Wording,” *Forbes* (Oct. 19, 2021); Wood, “Taxing Emotional Distress Damages: Now What? Settlement Wording!” *Tax Notes Federal*, Apr. 5, 2021, p. 81; Wood, “Another Settlement Is Taxed Because of Poor Settlement Agreement,” *Daily Journal* (Oct. 21, 2021).

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 . . . with your service and there shouldn't be a stigma against it.¹²

The Department of Veterans Affairs' National Center for PTSD estimates that 7.8 percent of Americans will suffer from PTSD at some point in their lives.¹³ Further, the National Center for PTSD reports that 11 to 20 percent of veterans who served in Iraq and Afghanistan suffer from PTSD in a given year,¹⁴ yet an estimated 85 percent of those cases result from events outside military service.¹⁵

With increasing diagnoses, allegations in litigation that a defendant caused or exacerbated a plaintiff's PTSD are no longer rare. They occur in medical and benefits litigation, employment claims, and other contexts.

PTSD can develop after a threat of physical trauma and is said to damage the natural fight-or-flight response to perceived danger.¹⁶ It may manifest as flashbacks, insomnia, headaches,

depression, and stomach disorders. Relevant events include sexual violence, a car accident, or the violent death of a friend or family member.¹⁷ Outside the military, women are twice as likely as men to develop PTSD.¹⁸ The Social Security Administration classifies certain PTSD sufferers as disabled.¹⁹

Disabilities and Physical Injury Damages

Since 1918 the tax code has generally considered compensatory damages in personal injury cases to be tax free. In 1996, section 104(a)(2) was amended so that its exclusion applies only to recoveries for physical injuries and physical sickness, not emotional distress. No published rulings, regulations, or cases have addressed whether PTSD is physical enough for this exclusion to apply.²⁰

For years, the IRS required observable bodily harm (like cuts or bruises) for an exclusion.²¹ Then in a 2008 ruling, the IRS excluded a recovery for sexual molestation, even though payment was made years later when no observable bodily harm could be seen.²² More generally, the observable bodily harm label seems to have dissipated, and the IRS seems to recognize that physical and emotional injuries may sometimes be inextricably

¹⁷ See Wolfe, *supra* note 13.

¹⁸ *Id.*

¹⁹ *Laskowski v. Department of Veteran Affairs*, No. 3:10-cv-600-JMM, at 17 (M.D. Pa. 2013); see also Social Security Administration, "Online Application for Disability Benefits" (last accessed May 2024).

²⁰ 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.

²¹ 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).").

²² See CCA 200809001 ("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 Wood, "IRS Allows Damages Exclusion Without Proof of Physical Harm," *Tax Notes*, Mar. 31, 2008, p. 1388.

¹² CNN, "Transcript: CNN Presidential Town Hall: America's Military and The Commander and Chief" Presidential Town Hall: America's Military and the Commander and Chief," CNN Press Room (Sept. 28, 2016).

¹³ See Alexandra Wolfe, "Charles Marmar," *The Wall Street Journal*, Jan. 7-8, 2017, at C11.

¹⁴ *Id.* Other studies claim that approximately 25 percent of the 2.6 million returning veterans from Afghanistan and Iraq since 9/11 have been diagnosed with PTSD. See Florida Center for Investigative Reporting, "Returning Iraq and Afghan War Vets Find Little Government Support, Investigation Finds," Aug. 26, 2013.

¹⁵ *Id.*

¹⁶ National Institute of Mental Health, "What Is Post-Traumatic Stress Disorder?" (last accessed May 2024).

entwined.²³ Although some nontax courts have determined that PTSD is not a physical injury,²⁴ that does not appear to be the medical consensus, and tax law should not take a narrow or outdated view.

Indeed, PTSD recoveries under workers' compensation acts are tax free even if the disability is not physical.²⁵ Section 104(a)(4) also excludes income amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces. Neither of these subsections requires the injury or sickness to be physical.

Yet outside these cases, PTSD damages would have to meet the "physical" requirement to be tax free. PTSD resulting from physical injuries, such as veterans who have lost limbs or sight in battle, clearly should qualify. A physical injury catalyst allows the taxpayer to exclude even garden-variety emotional distress damages.

However, PTSD may also result from workplace harassment, being kidnapped, or witnessing the deaths of fellow soldiers. Given what we now know from brain imaging, PTSD itself should be viewed as a physical sickness or observable bodily harm.

The physical structure of the brain is altered by PTSD just as the physical structure of the heart is altered by a heart attack. PTSD sufferers also exhibit a reduced hippocampus, a part of the brain that plays a major role in short-term memory and emotions. This part of the PTSD sufferer's brain is up to 20 percent smaller than a typical hippocampus.²⁶

Physical injuries and physical sickness also regularly include conditions that affect the body's hormone production. It is unlikely anyone would assert that conditions like hyperthyroidism, diabetes, Addison's disease, and Graves' disease are solely types of emotional distress; all are conditions that relate to the body's production of hormones. PTSD has also been shown to have a lasting effect on the body's production of hormones, particularly the production of cortisol.

Researchers can survey the human brain more thoroughly than with conventional X-ray or CT scans,²⁷ and a person with PTSD shows higher levels of cortisol.²⁸ Cortisol plays a key role in directing urgent physiological and metabolic processes, and individuals with PTSD generally have altered cortisol levels.²⁹ Child abuse victims with PTSD experience enhanced cortisol activity in response to exposure to traumatic reminders.³⁰

Patients suffering from PTSD show altered activity in the amygdala (which regulates emotional memory) and insular cortex (which handles negative emotional processing).³¹ The amygdala shows hyperactivity, and the insular cortex shows hypoactivity.³² These effects are observable with equipment, and outward manifestations of PTSD are also often apparent.³³

Long before Obama's 2016 remarks, Nina Olson, then serving as the national taxpayer

²⁷ Advances in MRIs allow neurologists to examine the brain at one-millimeter resolution, in color and in 3D, enabling detections in small changes in brain activity. See Berton, *supra* note 2.

²⁸ Eileen Delaney, "The Relationship Between Traumatic Stress, PTSD, and Cortisol," U.S. Naval Center for Combat and Operational Stress Control (May 14, 2013) (citing B.M. Elzinga et al., "Higher Cortisol Levels Following Exposure to Traumatic Reminders in Abuse-Related PTSD," 28 *Neuropharmacology* 1656 (2003)).

²⁹ The hypothalamus links the nervous system to the endocrine system. It controls body temperature, hunger, thirst, fatigue, and sleep.

³⁰ See Delaney, *supra* note 28.

³¹ The amygdala is in the temporal lobes of the brain and helps process memory and emotional reactions. The insular cortex is in the lateral sulcus of the brain and regulates a person's perception, motor control, self-awareness, and cognitive functioning. See Amit Etkin and Tor Wager, "Functional Neuroimaging of Anxiety: A Meta-Analysis of Emotional Processing in PTSD, Social Anxiety Disorder, and Specific Phobia," 164 *Am. J. Psychiatry* 1476 (Oct. 1, 2007).

³² Michael Koenigs and Jordan Grafman, "Post-Traumatic Stress Disorder: The Role of Medial Prefrontal Cortex and Amygdala," 15 *Neuroscientist* 540-548 (Oct. 2009).

³³ These include depression, withdrawal, moodiness, and unpredictable temperament.

²³ 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,'" at 10 regarding REG-127270-06:

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 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.

²⁴ See *Curtis v. Department of Justice*, 342 Fed. Appx. 610 (Fed. Cir. 2009); *Parker Drilling Offshore United States LLC v. Campbell*, 323 Fed. Appx. 330 (5th Cir. 2009).

²⁵ See section 104(a)(1).

²⁶ Mark W. Gilbertson et al., "Smaller Hippocampal Volume Predicts Pathologic Vulnerability to Psychological Trauma," 5 *Nat. Neuroscience* 1242-1247 (2002).

advocate, said that PTSD disorders are physical injuries for purposes of section 104.³⁴

Moreover, the Treasury, Labor, and Health and Human Services departments have found the line between emotional and physical injury to be increasingly tenuous. In 2013, these three departments issued final regulations holding that mental health or substance use disorder benefits should be treated the same as medical and surgical benefits in many key regards.³⁵

Some courts have considered PTSD to be a physical injury. In *City of Norman v. Helm*,³⁶ a firefighter developed PTSD after responding to an emergency in which two young boys were suffocating in the trunk of a car. He argued that PTSD “causes physiological changes in the brain itself, [and] therefore it is a physical injury.” The Oklahoma court found that PTSD was a physical injury to the brain.

In *Werline v. CSX Transportation Inc.*,³⁷ a federal district court recognized that PTSD caused physical and emotional injuries, even though the case was pled as one for negligent infliction of emotional distress. The court observed that there is “no recognizable clean-cut [line] that would allow the Court to partition off” emotional injuries from physical injuries associated with PTSD.

PTSD and Emotional Distress

Recognizing PTSD as a physical injury for purposes of section 104 means that emotional distress damages arising from PTSD should also be tax free. The section 104(a)(2) exclusion applies to damages received based on a claim of emotional distress that is on account of personal physical injuries or physical sickness.³⁸ Some courts have held that payments for insomnia,

headaches, and stomach disorders are taxable as mere symptoms of emotional distress.³⁹

However, the courts have recognized that these symptoms may arise on account of physical sickness or physical injury and can be characterized as “objective indications of a disease” rather than merely “subjective sensations.”⁴⁰ In LTR 200041022, the IRS ruled that emotional distress injuries sustained after physical injury are tax free. The Tax Court has also considered the effects of stress on the human body. In *Parkinson*,⁴¹ the taxpayer suffered a heart attack caused by stress on the job. The IRS argued that the settlement was not excludable because the claim was for emotional distress. The Tax Court sensibly viewed a heart attack as a physical injury, not merely a symptom of emotional distress. The *Parkinson* court explained that a heart attack’s physical effects are clearly diagnosable by examining physicians.

In another important case, *Domeny*,⁴² Julie Domeny’s multiple sclerosis was exacerbated by stressful conditions on the job. Her multiple sclerosis symptoms included shooting pain, fatigue, burning eyes, vertigo, and lightheadedness. Although Domeny was not physically touched and her stressors were emotional, the court sensibly ruled her damages to be tax free. As with a heart attack or multiple sclerosis, PTSD’s manifestations may not be as obvious to the naked eye as a cut, bruise, or broken bone. Yet all three conditions create entrenched physical (and mental) changes that can be visible with MRIs and other technologies.

Workers’ Compensation and Pensions

Regardless of whether one views PTSD as a physical or as an emotional condition, a workers’ compensation payment for PTSD should be tax free. Some states are making their workers’

³⁴ Olsen said this in her 2009 Report to Congress, *supra* note 20, and more recently in the “National Taxpayer Advocate 2013 Annual Report to Congress,” at 2 (Dec. 31, 2013).

³⁵ Section 9812 required “processes, strategies, evidentiary standards, and other factors used by the plan or issuer” to be “comparable to, and be applied no more stringently for, mental health or substance use disorder benefits than for medical surgical benefits.” T.D. 9640.

³⁶ *City of Norman v. Helm*, Okla. Civ. App. 106 (2012).

³⁷ *Werline v. CSX Transportation*, 1:09-cv-0886-TWP-MJD (S.D. Indiana 2010).

³⁸ PMTA 2009-035; see also *Commissioner v. Schleier*, 515 U.S. 323 (1995).

³⁹ See *Sanford v. Commissioner*, T.C. Memo. 2008-158; see also *Blackwood v. Commissioner*, T.C. Memo. 2012-190 (holding that payments for depression symptoms of insomnia, oversleeping, migraines, nausea, and vomiting were for emotional distress and not excludable from income); *Murphy v. IRS*, 493 F.3d 170 (D.C. Cir. 2007) (in which the D.C. Circuit considered sleeplessness, stomachaches, and headaches “minor and transitory” and did not exclude payments for these symptoms).

⁴⁰ *Parkinson*, T.C. Memo. 2010-142.

⁴¹ *Id.*

⁴² *Domeny*, T.C. Memo. 2010-9.

compensation benefits for PTSD quite clear. For example, Minnesota’s workers’ compensation statutes define “occupational diseases” — a threshold definition for qualifying for workers’ compensation — to include “a mental impairment . . . or physical disease” rising out of employment.⁴³ For these purposes, a “mental impairment” can include a PTSD diagnosis.⁴⁴ Although this construct implies that a mental impairment is distinct from a physical disease, it also reflects the view that PTSD and its impairment of normal cognitive function involve more than emotional distress.

Similarly, Connecticut’s workers’ compensation statutes generally exclude from workers’ compensation any:

mental or emotional impairment, unless such impairment (I) arises from a physical injury or occupational disease, (II) in the case of [certain police and law enforcement officers], arises from such police officer’s use of deadly force or subject to deadly force in the line of duty [with certain exceptions], or (III) is a diagnosis of post-traumatic stress injury as defined in section 31-294-k that meets all the requirements of section 31-294k.⁴⁵

Connecticut also generally excludes from workers’ compensation any “mental or emotional impairment that results from personnel action, including, but not limited to, a transfer, promotion, demotion or termination.”⁴⁶ Despite carving out most emotional distress like damages — other than emotional distress “arising from a physical injury or occupational disease” — from the scope of workers’ compensation through this “mental or emotional impairment” language, Connecticut’s statutes clarify that PTSD triggered by any of several “qualifying events” is considered a personal injury that can result in workers’ compensation benefits.⁴⁷

Just as workers’ compensation payments are tax free by statute with no physical requirement, payments received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces are tax free.⁴⁸ In *Sullivan*,⁴⁹ payments from the VA were for disabilities, including PTSD, resulting from service in Vietnam. The court did not dispute that these disability payments for PTSD were excludable under section 104(a)(4).

Conclusion

PTSD shares key characteristics with other medical conditions that clearly qualify as physical sickness under section 104. In the case of many maladies, physical harm occurs inside the human body or on a microscopic scale not visible to the untrained eye. Still, these less visible maladies, including heart disease, cancer, COVID-19, stroke, chronic lower respiratory disease, Alzheimer’s disease, diabetes, nephritis, and liver disease, represented nine out of the 10 leading causes of death in the United States in 2022 — accounting for all leading causes of death except unintentional injury, according to the Centers for Disease Control and Prevention’s National Center for Health Statistics. Conditions like these can often cause damage at the cellular level or can impair the function of internal organs, which can only be confirmed using special equipment and expert training. Still, no one would doubt that they are physical injuries or physical sickness.

The scientific and medical communities have verified that PTSD is observably physical, which should be enough for PTSD to be treated similarly to these other less overt, but nevertheless physical, injuries and sicknesses. A payment on account of PTSD should be confirmed by the IRS and the courts as tax free, just as a payment on account of many other less overt physical injuries and physical sicknesses would be, regardless of whether the payment comes via workers’ compensation, a pension, or under a legal settlement or judgment. ■

⁴³ Minn. Stat. section 176.011, subdivision 15(a).

⁴⁴ *Id.* at subdivision 15(d), (e).

⁴⁵ Conn. Gen. Stat. section 31-275, subdivision 16(B)(ii).

⁴⁶ *Id.* at subdivision 16(b)(iii).

⁴⁷ See Conn. Gen. Stat. sections 31-275, subdivision 16(B)(ii)(III); 31-294k, subdivision (a)(6)-(7) and (b).

⁴⁸ See section 104(a)(4).

⁴⁹ *Sullivan v. United States*, 46 Fed. Cl. 480 (Fed. Cl. 2000).