TAX CODE SECTION 104: DISPARATE TREATMENT OF SETTLEMENT PROCEEDS

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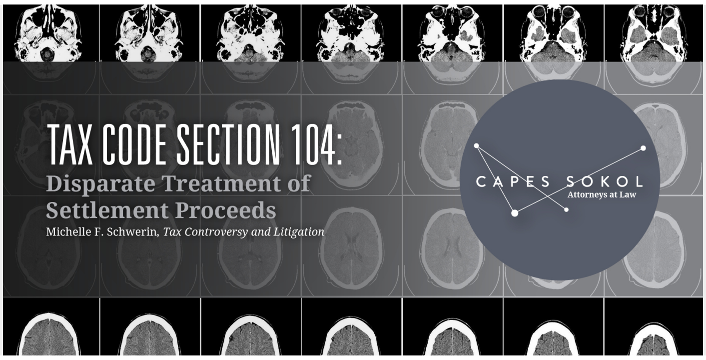

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Tax Code Section 104(a)(2) provides that "damages (other than punitive damages) received … on account of personal physical injuries or physical sickness" are excludable from the recipient's gross income for tax purposes. In 1996, Congress, through the Small Business Job Protection Act, amended this section to specifically provide that damages received under a claim of personal injury or sickness are only excludable if the injury or sickness is ***physical***.

Physical Injury versus Emotional Distress

Following the 1996 Act, if the cause of action was grounded in a physical injury or physical sickness, all damages (other than punitive damages) that flowed from the injury would be treated as payments received on account of personal physical injuries or physical sickness and therefore not income to the recipient.

Damages resulting from a physical injury or physical sickness include:

> *(1) damages to the physically injured party and*

> *(2) damages to another party (e.g., loss of consortium due to the physical injury of a spouse).*

In addition, damages related to emotional distress resulting from a physical injury are excluded from income under Section 104.

Emotional distress alone, however, is not considered a physical injury for purposes of applying Section 104(a)(2). And, according to legislative history, physical symptoms including insomnia, headaches, and other physical manifestations resulting from emotional distress are considered part of the emotional distress and also not excludable.

What does the IRS look for to determine physical injury?

The IRS looks for documented bodily harm in determining whether the Section 104 exclusion from income applies. If documented bodily harm is established, all consequential damages will be excluded from the recipient's income, including consequential damages for emotional distress.

The IRS recognizes that "personal physical injuries", while being the standard it must look for, is not defined in Section 104 nor in its legislative history.

The IRS's own analysis of the law concludes:

> *(i) that damages received from unwanted physical contacts without observable bodily harm were not "on account of" personal physical injuries or physical sickness, and*
>
> *(ii) physical injury can be determined from "observable bodily harms", which can be minor, such as bruises, cuts, swelling, and bleeding.*

Otherwise stated, the IRS will look for an observable physical ailment – at a minimum, a bruise, cut, swelling or bleeding – in determining whether settlement proceeds are excluded from the recipient's gross income.

Notable IRS Physical Injury Cases

Domeny v. Commissioner

Domeny v. Commissioner, T.C. Memo 2010-9. In *Domeny*, the Tax Court considered a taxpayer's receipt of settlement proceeds after the taxpayer was terminated from her employer. The employer and taxpayer reached a settlement addressing taxpayer's claim that the hostile work environment exacerbated the symptoms she suffered as a result of Multiple Sclerosis and the termination caused a second escalation of her MS symptoms.

The Tax Court determined that the settlement was for personal physical injury, citing the taxpayer's MS symptoms.

Parkinson v. Commissioner

Parkinson v. Commissioner, T.C. Memo 2010- 142. In another case, later that year, the Tax Court considered a settlement received by a taxpayer after he suffered a heart attack triggered by working long hours in a stressful work environment. The taxpayer argued that the settlement was for physical injuries, namely the heart attack caused by extreme emotional distress related to his employment. The IRS claimed that the settlement related solely to emotional distress.

The Tax Court determined that the settlement should be split – 50% for physical injuries, excludible from gross income and 50% for emotional distress, included in his gross income. The entire amount attributable to medical care (i.e., hospital bills) was excludable, even if related to the emotional distress.

In its determination, the Tax Court noted:

> *Insofar as the medical center intended the settlement payment to compensate petitioner for his alleged physical injuries or physical sickness, then, the payment is excludable under section 104(a), notwithstanding that the underlying claim was based on the tort of intentional infliction of emotional distress. Because petitioner's physical injuries were the overriding focus of his State court complaint, we have no doubt that those physical injuries figured prominently among the "noneconomic damages" for which the settlement payment was made.*

Does Section 104(a)(2) reflect today's reality?

Today, we have scientific-based medical studies that demonstrate observable physical consequences of stress and/or mental distress. We know that humans will exhibit physical manifestations of emotional distress. And, sometimes an emotional or mental condition is so severe that it will cause a physical consequence, such as a heart attack, ulcers, or an MS flare-up.

Does it make sense, then, that damages related to emotional distress resulting from physical injury qualify for exclusion under Section 104, while damages related to emotional distress without "observable bodily harm" do not?

With the rising focus on PTSD among veterans and other individuals exposed to traumatic experiences and an increased awareness of sexual harassment and sexual assault throughout the country, the current guidance and limitations surrounding Section 104(a)(2) are certainly ripe for challenge. It seems inevitable that a taxpayer who suffers an emotional or mental reaction to a traumatic situation, which subsequently manifests itself in physical symptoms, will challenge the current application of Section 104.

Such challenge will likely call on lawmakers, the IRS and/or the court system, to more accurately reflect our current understanding of mental and physical ailments. Whether the reaction will be through a legislative change to the statutory framework, a more liberal interpretation of the statute by the courts or IRS, or maintaining the status quo, remains to be seen.