

Recent U.S. Tax Court Decision Highlights Issues Regarding the Tax Treatment of Damages for Stress-Induced Physical Ailments

By JEREMY BABENER and NEIL KIMMELFIELD

In two cases decided in 2010, the U.S. Tax Court indicated that damages compensating for stress-induced physical ailments may be tax-free where (1) the taxpayer can demonstrate that the damages were actually received on account of those ailments and (2) the physical nature of the ailments was verified by a physician, preferably based on objective medical evidence rather than the taxpayer's subjective report of symptoms. In the Tax Court's July 11, 2012, decision in *Blackwood v. Commissioner*, T.C. Memo 2012-190, the taxpayer did not satisfy this standard, highlighting the difficulty of establishing that damages compensating for stress-induced physical ailments are excludable from income.

Section 104(a)(2) of the Internal Revenue Code provides that damages received on account of personal physical injuries or physical sickness are generally excluded from income. However, section 104(a) expressly states that "emotional distress" is not a physical injury or physical sickness. Thus, damages compensating for emotional distress are generally taxable.

What about damages received on account of physical ailments induced by stress?

The legislative history of 1996 amendments to section 104(a)(2) states that "emotional distress" includes "physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress." Courts have suggested, in non-binding "dicta," that other stress-induced physical ailments, including periodic impotency, fatigue, urinary incontinence, and elevated blood sugar levels, also may be considered symptoms of emotional distress. See *Lindsey, Jr. v. Commissioner*, 422 F.3d 684 (8th Cir. 2005); *Moulton v. Commissioner*, T.C. Memo 2009-38.

This limited guidance does not establish a clear dividing line between such symptoms and actual physical injuries or sickness, and leaves open the possibility that damages attributable to other stress-induced physical ailments may be excluded from income under section 104(a)(2).

In 2010, the Tax Court twice held that section 104(a)(2) applied to damages received on account of severe stress-induced physical ailments.

In *Domeny v. Commissioner*, T.C. Memo 2010-9, the Tax Court found that (1) the taxpayer, who had multiple sclerosis, "show[ed] that her work environment exacerbated her physical illness" and (2) the damages she received were intended to compensate her for "her acute physical illness caused by her hostile and stressful work environment." Based on those findings, the court held that section 104(a)(2) applied, and that the damages she received on account of her physical ailments were tax-free. The fact that the exacerbation of the taxpayer's physical ailments was due to stress, rather than an obviously physical cause, did not lead the Tax Court to view the resulting damages as received on account of emotional distress. Notably, in the underlying dispute, the taxpayer's physical ailment was medically verified by her doctor, who determined that she was too ill to work. The doctor's diagnosis apparently was based on the taxpayer's report of "[v]ertigo, shooting pain in both legs, difficulty walking due to numbness in both feet, a burning sensation behind her eyes, and extreme fatigue."

In *Parkinson v. Commissioner*, T.C. Memo 2010-142, the Tax Court held that section 104(a)(2) applied to damages that the taxpayer received on account of heart attacks and cardiovascular damage that he suffered due to intentional

infliction of emotional distress in his workplace. Interestingly, in concluding that the taxpayer's physical ailments were not "symptoms" of emotional distress, the Tax Court emphasized that, in medical parlance, a "symptom" is "subjective evidence of disease or of a patient's condition, i.e., such evidence as perceived by the patient." The court viewed the taxpayer's ailments, by contrast, as actual "physical injury or sickness rather than mere subjective sensations or symptoms of emotional distress."

The Tax Court's narrow reading of the term "symptom" in *Parkinson* could have far-reaching implications. Based on that reading, it is possible that section 104(a)(2) generally applies to damages for physical ailments caused by emotional distress as long as (1) the ailments are objectively verified by a physician based on signs of illness other than the taxpayer's subjective report of symptoms, and (2) the taxpayer can demonstrate that the damages were paid on account of those physical ailments. *Domeny* further suggests that section 104(a)(2) may apply to damages paid on account of a diagnosed physical illness, even if the diagnosis is based entirely on symptoms reported by the taxpayer, if the illness is "acute."

In the recent *Blackwood* decision, the Tax Court held that a settlement payment received by the taxpayer as a result of her wrongful termination was taxable even though the termination allegedly exacerbated the taxpayer's depression, causing her to suffer insomnia, migraines, nausea, and pain in her back, shoulder, and neck. In reaching its decision, the court emphasized that neither the taxpayer's letter to her employer threatening suit, nor the subsequent settlement agreement, identified any of the taxpayer's physical ailments, except by referencing her "depressive symptoms." The court also emphasized that the taxpayer did not show "the level of physical injury or physical sickness in *Domeny*" or that the taxpayer's "physical symptoms of depression were severe enough to rise to the level of a physical injury or physical sickness."

The *Blackwood* decision is a reminder that, when a taxpayer seeking damages for stress-induced ailments does not (1) obtain a medical diagnosis during the underlying dispute and (2) emphasize diagnosed physical ailments in communications with the defendant, the taxpayer will have difficulty establishing that any resulting damages were received on account of physical injuries or physical sickness.

It remains to be seen whether taxpayers who do obtain, and use, medical diagnoses in their pursuit of damages will obtain tax-free treatment when their stress-induced physical ailments are less acute than multiple sclerosis or heart disease.



Jeremy Babener concentrates his practice in the area of taxation. Prior to joining Lane Powell, he worked as a Tax Policy Fellow in the U.S. Treasury Department's Office of Tax Policy, focusing on partnership tax issues including noncompensatory partnership options and debt-equity exchanges. He has written and spoken on the taxation of personal injury damages, structured settlements and qualified settlement funds. He can be reached at 503.778.2140, or at babenerj@lanepowell.com.



Neil Kimmelfield is chair of Lane Powell's Taxation practice Group. He can be reached at 503.778.2196, or at kimmelfieldn@lanepowell.com.

This is intended to be a source of general information, not an opinion or legal advice on any specific situation, and does not create an attorney-client relationship with our readers. If you would like more information regarding whether we may assist you in any particular matter, please contact one of our lawyers, using care not to provide us any confidential information until we have notified you in writing that there are no conflicts of interest and that we have agreed to represent you on the specific matter that is the subject of your inquiry.