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February 3, 2010

Hon. Douglas Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments on Limitation of Section 104(a)(2) Exclusion

Dear Commissioner Shulman:

Enclosed are comments on limitation of section 104(a)(2) exclusion. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stuart M. Lewis  
Chair, Section of Taxation

Enclosure

cc: Michael Mundaca, Acting Assistant Secretary (Tax Policy), Department of the Treasury  
William Wilkins, Chief Counsel, Internal Revenue Service  
Joshua Odintz, Acting Tax Legislative Counsel, Department of the Treasury

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ABA SECTION OF TAXATION  
COMMENTS ON LIMITATION OF SECTION 104(a)(2) EXCLUSION

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Megan L. Brackney, Chair, and David L. Rice, Vice-Chair of the Individual and Family Tax Committee of the Section of Taxation. Substantive contributions were made by Toni Robinson and Peter Mills. The Comments were reviewed by Joseph Barry Schimmel of the Section’s Committee on Government Submissions and by Walter Burford, Council Director for the Individual and Family Tax Committee.

Although the members of the Section who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member (or firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these Comments.

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Date: February 3, 2010

## EXECUTIVE SUMMARY

On September 14, 2009, the Department of Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issued Proposed Regulations<sup>1</sup> to implement amendments made to section 104(a)(2)<sup>2</sup> by section 1605(a) and (b) of the Small Business Job Protection Act of 1996 (the “1996 Act”).<sup>3</sup>

The Proposed Regulations reflect the statutory amendments to section 104(a)(2), and provide that the income exclusion in section 104(a)(2) is limited to amounts received on account of personal “physical” injuries or “physical” sickness. The Proposed Regulations further provide that although emotional distress is not considered a physical injury or a physical sickness, damages not in excess of the amount paid for “medical care” (as described in section 213(d)(1)(A) or (B))<sup>4</sup> for emotional distress are excluded from income. In addition, the Proposed Regulations clarify that a taxpayer may exclude damages received for emotional distress “attributable” to a physical injury or physical sickness. The Proposed Regulations also eliminate the requirement that damages received from a legal suit, action or settlement agreement must be based upon “tort or tort type rights” to be excluded from gross income. The Proposed Regulations reverse the long-standing rule established in *United States v. Burke*<sup>5</sup> that the section 104(a)(2) exclusion does not apply to awards from personal injuries redressed by “no-fault” statutes that did not provide traditional tort-type remedies.

We commend Treasury and the Service for clarifying the scope of section 104(a)(2). As discussed below, however, we recommend that the final Regulations clarify that damages awarded for “physical injuries or sickness” are excludable from income under section 104(a)(2) irrespective of whether the initial cause of action was based on a physical touching.

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<sup>1</sup> REG-127270-06, 74 Fed. Reg. 47,152 (Sept. 14, 2009).

<sup>2</sup> References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

<sup>3</sup> Pub. L. No. 104-188, 110 Stat. 1838.

<sup>4</sup> Section 213(d)(1)(A) and (B) define “medical care” as amounts paid for “the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body,” and “for transportation primarily for and essential to” such medical care.

<sup>5</sup> 504 U.S. 229 (1992).

## DISCUSSION

### 1. Background of the 1996 Act Amendments to Section 104(a)(2)

In 1996, the Small Business Job Protection Act amended section 104(a)(2) to provide that damages for physical injuries or physical sickness were excludable from gross income. As amended, section 104(a)(2) provides that gross income does not include “the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.” In addition, Congress included the following limitation in section 104(a)(2):

For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress.

The legislative history of the 1996 Act explained that the term “emotional distress” includes physical symptoms, such as insomnia, headaches, or stomach disorders that result from such emotional distress.<sup>6</sup>

Prior to the 1996 Act, section 104(a)(2) required “personal” injuries as a threshold for excluding a damage award from taxable income. This vague standard created a split of judicial authority as to whether awards that did not have a physical injury or sickness element were excluded from income. For example, in *Bent v. Commissioner*,<sup>7</sup> the court held that damages awarded for the deprivation of the right to free speech were excludable from the taxpayer’s gross income under section 104(a)(2). However, in *United States v. Burke*,<sup>8</sup> the Supreme Court limited section 104(a)(2) by holding that it did not apply to an award of back pay under the pre-1991 version of Title VII of the 1964 Civil Rights Act,<sup>9</sup> because the award did not compensate the taxpayer for a “tort type” injury. Thus, in addition to limiting the exclusion to physical injuries under section 104(a)(2), the court also interpreted section 104(a)(2) as not covering personal injuries redressed by “no-fault” statutes that did not provide traditional tort-type remedies.

In *Commissioner v. Schleier*,<sup>10</sup> the Supreme Court held that the taxpayer’s recovery under the Age Discrimination in Employment Act of 1967 (“ADEA”)<sup>11</sup> constituted taxable income. The district court had ruled that the taxpayer’s employer had committed a willful violation of the ADEA, but the parties settled the case after the appellate court reversed the

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<sup>6</sup> H.R. Rep. No. 104-737, at 301 fn. 56 (1996) (Conf. Rep.), 1996-3 C.B. 741, 1041.

<sup>7</sup> 87 T.C. 236 (1986), *aff’d*, 835 F.2d 67 (3d Cir. 1988).

<sup>8</sup> 504 U.S. 229 (1992).

<sup>9</sup> 42 U.S.C. § 2000e. Title VII of the 1964 Civil Rights Act prohibits, *inter alia*, wage-based discrimination on account of sex or race.

<sup>10</sup> 515 U.S. 323 (1995).

<sup>11</sup> 29 U.S.C. § 621, *et seq.* The ADEA prohibits arbitrary discrimination in the work place based on age. The taxpayer in *Schleier* had sued his former employer under a provision of the ADEA which makes it unlawful for an employee to discharge an individual between the ages of 40 and 70 “because of such individual’s age.” 29 U.S.C. § 623(a)(1); 631(a).

district court's decision. Half of the settlement award was allocated to back pay and the other half was allocated to liquidated damages; the taxpayer reported only the back pay portion of the settlement award, and excluded the liquidated damages. In reaching its decision that the full amount of the settlement award was includable in gross income, the Court developed what has become known as the "*Schleier* test," which requires that for exclusion from gross income under section 104(a)(2), the damage award must be received (i) through prosecution or settlement of an action based on "tort or tort-type rights" and (ii) on account of personal injuries or sickness. Although *Schleier* did not specifically require it, courts have consistently interpreted the second prong of *Schleier* as implying that the injury be physical in nature.<sup>12</sup> Consistent with *Burke* and *Schleier*, Regulation section 1.104-1(c) sets forth the "tort or tort type" test as one of the qualifications for exclusion under section 104(a)(2).

As noted above, the 1996 Act amended section 104(a)(2) to provide that only damages for physical injuries or physical sickness were excludable from income, and to limit damages for emotional distress to those associated with medical care for a physical condition caused by such emotional distress. This statutory amendment, however, did not fully settle the uncertainty as to the types of damage awards that are excludable from income. This uncertainty is reflected in *Murphy v. Internal Revenue Service*.<sup>13</sup> In *Murphy*, the court held that damages awarded to the taxpayer in an administrative action against her former employer under a whistleblower statute for "mental pain and anguish" and "injury to professional reputation" were outside of the scope of the damages exclusion under section 104(a)(2), even though the taxpayer had suffered from certain physical manifestations of the emotional distress on which the award was based.

Under the Proposed Regulations, it is now clear that damages for physical injuries may qualify for the section 104(a)(2) exclusion even though the injury giving rise to the damages is not defined as a tort under state or common law. We believe, however, that the Proposed Regulations do not define the full scope of the types of damage awards that qualify for the exclusion under section 104(a)(2).

## **2. Recommendation**

We commend the Service for eliminating the *Burke* rule that did not exclude damages awarded under a "no-fault" statute, as this rule created different tax consequences for the exact same injuries depending on whether the taxpayer lived in a "no-fault" jurisdiction. However, to eliminate additional confusion as to the application of section 104(a)(2), we recommend that the Service clarify whether the cause of action must be based on a physical touching for the damage award to qualify for exclusion under section 104(a)(2).

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<sup>12</sup> See e.g., *Venable v. Commissioner*, 86 T.C.M. (CCH) 254, 2003 T.C.M. (RIA) ¶ 2003-240; *Shaltz v. Commissioner*, 85 T.C.M. (CCH) 1489, 2003 T.C.M. (RIA) ¶ 2003-173; *Henderson v. Commissioner*, 85 T.C.M. (CCH) 1469, 2003 T.C.M. (RIA) ¶ 2003-168, *aff'd*, 104 Fed. Appx. 47 (9th Cir. 2004).

<sup>13</sup> 493 F.3d 170 (D.C. Cir. 2007), *cert. denied*, 128 S. Ct. 2050 (2008).

There is no definition of either “physical injury” or “sickness” in section 104(a)(2) or in either the current or Proposed Regulations. Although the Service has issued a number of Private Letter Rulings in this area,<sup>14</sup> it has not issued formal guidance on the scope of section 104(a)(2).

Courts considering whether particular damage recoveries are excludable from income appear to contemplate that so long as the damage recovery was related to a physical injury or sickness, the nature of the cause of action itself is not dispositive. Ascertaining the nature of the claim is a factual determination that generally is made by reference to the settlement agreement and the facts and circumstances surrounding it. Key to this determination is the “intent of the payor” in making the payment.<sup>15</sup> Thus, the question is “[i]n lieu of *what* were the damages awarded?”<sup>16</sup> Although the payee’s belief is relevant to this inquiry, the ultimate character of the payment rests on the payor’s dominant reason for making the payment.<sup>17</sup>

Accordingly, so long as the damages were paid on account of a personal injury or sickness, we believe the nature of the claim should be irrelevant, particularly because the Proposed Regulations would eliminate the requirement of an action or settlement based upon “tort or tort type rights.” Courts analyzing cases deciding the application of section 104(a)(2) have strongly suggested that a physical touching is not required and that damage awards from causes of action, such as employment discrimination or damage to reputation, may be excludable.

First, in *Prasil v. Commissioner*,<sup>18</sup> the taxpayer sued her employer for sexual harassment and discrimination and contended that her employer’s conduct had exacerbated her illness, Sweet’s syndrome, a painful skin condition. As in *Murphy*, very little evidence was produced at trial establishing a connection between the taxpayer’s medical *condition* and her employer’s conduct. The parties reached a settlement agreement, and based on the language of this agreement, the Tax Court ruled that the damage award was not excludable from income under section 104(a)(2) because there was no evidence that the award compensated the taxpayer for any physical injuries. In so ruling, the Tax Court suggested that had the taxpayer presented such evidence, she might have been able to exclude the award from income.

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<sup>14</sup> See, e.g., PLR 200041022 (Oct. 13, 2000) (ruling that direct unwanted or uninvited physical contacts that caused bodily harm, such as cuts, bruises, swelling, and bleeding, were personal physical injuries under section 104(a)(2)). In 2009, the Service took the position that physical injuries that are observable, such as bruises, swelling, cuts or bleeding, are indeed evidence of “physical injury,” and thus all compensatory damages related thereto, including emotional distress, loss of wages, and loss of consortium would be excludable under section 104. PMTA 2009-035 (Oct. 22, 2008). The PMTA further provided, however, that damages recovered from an employment-related dispute generally will be included in the employee’s gross income. The Service has provided very little guidance as to the circumstances in which the section 104 exclusion will apply or whether it has changed its view that a physical touching is required.

<sup>15</sup> *Knuckles v. Commissioner*, 349 F.2d 610, 613 (10th Cir.1965), *aff’d* 23 T.C.M. (CCH) 182, 1964 T.C.M. (P-H) ¶ 64,033; *Agar v. Commissioner*, 290 F.2d 283, 284 (2d Cir.1961), *aff’d* 19 T.C.M. (CCH) 116, 1960 T.C.M. (P-H) ¶ 60,021; *Seay v. Commissioner*, 58 T.C. 32, 37 (1972).

<sup>16</sup> See *Robinson v. Commissioner*, 102 T.C. 116, 126 (1994) (emphasis in original).

<sup>17</sup> See *Agar*, 290 F.2d at 284.

<sup>18</sup> 85 T.C.M. (CCH) 1124, 2003 T.C.M. (RIA) ¶2003-100; see also *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1943) (in considering whether recovery in anti-trust action was a return of capital or income in form of compensation for goodwill, “[t]he test is not whether the action was one in tort or contract but rather the question to be asked is ‘[i]n lieu of what were the damages awarded?’”)

Next, in *Murphy*, the taxpayer claimed that she suffered physical injuries, specifically, Bruxism, a condition that caused her to grind her teeth and clench her jaw, as a result of her employer's actions, but the D.C. Circuit found that the Administrative Law Judge had awarded damages solely for "mental anguish and suffering" and injury to professional reputation.<sup>19</sup> The court thus held that the damages were not "awarded by reason of, or because of . . . [physical] personal injuries." The court appears to have kept the door open for cases in which the damage award was related to physical injuries even though the cause of action did not involve a physical touching. We believe that if the taxpayer had established that she recovered damages on account of Bruxism, those damages should have been treated as on account of "personal physical injuries or sickness."

Likewise, in *Tamberella v. Commissioner*,<sup>20</sup> the taxpayer sued for a number of claims, including wrongful termination. The taxpayer contended that her employer's actions against her caused her bipolar disorder to worsen. Like the taxpayers in *Murphy* and *Prasil*, the taxpayer did not present any evidence at trial that her mental illness was exacerbated by her employer's conduct, and again, the settlement agreement did not mention physical or mental illness.<sup>21</sup>

The cases discussed herein illustrate that there are many situations in which actionable physical injury or sickness results from conduct that does not include a physical touching. Moreover, the creation of the limited exclusion for damages for emotional distress in the 1996 Act strongly suggests that Congress intended section 104(a)(2) to include causes of action that are not based on touching and that the inquiry should be focused on the nature of the award as opposed to the cause of action. Indeed, there is no reference to physical touching in the statute itself or the legislative history.

As a result of recent technological advancements in medicine, we now know that many maladies formerly believed to be purely psychological, and thus not within the scope of section 104(a)(2),<sup>22</sup> have physical origins. For example, studies have shown that Post-Traumatic Stress Disorder actually results in physical changes in the brain and brain chemistry.<sup>23</sup> Moreover, there are many examples of physical injuries and sicknesses when there has been no physical touching, such as the physical impact on homeowners from the use of certain Chinese

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<sup>19</sup> 493 F.3d at 175.

<sup>20</sup> 139 Fed. Appx. 319 (2d Cir. 2005).

<sup>21</sup> The court made clear that it was not deciding "whether a serious mental illness, such as schizophrenia or bipolar disorder, constitutes a 'physical injury or sickness'" within the meaning of section 104(a)(2). 139 Fed. Appx. at 322, n.2.

<sup>22</sup> The legislative history to the 1996 Act states that conditions arising from emotional distress, such as headaches, insomnia and stomach aches, are not intended to come within the scope of section 104(a)(2). See fn. 6, *supra*.

<sup>23</sup> See V. Francati, E. Vermetten, J.D. Bremner, *Functional Neuroimaging Studies in Posttraumatic Stress Disorder: Review of Current Methods and Findings*, DEPRESSION AND ANXIETY, VL: 24, NO: 3, PG: 202-218 (2007) .

drywall.<sup>24</sup> A touching in the physical sense is not present, yet the resulting respiratory ailments would appear to be a physical injury or illness.<sup>25</sup>

In sum, we believe that the Service should include in the final Regulations language clarifying that the nature of the underlying cause of action is not dispositive, but merely a factor taken into consideration when determining whether the “physical injuries or sickness” test has been met.

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<sup>24</sup> See Leslie Wayne, *Thousands of Homeowners Cite Drywall for Ills*, THE NEW YORK TIMES (Oct. 7, 2009), available at <http://www.nytimes.com/2009/10/08/business/08drywall.html>.

<sup>25</sup> See PLR 200121031 (Feb. 16, 2001) (concluding damages received for both wrongful death and loss of consortium were non-taxable under section 104(a)(2) in case in which taxpayer’s husband died of lung cancer from exposure to asbestos on the job).