

The "Physical" Requirement in IRC § 104(a)(2) and Taxable Interest in a Settlement or Judgment

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The "Physical" Requirements

I. IRC § 104(a)(2), which excludes from taxable income certain amounts received on account of personal injuries, was amended by the Small Business Job Protection Act of 1996 to limit the exclusion to "personal *physical* injuries or *physical* sickness." (Emphasis supplied.) This limitation applies to damages received after August 20, 1996.

II. The legislative history (H.R. Conf. Rep. No. 737, 100 Cong., 2d Sess. 301 (1996)) provides some guidelines for applying the limitation. In general, it looks to whether the primary injury is physical. If so, all resultant damages (except punitive damages) are excludable. Damages for emotional distress, for example, are excludable if the emotional distress was caused by or resulted from a physical injury. Conversely, if the primary injury is not physical (for instance, if the tort was unlawful discrimination or libel), then the recovery is not excludable, even if the unlawful action causes emotional distress which in turn results in "insomnia, headaches, or stomach disorders." (*Id.*, at 301.) (Note that interest generally is not considered part of the damages.)

A. In an important concession, the Conference Report provides that resulting injuries to third parties, such as loss of consortium, are excluded if the primary injury was physical. (*Id.*) Similarly, recoveries for wrongful death are excluded. This is the case even though under applicable state law the claims of the plaintiffs (e.g., the spouse or next of kin recovering for loss of care and companionship of the decedent) are based upon the non-physical injuries the plaintiffs themselves suffer.

B. Also excluded from taxable income are payments received to pay for medical care necessitated by the personal injury, even if the injury was not physical (psychological counseling for emotional distress resulting from a discriminatory firing, for example). This is a narrow exception to the rule that the underlying injury must be physical. Taxpayers cannot use this exclusion if the same medical costs had been deducted on Schedule A.

III. Many questions remain, however, as to how "physical" is to be defined and what degree of proximity to the physical injury is required.

A. In Johnson v. United States, 2002 U.S. Dist. LEXIS 15894; 2002-2 U.S.T.C. P50,593 (D. Colo.) (July 3, 2002), proximity to the physical injury was the issue. The plaintiff was a prison guard who was injured in a confrontation with an inmate. When he could not return to his previous job because of his continuing physical problems, he was fired. He

sued under the Americans with Disabilities Act and received a verdict for back pay, front pay, emotional distress, interest and attorneys' fees and costs. The opinion does not mention any claim or recovery based directly on the physical injuries themselves. In the subsequent tax case, where he attempted to claim the § 104(a)(2) exclusion, he argued that although his injury claims had been "brought under the parameters of the ADA and common law tort for severe emotional distress, the true core of the case arose directly from [his] on-the-job physical injuries absent which he would have had no other claims." This reasoning was rejected. The court applied the holding of Commissioner v. Schleier, 515 U.S. 323 (1995), that there must be a direct link (not simply a "but for" connection) between the personal injury (which now must be the physical injury) and the recovery. It found that the taxpayer's claimed "causal link is too tenuous to support exemption from taxation under § 104(a)(2), and that the actual injury that Plaintiff recovered for was discrimination, which does not qualify as a physical injury...."

The Johnson case was affirmed by the Tenth Circuit (Docket No. 02-1330) on August 29, 2003, in a nonprecedential order that agreed with the district court that there was "no direct causal link" between the physical injury and the recovery. The appellate court disclosed that Mr. Johnson had in fact been unable to recover anything for his physical injuries because the state of Colorado refused to waive sovereign immunity.

B. The definition of "physical" has been addressed by the IRS in a private letter ruling, PLR 200041022 (July 7, 2000). The ruling describes a "slow progression" of affronts and injuries suffered by the plaintiff. She received a lump sum settlement that presumably was to be allocated among the various claims. The plaintiff's relationship with her employer had at first been friendly, then came to include his lewd remarks and unwanted attempts to make sexual contact, then progressed to unwanted physical touching without "observable bodily harm." After this he "assaulted" her, causing "what [she] represents was extreme pain," after which she had headaches and digestive problems, but her doctors found nothing to be "physically wrong" with her. During a subsequent road trip another assault included "cutting her and biting her." After this she became "executive director" of his household and suffered several further assaults, which resulted in "skin discoloration and swelling" and extreme pain. The IRS ruled that only upon the cutting and biting did the injuries become "physical" for purposes of § 104(a)(2). The ruling describes the standard as "uninvited physical contacts resulting in observable bodily harm such as bruises, cuts, swelling, and bleeding."

IV. There have now been a few Tax Court decisions on the "physical" issue, but because of their particular facts they do not offer highly useful guidance. See, e.g., Nield v. Commissioner, T. C. Summary Opinion 2002-110 (August 27, 2002), Parsil v. Commissioner, T.C. Memo 2003-100 (April 9, 2003), Dorroh v. Commissioner, T.C. Summary Opinion 2003-93 (July 18, 2003).

V. In Amos v. Commissioner, T.C. Memo 2003-329 (December 1, 2003), the taxpayer was a courtside photographer who had been kicked in the groin by Dennis Rodman during an NBA game. Mr. Amos was taken by ambulance to a hospital, treated, and released. At the hospital he complained of pain and was limping noticeably. That same day he filed a police report. Six days after the incident, after both parties had engaged legal counsel, he agreed to release all claims in return for a payment of \$200,000. He excluded that amount from his taxable income; the IRS after audit treated the entire amount except one dollar as taxable.

Tax Court found that "Rodman's dominant reason in paying the settlement amount at issue was to compensate petitioner for his claimed physical injuries." The judge then allocated \$120,000 of the settlement to Amos's release of claims on account of the physical injury, and \$80,000 to his agreement to keep the settlement confidential, not defame Rodman, or assist in the criminal prosecution. The parties had not allocated the \$200,000.

The court did not discuss the provision in the legislative history, mentioned above, that "If an action has its origin in a physical injury ... then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury ... whether or not the recipient of the damages is the injured party." Does the court distinguish between a physical injury being the "dominant reason" for the recovery, from an action having its "origins" in a physical injury?

The Amos rationale for allocating the recovery, if correct, would put into question a large number of § 104(a)(2) cases decided over the years, as confidentiality agreements and covenants not to defame are common and generally have not affected an otherwise tax free personal injury recovery.

Amos apparently has not been appealed.

Taxable Interest

I. The issue whether a settlement or judgment includes interest taxable under IRC § 61 arises in its sharpest form in cases where, absent interest, the recovery would be tax free under IRC § 104. (The issue can also be important in cases of taxable damages, for instance in an employment situation where, in some cases, the recovery would be treated as wages subject to FICA except to the extent it is interest. In that case interest treatment generally would be preferred.) It is now apparently well settled that statutory interest added to a judgment that has become final will be treated as taxable interest. *See, for example, Brabson v. United States*, 73 F.3d 1040 (10th Cir. 1996), and *Kovacs v. Commissioner*, 100 T.C. 124 (1993), *aff'd* 25 F.3d 1048 (6th Cir. 1994), *cert. denied*, 513 U.S. 963 (1994). The First Circuit has held that this applies both to prejudgment and postjudgment interest. *Rozpad v. Commissioner*, 154 F.3d 1, 5 (1st Cir. 1998).

II. There has been considerably less certainty in cases where the parties settle out of court, often for a lump sum amount with the dismissal documents filed with the court mentioning nothing about interest. Note that even in those cases the defendant probably will insist that claims for interest be specifically released along with all other claims. In the last 20 years or so the IRS has litigated a number of cases where the parties have settled after plaintiff received a verdict or judgment that would have had statutory interest added and paid if the defendant had not appealed. Plaintiffs have argued that the entire lump sum settlement consists of damages received on account of personal injuries, while the government has contended that some part of that lump sum must represent interest.

A. Two decisions from the First Circuit, *Delaney v. Commissioner*, 99 F.3d 20 (1996) and *Rozpad v. Commissioner*, 154 F.3d 1 (1998), now would appear to govern most cases where an unallocated amount is paid to settle the injury case after trial but before the appeal is concluded. The court applied the traditional Raytheon (*Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1943), *cert. denied*, 323 U.S. 779 (1944)) test: "in lieu of what were the damages awarded?" The court concluded that interest was part of the claim that the parties believed the settlement satisfied. The court rejected the argument that the interest should be viewed as part of the damages from the injury, citing the Supreme Court decision in *Commissioner v. Schleier*, 515 U.S. 323 (1995), for the requirement that there must be a direct link (not merely a "but for" connection) between injury and payment. *Delaney*, at 27. The court held that interest is not paid directly on account of the personal injury, but rather for the delay in the payment of the damages. The use of the phrase "without interest" in the settlement documents was held not to be probative.

1. The judge in each of the cases (*Delaney*, at 22; *Rozpad*, at 4) then determined the exact amount of deemed interest by following the method that had been used by the IRS on audit. The suggestion was not that this is the only possible method, but rather that it does have a rationale, the IRS determination is presumptively correct, and some method must be used. The method in these two cases was to determine a fraction, the numerator of which was the amount of prejudgment interest that had accrued at the time of the jury verdict and the denominator of which was the amount of the verdict. Taxable interest was then determined in each case by multiplying the settlement amount by that fraction.

2. Note that any postjudgment interest that would have accrued between the date of the verdict and the date of the settlement apparently does not come into the calculation.

3. The judge clearly found it significant that no allocation had been made by the parties, taking that lack as an invitation for the IRS and courts to determine the amount of interest. (The statement in the settlement documents that there was "no interest" did not rise to the level of an allocation, in his view.)

III. Note that it appears to be generally accepted that there is no interest component in a lump sum settlement reached before trial. The reason for this is suggested by the court in *Rozpad*, at 3-4: "When the interest component of a personal injury settlement is difficult to delineate, there is every reason for courts (and the Commissioner) to defer to section 104(a)(2) and treat the entirety as free from tax... .On the other hand, when the interest component of a personal injury settlement can be delineated with accuracy and ease - as when there has been a jury verdict and an ensuing judgment that contains separate itemizations of damages and interest - a subsequent settlement that does not purport to make a different allocation is quite logically viewed as including a pro rata share of interest." This suggests that it is the fixed verdict amount, plus statutory interest, that provides the necessary "delineation" to arrive at a definite "interest" percentage. In theory, of course, the interest percentage of any amount can be determined where there is a known term and known interest rate. But the tradition of not going behind pre-trial settlements to determine interest no doubt is a major factor encouraging such settlements, and there does not appear to be any pressure to change it.

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