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The United States Tax Court holds that emotional distress manifested in the form of depression suffered as a result of alleged employment-related retaliation was not exempt from taxation as a personal physical injury under the Internal Revenue Code. The Tax Court also explained how to determine the reason for a settlement payment, relying upon the language in the settlement agreement.

Tax Court Reiterates that Emotional Distress Suffered From Claims of Employment Retaliation Is Not Tax Exempt

By William Hays Weissman

In *Wells v. Commissioner*[1] the United States Tax Court reiterated that emotional distress manifested in the form of depression suffered as a result of alleged employment-related retaliation was not exempt from taxation as a personal physical injury under the Internal Revenue Code.[2]

Background

Marion Wells, the plaintiff, had worked for the Colorado Department of Transportation (CDOT) from 1975 to 1995. In 1995, she was assigned to a new project and had an altercation with her supervisor. In November 1995, she filed a discrimination and retaliation claim with the CDOT's Center for Equal Employment Opportunity. After filing the complaint the plaintiff began taking leave and sought treatment from a therapist to deal with the stress caused by altercation. Her employment was terminated in September 1996, after having exhausted her leave, which she had been on for approximately 8 of the 10 intervening months.

The plaintiff then filed suit in federal district court against the CDOT, her supervisor, and her supervisor's superior alleging gender discrimination and retaliation under 42 U.S.C. sections 1983 and 1988 and Title VII of the Civil Rights Act of 1964. Her complaint alleged employment discrimination based on gender, and further that the stress caused by the altercation and the subsequent perceived inaction by CDOT in response to her complaint she lodged caused her to take leave. She also asserted that when her leave was exhausted, her employment was terminated and she "was given no opportunity to return to her position."

The parties entered into a settlement agreement in February 2005. The settlement agreement stated that $175,000 was to be paid to the plaintiff "as damages for her emotional distress due to depression and other claims, not as wages or back pay," and that it "shall constitute a full and final settlement of all claims [the plaintiff] asserted or might assert" against the defendants in the 1997 lawsuit. The settlement agreement also stated that a Form 1099-MISC, Miscellaneous Income, would be issued to the plaintiff and reported to the Internal Revenue Service (IRS).

The IRS Gets Involved

The plaintiff did not report the settlement proceeds on her 2005 income tax return. The IRS issued her a deficiency, and she protested to the Tax Court. The court began by noting that "gross income includes all income from whatever source derived" while exclusions from income are narrowly construed. "[The plaintiff] must bring herself within the clear scope of any statutory exclusion."

The Tax Court noted that there is an exclusion for a personal physical injury under IRC section 104(a)(2). The court explained that for the damages to be excludable under this provision, however, the underlying cause of action must: (1) be based in tort or tort-type rights; and (2) the proceeds must be damages received on account of personal physical injury or physical sickness. It added that under the 1996 amendments to section 104(a)(2), damages for emotional distress, including its physical symptoms, resulting from nonphysical injury are not excludable from gross income (except for an amount of damages not in excess of the amount paid for medical care to treat the emotional distress).

The court next laid out the analysis when the amount paid is pursuant to a settlement agreement, stating that "the nature of the claim that was the basis for settlement, and not the validity of the claim, controls whether such amount is excludable under section 104(a)(2)."[3] "If the settlement agreement lacks express language stating what the settlement amount was paid to settle, we look to the intent of the payor, based on all the facts and circumstances of the case, including the complaint that was filed and the details surrounding the litigation."

Turning to the second prong, the Tax Court, based on the express language in the settlement agreement that the payment was for emotional distress and not wages, held that the payment was in fact "made as damages for emotional distress due to depression and, as a matter of law, such damages, not being attributable to physical injury or sickness, but to a nonphysical injury (namely, her claims of suffering gender-based discrimination and unlawful retaliation with respect to her employment) are not excludable from her gross income under section 104(a)(2) ...."

The Tax Court also rejected her assertion that because depression is not specifically excluded as a physical injury under section 104(a)(2), it is within the definition of a personal physical injury. "This is not the correct standard. [The plaintiff] must show that she falls within the clear scope of any statutory exclusion," which as a matter of law she could not do.

Finally, the Tax Court rejected her claim that she did not know that the amount paid in settlement would be includable as income. While recognizing that such an argument might have a bearing on the imposition of any penalties, it nonetheless stated that "a taxpayer is presumed to know the law and a mistake of law does not excuse liability." Therefore, the Tax Court upheld the IRS assessment.

Lessons Learned

This case represents yet another in a growing line of cases holding that payments for emotional distress, whether characterized as depression or stress, and whether evidenced by physical manifestations such as bruxism, insomnia, or ulcers, resulting from allegations of employment discrimination and retaliation simply is not the kind of payment on account of a personal physical injury that Congress exempted from income taxation under section 104(a)(2). Employers should continue to recognize that they have reporting obligations on the payments of such settlements, regardless of any reporting position that a plaintiff may desire to take. This case also demonstrates how the language used in the settlement agreement can be important evidence of the reasons for payment, and merely characterizing a payment as for distress does not, absent other evidence of a personal physical injury, convert taxable income into exempt income.

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[1] *Wells v. Commissioner*, T.C. Memo 2010-5 (Jan. 5, 2010).

[2] *See* IRC § 104(a)(2).

[3] Citing *Bagley v. Commissioner*, 105 T.C. 396, 406 (1995), aff'd, 121 F.3d 393 (8th Cir. 1997).