



Unreasonably Not Injured-Section 104(b) Exclusion and Reasonable Cause
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This week we look at the exclusion from income for personal injuries as discussed in a recent Tax Court case. We then go on to look at the question of what was a “reasonable basis” for the position in question, and also look at a second “reasonable basis” case when the taxpayer appealed to a response to a letter to the President.

Exclusion from Income

IRC §104(a)(2) provides for the exclusion from income for the following type of damages received:

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;

§104(a) goes on to note that “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 key issue that has arisen is whether amounts received are truly for physical injuries. In the case of *Goode v. Commissioner*, TC Memo. 2006-48, the taxpayer attempted to treat payments received in a settlement as due to physical injuries based on the terms of the agreement—terms that, the court decided, were primarily written by the taxpayer for self-serving purposes, and which the payor was not terribly interested in.

Mr. Goode received a settlement from the District of Columbia related to his employment and actions that involved:

The gravamen of petitioner's complaint —comprised of two underlying counts alleging, respectively, the District's infringement of petitioner's First Amendment rights under 42 U.S.C. sec. 1983 (2000) and violation of the D.C. Whistleblower Reinforcement Act of 1998, D.C. Code sec. 1-615.54 —concerns the District's averred retaliatory conduct against petitioner. Such reprisal was directed at petitioner, according to the complaint, because of his purported endeavor to inform various government agencies and officials of the dire conditions then prevalent in the District's developmentally disabled housing program. Petitioner's damages were enumerated in the complaint as comprising “emotional and mental anguish, humiliation and embarrassment, ridicule, physical pain and physical upset, damage to [petitioner's] professional reputation, and damage to his reputation in the community.”

The settlement contained the following language which the taxpayer claimed to rely upon when excluding most of the settlement from income:

compensatory damages pursuant to section 104(a)(2) and for out-of-pocket expenses only; * * * [the disputed settlement amount] does not constitute wages, and shall be considered as non-taxable to the fullest extent permitted by law. The parties understand and agree that no W-2 form shall issue from the District of Columbia with respect to * * * [the disputed settlement amount].

The District of Columbia did end up issuing 1099s, the original one of which overstated the amount of the settlement, managed to send the 1099 not to the recipient but to a law firm that once represented the taxpayer and only finally got one reporting the correct amount to the taxpayer nearly three years after the payment.

The Court notes the import of allocations in general in the following analysis:

Express allocations in a settlement, identifying payment amounts deemed eligible for the section 104(a)(2) exclusion, are generally accorded conclusive effect for tax purposes. *Fono v. Commissioner* [Dec. 39,454], 79 T.C. 680, 693-694 (1982), *affd.* without published opinion 749 F.2d 37 (9th Cir. 1984). However, the statutory proviso contained in the penultimate sentence of section 104(a) dictates one exception to this principle of judicial deference to manifest allocations. The penultimate sentence of section 104(a) provides: “For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness.”

As elucidated in the legislative history of the SBJPA amendment, “emotional distress” denotes “symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress.” H. Conf. Rept. 104-737, at 301 n.56 (1996), 1996-3 C.B. 741, 1041 n.56. To ascertain whether settlement proceeds fall

within the section 104(a)(2) “physical injuries or physical sickness” rubric —as opposed to ineligible payments stemming from physical manifestations of emotional distress —the caselaw surveys the circumstances surrounding the origin of the injury redressed in the settlement for a sufficient nexus, or “direct causal link”, between the amount paid and the asserted physical injury. See *Lindsey v. Commissioner*, 422 F.3d 684, 688 (8th Cir. 2005) (“We agree with the Tax Court that these health symptoms [i.e., fatigue, indigestion, insomnia, and incontinence] relate to emotional distress, and not to physical sickness.”), affg. [Dec. 55,632(M)] T.C. Memo. 2004-113; *Banaitis v. Commissioner* [2003-2 USTC ¶50,638], 340 F.3d 1074, 1080 (9th Cir. 2003), affg. in part and revg. in part on a different issue [Dec. 54,607(M)] T.C. Memo. 2002-5; *Allum v. Commissioner* [Dec. 56,100(M)], T.C. Memo. 2005-177 (“The mere mention of ‘personal physical injury’ in a complaint does not, by itself, serve to exclude the recovery from gross income under section 104(a)(2)”).

So the taxpayer needs to avoid the claim that emotional distress is the issue in question. The court was not convinced the taxpayer carried this issue.

As well, the court noted that it appeared that only the taxpayer's side had been involved in drafting the relevant provisions, driven for tax purposes:

Additionally, the allocation of the disputed amount was not apparently contested by the District during the course of the settlement negotiations with petitioner, and thus, the designation of the proceeds is not consonant with the nature of petitioner's underlying claims. Petitioner's complaint against the District contains no mention or allusion to the putative Graham assault. Petitioner's explanation for such conspicuous omission was that the complaint, which was never served on the District, was filed close to the expiration of the period of limitations for one or both of the causes of action, and was drafted in a sterile manner without reference to the putative Graham assault so as not to disrupt the progress of the settlement negotiations. Apart from petitioner's self-serving testimony, however, there is no evidence present in the record to establish that the putative Graham assault ever occurred.

Moreover, Teal testified at trial that the District's standard settlement agreements, utilized to resolve disputes of a similar nature to that involving petitioner, were relatively brief and rudimentary in format, and did not specify the designation of the compensatory damage payments. According to Teal's recollection at trial, she perceived of the characterization of the disputed settlement amount as outside the scope of the controversy between the District and petitioner. Teal had been informed that the settlement allocation did not present any potential adverse ramifications for the District because, irrespective of the express settlement allocation, the District would defer to respondent's ultimate determination of the applicability of the section 104(a)(2) exclusion.

Petitioner asserts that the characterization of the disputed settlement amount was the result of quid pro quo negotiation because petitioner's municipal income tax liability, derived from his computation of adjusted gross income for Federal income tax purposes, would be correspondingly lower if the section 104(a)(2) exclusion applied. The record contains no evidence, however, that Teal was ever cognizant of or considered such diminishment to the District's municipal fisc.

So the court held against the taxpayer.

But you might think that the taxpayer had “good reason” for his position and should avoid a penalty due to having reasonable cause for his position. However, the court noted that:

Petitioner contends that there was reasonable cause to rely on the settlement's explicit characterization of the disputed settlement amount, particularly since a timely Form 1099 was not provided to him. However, in qualifying the disputed settlement amount as “non-taxable *to the fullest extent permitted by law*,” the settlement contemplates that such allocation was not to be conceived of as a definitive pronouncement for tax purposes. (Emphasis added.) Additionally, petitioner presented no evidence that he consulted with a professional tax adviser, or took any other independent action, to confirm the treatment of the disputed settlement amount under Federal tax law. In light of our findings above concerning the nonadversarial nature of the settlement negotiations and the dubious origin of petitioner's ailments, the mere fact that petitioner did not receive the Form 1099 does not establish the applicability of the reasonable cause and good faith exception to the section 6662 penalty.

Ask the President

Continuing on the issue of “reasonable cause” there was an interesting case of *Smith v. Commissioner*, TC Memo. 2006-51 where a taxpayer tried to place his reliance on the top official of the United States government—a response to a letter to the President.

The issue was whether wages earned by the taxpayer while working on Johnston Island were subject to exclusion from tax. As the IRS explained in a news release in 2000:

The Internal Revenue Service reminds individuals in an unincorporated U.S. territory, such as Johnston Island, that they may not claim the exclusion for personal service income earned in a U.S. possession under section 931. They also cannot exclude this income as “foreign earned income” under the exclusion provision in section 911.

At one time Johnston Island was listed as a U.S. possession for purposes of the possessions exclusion under the 1954 Code; however, the law was changed under amendments enacted by the Tax Reform Act of 1986. Johnston Island is not a “specified possession” for purposes of new section 931, so income earned on the Island is not subject to exclusion.

The taxpayer was informed by his employer that his wages were not subject to exclusion from taxation on a couple of occasions. As well, IRS Publication 570 also noted that Johnston Island did not qualify for exclusion.

However, the taxpayer claimed to rely on a response to a letter to President George W. Bush:

Sometime prior to November 13, 2001, an individual named Brian Jordan (Mr. Jordan)³ sent a letter to President George W. Bush (Mr. Jordan's letter to President Bush). That letter stated in pertinent part:

Subject: CFR 26, Vol 10, Part 1, (secs 1.908 to 1.1000), Revised as of 1 April 1997

Dear Sir:

I would like to know if the above mentioned subject is still current for Johnston Atoll (Island) because I have been unable to obtain an answer from the I.R.S.

On November 13, 2001, in response to Mr. Jordan's letter to President Bush, the IRS Center in Philadelphia, Pennsylvania, sent a letter to Mr. Jordan (IRS November 13, 2001 letter to Mr. Jordan) that was signed by David L. Medeck, who was identified in that letter as "Field Director, Accounts Management". The IRS November 13, 2001 letter to Mr. Jordan stated in pertinent part:

I am responding to your letter to President George W. Bush. You asked about the Code of Federal Regulations (CFR) as it pertains to Johnston Island.

** * * * **

I am enclosing 26 CFR 1.931-1. These regulations are current as of October 24, 2001.

Attached to the IRS November 13, 2001 letter to Mr. Jordan was a copy of section 1.931-1, Income Tax Regs., which the Department of the Treasury (Treasury) promulgated under section 931 prior to its amendment by section 1272(a) of the Tax Reform Act of 1986 (TRA 1986), Pub. L. 99-514, 100 Stat. 2593.4 (We shall refer to section 931 prior to its amendment by the TRA 1986 as old section 931.)

The taxpayer claimed their reliance on this letter (even if not written to them) was reasonable cause for their position.

However, the court noted:

We consider now petitioners' third argument in support of their position that they had a reasonable basis in claiming the \$99,980 exclusion of 2001 wages in their 2001 joint return. As we understand that argument, petitioners maintain that in claiming that exclusion they relied on the IRS November 13, 2001 letter to Mr. Jordan¹⁴ that the IRS sent in response to Mr. Jordan's letter to President Bush.¹⁵ On the record before us, we reject any such argument. The record does not

establish that petitioners were even aware of the IRS November 13, 2001 letter to Mr. Jordan when they signed their 2001 joint return.