A Timely Analysis of Legal Developments

ASAP®

In This Issue:

January 2010

The U.S. Tax Court recently ruled that a settlement payment for allegations that work-related stress exacerbated a physical condition was excludable from taxable income under Internal Revenue Code section 104(a)(2). This opinion appears to be contrary to existing authority, and employers should be careful when plaintiff's counsel attempts to rely upon it.

Tax Court: Settlement Payment for Workplace Stress that Exacerbated Physical Condition Not Taxable Income

By William Hays Weissman

In *Domeny v. Commissioner*,[1] the U.S. Tax Court held that an employee's settlement payment for allegations that work-related stress exacerbated a physical condition was excludable from taxable income under Internal Revenue Code (IRC) section 104(a)(2).[2]

Background

In that case, the petitioner had been diagnosed with multiple sclerosis (MS) prior to commencing employment. The MS caused numbness in her feet, and she experienced fatigue, lightheadedness, vertigo, and sometimes a burning sensation behind her eyes. In 2000, the petitioner began employment as a fundraiser for the Pacific Autism Center for Education (PACE).

In 2004, PACE hired a new executive director to whom the petitioner reported. They had a strained relationship, and the executive director did not want the petitioner to socialize or have direct parent contact, although she was expected to continue fundraising efforts. As a result of her strained relationship and the restriction of her duties, petitioner's MS began to flare up in late 2004.

In November 2004, the petitioner became aware that the executive director had been embezzling funds. She went to PACE's board members with this information, and was told that they would take care of the situation. The petitioner experienced added stress and tension as a result of the situation, and on several occasions advised her superiors of her unhealthful work environment, including her stress from the embezzlement and PACE's failure to take any action.

During this time, the petitioner's MS symptoms intensified, and on March 7, 2005, she left work. The next day she visited her primary care physician, who determined that the petitioner was too ill because of her MS symptoms to return to work, and that she should not return to work until after March 21, 2005. On March 8, 2005, she notified PACE by facsimile of her doctor's diagnosis and instructions not to return to work until March 21.

After sending the facsimile on March 8, the petitioner received a telephone call from PACE's executive director, who notified her that her employment would be terminated effective March 15, 2005. After that telephone conversation petitioner's physical MS symptoms spiked, including shooting pain up her legs, fatigue, burning eyes, spinning head, vertigo, and lightheadedness.

The petitioner contacted an attorney, who negotiated a settlement with PACE. A settlement agreement was reached, which included a release for numerous possible causes of action or rights, including both wage-related claims and emotional distress related claims. Under the agreement, PACE paid the petitioner $33,308, of which $8,187.50 was for wages and $8,187.50 was attorneys' fees. The remaining portion, $16,933, was paid to the petitioner without withholding deductions. PACE issued a Form 1099-MISC reflecting that the amount was "Nonemployee compensation."

The petitioner did not attend the negotiations between her lawyer and PACE's lawyer. At the time petitioner received the settlement, she understood that it was to compensate her for physical injuries that occurred in a hostile work environment that PACE allowed to exist over an extended time. Her intense MS symptoms, which occurred during her PACE employment, prevented her from working until sometime in 2006.

The Tax Court Decision

The sole question before the Tax Court was whether the $16,933 settlement amount petitioner received was excludable from her gross income under IRC section 104(a)(2). The more narrow question was whether the payment was made on account of personal physical injury, as required by the IRC. The court found that the settlement agreement was ambiguous regarding any specific reason why PACE was making the payments. The IRS argued that the ambiguity showed that PACE had no specific intent when making the settlement payment. The court, however, stated that when a settlement agreement lacks express language stating the specific purpose of the settlement payment, the most important factor for courts to consider is the intent of the payor.

The payor's intent can be "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 specific facts, the court found that the petitioner's exposure to a hostile and stressful work environment exacerbated her MS symptoms to a point where she was unable to work. This fact was confirmed by her doctor, who prescribed two weeks off. She notified PACE of her condition and her doctor's diagnosis together with his instructions that she take time off from work because of illness. PACE terminated her employment a short time thereafter. The court further found that, as a result of the termination, the petitioner obtained the services of an attorney who met with PACE's attorney and worked out a settlement of her claims. The agreement contained a blanket release from any and all claims that petitioner might have had, but had no specific or express statement of the payor's intent.

Based on these facts, the court held an inference could be drawn from the terms of the settlement agreement despite the lack of any express statement of intent. Specifically, the settlement agreement was segregated into three separate and distinct payments: wages, attorneys' fees, and all other claims. The third payment was not subject to withholding, and was reported on a 1099-MISC.

Therefore, the court held:

> [T]he differing tax and reporting treatments used for the three payments show that PACE was aware that at least part of petitioner's recovery may not have been subject to tax; *i.e.*, was due to physical illness. Coupled with that inference is the fact that petitioner advised PACE of her illness before her employment was terminated and the likelihood that her attorney represented petitioner's circumstances to PACE in the course of the settlement negotiations. Petitioner made no other claim. We find that PACE intended to compensate petitioner for her acute physical illness caused by her hostile and stressful work environment.
>
> In summary, petitioner has shown that her work environment exacerbated her existing physical illness. [Footnote omitted.] Petitioner's condition and her MS flareup caused by her working conditions was intense and long lasting. Petitioner was

> physically unable to work until sometime in 2006, more than one year following her termination. She has shown that the only reason for the $16,933 payment was to compensate her for her physical injuries.

In reaching the above conclusion, the court also noted that "[i]t is of no consequence that petitioner had the MS condition before the flareup caused by her hostile work environment." In other words, the court did not find dispositive that she had MS before the stress.

A careful reading of this decision suggests that it was clearly result oriented. The amount at issue, $16,933, was not significant. The petitioner was a sympathetic person, suffering from MS. Her condition worsened as a result of the stress related to doing the right thing by reporting embezzlement and her subsequent employment termination.

Settlement Lessons Learned

This decision appears to run counter to the IRS's position as well as other cases. It also appears somewhat contrary to the specific amendments made by Congress in 2006 that the physical manifestations of stress were not excludable under IRC section 104(a)(2). Employers should be careful about the tax consequences of settlements when petitioners seek to rely upon *Domeny* to argue that catch all payments of nonwages should be excluded from income. Rather, a fairly narrow reading of the facts should be taken, and employers should expect that the IRS will likely not follow the decision.

Nonetheless, the court was clear in reiterating the rules for determining an employer's intent in making payments. The decision reinforces the need to draft settlement agreements carefully and to explicitly state the basis for what an employer is paying. Doing so can avoid problems in the future for both employers and plaintiffs.

William Hays Weissman is a Shareholder in Littler Mendelson's Walnut Creek office. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, or Mr. Weissman at wweissman@littler.com.

---

[1] *Domeny v. Commissioner*, T.C. Memo 2010-9 (January 13, 2010).

[2] IRC section 104(a)(2) states: "gross income does not include -- ... (2) 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."