Current Federal Tax Developments

Week of September 20, 2021

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SECTION: 104
ONLY PORTION OF AWARD RELATED TO PSYCHOTHERAPY EXPENSES INCURRED BY END OF TAX YEAR OF AWARD CAN BE EXCLUDED FROM INCOME

Citation: Tressler v. Commissioner, TC Summary Opinion 2021-33, 9/13/21

The taxation of lawsuit settlement proceeds brings taxpayers before the Tax Court regularly, as it did in the case of *Tressler v. Commissioner*, TC Summary Opinion 2021-33.[1]

Taxpayers often feel that much of any lawsuit award should not be taxable—they feel they have been wronged and it just doesn't "feel right" to pay tax on the amounts awarded to them to right that wrong by the court. But the IRC only treats certain types of award amounts as being nontaxable, with the rest being subject to tax because of the default rule of IRC §61—all items of gross income are subject to tax unless we can find an exception to that general rule.

The Tax Court in this case outlines the basics of the taxation of lawsuit awards as follows:

> Settlement proceeds paid to a taxpayer constitute gross income unless the taxpayer proves they fall within a specific statutory exception. See *Commissioner v. Schleier*, 515 U.S. 323, 328-337 (1995). Section 104(a)(2) supplies one such exception, excluding from gross income "any damages (other than punitive damages) received (whether by suit or agreement * * *) on account of personal physical injuries or physical sickness". Damages for emotional distress generally do not qualify for the section 104(a)(2) gross income exclusion because emotional distress is not treated as a physical injury or physical sickness. See sec. 104(a) (flush text); sec. 1.104-1(c)(1), Income Tax Regs. The foregoing authorities create two exceptions to this rule: Section 104(a)(2) does exclude from gross income (1) damages for emotional distress attributable to a physical injury or physical sickness and (2) damages not in excess of the amount paid for medical care described in section 213(d)(1)(A) or (B) for emotional distress. Section 213(d)(1)(A) includes 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". This Court has held that this definition of medical care includes psychotherapy. See *Fischer v. Commissioner*, 50 T.C. 164, 173, 176 (1968).[2]

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[1] *Tressler v. Commissioner*, TC Summary Opinion 2021-33, September 13, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/amount-paid-for-psychotherapy-excludable-from-settlement-income/784b5 (retrieved September 15, 2021)

[2] *Tressler v. Commissioner*, TC Summary Opinion 2021-33, September 13, 2021

As most often the lawsuit alleges a number of claimed damages, the award must be analyzed to determine what makes up any allocation of that award. As the opinion continues:

> When a taxpayer receives damages pursuant to a settlement agreement, the nature of the claim that was the basis for the settlement controls whether the damages are excludable under section 104(a)(2). See *United States v. Burke*, 504 U.S. 229, 237 (1992); *Bagley v. Commissioner*, 105 T.C. 396, 406 (1995) ("[T]he critical question is, in lieu of what was the settlement amount paid[?]"), aff'd, 121 F.3d 393 (8th Cir. 1997).[3]

The text of any settlement agreement is the first place that the courts will look to determine what the payment(s) are for:

> What petitioner and Amtrak intended to compromise through the settlement agreement is a question of fact determined by reference to the text of the agreement. See *Simpson v. Commissioner*, 141 T.C. 331, 340 (2013), aff'd, 668 F. App'x 241 (9th Cir. 2016).[4]

But if, as is often the case, the agreement does not give such details, the courts next look to other evidence to determine the intent of the party paying the award:

> Where the agreement does not disclose the nature of the claim underlying a settlement payment, we look to the payor's intent, examining extrinsic evidence including the allegations in the payee's complaint. See id.; *Bent v. Commissioner*, 87 T.C. 236, 245 (1986), aff'd, 835 F.2d 67 (3d Cir. 1987).[5]

In this case, the taxpayer had made a claim against her employer, Amtrak. The facts of the complaint are described as follows:

> Petitioner filed a lawsuit against the National Railroad Passenger Corp. (Amtrak), her employer at the time, in the U.S. District Court for the District of Columbia on October 28, 2009. On October 29, 2010, petitioner amended her complaint. The amended complaint explained that petitioner had worked for Amtrak as a railroad engineer and road foreman since 1987, and it asserted a litany of claims focused on workplace harassment and retaliatory employment practices. Among other claims, petitioner alleged she had endured emotional distress and that she experienced a workplace sexual assault, physical injuries resulting from a workplace stalking incident, physical manifestations of stress caused by the hostile work environment, and an injury to her ankle sustained exiting a train while on duty.[6]

The trial court granted Amtrak's motion for summary judgment, so Ms. Tressler filed an appeal of that decision with the U.S. Court of Appeals for the District of Columbia

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[3] *Tressler v. Commissioner*, TC Summary Opinion 2021-33, September 13, 2021

[4] *Tressler v. Commissioner*, TC Summary Opinion 2021-33, September 13, 2021

[5] *Tressler v. Commissioner*, TC Summary Opinion 2021-33, September 13, 2021

[6] *Tressler v. Commissioner*, TC Summary Opinion 2021-33, September 13, 2021

Circuit. Before getting a decision from the Court of Appeals, the parties settled the case:

> In February 2014 petitioner and Amtrak agreed to settle the case for an $82,500 payment from Amtrak to petitioner. In section 1 of the settlement agreement petitioner "waives and releases any and all claims" against Amtrak and certain related parties "arising from or relating to any and all acts, events and omissions occurring prior to" February 21, 2014, the date petitioner signed the agreement. Section 2 establishes the payment terms. In particular section 2.1 provides that Amtrak will withhold taxes on $27,500 of the settlement payment, which represents "settlement of Ms. Tressler's claims against Amtrak" in her lawsuit. Section 2.2 provides that the remaining $55,000 represents "settlement of Ms. Tressler's claim for emotional distress damages related to her allegations" in the lawsuit. Section 2.5 explains that the payments provided in section 2.1 and 2.2 are "inclusive of all claims by Ms. Tressler for any alleged damages against Amtrak, including, but not limited to, any alleged claims for physical injuries, emotional distress, attorneys' fees, and costs". Amtrak paid the full $82,500 by check on May 1, 2014.[7]

The taxpayer argued that the $55,000 payment for her emotional distress was not taxable, citing IRC §104(a)(2). IRC §104(a)(2) provides:

> (a) In general
>
> Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, 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;

The Tax Court did not agree with Ms. Tressler that the entire $55,000 was excludable under this provision. While she did claim some physical injuries, the Court did not find the $55,000 represented compensation for those based on the text of the agreement:

> The plain text of section 2.2 establishes that the $55,000 payment represents "settlement of Ms. Tressler's claim for emotional distress damages related to her allegations" in the lawsuit. Petitioner points to section 2.5, which provides that the $82,500 payment "is inclusive of all claims by Ms. Tressler for any alleged damages against Amtrak, including, but not limited to, any alleged claims for physical injuries, emotional distress, attorneys' fees, and costs". We recognize that petitioner's complaint in District Court included allegations of physical

[7] *Tressler v. Commissioner*, TC Summary Opinion 2021-33, September 13, 2021

> injuries, but section 2.5 does not state that any part of the $55,000 payment is attributable to the settlement of a physical injury claim. Section 2.5 is a general exculpatory provision whereby petitioner relinquishes the right to further sue Amtrak. This Court has held that a general liability release does not supersede explicit contractual text providing a settlement payment for emotional distress. See *Doyle v. Commissioner*, T.C. Memo. 2019-8, at *12, *15. We simply cannot accept petitioner's request to allocate the $55,000 payment among her claims for "physical injuries, emotional distress, attorneys' fees, and costs" when section 2.2 attributes the whole $55,000 to her claim for emotional distress damages related to her claims in the lawsuit.[8]

The taxpayer argued that Amtrak was motivated to pay this settlement due to the nature of the physical injuries noting:

> Although the text of the settlement agreement itself resolves this issue, petitioner points us to extrinsic evidence that Amtrak "had every reason to compensate" her for her physical injuries, which were well known to Amtrak when it settled the case. Petitioner testified that she was the victim of a violent sexual assault that occurred while she was on duty at Amtrak, and that Amtrak was aware of the assault.[9]

While the Court did not doubt what she said, the Court noted that she had entered into an agreement that did not provide for payments related to those injuries:

> While the Court found her testimony credible, the absence from section 2.2 of any reference to physical injuries represents a conscious choice by petitioner and Amtrak to exclude physical injuries, including any physical injuries from the sexual assault, from the $55,000 settlement allocation.[10]

It is understandable why Ms. Tressler did not push for such language in her settlement. First, it's very possible she was not aware of the impact of not having the agreement mention these injuries as part of what the $55,000 payment was being paid for to the taxation of that payment and there may or may not have been tax advice sought on the wording of the award. Second, even if she was aware it would be best to have such language, the case had drawn out for quite a while and additional haggling over the language would add to the costs of the litigation and would cause even more delay in receiving compensation for her injuries. And it's very possible Amtrak specifically did *not* want to have any reference to the sexual assault and resulting injuries in the settlement—so attempting to get them added might have taken any settlement offer off the table or had the amount of the offer substantially reduced.

However, the Court noted that there is still another way to exclude some of that $55,000 from Ms. Tressler's income. As was noted at the beginning of this article, there

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[8] *Tressler v. Commissioner*, TC Summary Opinion 2021-33, September 13, 2021

[9] *Tressler v. Commissioner*, TC Summary Opinion 2021-33, September 13, 2021

[10] *Tressler v. Commissioner*, TC Summary Opinion 2021-33, September 13, 2021

are two additional exceptions to excluding the income even if it traces back to emotional distress:

- Damages for emotional distress attributable to a physical injury or physical sickness are not taxable, and

- Damages not in excess of the amount paid for medical care are also exempt from taxation.

The taxpayer argued that the first exception should allow her to exclude at least ½ of the award from her income, but the Tax Court did not agree:

> We reject petitioner's argument that the first exception allows her to exclude from 2014 gross income at least half the $55,000, which she says compensates her for emotional distress resulting from her workplace injuries. Section 2.2 of the settlement agreement allocates the $55,000 to petitioner's emotional distress but does not say what caused her emotional distress. Following the Tax Court's suggestion in *Bent*, we turn to petitioner's amended complaint in District Court, which attributes her emotional distress to the harassment and retaliation she endured on the job, not to any physical injuries. The complaint repeatedly alleges that petitioner sustained emotional distress "as well as" physical injuries, and the portion of the complaint describing her physical injuries does not allege any associated emotional distress. Neither the District Court opinion granting Amtrak's summary judgment motion, *Tressler v. Nat'l R.R. Passenger Corp.*, No. 09-cv-2027 (RLW) (D.D.C. Nov. 30, 2012), nor the materials in our record relating to the settlement process, reference emotional distress attributable to physical injuries.[11]

But the Court did find that the medical expense exception may be more fruitful, but found the taxpayer was only able to document just under $7,000 of such expenses paid through the end of 2014 when she received the settlement:

> The second exception permits a taxpayer to exclude damages not in excess of the amount paid for medical care for emotional distress. Petitioner has not carried her Rule 142(a) burden of establishing her right to exclude any of the $55,000 on account of her expenditures on psychiatric medication, or on psychotherapy through 2011. She testified that she does not remember how much she spent on these items, and has not complied with her obligation to maintain documentary proof of these expenditures.
>
> On the other hand, petitioner may exclude $6,980 of the settlement proceeds, which corresponds to the $6,980 her psychotherapist billed from July 5, 2012, to the end of 2014. Section 104(a)(2) permits a taxpayer to exclude the amount "paid" for medical care, as opposed to the amount incurred. Although the record does not disclose when petitioner paid the bills, we infer she paid for each therapy session on

[11] *Tressler v. Commissioner*, TC Summary Opinion 2021-33, September 13, 2021

> or about the date it occurred, because the billing statement shows she paid for each session with a unique check, and the therapist consistently administered therapy over a period of years. Psychotherapy is medical care for purposes of section 104(a)(2), and petitioner received psychotherapy to help her cope with her PTSD.[12]

While it seems likely she will continue to incur psychotherapy costs related to her PTSD in later years, the Court noted that the Court could not make an allowance for the remainder of the award for such expenses she might incur in the future:

> As for any psychotherapy bills petitioner paid after 2014, a taxpayer must report an unrestricted cash payment as income for the year in which it was received, irrespective of any possible subsequent events. See *N. Am. Oil Consol. v. Burnet*, 286 U.S. 417, 424 (1932); *Green Gas Del. Statutory Tr. v. Commissioner*, 147 T.C. 1, 58-59 (2016), *aff'd*, 903 F.3d 138 (D.C. Cir. 2018). Petitioner must recognize the remaining $48,020 as income for 2014 because she received the $55,000 settlement payment in 2014, which she was free to spend however she chose. Section 6214(b) allows us to determine petitioner's liability only for the year shown on the notice of deficiency, see *Williams v. Commissioner*, 131 T.C. 54, 55 (2008), so we do not address the tax treatment in later years of any subsequent amounts she spent on psychotherapy.[13]

SECTION: 6662
TAXPAYER'S RELIANCE ON PRIOR SETTLEMENT FOUND REASONABLE CAUSE TO WAIVE SUBSTANTIAL UNDERSTATEMENT OF TAX ACCURACY-RELATED PENALTY

Citation: Ray v. Commissioner, Docket No. 20-60004, CA5, 9/14/21

While the Fifth Circuit Court of Appeals upheld the Tax Court's decision regarding the amount of tax owed by the taxpayer in the case of *Ray v. Commissioner*, Docket No. 20-60004, CA5,[14] the panel overruled the Tax Court on the issue of penalties and found that the taxpayer had a reasonable basis for a portion of his substantial understatement of tax on the return in question.

A penalty under IRC §6662, such as the substantial understatement penalty for income taxes, is waived if the taxpayer can demonstrate:

- Reasonable cause for the underpayment and

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[12] *Tressler v. Commissioner*, TC Summary Opinion 2021-33, September 13, 2021

[13] *Tressler v. Commissioner*, TC Summary Opinion 2021-33, September 13, 2021

[14] *Ray v. Commissioner*, Docket No. 20-60004, CA5, September 14, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/fifth-circuit-affirms-tax-court-on-deficiency-but-not-penalty/784j0 (retrieved September 15, 2021)

- The taxpayer acted with good faith with regard to the underpayment.[15]

In this case, the Fifth Circuit Court of Appeals agreed with the Tax Court that the taxpayer's legal expenses related to litigation that traced back to trading activities conducted with his ex-spouse in the 1990s did not arise from a trade or business. Thus, they were deductible only under IRC §212 as an expense related to the production of income rather than under IRC §162 as an expense related to a trade or business.

Not surprisingly, the taxpayer faced a greater tax liability when the expenses were deducted under IRC §212 than when they were deducted under IRC §162. In 2014 the lower benefits arose because:

- IRC §212 expenses are only deductible as a miscellaneous itemized deduction, requiring the taxpayer to itemize deductions and then also having to reduce the total deduction for miscellaneous itemized deductions by 2% of adjusted gross income for the year and

- Such expenses were not deductible at all in computing the alternative minimum tax.

Today the result is even worse, since IRC §67(g) added by the Tax Cuts and Jobs Act in 2017 completely denies individual taxpayers the benefit of any miscellaneous itemized deductions.

But even though the panel found that the Tax Court arrived at the correct decision regarding these expenses being deductible under IRC §212, the panel found that the taxpayer had reasonable cause to claim the deduction as a trade or business expense based on a settlement with the IRS of an issue related to this trading activity in 1997.

The Court describes the 1997 IRS exam and settlement as follows:

> Ames deducted his trading agreement losses as a Schedule C business loss on his 1993 tax return. The Internal Revenue Service (IRS) disallowed the deduction and sent Ames a notice of deficiency. Ames disputed the IRS's deficiency determination in the U.S. Tax Court, and he and the IRS eventually reached a settlement, which was entered by the Tax Court on December 16, 1997 as a stipulated decision "[p]ursuant to the agreement of the parties." Under the stipulated decision, Ames was charged a deficiency of $88,926.42 for the 1993 tax year and was still allowed to deduct $374,102.00 as a Schedule C business loss labeled "Futures Trader."[16]

The taxpayer argued that, based on that agreement, he believed the IRS had agreed that the activity was a trade or business.

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[15] IRC §6664(c)(1)

[16] *Ray v. Commissioner*, Docket No. 20-60004, CA5, September 14, 2021

But the IRS argued that this agreement was simply a way to settle the issue as a compromise, thus:

> …the 1997 stipulated Tax Court decision was entered pursuant to the agreement of the parties, and thus the issue of whether the trading agreement loss was a deductible business loss was not actually litigated. In response to Ray's alternative argument on the merits of § 162(a) deductibility, the Commissioner avers that Ray did not carry on the trading venture as a trade or business and was nothing more than an investor.[17]

The Tax Court agreed with the IRS that the taxpayer could not reasonably rely on that settlement to take the position the activity was a trade or business, finding "Ray's reliance on the 1997 stipulated Tax Court decision was unreasonable, as the stipulated decision "does not state or give rise to an inference that petitioner was involved in a computer programming business as he claims here[.]"[18]

The appellate panel described the reasonable cause exception as follows:

> An accuracy-related penalty does not apply to any portion of a taxpayer's underpayment for which the taxpayer had "reasonable cause" and acted in good faith. I.R.C. § 6664(c)(1). The taxpayer bears the burden of proving entitlement to the reasonable cause and good faith defense. *Klamath Strategic Inv. Fund v. United States*, 568 F.3d 537, 548 (5th Cir. 2009); accord *Brinkley*, 808 F.3d at 668. The assessment of whether the taxpayer has met this burden is "made on a case-by-case basis, taking into account all pertinent facts and circumstances." Treas. Reg. § 1.6664-4(b)(1); *Brinkley*, 808 F.3d at 669. "Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer." Treas. Reg. § 1.6664-4(b)(1). "The most important factor[,]" however, "is the extent of the taxpayer's effort to assess his proper liability in light of all the circumstances." *Klamath*, 568 F.3d at 548.[19]

The panel concludes the Tax Court erred when concluding this did not represent reasonable cause for Mr. Ray:

> The Commissioner is correct that the stipulated Tax Court decision related solely to Ray's trading agreement losses and not to Christina Ray's indebtedness. As discussed, Ray has failed to show that the claims underlying his first cause of action in *Ray I* are related to the trading agreement venture. However, the 1997 stipulated Tax Court decision is related to the characterization of the trading agreement losses, which implicates the portion of the accuracy-related penalty that was imposed on the difference in the amounts Ray would be

[17] *Ray v. Commissioner*, Docket No. 20-60004, CA5, September 14, 2021

[18] *Ray v. Commissioner*, Docket No. 20-60004, CA5, September 14, 2021

[19] *Ray v. Commissioner*, Docket No. 20-60004, CA5, September 14, 2021

> allowed to deduct for the relevant legal expenses if they were deductible under § 162(a) rather than § 212. Given the IRS's prior position regarding Ray's trading agreement venture, and considering the particular facts and circumstances of this case, it was reasonable for Ray to have relied upon the stipulated decision in assessing whether his legal expenses could be deducted under § 162(a) as a Schedule C business loss. We conclude that Ray is entitled to a reasonable cause and good faith defense for his understatement attributable to deducting his trading agreement legal fees under § 162(a) rather than § 212.[20]

Note that this holding is based on Mr. Ray's particular situation. An individual tax professional who had decades of experience in tax controversy matters might find that the Court would find his knowledge of the status of such a stipulated decision could make that person's reliance on the same stipulated decisions not undertaken in good faith, and thus not make the reasonable cause exception available. But Mr. Ray had no such expertise.

[20] *Ray v. Commissioner*, Docket No. 20-60004, CA5, September 14, 2021