

## MLI #4 Gross Income Under IRC § 61 and Related Sections

### SUMMARY

When preparing tax returns, taxpayers must complete the crucial calculation of gross income for the taxable year to determine the tax they must pay. Gross income has been among the Most Litigated Issues in each of the National Taxpayer Advocate's Annual Reports to Congress.<sup>1</sup> For this report, we reviewed 89 cases decided between June 1, 2013, and May 31, 2014. The majority of cases involved taxpayers failing to report items of income, including some specifically mentioned in Internal Revenue Code (IRC) § 61 such as wages,<sup>2</sup> interest,<sup>3</sup> dividends,<sup>4</sup> and annuities.<sup>5</sup>

### PRESENT LAW

IRC § 61 broadly defines gross income as “all income from whatever source derived.”<sup>6</sup> The U.S. Supreme Court has defined gross income as any accession to wealth.<sup>7</sup> However, over time, Congress has carved out numerous exceptions and exclusions from this broad definition of gross income, and has based other elements of tax law on the definition.<sup>8</sup>

The Commissioner may identify particular items of unreported income or reconstruct a taxpayer's gross income using methods such as the bank deposits method.<sup>9</sup> If the Commissioner determines a tax deficiency, the IRS issues a Statutory Notice of Deficiency.<sup>10</sup> If the taxpayer challenges the deficiency, the Commissioner's notice is entitled to a presumption of correctness; the taxpayer bears the burden of proving that the determination is erroneous or inaccurate.<sup>11</sup>

### ANALYSIS OF LITIGATED CASES

In the 89 opinions involving gross income issued by the federal courts and reviewed for this report, gross income issues most often fall into two categories: (1) what is included in gross income under IRC § 61, and (2) what can be excluded under other statutory provisions. A detailed list of the cases appears in Table 4 of Appendix III.

1 See, e.g., National Taxpayer Advocate 2013 Annual Report to Congress 355-61; National Taxpayer Advocate 2012 Annual Report to Congress 637-42.

2 IRC § 61(a)(1). See, e.g., *Aldrich v. Comm'r*, T.C. Memo. 2013-201.

3 IRC § 61(a)(4). See, e.g., *Duggan v. Comm'r*, T.C. Memo. 2014-17.

4 IRC § 61(a)(7). See, e.g., *Edem v. Comm'r*, T.C. Memo. 2013-238.

5 IRC § 61(a)(9). See, e.g., *Craighead v. Comm'r*, T.C. Memo. 2013-246.

6 IRC § 61(a).

7 *Comm'r v. Glenshaw Glass*, 348 U.S. 426, 431 (1955) (interpreting § 22 of the Internal Revenue Code of 1939, the predecessor to IRC § 61).

8 See, e.g., IRC §§ 104 (compensation for injuries or sickness); 105 (amounts received under accident and health plans); 108 (income from discharge of indebtedness); 6501 (limits on assessment and collection, determination of “substantial omission” from gross income).

9 IRC § 6001. See, e.g., *DiLeo v. Comm'r*, 96 T.C. 858, 867 (1991).

10 IRC § 6212. See also Internal Revenue Manual (IRM) 4.8.9.2 (July 9, 2013).

11 See IRC § 7491(a) (burden shifts only where the taxpayer produces credible evidence contradicting the Commissioner's determination and satisfies other requirements). See also *Welch v. Helvering*, 290 U.S. 111, 115 (1933) (citations omitted).

In 34 cases (about 38 percent), taxpayers were represented, while the rest were *pro se* (without counsel). Eight of the 34 represented taxpayers (about 24 percent) prevailed in full in their cases and four prevailed in part, whereas *pro se* taxpayers prevailed in full in just two cases and in part in two others. Overall, taxpayers prevailed in full or in part in 16 of 89 cases (about 18 percent).

Drawing on the full list in Table 4 of Appendix III, we have chosen to discuss cases involving damage awards and IRA distributions, which were among the most common issues. In addition, we discuss a case of first impression involving the characterization of payments to a parent to care for her disabled adult son as foster care payments.

### Damage Awards

Taxation of damage awards continues to generate litigation. This year, taxpayers in at least five cases (about six percent of those reviewed) challenged the inclusion of damage awards in their gross income, but just one taxpayer prevailed, and only in part, on the issue.<sup>12</sup>

IRC § 104(a)(2) specifies that damage awards and settlement proceeds<sup>13</sup> are taxable as gross income unless the award was received “on account of personal physical injuries or physical sickness.”<sup>14</sup> Congress added the “physical injuries or physical sickness” requirement in 1996;<sup>15</sup> until then, the word “physical” did not appear in the statute. The legislative history of the 1996 amendments to IRC § 104(a)(2) provides that “[i]f an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness...[but] emotional distress is not considered a physical injury or physical sickness.”<sup>16</sup> Thus, damage awards for emotional distress are not considered as received on account of physical injury or physical sickness, even if the emotional distress results in “insomnia, headaches, [or] stomach disorders.”<sup>17</sup>

To justify exclusion from income under IRC § 104, the taxpayer must show settlement proceeds are in lieu of damages for physical injury or sickness.<sup>18</sup> In *Molina v. Commissioner*, the taxpayer petitioned the U.S. Tax Court to exclude from his income a settlement award from his former employer for alleged discrimination, alleged creation of a hostile work environment, and alleged retaliation for reporting the alleged discrimination.<sup>19</sup>

The parties entered into mediation and negotiated a settlement after Mr. Molina filed suit in the Superior Court of New Jersey. Mr. Molina’s complaint only alleged serious and significant emotional and physical distress, and made no mention of any physical injuries or sickness suffered as a result of the alleged discrimination and retaliation. He settled with his former employer, and in 2007 received an installment payment under the agreement and a payment for attorneys’ fees. While he reported the installment

12 See, e.g., *Simpson v. Comm’r*, 141 T.C. 331 (2013), *appeal docketed*, No. 14-72372 (9th Cir. Aug. 4, 1014).

13 See Treas. Reg. § 1.104-1(c) (damages received, for purposes of IRC § 104(a)(2), means amounts received “through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of such prosecution”).

14 IRC § 104(a)(2).

15 Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838 (1996).

16 H.R. Rep. No. 104-586, at 143-44 (1996).

17 H.R. Conf. Rep. No. 104-737, at 301 (1996). Note, however, that IRC § 104(a)(2) excludes from income damages, up to the cost of medical treatment for which a deduction under IRC § 213 was allowed for any prior taxable year, for mental or emotional distress causing physical injury.

18 See, e.g., *Green v. Comm’r*, 507 F.3d 857 (5th Cir. 2007), *aff’g* T.C. Memo. 2005-250.

19 T.C. Memo. 2013-226.

payment on his tax return, he argued that it was excludible from gross income and did not include it in his total gross income.<sup>20</sup>

The court looked to the employer's intent in making the payments.<sup>21</sup> The settlement agreement characterized the payments as wages and attorney fees.<sup>22</sup> The Tax Court then looked to the contents of the taxpayer's complaint for insight into what the settlement payment was for, and determined it made no claims of physical injuries or illness, nor was there any evidence that Mr. Molina ever informed his former employer of any injuries or illness. This led the court to conclude that the employer intended the payments to be solely for wages and attorney fees.<sup>23</sup> This case serves as a caution to taxpayers that failure to carefully consider how the settlement agreement specifies the reasons and characterization for the payments can lead to significant tax consequences down the road.

As illustrated by continuing litigation of the characterization of settlement damages, the question of when damage awards can be excluded from gross income continues to confuse taxpayers. Even when taxpayers seek legal advice before filing a complaint for damages or accepting settlement proceeds, they may not understand how to characterize the damages in the complaint to be able to exclude them under IRC § 104(a)(2), or they may be uncertain about the proper tax treatment of the proceeds. For example, in *Simpson v. Commissioner*, the taxpayer's attorney informed the taxpayer and her family that her settlement proceeds would not be taxed.<sup>24</sup> The taxpayer relied on her attorney (who was not her tax advisor) and failed to include the settlement proceeds in her gross income.<sup>25</sup>

As these cases illustrate, the issue of including damages awarded on account of mental illness in gross income continues to plague the courts, and taxpayers continue to disagree with the IRS's and courts' interpretation that mental illness equates to emotional distress, opposed to physical sickness or injury. As discussed in the National Taxpayer Advocate's 2009 Annual Report to Congress, this assessment seems particularly outdated when considering the medical communities' advancements in understanding the physical cause and symptoms of mental illness.<sup>26</sup>

### IRA Distributions

IRC § 61(a) defines gross income as "all income from whatever source derived, including (but not limited to)... (9) Annuities; ... and (11) Pensions."<sup>27</sup> IRC § 408(d)(1) governs the tax treatment of distributions from individual retirement accounts (IRAs), and provides that they are generally included in gross income as amounts received as an annuity under IRC § 72.

20 *Molina v. Comm'r*, T.C. Memo. 2013-226.

21 *Id.*

22 *Id.*

23 *Id.*

24 141 T.C. 331 (2013).

25 *Simpson v. Comm'r*, 141 T.C. 331 (2013).

26 National Taxpayer Advocate 2009 Annual Report to Congress 351-56 (Legislative Recommendation: *Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income*). The National Taxpayer Advocate recommended that Congress amend IRC §104(a)(2) to exclude from gross income payments received as settlement for mental anguish, emotional distress, and pain and suffering. Such change was recommended because mental anguish, emotional distress, and pain and suffering can be caused by a physical condition in the body and can cause physical symptoms. Over the past few years, doctors and researchers have made significant advances in identifying changes that occur in the brain when a person is plagued with mental illness.

27 IRC § 61(a).

Taxpayers in at least ten cases argued that portions of their IRA distributions were excluded from gross income, prevailing in full in two cases and in part in one case.<sup>28</sup> Taxpayers in at least three cases challenged the taxability of the distributions, arguing the “rollover provision” under § 408(d) applied.<sup>29</sup> The “rollover provision” generally excludes from gross income IRA distributions that are transferred into an eligible retirement account within 60 days of receipt.<sup>30</sup> Taxpayers are limited, however, under IRC § 408(d)(3)(B) to one nontaxable rollover per year.<sup>31</sup>

For example, in *Bobrow v. Commissioner* the taxpayers (husband and wife) received distributions from three separate IRAs, and attempted to complete two nontaxable rollovers for the husband in one tax year.<sup>32</sup> The court found that distributions from two of the accounts were includible in gross income, while the distribution from the third account was excludible. In addition, the court found Mr. Bobrow’s second rollover for the tax year was properly characterized as a taxable distribution and includible in gross income.

### Foster Care Payments

One court this year decided a case of first impression regarding the characterization of payments from the state as foster care payments.<sup>33</sup> Qualified foster care payments, received by a foster care provider, are excludible from gross income under IRC § 131(a).

In *Ray v. Commissioner*, Mrs. Ray provided certified care to her severely disabled adult son Tony. Tony’s Individualized Service Plan (ISP), developed by the Franklin County (Ohio) Board of Developmental Disabilities after he turned 18, requires that he receive this care from a certified provider, and further dictates that he reside in the Rays’ home.<sup>34</sup> Additionally, upon Tony turning 18, Mrs. Ray was appointed his legal guardian, as his disabilities are such that he is unable to talk, walk, or provide for any of his own needs.<sup>35</sup> She receives compensation for the care she provides to Tony from the state of Ohio, through a Medicaid program called Individual Options Waiver, which permits a person with disabilities to live at home.<sup>36</sup>

The Rays filed amended returns for tax years 2005–2007 to exclude the payments Mrs. Ray received from the state for her care of Tony as foster care payments.<sup>37</sup> The issue before the court was whether the payments were excludible as qualified foster care payments. The decision turned on the meaning of “foster,” and whether the IRC § 131 exclusion is applicable if the taxpayer providing the care is the biological parent of a recipient older than 18. The word “foster” appears throughout IRC § 131, but Congress did not define the term.

28 See *Roberts v. Comm’r*, 141 T.C. No. 19 (2013) (taxpayer prevailed in full); *Haury v. Comm’r*, 751 F.3d 867 (8th Cir. 2014) (taxpayer prevailed in full); *Bobrow v. Comm’r*, T.C. Memo. 2014-21 (taxpayers prevailed in part).

29 See *Alexander v. Comm’r*, T.C. Summ. Op. 2014-18; *Bobrow v. Comm’r*, T.C. Memo. 2014-21; *Haury v. Comm’r*, 751 F.3d 867 (8th Cir. 2014).

30 IRC § 408(d)(3)(A)(i), (ii); *Schoof v. Comm’r*, 110 T.C. 1, 7 (1998).

31 IRC § 408(d)(3)(B).

32 T.C. Memo. 2014-21.

33 See *Ray v. U.S.*, 113 A.F.T.R.2d (RIA) 382 (S.D. Ohio 2014).

34 *Id.*

35 *Id.*

36 *Id.*

37 *Id.*

Where a word is not defined statutorily, the court must use its “ordinary meaning.”<sup>38</sup> The court determined that a foster care situation exists when one voluntarily provides care for a minor or other qualified foster individual in absence of a legal obligation.<sup>39</sup> Because Mrs. Ray is Tony’s legal guardian, she was under a legal obligation to either obtain or provide care to him. As a result, payments made to her for personally providing that care cannot be construed as foster care payments.<sup>40</sup> Thus, the payments Mrs. Ray received from the state were not excludible.

## CONCLUSION

Taxpayers litigate many of the same gross income issues every year due to the complex nature of what constitutes gross income. As the definition is very broad and the courts broadly interpret accession to wealth as gross income, most cases were decided in favor of the IRS and exclusions from gross income continued to be narrowly interpreted.

While the number of cases involving the tax treatment of settlements and awards continued to decrease, from six in 2013 to five this year, it remains a perennial area of confusion for taxpayers. The National Taxpayer Advocate has previously recommended a legislative change that would clarify the tax treatment of court awards and settlements by permitting taxpayers to exclude any payments received as a settlement or judgment for mental anguish, emotional distress, or pain and suffering.<sup>41</sup> Additionally, the National Taxpayer Advocate plans to provide for inclusion in the IRS 2015-2016 Priority Guidance Plan her recommendations for published guidance regarding facts and circumstances under which damages awarded on account of mental illness should be considered a physical injury, and thereby excluded from gross income under IRC § 104(a)(2).

Cases involving the tax treatment of distributions from IRAs continued to rise this year, with ten cases compared to eight last year. Taxpayers litigated this issue with some success, prevailing in full or in part in three cases.

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38 *Ray v. U.S.*, 113 A.F.T.R.2d (RIA) 382 (S.D. Ohio 2014) (quotations omitted).

39 *Id.*

40 *Id.*

41 National Taxpayer Advocate Annual 2009 Report to Congress 351-56 (Legislative Recommendation: *Exclude Settlement Payments for Mental Anguish, Emotional Distress, and Pain and Suffering from Gross Income*).