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.[1] For this report, we reviewed 80 cases decided between June 1, 2014, and May 31, 2015. 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,[2] interest,[3] dividends,[4] and annuities.[5]

TAXPAYER RIGHTS IMPACTED[6]

- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to a Fair and Just Tax System*

PRESENT LAW

IRC § 61 broadly defines gross income as "all income from whatever source derived."[7] The U.S. Supreme Court has defined gross income as any accession to wealth.[8] Over time, however, 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.[9]

The Commissioner may identify particular items of unreported income or reconstruct a taxpayer's gross income using methods such as the bank deposits method.[10] If the Commissioner determines a tax deficiency, the IRS issues a Statutory Notice of Deficiency.[11] If the taxpayer challenges the deficiency, the Commissioner's notice is entitled to a presumption of correctness; the taxpayer generally bears the burden of proving that the determination is erroneous or inaccurate.[12]

1 *See, e.g.*, National Taxpayer Advocate 2014 Annual Report to Congress 472-76; National Taxpayer Advocate 2013 Annual Report to Congress 355-61.

2 IRC § 61(a)(1). *See, e.g.*, *Nix v. Comm'r*, 580 F. App'x 887 (11th Cir. 2014).

3 IRC § 61(a)(4). *See, e.g.*, *Shi v. Comm'r*, T.C. Memo. 2014-173.

4 IRC § 61(a)(7). *See, e.g.*, *Ebert v. Comm'r*, T.C. Memo. 2015-5.

5 IRC § 61(a)(9). *See, e.g.*, *Robertson v. Comm'r*, T.C. Memo. 2014-143.

6 *See* Taxpayer Bill of Rights, *available at* www.Taxpayer.Advocate.irs.gov/taxpayer-rights.

7 IRC § 61(a).

8 *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).

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

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

11 IRC § 6212. *See also* Internal Revenue Manual (IRM) 4.8.9.2, *Notice of Deficiency Definition* (July 9, 2013).

12 *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).

ANALYSIS OF LITIGATED CASES

In the 80 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 3.

In 27 cases (34 percent), taxpayers were represented, while the rest were *pro se* (without counsel).[13] Ten of the 27 cases where taxpayers had representation (about 37 percent) prevailed in full or in part in their cases, whereas *pro se* taxpayers prevailed in full or in part in seven cases. Overall, taxpayers prevailed in full or in part in 17 of 80 cases (about 21 percent).

Drawing on the full list in Table 4 of Appendix 3, we have chosen to discuss cases involving damage awards and IRA distributions. In addition, we discuss a case of first impression involving the characterization of refundable state tax credits.

Damage Awards

Taxation of damage awards continues to generate litigation. This year, taxpayers in at least four cases (five percent of those reviewed) challenged the Commissioner's inclusion of damage awards in their gross income, but no taxpayers prevailed in these cases.[14]

IRC § 104(a)(2) specifies that damage awards and settlement proceeds[15] are taxable as gross income unless the award was received "on account of personal physical injuries or physical sickness."[16] Congress added the "physical injuries or physical sickness" requirement in 1996;[17] 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."[18] 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."[19]

To justify exclusion from income under IRC § 104, the taxpayer must show settlement proceeds are in lieu of damages for physical injury or sickness.[20] One case presented a unique issue regarding the characterization of payments made to a taxpayer for contracting to comply with the process to become an egg donor. In *Perez v. Commissioner*, the taxpayer petitioned the U.S. Tax Court to exclude from her income

13 One case involved three consolidated cases, where one case docket showed the taxpayers were *pro se* while the other two case dockets showed representation. *See Worth v. Comm'r*, T.C. Memo. 2014-232, *appeal docketed*, No. 15-70665 (9th Cir. Mar. 3, 2015). For the purpose of calculating the number and percentage of cases where taxpayers appeared *pro se*, we have included *Worth* in the *pro se* category.

14 *See, e.g.*, *Duffy v. U.S.*, 120 Fed. Cl. 55 (Fed. Cl. 2015), *appeal docketed*, No. 15-5076 (Fed. Cir. Apr. 28, 2015).

15 *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").

16 IRC § 104(a)(2).

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

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

19 H.R. Rep. No. 104-737, at 301 (1996) (Conf. Rep.). 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.

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

payments received as compensation for the pain and suffering associated with donating her eggs to a fertility clinic under the theory that the payments should be construed as damages.[21]

Ms. Perez entered contracts with the fertility clinic and the intended recipients of her donor eggs. The contracts detail that the payments are compensation for Ms. Perez's time, effort, pain, and suffering and in no way are the payments for her eggs or for the sale of body parts. Ms. Perez would be paid regardless of the outcome of the egg retrieval; that is, payment was not contingent on her producing usable eggs or on the intended recipients conceiving a viable pregnancy. Although the fertility clinic issued a Form 1099 to Ms. Perez for the payments she received, Ms. Perez, after conferring with other donors on the internet, did not report the payments on her tax return under the theory that the payments were not taxable since they compensated her only for pain and suffering.[22]

The court looked to the question of whether Ms. Perez was compensated for services rendered or for the sale of property.[23] The contract agreement characterized the payments as compensation for her compliance with the egg donor procedure.[24] The Tax Court found the payments to be for services rendered and then looked to the question of whether the payments may be excluded as damages. The court looked at Ms. Perez's challenge to the validity of the Secretary of Treasury's interpretation of "damages" in the regulations.[25] In applying the framework set forth in *Chevron*, the court determined the regulation is a reasonable interpretation and therefore valid.[26] The court then concluded that Ms. Perez voluntarily contracted to undergo the prospective pain and suffering and was compensated for the risk, rendering the compensation not damages.[27]

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. Although we did not identify any cases this year involving mental illness, the National Taxpayer Advocate remains concerned that taxpayers continue to disagree with the IRS's and courts' interpretation that mental illness equates to emotional distress as opposed to physical sickness or injury. In the same way that a physical injury or sickness may have emotional side effects, many mental illnesses manifest themselves as physical symptoms. For instance, many people who have severe depression experience the following physical symptoms: stomachaches, indigestion, constant headaches, tightness in the chest, difficulty breathing, and fatigue.[28] Physical symptoms occur in other mental disorders, such as Post-Traumatic Stress Disorder (PTSD), which affects people who have experienced a traumatic event, such as mugging, rape, torture, being kidnapped or held captive, child abuse, car accidents, train wrecks, plane crashes, bombings, natural or human-caused disasters, or military combat.[29] Current research shows that the experience of trauma can cause neurochemical changes in the brain that create a vulnerability to hypertension and atherosclerotic

21 144 T.C. 51 (2015).

22 *Id*.

23 *Id.*

24 *Id.*

25 *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").

26 *Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) (agency regulations are entitled to deference unless they (1) contradict an unambiguous statute or (2) adopt an unreasonable construction of it).

27 *Perez v. Comm'r*, 144 T.C. 51 (2015).

28 National Institute of Mental Health, *Signs and Symptoms of Depression*, *available at* http://www.nimh.nih.gov/health/topics/depression/men-and-depression/signs-and-symptoms-of-depression/persistent-physical-symptoms.shtml (last visited Oct. 6, 2015).

29 National Institute of Mental Health, *Post-Traumatic Stress Disorder*, *available at* http://www.nimh.nih.gov/health/topics/post-traumatic-stress-disorder-ptsd/index.shtml#part_145373 (last visited Oct. 6, 2015).

heart disease, abnormalities in thyroid and other hormone functions, and increased susceptibility to infections and immunologic disorders that are associated with PTSD.[30] As discussed in the 2009 Annual Report to Congress, the interpretation that mental illness equates to emotional distress seems particularly outdated when considering the medical communities' advancements in understanding the physical cause and symptoms of mental illness.[31]

Individual Retirement Accounts Distributions

IRC § 61(a) defines gross income as "all income from whatever source derived, including (but not limited to)… (9) Annuities; … and (11) Pensions."[32] 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.

Taxpayers in at least ten cases argued that portions of their IRA distributions, pensions, or retirement accounts were excluded from gross income, prevailing, in part, in one case.[33] Taxpayers in at least two cases challenged the taxability of the distributions, arguing the "rollover provision" under IRC § 408(d) applied.[34] The "rollover provision" generally excludes from gross income IRA distributions that are transferred into an eligible retirement account within 60 days of receipt.[35] Taxpayers are limited, however, under IRC § 408(d)(3)(B) to one nontaxable rollover per year.[36]

For example, in *Bohner v. Commissioner*, the taxpayer initiated two withdrawals from his IRA and characterized the withdrawals as a rollover to repay a loan he took from a friend and his own funds earlier that year to pay an extra amount to the Office of Personnel Management to boost his federal retirement pay.[37] The court found the distributions includible in gross income. The federal retirement system is not required to accept tax-free rollovers as a form of deposit, and even if it did, the court found that the taxpayer did not make the retirement plan aware of his attempt to complete a rollover and, therefore, the plan would not have been able to determine the proper tax treatment of the contribution.[38]

Refundable State Tax Credits

The Tax Court decided a case of first impression regarding the characterization and taxability of targeted New York State tax credits. In *Maines v. Commissioner*, the taxpayers (husband and wife) petitioned for

30 *See* U.S. Department of Veterans Affairs, National Center for PTSD, *available at* http://www.ptsd.va.gov/professional/co-occurring/ptsd-physical-health.asp (last visited Oct. 6, 2015).

31 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.

32 IRC § 61(a).

33 *See Morles v. Comm'r*, T.C. Summ. Op. 2015-13 (portion of IRA distribution allocable to income was included in gross income; portion allocable to the taxpayer's investment in the contract was not included in gross income).

34 *See Bohner v. Comm'r*, 143 T.C. 224 (2014); *Dabney v. Comm'r*, T.C. Memo. 2014-108.

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

36 IRC § 408(d)(3)(B).

37 143 T.C. 224 (2014).

38 *Id*. at 230.

redetermination of income tax deficiencies arising from receipt of refundable tax credits passed through their S Corporation and Limited Liability Company.[39]

New York state offers certain refundable state tax credits to businesses that either expand or enter into business in targeted impoverished areas and maintain the business in those areas with a required number of employees. The business must meet all requirements to be eligible for the credits. New York characterizes the credits as refunds of overpayments of state income tax, the same position the taxpayers maintained, with the result that the payments should not be included in gross income.[40] In contrast, the Commissioner asserted the credits were taxable income.[41] The court determined that the label for the credits by New York is not binding on the federal government for federal taxation purposes.

Three different credits were at issue in *Maines*. Each has distinct qualifications, and the court determined that the credits fall into two categories. Two credits were not tied to state taxes previously paid to New York and were, therefore, subsidies to the business and as such were fully includible in the taxpayers' gross income.[42] The third credit was partially refundable to the taxpayers above the amount of the credit used to reduce the taxpayers' property tax liability. As a result, the taxpayers were required to include in gross income the amount of the credit refunded above their property tax liability.[43] The court's decision will impact a number of other New York residents who were similarly challenging the tax treatment of these credits.[44]

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 courts continued to narrowly interpret exclusions from gross income.

While the number of cases involving the tax treatment of settlements and awards continued to decrease, from five in 2014 to four 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.[45]

Cases involving the tax treatment of distributions from IRAs and pensions made up a larger percentage of overall cases this year, with almost 13 percent of cases compared to about 11 percent in 2014. Taxpayers litigated this issue with only minor success this year, prevailing, in part, in only one case.

39 144 T.C. No. 8 (2015).

40 State tax refunds are not income unless a taxpayer claimed a deduction for them by itemizing for the previous year. *See* IRC § 111.

41 *Maines v. Comm'r*, 144 T.C. No. 8 (2015).

42 *Id*.

43 *Id*.

44 *Id*. at n. 5 (acknowledging that there were 11 related but unconsolidated cases pending before the Tax Court that were filed by New York residents involving this issue).

45 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*).