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 85 cases decided between June 1, 2016, and May 31, 2017. 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 IMPACTED6
- The Right to Be Informed
- The Right to Pay No More Than the Correct Amount of Tax
- The Right to Appeal an IRS Decision in an Independent Forum
- 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 The concept of “gross income” is to be broadly construed, while exclusions from income are to be narrowly construed.9 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.10

The Commissioner of Internal Revenue may identify particular items of unreported income or reconstruct a taxpayer’s gross income using methods such as the bank deposits method.11 After

7 IRC § 61(a).
10 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).
determining a tax deficiency, the IRS issues a statutory notice of deficiency. 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. Taxpayers who seek an exclusion from gross income must demonstrate eligibility for the exclusion and bring themselves “within the clear scope of the exclusion.”

**ANALYSIS OF LITIGATED CASES**

In the 85 opinions involving gross income issued by the federal courts and reviewed for this report, gross income issues most often fell 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 5 of Appendix 3.

In 28 cases (about 33 percent), taxpayers were represented, while the rest were *pro se* (without counsel). Eight of the 28 taxpayers who had representation (almost 29 percent) prevailed in full or in part in their cases, whereas *pro se* taxpayers prevailed in part in ten cases. Overall, taxpayers prevailed in full or in part in 18 of 85 cases (about 21 percent).

Drawing on the full list in Table 5 of Appendix 3, we have chosen to discuss cases involving damage awards, Individual Retirement Account (IRA) distributions, and discharge of indebtedness, which were among the most common issues.

**Damage Awards**

Taxation of damage awards continues to generate litigation. This year, taxpayers in at least seven cases (about eight percent of those reviewed) challenged the inclusion of damage awards in their gross income, but no taxpayers prevailed in these cases.

IRC § 104(a)(2) specifies that damage awards and settlement proceeds are taxable as gross income unless the award was received “on account of personal physical injuries or physical sickness.” Congress added the “physical injuries or physical sickness” requirement in 1996; 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.” Thus, damage awards for emotional distress are not considered as received on

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12 IRC § 6212. See also Internal Revenue Manual (IRM) 4.8.9.2, Notice of Deficiency Definition (Aug. 11, 2016).
13 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).
16 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 prosecution”).
17 IRC § 104(a)(2).
account of physical injury or physical sickness, even if the emotional distress results in “insomnia, headaches, [or] stomach disorders.”

To justify exclusion from income under IRC § 104, the taxpayer must show settlement proceeds are in lieu of damages for physical injury or sickness. In *George v. Commissioner*, the taxpayer filed a complaint against his former employer and coworkers. He sought damages under various civil rights laws and human rights laws, both state and federal. He alleged in his complaint that he suffered "psychological and physical harms" and sought compensatory damages, punitive damages, and liquidated damages. He also claimed that he was constructively fired from his employer due to the continued alleged harassment by his coworkers because of his national origin.

The taxpayer and his former employer entered into a settlement agreement. The taxpayer agreed to release all claims against his former employer and coworkers in exchange for $45,000. The settlement agreement did not mention any injury or physical harm the taxpayer suffered. The insurance company issued the taxpayer a 1099-MISC, *Miscellaneous Income*. The taxpayer did not report the income and argued it was excludible under IRC § 104(a)(2). The IRS issued a timely notice of deficiency.

The court looked at the nature of the claim settled, by the terms of the settlement agreement, to determine for what the settlement payment compensated the taxpayer. The Tax Court stated that it is crucial to determine the intent of the payor in making the settlement payment, which can be determined by taking into account all the facts and circumstances, including the amount paid, that led to the settlement. The court found that while the taxpayer had alleged psychological and physical harm in his complaint, he had not done so with any specificity and in fact made his claims under various civil and human rights statutes. The Tax Court then looked to the actual settlement agreement, which made no mention of physical sickness or injury and did not allocate any portion of the payment to such. While the court acknowledged that the situation that gave rise to the claim likely caused emotional distress, emotional distress does not qualify a payment for exclusion and the clear terms of the settlement indicated no intent to compensate for physical sickness or injury. The Tax Court found for the IRS.

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. 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. At least three taxpayers in this reporting cycle argued that settlement awards for emotional distress should be excluded from gross income. In the same way that a physical injury or sickness may have mental or 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

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20 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.

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

22 T.C. Memo. 2016-156.

23 *Id.*

24 *Id.*

25 *Id.* (quotation omitted).

26 *Id.*

breathing, and fatigue. 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. Current research shows that the experience of trauma can cause neurochemical changes in the brain that create a vulnerability to hypertension and atherosclerotic heart disease, abnormalities in thyroid and other hormone functions, and increased susceptibility to infections and immunologic disorders that are associated with PTSD. The interpretation that mental illness equates to emotional distress seems particularly outdated when considering the medical advancements in understanding the physical cause and symptoms of mental illness.

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." 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. Similarly, IRC § 402(a) provides that an amount distributed to any employees’ trust described in section 401(a), which is tax-exempt under section 501(a), shall be taxable to the distributee under IRC § 72.

Taxpayers in at least 18 cases argued that portions of their IRA distributions, pensions, retirement accounts, or annuity payments were excluded from gross income, prevailing in part in one case and in full in another case. Taxpayers in at least one case challenged the taxability of the distributions, arguing the “rollover provision” under § 408(d) applied. The “rollover provision” generally excludes from gross income IRA distributions that are transferred into an eligible retirement account within 60 days of receipt. Taxpayers are limited, however, under IRC § 408(d)(3)(B) to one nontaxable rollover per year.

In the case of Trimmer v. Commissioner, the taxpayers (married filing jointly) prevailed in full on the issue of whether distributions had to be rolled over within 60 days of receipt in order to be a nontaxable

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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 Harrell v. Comm’r, T.C. Memo. 2017-76.
36 IRC § 408(d)(3)(A)(i), (ii); Schoof v. Comm’r, 110 T.C. 1, 7 (1998). See also IRC § 402(c)(3), which contains an analogous 60-day rollover period for transfers of distributions from an employees’ trust.
37 IRC § 408(d)(3)(B).
rollover. Mr. Trimmer retired after 20 years of service with the New York Police Department (NYPD). After his retirement, he was supposed to begin a job as a private security guard; however, the job fell through. He could not find another job or return to the NYPD because its policy prohibits the rehiring of retired police officers. Shortly thereafter, Mr. Trimmer fell into a debilitating depression and ceased to manage any of his affairs. During this time, his pension issued him two distributions on May 27 and June 10, 2011. He left the checks sitting on his dresser for two months before even depositing them, and did not touch the money after depositing it. When, after much prodding by Mrs. Trimmer, he went to his tax return preparer to prepare his tax return, the preparer informed him that he needed to place the pension distributions into an IRA. The taxpayers reported two distributions nontaxable on their 2011 tax return filed on March 29, 2012, and acting on advice of the tax return preparer, rolled over the funds earlier deposited to a new IRA on April 16, 2012.

The IRS issued a timely Notice CP 2000, Proposed Changes to Your 2011 Form 1040, asserting that the taxpayers had failed to report $100,700 from the two IRA distributions. Mr. Trimmer timely filed a protest explaining his depression, detailing his actions upon learning he needed to rollover the funds, and requesting that the IRS waive the penalty because it would amount to several years of salary for his family and cause extreme hardship. The IRS responded via two letters. The first letter issued on June 3, 2014 stated that the taxpayers “don’t need to do anything else for now. We will contact you again within 60 days to let you know what action we are taking.” Three days later, on June 6, 2014, the IRS issued another letter summarily denying the requested relief, without addressing the availability of a hardship waiver, seeking additional information, or responding to the circumstances detailed in the taxpayer’s request. The IRS then issued a statutory notice of deficiency. The taxpayers filed suit and alleged that Mr. Trimmer qualified for a hardship waiver of the 60-day rollover requirement under IRC § 402(c)(3)(B).

The IRS asserted that the taxpayers did not properly request relief due to hardship under the applicable revenue procedure. Additionally, the IRS argued:

- That it had made no final administrative determination regarding the request for relief,
- That even if a final determination had been made, it was not subject to judicial review, and
- That there was no abuse of discretion in the denial because the taxpayers failed to establish that Mr. Trimmer had been incapable of completing the rollovers timely.

The court considered the IRS’s argument that the taxpayers failed to comport with the requirements of Revenue Procedure 2003–16 by not requesting and paying for a private letter ruling to determine whether a hardship exception from the 60-day rollover requirement existed. The court did not find any prohibition in the IRC or in the revenue procedure that would not permit an examiner from considering a hardship waiver during the exam. Further, the court was not persuaded by the IRS’s argument that no final determination had been made on the hardship request. Instead, the court stated that Mr. Trimmer’s letter had resulted in the IRS summarily denying his request on legal grounds, “without

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38 148 T.C. No. 14 (2017). This case was litigated by student attorneys and the Director of a Low Income Taxpayer Clinic (LITC). For more information on the LITC program, which is administered by TAS, see IRC § 7526; IRS Pub. 3319, Low Income Taxpayer Clinics Grant Application Package and Guidelines, and IRS Pub. 5066, Low Income Taxpayer Clinics Program Report. See also https://www.irs.gov/advocate/low-income-taxpayer-clinics.

39 The IRS may waive the 60-day requirement “where the failure to waive such requirement would be against equity or good conscience, including casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.” IRC § 402(c)(3)(B).


even acknowledging the specific facts and circumstances spelled out in Mr. Trimmer’s letter.” Thus, the court concluded the IRS’s insistence on the taxpayers to respond yet again to the denial letter if they disagreed would be “an empty gesture or mere boilerplate.” Next, the court rejected the IRS’s assertion that the court did not have jurisdiction to review the administrative denial of a hardship waiver. The court found that the denial of the hardship waiver went to the merits of the deficiency determination which initially conferred jurisdiction on the court. Finally, the court found that by denying the taxpayers’ initial request for a hardship waiver the IRS had abused its discretionary authority. The court concluded that the IRS proceeded based on “an incomplete understanding of the pertinent statutory provisions, failed to address or even acknowledge any of the facts and circumstances Mr. Trimmer set forth in his letter.”

After considering the objections of the IRS to the taxpayers’ claims, the court turned to the merits of the taxpayers’ request for a hardship waiver of the 60-day requirement. The court focused on the phrase “against equity or good conscience” in IRC § 402(c)(3)(B). After considering the statutory meaning of the phrase, the court turned to the four factors enumerated in the relevant revenue procedure and determined one factor was irrelevant, two favored the taxpayers, and the final factor, after considering the evidence presented, also turned in favor of the taxpayers. The court thus found it would be against equity or good conscience to deny the taxpayers’ hardship waiver request.

In light of current IRS guidance, which no longer requires taxpayers who meet certain conditions to pursue a private letter ruling and instead allows taxpayers to self-certify that they meet the requirements for a hardship waiver, the Trimmers would never have ended up in court to pursue a hardship waiver. A taxpayer is now allowed to self-certify (subject to verification on audit) that he or she is eligible for a waiver of the 60-day requirement instead of seeking a costly private letter ruling. The current revenue procedure provides 11 reasons for missing the deadline that are eligible for self-certification. It also provides a model letter that may be used for the self-certification. The National Taxpayer Advocate applauds the IRS for this change, which promotes taxpayers’ right to a fair and just tax system. While we anticipate this new revenue procedure will eventually result in less litigation, cases that resulted from the previous regime are still working their way through the courts. We also remain deeply concerned that, as the Tax Court observed, IRS and counsel employees knew so little about the relevant law and thus forced this and other taxpayers to litigate, thereby exacerbating the hardship.

**Discharge of Indebtedness**

We reviewed nine cases in which taxpayers disputed the IRS’s determination that a discharge of indebtedness was taxable income, a 125 percent increase over last year’s analysis. Taxpayers prevailed in full in two of these cases. Generally, a taxpayer must include income from discharge of indebtedness when calculating gross income, but in certain circumstances cancellation of indebtedness income may be excluded. In this regard, IRC § 108(a) provides that a taxpayer may exclude, subject to limitations,
income from the discharge of indebtedness if the discharge occurs in a title 11 bankruptcy case, when the taxpayer is insolvent, or if the indebtedness is qualified farm or business real estate debt or qualified principal residence indebtedness, or if the indebtedness is qualified principal residence indebtedness discharged before January 1, 2017, or subject to an arrangement that is entered into and evidenced in writing before January 1, 2017. The creditor may issue a Form 1099-C, Cancellation of Debt, to the taxpayer for canceled debts of $600 or more. If a creditor has discharged a debt the taxpayer owes, the taxpayer must include the discharged amount in gross income, even if it is less than $600 or a Form 1099-C is not received, unless one of the exceptions in IRC § 108(a) applies. The issuance of a Form 1099-C is not dispositive of whether or when the debt is actually discharged. A debt is deemed to have been discharged, and a Form 1099-C is required, if and only if, an “identifiable event” has occurred. If a Form 1099-C serves as the basis for the determination of a deficiency, IRC § 6201(d) may apply to shift the burden of production to the IRS. Section 6201(d) provides that in any court proceeding, if a taxpayer asserts a reasonable dispute with respect to the income reported on an information return and the taxpayer has fully cooperated with the IRS, then the IRS has the burden of producing reasonable and probative information in addition to the information return. The burden of proof is on the taxpayer to show that any of the exceptions in IRC § 108(a) apply.

In one case we reviewed, the taxpayer prevailed in full under the insolvency exception in IRC § 108(a)(1)(B). In the case of Newman v. Commissioner, the taxpayer opened a checking account at a new bank and deposited a check for $8,500 drawn on an account he owned at another bank. He then withdrew $8,000 from the new account; however, the initial deposit check never cleared, so the account was overdrawn. The bank closed the account in 2008 and in 2011 issued the taxpayer a Form 1099-C, Cancellation of Debt.

The IRS issued a notice of deficiency for the discharge of indebtedness income, and the taxpayer timely petitioned the Tax Court for redetermination of the deficiency. After the Tax Court determined that the taxpayer had received cancellation of debt income, the court turned to the question of whether the taxpayer was insolvent, and to what extent, at the time the debt was discharged. The court found that at the time of the discharge, the taxpayer had assets totaling $35,500, and debts totaling $50,000. Therefore, the taxpayer was insolvent by $14,500, the total of his debt minus his assets, and could therefore exclude the entire $7,875 of discharge of indebtedness income from his 2011 income.

48 IRC § 108(a)(1)(A)-(E).
50 Kleber v. Comm’r, T.C. Memo. 2011-233 (citation omitted).
51 See Treas. Reg. § 1.6050P-1(a)(1). Note that the IRS has issued final regulations which eliminate the 36-month testing period for information returns required to be filed, and payee statements required to be furnished, after December 31, 2016. 81 Fed. Reg. 78908 (Nov. 10, 2016). See also National Taxpayer Advocate 2010 Annual Report to Congress 383-86 (Legislative Recommendation: Remove the 36-Month “Testing Period” that May Trigger Cancellation of Debt Reporting).
52 U.S. Tax Court Rules of Practice and Procedure, Rule 142(a).
53 T.C. Memo. 2016-125.
54 Id.
55 Id.
56 Id.
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.

Overall, litigation of items of gross income increased this year, from 81 cases in the 2016 reporting cycle to 85, an almost five percent increase.\(^57\) Additionally, the number of cases litigated in our common issue areas also increased. The number of cases involving the tax treatment of settlements and awards increased after remaining steady or decreasing, from four in 2016 to seven this year; thus, it clearly remains a perennial area of confusion for taxpayers.\(^58\) 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.\(^59\)

Discharge of indebtedness cases made up about 11 percent of cases, compared to only five percent of cases in 2016.\(^60\) Finally, cases involving the tax treatment of distributions from IRAs, pensions, and annuities made up a larger percentage of overall cases this year, at 21 percent of cases compared to about 15 percent in 2016.\(^61\) Litigation in the area of IRA rollovers is expected to decrease under the current revenue procedure allowing taxpayers to self-certify that they qualify for an exception to the 60-day rollover requirement.

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57 National Taxpayer Advocate 2016 Annual Report to Congress 465.
58 National Taxpayer Advocate 2016 Annual Report to Congress 467.
60 National Taxpayer Advocate 2016 Annual Report to Congress 470.
61 id. at 469.