

Wednesday, July 12, 2006

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From the October 13, 2003 Lawyers USA.

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Guest Article

Taxation Of Damages: Emotional Distress & 'Non-Physical' Injuries

By Jeffrey A. Baskies

After a recent column ("Taxation Of Personal Injury Settlements: A Trap For The Unwary Personal Injury Lawyer," Sept. 15, 2003), I received several e-mails commenting upon the subject of the taxation of damages in personal injury cases. A few issues were consistently raised.

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Several readers pointed out that my article was focused on the alternative minimum tax (AMT) impact of a wholly taxable settlement (it was employment litigation), so it perhaps glossed over the basic rules of taxation of damages. And several readers commented that this subject was worthy of further attention.

With the pending settlement of the church sex-abuse cases in Boston (the hundreds of plaintiffs are currently deciding whether to sign on

to the agreement), this issue has been thrust to the forefront in our legal community.

So here goes.

The general rule is that amounts recovered in a personal injury lawsuit are not subject to income tax if they are on account of physical injuries and the payments are received on account of such physical injuries. Conversely, amounts recovered in a personal injury lawsuit for non-physical damages (e.g. emotional distress - unless such is the result of physical harm) and/or for punitive damages are generally income-taxable.

Current Law

Prior to 1996, the taxation of personal injury settlements was guided by case law. Taxpayers utilized different court rulings to push their positions with the Internal Revenue Service.

In general, the case law developed the distinction between a "physical harm" (not taxed) and a "non-physical harm" (taxed). In 1996, Congress passed the Small Business Job Protection Act, which amended Sect. 104(a)(2) of the Internal Revenue Code. That act narrowed the exclusion for personal injury damages received pursuant to a judgment (a trial) or a settlement and generally reflected this distinction between physical and non-physical harm.

Here's what the amended Sect. 104(a)(2) provides, in part:

1. Generally, punitive damages are not excludible from taxable income under Sect. 104(a)(2); and
2. In order to exclude the damages from income taxes (under Sect. 104(a)(2)), the personal injury or sickness must be physical.

Some practitioners questioned if this distinction between physical and nonphysical injuries was even constitutional. However, one court - the 6th Circuit - decided a case called *Young v. United States* earlier this year that held that the physical/nonphysical distinction in amended Sect. 104(a)(2) does not violate the Equal Protection clause of the Fifth Amendment of the Constitution. Thus, as written, it is the law, and we must deal with it.

Harm Must Be Physical Injury

It appears to be settled at this time that the taxability of damages in a personal injury suit revolves on the nature of the damage/harm done.

In other words, was the harm physical or not? (Punitive damages, in contrast, are *virtually always* subject to income taxation.) To be income tax-free, the damages must not be for punitive harm, and they must be compensating for a physical injury.

But what is a physical injury?

The statute isn't much help answering that question. Section 104(a)(2) does not define what personal physical injuries are. Regulations have not been issued to clarify the issue.

However, the IRS has considered this issue in at least one private letter ruling. In PLR 200041022, the IRS stated that "direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under Sect. 104(a)(2)."

While private letter rulings are not binding on the IRS, they do indicate the IRS' position on a subject, and they can be indicators of how the IRS would act in similar matters.

Nonphysical personal injuries are also not defined. However, it seems pretty well established that damages for such things as wrongful termination, discrimination (age, race or otherwise) or defamation, shall be treated as paid on account of nonphysical personal injuries.

Emotional Distress Damages May Be Taxable Or May Not

Section 104 also provides that emotional distress damages generally are not considered a physical injury under Sect. 104(a)(2). Thus, they are generally considered taxable.

However, emotional distress damages may be tax-free if closely related to a physical injury.

The House Conference Report that accompanied the 1996 statute provided in part:

"Because all damages received on account of physical injury or physical sickness are

excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to physical injury or physical sickness."

The House Conference Report and PLR 200041022 both note that, while emotional distress damages generally do not qualify as a physical injury, there is an exception under which medical expenses incurred to treat emotional distress resulting from direct physical injury can qualify for exclusion under Sect. 104(a)(2) and be tax-free.

Let's use PLR 200041022 as an example.

That ruling involved a woman, who we'll call Jane Smith, who was an employee of a man, who we'll call Thurston Acme, and his company, Acme Corporation. At some point, Acme made sexual advances toward Smith and there was some "minor" uninvited touching. Smith complained of headaches and digestive problems. Later, Acme made more aggressive overtures toward Smith and assaulted her - resulting in biting, cutting, bruising and "extreme pain."

Smith then sued for sex discrimination, battery and emotional distress and recovered a sizeable settlement. What part of it was taxable?

According to the IRS, the portion of the settlement allocable to damages from the original advances and touching (including for the headaches and stomach disorder) were not on account of physical injury and were thus taxable.

However, once the physical touching left marks, severe pain, discoloration etc., any damages allocable to that time period forward (including any damages for emotional distress as a result of the physical injuries) were properly allocated to physical injuries and were excluded from taxable income. Those damages, said the IRS, created "observable bodily harms."

It is unclear exactly what degree of physical harm is needed, but obviously the IRS indicated that something more than a slight touching was required.

The Church Sex-Abuse Cases

These issues may come to light in the pending settlement of the sex-abuse suits against the Archdiocese of Boston, and in other settlements across the country (this past month alone has seen settlements in Miami and a diocese in Minnesota).

Of course, the harms alleged in the consolidated cases in Boston are not identical. Thus it is hard to be categorical in deciding if the settlements should be taxable or not.

However, we can make some assumptions.

First, many (perhaps the vast majority) of the cases stem from physical assault by priests. It appears clear that those physically molested should not have to pay taxes on their damages. Moreover, as any claims for their emotional distress undoubtedly will relate directly to such physical abuse or to sickness or illness caused directly thereby (e.g. depression is an illness), there is a strong argument that as to those plaintiffs all of the settlement proceeds should be excluded from income.

Moreover, because there were no punitive damages claims, there should be no argument that part or all of the settlement should be taxed as punitive damages.

However, it is not immediately clear that all of the plaintiff's cases will be so obvious. Some of their claims may not be based on any direct physical harm. Or some of their claims may be

based on a "pat" or "minor touching." Under the PLR, the plaintiffs in such cases need to weigh the IRS' position and consider if their share of the settlement will be taxable.

One of the leading plaintiffs' lawyers in the Boston litigation, Eric MacLeish of Greenberg Traurig, told me that his firm has not been offering tax advice to the plaintiffs. Instead, he said, they have counseled all of their clients to seek outside independent, qualified advice from tax lawyers or accounting firms.

Ultimately, each case must be reported for tax purposes individually and the taxability determination will be based on its unique facts. Some of the cases may be based on physical harm that reaches the level of observable bodily harms (as described in PLR 200041022). Other cases may not.

What degree of bodily harm is enough? Those issues and the lines that need to be drawn are not completely clear. Each of the plaintiffs involved in the settlement face different degrees of risk in taking positions on their tax returns depending upon their cases.

Conclusion

Unfortunately, the issue of the taxation of damages in personal injury suits is not a well-settled area of law. Since the 1996 changes are still relatively new, there have not been enough new cases or IRS rulings to clarify all of the judgment calls that go into the calculations and allocations of damages.

Jeffrey A. Baskies, Esq., who practiced estate planning in Florida for many years, is currently the CEO of Lawyers Weekly Inc. in Boston. Board certified as a specialist in wills, estates and trusts law by the Florida Bar, his column runs regularly in Lawyers Weekly USA, the national newspaper for small law firms. If you have questions or issues relating to estate planning, please feel free to e-mail Jeff at jbaskies@lawyersweekly.com. All questions are

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