

Taxability of damages in elder sexual abuse cases depend on “injury”

TAX: Damages received in abuse cases are only excludable from income if they result from physical injuries — but what defines physical injuries?

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Each year, an estimated 2.1 million older Americans are victims of physical, psychological, or other forms of abuse and neglect.¹ Although the majority of cases involve caregiver neglect, a significant portion involves physical and sexual abuse.²

A controversy is brewing among tax professionals as to the taxability of damages received in sexual abuse lawsuits, especially those involving the elderly.

Suppose that a woman living in a nursing home is raped by one of the nursing home’s employees. She sustains no bruises, cuts, or other noticeable injuries. The woman sues the employee and the nursing home, and the case is settled for \$400,000. Is the \$400,000 excludable from income?

Excludable damages

Taxpayers may exclude from gross income amounts received for personal injuries.³ Before 1996, “personal injuries” included non-physical injuries such as emotional distress, injury to one’s reputation, discrimination, wrongful termination, and sexual harassment.

The Small Business Job Protection Act

of 1996⁴ (“1996 Act”) changed the law by requiring the damages to be “on account of personal physical injuries or physical illness,” and by providing that except for out-of-pocket medical expenses, emotional distress is not a physical injury or physical illness.

Although damages received for emotional distress alone are not excludable from income, Congress explained that if an action has its origin in a physical injury or physical sickness, then all damages that flow from that physical injury or physical sickness, including damages for emotional distress (but not punitive damages), are excludable from gross income.⁵

For example, a dog-bite victim who receives damages for medical costs, pain

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and suffering and emotional distress would be able to exclude these amounts because all of the damages flowed from the physical injury.

What are “physical injuries”?

The term “personal physical injuries” is not defined in either IRC §104 or in the legislative history of the 1996 Act.

Where the statute does not define a particular term or phrase, the courts have held that it is appropriate to consult dictionaries in order to determine the ordinary meaning of words.⁶ Most courts consult **Black’s Law Dictionary**, which in this case defines “physical injury” as “physical damage to a person’s body.”⁷

In a private letter ruling, the IRS considered whether damages from unwanted physical and sexual contacts were excludable under IRC §104(a)(2).⁸ The ruling discussed a woman whose employer sexually harassed and then later physically and sexually assaulted her.

The woman filed a lawsuit alleging sex discrimination, reprisal, battery, and intentional infliction of emotional distress. The employer settled the case.

The IRS ruled that the portion of the settlement allocable to the unwanted physical contacts that didn’t result in any “observable bodily harm” (i.e. harassment) was not excludable under IRC §104(a)(2), but the portion allocable to the physical and sexual assaults was excludable.

The IRS held that “personal physical injuries” meant “direct unwanted or uninvited physical contacts resulting in observable bodily harms ... such as bruises, cuts, swelling and bleeding.” However, private letter rulings cannot be cited as precedent,⁹ so this holding has questionable value for other situations.

One commentator has suggested that the IRS went too far by saying that “personal physical injuries” require “observable bodily harms.”¹⁰ He said that it is ludicrous to think that physical maltreatment and the consequential emotional injuries that often result are not “personal physical injuries” merely because there are no “observable bodily harms.”¹¹

Elder neglect may result in physical injuries. A caregiver might not be providing the elderly person with such life

necessities as food, water, clothing, shelter or medicine. Symptoms of neglect might include dehydration, malnutrition, untreated health problems, or lack of personal hygiene.

Where these types of symptoms exist, damages for neglect and damages for emotional distress caused by the neglect are probably excludable because the neglect resulted in physical injuries.

Commentary

At present, the private letter ruling discussed above is the only IRS guidance on whether damages received in a sexual abuse lawsuit are excludable from income under IRC §104(a)(2). While the IRS has suggested that it might issue regulations in this area,¹² it has no current plans to do so.¹³

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The private letter ruling’s conclusion that “personal physical injuries” require “observable bodily harms” seems to be incorrect. For example, in the hypothetical situation described above, although there were no outwardly visible physical indications of injury, the woman was raped. It seems obvious that rape results in “personal physical injuries.”

Damages received for elder sexual abuse where there has been a physical attack, even if such attack does not leave any “observable bodily harms,” should be excludable under section IRC §104(a)(2).

The courts have not addressed whether a particular injury constitutes a “personal physical injury.” In the absence of any regulations or clarification from the IRS, the courts likely will determine this on a case-by-case basis, which may result in varying results and/or protracted litigation.

This situation may also hamper achieving settlements in personal injury cases if it is unclear whether all or a por-

tion of a settlement will be taxable. Accordingly, more definitive and realistic guidelines from the IRS on this issue are needed. **S**

- 1 “Elder Abuse and Neglect: In Search of Solutions,” American Psychological Association, 2003.
- 2 “A Response to the Abuse of Vulnerable Adults: The 2000 Survey of State Adult Protection Services,” National Center on Elder Abuse, Mar. 7, 2003.
- 3 IRC §104(a)(2)
- 4 Public Law No. 104-188.
- 5 H.R. Rep. No. 104-737, 104th Cong., 2nd Sess., p. 301 (Aug. 1, 1996), 1996-3 C.B. 1041.
- 6 **Rome I, Ltd. v. Commissioner**, 96 T.C. 697, 704 (1991), citing **National Muffler Dealers Association, Inc. v. United States**, 440 U.S. 472, 480, n.10 (1979) and **Woods v. Commissioner**, 91 T.C. 88, 97 n.16 (1988).
- 7 **Black’s Law Dictionary** 789 (7th Ed. 1999). A previous edition defined “physical injury” as “bodily harm or hurt, excluding mental distress, fright, or emotional disturbance.” **Black’s Law Dictionary** 1032 (5th Ed. 1979).
- 8 IRS Letter Ruling 200041022.
- 9 Code sec. 6110(k)(3).
- 10 Robert W. Wood, “What Litigation Recoveries Are Excludable as ‘Physical’”, 2001 Tax Notes Today 28-58 (2/2/01); Robert W. Wood, “Were Church’s Payments to Sex Abuse Victims Because of Physical Injuries or Physical Sicknes?”, 2004 Tax Notes Today 126-23 (6/30/04); Robert W. Wood, “Tax Treatment of Settlements and Judgments: Post-1996 Act Section 104 Cases — Where Are We Eight Years Later?” 2004 Tax Notes Today 189-27 (9/29/04).
- 11 Robert W. Wood, “Tax Horrors Of Sexual Molestation Recoveries,” California Tax Lawyer, p. 13, 15 (Summer 2004).
- 12 See the last paragraph of IRS Letter Ruling 200041022.
- 13 IRS’s Semiannual Regulatory Agenda, 69 Fed. Reg. 38029-38102 (June 28, 2004).

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