



IRS Rules Wrongful Life Damages Are Tax Free

by Robert W. Wood



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In this article, Wood reports on a recent IRS private letter ruling that treats damages for wrongful life and wrongful birth as tax free.

This discussion is not intended as legal advice.

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Wrongful birth actions are brought by parents to recover damages for the birth of an unhealthy child. The parents' right to recover is based on the defendant's negligent deprivation of the parents' right not to conceive the child, or to prevent the child's birth. Wrongful life actions are brought by the child rather than the parents, but they essentially parallel wrongful birth causes of action. States vary in their approaches to allowing these kinds of claims — and there are slight differences in how the cases can be presented.

However, both actions generally involve medical evidence and damage studies that focus on the life-care needs of a disabled or sick child. These studies usually attempt to quantify what may be a lifetime of special medical needs, expenses, and other costs likely to result from the child's injury or illness. To my mind, that has always made these awards good candidates for exclusion from income as compensatory recoveries under section 104. Not surprisingly, the

legislative history of section 104 does not mention these causes of action.

Although these lawsuits are becoming increasingly common, there appears to be no tax case law addressing them. Opinion about the likely tax treatment of these recoveries varies. So does the degree of cooperation one can expect from defendants and insurance companies at settlement time. Until now, the IRS has not officially addressed these recoveries.

Fortunately, a recent IRS private letter ruling gives the best answer: excludable. To be excludable, of course, damages must be compensatory, and received on account of personal physical injuries or physical sickness. Most wrongful life and wrongful birth claims should satisfy this standard. But a causal connection may be more attenuated in a wrongful birth claim.

That is, in wrongful birth claims, parents seek damages for physical injuries or physical sickness experienced by their child. In a wrongful life claim, the child seeks damages for their own injuries or sickness. Yet in either case, the damages are all about medical and life care. Authorities have supported the tax-free treatment of damages for loss of consortium and similar emotional distress-type injuries, even if the person awarded the damages was himself not physically injured.¹

Nevertheless, in my experience, plaintiffs and defendants in wrongful life and wrongful birth actions often spar over settlement agreement wording and the issuance of IRS Forms 1099. I have long argued that these damages should be excludable, and I have written tax opinions to that effect. However, some defendants are more helpful than others when it comes to inserting

¹ See LTR 200121031, discussed later.

favorable tax language and agreeing not to issue Forms 1099.

Tax practitioners may argue that a defendant's actions constituted physical harm to the mother carrying the child. The child might even be considered a part of the mother's body at the time of the harm. The complaint in a wrongful birth or wrongful life case is likely to focus on medical care and medical needs, including a list of the hospital, medical, surgical, rehabilitative, therapeutic, and other services called for.

The complaint may also list a litany of harms and inconveniences, including examinations, tests, medications, hospital admissions, and other care. The enumerated damages to parent and child are likely to note such items as emotional distress, anguish, inconvenience, impairment of quality of life, and other noneconomic damages. The complaint is likely to seek past, present, and future economic costs.

The list of damages a plaintiff seeks may include extraordinary medical, life-care, educational, support, out-of-pocket, essential services, and other expenses. Often, the list extends beyond the amounts one would normally expend to raise a healthy child. Whatever additional needs the child has may necessitate special care for life.

IRS Ruling

The IRS has provided welcome relief and certainty for plaintiffs in these difficult legal cases in LTR 107009-19.² In it, the taxpayer contracted with a clinic to provide a suitable anonymous donor egg. The clinic was then to perform an embryo transfer via in vitro fertilization. As agreed, the clinic implanted an embryo into the taxpayer, which the clinic had developed using an anonymous donor's egg.

The taxpayer conceived and eventually gave birth. She later discovered that the clinic had not tested the donor egg or the embryo for genetic mutations. The ruling does not identify the specific genetic condition in question, but states that the clinic did not test for it. Some months after

birth, the child underwent a medical examination and genetic testing.

That testing revealed that the child suffered from a serious genetic condition. At no point before the birth did the clinic inform the taxpayer that the donor egg or donor carried (or was at risk for carrying) the gene causing the genetic condition. The ruling says that the genetic condition led to multiple physical, cognitive, and behavioral disabilities.

The mother, individually and on behalf of her child, filed a complaint against the clinic in state court. The complaint sought damages for the physical injuries and physical sickness the child suffered. It stated that after the taxpayer informed the clinic of the results of the testing, the clinic provided the taxpayer with the genetic testing results of the anonymous donor egg. The tests showed that it was positive for the gene causing the genetic condition.

The taxpayer's complaint alleged that the physical injuries and physical sickness were the result of: (1) the clinic using a donor egg carrying the gene that caused the genetic condition for the embryo; (2) the clinic implanting it into the taxpayer; and (3) the clinic failing to test the donor egg or embryo for the gene causing the genetic condition before the implantation procedure.

Apart from seeking damages for the child, the complaint sought damages for the mother's emotional distress arising from the child's physical injuries and physical sickness. The lawsuit was eventually settled for a lump sum amount.

Sensible Reading

The ruling recites the basics of section 104. It recites the rule that damages for emotional distress attributable to physical injury or physical sickness are also excluded from income. In her complaint against the clinic, the taxpayer claimed that the child suffered (and would continue to suffer) physical, cognitive, and behavioral disabilities because the donor egg the clinic used for the embryo was not tested. By failing to test it and implanting the embryo, the clinic *caused* the child to suffer physical injuries and disabilities.

To the IRS, that meant the child's damages were excludable from income. So were the mother's related emotional distress damages. The

²The ruling was obtained by John McCulloch of Arcadia Settlements Group, in conjunction with Randy Levine of Sage Settlement Consulting and the National Structured Settlements Trade Association.

ruling does not expressly say it, but it seems clear that the mother's emotional distress damages are given a kind of piggyback status on top of the child's excludable damages. The IRS even says that the mother's tax-free treatment for her related emotional distress would only be limited by the amounts that reimbursed her for medical expenses that she previously incurred and previously deducted. That, after all, is our old friend the tax benefit rule.

In my experience, there are often worries about how to allocate amounts between parent and child in these types of cases. Frequently, all amounts paid to resolve wrongful life and wrongful birth cases can fairly be attributed to payments on account of medical needs and the disability needs of the child. It is worth remembering *Domeny*,³ in which the taxpayer had multiple sclerosis, which the Tax Court concluded was a physical sickness within the meaning of section 104(a)(2).

The taxpayer in *Domeny* was paid for conduct that made her multiple sclerosis worse, and that qualified for an exclusion. Wrongful life and wrongful birth cases are all about the damages from serious medical conditions. In wrongful life or birth cases, the defendant's actions arguably take away only the parent's right to make an informed decision on whether to carry a fetus to term. In that sense, the defendant caused the birth and thus caused the physical injury or disability.

Put differently, if not for the defendants' negligence, the child's medical condition would not have had the opportunity to manifest itself, with the resulting medical and life-care expenses. The defendant's negligence is a "but for" cause of the damages.

Settling Cases

An IRS private letter ruling is not precedential authority. As a technical matter, no other taxpayer can rely on it. Yet there is no question that as a practical matter, taxpayers and tax professionals do rely on private rulings. Plainly, in an informal way, they will here, too — and that's good.

Defendants may be more willing to include physical injury language in settlement

agreements. Defendants may be more willing to agree not to issue Forms 1099 to plaintiffs in these cases. Insurance companies are likely to be more amenable to structuring these recoveries as excludable, with qualified section 130 assignments. That is good too, for plaintiffs who want to structure.

Of course, there are still likely to be hiccups. Some defendants may insist on issuing Forms 1099 because the parties may not agree to specific language about taxes and reporting. Indeed, defendants and insurance companies often do issue the forms unless the settlement agreement expressly states that they won't.

Some plaintiffs won't even think about the tax issues until after the settlement is concluded and the money is paid. A common time to think about them is when Forms 1099 arrive. A Form 1099, by definition, needs to be reported on the tax return, even if the taxpayer can explain that the amounts shown should not be taxed.

Egg Donations?

It is worth a reminder that section 104 has its limits. In *Perez*,⁴ the taxpayer was paid for donating her eggs for transfer to infertile couples, a process that involved a long series of painful injections and invasive medical operations. Although styled egg *donation*, the taxpayer was paid \$20,000 for two rounds of donations that harvested dozens of eggs.

The contract she signed said the payment was for her "time, effort, inconvenience, pain, and suffering in donating her eggs." She excluded the \$20,000 from her income based on the section 104 exclusion and wound up in Tax Court, which held that the amount was taxable and that reg. section 1.104-1(c) only excludes "damages."

According to the Tax Court in *Perez*, the exclusion does not apply to proceeds from the consensual performance of a service contract. Contract payments are not damages, in the Tax Court's view. In contrast, of course, a recovery for wrongful life or wrongful birth is not consideration for a voluntary sale of property or performance of services. It is unambiguously a

³*Domeny v. Commissioner*, T.C. Memo. 2010-9.

⁴*Perez v. Commissioner*, 144 T.C. 51 (2015). For further discussion, see Robert W. Wood, "Taxing Egg Donations With the Wisdom of Solomon," *Tax Notes*, June 29, 2015, p. 1581.

payment for damages on account of the negligence of one or more defendants.

Emotional Distress From Physical Harm

The legislative history of section 104(a)(2) also supports excluding emotional distress damages attributable to physical harm:

If 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 whether or not the recipient of the damages is the injured party.⁵

The exclusion is broad, including all non-punitive damages flowing from a physical harm. The recipient of the damages (including emotional distress) need not be the one physically injured. The legislative history continues by giving examples of excluded ancillary damages such as damages for loss of consortium or wrongful death.⁶

Identity of Plaintiff

Does it matter whether the child, the parent, or both receive damages? No; arguably it should have no effect. The authorities suggest that the ultimate recipient of damages is less important than their nature. For example, in LTR 200121031, the IRS concluded that a wife's recovery from claims related to her husband's death were still excludable.

The husband died from asbestos-related lung cancer from his job installing drywall. The wife asserted various claims against the employer, including damages for loss of consortium and wrongful death. The IRS reasoned that the employer was the proximate cause of the diseases and the husband's ultimate death, which gave rise to the wife's claims. The wife's compensatory damages had a direct link to the husband's physical injury and death.

It was immaterial that the wife had not been physically harmed. Similarly, in *Paton*,⁷ the taxpayer's husband committed suicide after stressful conditions at work. The spouse threatened a claim against the employer for the wrongful death of her husband, a clear physical harm. The employer settled, and the taxpayer was allowed to exclude her award from income.

Therefore, although the recent ruling concerned a wrongful life claim brought in the child's name, it should also give equal comfort in wrongful birth cases brought in the name of one or both of the child's parents.

Conclusion

Wrongful life or wrongful birth damages are meant to pay for the enormous challenges of caring for an ill or disabled child, and the attendant costs. The recent IRS ruling should give plaintiffs needed certainty in many cases, even if the ruling technically does not apply to them. It should also give life insurance companies that write structured settlement annuities confidence that they can write policies with qualified assignments, assuring tax-free treatment of the entire stream of payments to plaintiffs.

Of course, as with virtually any legal settlement, the wording and the mechanics still matter. Stressing tax language in settlement agreements is still wise. Pushing hard to get written commitments from defendants and insurance companies that they will not issue Forms 1099 to plaintiffs is still important. Hopefully those efforts will now be a little easier. ■

⁵ Section 1605 of the Small Business Job Protection Act of 1996.

⁶ See *id.*

⁷ *Paton v. Commissioner*, T.C. Memo. 1992-627.