

Are Damages in Wrongful Life and Wrongful Birth Cases Taxable?

By Robert W. Wood

As medicine, science, and the law continue to develop, lawsuits for wrongful birth and wrongful life are increasingly being recognized. These causes of action sound similar but are technically different. They both are akin to medical malpractice cases. Wrongful birth actions are brought by parents to recover for the birth of an unhealthy child. The parents' right to recover is based on the defendant's negligent deprivation of their right to *not* conceive the child, or to prevent the child's birth.

In contrast, wrongful life actions are brought by the child but parallel a wrongful birth cause of action. Both kinds of cases generally involve medical evidence and damage studies that focus on the life-care needs of a disabled or ill child. States vary in whether they allowing either or both kinds of cases. As tort law continues to develop, it is not surprising that the law concerning the tax treatment of recoveries for these emerging torts of wrongful life and wrongful birth is unclear.

If a parent or child sues and recovers a settlement or judgment, is it taxable? Damages for personal physical injuries (like an auto accident or slip and fall case) are tax-free. So are damages for physical sickness. But punitive damages and interest are taxable, as are damages for mere emotional distress. Up until 1996, just about anything qualified as excludable personal injury damages, including emotional distress, defamation or invasion of privacy.

In 1996, the tax code was changed so only recoveries for personal *physical* injuries or *physical* sickness qualify. Frustrated tax lawyers and accountants have repeatedly asked for regulatory guidance, and the U.S. Tax Court faces many cases over what's taxed. If your damages aren't physical enough, they are taxed. Unfortunately, the IRS is notoriously tough on just what is physical.

Traditionally it means injuries you can see like bruises or broken bones, though that may be changing gradually. How do wrongful life and wrongful birth damages stack up to this standard? For a wrongful life claim, a plaintiff child's personal physical injury or physical sickness may be evident at the time of suit. Damages are usually assessed based on the additional medical and special needs of the child.

Arguably that goes a long way toward the tax-free standard. The causal connection may be even more attenuated in a wrongful birth claim. It may be possible to argue that a defendant's actions constituted physical harm to the mother and thus should be tax-free. With both types of cases, though, be careful, as the tax authorities aren't clear.

Paying attention to the particular language in the settlement agreement can matter. So can tax reporting. Ideally, consider these issues *before* the settlement documents are finalized. After all, there's a big difference between taxable and tax-free. The IRS could argue that a settlement was not on account of the child's disability because the defendant's negligence did not cause it to exist.

In wrongful birth cases, the defendant's actions arguably only take away the parent's right to make an informed decision on whether to carry a fetus to term. But in that sense, the defendant caused the birth and thereby caused the physical injury or disability. Put differently, except for the defendant's negligence, the child's medical condition would not have had the opportunity to manifest itself, with the resulting medical and life-care expenses.

In that sense, the defendant's negligence is a 'but for cause of the damage. Does it matter whether it is the child or the parents who receive the damages? Probably not. The authorities suggest that the ultimate recipient of damages is less important than their nature.

For example, in IRS private letter ruling 200121031, the IRS concluded that a wife's recovery from claims concerning her husband's death was still excludable because her damages were attributable to the victim's physical harm. Similarly, in *Paton v. Commissioner*, a 1992 Tax Court case (T.C. Memo. 1992-627), a woman's husband committed suicide after enduring stressful conditions at work. She never actually threatened a claim against the employer for the wrongful death of her husband.

But she said she thought the company was at fault for his death, and the company paid her a settlement. She was allowed to exclude her settlement from income, even though she was only a bystander to her husband's death. Wrongful life or wrongful birth damages are meant to pay for the stress of caring for an ill or disabled child and the attendant costs. Besides, the legislative history of the tax code section says that all non-punitive damages that flow from a physical harm can be excluded, regardless of whether the recipient of the damages is actually the injured party.

In wrongful birth or wrongful life cases, it is the parents receiving the funds, and they are really receiving it on account of the injuries to or special needs of the child. To me, that makes a good case that these monies should generally be tax free. There is no guarantee the IRS would agree, of course, and we may eventually see tax disputes involving wrongful life and wrongful birth recoveries. At worse, the IRS could see them as fundamentally emotional distress recoveries.

However, using strong tax language in settlement agreements may keep the issue from arising. Stressing the nature of the damages and the medical failures in question should help. So, too, should statements that the settlement payment is being made on account of medical expenses, physical injuries, physical sickness, and emotional distress they caused.

Robert W. Wood is a tax lawyer with www.WoodLLP.com, and the author of "Taxation of Damage Awards & Settlement Payments" (www.TaxInstitute.com). This is not legal advice.