

# Taxing California Elder Abuse Recoveries

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**T**he U.S. Department of Health and Human Services and Department of Justice report that each year, up to 5 million older persons are abused, neglected, or exploited.<sup>1</sup> Some studies even suggest that as few as one in 23 cases of elder abuse is reported to authorities.<sup>2</sup> Legislatures in all 50 states have passed some form of elder abuse prevention laws. The laws vary considerably, but abuse can generally be broken into multiple categories, including:

- Physical Abuse, generally involving the infliction of physical pain or injury on a senior;
- Sexual Abuse, involving non-consensual sexual contact of any kind;
- Neglect, such as by failing to provide food, shelter, health care, or protection for a vulnerable elder;
- Exploitation, involving the illegal taking, misuse, or concealment of funds, property, or assets of a senior for someone else's benefit;
- Emotional Abuse, including the infliction of mental pain, anguish, or distress on an elder person through humiliation, intimidation, or threats; and
- Abandonment, involving the desertion of a vulnerable elder by someone with responsibility for care or custody.<sup>3</sup>

Litigation based on alleged elder abuse is occurring more frequently.<sup>4</sup> Due to the panoply of applicable laws, it is not surprising that such suits are brought in many different ways. An elder abuse case may involve appalling physical injuries or even wrongful death. Conversely, it may involve entirely financial transgressions. Of course, a single lawsuit may involve multiple claims, including claims based on financial, physical, and emotional harm.

The diversity of possible claims makes it difficult to generalize about the tax consequences of elder abuse claims, and, for these and other reasons, there is relatively little discussion in the literature about those consequences.

Like other litigants, plaintiffs in elder abuse cases might not consider tax issues until the conclusion of the case or until the following January, when Internal Revenue Service ("IRS") Forms 1099 arrive reflecting the payment of amounts awarded in respect of their claims. Some plaintiffs wait even longer, first worrying about taxes as they hover over their Form 1040. Taxes on legal settlements, however, can involve a rude awakening.

Section 104 of the Internal Revenue Code ("IRC") can certainly play a part in determining the taxation of awards in elder abuse cases. That section states that recoveries for personal physical injuries, physical sickness, and emotional distress caused thereby are tax-free. There is no reason to think that elder abuse claims should be viewed as a distinct class of cases for purposes of section 104 analysis. Thus, an award deriving from a purely financial elder abuse claim, not involving any component of physical injury or sickness, would presumably be 100% taxable. On the other hand, an elder abuse claim may result in an award that includes some taxable and some tax-free damages, depending on the facts, the claims made, and the resolution of the case. Unfortunately, therefore, the scope of the section 104 exclusion continues to cause taxpayers, lawyers, and tax preparers considerable trouble. The Tax Court is frequently glutted with section 104 cases.<sup>5</sup>

Section 104 tries to divide the world neatly between the physical and the emotional. The provision excluded from income all recoveries in respect of "personal" injuries until 1996, when Congress added the word "physical."<sup>6</sup> This was mostly aimed at employment

lawsuit recoveries: in the 1980s and 1990s, many litigants in discrimination and wrongful termination cases claimed virtually all of their settlements as emotional distress, a “personal injury” that, until the change in section 104, was tax-free. Since 1996, a recovery must be for physical injuries or physical sickness, or for emotional distress damages that arise out of the physical injuries or physical sickness, to be tax-free.<sup>7</sup>

In elder abuse cases, if there has been significant physical abuse, there may be a good case to treat many, or even all, of the damages as emanating from the physical abuse. Where that is appropriate, plaintiffs will want to expressly state in the settlement agreement that the damages are paid on account of physical injuries, physical sickness, and emotional distress therefrom. It is appropriate to state also that such damages are excludable from the recipient’s income under section 104 of the tax code. (That does not make it true, but saying it expressly does not hurt. In the author’s experience, such language can often help in an audit.) And, if the plaintiff is claiming tax-free treatment, expressly asking that the defendant not issue a Form 1099 is a good idea, too (and the settlement agreement should expressly so state), since not issuing that form would be consistent with having a recovery entitled to exclusion under section 104.

Of course, many elder abuse cases are mostly, or exclusively, financial. In these circumstances, the section 104 exclusion is of no help. Damages in purely financial cases are fully taxable, and, in *all* cases, both punitive damages and interest are taxable.<sup>8</sup>

This article focuses on legal fees in elder abuse cases that are not entirely excluded from the recipient’s income for tax purposes.

### Attorney Fees on Taxable Recoveries

With recoveries that are wholly or partially taxable, the way attorney fees are deducted can be a problem. In *Commissioner v. Banks*,<sup>9</sup> the U.S. Supreme Court held that plaintiffs are generally treated as receiving 100% of their settlements and judgments, even if their lawyers receive the settlement funds, withhold (“net”) the contingent fees to which the lawyers are entitled, and pay their clients only the balance.

In 100% tax-free cases, of course, this rule causes no harm. For example, if the plaintiff is entitled to a \$1 million settlement, but owes a 40% contingent fee to the lawyer, and the plaintiff is treated as having received only \$600,000

tax-free, he (or she) pays zero tax. So does a plaintiff who is treated as having received the \$1 million award tax-free and thereafter having paid \$400,000 to his or her lawyer. But in taxable cases, where any part of the recovery is taxed, it is a different story: the plaintiff will generally be taxed on his net recovery (as opposed to the entire amount) only if the fees can be deducted above the line (i.e., excluded in their entirety from “income” for purposes of determining an individual’s “adjusted gross income”).

In 2004, Congress amended IRC section 62(a) (which provides that “adjusted gross income” means, in the case of an individual, gross income minus amounts included in a list of specified deductions) to add section 62(a)(20), allowing an above-the-line deduction for certain legal fees:<sup>10</sup>

Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination (as defined in subsection (e)) or a claim of a violation of subchapter III of chapter 37 of title 31, United States Code [1] or a claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C. 1395y(b)(3)(A)). . . .<sup>11</sup>

For cases covered by the amended law—primarily employment cases and whistleblower claims—the change has been huge. The provision prevents the often unfair (and counterintuitive) treatment of the fees as miscellaneous itemized deductions. The 2% threshold, phase outs, and alternative minimum tax rules that limit a taxpayer’s benefit from itemized deductions can mean that, in taxable recoveries not covered by section 62(a) (20), the client must pay tax on the attorney fee portion of damages. This can occur even in cases involving catastrophic physical injury.

If the origin of the case is a catastrophic physical injury or wrongful death, many non-tax lawyers, and even some tax professionals, are lulled into ignoring attorney fees. They may assume that all such damages would be tax-free, yet the presence of punitive damages means an allocation is necessary. The portion of the recovery that constitutes punitive damages or interest remains taxable. To the extent a recovery is taxable, the gross amount, including the legal fees attributable to that portion of the recovery, is taxable. The bigger the recovery and

the larger the attorney fees and costs, the worse the tax result. With only a miscellaneous itemized deduction, the plaintiff may truly be paying tax on the monies sent to the plaintiff's lawyer. As the Supreme Court noted in *Banks*, there are even situations where the tax on the gross recovery may exceed the net recovery received by the taxpayer, creating "the perverse result that the plaintiff loses money by winning the suit."<sup>12</sup> The applicability of the above-the-line deduction is therefore important.

### Legal Fees for Elder Abuse

Virtually any claim in the employment context, including a whistleblower claim, is covered by the 62(a)(20) deduction. Beyond these obvious cases, though, what else qualifies for an above-the-line deduction of legal fees? What, for example, about an elder abuse claim?

Elder abuse claims can be brought under federal or state elder abuse statutes. Some are brought as medical malpractice claims. Regardless of how the case is brought, however, some of these cases should give rise to tax-free awards. A mistreated elder plaintiff may have personal physical injuries or physical sickness, along with related emotional distress. But not everyone does. The elder abuse claim may involve no award excludible from income.

Claims of elder abuse are being included in complaints filed with respect to employment suits, contract claims, rent disputes, and many other garden-variety legal matters. With no physical injuries, physical sickness, or exacerbation of the plaintiff's existing physical sickness, the resulting damage awards will be included in the recipient's income, and taxing the related award could result in real financial hardship. Section 62(a)(20) might help. Among other things, the statute permits the deduction from gross income of attorney fees in respect of:

(18) Any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law—

(i) providing for the enforcement of civil rights,

...<sup>13</sup>

The statute does not explicitly address elder abuse, but there are some indications that it could well apply to many elder abuse claims.

### Kinds of Discrimination

As just noted, a claim of unlawful discrimination is defined to include any claim, under any law—even a common law claim—providing for the enforcement of civil rights.<sup>14</sup> It is not clear, however, exactly what constitutes a law "providing for the enforcement of civil rights." Structurally, clause (18) of section 62(e) is a catch-all provision, intended to benefit even claims of unlawful discrimination that are not otherwise specifically listed in that section.

The provision certainly lends itself to a broad interpretation. The Committee Reports for the House, Senate, and Conference Committee when passing the American Jobs Creation Act of 2004 (which added this language),<sup>15</sup> reveal nothing particularly useful, but Black's Law Dictionary defines "civil rights" to include "the individual rights of personal liberty guaranteed by [the Constitution], as well as by legislation such as the Voting Rights Act."<sup>16</sup> This suggests that civil rights can stem from legislative action (and possibly from regulatory action), and not just from the Constitution and the Fourteenth Amendment cases. The definition also invites the question of what is a "personal liberty." "Liberty" is defined in Black's Law Dictionary to include "a right, privilege, or immunity enjoyed by prescription or by grant."<sup>17</sup> "Personal liberty" is defined to mean "one's freedom to do as one pleases, limited only by the government's right to regulate the public health, safety, and welfare."<sup>18</sup>

Protections for the elderly and for patients seem to fit within the broader definition of liberty, but perhaps not within the more narrow definition of personal liberty. Laws protecting the elderly generally establish a right not to be abused or a right to be treated fairly (an egalitarian right). However, they do not seem to establish a freedom to do as one pleases (a libertarian right).

The term "unlawful discrimination" (and by implication the ambit of the catch-all "civil rights" provision) in IRC section 62 appears to be broad, rather than narrow, however: specifically included in the definition of "unlawful discrimination" are violations of certain sections of the Americans with Disabilities Act (the "ADA").<sup>19</sup> The enumerated sections prevent discrimination against the disabled with respect to employment, public accommodation, and government services.<sup>20</sup> The ADA is concerned with preventing abuse against the protected constituency (egalitarianism), rather than allowing the constituency to do as it pleases (libertarianism).

Notably, the ADA provisions listed in section 62 do not relate just to employment. They also cover public accommodations and government services. ADA claims (whether relating to employment, public accommodations, or government services) that give rise to taxable damages are taxable; yet, under section 62, the attorney fees are deductible above the line. The same is true for 42 U.S.C. section 1983 civil rights claims.

### Federal Elder Abuse Protections

Under federal law, statutes proscribing discrimination against the elderly are generally evaluated according to the lowest rational-basis for constitutional review. There is at least one federal statute, namely the Age Discrimination in Employment Act of 1967 (the “ADEA”),<sup>21</sup> that proscribes discrimination against the elderly in the employment context, and the ADEA is specifically included in the list of qualifying laws in IRC section 62(e).

Unlike the ADA, though, the inclusion of the ADEA may be more easily distinguished from the laws at issue in many elder abuse claims. That is because the ADEA is concerned principally with the employment relationship. Many elder abuse claims in California, however, are brought under the Elder Abuse and Dependent Adult Civil Protection Act (the “Elder Abuse Act,” codified into the California Welfare and Institutions Code (the “WIC”)),<sup>22</sup> which does not concern employment. Nevertheless, many of the legislative findings specifically incorporated into the first section of the portion of the WIC added by the Elder Abuse Act<sup>23</sup> are helpful to the argument that an elder abuse claim is a civil rights claim fitting nicely within the scope of section 62(a)(20). Consider, for example, the following legislative findings:

- The Legislature recognizes that elders and dependent adults may be subject to abuse, neglect, or abandonment and that this state has a responsibility to protect these persons.<sup>24</sup>
- The Legislature further recognizes that a significant portion of these persons have developmental disabilities and that mental and verbal limitations often leave them vulnerable to abuse and incapable of asking for help and protection.<sup>25</sup>
- The Legislature recognizes that most elders and dependent adults who are at the greatest risk of abuse, neglect, or abandonment by the families or caretakers suffer physical impairments and other poor health that place them in a dependent and vulnerable position.<sup>26</sup>

- The Legislature further declares that uniform state guidelines, which specify when county adult protection service agencies are to investigate allegations of abuse of elders and dependent adults and the appropriate role of law enforcement is necessary in order to ensure that a minimum level of protection is provided to elders and dependent adults in each county.<sup>27</sup>
- The Legislature further finds and declares that infirm elderly persons and dependent adults are a disadvantaged class....<sup>28</sup>

These statements make clear that the Elder Abuse Act is intended to protect the elderly (a disadvantaged class) from abuse and from violations of their rights. Furthermore, these statements suggest that such rights are often violated because of the physical and mental disabilities frequently suffered by persons within this disadvantaged class. In that sense, the Elder Abuse Act can be viewed as a state law enforcing the civil rights of the elderly and disabled.

There appear to be strong parallels between the Elder Abuse Act (and statutes like it) and the federal ADA. Of course, the ADA is explicitly included in IRC section 62(a)(20), but the similarity between that act and the Elder Abuse Act supports the notion that an elder abuse claim should be treated in the same manner for purposes of section 62(a)(20)—possibly, regardless of how the claim is pleaded: claims of this sort (brought under the Elder Abuse Act or similar laws) should, arguably, be viewed as claims brought under state law providing for the enforcement of civil rights.

### Patient’s Bill of Rights

Some elder abuse claims are also brought under patient’s rights laws. This is another fruitful area of inquiry with respect to the treatment of attorney fees. For example, there are numerous California regulations relating to patients and nursing homes.

A complaint alleging elder abuse claims might refer to the Patient’s Bill of Rights, a part of California’s Code of Regulations.<sup>29</sup> Among the rights listed are rights:

- To refuse medical treatment;
- To be free from discrimination based on sex, race, color, religion, ancestry, national origin, sexual orientation, disability, medical condition, or marital status;

- To meet with others and participate in activities of social, religious and community groups; and
- To be allowed privacy for visits.

These rights arguably invoke classic constitutional civil rights, such as freedom of religion, the right of free association, the right to non-discriminatory treatment, and the right privacy. Another regulatory provision, in fact, appears to require due process for the denial of the listed rights: it allows them to be denied or limited only to the extent authorized by law, and it requires the denial or limitation of the rights to be documented in the health records.

In California, other elder abuse claims may allege violations of 22 CCR § 87468. This section, titled “Personal Rights,” applies specifically to residential care facilities for the elderly. It too contains protections that sound in civil rights: it expressly protects the rights to religious freedom, to vote, and to be free from “corporal or unusual punishment.”

An elder abuse complaint may allege violations of 22 CCR § 87467, too. That provision does not contain overtly civil-rights provisions; however, it generally assures that a resident in a California residential care facility will have the ability to participate in decision-making. One is reminded of the constitutional right of privacy to make medical decisions regarding one’s own body, recognized in *Roe v. Wade*.<sup>30</sup> For these types of claims too, therefore, it may be argued that the predicate regulations should be found to be State laws enforcing civil rights.

### Allocating Fees

One can reasonably argue that legal fees for pursuing elder abuse claims should be entitled to above-the-line deduction. Apart from the other points enumerated here, there is also the general notion that the IRS and the courts appear to be construing above-the-line legal fee deductions liberally. This suggests that a successful (and taxable) elder abuse claim should be taxed like a successful (and taxable) employment claim insofar as legal fees are concerned.

Of course, there are still many legal claims that fall entirely outside the scope of the above-the-line deduction. Examples include claims for defamation, infliction of emotional distress, contract disputes, property disputes, etc. Unless such claims are made in the context of an employment claim or involve civil rights, awards of legal fees in respect of such claims can generally be deducted only to the same extent as miscellaneous itemized deductions generally. If, on the other hand, employment claims or

violations of civil rights are part of the case, the IRS and the courts seem to approve all of the fees as an above-the-line deduction. In such cases, the IRS has not pushed to bifurcate the legal fees and to allocate them based on which claims truly involve “employment” or “civil rights” and which do not. That stands as a welcome contrast to some other areas, in which legal fees are bifurcated and treated as non-deductible, deductible, or subject to capitalization.<sup>31</sup>

### Conclusion

With the aging of America and the expansion of laws designed to protect the elderly, elder law has emerged as an important legal specialty. Elder abuse claims are burgeoning, and it is only a matter of time before the tax laws catch up. Perhaps because of the very name “elder abuse,” some plaintiffs, their counsel, and their tax advisers are making aggressive use of the section 104 exclusion for damages for personal physical injuries, physical sickness, and resulting emotional distress. There is no suggestion that the IRS will view elder abuse claims differently from the other myriad contexts in which damages are awarded, and it appears that, regardless of the identity of the plaintiff and the way in which the case is pleaded, damages paid “on account of” personal physical injuries and physical sickness will continue to be examined as they have been. Still, where recoveries are wholly or partially taxable—as some clearly are—the tax treatment of contingent attorney fees is an issue waiting to be addressed.

### Endnotes

- 1 Connolly, Marie-Therese, B. Brandl, R. Breckman, The Elder Justice Roadmap: A Stakeholders Initiative to Respond to an Emerging Health, Justice, Financial and Social Crisis (July 9, 2014), p. 4, *available at* [http://www.justice.gov/elderjustice/research/resources/EJRP\\_Roadmap.pdf](http://www.justice.gov/elderjustice/research/resources/EJRP_Roadmap.pdf). “Elder abuse” generally refers to a knowing, intentional, or negligent act by a caregiver or other person that causes harm or serious risk of harm to a vulnerable adult. *See* Dept. of Health and Human Services, “How can I recognize elder abuse?,” *available at* <http://www.hhs.gov/answers/programs-for-families-and-children/how-can-i-recognize-elder-abuse/index.html>
- 2 *See* Lifespan of Greater Rochester, Inc., Weill Cornell Medical Center of Cornell University, & New York City Department for the Aging, *Under the Radar: New York State Elder Abuse Prevalence Study*, Table 18 (2011); *see also* White House Conference On Aging Final Report (2015).
- 3 *See, e.g.*, Cal. Wel. & Inst. Code § 15600 et seq.; Nev. Rev. Stat. Ann. §§ 200.5091 through 200.50995; Or. Rev. Stat. §§ 124.050 through 124.095.
- 4 *See* Effective Court Practice for Abused Elders (Feb. 2008), p. 9; Stronger Federal Leadership Could Enhance National Response to Elder Abuse, GAO-11-208 (Mar. 2, 2011).

- 5 See National Taxpayer Advocate 2015 Annual Report to Congress, p. 477-479.
- 6 See Section 1605(a) and (b) of the Small Business Job Protection Act of 1996, Public Law 104-188, 110 Stat. 1838. The legislative history of the 1996 amendments to IRC § 104(a)(2) provides that the reason for the change is because “[t]he confusion as to the tax treatment of damages received in cases not involving physical injury or physical sickness has led to substantial litigation, including two Supreme Court cases within the last four years. The taxation of damages received in cases not involving a physical injury or physical sickness should not depend on the type of claim made.” H.R. Rep. No. 104-586, at 143 (1996) (Conf. Rep.).
- 7 H.R. Rep. No. 104-586, at 143-44 (1996) (Conf. Rep.) (“[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.”).
- 8 See IRS Pub. 4345 Settlements-Taxability (rev. Apr. 2015).
- 9 *Commissioner v. Banks*, 543 U.S. 426 (2005).
- 10 See Section 703 of The American Jobs Creation Act of 2004, Public Law 108-357, (118 Stat. 1418).
- 11 Section 62(e), which sets out qualifying discrimination claims, reads as follows:
- (e) Unlawful discrimination defined. For purposes of subsection (a)(20), the term “unlawful discrimination” means an act that is unlawful under any of the following:
- (1) Section 302 of the Civil Rights Act of 1991 (2 U.S.C. 1202).[2]
  - (2) Section 201, 202, 203, 204, 205, 206, or 207 of the Congressional Accountability Act of 1995 (2 U.S.C. 1311, 1312, 1313, 1314, 1315, 1316, or 1317).
  - (3) The National Labor Relations Act (29 U.S.C. 151 et seq.).
  - (4) The Fair Labor Standards Act of 1938 (29 U.S.C. 201 et seq.).
  - (5) Section 4 or 15 of the Age Discrimination in Employment Act of 1967 (29 U.S.C. 623 or 633a).
  - (6) Section 501 or 504 of the Rehabilitation Act of 1973 (29 U.S.C. 791 or 794).
  - (7) Section 510 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1140).
  - (8) Title IX of the Education Amendments of 1972 (20 U.S.C. 1681 et seq.).
  - (9) The Employee Polygraph Protection Act of 1988 (29 U.S.C. 2001 et seq.).
  - (10) The Worker Adjustment and Retraining Notification Act (29 U.S.C. 2102 et seq.).
  - (11) Section 105 of the Family and Medical Leave Act of 1993 (29 U.S.C. 2615).
  - (12) Chapter 43 of title 38, United States Code (relating to employment and reemployment rights of members of the uniformed services).
  - (13) Section 1977, 1979, or 1980 of the Revised Statutes (42 U.S.C. 1981, 1983, or 1985).
  - (14) Section 703, 704, or 717 of the Civil Rights Act of 1964 (42 U.S.C. 2000e-2, 2000e-3, or 2000e-16).
  - (15) Section 804, 805, 806, 808, or 818 of the Fair Housing Act (42 U.S.C. 3604, 3605, 3606, 3608, or 3617).
  - (16) Section 102, 202, 302, or 503 of the Americans with Disabilities Act of 1990 (42 U.S.C. 12112, 12132, 12182, or 12203).
  - (17) Any provision of Federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law.
  - (18) Any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law—
    - (i) providing for the enforcement of civil rights, or
    - (ii) regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.
- 12 *Commissioner v. Banks*, 543 U.S. 426, 438 (2005).
- 13 26 U.S.C. § 62(18)(i).
- 14 *Id.*
- 15 See H. Rept. 108-548; H. Rept. 108-755 (Conf. Rep.).
- 16 *Black’s Law Dictionary* (10th ed. 2014).
- 17 *Black’s Law Dictionary* (10th ed. 2014).
- 18 *Black’s Law Dictionary* (10th ed. 2014).
- 19 42 U.S.C. § 12101 et seq.
- 20 See 42 U.S.C. §§ 12132 and 12182.
- 21 Pub. L. No. 90-202, codified at 29 U.S.C. §§ 621 through 634.
- 22 Cal. WIC §§ 15600 through 15660.
- 23 See Cal. WIC § 15600.
- 24 Cal. WIC § 15600(a).
- 25 Cal. WIC § 15600(c). This provision is helpful for drawing analogy to the ADA, which is specifically identified as a statute that qualifies for above-the-line deduction of attorney fees.
- 26 Cal. WIC § 15600(d).
- 27 Cal. WIC § 15600(g).
- 28 Cal. WIC § 15600(h).
- 29 22 CCR § 72527.
- 30 410 U.S. 113, 153 (1973).
- 31 See *Johnson-Waters v. Commissioner*, T.C. Memo. 1993-333; *Church v. Commissioner*, 80 T.C. 1104, 1110 (1983).