

## LAWSUIT Hotline

**Tax-Free Damages For Physical Injury**

**D**amages received for personal injury are tax free only when the injury is "physical." In 1996, Congress adopted this rule in the Tax Code to end excessive claims of tax-free damages for emotional distress and other forms of mental harm. In enforcing this rule, the IRS has strictly insisted that an injury be "visible" to be deemed physical.

**Example:** A woman received damages for being sexually abused by an employer, the abuse consisting of lewd remarks and improper physical contact. The physical contacts resulted in no injury or visible marks. Then, one day, an assault *did* result in a visible physical injury.

**IRS ruling:** The damages the woman received allocable to the period before the date of the visible injury were taxable, and those allocable to that date and later were tax free. (*Letter Ruling 200041022*)

**Problem:** Damages may be received for a physical injury that is no longer visible at the time a case is pursued. Thus, it might be impossible to then verify the visible nature of the harm.

**New case:** An individual recovered damages for sexual abuse. A substantial period of time had elapsed since the wrong occurred. The plaintiff continues to struggle with the trauma resulting from the wrongful act.

The IRS said in such a case that "it is reasonable...to presume that the settlement compensated [the plaintiff] for personal physical injuries, and that all damages for emotional distress were attributable to the physical injuries."

Thus, all the damages are tax free, even though no visible physical injury was ever proven to exist, but was only reasonably presumed. (*IRS Legal Memorandum 200809001*)

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