

Are Fertility Lawsuit Settlements Taxable?

By Robert W. Wood

Fertility treatments and alternatives have made great advances over the years. Many patients seek fertility treatments and services such as the extraction, freezing and preservation of eggs and embryos, IVF, and implantation of embryos. Unfortunately, sometimes things do not go smoothly. Apart from the complications of the medical procedures themselves, there are also the mechanics and longevity of storage to consider, and sometimes, failures occur.

Receiving notice that your eggs or embryos were destroyed can be devastating. Instead of facilitating a family, plaintiffs may be informed that their eggs or embryos were damaged and are unusable. Depending on the age and medical condition of the patient, additional medical procedures to produce replacement eggs or embryos may be difficult or impossible. When human eggs or embryos are destroyed as the result of commercial egg storage tank failures, lawsuits may follow, singly, as a group, or in a class action. There have been numerous such lawsuits, and some are currently underway.

The defendants may range from doctors and fertility centers with whom patients generally have direct interactions, to the manufacturers of storage tanks and other equipment. Complaints in fertility cases vary, and may include claims for negligence, gross negligence, premises liability, breach of contract, conversion, products liability, and so on. In some cases, there is an express claim for personal physical injuries or physical sickness. In nearly all cases, plaintiffs claim emotional distress damages, and some may involve claims that can fairly be called physical sickness or physical injuries, including post-traumatic stress disorder.

Some plaintiffs may undergo further treatments resulting from the failure, including additional painful egg collection procedures. If the plaintiffs ultimately stand poised to receive a settlement, they may ask, is the settlement taxable? That is not a simple question with many varieties of lawsuit recoveries, and that is particularly true in the nuanced area of fertility litigation. I believe that it is possible reach a nontaxable position in many cases, but the details and documentation are particularly important.

The complaint is a good place to start, since the basic IRS rule is that taxes are determined based on the origin of the claim. The damages sought are also relevant, which may include economic and non-economic damages, physical injuries, emotional distress, loss of consortium, exemplary damages, prejudgment interest, and attorneys' fees and costs. There is no IRS guidance squarely on point about how taxes should apply to these settlements. One limited guidepost is *Perez v. Commissioner*, 144 T.C. 4 (2015), where the U.S. Tax Court considered a woman who sold her eggs for use by women who struggled to conceive.

Perez went through two donation cycles and was paid \$20,000. When she didn't pay taxes on it, the case went to Tax Court. The Tax Court agreed with the IRS that the amounts she received for use in fertility treatments were taxable. Perez argued unsuccessfully that she was being paid for undergoing

the painful procedure of egg removal and that the payment represented damages for physical injuries.

However, the Tax Court held that the payment Perez received was for compensation for her services. Perez's contracted-for services (*i.e.*, egg harvesting and donation) certainly involved an appreciable degree of physical pain and discomfort. Nevertheless, the *Perez* case supports the view that a voluntary agreement to be paid for services that can be reasonably expected to involve pain or discomfort is not the same as seeking damages for a physical injury or physical sickness one experienced non-consensually due to the other party's negligence, tort, or breach.

More positively, in one ruling, the IRS said that a wrongful birth lawsuit settlement was nontaxable. In IRS Private Letter Ruling 107009-19 (September 13, 2019), the taxpayer contracted with a clinic to provide a suitable anonymous donor egg. The clinic implanted an embryo using an anonymous donor's egg, the taxpayer conceived and gave birth. She later discovered that the clinic had not tested the donor egg or embryo for genetic conditions typically screened for in egg donor situations. Consequently, the child suffered from serious genetic conditions leading to physical disabilities. The mother sued individually and on behalf of her child, recovered, and the IRS ruled that the child's damages were nontaxable physical injury damages.

How do fertility settlements fare against these limited authorities? There are likely to be variations depending on the claims alleged and the way the settlements are documented. In physical injury cases, compensatory damages are nontaxable. This applies to auto accidents, slip and fall injuries, medical malpractice, toxic torts, and myriad other cases where the plaintiff is physically injured. However, in a case that is resolved after a verdict, punitive damages and interest are always taxable, no matter how serious the injuries may be.

Are fertility case damages for physical injuries or physical sickness? It depends on the claims, which some may analogize to medical malpractice. However, depending on the case and documents, the IRS could view a fertility settlement as one for the destruction of property, for lost eggs or embryos, even if the plaintiff may anticipate physical pain in ensuing medical procedures.

One question that may influence the tax result is whether the IRS and the courts may eventually analogize damage or loss of viability to an embryo *in vitro* as similar to damage or loss of viability to an embryo *in utero*. For example, if a defendant were to cause a woman's pregnancy to fail while an embryo is *in utero*, there should be no difficulty in viewing a recovery as one for physical injuries. This should be the result even if the defendant's conduct (*e.g.*, the prescription of the wrong medication by a medical provider) does not result in any significant physical pain to the woman or any lasting physical effects on her body.

That is, the loss of a pregnancy itself seems sufficient to constitute a physical injury for tax purposes, without the need to show any additional physical injuries or pain. The loss of a pregnancy is physical in itself, bringing physical, physiological and related emotional distress changes that

naturally result from the termination of a pregnancy. Of course, one could also conceptualize an *in utero* loss of pregnancy as the loss of viability of the embryo, as its own physical injury sufficient to qualify for exclusion.

If the physical injury is considered to relate *solely* to the woman's body, with only indirect regard for the loss of the embryo, then recoveries for damage done to an embryo *in vitro* could perhaps be treated differently than damage *in utero*. However, if we understand that the loss of an embryo is intrinsically a physical injury, then it may be more difficult to reconcile whether the tax consequences to the expectant parents should be any different if their embryo is lost *in utero* or *in vitro*.

The IRS tends to be stingy about the scope of the physical injury and physical sickness exclusion, and there are large numbers of tax cases in which plaintiffs fail to convince the IRS or the Tax Court. Even so, the IRS also pays close attention to settlement agreement wording. A settlement agreement that says that a defendant is paying for plaintiff's alleged damages for physical injuries and physical sickness can go a long way to helping to support that tax treatment. If a payment is for physical injuries, it also should not be subject to IRS Form 1099 reporting, and that, too may be important in this context. Settlement agreement wording does not bind the IRS, but I have seen many audits that are favorably resolved if the IRS is satisfied with the wording in a settlement agreement.

The IRS can go behind a settlement agreement to investigate further if it chooses. If it does, a plaintiff may point to arduous and painful egg retrieval processes, the required supplements and medications, injections, invasive and painful procedures, and restrictions on their physical activities. Since emotional distress claims often feature prominently in fertility cases, the IRS may also fall back on taxable emotional distress cases, of which there are numerous examples.

The tax treatment of emotional distress damages can be a particularly difficult point to explain. Under the tax law, emotional distress damages are taxable, unless they emanate from physical injuries or physical sickness. In other words, the order of events is important, and even what is "physical" is not clear. If you claim that the defendant caused you to become *physically sick*, it may be tax free. However, if emotional distress from the defendant's actions *causes* you to be physically sick, the IRS may say it is taxable.

Some of the line-drawing comes from a footnote in the legislative history when the 'physical' requirement was added to the tax law. It says emotional distress includes physical symptoms, such as insomnia, headaches, and stomach disorders (See H. Conf. Rept. 104-737, at 301 n. 56 (1996)). The IRS has never defined what is physical, but some plaintiffs succeed with arguments that they had *bona fide* medical conditions that were made worse by a defendant, even if the defendant did not cause the original illness.

In fertility cases, apart from including express settlement agreement language and negating IRS Form 1099, physical sickness and emotional distress may go hand in hand. All plaintiffs have some degree of emotional distress, and some of its ramification may rise to the level of physical sickness. Two tax cases that arose out of employment disputes, where the IRS tendency to treat recoveries as taxable seems strongest, may be helpful.

In *Domeny v. Commissioner*, Ms. Domeny suffered from multiple sclerosis ("MS"), which got worse because of workplace stress. Her health and physical condition clearly worsened because of her employer's actions, so the Tax Court held that portions of her settlement were tax free. In *Parkinson*

v. Commissioner, a man suffered a heart attack while at work. The IRS said that it was taxable emotional distress, but the Tax Court disagreed. The court acknowledged that the IRS was right that Parker's complaint claimed emotional distress, something that is normally taxable unless the emotional distress arises out of physical injury or physical sickness that occurs first.

However, the Tax Court was not bothered by the order of events, and said that in some cases, the infliction of emotional distress *can* result in bodily harm, making it tax free. Thus, in the Tax Court's view, emotional distress can have physical consequences that are severe enough to qualify. If a plaintiff has alleged that a defendant gave her PTSD (or exacerbated pre-existing PTSD), that is arguably enough to be treated as an independent physical injury or sickness.

Finally, it is worth noting the tax treatment of legal fees. When a contingent fee case is resolved, for tax purposes, the plaintiff will be treated as receiving the *gross* settlement, even if the lawyer's fees are paid solely to the attorney without passing through the client's hands. Thus, for any recovery that is taxable, the plaintiff not only needs to worry about taxes on their *net* recovery, but potentially on their gross recovery. Tax deductions for legal fees became more limited since 2018.

However, a broad tax deduction for legal fees related to claims of civil rights remains available, allowing a dollar-for-dollar deduction from gross income. Given past IRS interpretations of civil rights, a deduction for legal fees in this context should be available. Should one of these recoveries be taxable, I believe there is little likelihood that a plaintiff will be saddled with taxes on 100%.

It is difficult to classify fertility recoveries for tax purposes, and even that name may not be an appropriate label. Planning in these cases can be particularly important. The facts matter, the legal claims matter, and so do the damages being sought. The settlement agreement wording and the issuance of tax reporting forms will be important. As the tax law repeatedly shows, express settlement agreement wording can help to shape the tax treatment of a recovery, and the IRS often is willing to rely upon it.

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