© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Be Careful: Some Sexual Assault Recoveries May Be Taxable

by Robert W. Wood, Alex Z. Brown, and Elizabeth A. McGee

Robert W. Wood practices law with Wood LLP (www.WoodLLP.com) and is the author of *Taxation of Damage Awards and Settlement Payments* and other books available at www.TaxInstitute.com. Alex Z. Brown is a partner and Elizabeth A. McGee is of counsel with Wood LLP.

In this article, the authors respond to two letters that appeared in *Tax Notes* regarding sexual assault recoveries, explaining that while the law should cover all recoveries involving inherently physical injuries, they do not believe that is the law today.

This article is not intended as legal advice.

Copyright 2022 Robert W. Wood, Alex Z. Brown, and Elizabeth A. McGee. All rights reserved.

In a recent *Tax Notes* article,[1] David M. Higgins and Dr. Janet Guzman criticized the section 104 exclusion and the IRS's rigid stance when it comes to what constitutes damages for physical injuries or physical sickness. In a reply letter,[2] Kat Gregor, Brittany G. Cvetanovich, Elizabeth Julia Smith, Maggie Heine, and Michelle Chaing Perry, all of Ropes & Gray LLP, responded that all recoveries for sexual assault, abuse, post-traumatic stress disorder, and some false imprisonment torts receive a presumption of physical injury, so they are tax free.

Higgins and Guzman and the tax attorneys from Ropes & Gray all make valid observations. As Higgins and Guzman note, section 104 presumptively treats many damages as taxable that should not be. Ropes & Gray is right to say that sexual assault *should* be a physical injury itself, for which recoveries should be tax free.[3] This should be the rule, but our view is that the current law is not as reasonable as Ropes & Gray suggests, or as bleak as Higgins and Guzman assert.

We would expect that rape cases would be the most likely cases in which the IRS might assume physical injuries, as we hope and believe that it would be difficult for the IRS to successfully assert that a physical injury was not involved, even if a plaintiff had difficulty documenting it. At the same time, a large spectrum of sexual assaults and abuses fall outside the definition of rape. These cases may turn on the ability of the victim to document sufficient physical injuries resulting from the assault and the lawyer's clarity in the litigation documents and settlement agreement that the victim has received damages for those physical injuries.

ILM 200809001, discussed by both Higgins and Guzman and Ropes & Gray, recognizes the need to consider the extent of physical injuries — even for sexual assault. That IRS legal memorandum used the following reasoning:

> Because of the passage of time and because C was a minor when the Tort allegedly occurred, C may have difficulty establishing the extent of his physical injuries. Under these circumstances, it is reasonable for the Service to presume that the settlement compensated C for personal physical injuries.

This falls short of saying that sexual assaults are per se physical. Instead, the IRS's concern about the extent of physical injuries reinforces a

[1] *See* David M. Higgins and Janet Guzman, "Fixing the Definition of Physical Personal Injury," *Tax Notes Federal*, Jan. 10, 2022, p. 221.

[2] *See* Kat Gregor et al., "Damages From Inherently Physical Injuries Are Not Taxable," *Tax Notes Federal*, Mar. 7, 2022, p. 1389.

[3] For convenience, we refer to the five tax attorneys as Ropes & Gray.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

hierarchy of physical injuries — even for sexual assault. With an adult victim, or when the extent of the observable physical injuries could be documented relatively contemporaneously with the crime, ILM 200809001 implies that the IRS may want evidence of the extent of the victim's physical injuries before allowing an exclusion. The false imprisonment authorities, which Higgins and Guzman and Ropes & Gray both mention, are unfortunately consistent with considering the extent of physical injuries.

Tax cases with and without sexual assault focus on whether the injury created by the violation is sufficiently physical, not whether the violation itself is inherently physical. Victims can face the burden of demonstrating the extent of their injuries, even when it should be uncontroversial that the act itself was a physical injury. In some cases in which victims have experienced physical violence that resulted in visible bruising, the Tax Court determined that the injuries were not sufficiently physical.

In a 2005 case, *Mumy*,[4] a woman was pinched by a coworker so intensely that she was bruised for two weeks. A pinch without permission is a physical assault, although it clearly is not a rape or serious sexual assault. Yet the pinch produced a visible bruise, a clear indicator of physical injury. The Tax Court ruled that her recovery was entirely taxable, in part because she did not seek medical attention.

Similarly, in 2017 the Tax Court decided *Devine*,[5] which denied the exclusion of settlement proceeds paid to a pregnant woman who was exposed to toxic chemicals that resulted in a physically observable rash. She was also forcefully and nonconsensually hugged in a way that caused physical pain. The Tax Court's holding turned on the language in the litigation documents, which apparently did not make it clear enough that she wanted compensation for those physical injuries.

These are not rape cases, but taxpayers cannot always rely on the inherently physical nature of a violation to qualify for the exclusion of damages. The IRS and the courts still feel obligated to consider the extent of the physical injuries, and whether the right language appears in the litigation documents. The language issue arose in another 2017 Tax Court case, *Maciujec*,[6] which involved a woman who was the victim of a battery described in her complaint. However, she failed to specifically identify the battery when she listed her damages, and she did not receive medical treatment. Again, no exclusion.

In *Tressler*,[7] although the plaintiff was sexually assaulted, it did not appear that her suit was premised on it, and the Tax Court denied the exclusion. Of course, in some cases, courts have been more liberal about assuming physical injuries, such as in *Amos*,[8] in which a male camera operator was famously kicked in the groin by Dennis Rodman. But as a general proposition, the authorities seem unlikely to infer a physical injury after an assault in most cases.

The lack of consistency and clarity in the tax law has real consequences, and we tell plaintiffs that the waters are treacherous. If you are negotiating a settlement agreement, convincing a defendant to agree to helpful tax language is often not easy, even with a sexual assault. Defendants may have views that sound like the IRS. The cases are legion in which complaint language and settlement agreement wording doom a section 104 argument, even when there is evidence of a physical violation or injury. *Devine*, *Maciujec*, and *Tressler* are just three examples.

A common line some defense lawyers will not cross involves negating Forms 1099. Many defendants will agree to some personal physical injury language in a settlement agreement but will insist on issuing a Form 1099. And for plaintiffs, a Form 1099 means reporting, at least to explain that Form 1099 on the return. Defendants may justify issuing a Form 1099 based on a lack of clarity in the tax law, even pertaining to sexual assaults. There is also the uncomfortable issue of the type and degree of sexual assault.

Context can also be crucial. In our experience, two otherwise identical sexual assaults are likely to be viewed quite differently when one is a

[4] *Mumy v. Commissioner*, T.C. Summ. Op. 2005-129.

[5] *Devine v. Commissioner*, T.C. Memo. 2017-111.

[6] *Maciujec v. Commissioner*, T.C. Summ. Op. 2017-49.

[7] *Tressler v. Commissioner*, T.C. Summ. Op. 2021-33.

[8] *Amos v. Commissioner*, T.C. Memo. 2003-329.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

former employee's claim against an employer, and the other is a passenger's claim against Uber or in some other non-employment setting. In an employment setting, the IRS is more likely to assume that damages are for wages, retaliation, or sexual harassment, even if a physical violation has occurred. An employer defendant is less likely to agree to negate Form 1099 or W-2 reporting.

This is particularly true when the sexual assault involves groping, unwanted kissing, or other nonconsensual touching that may not result in observable physical injuries, and which may not be afforded the same assumption of a resulting physical injury that the IRS has sometimes applied to rape and child abuse cases. Suggesting that any sexual assault means a tax-free recovery sends an overly optimistic message to plaintiffs, except on graphic facts and strong documents. In our practice, we do not tell clients that it is a certainty the IRS or courts will agree that their sexual assault recoveries are tax free, particularly outside the context of rape.

Many victims build their physical injury and physical sickness documentation, get tax advice, claim an exclusion, and wait for the statute of limitations to run on their returns. In our opinion, clients should be given a full and accurate description of the law, both positive and negative so they can make an informed decision about how much (and what type of) support they need for their tax position, and whether and how much to disclose. Except for plaintiffs with strong and clear cases against non-employer defendants with good documents, there can be no guarantee an audit would go well.

The IRS's decades-long reluctance to address these issues compounds the injuries experienced by a group of plaintiffs who have already suffered. We agree with Higgins and Guzman and Ropes & Gray that additional guidance from the IRS would be helpful. It could come from Congress too. The American Association of Settlement Consultants has advocated amending section 104 to expressly include sexual assault and abuse and PTSD, but no bill has been introduced.[9]

■

[9] American Association of Settlement Consultants, "Legislative Agenda" (2022).

taxnotes®

Need audit guidance?
Get Audit Insight.

Tax Notes has the audit guidance you need to stay tax compliant. Compare documents side-by-side, add annotations, create tags to categorize, and easily share with others.

taxnotes.com/audit

Upgrade your tax audit workflow.

© 2022 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.