

# Exempting Sexual Abuse And Assault Recoveries From Tax Is Overdue

By Robert W. Wood

Should sexual assault and abuse settlements be taxed? Most people would answer no, yet the tax law has long been unclear. Under the tax code, compensatory damages for personal physical injuries or physical sickness are tax free, while damages for emotional injuries are taxable. Yet if you have emotional injuries *triggered* by physical ones, the damages for the emotional injuries are *also* tax-free.

If the causation is reversed (with a physical condition created or exacerbated by emotional distress), it is presumptively taxable. A few taxpayers succeed with an exclusion if the physical condition is considered a *bona fide* physical injury or physical sickness on its own. However, a mere physical symptom of emotional distress (such as headaches, stomachaches, sleeplessness, etc.), makes the recovery taxable.

If you've been through an ordeal and eventually collect a settlement or judgment, the last thing you want is uncertainty about taxes. Settlement agreement wording is important, and the defense may agree not to issue Forms 1099 to plaintiffs. However, the lack of a Form 1099 does not prove the payment is nontaxable. Many plaintiffs arrive at the conclusion that they should not pay tax, but uncertainties about tax return disclosures and audit risk can be palpable. It can be especially difficult in standalone cases that are not part of a class action or large group of plaintiffs.

Representative Lloyd Smucker (PA-11), a member of the House Ways and Means Committee, introduced the Survivor Justice Tax Prevention Act (H.R. 10055), co-sponsored by Gwen Moore (WI-04), also of the House Ways and Means Committee, and Gregory Meeks (NY-5). If passed, it will amend the tax code so that survivors of sexual abuse and unwanted and illegal sexual contact do not have to pay taxes on their settlements. The exclusion is not retroactive, and an anti-abuse provision provides that you cannot restate an existing settlement agreement to be dated after the date of enactment to try to qualify.

For generations, legal settlements for *personal* injuries or sickness (including emotional distress) were not taxable. However, in 1996, Congress amended Section 104 of the tax code to say that only physical injuries or physical sickness qualify. There have been no clarifying tax regulations and few rulings about the physical injury/sickness issue, but there have been large volumes of cases decided by the U.S. Tax Court. That means plaintiffs were audited, and they and the IRS were not willing or able to work out a resolution or compromise of their dispute, not even at IRS Appeals. In the end, they go to court.

The IRS can be harsh about what constitutes physical injuries and physical sickness. Traditionally, the IRS likes to see "observable bodily harm" such as bruises or broken bones. If you are sexually assaulted or abused, you may not have that. The IRS's rulings (principally private letter rulings that are

non-precedential) about cuts and bruises have never involved a sexual assault case.

The mixture of tax authorities has resulted in a long period of unresolved ambiguity for victims of sexual assault. In 2009, the IRS issued one piece of *non-precedential* internal guidance in which an IRS attorney advised an IRS agent to *presume* that a victim of sexual assault experienced cuts, bruises, or scrapes sufficient to qualify for exclusion under Section 104(a)(2). But the guidance relies on the fact that the victim was a minor at the time of the assault but was an adult when recovering years later. The guidance is vague about the specific facts.

The IRS allowed the exclusion without proof of cuts, scrapes, or bruises. Yet it did so by *assuming* they existed and had healed due to the passage of time between the alleged assaults, not by clarifying that they were not needed in the context of a sexual assault in the first place. HR 10055, if enacted, would finally provide clarity.

Representatives Smucker and Moore rightly point out that the observable harm standard can be difficult to meet and is unfair with sexual assault or sexual contact where physical injuries may not be visible or may have healed. The proposed legislation narrowly clarifies current law to help survivors of sexual assault or unwanted sexual contact by tying the IRS tax exemption to the definitions of sexual act and sexual contact under federal criminal law.

Tax legislation is not easy to write, and many tax bills fail to pass. But this tax bill is extremely specific. It would implement the exclusion by amending Section 104(a)(2) to include within the exclusion amounts (other than punitive damages) received by a taxpayer on account of a "sexual act" or "sexual conduct." The definition of sexual act and sexual contact are clearly identified as referring to definitions of the same terms under 18 USC 2246. Here are the relevant definitions in that provision:

(2) the term "sexual act" means—

- (A) contact between the penis and the vulva or the penis and the anus, and for purposes of this subparagraph contact involving the penis occurs upon penetration, however slight;
- (B) contact between the mouth and the penis, the mouth and the vulva, or the mouth and the anus;
- (C) the penetration, however slight, of the anal or genital opening of another by a hand or finger or by any object, with an intent to abuse, humiliate, harass, degrade, or arouse or gratify the sexual desire of any person; or
- (D) the intentional touching, not through the clothing, of the genitalia of another person who has not attained the age of 16 years with an intent to abuse, humiliate, harass,

degrade, or arouse or gratify the sexual desire of any person;

(3) the term “sexual contact” means the intentional touching, either directly or through the clothing, of the genitalia, anus, groin, breast, inner thigh, or buttocks of any person with an intent to abuse, humiliate, harass, degrade, or arouse or gratify the sexual desire of any person;

Cases of abuse and assault that *do* produce documented cuts, bruises, and scrapes, should be excludable already. But it is worth considering fact patterns involving sexual abuse whose tax treatments are more ambiguous under current law. For example, under the proposed legislation, the groping of a person’s buttocks, inner thigh, or breast even “through the clothing” is sexual contact, so a settlement should be excludable.

The bill also provides that it is enough to qualify for the exclusion if the judgment or settlement agreement states that the damages are for an alleged sexual act or sexual conduct. It goes on to say that the IRS or a court cannot use a lack of medical records about the groping or other incident occurred to deny tax-free treatment. It would seem difficult for the IRS to be able to impose a cut, bruise, or scrape requirement on sexual abuse recoveries with this language.

Cases that are already settled and monies that are already paid will not be covered by this tax bill. Those plaintiffs need to take tax positions under the current Section 104(a)(2) language. Getting to an acceptable tax position that their recoveries are excludable as amounts received on account of a physical injury is likely to be possible in many cases, despite the current ambiguity in the tax law.

The interactions between physical and emotional injuries are starting to be explored. In one employment case, stress at work produced a heart attack. In another, stressful conditions exacerbated a worker’s pre-existing multiple sclerosis, which the Tax Court found to be a nontaxable physical sickness recovery. Damages for PTSD may also qualify, although the tax law is not year clear.

Unless and until the pending tax bill passes, plaintiffs in current sex abuse or sexual assault cases may want to consider the following:

- If you have not yet signed a release or settlement agreement, ask for the payment to be described as for your “personal physical injuries, physical sickness and emotional distress therefrom.”
- If possible and to the extent you feel comfortable, mention the primary event, i.e., that you allege you were sexually assaulted or abused. At a minimum, it may be worth describing your allegations as including unwanted “sexual contact” or an unwanted “sex act,” if you feel comfortable doing so, since those are the words used in the proposed new language.
- Ask that no IRS Form 1099 reporting the payment be issued to you. Forms 1099 are only supposed to report a payment that is gross income. Payments that are tax-free should *not* be reported on these forms. If you do not have a commitment from the defendant negating Forms 1099, you might be issued a form and will need to report or explain it.
- If possible, get tax advice *before* your settlement is documented. The IRS isn’t bound by the parties’ tax characterization, but lawsuit taxes often hinge on settlement agreement wording and the IRS often will respect it.

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