PERSPECTIVE

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IRS Will Tax Egg Donations, But Not Other Procedures

By Robert W. Wood

In an egg "donation," a female donor is subjected to elaborate screening and testing, and then undergoes a painful extraction procedure. Donors are paid up to $50,000. Many donors assume these payments are tax-free, since payments for physical injuries or medical malpractice would be.

But the Internal Revenue Service says these payments are taxable, and this year in *Perez v. Commissioner*, 144 T.C. 4 (2015), the U.S. Tax Court agreed. Some people are reading the case as conclusive for egg donations and perhaps even for other medical procedures. But that is an overreaction and there will be other cases.

Up until now, breast milk has been considered property. Donating it can result in a charitable contribution. Donating blood can be a sale of property or the performance of a service, depending on the court. And now we have our first tax case on egg donation.

Nichelle Perez went through two donation cycles and was paid $20,000. She signed two contracts, one with Donor Source International and one with the anonymous intended parent. The contract with Donor Source stated that she was not selling her eggs, intimating instead that she was being compensated for her physical suffering. The contract with the prospective parent said payment was "in consideration for all of her pain, suffering, time, inconvenience, and efforts."

Perez did not report the $20,000 as income, but Donor Source issued a Form 1099. That obvious mismatch generated an audit, and eventually went to Tax Court. The Tax Court expressly said it would not decide if human eggs are capital assets, how to allocate basis in the human body, the holding period for body parts, or the character of gain from the sale of those parts. We can look forward to those tax issues in the future!

The Tax Court held that Perez was not paid for injuries after a legal claim. Her deal for payment struck *before* any injuries took place. And that was an easy line for the court to draw.

In 1996, the personal injury tax exclusion was narrowed to require that the injury must be "physical." Since then, most of the focus has been on what is *physical*. Headaches, insomnia and stomachaches are not enough. They are mere symptoms of emotional distress.

However, extreme emotional distress (caused intentionally or otherwise) can produce a heart attack. In *Parkinson v. Commissioner*, T.C. Memo. 2010-142, the Tax Court held an employee's settlement with his employer for causing a heart attack was tax free. The job caused the stress that triggered his condition.

Similarly, in *Domeny v. Commissioner*, T.C. Memo. 2010-9, the employer exacerbated Domeny's pre-existing multiple sclerosis. Thus, a portion of her employment settlement was tax free. In *Perez*, though, the Tax Court made its decision primarily based on contracting for future harm.

As the court noted, most payments within Section 104 are excluded "because they make the taxpayer whole from a previous loss of personal rights." Perez may have been hurt, but if she did not pay tax, the court noted, someone who boxes or works in a mine could *also* argue that a portion of their compensation was non-taxable. However, it seems premature to say that contracting can *never* precede an injury.

Different contracts might yield different results. Virtually every release includes both known and unknown claims. In class actions, it is common for plaintiffs to release claims that might later materialize even though they clearly have not at the time of payment. Some class members may already have the disease or injury from the defendant's product or actions, but many will not.

They sign off *in advance*. Yet no one seriously questions whether such amounts are tax free. Even outside of class actions, apart from the blanket general release of known and unknown claims, consider the known *future* claim.

When a plaintiff is physically injured, the release is likely to not only cover the injury, but all that emanates from it. Later claims — including for wrongful death if the plaintiff should later die — are often explicitly covered. This, too, is a type of advance contracting, and this, too, clearly does not make the payment taxable.

Thus, it is at least arguable that damages can be paid — and frequently are paid — for injuries not yet suffered. They are every bit as consensual as an egg donation. It is also worth questioning whether bifurcating the payments might achieve a better tax result.

The IRS and the courts often will not disturb express tax provisions in documents where they are reasonable, especially where they divide payments into categories. This may be the most important practice pointer in the taxation of damage awards and settlement payments. The wisdom of Solomon shines through time and again.

How would Perez have fared with a contract that contained a $10,000 fee for services in undergoing all the preparation work, and a separate $10,000 fee paid on account of all the assumed physical injuries, physical sickness and related emotional distress? Perhaps one gets even more Solomonic and drafts two contracts, not one.

In either event, would not the second $10,000 have been tax free? Add in the usual provisions accompanying many medical procedures, including arbitration of disputes, and the related list of horrible potential side effects. The complexion would be quite different.

And maybe the payer would even report more carefully. One Form 1099 for the first payment, and explicitly no Form 1099 for the second? The Form 1099 instructions (and the regulations) are clear that no Form 1099 should be issued if the payment is excludable.

We know from legions of tax cases that to exclude a payment on account of physical injuries or physical sickness, you need not have a medical diagnosis that you suffer from something as serious as multiple sclerosis or a heart attack. But you need some kind of medical diagnosis, and the more physical the better. Regardless of when you sign the contract or release, obtain and be prepared to present evidence of medical care.

Many taxpayers fail because they have no medical documentation, no linking of the symptoms to diagnosis, and nothing beyond the ''headaches, stomachaches, and insomnia'' that the IRS says is not enough. Be reasonable in allocating which payments are for what. That advice is universal.

Do not pick figures you cannot support. Collect good documentation contemporaneously. Especially if there is a thin record of medical expenses, consider what other documents you can collect.

These thoughts may not change the face of egg donations, but one Tax Court case is unlikely to conclusively resolve this point either. And when one considers that there are (as the Tax Court acknowledged) numerous other tax issues facing the medical and legal changes we all face, we should expect more. A lot more.

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