

Sexual Assault Settlements Nuanced Tax Issues Could Soon Change

By Robert W. Wood

Although how lawsuit settlements are taxed is a nuanced subject, you might assume that sexual assault settlements would not present any tax issues. In fact, that is far from true. The potential applicability of taxes involves one of those fuzzy “it depends” answers. Although compensatory damages for personal physical injuries or physical sickness are tax free, damages for emotional injuries are fully taxable.

Over many decades, this has made taxing emotional distress and physical sickness a kind of chicken and egg issue. Yet exactly what constitutes physical injuries or physical sickness is still not defined. The IRS likes to see “observable bodily harm” such as bruises or broken bones, but if you are sexually assaulted or abused, you may not have outward signs of your injuries. That is one reason sexual assault victims often face uncertainty.

The IRS once issued non-precedential internal guidance allowing tax free treatment for a sexual assault victim who was a minor at the time of the assault, but who later recovered as an adult. The IRS allowed the exclusion without proof of cuts, scrapes or bruises, but the guidance is vague. In fact, the IRS *assumed* that there were cuts and bruises that had healed due to the passage of time. It would have been much better if the IRS had said that cuts, scrapes or bruises were not needed in the context of a sexual assault in the first place.

In short, stronger and clearer tax guidance about sexual assaults has been needed for decades. Fortunately, things appear to finally be moving in the right direction. The House of Representatives has passed the Survivor Justice Tax Prevention Act, H.R. 2347, bipartisan legislation that was introduced by Rep. Lloyd Smucker (PA-11) and Rep. Gwen Moore (WI-04). It would amend the Internal Revenue Code so that survivors of sexual abuse and unwanted, illegal sexual contact do not have to pay taxes on their legal settlement income.

If you’ve been through an ordeal and eventually collect a settlement or judgment, the last thing you want is uncertainty about taxes. You want predictability, you don’t want to face an audit and claims by the IRS or state tax authorities several years later. The Senate will need to pass this bill before it can become law. And notable, the Survivor Justice exclusion is not retroactive. What’s more, an anti-abuse provision says that you cannot restate an existing settlement agreement to be dated after the date of enactment in order to qualify for the exclusion.

The law would implement the exclusion by amending Section 104(a)(2) of the Internal Revenue Code to include within the ambit of the exclusion amounts (other than punitive damages) received on account of a “sexual act” or “sexual conduct.” The definition of sexual act and sexual contact refer to definitions of the same terms under 18 USC 2246.

Sexual Act Defined

A sexual act means:

- 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;
- contact between the mouth and the penis, the mouth and the vulva, or the mouth and the anus;
- 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
- 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.

Sexual Contact Defined

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. Thus, under this tax bill, the groping of a person’s buttocks, inner thigh, or breast even through clothing is sexual contact, so a settlement would therefore be excludible.

The bill also specifically 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.

Again, cases that are already settled and monies that are already paid will not be covered. 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 excludible as amounts received on account of a physical injury may still be possible in many cases, despite the current ambiguity in the tax law.

The interactions and overlap between physical and emotional injuries and sicknesses are starting to be more thoughtfully explored in tax law. In one employment case, stress at work produced a heart attack. In another, stressful conditions exacerbated the worker’s pre-existing multiple sclerosis, which the Tax Court found to be a nontaxable physical sickness recovery. Damages for PTSD may also qualify. Of course, the context matters too.

For example, sexual assault cases arising in the context of employment can be more nuanced from a tax viewpoint than outside of employment. But in any context, settling plaintiffs should seek tax advice before their settlement is documented. Specific settlement agreement wording and negating the issuance of IRS Form 1099 can help a good deal. The IRS is not 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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