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IRS Should Not Tax Egg, Embryo, Egg And IVF Legal Settlements



Lawsuits over fertility treatments and over the destruction of eggs or embryos have exploded in recent years, and the tax treatment of recoveries in these cases is not yet established. 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 everything does 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.

Legal Claims

Patients may be informed that their eggs or embryos were damaged or destroyed, which can be devastating. Depending on the age and medical condition of the patient, additional medical procedures may be difficult or impossible. When 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.

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. As a general matter, most lawsuit settlements are taxable. The only major exception is for compensatory damages for physical injuries, which are tax free under Section [104](#) of the tax code.

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. Plaintiffs often claim emotional distress

damages, and some may involve claims that can fairly be called physical sickness or physical injuries, including [PTSD](#).

Some plaintiffs undergo further treatments, including painful egg collection procedures. If the plaintiffs ultimately stand poised to receive a settlement, they may ask, is the settlement taxable?

Documentation Matters

Reaching a nontaxable position is possible 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 relevant, which may include economic and non-economic damages, physical injuries, emotional distress, loss of consortium, etc.

Limited Tax Authorities

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 Tax Court considered a woman who sold her eggs. Perez went through two donation cycles and was paid \$20,000, which she did not report as 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. But the Tax Court agreed that the [IRS could tax her egg donations](#).

Perez's contracted-for services (*i.e.*, egg harvesting and donation) certainly involved an appreciable degree of physical pain and discomfort. But the court said that was not the same thing as seeking damages for a physical injury or

physical sickness one experienced non-consensually. 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 an anonymous donor egg. The clinic implanted an embryo using a donor's egg, the taxpayer conceived and gave birth. She later discovered that the clinic had not tested the egg or embryo for genetic conditions. 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. This suggests that many [wrongful life and wrongful birth settlements](#) can be positioned as nontaxable.

Uncharted Territory

There are 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 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. 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) may not result in significant physical pain.

The loss of a pregnancy seems sufficient to constitute a physical injury for tax purposes, without the need to show additional physical injuries or pain. However, the IRS tends to be narrow in its interpretations of the physical injury and physical sickness exclusion, and plaintiffs claiming an exclusion often 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.

Emotional distress damages are taxable, unless they emanate from physical injuries or physical sickness. 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.

In *Domeny v. Commissioner*, Ms. Domeny suffered from multiple sclerosis (“MS”), which got worse because of workplace stress. 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 said that emotional distress *can* result in bodily harm, making it tax free. Both cases suggest that [damages for physical sickness can be tax free.](#)

Bottom Line

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. Settlement agreement wording and Form 1099 issues are important.