

Taxing Damages for Wrongful Life and Wrongful Birth

By Robert W. Wood



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not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

In this article, Wood discusses emerging claims for wrongful life and wrongful birth and the tax issues raised by those recoveries. He contends that despite published authority, the recoveries are paid “on account of” physical injuries or sickness and should be viewed as excludable from income.

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As reproductive medicine, other science, and law develop, causes of action for wrongful birth and wrongful life are increasingly being recognized. They sound similar but are technically different. In some ways, they both may read like medical malpractice cases.

Wrongful birth actions are brought by parents to recover for the birth of an unhealthy child. The parents’ right to recover is based on the defendant’s negligent deprivation of their right to not conceive the child or to prevent the child’s birth. In contrast, wrongful life actions are brought by the child and essentially parallel a wrongful birth cause of action.

But both kinds of cases generally involve medical evidence and damage studies that focus on the life-care needs of a disabled or ill child. States vary in allowing either, any, or both of the two kinds of cases. As tort law continues to develop, it is perhaps not surprising that the law concerning the tax treatment of recoveries for these emerging torts of wrongful life and wrongful birth is unclear.

The legislative history of section 104(a)(2) does not mention these causes of action, nor apparently have the courts or the IRS addressed them. Of course, there are many decades of relevant tax authorities, both before and after the 1996 statutory change. To be excludable, damages must be received on account of personal physical injuries or physical sickness.

Arguably, most wrongful life and wrongful birth claims should satisfy this fundamental standard in whole or in part. For a wrongful life claim, a plaintiff-child’s physical injury or physical sickness may be evident at the time of the suit. A causal connection may be more attenuated in a wrongful birth claim than with wrongful life, but the damages will still be all about medical and life care.

Tax practitioners may assert that a defendant’s actions constituted physical harm to the mother carrying the child. In fact, the child might be considered part of the mother’s body at the time of the harm. The complaint in a wrongful birth or wrongful life case is likely to focus on medical care and medical needs.

These needs may include a list of the hospital, medical, surgical, rehabilitative, therapeutic, and other care. The complaint may also include a litany of harms and inconveniences, including examinations, tests, medications, hospital admissions, and other care. The enumerated kinds of damage to parent and child are likely to note such items as emotional distress, anguish, inconvenience, impairment of quality of life, and other noneconomic damage.

The complaint will likely seek past, present, and future economic costs. The list of damages a plaintiff seeks may include extraordinary medical, life-care, educational, support, out-of-pocket, essential service, and other expenses. Often the list is seen as beyond the amounts that one would normally expend to raise a healthy child. Whatever additional needs the child has may necessitate special care for the entirety of his life.

Tort Status Irrelevant

Before 2009, the Supreme Court’s holding in *Commissioner v. Schleier*¹ required a recovery to be based on “tort or tort-type rights” for the taxpayer

¹515 U.S. 323, 337 (1995).

to exclude a payment under section 104(a)(2). However, in September 2009, Treasury proposed regulations abandoning that requirement.² The proposed regulations were finalized in 2012.³

The regulations indicate that the section 104(a)(2) exclusion applies even if the injury is not defined as a tort under state or common law.⁴ Nevertheless, the income must still constitute damages. In *Perez v. Commissioner*,⁵ the taxpayer was paid for donating her eggs for transfer to infertile couples, a process that involved a long series of painful injections and invasive medical operations.

The taxpayer was paid \$20,000 for two rounds of egg donations (ultimately harvesting dozens of eggs). The contract she signed said the payment was for her "time, effort, inconvenience, pain, and suffering in donating her eggs." She excluded the \$20,000 from her income based on the section 104 exclusion and wound up in Tax Court.

The Tax Court concluded the amount was taxable, holding that reg. section 1.104-1(c) excludes only damages. According to the *Perez* court, the removal of the tort or tort-type right requirement may have broadened the scope of the exclusion, but it still does not apply to proceeds from the consensual performance of a service contract.

Contract payments are not damages. In contrast, a recovery for wrongful life or wrongful birth is not consideration for a voluntary sale of property or performance of services. It is unambiguously a payment for damage on account of the negligence of one or more defendants.

'On Account Of'

The standard for what constitutes personal physical injuries has never been thoroughly defined by Congress or the IRS. But the IRS has ruled that personal physical injuries should include objectively observable bodily harm such as bruises, cuts, swelling, or bleeding.⁶ Similarly, personal physical sickness may include bodily harms that are objectively observable by a doctor, such as signs of multiple sclerosis.

²See prop. reg. section 1.104-1(c).

³See T.D. 9573; reg. section 1.104-1(c).

⁴See *Simpson v. Commissioner*, 141 T.C. 10 (2013) (interpreting then-new reg. section 1.104-1(c) to obviate the requirement for a tort or tort-like cause of action to qualify under section 104(a)(2)).

⁵144 T.C. 4 (2015). For further discussion, see Robert W. Wood, "Taxing Egg Donations With the Wisdom of Solomon," *Tax Notes*, June 29, 2015, p. 1581.

⁶See LTR 200041022.

For example, in *Domeny v. Commissioner*,⁷ a taxpayer was fired after her hostile work environment exacerbated her multiple sclerosis. She brought suit, alleging various causes of action, and produced evidence of damage consisting of signs of multiple sclerosis that were observed and verified by a doctor. She ultimately settled with her former employer.

The Tax Court held that she could exclude the portion of the settlement payment intended to compensate for "her acute physical illness caused by her hostile and stressful work environment." It did not clarify the meaning of physical illness, but the opinion indicates that the taxpayer's physical illness (signs of multiple sclerosis) constituted a physical sickness under section 104(a)(2). Regardless of the words used to describe her signs of multiple sclerosis (that is, "physical illness" or "physical sickness"), the payments compensating for the multiple sclerosis signs appear to be excludable because they were observed and verified by a doctor.

Further, the non-punitive damages payment must be on account of the physical harm. The "on account of" requirement should be satisfied when there is a direct link between the physical harm suffered and the damages recovered.⁸ A direct link exists if the plaintiff alleges that the defendant proximately caused the physical harm and the defendant intended to compensate for it.

For example, in LTR 200121031, a wife received a recovery from claims concerning her husband's death. The husband died from asbestos-exposure lung cancer related to his job as a drywall installer. The wife asserted various claims against the employer, including for damages for loss of consortium and wrongful death.

The IRS reasoned that the employer was the proximate cause of the disease and the husband's ultimate death, which gave rise to the wife's claims. Therefore, the wife's non-punitive damages had a direct link to the husband's physical injury and death. It was immaterial that the wife was not physically harmed and that there was no direct (only proximate) causation between the employer's actions and the husband's death.

Emotional Distress

In contrast to payments for physical harm, payments received on account of emotional distress damage may be taxable. Emotional distress can be manifested with objective, observable physical

⁷T.C. Memo. 2010-9; see also Wood, "Tax-Free Physical Sickness Recoveries in 2010 and Beyond," *Tax Notes*, Aug. 23, 2010, p. 883.

⁸See LTR 200121031.

signs, or more subjective symptoms such as insomnia, headaches, and stomachaches.⁹ Regardless of how emotional distress is manifested, payments for emotional distress are taxable.¹⁰

However, in *Parkinson v. Commissioner*,¹¹ the taxpayer suffered a heart attack after he worked long hours under stressful conditions. He brought suit against specific co-workers for various causes of action (some were dropped) and ultimately claimed intentional infliction of emotional distress. The Tax Court acknowledged that damages for emotional distress manifested by symptoms (that is, insomnia, headaches, or stomach disorders) are not excludable from income under section 104(a)(2).

In contrast, emotional distress manifested with signs (objective indications of a disease such as a heart attack brought on by a stressful environment) apparently should be excludable from income. According to the *Parkinson* court, the latter “constitute physical injury or sickness rather than mere subjective sensations or symptoms of emotional distress.”

Emotional Distress From Physical Harm

Once a physical harm is identified, payments to compensate for emotional distress attributable to it can be excluded from income. Reg. section 1.104-1(c) states that “damages for emotional distress attributable to a physical injury or physical sickness are excluded from income under section 104(a)(2).” The legislative history of section 104(a)(2) also supports excluding emotional distress damages attributable to physical harm:

If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party.¹²

The exclusion appears to be broad, including all non-punitive damages that flow from a physical harm. Also, it appears that the recipient of the damages (including those for emotional distress) does not have to be the person physically injured — that is, a loved one can be the victim of the physical harm. The legislative history continues by giving examples of excluded ancillary damages such as damages for loss of consortium or wrongful death.¹³

⁹See H.R. Conf. Rep. No. 104-737, at 301, n.56 (1996).

¹⁰See section 104, flush language.

¹¹T.C. Memo. 2010-142.

¹²Section 1605 of the Small Business Job Protection Act of 1996.

¹³See *id.*

Damages

In many cases, the amounts paid to resolve wrongful life and wrongful birth cases can fairly be attributed to payments on account of medical needs and the disability needs of the child. Often, a specific physical sickness, disease, or malady will complicate the child’s life. Some cases involve cystic fibrosis, a genetic condition that manifests itself with physical symptoms such as difficulties in breathing, digestion, and reproduction.

In *Domeny v. Commissioner*,¹⁴ the taxpayer had multiple sclerosis, which the Tax Court concluded was a physical sickness under section 104(a)(2). If a medical condition manifests itself in physical symptoms that have been observed and verified by doctors, the resulting damage can probably be viewed as on account of a personal physical harm. Wrongful life and wrongful birth cases are all about the damage from serious medical conditions.

The IRS could argue that a settlement was not on account of the child’s disability because the defendant’s negligence did not cause it to exist. In wrongful birth cases, the defendant’s actions arguably only take away the parent’s right to make an informed decision on whether to carry a fetus to term. But in that sense, the defendant caused the birth and thereby caused the physical injury or disability.

Put differently, if not for the defendant’s negligence, the child’s medical condition would not have had the opportunity to manifest itself, with the resulting medical and life-care expenses. In that sense, the defendant’s negligence is a “but for” cause of the damage.

Identity of the Plaintiff

Does it matter whether it is the child or the parents who receive the damages? Probably not. The authorities suggest that the ultimate recipient of damages is less important than their nature. For example, in LTR 200121031, discussed above, the IRS concluded that a wife’s recovery from claims concerning her husband’s death was still excludable because her damages were attributable to the victim’s physical harm.

Similarly, in *Paton v. Commissioner*,¹⁵ the taxpayer’s husband committed suicide after enduring stressful conditions at work. The spouse threatened a claim against the employer for the wrongful death of her husband, a clear physical harm. The employer settled, and the taxpayer was allowed to exclude her award from income, even though she was only a bystander to her husband’s death.

¹⁴T.C. Memo. 2010-9.

¹⁵T.C. Memo. 1992-627.

Wrongful life or wrongful birth damages are meant to pay for the stress of caring for an ill or disabled child and the attendant costs. Further, as noted, the legislative history of section 104(a)(2) specifies that all non-punitive damages that flow from a physical harm can be excluded, regardless of whether the recipient of the damages is the injured party.¹⁶

Conclusion

It may be some time before we see tax disputes involving wrongful life and wrongful birth recoveries. One must recognize the possibility that the IRS may see them as fundamentally emotional distress recoveries. However, emphasizing tax language in settlement agreements may keep the issue from arising.

Stressing the nature of the damages and the medical failures in question should help. So, too, should statements that the settlement payment is being made on account of medical expenses, physical injuries, physical sickness, and emotional distress therefrom.

¹⁶See *supra* note 12.

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