Taxing Egg Donations With The Wisdom of Solomon

By Robert W. Wood


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In this article, Wood discusses the tax consequences of payments for physical injury or sickness and contracting for future harm in light of *Perez v. Commissioner*, the Tax Court's decision on payments for egg donation.

In an egg donation, a female donor is usually given hormones to increase egg production. Eggs are removed, fertilized in a laboratory, and later implanted in a recipient. Removal and the lead-up to it can be painful. Theoretically, any woman could undergo this.

However, only nonsmokers between ages 21 and 30 who pass personal and family medical and mental screening are likely to be considered. Thereafter, they may have to undergo psychological and physical evaluations, blood tests, Pap smears, breast exams, pregnancy tests, etc. Donors endure intrusive physical examinations and hormonal injections.

Injections done directly into the donor's stomach may cause burning and bruising. Yet the process can be rewarding in helping others to conceive — and rewarding financially. The American Society for Reproductive Medicine caps the compensation for egg donors at $5,000 to $10,000.[1] Nevertheless, ads in college newspapers and on the website Craigslist may offer women $20,000 to $50,000 to undergo this process. In that sense, donation is a misnomer.

Are such payments taxable? Earlier this year, in *Perez v. Commissioner*,[2] the Tax Court concluded that amounts received by a donor for use in fertility treatments were taxable. This is the first answer by a court. It is unlikely to be the last, even though some people are reading the case as conclusive regarding egg donations and perhaps even for other medical procedures.

The latter is clearly an overreaction, and the former may be too. 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.

Perez Facts

Nichelle Perez contracted with Donor Source International LLC to donate her eggs to women who struggled to conceive on their own. In 2009 Perez went through two donation cycles and was paid a total of $20,000. For each donation, Perez entered into two contracts — one with Donor Source and one with the anonymous intended parent.

The contract with Donor Source made clear that she was not selling her eggs, intimating instead that she was being compensated for her physical suffering:

> Donor Fee: Donor and Intended Parents will agree upon a Donor Fee for Donor's time, effort, inconvenience, pain, and suffering in donating her eggs. This fee is for Donor's good faith and full compliance with the donor egg procedure, not in exchange for or purchase of eggs and the quantity or quality of eggs retrieved will not affect the Donor Fee. . . . The Parties acknowledge and agree that the funds provided to the Donor shall not in any way constitute payment to Donor for her eggs.[3]

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[1]*See* "ASRM Ethics Committee Report: Financial Compensation of Oocyte Donors," *Fertility and Sterility*, Vol. 88, No. 2, at 305 (Aug. 2007).
[2]144 T.C. No. 4 (Jan. 22, 2015).
[3]*Id.* at 5.

The contract with the prospective parent read the same, stating that payment was ''in consideration for all of her pain, suffering, time, inconvenience, and efforts.'' Based on this language, Perez did not report the $20,000 as income, treating it as excludable under section 104. Many other egg donors take the same position.

It might not have become a tax dispute, except that Donor Source issued a Form 1099, which Perez did not explain or ''back out'' of her tax return. That obvious mismatch generated an audit, which eventually went to the Tax Court.

Tax Court Decision

Predictably, the IRS said Perez received the $20,000 in exchange for services. The IRS argued that Perez may not have been selling her eggs, but she was providing a service when she went through the process of donating. The Tax Court made it clear that it would decide the narrow tax issue presented.

The Tax Court expressly noted that it would not decide: (1) whether human eggs are capital assets, (2) how to allocate basis in the human body, (3) the holding period for body parts, or (4) the character of gain from the sale of those parts.

The contracts made clear that Perez was not selling her eggs. She was to be compensated regardless of whether she produced any usable eggs. Reg. section 1.104-1(c)(1) defines the term ''damages'' as an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution.

Perez had not sued or settled with Donor Source. She therefore argued that the regulations were too narrow. She said damages should extend to situations in which a taxpayer receives compensation for a loss regardless of legal suit or action.

Judge Mark V. Holmes concluded that the regulations were valid. Moreover, Perez did not receive the payments from any type of action (legal or otherwise) taken after the physical injuries occurred. The court said this was about timing — the deal for the payment was made *before* any injuries took place.

Regarding anticipated and consensual injuries, Judge Holmes concluded:

> Had the Donor Source or the clinic exceeded the scope of Perez's consent, Perez may have had a claim for damages. But the injury here, as painful as it was to Perez, was exactly within the scope of the medical procedures to which she contractually consented. Twice. Her physical pain was a byproduct of performing a service contract, and we find that the payments were made not to compensate her for some unwanted invasion against her bodily integrity but to compensate her for services rendered.[4]

History

Since 1918 our tax code has excluded payments for personal injuries and sickness, whether by settlement or judgment and whether paid in a lump sum or over time. For most of that history, the exclusion has been stated clearly in section 104. But since 1996, in order to be excludable under this storied provision, the damages must be for personal *physical* injuries or personal *physical* sickness.[5]

Since then, taxpayers and the government have mostly focused on the meaning of the term ''physical.'' Because the injection of this modifier 18 years ago was a sea change, this is understandable. With the spotlight on what is physical — and still no regulations to address it — there might have been little need to distinguish between injuries and sickness.

For years, the IRS required an overt manifestation of physical injuries and observable bodily harm for an exclusion to apply.[6] However, in an important 2008 ruling, the IRS said it would assume personal physical injuries from a sexual molestation, even if payment occurred many years after the fact when no observable bodily harm could be shown.[7]

This conclusion may seem so obvious that no ruling would need to enunciate it. In fact, it was a bold and innovative position for the IRS to take. Yet drawing the line between injury and sickness has proven to be more challenging.

Sickness

Physical injuries and physical sickness are quite different. In most cases of physical sickness, there is no striking or other physical event that triggers the sickness. Plus, many physical sicknesses are not

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[4]*Id.* at 17.

[5]*See* Small Business Job Protection Act of 1996, P.L. 104-188.

[6]*See* LTR 200041022: ''We believe that direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under section 104(a)(2).''

[7]*See* CCA 200809001: ''C has alleged that Entity's agent(s) X caused physical injury through Tort while he was a minor under the care of X. . . . Because of the passage of time and because C was a minor when the Tort allegedly occurred, C may have difficulty establishing the extent of his physical injuries. Under these circumstances, it is reasonable for the Service to presume that the settlement compensated C for personal physical injuries, and that all damages for emotional distress were attributable to the physical injuries.'' *See* Robert W. Wood, ''IRS Allows Damages Exclusion Without Proof of Physical Harm,'' *Tax Notes*, Mar. 31, 2008, p. 1388.

observable, at least not to the naked eye the way that bruises and broken bones are.

LTR 200121031 makes clear that sickness can be physical even without obvious marks. In the ruling, a woman received damages from asbestos manufacturers for her husband's death from lung cancer. The husband had inhaled asbestos fibers. Reasoning that the husband contracted a physical disease from exposure to asbestos and that it was the proximate cause of the circumstances giving rise to the taxpayer's claims, the IRS excluded the wife's recovery. The IRS has not clarified whether it views these payments as made for personal physical *injuries* or personal physical *sickness*. The IRS's failure to provide guidance on these points has become a flash point.[8]

Can one discern the difference between physical manifestations (or mere symptoms) of emotional distress, on one hand, and signs that cause the physical injuries or sickness, on the other? That can be a thin, even rhetorical, line. The 1996 act's legislative history says that headaches, insomnia, and stomachaches are not enough and are mere symptoms of emotional distress.[9]

Although mere symptoms of emotional distress include more than headaches, insomnia, and stomachaches, physical symptoms of emotional distress have a limit. For example, ulcers, shingles, aneurisms, and strokes may all be an outgrowth of stress, but they are clearly not mere symptoms of emotional distress. Extreme emotional distress (caused intentionally or otherwise) can produce a heart attack.

That is not a *symptom* of emotional distress. These are *signs* of emotional distress, which appear to be qualitatively different. The Tax Court said so in *Parkinson*,[10] even though the suit was against Parkinson's employer for causing the stress that triggered his condition.

Similarly, in *Domeny*,[11] the Tax Court held that the exacerbation of Domeny's preexisting multiple sclerosis — a spike in symptoms — was enough to make the payment from the employment suit tax free.

PTSD

The line between physical and emotional is frayed with post-traumatic stress disorder. At first glance, PTSD may appear to be purely psychological. Yet it consists of considerably more than extreme anxiety regarding a traumatic event.

PTSD involves measurable changes in both the victim's neuroendocrinology and neuroanatomy. The former are changes to how the brain functions. The latter are changes to the brain's physical structure.

The overarching nature of these neurological changes suggests they are the cause of PTSD and not its symptoms. PTSD is not merely a frame of mind that can manifest itself in physical ways. Instead, the physical results of traumatic events are the cause, and PTSD is the effect.[12]

On a neuroendocrinological level, traumatic events that lead to PTSD can cause an overactive adrenaline response, resulting in the formation of deep neurological patterns in the brain.[13] Based on the prevailing scientific data, PTSD should not be considered an emotional or mental disorder for tax purposes. A plaintiff paid on account of PTSD should be like the taxpayers in *Parkinson* or *Domeny*, paid for physical sickness.[14]

In short, PTSD should be recognized as a physical sickness or physical injury within the meaning of section 104. National Taxpayer Advocate Nina Olson has correctly argued that PTSD is physical.[15]

Future Harm and Floodgates

Where does *Perez* fit into this continuum? It is understandable that the Tax Court in *Perez* based its decision primarily on contracting for future harm. There are precedents on that point.

For example, in *Roosevelt v. Commissioner*,[16] the producer of a play about the taxpayer's family entered into a contract with the taxpayer before the

[8]*See* Nina Olson, "National Taxpayer Advocate 2009 Annual Report to Congress," at 356 (Dec. 31, 2009): "Since the amendment of IRC section 104(a)(2) in 1996, the scientific and medical community has demonstrated that mental illnesses can have associated physical symptoms. Accordingly, conditions like depression or anxiety are a physical injury or sickness and damages and payments received on account of this sickness should be excluded from income. Including these damages in gross income ignores the physical manifestations of mental anguish, emotional distress, and pain and suffering."

[9]H. Conf. Rep. 104-737, at 301, n.56 (1996).

[10]T.C. Memo. 2010-142. For further discussion of *Parkinson*, see Wood, "Taxing Physical Sickness, Workers' Compensation, and PTSD," *Tax Notes*, Feb. 24, 2014, p. 857.

[11]T.C. Memo. 2010-9. For a more extensive discussion of *Domeny*, see Wood, "Is Physical Sickness the Next Emotional Distress?" *Tax Notes*, Feb. 22, 2010, p. 977.

[12]*See* Monica Uddin et al., "Epigenetic and Immune Function Profiles Associated With Posttraumatic Stress Disorder," *Proc. of the Nat'l Acad. of Sci.* (2010).

[13]*See* J.W. Mason et al., "Elevation of Urinary Norepinephrine/Cortisol Ratio in Posttraumatic Stress Disorder," 176(8) *J. Nerv. Ment. Dis.* 498 (1988).

[14]For further discussion, see Wood, "Taxing Post-Traumatic Stress Disorder," *Tax Notes*, July 7, 2014, p. 89.

[15]*See* Olson, *supra* note 8.

[16]43 T.C. 77 (1964).

play was produced. The producer agreed to give the taxpayer a share of revenues from the play in exchange for the taxpayer's release of the producer from potential claims for invasion of privacy rights. The court found that the advance payment for possible future damages was taxable.

Similarly, in *Starrels v. Commissioner*,[17] the taxpayer received compensation for her consent to the future portrayal of her family in a film. The Tax Court and Ninth Circuit both concluded that the compensation was taxable. There was an agreement in advance, but the real reason for the decision was that there was simply no proof of injury.

These cases do not compel the *Perez* decision, but they support it. Indeed, with the stark contract issues, lack of legal claims, and lack of proof of injury, the *Perez* court's conclusion is hardly surprising. Most payments within section 104 are excluded "because they make the taxpayer whole from a previous loss of personal rights."[18]

Instead of damages, the Tax Court in *Perez* concluded that Perez simply received compensation for services. Perhaps that was correct given the form of the contracts. Different contracts might have yielded a different result. Still, much of the Tax Court's worry concerned opening the floodgates.

The court even suggested the mischief that could result from a contrary finding. The court mentioned the potential impact on taxpayers who receive compensation for painful and dangerous physical services. If Perez did not pay tax, professional boxers or miners could argue that a portion of their compensation is nontaxable.

Solomonic Approach

Many commentators believe *Perez* is a correct tax decision, but is it? It may be as a policy matter, and it is true that it could be hard to distinguish payments to egg donors from payments to stunt performers or boxers. But it seems unwise to say that contracting can *never* precede an injury, assumed or otherwise.

After all, virtually every release includes both known and unknown claims. Moreover, in the context of class actions, it is common for plaintiffs to release claims that have not yet materialized at the time of payment but might at a later date. In class actions, some members may already have the disease or injury from the defendant's product or actions, but many will not. These plaintiffs sign off in advance. Yet no one seriously questions whether these payments are tax free.

Outside of class actions and apart from blanket general releases of known and unknown claims, consider the known *future* claim. When a plaintiff is physically injured, the release likely covers not only the injury, but all that emanates from it. Subsequent claims — including for wrongful death if the plaintiff should later die — are often explicitly covered. This is a type of advance contracting, and this 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. These arrangements are every bit as consensual as the egg donation example.

And in that sense, consider Solomon's idea of splitting the baby (whether or not his wisdom was correct legal theory). Perhaps more than any other theory in the taxation of damage awards and settlement payments, his wisdom shines through, time and again. It may not be right, and it may not be pretty, but it underscores a common truth. Most payers pay money for multiple purposes. Most recipients have multiple claims.

How would Perez have fared with a contract that contained a $10,000 fee for services for 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 that accompany 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 submitted for the first payment, and explicitly no Form 1099 submitted for the second? The Form 1099 instructions (and the regulations) are clear that no Form 1099 should be issued if the payment is excludible.

I am not suggesting that the answer is clear, but it is surely debatable. We know from the voluminous history of the legions of tax cases under section 104 that the facts and proof matter. To exclude a payment on account of physical sickness, you need not have a medical diagnosis that your condition is 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 the 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 the diagnosis, and nothing beyond the

[17]35 T.C. 646 (1961), *aff'd*, 304 F.2d 574 (9th Cir. 1962).
[18]*Perez*, 144 T.C. No. 4, at 16.

headaches, stomachaches, and insomnia noted in the 1996 act's legislative history.

Be as explicit as you can in the agreements, whenever they are signed. If an express allocation is reasonable and has a rationale, the IRS will frequently accept it. That is surely less true for egg donations after *Perez*. But the Solomonic approach may still prevail.

Be reasonable when specifying which payments are for what. That advice is universal in any context. Don't pick figures you cannot support. Keep good contemporaneous documentation. Especially if there is a thin record of medical expenses, consider what other documents you can collect.

A letter from an attorney may help, as may a letter from a treating physician or an expert. Declarations signed under penalties of perjury may be more persuasive than letters. Do as much as you can contemporaneously. Don't wait for an audit to gather supporting documentation.

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