Were Sex Abuse Payments for Physical Injuries or Sickness?

By Robert W. Wood

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Accusations of sexual abuse have devastated the Catholic Church for more than a few years. See, for example, Laurie Goodstein, ''Two Studies Cite Child Sex Abuse by 4 Percent of Priests,'' *The New York Times*, Feb. 27, 2004, p. A1; Victoria Griffith, ''$85M for Victims of Sex Abuse by Priests,'' *London Financial Times*, Sept. 10, 2003, p. 10. Apart from moral and religious effects — and pure human suffering — the amount of money at issue has risen to near biblical proportions. The Catholic Church has paid over a half-billion dollars in settlements throughout the country. See ''The Bishops' Victims,'' *The Chicago Tribune*, Mar. 1, 2004, p. 16. One of the most widely publicized of those settlements occurred in the Boston Archdiocese, where the Catholic Church paid a reported $85 million to sex abuse victims. See, for example, Mark Miller, ''The Archbishop of Boston Gets His $85 Million Deal Done,'' *Newsweek*, Sept. 22, 2003, at 34.

The tax consequences of the settlements may not be at the forefront of anyone's mind in this tragic tapestry. Nevertheless, the increasing prevalence of those settlements, and their sheer magnitude, suggests that there will be tax cases arising from them. Because of the atrocious nature of the cases, there is an argument that Congress or the IRS should treat those settlements differently. The IRS should recognize the unique circumstances brought about by the tragedy and alleviate the uncertainty in the taxation of the settlement payments. Also, Congress should consider clarifying legislation regarding those settlement payments.

Following the terrorist attacks of September 11, 2001, the IRS provided special relief for victims of those attacks. See, for example, Notice 2001-74, 2001-2 C.B. 551, *Doc 2001-28312, 2001 TNT 219-10*; Notice 2001-68, 2001-2 C.B. 504, *Doc 2001-27716, 2001 TNT 214-10*. In 2003 the IRS issued a revenue ruling providing that some payments relating to the 9/11 attacks are excludable under section 104(a)(2). See Rev. Rul. 2003-115, 2003-46 IRB 1052, *Doc 2003-23359, 2003 TNT 209-15*. The IRS should follow a similar path for the Catholic Church sex abuse scandal. For now at least, we must assume a traditional tax analysis will apply to those settlements.

A Seemingly Unending String of Controversies

It is axiomatic that section 104(a)(2) provides an exclusion from gross income for recoveries made for personal physical injuries or physical sickness. Before August 20, 1996, no *physical* injury or *physical* sickness was required for recoveries to be excludable under section 104(a)(2). Before 1996, section 104(a)(2) merely required that recoveries be received because of *personal* injuries or sickness. The 1996 amendments to section 104(a)(2) were not

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voluminous. In fact, only a few words were added, but those words have turned out to be significant.

Unfortunately, nowhere in the Internal Revenue Code or the accompanying regulations is the definition of the term ''physical injuries or physical sickness'' provided. Even the legislative history to the 1996 amendments to section 104(a)(2) is less than helpful. Given the importance of the term, it is reasonable to assume that the Service or perhaps the judiciary would provide guidance on the meaning of ''physical injuries or physical sickness.''

At a minimum, you would like to think that the IRS might issue proposed or temporary regulations, or maybe even a notice or announcement, which are easier to issue than regulations. Anything written by the IRS would offer only an IRS statement of *its* view of what constitutes physical injuries or physical sickness. Still, guidance is needed.

Most tax practitioners are frustrated that the IRS has been all but silent as to what exactly constitutes physical injuries or physical sickness. As in other gray areas of the tax law, taxpayers are entitled to read the statute and the legislative history to attempt to achieve a favorable result. Of course, this reading is not without limits and it carries inherent risks. Attempting to divine congressional intent and the Service's interpretation of the law can be tricky business.

The lack of guidance in that area of the tax law has allowed some taxpayers to take positions that are, in a word, aggressive. It is inefficient and risky for taxpayers to go too far. However, it is also inefficient to fail to claim an exclusion if one is entitled to it. We know very little about the IRS's true thoughts on the meaning of the term ''physical injuries or physical sickness.'' That suggests that any rule, even a harsh one, is better than no rule at all.

Lessons From the Trenches

Private letter rulings cannot be relied on by anyone other than the requesting taxpayer. See section 6110(k)(3). To make sure everyone knows this, a disclaimer is emblazoned on every LTR issued. It is not surprising that many courts have refused to consider LTRs as any form of precedent. See, for example, *Peerless Corp. v. United States*, 185 F.3d 922, 928, *Doc 1999-28429, 1999 TNT 169-3* (8th Cir. 1999); *Fox Valley & Vicinity Constr. Workers Pension Fund v. Brown*, 897 F.2d 275, 280 (7th Cir. 1990 (*en banc*)), *cert. denied* 498 U.S. 820 (1990); *Liberty Nat. Bank & Trust Co. v. United States*, 867 F.2d 302, 305 (6th Cir. 1989); *American Ass'n of Christian Schools Voluntary Employees v. United States*, 850 F.2d 1510, 1515 (11th Cir. 1988); *Exxon Corp. v. United States*, 45 Fed. Cl. 581, 668, *Doc 1999-39224, 1999 TNT 241-6* (1999).

However, the Supreme Court has at times found LTRs to have some precedential value. In *Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962), the Court found that LTRs ''reveal the interpretation put upon the statute'' by the IRS. Admittedly, that decision predates the enactment of section 6110 as part of the Tax Reform Act of 1976, and it certainly cannot be cited as standing for the proposition that LTRs may be used as precedent, notwithstanding section 6110(k)(3). Even so, in *Rowan Cos. Inc. v. United States*, 452 U.S. 247 (1981), the Court actually cited several LTRs as an indication that the IRS had regularly considered and issued rulings on a particular subject. *Id.* at 261.

Of course, most taxpayers do not want to apply for an LTR unless they are almost sure they will achieve a favorable result. For one thing, they are expensive. Second, they take time, often many months. But even if one is willing to endure the expense and delay, there is the problem of certainty.

In most areas in which there is some controversy, as there is with the tax consequences of sexual molestation, LTRs are impractical. This is, in part, because the IRS does not want to go out on a limb. It's also a result of taxpayers not wanting to ''give away the farm,'' so to speak, and potentially expose themselves to additional tax liabilities by asking a question to which they may not know the answer. It seems paradoxical, but taxpayers do not typically ask for a LTR unless they know how the IRS will rule before the ruling request is submitted. Do not ask a question, an old adage professes, if you cannot stand the answer.

Even when the IRS is not going to give the taxpayer the desired ruling for one reason or another, it is customary for the Service to notify the taxpayer before issuing an adverse ruling. That inevitably leads to the ruling request being withdrawn by the taxpayer, but the damage may already be done. The taxpayer's identity has been revealed in the ruling request process. Also, the local IRS field office will frequently (if not always) be notified of a ruling request withdrawal. That puts the taxpayer in the unenviable position of being potentially subjected to increased IRS scrutiny. Given the abuse the victims of the Catholic Church sex abuse scandal have suffered, increased IRS scrutiny is the last thing they need.

The 'Bruise' Ruling

Despite their caveats, tax practitioners still look to LTRs for guidance of the Service's general position on matters. Unfortunately, such as in the case of attempting to divine the meaning of the term ''physical injuries or physical sickness,'' LTRs may be the only real guidance available to tax practitioners. LTR 200041022, *Doc 2000-26382, 2000 TNT 201-10*, deals with the difficult topic of a taxpayer who receives damages for sexual harassment and assault, both before and after there is any observable bodily harm. The LTR concludes that the damages a taxpayer received that were allocable to unwanted physical contacts without any ''observable bodily harm'' did not constitute ''physical injury or physical sickness'' for purposes of section 104(a)(2).

The ruling goes so far as to say: ''The term 'personal physical injuries' is not defined in either Section 104(a)(2) or the legislative history of the 1996 Act. However, 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).'' That line of reasoning might prove to be disastrous in the case of the Catholic Church sex abuse victims. Conceivably, it could result in sex abuse victims who were sexually assaulted, but suffered no bruises, cuts, swelling, or bleeding, being taxed on their recoveries. Given the horrendous nature of this abuse, the result seems exceptionally unjust.

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The facts in LTR 200041022 are reminiscent of many sexual harassment cases. The taxpayer was employed as a full-time driver. Her employer began making suggestive and lewd remarks to her and began touching her inappropriately. According to the ruling, those physical contacts did not leave any ''observable bodily harm.'' However, while the taxpayer was on one road trip with her employer, he physically assaulted her, causing her extreme pain. The employer also assaulted her on other occasions, causing physical injury. He later physically and sexually assaulted her.

The taxpayer quit her job and filed a suit alleging sex discrimination and reprisal (including sexual harassment), battery, and intentional infliction of emotional distress. The employer settled the case, but there was no express allocation of the proceeds in the settlement agreement. From a tax perspective, this was less than ideal planning. Always allocate — it's just that simple. See *Robinson v. Commissioner*, 102 T.C. 116, *Doc 94-1439, 94 TNT 23-18* (1994), *aff'd in part and rev'd in part on another issue* 70 F.3d 34, *Doc 95-10932, 95 TNT 238-7* (5th Cir. 1995), *cert. denied* 519 U.S. 824 (1996). At least then you have a fighting chance.

Under those facts, the IRS concluded that the damages the taxpayer received from her employer's unwanted physical contacts that did not result in any observable bodily harm were not received on account of personal physical injuries or physical sickness. Those amounts were therefore taxable. However, the damages received for pain, suffering, emotional distress, and reimbursement of medical expenses after the first assault were excludable under section 104(a)(2) because they were attributable to physical injuries.

The exact amount and extent of physical consequences required under the post-1996 incarnation of section 104(a)(2) have been enigmas for almost a decade. For example, in *Johnson v. United States*, 76 Fed. Appx. 873, *Doc 2003-19761, 2003 TNT 172-6* (10th Cir. 2003), a guard at a juvenile detention center who suffered injuries while restraining an inmate was not permitted to exclude damages he recovered in a suit brought under the Americans With Disabilities Act after his employer failed to accommodate his physical limitations that resulted from the incident. The court found that Johnson's recovery was on account of unlawful termination rather than personal physical injuries.

Over the years, the government's line-drawing exercises in this area of the tax law have at times been difficult to follow. It's certainly clear that ''but for'' the incident with the inmate (''but for'' being a traditional tort causation index), Johnson would not have suffered the injuries that ultimately resulted in his recovery. Nonetheless, the court was not convinced, and it sided with the Service.

Returning briefly to LTR 200041022, it is fair — and perhaps even right, to use moral terminology — to question how the government could engage in such precise line-drawing between various incidents of sexual harassment and assault. Admittedly, it is possible to discern between the various incidents of sexual harassment and touching that left no ''observable bodily harm,'' and the various assaults that began with what the IRS termed the ''first pain incident.'' Nonetheless, that type of line-drawing seems akin to splitting hairs with a machete. Attempting to draw those kinds of lines for each victim in the Catholic Church sex scandal could produce harsh, unjust (and potentially irreconcilable) results.

The Good, the Bad, and the Ugly

Almost a decade after section 104(a)(2) was amended to exclude from gross income *only* recoveries for personal *physical* injuries or *physical* sickness, tax practitioners still know very little about what constitutes personal physical injuries or physical sickness. It is difficult to say, based on established case law or administrative guidance at least, whether the recoveries by the Catholic Church sex abuse victims constitute amounts received on account of personal physical injuries or physical sickness. If no portion of those recoveries is found to be paid on account of personal physical injuries or physical sickness, the recoveries would be fully taxable to the victims, including any amounts paid for emotional distress, and possibly even including amounts paid to their attorneys.

But should it matter if there are demonstrable bruises or scratches? I don't think it should. In fact, it seems ludicrous to think that damages resulting from invasive intentional physical maltreatment, and the corresponding (often lifelong) resulting emotional injuries, are not paid ''on account of personal physical injuries or physical sickness'' merely because visible bruises (or no bruises remaining after years of hiding the appalling incidents) may be absent. That makes no sense, given the purpose of section 104, even after the 1996 amendments to it.

It leads many people to conclude that the payments should be fully excludable. Scars on the inside resulting from physical trauma may well be more debilitating than those on the outside. It is important to remember what Congress attempted to curtail with its 1996 amendments to section 104(a)(2) — primarily plaintiffs claiming the exclusion for recoveries in employment litigation that did not result in physical injuries or physical sickness. The rationale behind making the amendments was that only those who have truly suffered a loss of ''human capital'' should be able to exclude their recovery under section 104(a)(2).

With that as our backdrop, can anyone in their right mind compare a run-of-the-mill discrimination case to a case of sexual molestation or abuse? Bear in mind too that section 104 contains no explicit touching (or physical contact) requirement. The Service may prefer to read one in, but *it is not in the statute*.

Lost in Translation

The circuit courts of appeal do not agree on the tax treatment of contingent attorney fees. Everybody knows the decisions, and even the underlying rationales, of the circuits on this issue are incredibly inconsistent. See Robert W. Wood and Dominic L. Daher, ''Contingent Attorney's Fees in Class Action Cases — From Bad to Worse for Taxpayer-Plaintiffs,'' 99 *J. Tax'n* 228 (Oct. 2003); Robert W. Wood and Dominic L. Daher, ''Attorneys' Fee Saga Continues: Maverick Circuit Says, 'Oregon Good, California Bad,''' *Tax Notes*, Oct. 6, 2003, p. 91; Robert W. Wood and Dominic L. Daher, ''Attorney Fee: Rebellious Circuit Don't Need No Stinkin' Lien Law,'' *Tax Notes*, Dec. 22, 2003, p. 1427.

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The majority has held that contingent attorney fees are taxable to both the attorney and the plaintiff. See *Alexander v. Commissioner*, 72 F.3d 938, *Doc 96-602, 96 TNT 1-74* (1st Cir. 1995); *Raymond v. United States*, 355 F.3d 107, *Doc 2004-760, 2004 TNT 10-11* (2d Cir. 2004), *petition for cert. filed* 72 U.S.L.W. 1437 (U.S. April 9, 2004) (No. 03-1415); *O'Brien v. Commissioner*, 319 F.2d 532 (3d Cir. 1963), *cert. denied* 375 U.S. 930 (1963); *Young v. Commissioner*, 240 F.3d 369, *Doc 2001-5150, 2001 TNT 36-11* (4th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881, *Doc 2001-21203, 2001 TNT 154-9* (7th Cir. 2001); *Bagley v. Commissioner*, 121 F.3d 393, *Doc 97-23130, 97 TNT 153-8* (8th Cir. 1997), *en banc reh'g denied* 1997 U.S. App. LEXIS 27256 (8th Cir. 1997); *Benci-Woodward v. Commissioner*, 219 F.3d 941, *Doc 2000-20007, 2000 TNT 144-8* (9th Cir. 2000), *cert. denied* 531 U.S. 1112 (2001); *Coady v. Commissioner*, 213 F.3d 1187, *Doc 2000-16766, 2000 TNT 117-9* (9th Cir. 2000), *cert. denied* 532 U.S. 972 (2001); *Sinyard v. Commissioner*, 268 F.3d 756, *Doc 2001-24862, 2001 TNT 188-11* (9th Cir. 2001), *cert. denied* 536 U.S. 904 (2002); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312, *Doc 2001-31455, 2001 TNT 247-75* (10th Cir. 2001), *cert. denied* 535 U.S. 1056 (2002); *Baylin v. Commissioner*, 43 F.3d 1451, *Doc 95-342, 95 TNT 4-23* (Fed. Cir. 1995).

The minority has held that contingent attorney fees are not taxable to the plaintiff; instead, they are taxable to the attorney. See *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959); *Estate of Clarks v. United States*, 202 F.3d 854, *Doc 2000-1776, 2000 TNT 10-21* (6th Cir. 2000); *Davis v. Commissioner*, 210 F.3d 1346, *Doc 2000-12246, 2000 TNT 86-7* (11th Cir. 2000); *Srivastava v. Commissioner*, 220 F.3d 353, *Doc 2000-20090, 2000 TNT 145-9* (5th Cir. 2000); *Banaitis v. Commissioner*, 340 F.3d 1074, *Doc 2003-19359, 2003 TNT 167-5* (9th Cir. 2003), *petition for cert. granted* 2004 U.S. LEXIS 2385 (U.S. Mar. 29, 2004) (No. 03-907); *Banks v. Commissioner*, 345 F.3d 373, *Doc 2003-21492, 2003 TNT 190-11* (6th Cir. 2003), *petition for cert. granted* 2004 U.S. LEXIS 2384 (U.S. Mar. 29, 2004) (No. 03-892).

On March 29, 2004, the Supreme Court decided to resolve the split in the circuits on the tax treatment of contingent attorney fees, granting certiorari petitions in *Banaitis* and *Banks*.

Before granting certiorari in *Banks* and *Banaitis,* the Supreme Court declined to resolve the attorney fee issue on five prior occasions. See *O'Brien, Benci-Woodward, Coady, Sinyard,* and *Hukkanen-Campbell*. I can only hope that the Court sides with the taxpayers, but my fear is that that result is unlikely.

Adding Insult to Injury

It's probably unlikely that many of the victims of the Catholic Church sex abuse scandal have contemplated that on top of their trauma, they may have staggering tax consequences, too. As a matter of fact, there have even been cases in which taxpayers have ended up out-of-pocket on an after-tax basis after ostensibly "winning" a lawsuit. See *Spina v. Forest Preserve District of Cook County*, 207 F. Supp.2d 764 (N.D. Ill. 2002) (a Chicago woman who won a sex discrimination suit against her former employer ended up *paying* $99,000 *more* in federal income tax than she recovered).

This Alice-in-Wonderland-like result (or perhaps *Friday the Thirteenth*?) occurs because of the AMT. Let's see how it might work when a disproportionately small settlement payment is recovered along with a substantial amount of attorney fees.

Assume a victim of the Catholic Church sex scandal recovers $5 million in a settlement, inclusive of attorney fees. Assume further that the recovery is found to be taxable because it fails to qualify as being received on account of personal physical injuries or physical sickness. If the victim lives in one of the majority jurisdictions and is required to recognize the gross amount (including the attorney fees), he or she will be taxed on the entire $5 million recovery. Of course, the victim may be entitled to a miscellaneous itemized deduction for the amount of the recovered attorney fees (assume $4 million). But the deduction is disallowed entirely for AMT purposes (and also subject to a 2-percent-of-AGI floor and phaseout for regular tax purposes).

That results in the victim owing just shy of $1.4 million in federal income tax on the recovery. Of that amount, just shy of $1 million stems from the AMT. The appalling result here is that the victim will actually end up losing almost $400,000 because of that "recovery"! That's right, the victim will actually end up *in the hole* almost $400,000 after an ostensibly "successful" settlement!

While the victim is allocated $1.4 million in gross income, he or she actually receives only $1 million in cash. From a cash-flow standpoint, the victim is left with roughly a $1.4 million tax bill and only $1 million with which to pay it. It does not seem fair to receive a favorable settlement and then end up paying more in federal income tax than you recovered.

The saddest part about the unjust tax result is that virtually everyone knows about it, and has known about it for years, but nobody has been willing to do anything to resolve it. See *2002 National Taxpayer Advocate Annual Report to Congress* at 166. See also *2003 National Taxpayer Advocate Annual Report to Congress* at 347. All of this will undoubtedly provide very little solace to victims of the Catholic Church sex scandal if the payments made to them are not found to have been made on account of physical injuries or physical sickness. I hope the IRS will realize that the victims of the Catholic Church sex abuse scandal have endured enough without being burdened with an unexpected tax bill.

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