

LETTERS TO THE EDITOR

tax notes federal

Damages From Inherently Physical Injuries Are Not Taxable

To the Editor:

As tax lawyers, we hold certain truths to be self-evident. We can't deduct the cost of our vacations, even if we worked every day and ran into a client on the beach. We don't get to do a like-kind exchange of stock, even if the two companies basically do the same thing. And, most relevant to this letter, rape is a personal physical injury.

We read David M. Higgins's and Dr. Janet Guzman's recent article¹ with interest, as we agree that the area of taxation of settlement payments (like many areas of tax law) is gray. Many determinations depend on the facts at hand, and advising clients on the right approach to tax questions in a complex settlement negotiation can be difficult. This is true for plaintiffs and defendants alike — while many claimants will struggle to determine how to report settlement payments on their tax returns, defendants making payments must also determine whether a payment is subject to withholding and how to report it. And we agree that additional guidance in this area could be helpful.

However, we disagree with Higgins's and Guzman's suggestion that it is necessary to determine (and advise our clients) that a settlement of damages for a civil suit alleging sexual abuse or rape is something other than a payment for personal physical injury, and therefore excludable from income under section 104(a)(2).

We also disagree about the degree to which there is a lack of guidance in this area, despite Higgins's and Guzman's claims.² We are lawyers, after all — we need to work with what we are given, and if we are given a statute that simply states compensation for personal physical injury

is tax-free, we may take those statutory words at face value.

Higgins and Guzman argue that IRS guidance on what constitutes a personal physical injury requires the taxpayer to suffer an "observable bodily harm" to exclude recoveries from income under section 104(a)(2), even if the damages are for obviously physical injuries, including those from medical battery, sexual abuse, post-traumatic stress syndrome, torture, and certain false imprisonment torts. But the argument is faulty in two regards, namely that it treats a 2000 IRS private letter ruling, known amongst practitioners as the "Bruise Ruling,"³ as both binding and limiting. It is neither. The Bruise Ruling, as a private letter ruling, is only binding on the taxpayer that requested it.

Further, the Bruise Ruling merely acknowledges another self-evident truth: If you bleed, or are cut, or are bruised, you have suffered a physical injury. Nowhere in the Bruise Ruling does the IRS suggest that there is no physical injury absent bleeding, a cut, or bruising. Rather, the ruling found a portion of the particular damages at issue taxable to the extent they were attributable to physical contact that resulted in neither "any observable harms" — of which "bruises, cuts, etc." were clearly a non-exhaustive list of examples — *nor any pain*. The Bruise Ruling acknowledges a victim who experiences pain absent a cut, bruise, or other similar bodily harm has suffered a personal physical injury.⁴

Higgins's and Guzman's faulty assumption that physically manifesting a visible injury is a standard that *must* be met by taxpayers, rather than an example that *could* be met by taxpayers,

³ LTR 200041022.

⁴ The Bruise Ruling acknowledges that contact causing pain is a physical injury: "Because the perception of pain is essentially subjective, it is a factual matter. Therefore, pursuant to [section] 7.01 of Rev. Proc. 2000-1, [2000-1 C.B. 4, which prohibits the IRS from issuing a private letter ruling on factual matters,] we cannot rule whether damages properly allocable to the First Pain Incident (a physical contact that did not manifest in the form of a cut, bruise, or other similar bodily harm) were received on account of personal physical injuries or physical sickness." *Id.*

¹ Higgins and Guzman, "Fixing the Definition of Physical Personal Injury," *Tax Notes Federal*, Jan. 10, 2022, p. 221.

² See, e.g., ILM 200809001; IRS Publication 4345, "Settlements — Taxability" (rev. Nov. 2021).

immediately leads to consternation by the authors themselves. Namely, they identify it as “odd” that the Bruise Ruling cites the *Black’s Law Dictionary* definition of “physical injury” for support.⁵ And yet the Bruise Ruling’s reference to the open-ended language in *Black’s* is, itself, evidence that the ruling did not operate to limit what constitutes physical injury. Instead, the IRS provided an example, consistent with the facts before it, of one type of physical injury that would be consistent with blackletter law.

The authors also omit important subsequent IRS advisory guidance that supports the interpretation that the Bruise Ruling was an example, not a standard. ILM 200809001, written by the same member of the IRS Office of the Chief Counsel as the Bruise Ruling, addressed a tort committed against a minor many years earlier. The memorandum concludes that “it is reasonable for the Service to presume that the settlement compensated [the victim] for personal physical injuries, and that all damages for emotional distress were attributable to the physical injuries,” even where the victim could not provide evidence establishing the extent of those physical injuries at the time of entering the settlement. Nowhere in the memorandum does the IRS state that the physical injury alleged must have resulted in visible bruises, cuts, or bleeding. Rather, the IRS merely restates the words of section 104 — that compensation for personal physical injuries is excludable from income — and concludes that this is true, at least in certain circumstances, even in the absence of evidence of the extent of those physical injuries. In other words, the memorandum concludes that a victim can exclude damages for physical injury even absent evidence of observable bodily harm in certain circumstances.

Like the Bruise Ruling, ILM 200809001 is not binding precedent, but it is more recent than the Bruise Ruling and more directly applicable to

cases of sexual abuse.⁶ And it simply restates a general rule that compensation for physical injury is not taxable. It does not limit the definition of physical injury. Nor are we aware of any other published IRS guidance doing so.⁷

The Higgins and Guzman article goes on to apply its false premise — that the IRS standard absolutely requires observable bodily harm — to claim torts that definitionally involve physical injury would not meet this standard. They describe a medical battery in which a surgeon removed portions of a patient’s cervix without the patient’s knowledge or consent — by definition inflicting a physical injury — but state that this fact pattern would fail the observable bodily harm standard such that any recovery would likely be included in income. This is incongruent logic at its worst, which, while not explained by the authors, appears to stem from their groundless conclusion that the IRS requires any physical injury to be “observable” to the naked eye of a casual observer. We can think of no colorable argument that a medical battery is not physical injury.

Similarly, the Higgins and Guzman article cites the *Stadnyk* case for a general rule that false imprisonment does not result in physical injury under an observable bodily harm standard.⁸ But it does so without explaining that the conclusion in *Stadnyk* is grounded in the taxpayer’s testimony that she suffered no physical injury during her period of imprisonment.⁹ The Tax Court did *not* hold that a victim of false imprisonment could not suffer physical injury.¹⁰ To the contrary, the court examined direct evidence, through testimony of the victim, about her singular experience.¹¹ And that carried the day in determining tax treatment.

⁶ While overt discussion of the tort in question has been redacted in ILM 200809001, the legal community broadly accepts that this advice relates to sexual abuse. See, e.g., Robert W. Wood, “Should False Imprisonment Damages Be Taxable?” 81 N.Y. St. B.A. J. 38 (2009).

⁷ See, e.g., section 104; reg. section 1.104-1, Rev. Rul. 96-65, 1996-2 C.B. 6. See generally IRS, “Tax Implications of Settlements and Judgments” (last visited Jan. 28, 2022).

⁸ *Stadnyk v. Commissioner*, T.C. Memo. 2008-289, *aff’d* 367 F. App’x 586 (6th Cir. 2010).

⁹ See *Stadnyk*, T.C. Memo. 2008-289.

¹⁰ Nor would that outcome have made sense. Some examples of physical injuries from false imprisonment not before the *Stadnyk* court include denial of access to medical treatment, starvation, and the physical impacts of lack of exercise and vitamin D.

¹¹ *Stadnyk*, T.C. Memo. 2008-289.

⁵ *Id.* The Bruise Ruling states: 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). See *Black’s Law Dictionary* 1304 (Rev. 4th ed. 1968) which defines the term ‘physical injury’ as ‘bodily harm or hurt, excluding mental distress, fright, or emotional disturbance.’”

Further, Higgins and Guzman ignore that the outcome of *Stadnyk* supports exclusion from income of damages from rape-related torts. As the Tax Court makes clear, the tort in *Stadnyk* is “in a sense a mental one,” because it can definitionally occur without physical harm, as in the plaintiff’s case in *Stadnyk*.¹² In contrast, the civil tort battery claims associated with rape often explicitly require physical injury. As noted in the widely adopted Restatement (Second) of Torts, “harmful contact” with the victim is an essential element of these battery claims.¹³

This leads us to perhaps the most dangerous (and damaging to victims) summary conclusion in the article by Higgins and Guzman: Their broad statement that acts of sexual abuse do not constitute physical injury under the IRS’s standard. We could not disagree more. Rape is a physical injury, however perpetrated and regardless of whether any cuts, bruises, or bleeding occur. We acknowledge that when there is observable bodily harm or pain, and when that harm is contemporaneously documented, then there is no question that there is adequate substantiation or evidence that the act was physical in nature. But when an act is inherently and necessarily a physical injury on its face, like rape, no further proof is needed. As ILM 200809001 acknowledges, the IRS does not in fact require proof of observable bodily harm when the facts otherwise show that damages are for personal physical injury.

The hidden danger of the misstatements of the law advocated by Higgins and Guzman is the creation of uncertainty in the public discourse. We understand the authors are advocating for more clarity, but manufacturing nonexistent legal uncertainty will hurt victims of sexual abuse on a day-to-day basis. When a victim seeks advice from a tax professional about the tax consequences of their settlement, the authors’ words might encourage that professional to

advise that the victim must pay tax on compensation for a rape. This would be incorrect and creates a systemic risk of revictimizing those who should be supported by society in their recovery. Rather, such victims should be told the truth: Congress and the IRS believe that they should keep every penny of compensation for the physical harm they suffered as a result of being raped, as is reflected in the blackletter law.

The law listens to the injured. When a plaintiff receives damages from a settlement, the tax analysis applies the origin of the claim doctrine: The injury alleged by the plaintiff is assumed to have occurred, and the damages are treated for tax purposes in accordance with that alleged injury and underlying facts.¹⁴ Plaintiffs are not required to prove the truth of their claims to the IRS, nor must the IRS be able to see a bruise or a cut for there to have been a personal physical injury. This is consistent with the IRS giving power to the voice of victims in its guidance. ILM 200809001 concludes that no more evidence of physical injury was necessary beyond the allegation itself. And the Bruise Ruling acknowledges that an incident resulting in subjective pain to the victim constitutes a physical injury. Based on this legal standard, if a client of ours receives or pays a settlement that, in whole or in part, is compensation for a claim of rape or other physical injury, as lawyers, we feel confident in advising them that that amount is not taxable.

There remain many nuances and much uncertainty in this area that we, as lawyers, must help our clients navigate. For example, if an employer engages in human trafficking and both sexually abuses the victim and fails to pay that victim adequate wages, we must help our clients allocate a settlement between taxable wages and compensation for the abuse. This is true whether we represent a defendant or a victim. But tax treatment of the amount that is compensation for the abuse should never be in question. By the plain language of the law, it is not taxable.

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¹² *Id.*

¹³ Restatement (Second) of Torts, section 13(b) (1965). Section 15 defines bodily harm as “any physical impairment of the condition of another’s body, or physical pain or illness.” Comment (a) further notes that there is an “impairment of the physical condition of another’s body if the structure or function of any part . . . is altered to any extent even though the alteration causes no *other* harm” (emphasis added). *Id.* Section 15(a).

¹⁴ *United States v. Gilmore*, 372 U.S. 39 (1963).