

# **The Taxable Nature of Sexual Abuse Settlements in Mass Torts**

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## ***BACKGROUND***

The taxable nature of a sexual abuse settlement in mass torts will have a significant impact on survivors. The greater the taxable burden on a settlement award, the smaller the recovery. On large recoveries, this impact will be even greater. As attorneys, we have a duty to zealously advocate on behalf of our clients.<sup>1</sup> The purpose of this memorandum is to provide clear and concise guidance for sexual abuse survivors and the plaintiff bar at large.

## ***QUESTIONS PRESENTED***

The overarching question in this memorandum is whether sexual abuse settlements are generally nontaxable. This question contains five separate issues. The first issue is what constitutes a physical injury or sickness for purposes of §104(a)(2). The second issue is which damages are non-taxable under a claim of sexual abuse. The third issue is whether the IRS will give deference to the express language within a settlement agreement. The fourth issue is under what standard will the IRS overturn an express settlement agreement. The fifth and last issue is whether these standards apply to mass tort litigations.

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<sup>1</sup> Model Rules of Prof'l Conduct R. 1.3 (2009).

## ***BRIEF ANSWER***

First, settlements directed to victims of sexual abuse should generally be excluded from gross income. This is because sexual abuse claims will often involve observable bodily harms, physical pain, or a qualifying internal injury. The exclusion will also apply in cases where a claimant cannot presently substantiate the existence of physical injuries or sickness that were incurred at the time the sexual abuse was committed. Second, all damages except for punitives that flow from a physical injury can be excluded from gross income. Third, the IRS will give deference to an express settlement agreement that is entered into at arm's length, in an adversarial context, and in good faith. Fourth, if the express language within a settlement agreement is challenged, a court will look to the intent of the payor to determine the tax allocation of the settlement proceeds. Lastly, global settlement agreements are afforded the same deference as single claimant settlement agreements. Therefore, global settlement agreements that stipulate a sex abuse mass tort litigation is being paid on account of physical injuries will allow those proceeds to be received tax-free under §104(a)(2).

## ***ANALYSIS***

Section 61(a) of the Internal Revenue Code provides a broad definition of “gross income”: Except as otherwise provided in this subtitle, gross income means all income from whatever source derived.<sup>2</sup> According to the Supreme Court, the concept of gross income

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<sup>2</sup> 26 U.S.C. § 61(a) (1954).

encompasses accessions to wealth, clearly realized, over which taxpayers have complete dominion.<sup>3</sup>

Settlement proceeds paid to a taxpayer constitute gross income unless the taxpayer proves they fall within a specific statutory exception.<sup>4</sup> The default rule of statutory interpretation is that exclusions from income must be narrowly construed.<sup>5</sup>

Under Title 26, §104(a)(2) of the U.S. Code, gross income does not include the amount of any damages received on account of personal injuries or sickness.<sup>6</sup> In 1996, Congress passed the Small Business Job Protection Act (“SBJPA”), which amended §104(a)(2) to require that personal injuries or sickness be physical for the taxpayer to qualify for income exclusion.<sup>7</sup>

The Supreme Court has thus identified two requirements for settlements to be excluded from gross income: (1) the taxpayer must prove the cause of action giving rise to the recovery is based upon tort or tort type rights, and (2) the taxpayer must demonstrate the tortfeasor paid the proceeds on account of personal physical injuries or sickness.<sup>8</sup>

The IRS and Congress have deliberately left §104(a)(2) vague.<sup>9</sup> Those bodies are hesitant to issue bright line rules on the issue of personal injury because claims will almost always

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<sup>3</sup> See Comm’r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

<sup>4</sup> Comm’r v. Schleier, 515 U.S. 323, 328 (1995).

<sup>5</sup> United States v. Burke, 504 U.S. 229, 248 (1992).

<sup>6</sup> 26 U.S.C. § 104(a)(2) (1954).

<sup>7</sup> See Small Business Job Protection Act of 1996, Pub. L. 104-188, § 1605, 110 Stat. (1996).

<sup>8</sup> Schleier, 515 U.S. at 337.

<sup>9</sup> Benjamin T. Cory, Note, Amos v. Commissioner: The Ambiguous and Ever-Changing Definition of What Constitutes a Personal Physical Injury Under Internal Revenue Code Section 104(A)(2), 66 MONT. L. REV. 247, 248 (Winter 2005) (stating that “[d]ue to the vague nature of §104(a)(2), the courts have had difficulty limiting the scope of, as well as defining, “personal injuries” under §104(a)(2).”

depend on the facts of the case. However, there is plenty of guidance to formulate a conclusion on this matter.

## **I. Sexual Abuse Claims Generally Involve Physical Injuries**

### *Observable Bodily Harm*

In 2000, the IRS issued a private letter ruling to decide whether a sexual abuse survivor's injuries comported with §104(a)(2) so as to exclude the resulting damages from gross income.<sup>10</sup> The private letter has been commonly known as the "Bruise Ruling."<sup>11</sup> Although non-binding, private letters do represent the IRS's stance on the tax law at particular snapshots in time.<sup>12</sup>

The case involves an individual who was subjected to sexual advances by her full-time driver.<sup>13</sup> The driver had, on many occasions, made sexual advances toward her.<sup>14</sup> On one occasion, the driver assaulted the individual by biting and cutting her.<sup>15</sup> The individual sustained

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<sup>10</sup> I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000).

<sup>11</sup> See Wood, Robert. "Cut or Bruise Can Yield Tax-Free Damages." Tax Notes, 2013.

<sup>12</sup> "A private letter ruling, or PLR, is a written statement issued to a taxpayer that interprets and applies tax laws to the taxpayer's specific set of facts. A PLR is issued to establish with certainty the federal tax consequences of a particular transaction before the transaction is consummated or before the taxpayer's return is filed. A PLR may not be relied on as precedent by other taxpayers or IRS personnel." IRS, "Understanding IRS Guidance - A Brief Primer" (last updated May 31, 2022). See also *Hanover Bank v Comm'r*, 369 US 672, 686 (1962). "Although the petitioners are not entitled to rely upon unpublished private rulings which were not issued specifically to them, such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws."

<sup>13</sup> See *id.*

<sup>14</sup> See *id.* at 2.

<sup>15</sup> *Id.*

observable harms from this battery.<sup>16</sup> In determining what damages would be excludable from gross income, the IRS unequivocally ruled that “direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under § 104(a)(2).”<sup>17</sup>

It must be emphasized that this determination is not limiting; in no way are observable bodily harms intended to be a prerequisite for income exclusion under §104(a)(2).<sup>18</sup> Further, the list of observable harms (bruises, cuts, etc.) that are sufficient for §104(a)(2) exclusion is not limited to the harms laid out in the private letter.<sup>19</sup>

Therefore, in the case of sexual abuse settlements that involve observable bodily injuries, all damages (other than punitive damages) that are allocated to an observable bodily injury will be excluded from gross income.

### Physical Pain

The *Bruise Ruling* also illustrates the IRS’s position on the issue of physical pain.<sup>20</sup> The same above-mentioned facts apply. However, to understand how the IRS viewed physical pain as it relates to §104(a)(2), we must look at another instances of abuse in that case. On that occasion,

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<sup>16</sup> Id.

<sup>17</sup> Id. at 4.

<sup>18</sup> See Horton v. Comm’r, 100 T.C. 93, 103-104 (1993). “Hence, personal injury is not properly defined as any injury that is tortious, but as tortious injury to the person, of which bodily harm is the clearest example.”

<sup>19</sup> See Perez v. Comm’r, 144 T.C. 51, 63 (2015). “A professional boxer could argue that some part of the payments he received for his latest fight is excludable because they are payments for his bruises, cuts, and nosebleeds. A hockey player could argue that a portion of his million-dollar salary is allocable to the chipped teeth he invariably suffers during his career. And the same would go for the brain injuries suffered by football players and the less-noticed bodily damage daily endured by working men and women on farms, ranches, in mines, or on fishing boats.”

<sup>20</sup> I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000).

the individual was sexually abused in a way which caused her physical pain, but no observable bodily harm.<sup>21</sup> The private letter refers to this event as the “First Pain Incident.”<sup>22</sup>

In the private letter the IRS turned to *Black’s Law Dictionary* to define “physical injury.”<sup>23</sup> *Black’s* defines physical injury as “*bodily harm or hurt*, excluding mental distress, fright, or emotional disturbance.”<sup>24</sup> This definition is instructed by case law, and according to *Black’s*, must incorporate physical pain within the meaning of physical injury as both *bodily harm*<sup>25</sup> and *hurt*<sup>26</sup> have both been defined by *Black’s* to include physical pain. The Restatement (Second) of Torts has also adopted this definition.<sup>27</sup>

Notably, the IRS did not answer whether the damages that flowed from the “First Pain Incident” should be excluded from gross income because pain is a factual matter and private letter rules cannot adjudicate on factual matters.<sup>28</sup>

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<sup>21</sup> See id. at 2.

<sup>22</sup> See id.

<sup>23</sup> See id. at 4.

<sup>24</sup> PHYSICAL INJURY. Bodily harm or hurt, excluding mental distress, fright, or emotional disturbance. BLACK’S LAW DICTIONARY 1304 (4th ed. 1968).

<sup>25</sup> BODILY HARM. Any touching of the person of another against his will with physical force, in an intentional, hostile, and aggressive manner, or a projecting of such force against his person. Any impairment of physical condition of another's body or physical pain or illness. BLACK’S LAW DICTIONARY 221 (4th ed. 1968).

<sup>26</sup> HURT. This word is not restricted to physical injuries, but includes also mental pain, as well as discomfort or annoyance. BLACK’S LAW DICTIONARY 875 (4th ed. 1968).

<sup>27</sup> “Bodily harm is any physical impairment of the condition of another's body, or physical pain or illness.” Restatement (Second) of Torts, § 13(b) (1965).

<sup>28</sup> See id. at 5. “Under § 7.01 of Rev. Proc. 2000-1, 2000-1 I.R.B. 5, 21 a letter ruling will not ordinarily be issued because of the factual nature of the problem. Because the perception of pain is essentially subjective, it is a factual matter. Therefore, pursuant to § 7.01 of Rev. Proc. 2000-1, we cannot rule whether damages properly allocable to the First Pain Incident (a physical contact that did not manifest itself in the form of a cut, bruise, or other similar bodily harm) were received on account of personal physical injuries or physical sickness.”

It cannot be stressed enough; the absence of this factual determination does not indicate that the IRS views physical pain outside the purview of §104(a)(2). In contrast, the omission indicates that, on certain occasions, physical pain will itself be within the reach of §104(a)(2) to exclude a settlement from gross income. If the IRS believed otherwise, they would've settled the issue as a matter of law. The holdings of the non-binding private letter are outlined below:

(1) “damages [...] that are properly allocable to events *prior* to the First Pain Incident are not received on account of personal physical injuries or physical sickness under §104(a)(2);”

and

(2) “damages [...] for pain, suffering, emotional distress [...] that are properly allocable to the period beginning with the First Physical Injury are excludable from their gross income under §104(a)(2).”<sup>29</sup>

The Tax Court, in *Perez v. Commissioner*, provides another example of physical pain’s inclusion within the meaning of physical injury.<sup>30</sup>

There, Nichelle Perez signed a contract with Donor Source International LLC, an egg donation clinic.<sup>31</sup> Under the contract, Perez would allow Donor Source to surgically extract her eggs for a fee.<sup>32</sup> The contract provided that compensation was based solely on the process of surgically extracting her eggs, not on the eggs themselves.<sup>33</sup> This is evidenced by the fact that

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<sup>29</sup> Id.

<sup>30</sup> See Perez, 144 T.C. at 51.

<sup>31</sup> See id. at 53.

<sup>32</sup> See id. at 54.

<sup>33</sup> See id.

Perez would still be compensated if the process did not yield any eggs for Donor Source.<sup>34</sup> Pursuant to their contract, Donor Source surgically extracted Perez's eggs.<sup>35</sup> In exchange, Perez received \$10,000 for the pain and suffering she experienced through the process.<sup>36</sup> Perez repeated the process later that year for an additional \$10,000.<sup>37</sup> Perez, believing that the compensation was not taxable, did not report it in her federal income tax return.<sup>38</sup> The IRS issued Perez a notice of deficiency, claiming that the full \$20,000 was taxable.<sup>39</sup>

In the end, the Tax Court held that Perez could not exclude her damages for bodily harm under §104(a)(2) because the pain and suffering she endured was within the scope of the medical procedures to which she consented, and therefore, the damages were to compensate her for services she rendered.<sup>40</sup> Importantly though, had the damages been issued to compensate physical pain that resulted from an unwanted invasion against her bodily integrity, the court held that they would have been excludable from gross income under 104(a)(2).<sup>41</sup>

The above-mentioned cases indicate that physical pain can suffice on its own as a physical injury under §104(a)(2). Therefore, as stated by the Tax Court in *Perez*, and parallel to

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<sup>34</sup> See id.

<sup>35</sup> See id. at 52.

<sup>36</sup> See id. at 53.

<sup>37</sup> See id. at 54.

<sup>38</sup> See id. at 56.

<sup>39</sup> See id.

<sup>40</sup> See id. at 61.



the conclusion reached in *I.R.S. Priv. Ltr. Rul. 200041022*, physical pain that results from an unwanted invasion of bodily integrity constitutes a physical injury under §104(a)(2).

### *Internal Physical Injuries*

In 2001, the IRS issued another private letter that provided insight on the nature of internal physical injuries.<sup>42</sup>

There, an individual had worked for over thirty years as a Drywall installer.<sup>43</sup> Over the years the individual had been exposed to asbestos fibers which caused him to develop lung cancer.<sup>44</sup> The individual and his wife filed a claim for personal injury against the manufacturers and advertisers of the asbestos related products that caused his cancer.<sup>45</sup> Despite having internal injuries that were invisible to the naked eye,<sup>46</sup> the IRS ruled that his lung damage constituted a personal physical injury or sickness under §104(a)(2).<sup>47</sup>

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<sup>42</sup> IRS Priv. Ltr. Rul. 200121031 (Feb. 16, 2001).

<sup>43</sup> See id. at 1.

<sup>44</sup> See id.

<sup>45</sup> See id.

<sup>46</sup> See Asbestos, Agency for Toxic Substances & Disease Registry, Apr. 1, 2008.

<sup>47</sup> See id. at 4.

The Tax Court, through a memorandum opinion,<sup>48</sup> shed further light on the scope of internal physical injuries in *Parkinson*.<sup>49</sup>

In that case, Ronald Parkinson worked as the Chief Supervisor of the ultrasound and vascular department at Anne Arundel Medical Center (“AAMC”).<sup>50</sup> He regularly worked long hours, often under stressful conditions.<sup>51</sup> Due to the stressful nature of his employment, Ronald suffered a heart attack; he later reduced his working hours.<sup>52</sup> It was at this moment that some employees at AAMC began haranguing Ronald to work longer hours.<sup>53</sup> Because of this harassment, Ronald suffered a second heart attack, which led him to terminate his employment with AAMC.<sup>54</sup>

Ronald filed a claim for Intentional Infliction of Emotional Distress (“IIED”) against AAMC;<sup>55</sup> the parties later settled the IIED claim for noneconomic damages.<sup>56</sup> Noneconomic damages are typically received as taxable income, but the Tax Court opined that Ronald’s heart

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<sup>48</sup> The precedential value of memorandum opinions is contested, but there is no denying that they have at least some precedential effect. See Grewal, Amandeep S. “The Un-Precedented Tax Court.” *Iowa Law Review*, vol. 101, no. 5 (2016). (“The Tax Court should no longer call its Memo opinions non-precedential. The Tax Court, taxpayers, the IRS, and Article III courts routinely cite Memo opinions as persuasive or binding authority. To simultaneously maintain, as the Tax Court does, that Memo opinions lack precedential value sows confusion in the law.”).

<sup>49</sup> *Parkinson v. Comm’r*, 2010 Tax Ct. Memo LEXIS 180.

<sup>50</sup> See id. at 2.

<sup>51</sup> See id.

<sup>52</sup> See id.

<sup>53</sup> See id. at 4.

<sup>54</sup> See id. at 2.

<sup>55</sup> See id. at 4.

<sup>56</sup> See id. at 12.

attacks constituted physical injuries under §104(a)(2).<sup>57</sup> As stated by the Tax Court, “it would seem self-evident that a heart attack and its physical aftereffects constitute physical injury or sickness rather than mere subjective sensations or symptoms of emotional distress.”<sup>58</sup>

These cases represent important developments for the taxable nature of sexual abuse claims. Many sexual abuse cases don’t involve external physical harms from direct bodily contact. This is the case for the array of torts that comprise sexual abuse claims, namely, the torts of false imprisonment, harassment, and IIED. The above cases demonstrate that physical contact isn’t a necessary condition for an injury to satisfy §104(a)(2).

There’s no clear guidance on what other internal injuries satisfy §104(a)(2), but it would be illogical for the IRS to preclude injuries like post-traumatic stress disorder (“PTSD”) from the same exclusion. PTSD has been shown to alter the physical structure of the brain just as a heart attack alters the physical structure of the heart.<sup>59</sup> Individuals who suffer from PTSD are also shown to have damaged autonomic nervous systems, which has lasting impacts on those individuals’ ability to work and function in society.<sup>60</sup> This distinction between emotional and physical injuries is largely illusive; most emotional injuries have an objective physical component and it would be harmful to label such injuries as merely “subjective sensations,” as quoted by the Tax Court in *Parkinson*.

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<sup>57</sup> See *id.* at 15.

<sup>58</sup> *Id.*

<sup>59</sup> Advances in technology allow neurologists to examine the brain at 1-millimeter resolution, in color and in 3-D, enabling detections in small changes in brain activity. See Justin Berton, “PTSD Leaves Physical Footprints on the Brain,” *S.F. Gate*, July 27, 2008.

<sup>60</sup> Sherin, Jonathan E., and Charles B. Nemeroff. “Post-Traumatic Stress Disorder: The Neurobiological Impact of Psychological Trauma.” *Dialogues in Clinical Neuroscience*, vol. 13, no. 3, 2011, pp. 263–78.

The case law has affirmed this position on many occasions. In *United States v. Spinelli*, the Second Circuit adjudicated whether purely emotional injuries could constitute serious bodily injury for purposes of imposing an enhanced sentence pursuant to the United States Sentencing Guidelines.<sup>61</sup> The United States Sentencing Commission (“USSC”) defines serious bodily injury to include injuries that result in the “loss or substantial impairment of a . . . mental faculty.”<sup>62</sup> In *Spinelli*, the court ruled that a purely emotional injury could constitute a serious bodily injury under the USSC guidelines.<sup>63</sup> As a result, the court also held that PTSD could itself constitute a serious bodily injury so long as such injury results in the “loss or substantial impairment of a mental faculty,” evidenced by lasting psychological debilitation;<sup>64</sup> this holding has precedent in other federal circuits.<sup>65</sup>

To conclude, bodily contact is not a necessary prerequisite for incurring a physical injury under §104(a)(2). Therefore, under a claim of sexual abuse, settlement proceeds that flow from internal injuries as a result of the abuse can be also excluded from gross income.

### *Presumption of Physical Injury*

The most important development for the taxable nature of sexual abuse settlements is the presumption of physical injury. In 2008, the IRS issued a Chief Counsel Advisory

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<sup>61</sup> *United States v. Spinelli*, 352 F.3d 48 (2d Cir. 2003).

<sup>62</sup> U.S. Sentencing Guidelines Manual § 1B1.1(k).

<sup>63</sup> See *Spinelli*, 352 F.3d at 57.

<sup>64</sup> *Id.* at 59.

<sup>65</sup> See *United States v. Rodgers*, 122 F.3d 1129, 1132-33 (8th Cir. 1997).

Memorandum<sup>66</sup> (“CCAM”) that provided an important example of when the presumption would apply.<sup>67</sup>

In that case, an entity’s agent had sexually abused a minor child.<sup>68</sup> A substantial amount of time had passed before the minor child eventually filed a claim of tort against the entity.<sup>69</sup> The entity and the sexual abuse survivor settled the claim, but because of the lapse in time, it was difficult for the claimant to substantiate the categorization of the abuse as a personal physical injury under §104(a)(2).<sup>70</sup>

The IRS ruled that, “under these circumstances, it is reasonable for the Service to presume that the settlement compensated [the survivor] for personal physical injuries, and that all damages for emotional distress were attributable to the physical injuries.”<sup>71</sup> In other words, even without evidence of physical injury, the claimant was able to presumptively categorize their claim under §104(a)(2).

Notably however, the CCAM only touched on a fact pattern involving a child sexual abuse survivor. The memorandum expressly reasoned that it was difficult for the claimant to establish physical injuries “because of the passage of time and because C was a minor when the

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<sup>66</sup> “These documents are legal advice, signed by executives in the National Office of the Office of Chief Counsel and issued to Internal Revenue Service personnel who are national program executives and managers. They are issued to assist Service personnel in administering their programs by providing authoritative legal opinions on certain matters, such as industry-wide issues. See IRS, “Legal Advice Issued by Associate Chief Counsel” (last updated May 6, 2022). See also CCDM 33.1.2, Chief Counsel’s Legal Advice Program.

<sup>67</sup> I.R.S. Chief Couns. Mem. 200809001 (Nov. 27, 2007).

<sup>68</sup> See id. at 2.

<sup>69</sup> See id.

<sup>70</sup> See id.

<sup>71</sup> Id.

Tort allegedly occurred.”<sup>72</sup> It’s also true that there could be heightened scrutiny for cases of abuse involving children. As stated by the Supreme Court, “child pornography involves the commission of a crime that inflicts severe *personal injury* to the children who are made to engage in sexual conduct.”<sup>73</sup> In conclusion, the CCA Memorandum may only have direct application to child sexual abuse survivors.

Despite this, there may be indirect application to adult sexual abuse survivors. The same difficulties in substantiating past observable bodily harm, pain, or internal injury will apply to all claimants no matter their age. Apart from the inclusion that the claimant was a child survivor, the facts of the CCAM are left very vague. According to one tax expert, “the lack of factual detail” will lead to a “broader application of the principles enunciated in this ruling.”<sup>74</sup> Thus, although the ruling only concerns child survivors, it cannot be said that the ruling necessarily precludes adult survivors from the same presumption entitlement.

Therefore, where a claimant cannot presently substantiate a claim of physical injury that was suffered when the claimant was a minor, the IRS will generally presume that the claimant suffered personal physical injuries under 104(a)(2); adult survivors may also be entitled to this presumption of physical injury depending on the facts at hand.

## **II. Compensatory Sexual Abuse Settlements Are Excluded From Income**

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<sup>72</sup> Id.

<sup>73</sup> United States v. Stevens, 559 U.S. 460, 493 (2010).

<sup>74</sup> Wood, Robert. “IRS Allows Damages Exclusion Without Proof of Physical Harm.” Tax Notes, 2008, pp. 1390. “The lack of factual detail is probably a good thing, leading to a broader application of the principles enunciated in this ruling.”

### Punitive Damages

The SBJPA amended §104(a)(2) to preclude punitive damages from personal injury exclusion.<sup>75</sup> Now, §104(a)(2) plainly states that gross income will not include “the amount of any damages, other than punitive damages, received [...] on account of personal physical injuries or physical sickness.”<sup>76</sup> Thus, because punitive damages represent additions of wealth, those damages will be taxed in a personal injury settlement.<sup>77</sup>

### Compensatory Damages

The Internal Revenue Code provides that certain compensatory damages be excluded from gross income.<sup>78</sup> According to §104(a)(2), gross income will not include “the amount of any damages [...] received [...] on account of personal physical injuries or physical sickness.”<sup>79</sup>

Under the SBJPA amendment to §104(a)(2), damages for emotional distress and the symptoms that may result from emotional distress (insomnia, headaches, or stomach disorders) cannot be excluded from gross income when those damages relate to a claim of “emotional injury.”<sup>80</sup> This is reflected in the flush language of the §104(a), which states that “emotional

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<sup>75</sup> See Small Business Job Protection Act § 1605 (1996).

<sup>76</sup> 26 U.S.C. § 104(a)(2) (1954).

<sup>77</sup> See NCA Argyle LP v. Comm’r, T.C. Memo 2020-56.

<sup>78</sup> 26 U.S.C. § 104(a) (1954).

<sup>79</sup> Id.

<sup>80</sup> Small Business Job Protection Act § 1605 (1996).

distress is not considered a physical injury or sickness.”<sup>81</sup> Thus, damages for emotional distress fall outside the purview of §104(a)(2), and consequently, cannot be deducted from gross income *on their own*.

Despite this, it would be incorrect to say that damages for emotional distress are always taxable. As stated in the language of 104(a)(2), “any damages on account of personal physical injury or sickness are excludable from gross income.”<sup>82</sup>

The legislative history of 104(a)(2) is clear, “because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness.”<sup>83</sup> This fact is illustrated in the Tax Court case, *Parkinson*.<sup>84</sup>

As herein mentioned, Ronald Parkinson sued his employer, AAMC, solely under a claim of IIED.<sup>85</sup> Through a settlement agreement, Parkinson and AAMC resolved all their disputes, with the medical center agreeing to pay Parkinson \$350,000 as noneconomic damages.<sup>86</sup> The settlement agreement did not expressly allocate or characterize the settlement payment other than to state that it was for noneconomic damages.<sup>87</sup>

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<sup>81</sup> 26 U.S.C. § 104(a)(6)(B) (1954).

<sup>82</sup> *Id.*

<sup>83</sup> H. Conf. Rept. 104-737, at 301 n.56 (1996).

<sup>84</sup> *Parkinson v. Comm’r*, 2010 Tax Ct. Memo LEXIS 180.

<sup>85</sup> *See id.* at 3,12.

<sup>86</sup> *Id.* at 6.

<sup>87</sup> *Id.* at 11-12.



The Tax Court determined that Parkinson had suffered both physical and emotional injuries within his claim of IIED.<sup>88</sup> Because no allocation was made, the Tax Court loosely, and somewhat arbitrarily, held that half of the settlement should be attributable to the physical injury (heart attack) and the other half should be attributable to emotional distress.<sup>89</sup> Despite the fact that the settlement was entirely comprised of noneconomic damages<sup>90</sup> under a claim of emotional injury (IIED), the court still held that the half attributable to the physical injury could be excluded from gross income under §104(a)(2).<sup>91</sup>

Therefore, damages and or settlement proceeds that are expressly allocated or characterized as compensation for a physical injury – even if they are not related to visible injuries – can be excluded from gross income under §104(a)(2).

### **III. The IRS Will Give Deference to the Express Terms of a Settlement Agreement**

Under §104(a)(2), gross income does not include the amount of any damages [...] received, whether by suit or agreement, [...] on account of personal physical injuries or sickness.<sup>92</sup>

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<sup>88</sup> See *id.* at 17-18.

<sup>89</sup> See *id.* at 19.

<sup>90</sup> 42 U.S.C. § 247d-6d(e)(8) (1944). “The term ‘noneconomic damages’ means damages for losses for physical and emotional pain, suffering, inconvenience, physical impairment, mental anguish, disfigurement, loss of enjoyment of life, loss of society and companionship, loss of consortium, hedonic damages, injury to reputation, and any other nonpecuniary losses.

<sup>91</sup> See *id.*

<sup>92</sup> 26 U.S.C. § 104(a)(2) (1954).

“Damages received ‘whether by suit or agreement’ means an amount received [...] through prosecution of a legal suit or action based upon tort or tort-type rights, or through a settlement agreement entered into in lieu of such prosecution.”<sup>93</sup>

To determine whether a settlement is excludable under §104(a)(2), a court must determine whether the settlement amount was received for claims based upon tort or tort type rights as well as paid on account of personal physical injuries or sickness.<sup>94</sup>

Where damages are received pursuant to a settlement agreement, the nature of the claim that was the actual basis for settlement controls whether those damages are excludable under §104(a)(2).<sup>95</sup> To assess whether settlement damages are excludable, the key question is “in lieu of what were the damages awarded.”<sup>96</sup> This determination is factual and is generally made by reference to the settlement agreement in light of the surrounding circumstances.<sup>97</sup>

Where there is an express allocation contained in a settlement agreement, it will be followed in determining what settlement proceeds are received as compensation for personal injuries, provided the agreement is entered into by the parties in an adversarial context, at arm's length, and in good faith.<sup>98</sup> However, an express allocation set forth in the settlement is not

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<sup>93</sup> Church v. Comm’r, 80 T.C. 1104, 1106 (1983).

<sup>94</sup> See Schleier, 515 U.S. at 337.

<sup>95</sup> Burke, 504 U.S. at 237.

<sup>96</sup> Church, 80 T.C. at 1107.

<sup>97</sup> Robinson v. Comm’r, 102 T.C. 116, 126 (1994).

<sup>98</sup> Bagley v. Comm’r, 105 T.C. 396, 406 (1995).

necessarily determinative if other facts indicate that the payment was intended by the parties to be for a different purpose.<sup>99</sup> There are many case that exemplify this principle.

In *Burditt*, the Tax Court overruled the express language of a settlement agreement because the terms of settlement agreement were not made in an ‘adversarial context’ and were instead ‘tax-motivated.’<sup>100</sup> In that case, the petitioner had instructed the attorney engaging in the settlement negotiations to “make sure he inserted the ‘proper personal injury language’ so that proceeds could be received free of tax; the attorney consulted an accountant for this purpose, who provided ‘boilerplate’ language.”<sup>101</sup>

In *Mitchell*, the Tax Court also overruled the express allocations of a settlement agreement.<sup>102</sup> There, the court had determined that express allocations were not made in an adversarial context where the taxpayer drafted the document without the participation or approval of his adversary.<sup>103</sup>

If the settlement agreement lacks express language stating that the payment was (or was not) made on account of personal injury, then the most important fact in determining how §104(a)(2) is applied is ‘the intent of the payor’ as to the purpose in making the payment.”<sup>104</sup>

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<sup>99</sup> Id.

<sup>100</sup> Burditt v. Comm’r, 1999 Tax Ct. Memo LEXIS 131.

<sup>101</sup> Id. at 23.

<sup>102</sup> See Mitchell v. Comm’r, T.C. Memo 1990-617, 1378.

<sup>103</sup> See id.

<sup>104</sup> Bent v. Comm’r, 87 T.C. 236, 245 (1986) (citing Knuckles v. Comm’r, 349 F.2d 610, 613 (10th Cir. 1965), and Fono v. Comm’r, 79 T.C. 680, 694 (1982)).

If the payor's intent cannot be clearly discerned from the settlement agreement, his or her intent must be determined from all the facts and circumstances of the case.<sup>105</sup> “Factors to consider include the details surrounding the litigation in the underlying proceeding, the allegations contained in the payee's complaint and amended complaint in the underlying proceeding, and the arguments made in the underlying proceeding by each party there.”<sup>106</sup> “None of these factors are always outcome-determinative; in a given case, any of these factors may ultimately be persuasive or ignored.”<sup>107</sup>

Despite the seemingly holistic approach taken by the Tax Court above, the court has often precluded proceeds from §104(a)(2) exclusion when settlement agreements had failed to expressly allocate those proceeds to personal physical injuries.

In *Tressler*, the Tax Court precluded income exclusion even when the underlying complaint giving rise to the claim had asserted personal physical injuries.<sup>108</sup> As stated by the Tax Court there, “we recognize that petitioner's complaint in District Court included allegations of physical injuries, but section 2.5 [of the settlement agreement] does not state that any part of the \$55,000 payment is attributable to the settlement of a physical injury claim.”<sup>109</sup>

In *Gutierrez*, a seemingly valid §104(a)(2) claim was also precluded from income exclusion because the agreement failed to allocate settlement proceeds to a personal physical

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<sup>105</sup> Robinson, 102 T.C. at 126.

<sup>106</sup> *Id.* (citing Estate of Morgan v. Comm’r, 332 F.2d 144, 150-151 (5th Cir. 1964); Threlkeld v. Comm’r, 87 T.C. 1294, 1306 (1986); Bent, 87 T.C. 245).

<sup>107</sup> Threlkeld, 87 T.C. at 1306.

<sup>108</sup> Tressler v. Comm’r, 2021 Tax Ct. Summary LEXIS 32, 6.

<sup>109</sup> Id.

injury.<sup>110</sup> As stated by the Tax Court in that case, “the fact that the settlement agreement does not reference any physical injury persuades us that there was no intention to compensate for physical injury.”<sup>111</sup>

The above cases signify the importance of express settlement agreement allocations. As shown, the absence of express language will often preclude settlement proceeds from being received as compensation for personal injury.

To conclude, the IRS will give deference to an express settlement agreement that is entered into in an adversarial context, at arm’s length, and in good faith, provided that no other facts indicate the parties intended the payment to be for any other purpose. Thus, all proceeds that are allocated as damages for personal physical injury within a deferred upon settlement agreement will be excluded from gross income inclusion.

#### **IV. The IRS Will Always Defer to Consistent Language in the Pleadings and Agreement**

When a settlement agreement clearly allocates settlement proceeds to tort-like personal injury damages, that allocation is generally binding for tax purposes if the agreement is entered into by the parties in an adversarial context, at arm's length, and in good faith.<sup>112</sup>

However, an express allocation set forth in the settlement is not necessarily determinative if other facts indicate that the payment was intended by the parties to be for a different

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<sup>110</sup> Gutierrez v. Comm’r, 2011 Tax Ct. Memo LEXIS 254, 10.

<sup>111</sup> Id.

<sup>112</sup> Bagley, 105 T.C. at 407.

purpose.<sup>113</sup> As stated in *Bent*, the most important factor to be considered under §104(a)(2), other than the express language of a settlement agreement, is the intent of the payor.<sup>114</sup>

To assess the ‘intent of the payor’ a court will look to the surrounding facts of the case, the allegations contained in the complaint, and the arguments made in the underlying proceeding.<sup>115</sup>

In most instances however, a sexual abuse case will not progress far enough for argumentative proceedings to provide guidance on the nature of the claim. As a result, only the complaint giving rise to the underlying claim will be able to provide evidence of the payor’s intent. As a result, the Tax Court has and will continue to look to the complaint to assess the intent of the payor.<sup>116</sup>

In one specific case, the Tax Court determined settlement proceeds were not received under §104(a)(2) because the “settlement agreement and the second amended complaint together do not show that the actual basis of settlement was on account of personal injury.”<sup>117</sup>

Furthermore, “in the context of a settlement agreement, determining the exclusion from gross income depends on the nature of the claim, which was the actual basis for settlement, not the validity of the claim.”<sup>118</sup> Consequently, the Tax Court must accept all allegations within a

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<sup>113</sup> *Id.* at 406.

<sup>114</sup> *Bent*, 87 T.C. at 244, *affd.* 835 F.2d 67 (3d Cir. 1987).

<sup>115</sup> See *Robinson*, 102 T.C. at 126.

<sup>116</sup> See *Knuckles*, 349 F.2d at 613; *Tishkoff v Comm’r*, 2016 Tax Ct. Summary LEXIS 66, 11.

<sup>117</sup> *Emerson v Comm’r*, 2003 Tax Ct. Memo LEXIS 81, 17.

<sup>118</sup> *Seay v. Comm’r*, 58 T.C. 32, 37 (1972).

complaint if those allegations are consistently outlined as the basis for damages in a settlement agreement.

Therefore, settlements proceeds will be received tax free under §104(a)(2) if the pleadings and settlement agreement consistently provide that damages will be received to compensate a qualifying physical injury or sickness.

#### **V. The IRS Will Also Give Deference to the Terms of a Global Settlement Agreement.**

When a global settlement agreement clearly allocates settlement proceeds to tort-like personal injury damages, that allocation is generally binding for tax purposes.<sup>119</sup>

In *Amos*, the Tax Court addressed the question of whether a global settlement agreement that releases a payor from tort liability, but also provides him with other benefits, is excludable from the recipient's gross income under section 104(a)(2).<sup>120</sup> In order to receive the settlement money at issue, the taxpayer not only waived all potential claims against the payor, but also agreed to maintain the confidentiality of all matters pertaining to the incident and to repay the entire settlement amount as liquidated damages should he breach that confidentiality.<sup>121</sup>

Ultimately, the court held that the intent of the payor was critical in determining whether the settlement was excludable by the recipient. Finding that the payor's dominant reason in paying the settlement was to compensate for claimed physical injuries, the court concluded that

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<sup>119</sup> *Amos v. Comm'r*, 2003 Tax Ct. Memo LEXIS 330, 17.

<sup>120</sup> *See id.*

<sup>121</sup> *See id.*

60% of the settlement income was excludable. Because the agreement expressly provided that a portion of the settlement money was paid in consideration for the taxpayer's silence on all matters pertaining to the incident, however, the court ruled that the remaining 40% was included in gross income."<sup>122</sup>

While the Tax Court's attempt to allocate the settlement income between its taxable and nontaxable elements lacked any meaningful precedential guidance, the allocation nevertheless was an appropriate undertaking given the judicial construction of the section 104(a)(2) exclusion. Thus, the same deference applies to global settlement agreements as well as single-claimant settlement agreements.

## ***CONCLUSION***

Sexual abuse claims within the context of mass tort litigation should be excluded from gross income under §104(a)(2) if a global settlement agreement stipulates that proceeds are being received on account of physical injuries.

First, almost all forms of sexual abuse will cause a survivor to suffer a personal physical injury. The IRS has stated that ‘observable bodily harms’ like bruises, cuts, bleeding, or swelling are physical injuries. This means that rape survivors will always be able to claim a personal physical injury in their complaint and settlement agreement. A showing of observable bodily harm is sufficient for income exclusion, but it’s far from necessary as well.

Heart attacks and diseases have also been deemed to be personal physical injuries when attached to a tort claim. So, if a survivor suffers a heart attack or other internal injury as a result

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<sup>122</sup> See *id.*



of harassment or false imprisonment, the damages allocated to that injury will be received tax free.

It's unclear what other internal injuries satisfy §104(a)(2), but the IRS's logic should incorporate disorders. Science supports this assertion. Internal injuries like PTSD have been shown to alter the physical structure of the brain just as a heart attack alters the physical structure of the heart. Individuals who suffer from PTSD have also been shown to have damaged autonomic nervous systems. Despite this logical conclusion, the social dialogue still needs time to catch up to the established science. Until this stigma wanes, damages that flow from disorders cannot be conclusively held as excluded from gross income.

Sexual abuse claims that involve physical (bodily) pain can also be excluded under §104(a)(2), though on a narrower basis than claims which can substantiate observable harm or a qualifying internal injury. Evidence of observable bodily harm is an objective showing. If there is observable bodily harm stemming from a tort, those damages will be tax free. In contrast, physical pain is a subjective showing which can only be established case-by-case. Thus, the more facts that support the allegation of physical pain, the more likely a settlement will be entitled to §104(a)(2) exclusion.

In cases where a claimant does not have the present ability to substantiate a physical injury, the IRS has ruled that it will presume the damages relate to a physical injury. The presumption of physical injury should apply to both minor and adult survivors. For both types of survivors, the lapsing of time will obstruct the survivor's ability to substantiate physical injuries. There is no explicit time period where the presumption would apply. The presumption will apply in any case where the lapsing of time has made it difficult to establish physical injuries, as stated

by the IRS in ILM 200809001. Therefore, settlement proceeds used to compensate past physical injuries that cannot be presently supported can also be excluded from gross income.

Second, all damages that flow from a personal injury will be excludable from gross income under §104(a)(2). This fact is important for sexual abuse cases that are settled out of court. Often times, sexual abuse settlements will almost entirely be comprised of noneconomic damages. Therefore, if litigants choose to allocate all damages of a sexual abuse claim to a physical injury, all of those damages will be received tax free.

Third, the express allocations in a settlement will be legally binding if the litigants negotiate the terms in an adversarial context, at arm's length, and in good faith. On some occasions, express language can be challenged if the facts indicate the parties did not intend the payments to compensate physical injuries. In these cases, the parties had not negotiated the terms of the agreement in an adversarial context, at arm's length, and in good faith. When the language of a settlement agreement is challenged, a court will look to the intent of the payor to determine the proper tax allocation.

For sexual abuse cases that include testimonies, in-court arguments, and other civil proceedings, all facts will be taken into consideration to determine the intent of the payor. However, most sexual abuse claims will not advance this far. In most cases, a court will look to the claimant's pleadings to determine what injuries the payor intended to compensate.

Fourth, the IRS cannot challenge the allegations of a complaint. Proper tax allocation depends on the nature of the claim that gave rise to the settlement. The validity of the claim must be respected by the IRS. As a result, pleadings can outline that all damages of the case flow from

the survivor's physical injuries. If this same express allocation is included in a settlement agreement, the IRS must give deference to it.

Lastly, this deference also applies to global settlement agreements. Therefore, global settlement agreements can stipulate to the receipt of settlement proceeds under §104(a)(2) on behalf of sexual abuse survivors.

All in all, this is the most important takeaway for the legal community to receive from this memorandum:

A mass tort global settlement agreement that clearly and consistently outlines how a sexual abuse tort contributed to physical injuries, and how the damages of those claims are being received on account of physical injuries under §104(a)(2), will allow claimants to receive the proceeds tax exempt.

Sexual abuse survivors deserve full compensation for the injuries they have suffered. Survivors cannot be compensated fully if large portions of their settlements must be taxed. The legal community has a duty to provide guidance on §104(a)(2) and other laws<sup>123</sup> that can help survivors moving forward. Now more than ever, as mass tort and multi-party sex abuse litigations unfold, we must provide clear and concise guidance on this issue so that survivors can obtain as much recourse as they deserve. For cases involved in the Uber Passenger Sexual Abuse Litigation, Boy Scouts of America Litigation, various clergy/diocese sex abuse litigations, and

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<sup>123</sup> Title 26, §213 of the IRC provides a tax deduction for any medical expenses that exceed 7.5% of your adjusted gross income for the year. 26 U.S.C. § 213(a) (1954). This medical deduction is limited to medical expenses that are primarily incurred to alleviate or prevent a physical or mental disability or illness. See *Havey v. Comm'r*, 12 T.C. 409 (1949). As held by the Tax Court in *Hendrick*, “the definition of medical expenses is sufficiently broad to include amounts paid to qualified psychologists and psychiatrists.” *Hendrick v. Comm'r*, 35 T.C. 1223, 1237 (1961). The injuries associated with sexual abuse trauma is unquestionably covered by the broad reach of §213(a). Therefore, any medical expenses (therapy, medication, etc.), in excess of 7.5% of the taxpayer's gross income, and that are incurred by a sexual abuse survivor to treat their trauma, will be entitled to the §213 medical expense deduction.

any others, attorneys and survivors must be aware of the contents of this memo to ensure they fully consider the taxation of their sexual abuse settlements.