

Congress Should Pass Sex Abuse Settlement Tax Exemptions

By **Rocco Strangio** (January 27, 2025)

The proposed Survivor Justice Tax Prevention Act would expand the language within the personal injury statute to also include many forms of sexual abuse, effectively giving them access to tax exemption.

This bill, introduced in Congress in October 2024, is important, not just because it would expand tax exemptions more clearly for sexual abuse cases, but more so for the fact that it would finally remove the stigma around compensation for emotional and psychological damage.



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This article discusses the tax dichotomy of personal injury cases, advocates for the Survivor Justice Tax Prevention Act, and lastly, provides attorneys with other avenues to achieve a tax exemption for their survivor claimants, even if this legislation fails.

Background

Reps. Lloyd Smucker, R-Pa., and Gwen Moore, D-Wis., members of the U.S. House Ways and Means Committee, jointly introduced the Survivor Justice Tax Prevention Act during Domestic Violence Awareness Month in October. The legislation would amend the nation's tax code to ensure survivors of sexual abuse and unwanted and illegal sexual contact do not have to pay taxes on settlement recourse they receive after prevailing against their abusers.

To understand the importance of this bill, we must understand how the Internal Revenue Service currently taxes personal injury and sexual abuse cases. Under Title 26 of the U.S. Code, Section 104(a)(2), any damages received on account of personal injury or sickness are excluded from gross income.[1]

The theory is that compensation is designed to make the injured plaintiff "whole" — meaning putting them in the position that they would have been in had no incident ever happened. In such a scenario, plaintiffs haven't gained anything, and thus, there is no consequential income to tax.

Physical Injury Requirement

In 1996, Congress passed the Small Business Job Protection Act, which amended Section 104(a)(2) to require that personal injuries or sickness be physical for the taxpayer to qualify for income exclusion.[2] In October 2000, the IRS issued a nonbinding private letter ruling, commonly referred to as the bruise ruling, in which it determined 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).[3]

Although nonbinding, private letter rulings represent the IRS' stance on the tax law at a particular snapshot in time.[4] The above private letter ruling did well to clarify a specific set of injuries that will qualify for Section 104(a)(2) exemption.

However, the issue for sexual abuse survivors is that not all instances of sexual abuse have overt bodily harms that are visible to the naked eye. Rather, in many cases, survivors will suffer internal injuries that can't be easily substantiated to a claim of abuse. As a result, the U.S. Tax Court has ruled that in certain situations internal injuries can also be afforded tax exemption.

In 2010, the Tax Court offered a useful example of this in *Parkinson v. Commissioner*.^[5] There, work-related stress and harassment caused an individual to suffer a heart attack.^[6] That employee filed an emotional distress claim, and it was held that all damages flowing from that heart attack were nontaxable.

That same year, the Tax Court ruled on *Domeny v. Commissioner*.^[7] In that case, stressful work conditions exacerbated a worker's preexisting multiple sclerosis.^[8] There, the IRS again found damages flowing from that injury to be nontaxable under Section 104(a)(2).

These cases and many others show that physical injury is not limited to the overt and external bodily harms listed in the bruise ruling. Physical injury will also include internal injuries, the breadth of which goes beyond just heart attacks and strokes.

Despite offering positive guidance for certain cases of sexual abuse, these examples fall short for the majority of survivors. In many cases, the most consequential damages are the lasting emotional and psychological harms that survivors are forced to endure.^[9] While it is true that emotional, mental and psychological consequences do not fall under the IRS' definition of physical damage, they are life-altering in the same way a physical injury may be.

In other areas, settlements on account of psychological disorders like post-traumatic stress disorder provide recourse to survivors and seek to make them whole once more. It should be held that such settlements fit within the ambit of Section 104(a)(2) and the statute's overall purpose. Without explicit legislation, however, these cases fall in a gray area.

Survivor Justice Tax Prevention Act

The Survivor Justice Tax Prevention Act would clear up this gray area by modifying Section 104(a)(2) to exclude from gross income any damages, other than punitive damages, received by a taxpayer on account of a "sexual act"^[10] or "sexual conduct."^[11] Adding this language will clear up the confusion surrounding the taxation of damages paid on account of sexual abuse injuries.

Abuse that comports with the definitions of sexual acts and conduct will automatically satisfy Section 104(a)(2) and receive tax exemption. It must be noted though, that the revised statute would not necessarily preclude tax exemption for damages paid on account of sexual abuse that does not fit within the definitions of sexual acts or conduct.

Rather, abuse such as harassment that leads to internal or external physical injury, would still be afforded a tax exemption under Section 104(a)(2).

Current Best Practice

Even if the bill does not pass, attorneys have the ability to secure tax-exempt settlements for their survivor clients. The vast majority of civil suits do not reach trial and tend to be resolved through a settlement agreement.^[12]

When 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 Section 104(a)(2).[13] The nature of the claim is a factual determination generally made by reference to the settlement agreement in light of the surrounding circumstances.[14]

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.[15]

The latter requirement cannot be overlooked.

In the 1999 case of *Burditt v. Commissioner*, the Tax Court overruled the express language of a settlement agreement because the terms of the settlement agreement were not made in an "adversarial context" and were instead "tax-motivated." [16] 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." [17]

And in 1990, in *Mitchell v. Commissioner*, the Tax Court also overruled the express allocations of a settlement agreement since the taxpayer drafted the document without the participation or approval of his adversary. [18]

Further, the most important factor to be considered under Section 104(a)(2), other than the express language of a settlement agreement, is the intent of the payor. [19] 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. [20]

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. Thus, the Tax Court has and will continue to look to the complaint to assess the intent of the payor. [21]

In one specific case from 2003, *Emerson v. Commissioner*, the Tax Court determined settlement proceeds were not received under Section 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." [22]

In summary, Tax Court guidance suggests that consistency between a well-formulated complaint and settlement agreement expressly stating that damages are being received on account of physical injury will ensure that such proceeds are nontaxable, provided the agreement is entered into in good faith and at arm's length.

Conclusion

The above-mentioned guidance would seem to make the recently introduced bill unnecessary. This belief is wrong for two reasons.

First, we cannot rely solely on the aforementioned guidance to safeguard all survivors. In many cases, to protect survivors and their own practices, attorneys are forced to obtain

tailored tax opinions confirming that settlements are tax-exempt for their clients. These personalized opinions oftentimes are paywalled and too expensive to obtain for the tax benefit involved.

Second, and arguably most important, is that Smucker and Moore's proposed legislation seeks to remove a stigma that is attached to emotional and psychological injuries. As mentioned earlier, some of the most consequential damages in sexual abuse cases may be the emotional and psychological effects that persist throughout a survivor's lifetime.

With the proposed legislation, any damages associated with certain acts of sexual abuse, even damages compensating for emotional and psychological distress, will be viewed as intended to make survivors whole. This is a hard-line stance that will ultimately afford more recourse to the hundreds of thousands of sexual abuse survivors in this country.

My colleagues and I fully back this bill, and I encourage other members of the bar to support it as well.

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[1] 26 U.S.C. § 104(a)(2) (1954).

[2] See Small Business Job Protection Act of 1996, Pub. L. 104-188, § 1605, 110 Stat. (1996).

[3] I.R.S. Priv. Ltr. Rul. 200041022 (Oct. 13, 2000).

[4] "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."

[5] *Parkinson v. Comm'r*, 2010 Tax Ct. Memo LEXIS 180.

[6] See *Id.*

[7] *Domeny v. Comm'r*, 2010 Tax Ct. Memo LEXIS 9.

[8] See *Id.*

[9] Pasque, Lisa Speckhard. "The Lingering Effects of Sexual Trauma." Mayo Clinic Press, 7

June 2023, <https://mcpres.mayoclinic.org/women-health/lingering-effects-of-sexual-trauma/>.

[10] The term "sexual act" means

(A) contact between the penis and the vulva or the penis and the anus, and for purposes of this subparagraph contact involving the penis occurs upon penetration, however slight;

(B) contact between the mouth and the penis, the mouth and the vulva, or the mouth and the anus;

(C) the penetration, however slight, of the anal or genital opening of another by a hand or finger or by any object, with an intent to abuse, humiliate, harass, degrade, or arouse or gratify the sexual desire of any person; or

(D) the intentional touching, not through the clothing, of the genitalia of another person who has not attained the age of 16 years with an intent to abuse, humiliate, harass, degrade, or arouse or gratify the sexual desire of any person.

[11] The term "sexual contact" means the intentional touching, either directly or through the clothing, of the genitalia, anus, groin, breast, inner thigh, or buttocks of any person with an intent to abuse, humiliate, harass, degrade, or arouse or gratify the sexual desire of any person.

[12] <https://www.roycomer.com/most-civil-cases-settle-prior-to-trial/>

[13] *Burke*, 504 U.S. at 237.

[14] *Robinson v. Comm'r*, 102 T.C. 116, 126 (1994).

[15] *Bagley v. Comm'r*, 105 T.C. 396, 406 (1995).

[16] *Burditt v. Comm'r*, 1999 Tax Ct. Memo LEXIS 131.

[17] *Id.* at 23.

[18] See *Mitchell v. Comm'r*, T.C. Memo 1990-617, 1378.

[19] *Bent*, 87 T.C. at 244, *affd.* 835 F.2d 67 (3d Cir. 1987).

[20] See *Robinson*, 102 T.C. at 126.

[21] See *Knuckles*, 349 F.2d at 613; *Tishkoff v. Comm'r*, 2016 Tax Ct. Summary LEXIS 66, 11.

[22] *Emerson v. Comm'r*, 2003 Tax Ct. Memo LEXIS 81, 17.