

Focus: Personal Injury

Maximizing the medical care exception to the tax on emotional distress damages

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When clients receive personal injury damages in a settlement or award, their tax liability can make the difference between a sufficient and an insufficient recovery.

For those plaintiffs receiving damages on account of a “physical” injury, § 104(a)(2) generally prevents such liability. However, non-physical damages like emotional distress are typically taxable, unless they are consequences of a “physical” injury. Damages paid for physical symptoms resulting from emotional distress are also taxable.

The one codified exception, found in § 104(a), excludes from gross income “damages not in excess of the amount paid for medical care ... attributable to emotional distress.” Plaintiff and defense attorneys, settlement planners and special needs planners should always consider this exception if a plaintiff has paid or



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will incur consequential medical care expenses. By doing so, plaintiffs may benefit more, and defendants may pay less.

The policy rationale for the exception seems self-evident. To the extent that a defendant is reimbursing a plaintiff for past expenses, damages are not “income” in the traditional sense. Of course, many have argued that where defendant is paying plaintiff for past injuries, the damages are also “making plaintiff whole.” For this reason, the National Taxpayer Advocate at the IRS has recommended to Congress that all emotional distress damages be received tax-free.

In any case, when a client plans to receive damages on account of emotional distress, taking advantage of the medical care exception requires deliberate planning. As will be discussed, while excluding damages based on *past medical care expenses* is relatively straightforward, excluding damages based on *future medical care expenses* is anything but.

Due to the ambiguity, and to achieve additional financial benefit, plaintiff attorneys should consider and discuss with clients the option of using a structured settlement.

Past medical care expenses

For tax purposes, plaintiffs can subtract from their emotional distress damages any medical care expenses incurred as a result of the emotional distress being compensated for, so long as the expenses were not previously deducted.

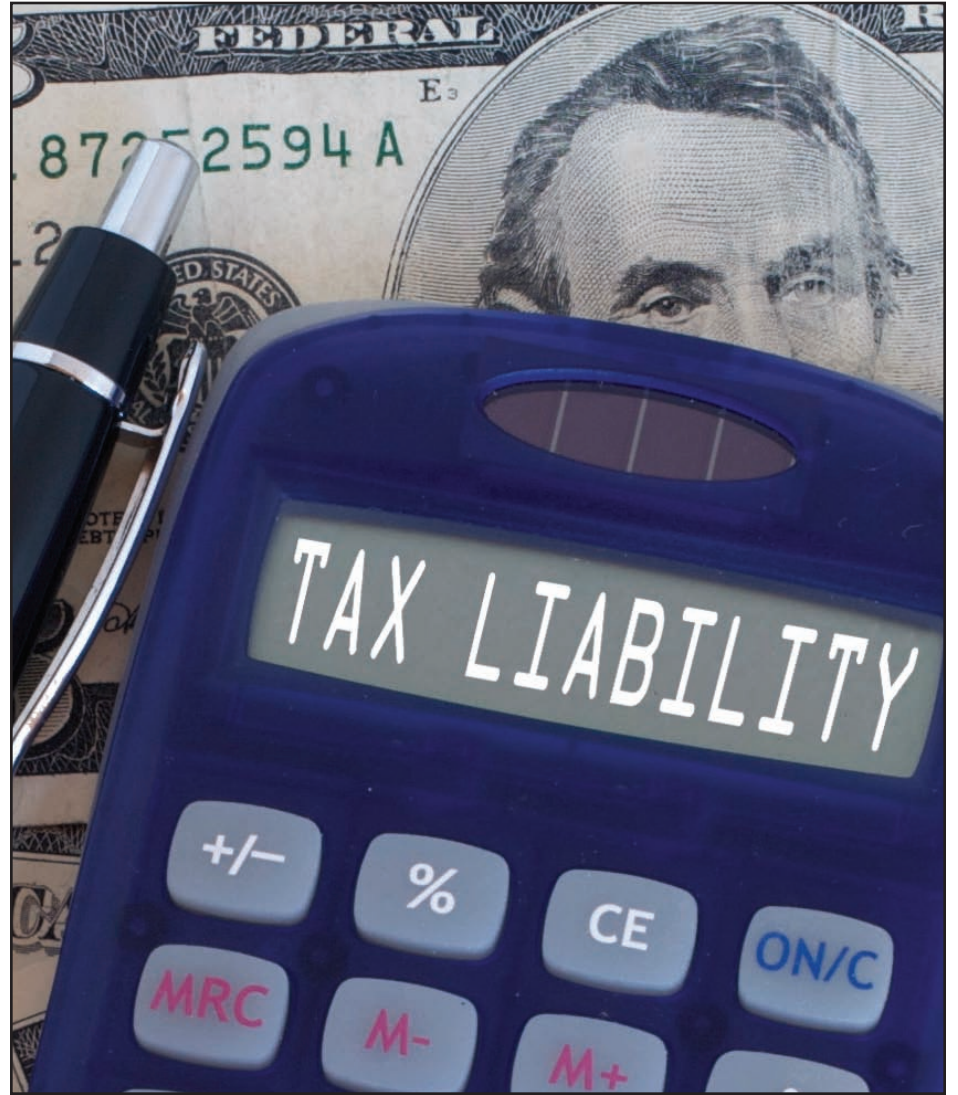
Here, the law is fairly straightforward. The definition of “medical care,” which can be found in § 213(d), is the same as the one that governs medical expense deductions.

While there is no case law directly requiring a settlement or award to allocate a portion of damages to prior medical care expenses, doing so is probably wise. This is especially true when some expenses are not obviously attributable to the asserted personal injury.

In the physical injury damages context, the IRS provides a presumption of correct allocation to medical expenses. Revenue Ruling 75-230 stated just this, with the caveat that the presumption disappears if the allocation “is unreasonable in the light of all the facts.”

Future medical care expenses

Unfortunately, there is considerable ambiguity in determining whether a plaintiff can exclude damages paid for future medical care expenses. Again, plaintiffs can receive damages on account of emotional distress tax-free “not in excess of the amount paid for medical care ... attributable to emotional distress.”



A straightforward reading of the exception might lead to the conclusion that it applies only to damages compensating for *past* medical care expenses. After all, the law refers to the amount *paid* for medical care, not *paid or to be paid* for medical care. At best, the law only arguably applies to future medical care.

Of course, the language might be referring to the damages that the plaintiff is being *paid for medical care*. Pursuant to this interpretation, what matters would not be the actual expenses the plaintiff incurs, but rather the amount of damages the defendant pays the plaintiff with such expenses in mind.

In fact, this may be the current IRS interpretation. In IRS Publication 525, the exception is said to apply to “any damages you receive for medical care due to [the] emotional distress.”

While this may provide some comfort when considering whether to advise a client to allocate and exclude emotional distress damages for future medical care, one should proceed with caution. There are two reasons to believe that this interpretation may not win out, even if enforcement concerns are reduced.

First, the language of § 104 suggests that the payee in the medical care exception is the medical care provider, and not the plaintiff. This would mean that emotional distress damages received by plaintiff are tax-free only when equal or less than medical care expenses paid by the plaintiff.

The implication derives from language throughout § 104, which provides several damages exclusions. Repeatedly, the section excludes from gross income amounts “received.” For example, § 104(a)(1) excludes “amounts received under workmen’s compensation acts as compensation for personal injuries or sickness.”

The word “received” is used for only the plaintiff taxpayers. “Paid” is used once outside of the medical care exception context, and refers to the compensating party, not the compensated party. Thus, the Service’s interpretation that “any damages [a taxpayer] receive[s] for medical care due to [the] emotional distress” seems inconsistent with the Code’s use of “paid.” The medical care exception excludes “damages not in excess of the amount paid for medical care ... attributable to emotional distress.”

Second, dictum in a 2004 Tax Court Summary Opinion may also suggest that the medical care exception applies only to damages received for past medical care. In *Oyelola* (T.C. Summary Opinion 2004-289), the Tax Court considered whether a portion of a racial discrimination settlement was physical or non-physical.

Finding the portion to represent damages for emotional distress, the court noted the medical care exception to emotional distress damages being fully taxable. Rather than quoting the law verbatim, however, the court twice rephrased the exception by adding the word “actually.” Thus, emotional distress damages are taxable “except for amounts actually paid for medical care attributable to the emotional distress.”

The Tax Court’s language of “actually paid” may suggest that the medical care exception applies only to damages for medical care “already paid.” Likewise, it may suggest that the payee of the medical care must be the medical care provider. Otherwise the emphasis produced by the word “actually” could only be interpreted as mandating a correct settlement allocation.

These arguments can all be made. Unfortunately, even after considering relevant guidance and precedent, one is left with ambiguity. Plaintiff clients should be advised that allocating future medical care for emotional distress in a personal injury settlement may not secure them the tax benefit of the medical care exception. Fortunately, a settlement can be designed to take advantage of the exception, even for future medical care.

Structured settlements

Because the ambiguity results from the receipt of damages before medical care expenses are paid, plaintiff clients can sidestep the ambiguity by postponing receipt for tax purposes until they have incurred the matching medical care expenses.

Plaintiff attorneys can achieve this result by using a “structured settlement.” Structured settlements provide for plaintiffs to receive periodic payments over given lengths of time, sometimes the life of a plaintiff.

Much has been written on the tax mechanics of structured settlements. It is safe to say, in summation, that although

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