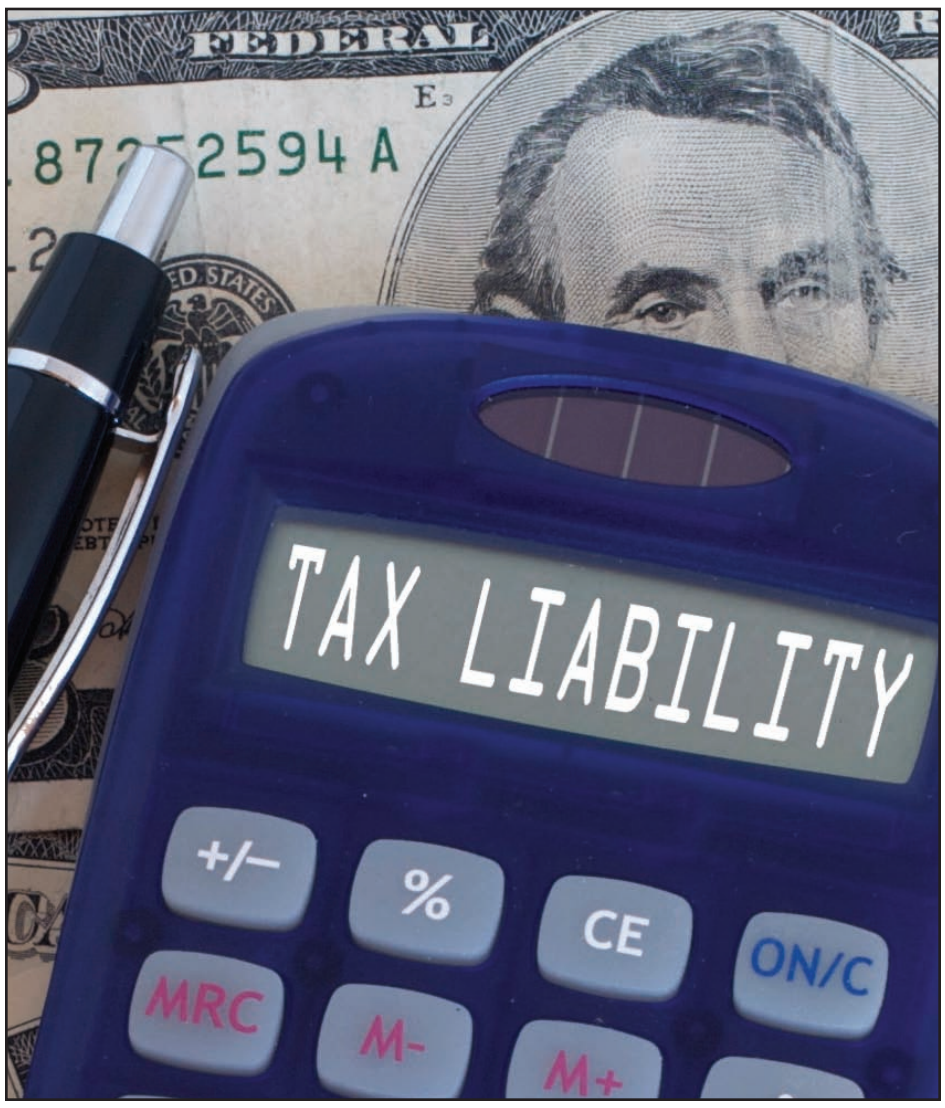
Focus: Personal Injury

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




**By JEREMY BABENER, Special to Lawyers Weekly**
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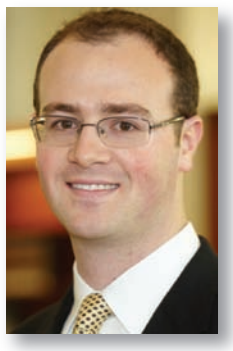
Babener

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 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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# Dealing with difficult claims adjusters

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Every lawyer at some time has encountered a difficult client — the one who is demanding or unreasonable or unrealistic. Or all three.

Every lawyer who does civil defense work at some time has encountered a difficult claims adjuster, the insurance company representative with the power to say thumbs up or down to a settlement. Part of the problem is that the adjuster *isn't* the client — the insured defendant holds that title.

The adjuster may hold the key to whether the lawyer continues to have a steady stream of cases to work or whether he will be preparing for a new career in trusts and estates. Still, the defense lawyer owes all ethical duties to the insured.

This "tripartite relationship" may create some of the tension with adjusters, but defense lawyers must remember the Rules of Professional Conduct, which require the lawyer to exercise independent judgment on behalf of the insured, said Harrisonburg, Va., lawyer Daniel L. Fitch.

Fitch spoke to the Virginia Association of Defense Attorneys at the group's annual meeting at The Homestead last month. He outlined some of the concerns a defense lawyer encounters when "Working with a Difficult Claims Adjuster."

### No respect

Some adjusters simply "don't value what a good defense lawyer brings to the table," Fitch noted. Defense lawyers provide a number of skills that are important to achieving a good result in a case. Chief among these is "the ability to value cases," he said.

Lawyers also bring strategy skills and the ability to build a narrative, as well as the capacity "to crawl into the hide of the other side."

The adjusters who forget or overlook these valuable traits are problematic.

### Narrow view

Fitch said that some adjusters lose sight of the bigger picture. They have "a narrow focus on defense costs" while forgetting the global view of total indemnity costs.

He recalled a time that he handled a case for an insurance company, winning a defense verdict after making a substantial offer that had been rejected. The adjuster then proceeded to give him "a speech about costs."

While the defense lawyer may not expect to get "a chariot and laurels" for winning a big favorable verdict, he might at least get a pat on the back, he said. Not in that instance.

When that scenario unfolds, he advised, "Don't take it personally. Take your lumps like a professional and soldier on."

### Regional differences

Adjusters who aren't on site may not be aware of regional differences.

Fitch cited an example close to his own home. Harrisonburg is a conservative city, more likely to return smaller verdicts. But nearby Page County has very "different cultural values." That kind of local nuance means a lot in valuing lawsuits. But a "lack of regional appreciation" can cause tension with the adjuster, he said.

### Lack of experience

Learning how to value cases properly takes years to master, Fitch said. But some younger adjusters are convinced they have it knocked. And in "the echo chamber of the claims office" they may get an over-inflated sense of their own abilities.

### Too much experience

At the other end of the spectrum, longtime, old-school adjusters present a different problem, at least in mediation. They are used to seeing defense lawyers as warriors or fighters, with "your armor on and your sword drawn," Fitch said.

Mediation presents a very different process, and those adjusters may lose respect for the lawyer in an atmosphere that includes apologies and statements that may be admissions against interest.

Manage their expectations, Fitch counseled. Let the adjuster know your behavior during a mediation will be different from how you may act in a courtroom, and that disclosure and flexibility are required.

### Lack of deference

Fitch said that a lawyer may spend her time thinking about a case, staring at the ceiling at night, then giving her best advice. Then that counsel is ignored.

As a defense lawyer, you have to fight to be heard sometimes, so fight, he said.

Sometimes the situation may require you to get in your car and drive over to the adjuster's office to talk in person. That step "shows seriousness," he said.

"If you're not being heard, go down there," he said. "You owe it to your client."

**Editor's note:** *This article first appeared in Virginia Lawyers Weekly, our sister publication.*

# TAX

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a plaintiff fully expects to receive a future stream of income, the income is not received for tax purposes until paid to plaintiff. This is true even when, as is generally the case, defendants make payments to assignment companies, which then purchase annuities to fund plaintiffs' payments.

### The benefits of structuring

If a client expects to incur $10,000 of medical care annually for 30 years, and prefers not to exclude damages based on ambiguous law, structuring can save thousands of dollars.

Accepting $300,000 of taxable income in one year may shift the client into the highest tax bracket for that year. Earnings on the money before it is spent on medical care will likely face taxation. Moreover, the medical expense deduction, available only to itemizers, excludes expenses only in excess of 7.5 percent of gross income (10 percent after 2012 except for a temporary waiver for the elderly).

If the same client structures the settlement so that $10,000 is paid each year, matching each year's expenses of $10,000, it all can be excluded from gross income. Moreover, the portion of the periodic payments received that is generated from investment will also be received tax-free.

While it is difficult to match future payments with future need, conservative predictions can be made. Consulting with a settlement planner would be well advised.

Some authors argue, based on the economic benefit doctrine, that the ordinary use of a third-party assignment company to make structured settlement payments should prevent a plaintiff from postponing realization of non-physical injury damages (Gregg Polsky & Brant Helwig, *Taxing Structured Settlements*, 39 B.C. L. Rev, 754-76. (2010)).

While the argument may have merit, the Service has directly ruled otherwise. In Private Letter Ruling 2008-36-019, it allowed a plaintiff to postpone the receipt of emotional-distress damages, for tax purposes, by structuring her settlement. The ruling implicitly upheld and built on the Tax Court's earlier decision in *Childs*, 103 T.C. 634, 648-53 (1994), *aff'd*, 89 F.3d 856 (11th Cir. 1996), which allowed attorneys to defer receipt of their fees, for tax purposes, by structuring.

While the possibility of the academic argument eventually winning out must be considered, advice to clients to structure in order to maximize future medical expense deductions would be based on legal precedent and administrative practice.

In the extreme, structuring damages compensating for future medical care expenses could render the entire amount tax-free when it otherwise would have been fully taxable. Hypothetically, this could happen if a settlement only compensated for future medical expenses. If a client can even obtain a portion of the benefit that such tax treatment delivers, it is worth considering structuring.

**Editor's note:** *Babener is a 2010-11 Tax Policy Fellow in the U.S. Treasury Department's Office of Tax Policy. He is a J.D. graduate of, and a tax LL.M. candidate at, the NYU School of Law. He is also a member of the Oregon State Bar. He has spoken at settlement-related conferences on tax law, and his writings on the taxation of personal injury damages, qualified settlement funds and structured settlements are available at http://www.taxstructuring.com. The views expressed herein are those of the author and do not reflect Treasury policy. Previously published as "Maximizing the Medical Care Exception to the Tax on Emotional Distress Damages," Practical Tax Strategies (Vol. 85, No. 32), Copyright © Jeremy Babener 2010.*