

Recent Tax Court Decision Addresses the Tax Treatment of Amounts Received for Anticipated Injuries

By Jeremy Babener

On January 23, 2015, in *Perez v. Commissioner*, 144 T.C. No. 4, the U.S. Tax Court held that a woman was taxable on the \$20,000 she received for serving as an “egg donor” to an infertile couple.

To serve as an “egg donor,” Nichelle Perez, the taxpayer, underwent hormonal treatment and a retrieval procedure. The Tax Court concluded that both caused her significant pain and discomfort.

The agreements between the taxpayer and the couple, and between the taxpayer and the company brokering the transfer, stated that her compensation was paid for Perez’s “time, effort, inconvenience, pain, and suffering,” and her “good faith and full compliance with the donor egg procedure.” Her compensation did not depend on the quantity or quality of eggs transferred.

Perez did not report the compensation on her tax return for 2009. She argued that her compensation was excludable from her gross income under Internal Revenue Code section 104(a)(2). That section provides that gross income generally does not include “damages ... received ... on account of personal physical injuries or physical sickness.”

Treasury Regulation section 1.104-1(c)(1) defines “damages” as “an amount received (other than workers’ compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution.” The Tax Court clarified that payments received by a taxpayer in exchange for the taxpayer’s consent to endure pain and possible injury are not “damages” within the meaning of section 104(a)(2), and that the payments Perez received were therefore taxable.

In reaching this conclusion, the Tax Court emphasized two prior Tax Court decisions relating to the treatment of amounts received by a taxpayer in anticipation of incurring future harm.

In *Roosevelt v. Commissioner*, 43 T.C. 77 (1964), the producer of a play about the taxpayer’s family entered into a contract with the taxpayer before the play was produced, agreeing to give the taxpayer a share of revenues from the play in exchange for the taxpayer’s release of the producer from potential claims for invasion of privacy rights. The Tax Court stated: “[M]oneys paid to any taxpayer as compensation for an *advance waiver of possible future damages* for personal injuries ... would not be excludable from his gross income under section 104(a)(2).”

The Court also referred to *Starrels v. Commissioner*, 34 T.C. 646 (1961), affirmed by the Ninth Circuit Court of Appeals, 304 F.2d 574 (1962). In *Starrels*, the taxpayer received compensation for consenting to the future portrayal of her family in a film. The Tax Court and the Ninth Circuit concluded that the compensation was taxable because the record did not show that the taxpayer had actually sustained any injury. In *Perez*, the Tax Court emphasized the Ninth Circuit’s observations in *Starrels* that section 104(a)(2) “reads most naturally in terms of payment for injuries sustained *prior to* a suit or settlement agreement,” and that such payments are excluded “because they make the taxpayer whole from a previous loss of personal rights.”

Instead of damages, the Tax Court in *Perez* concluded that Perez received compensation “for services rendered.” The Court noted the “mischief” that could result from a contrary finding, pointing out that taxpayers receiving compensation for performing painful and dangerous physical services, such as boxing or working in a mine, could argue that a portion of their compensation was non-taxable.



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