Internal Revenue Service

Index No.: 104.03-00

199952080

Refer Reply To:
CC:DOM:IT&A:2 – PLR-110300-99
Date: SEP 30 1999

Legend:

A =
B =
$x =
$y =
$z =
$w =
State =
Company =

Dear :

This letter is in response to your request for a ruling submitted on behalf of A and his wife B, regarding the taxation of a damage award they received pursuant to a jury award and judgment in a lawsuit against Company and related parties. You request a ruling that the award will be excludable from A's and B's gross income under § 104(a)(2) of the Internal Revenue Code.

FACTS

A was injured in a logging accident on a job that his employer was performing for Company in June 1997. He sustained a crushing, life-threatening injury resulting in the separation of three pelvic bones. A's injuries required surgery.

In February 1999, A and B sued Company and related parties for damages and loss of consortium. You represent that in March 1999, the jury awarded (1) $x in damages to A for lost wages and unpaid medical bills, (2) $y in damages to A for pain and suffering,

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and (3) $z in damages to B for loss of consortium. The court subsequently entered judgments based on the jury awards. A and B have not deducted on any prior years tax returns any of the medical bills for which they were awarded damages.

All of A's and B's judgments have been paid, except for that portion of the $y damages exceeding State's $w statutory limit for noneconomic personal injury damages in a tort action. Company's insurance carrier is retaining that amount in an interest-bearing account while the State Supreme Court decides a legal challenge to the statutory limit. If the State Supreme Court finds that the $w statutory limit is unconstitutional, then Company will be required to pay the remainder of the judgment, plus interest from the date of the judgment to A and B. If the State Supreme Court finds that the $w statutory limit is constitutional, then Company will not pay to A and B the noneconomic damages awarded in excess of the $w statutory limit.

LAW AND ANALYSIS

Section 104(a)(2) provides that except in the case of amounts attributable to (and not in excess of) deductions allowed under § 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include the amount of any damages received (whether by suit or agreement) on account of personal physical injuries or physical sickness.

Section 1.104-1(c) of the Income Tax Regulations provides, in part, that the term "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.

In Commissioner v. Schleier, 515 U.S. 323 (1995) the Supreme Court of the United States ("Court") held that two independent requirements must be met for a recovery to be excluded from income under former § 104(a)(2):

> First, the underlying cause of action giving rise to the recovery must be "based upon tort or tort type rights." In United States v. Burke, 504 U.S. 229 (1992) the Court concluded that in order for the first requirement to be met the relevant cause of action must provide the availability of a broad range of damages, such as damages for emotional distress, pain, and suffering.
>
> Second, the damages must be received "on account of personal injuries or sickness." In Schleier, the Court illustrated the application of the second requirement by way of an example in which a taxpayer who is injured in an automobile accident sues for (1) medical expenses, (2) pain, suffering, and emotional distress that cannot be measured with precision, and (3) lost wages. The Court explained that the second requirement would be met for recovery of (1) the

> medical expenses for injuries arising out of the accident, (2) the amounts for pain, suffering and emotional distress, and (3) the lost wages as long as the lost wages resulted from the time in which the taxpayer was out of work due to the injuries sustained in the accident.

Rev. Rul. 85-97, 1985-2 C.B. 50, concerns a taxpayer who received damages in settlement of suit for injuries he suffered when he was struck by a bus. The taxpayer's complaint alleged that as a direct result of being struck by the bus he had been unable to pursue normal employment activities and had lost wages, had suffered and would continue to suffer great pain of body and mind and loss of earning capacity, and had incurred and would incur hospital and doctors' bills. The ruling concludes that the entire amount of the settlement received by the taxpayer, including the amount attributable to lost wages, was excludable from gross income as amounts received on account of personal injuries under former § 104(a)(2).

Section 1605 of the Small Business Job Protection Act of 1996 (the "1996 Act") restricted the exclusion from gross income provided by § 104(a)(2) to amounts received on account of personal **physical** injuries or **physical** sickness. [Emphasis added.] H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 301 (1996), provides the following explanation of the amendment made by the 1996 Act:

> If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income. ...
>
> 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 physical injury or physical sickness.

In this case A and B recovered damages under State laws permitting recovery of a broad range of damages, including damages for pain and suffering. Thus, A and B received their damages in a suit or action based on tort or tort type rights within the meaning of § 1.104-1(c). In addition, (1) the $x in damages received by A for lost wages and unpaid medical bills, (2) the $y in damages received by A for pain and suffering, and (3) the $z in damages received by B for loss of consortium were directly attributable to and linked to the physical injuries A suffered in the logging accident.

However, postjudgment interest that A and B receive is not received on account of any physical injury or physical sickness. See Aames v. Commissioner, 94 T.C. 189 (1990).

HOLDING

Based strictly on the information submitted and representations made, we conclude that (1) the $x in damages received by A for lost wages and unpaid medical bills, (2) the $y in damages received by A for pain and suffering (or the lesser amount of $w if the State law limit on noneconomic damages is constitutional), and (3) the $z in damages received by B for loss of consortium are compensation for the personal physical injuries A sustained in the logging accident. Therefore, such amounts are excludable from A's and B's gross income under § 104(a)(2). However, postjudgment interest received on the award is includible in their income.

A copy of this letter should be attached to any income tax return to which it is relevant. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer(s) requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Deputy Assistant Chief Counsel
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By
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Branch 2