

INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Index (UIL) No.: 61.28-02; 104.03-00
CASE MIS No.: TAM-123177-02/CC:ITA:B4

Area Director, Field Compliance, SB/SE

Taxpayer's Name: [REDACTED]
Taxpayer's Address: [REDACTED]
Taxpayer's TIN: [REDACTED]
Year Involved: [REDACTED]
Date of Conference: [REDACTED]

LEGEND:

a = [REDACTED]
b = [REDACTED]
c = [REDACTED]
d = [REDACTED]
Y = [REDACTED]
State = [REDACTED]
Statute = [REDACTED]
Year 1 = [REDACTED]
Year 2 = [REDACTED]
Year 3 = [REDACTED]
x = [REDACTED]

ISSUE:

Whether, by virtue of the language contained in § 104(c) of the Internal Revenue Code, a may exclude from gross income exemplary damages recovered in a wrongful death action?¹

CONCLUSION:

Because Congress, in adding the present version of § 104(c), did not abrogate the requirement that to be excludable damages must be received "on account of" personal physical injuries or physical sickness, a must include the exemplary damages in gross income.

FACTS:

¹Although technical advice was requested only as to a, the director has indicated that the same tax treatment should apply to all three taxpayers.

In Year 1 d was killed while carrying on duties for his employer, Y. At the time of his death d was married to the taxpayer, a, and had two minor children, b and c. Later that year a, individually and on behalf of the minor children, brought suit against Y under the State Statute.

Under section 3 of the Statute, an employee waives his right to recover actual damages for personal injuries sustained during the course of employment unless he gives notice to the employer at the time employment begins. In addition to any award of workmens' compensation authorized by Statute, certain survivors of an employee may recover exemplary damages under the State Constitution² if the employer's conduct in causing the death of the employee was wilful or grossly negligent. State Statute provides:

(a) Recovery of workers' compensation benefits is the exclusive remedy of an employee covered by workers' compensation insurance coverage or a legal beneficiary against an employer or an agent or employee of the employer for the death of or a work-related injury sustained by the employee.

(b) This section does not prohibit the recovery of exemplary damages by the surviving spouse or heirs of the body of a deceased employee whose death was caused by an intentional act or omission of the employer or by the employer's gross negligence.

By Year 2, c had reached his majority and had entered the case on his own behalf. In Year 2, the trial court submitted the case to the jury with the following charge:

What sum of money, if any, should be assessed against [Y] and awarded to Plaintiffs as exemplary damages for the death of [d]?

"Exemplary damages" means an amount that you may, in your discretion, award as an example to others and as a penalty or by way of punishment.

Factors to consider in awarding exemplary damages, if any, are:

- A. The nature of the wrong.
- B. The character of the conduct involved.
- C. The degree of culpability of the wrongdoer.
- D. The situation and sensibilities of the parties concerned.
- E. The extent to which such conduct offends a public sense of justice and propriety.
- F. Inconvenience or frequency of the wrongs committed.
- G. The size of the award needed to deter similar wrongs in the future.

² Art. [REDACTED] of the State Constitution authorizes the individuals described in the Statute to recover exemplary damages from any tortfeasor "that may commit a homicide, through wilful act, or omission, or gross neglect."

The jury awarded the plaintiffs \$5,000,000~~x~~, allocating 10~~x~~ percent to a, and 5~~x~~ percent to b and c, respectively. Subsequently in Year 2, the trial court approved a settlement of the jury verdict for \$2,100,000~~x~~, allocated in the same manner as prescribed by the jury. In Year 2 a included her share of the proceeds in gross income and claimed a miscellaneous itemized deduction for the attorneys' fees paid to recover the exemplary damages. In Year 3, the Internal Revenue Service allowed a claim for refund filed by a for Year 2 on the basis that the attorneys' fees paid were not includible in her gross income under [REDACTED]. Also in Year 3, a filed a second claim for refund on the basis that the exemplary damages recovered were excludable from gross income under § 104(a)(2) by virtue of the flush language contained in § 104(c).

LAW AND ANALYSIS:

Under § 61, except as otherwise provided in the Code, a taxpayer must include in gross income "all income from whatever source derived." The Supreme Court of the United States has long recognized that the definition of gross income sweeps broadly and reflects Congress' intent to exert the full measure of its taxing power and to bring within the definition of income "any accession to wealth." Commissioner v. Schleier, 515 U.S. 323, 327 (1995); United States v. Burke, 504 U.S. 229, 233 (1992). Accordingly, any receipt of funds by a taxpayer is presumed to be gross income unless the taxpayer can demonstrate that the accession fits into one of the exclusions created by other sections of the Code. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

One of these exclusions, found at § 104(a)(2), permits a taxpayer to exclude from gross income "the amount of any damages (**other than punitive damages**) received (whether by suit or agreement and whether as lump sums or periodic payments) on account of personal **physical** injuries or **physical** sickness."³ The Court has emphasized "the corollary to § 61(a)'s broad construction, namely, the default rule of statutory interpretation exclusions from income must be narrowly construed." Commissioner v. Schleier, 515 U.S. at 328.

In construing § 104(a)(2) prior to its 1996 amendment, the Court enunciated two independent tests a taxpayer who seeks an exclusion thereunder must satisfy: first, the taxpayer must demonstrate that the underlying cause of action giving rise to the recovery is based on tort or tort type rights; and second, the taxpayer must show that the damages were received on account of personal injuries or sickness. Schleier, 515 U.S. at 336-337. In describing the second test, the Court indicated that there must be a direct relationship between the damages and the injuries, *i.e.*, the damages must be related to the existence and extent of a personal injury. Schleier, 515 U.S. at 330-331.

In 1996, in addition to the amendment to § 104(a)(2), Congress also added the

³ The highlighted portions were added by section 1605 of the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1838 (1996 Act).

following new subsection to § 104:

(c) Application of prior law in certain cases.

The phrase “(other than punitive damages)” shall not apply to punitive damages awarded in a civil action -

(1) which is a wrongful death action, and

(2) with respect to which applicable State law (as in effect on September 13, 1995 and without regard to any modification after such date) provides, or has been construed to provide by a court of competent jurisdiction pursuant to a decision issued on or before September 13, 1995, that only punitive damages may be awarded in such an action.

This subsection shall cease to apply to any civil action filed on or after the first date on which the applicable State law ceases to provide (or is no longer construed to provide) the treatment described in paragraph (2).

Before Congress enacted the 1996 Act, the Court determined it would review the appellate court’s opinion in O’Gilvie v. United States, 66 F.3d 1550 (10th Cir. 1995), that punitive damages were taxable. This was recognized in the legislative history to the 1996 Act. H.R. Rep. No. 104-586, 104th Cong. 2d Sess. 142-43, 1996-3 C.B. 480-81, provides as follows:

Present Law

....

The exclusion from gross income of damages received on account of personal injuries or sickness specifically does not apply to punitive damages received in connection with a case not involving physical injury or sickness. Courts presently differ as to whether the exclusion applies to punitive damages received in a case involving a physical injury or a physical sickness.(Fn) Certain States provide that, in the case of claims under a wrongful death statute, only punitive damages may be awarded.

....

Explanation of Provisions

Include in income all punitive damages

The bill provides that the exclusion from gross income does not apply to any punitive damages received on account of personal injury or sickness whether or not related to a physical injury or physical sickness. Under the bill, present law continues to apply to punitive damages received in a wrongful death action if the applicable State law (as in effect on September 13, 1995 without regard to subsequent modification) provides, or has been construed to provide by a court decision issued on or before such date, that only punitive damages may be awarded in a wrongful death action.

(Fn) The Supreme Court recently agreed to decide whether punitive damages awarded in a physical injury lawsuit are excludable from gross income. *O’Gilvie v. U.S.*, 66 F.3d 1550 (10th Cir. 1995), *cert. granted*, 64 U.S.L.W. 3639 (U.S. March 25, 1996)(No. 95-966). Also, the Tax Court recently held that if punitive damages are not of a compensatory nature, they are not excludable from gross income regardless of whether the underlying claim involved a physical injury or physical sickness. *Bagley v. Commissioner*, 105 T.C. No. 27 (1995).

Thereafter, in O’Gilvie v. United States, 519 U.S. 79 (1996), the Court concluded that punitive damages recovered in a wrongful death action do not qualify for the § 104(a)(2)

exclusion. The Court held unequivocally that noncompensatory punitive damages do not meet the second test for exclusion because they do not meet the “on account of” test.

The Service construes § 104(c) as requiring the application of § 104(a)(2) as interpreted by the Court in Schleier with the added requirement that the damages be received on account of physical injuries or physical sickness. Thus, to be excludable, all damages, regardless of their nature, must be received “on account of” physical injuries or physical sickness.

The taxpayer, relying on [REDACTED], and [REDACTED], argues that under State jurisprudence, exemplary damages serve “quasi” compensatory purposes and consequently, all or a portion of the recovery clearly satisfies the requirements for the § 104(a)(2) exclusion.

However, this identical view was rejected by the Court of Appeals [REDACTED] in [REDACTED]. In [REDACTED], the [REDACTED] first noted that it had recently decided in [REDACTED], that noncompensatory punitive damages awarded under [REDACTED] law failed to qualify for the § 104(a)(2) exclusion. The Fifth Circuit indicated that the sole issue to be decided in [REDACTED] was “whether punitive damages awarded under [REDACTED] law are compensatory in a way which would bring them within § 104(a)(2)’s exclusion.” [REDACTED]. In concluding that they did not qualify for exclusion, the court stated:

Despite [REDACTED] and [REDACTED] we find [REDACTED] argument unpersuasive. Notwithstanding any compensatory **effect** that punitive damages might have, the State Supreme Court has emphasized at least since 1847 that exemplary damages are awarded not to compensate the plaintiff for any injury received but to punish the defendant and to deter others. (Emphasis added) (citations omitted)

[REDACTED]

The [REDACTED] noted that one year after the State Supreme Court decided [REDACTED], that court held that prejudgment interest was not available on exemplary damages because of their noncompensatory nature. [REDACTED]. We conclude, therefore, that the exemplary damages recovered by a did not serve any compensatory purpose.

Even if such quasi-compensatory purposes may be found generally, the tenor of the jury instructions recited above reveal that the recovery of exemplary damages in this case bore no relation to the existence or extent of any personal injury suffered by the

decedent or the plaintiffs; rather, the recovery was measured by the conduct of the employer and served to punish and deter future, similar conduct. Because they did not compensate a, or any personal physical injury, the exemplary damages fail to qualify for exclusion under § 104(a)(2).⁴

In Situation 2 of Rev. Rul. 84-108, 1984-2 C.B. 302, the Service published its position that proceeds recovered under the Alabama wrongful death statute fail to qualify for exclusion under a former version of § 104(a)(2) because they were punitive in nature. See Painter v. Tennessee Valley Authority, 476 F.2d 943, 944 (5th Cir. 1973) (recovery not permitted because Government had not waived its sovereign immunity against award of punitive damages). Notwithstanding, a federal district court disagreed with the ruling, citing state court decisions for the proposition that the wrongful death proceeds were compensatory. Burford v. United States, 642 F. Supp. 635 (N.D. Ala. 1986). The taxpayer relies on this case in support of her position that when a statute authorizes the recovery of punitive damages only, such damages are excludable from gross income.

The taxpayer construes the statement that from the legislative history of the 1996 Act that “present law continues to apply to punitive damages” to mean that judicial opinions interpreting state wrongful death statutes rendered on or before September 13, 1995, continue to control the taxation of punitive damages recovered thereunder. The only case in this category is Burford, and, because the State statute is similar to the Alabama statute, a contends that the result reached in Burford is required here.

The Court has consistently held that its interpretation of a statute is an authoritative statement of what the statute meant before as well as after the decision of the case giving rise to that construction. See, e.g., Harper v. Virginia Dep’t of Taxation, 509 U.S. 86, 97 (1993); Landgraf v. USI Film Products, 511 U.S. 244 (1994); Rivers v. Roadway Express, Inc., 511 U.S. 298, 312-13 (1994). In O’Gilvie, the Court rejected the taxpayers’ argument that the “on account of” test is satisfied by merely showing that the damages would not have been recovered “but for” the personal injury. Instead, the Court adopted a more stringent requirement urged by the Government that to come within the exclusion the damages must be received “by reason of” or “because of” the personal injuries. The Court concluded that punitive damages were not received on account of personal injuries suffered by the victim but because of the reprehensible

⁴ Because a continues to receive nontaxable workmens’ compensation payments due to d’s death, it is questionable that the Statute qualifies as one described in § 104(c). The State Supreme Court, however, has held that a plaintiff is not required to prove actual damages in order to recover exemplary damages under the Statute and declined to decide whether workmens’ compensation constitutes compensatory damages. [REDACTED].

conduct of the actor. Applying the principle enunciated in Harper the Court's interpretation of the "on account of" requirement contained in § 104(a)(2) in O'Gilvie constituted a statement of what the statute meant prior to amendment by the 1996 Act and thereafter, unless that requirement of the statute was changed or eliminated.

Congress, in enacting § 104(c) in 1996, was fully aware that the Court was considering whether punitive damages were excludable from gross income under § 104(a)(2). Nevertheless, Congress did not purport to eliminate the second test for exclusion under § 104(a)(2), *i.e.*, that the damages must be received "on account of" personal physical injuries or physical sickness. See Schleier, 515 U.S. at 330. Had Congress wanted to exempt from the scope of § 61(a) punitive damages recovered under a statute providing for an award of such damages only in wrongful death cases, it could have done so explicitly, regardless of the pending resolution of the issue by the Court in O'Gilvie.⁵ This interpretation of the legislative history comports with the broad reach of § 61(a) and the corollary that exemptions from income must be narrowly construed. See Schleier, 515 U.S. at 328.

CAVEAT(S):

A copy of this technical advice memorandum is to be given to the taxpayer(s). Section 6110(k)(3) provides that it may not be used or cited as precedent.

⁵ As passed by the Senate, section 1603 of H.R. 3448 stated in part that "[n]otwithstanding subsection (a)(2), gross income shall not include punitive damages awarded in an action" The difference in the language of § 104(c) as enacted supports the conclusion that Congress did not intend to exclude from gross income punitive damages recovered under the circumstances present here.