

**Internal Revenue Service**

**Department of the Treasury**

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Person to Contact:

Identifying Number:

Telephone Number:

Refer Reply To:

CC:IT&A:2 – PLR-101732-00

Date: July 17, 2000

In Re:

Legend:

A =

B =

C =

date 1 =

date 2 =

date 3 =

date 4 =

date 5 =

Statute =

x =

y =

z =

State =

Dear

This letter is in response to your request for a ruling submitted on behalf of A and her husband, B, regarding the tax treatment of a damage award they received pursuant to a settlement agreement with C. You request a ruling that the entire award will be excludable from A's and B's gross income under § 104(a)(2) of the Internal Revenue Code.

**FACTS**

C and C's corporation employed A in various capacities from date 1 through date 4. From date 2 through date 3, A was C's full-time driver and accompanied C on many trips. Early in this period, C acted in a friendly manner toward A. After a while, however, C began a slow progression of attempts to make sexual contact with A and made several suggestive or lewd remarks in A's presence. Also, early in this period, C

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physically touched A but these contacts did not result in any observable bodily harm (e.g., cuts, bruises, etc.) to A's body or cause extreme pain to A. Later, while on a road trip, C assaulted A causing what A represents was extreme pain (the "First Pain Incident"). After the First Pain Incident, A began to have headache and digestive problems, but two doctors could not find anything physically wrong. Your ruling request does not assert that these problems were due to the First Pain Incident or prior events. On a subsequent road trip, C also assaulted A, cutting her and biting her (the "First Physical Injury").

A became executive director of C's household around date 3. During this period, C physically and sexually assaulted A. In one assault, C cut A. As a result of another series of C's assaults, A suffered skin discoloration and swelling accompanied by extreme pain for which A received medical treatment from a doctor. On date 4, A terminated her employment with C.

A subsequently retained the services of a law firm, which presented C with a complaint. The complaint alleged that C inflicted emotional and physical harm on A. A's complaint asserted causes of action, including sex discrimination and reprisal under Statute, battery, and intentional infliction of emotional distress. The complaint also specifically requested leave to amend the complaint to add a claim for punitive damages for A's common law claims. The complaint does not refer to claims for interest. On date 5, C executed the Settlement Agreement with A and B under which C agreed to pay \$z to settle all claims of A and B. The Settlement Agreement did not allocate the proceeds to any of the claims.

Statute permits claimants to sue for discrimination in employment on account of sex (including sexual harassment) and reprisal. Under sections x and y of Statute, a claimant may recover damages for mental anguish and suffering. Likewise, State law permits a claimant to recover damages for humiliation and disgrace in an action for assault and battery.

## LAW AND ANALYSIS

Section 61 provides, in general, that gross income means all income from whatever source derived.

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 (other than punitive damages) received (whether by suit or agreement) on account of personal physical injuries or physical sickness.

Section 104 also provides that for purposes of § 104(a)(2), emotional distress shall not be treated as a physical injury. However, § 104 also provides that the preceding

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sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in § 213(d)(2)(A) or (B)) that is attributable to emotional distress.

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, or through a settlement agreement entered into in lieu of such prosecution.

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 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.]

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H.R. Conf. Rep. No. 737, 104<sup>th</sup> Cong., 2d Sess. 301 (1996), provides the following explanation of the amendment made by the 1996 Act:

The House bill also specifically provides that emotional distress is not considered a physical injury or physical sickness.<sup>56</sup> Thus the exclusion from gross income does not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. 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 addition, the exclusion from gross income specifically applies to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress.

Footnote 56 of the Conference Report states, "It is intended that the term emotional distress includes symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such distress." H.R. Conf. Rep. No. 737 at 301.

In this case State law actions under Statute and in battery permit recovery for a broad range of damages of the kind described in Burke, such as damages for emotional distress and humiliation. Thus, A and B received their damages in a settlement agreement that is in lieu of a suit or action based on tort or tort type rights within the meaning of § 1.104-1(c).

The term "personal physical injuries" is not defined in either § 104(a)(2) or the legislative history of the 1996 Act. However, we believe that direct unwanted or uninvited physical contacts resulting in observable bodily harms such as bruises, cuts, swelling, and bleeding are personal physical injuries under § 104(a)(2). See Black's Law Dictionary 1304 (Rev. 4<sup>th</sup> ed. 1968) which defines the term "physical injury" as "bodily harm or hurt, excluding mental distress, fright, or emotional disturbance."

In this case, C's uninvited and unwanted physical contacts with A prior to the First Pain Incident did not result in any observable harms (e.g., bruises, cuts, etc.) to A's body or cause A pain. Further, it is not represented that the medical treatment that A received after the First Pain Incident for headaches and digestive problems were related to events that occurred with or prior to that incident. Thus, any damages A received for events occurring prior the First Pain Incident are not received on account of personal physical injuries or physical sickness under § 104(a)(2).

However, according to the representations submitted, A suffered several physical injuries within a relatively short period of time commencing with the First Physical Injury. Thus, under the facts of this case, damages A and B received under the Settlement Agreement for pain, suffering, emotional distress and reimbursement of medical

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expenses that are properly allocable to the period beginning with the First Physical Injury are attributable to and linked to the physical injuries A suffered and were received on account of personal physical injuries or physical sickness under § 104(a)(2).

Finally, damages A and B received under the Settlement Agreement that are properly allocable to punitive damages are includible in their gross income. A portion of damages received may be properly allocable to punitive damages notwithstanding that a settlement agreement is entered into prior to a jury's award of punitive damages. See Burditt v. Commissioner, T.C.M. 1999-117 and Rev. Rul. 85-98, 1985-2 C.B. 51.

#### HOLDING

Based strictly on the information submitted and each of the representations made, we conclude that –

(i) damages that A and B received under the Settlement Agreement that are properly allocable to events prior to the First Pain Incident are not received on account of personal physical injuries or physical sickness under § 104(a)(2) and are includible in their gross income under § 61; and

(ii) damages that A and B received under the Settlement Agreement for pain, suffering, emotional distress and reimbursement of medical expenses that are properly allocable to the period beginning with the First Physical Injury are excludable from their gross income under § 104(a)(2) except for amounts attributable to (and not in excess of) deductions allowed under § 213 (relating to medical, etc., expenses) for any prior taxable year; and

(iii) damages that A and B received under the Settlement Agreement that are properly allocable to punitive damages are includible in their gross income under § 61.

A copy of this letter should be attached to any income tax return to which it is relevant. Except as expressly provided in the preceding paragraph, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Under § 7.01 of Rev. Proc. 2000-1, 2000-1 I.R.B. 5, 21 a letter ruling will not ordinarily be issued because of the factual nature of the problem. Because the perception of pain is essentially subjective, it is a factual matter. Therefore, pursuant to § 7.01 of Rev. Proc. 2000-1, we cannot rule whether damages properly allocable to the First Pain Incident (a physical contact that did not manifest itself in the form of a cut, bruise, or other similar bodily harm) were received on account of personal physical injuries or physical sickness.

In addition, no opinion is expressed concerning the percentage of the damages received that is excludable from income under § 104(a)(2). Under § 4.01(6) of Rev.

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Proc. 2000-3, 2000-1 I.R.B. 103, 109, the Service will not ordinarily issue a ruling whether an allocation of a settlement award (including a lump sum award) between back pay, compensatory damages, and punitive damages is a proper allocation for federal income tax purposes.

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. Temporary or final regulations pertaining to one or more of the issues addressed in this letter have not yet been adopted. Therefore, this letter ruling will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in the letter ruling. See § 12.04 or Rev. Proc. 2000-1, 2000-1 I.R.B. 46 (or any successor). However, if the taxpayer can demonstrate that the criteria in § 12.05 of Rev. Proc. 2000-1, 2000-1 I.R.B. 47, are met, a letter ruling is not revoked or modified retroactively except in rare or unusual circumstances.

Sincerely,

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By \_\_\_\_\_  
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