

**Internal Revenue Service**

Department of the Treasury  
Washington, DC 20224

Number: **200403046**  
Release Date: 01/16/2004  
Index Number: 61.00-00, 104.00-00

Person To Contact:

Telephone Number:

Refer Reply To:  
CC:ITA:4 – PLR 104936-03

Date:

Legend

B =  
Z =  
Court =  
State =  
Date 1 =  
s =  
t =  
u =  
v =  
w =  
x =  
y =

Dear \_\_\_\_\_ :

This letter responds to a letter dated January 17, 2003 requesting a ruling that a portion of legal costs (attorney fees and other litigation costs) paid to B's attorney pursuant to a settlement agreement will not be included in B's gross income.

FACTS:

The taxpayer, B, was covered under a Z disability insurance policy that entitled him to benefits for either total or residual disability. B paid the premiums for the policy with

PLR 104936-03

after tax dollars. B claimed that he was disabled as a result of his work environment and submitted a claim under his insurance policy.

After investigating B's disability claim, Z denied B disability benefits. A subsequent appeal of Z's decision affirmed the decision to deny disability benefits to B. B then brought suit against Z in the Court alleging breach of contract and bad faith. The Court issued a decision that Z had violated the disability policy by denying B residual benefits and acted in bad faith under State law in handling B's residual benefits claim. Z filed for reconsideration of the Court's decision.

On Date 1, B and Z entered into an agreement to settle all existing claims. The settlement agreement called for a lump-sum settlement of \$s and a monthly disability benefit of \$t. The agreement allocates \$s as follows: \$u for return of premiums, \$v for past monthly disability benefits, \$w for interest on the past disability benefits, and \$x for legal costs (attorney fees and other litigation costs). Additionally, the agreement called for Z to reimburse B in the amount of \$y for the potential income tax liability associated with the lump-sum settlement of \$s.

#### LAW AND ANALYSIS:

Section 61(a) of the Internal Revenue Code provides that gross income means all income from whatever source derived unless otherwise excepted by law. Section 61(a)(4) specifically includes interest in gross income.

Section 104(a)(3) provides that except for amounts attributable to (and not in excess of) deductions allowed under § 213 for any prior taxable year, gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee to the extent such amounts are attributable to contributions by the employer that were not includable in the gross income of the employee, or are paid by the employer).

Section 1.104-1(d) of the Income Tax Regulations states that if an individual purchases a policy of accident or health insurance out of his own funds, amounts received thereunder for personal injuries or sickness are excludable from his gross income under § 104(a)(3).

Prior to its amendment in 1996, § 104(a)(2) provided for an exclusion from gross income for damages received on account of personal injury. Under the prior version of § 104(a)(2), damages awarded under the Age Discrimination in Employment Act (ADEA) were sometimes held to be excludable as damages from personal injury. When ADEA damages were excluded from income, an award of attorney's fees was also

PLR 104936-03

found to be excluded from income. See, e.g., Renner v. Commissioner, 67 T.C.M. 3072 (1994); Cassino v. Commissioner, 67 T.C.M. 2193 (1994); Fite v. Commissioner, 66 T.C.M. 1588 (1993), rev'd U.S. Tax Cas. P50,159 (6<sup>th</sup> Cir. 1995) (holding ADEA damages were not excludable from income).

In Johnson-Waters v. Commissioner, 66 T.C.M. 252 (1993), the court assumed that attorney's fees and costs were paid proportionally to the damages (both includable and excludable from gross income). The amount of the attorney's fees award excluded from income bore the same ratio to the entire attorney's fees award as the damages excluded from income bore to the entire damages award.

Because B paid the premiums for the disability insurance policy, the monthly disability benefits of \$t and past disability payments awarded of \$y are excludable from B's gross income under § 104(a)(3). Accordingly, the portion of the settlement paid on account of B's legal costs that is allocable to the benefits excludable from gross income under § 104(a)(3) is not includible in B's gross income.

CAVEATS:

A copy of this letter must be attached to any income tax return to which it is relevant. We enclose a copy of the letter for this purpose. Also enclosed is a copy of the letter ruling showing the deletions proposed to be made in the letter when it is disclosed under § 6110.

In accordance with the power of attorney on file in this office, a copy of this letter is being sent to the authorized representatives indicated on the power of attorney

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any 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,

Robert A. Berkovsky  
Branch Chief  
Office of Associate Chief Counsel  
(Income Tax & Accounting)

PLR 104936-03

Enclosures (2)