



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
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Dear _____ :

I am responding to your letter requesting general information on the taxation and withholding requirements of amounts paid in settlement of an action arising under the Americans with Disabilities Act (ADA). We are happy to provide you with the following general information.

Income Tax Considerations

Under § 61 of the Internal Revenue Code, a taxpayer must include in gross income all income from whatever source derived. Accordingly, a taxpayer must include in gross income an accession to wealth, unless it is excluded from income by another section of the Code. Section 104(a)(2) excludes from gross income the amount of any damages (excluding punitive damages) received on account of personal physical injuries or physical sickness. Emotional distress and the physical manifestations thereof, do not fall within the definition of personal physical injuries or physical sickness. A taxpayer, nevertheless, may exclude from gross income an amount for medical care attributable to emotional distress that was not deducted in a prior taxable period. Further, the Supreme Court recently held that a taxpayer must include in gross income the portion of a taxable recovery paid to an attorney under a contingent fee arrangement. *Commissioner v. Banks*, 125 S.Ct. 826 (2005).

Whether settlement proceeds are excludable from gross income as damages received on account of personal physical injuries or physical sickness is, in part, a factual question. In reaching this determination, courts look at the settlement agreement in light of all the surrounding circumstances. Neither the courts nor the Commissioner are bound by the terms of a settlement agreement between third parties that is not the result of good faith, adversarial, arms-length negotiations. A court may look at the

GENIN-138530-05

allegations of the complaint to determine whether the claims to which the proceeds are allocated in the settlement agreement are claims for personal physical injuries or physical sickness. The mere mention of “personal physical injuries” in a complaint does not, by itself, serve to bring a recovery within the exclusion.

Whether a recovery under the ADA is excludable from gross income under § 104(a)(2) of the Code is beyond the scope of this letter, which is for informational purposes only and does not constitute a ruling. See § 2.04 of Rev. Proc. 2005-1, 2005-1 I.R.B. 1. The IRS will consider a request for a private letter ruling if the taxpayer meets all of the requirements of Rev. Proc. 2005-1. A letter ruling addresses the tax consequences of the taxpayer’s acts and transactions, not those of a third party. See § 2.01 of Rev. Proc. 2005-1. You can access Rev. Proc. 2005-1 at www.irs.gov/pub/irs-irbs/irb05-01.pdf.

Information Reporting Requirements

Section 6041(a) generally provides that all persons engaged in a trade or business and making payment in the course of such trade or business to another person of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed and determinable gains, profits, and income of \$600 or more in any taxable year shall render a true and accurate statement to the Secretary, under such regulations and in such form and manner and to such extent as may be prescribed by the Secretary, setting forth the amount of such gains, profits, and income, and the name and address of the recipient of such payment.

Section 1.6041-1(a)(1)(i) of the Income Tax Regulations provides generally that every person engaged in a trade or business shall make an information return for each calendar year with respect to payments it makes during the calendar year in the course of its trade or business to another person of fixed or determinable income comprised of salaries, wages, commissions, fees, and other forms of compensation for services rendered aggregating \$600 or more, or interest (including original issue discount), rents, royalties, annuities, pensions, and other gains, profits, and income aggregating \$600 or more.

Section 1.6041-1(c) provides that income is fixed when it is to be paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. The income need not be paid annually or at regular intervals. The fact that the payments may be increased or decreased in accordance with the happening of an event does not for purposes of this section make the payments any the less determinable. A payment made jointly to two or more payees may be fixed and determinable income to one payee even though the payment is not fixed and determinable income to another payee. For example, property insurance proceeds paid jointly to the owner of damaged property and to a contractor that repairs the property may be fixed and determinable income to the contractor but not

GENIN-138530-05

fixed and determinable income to the owner, and should be reported to the contractor. A salesman working by the month for a commission on sales which is paid or credited monthly receives determinable income.

Section 6045(f)(1) generally provides that any person engaged in a trade or business and making a payment (in the course of such trade or business) shall file a return with the Service and furnish a statement to the payee with respect to any payment to an attorney in connection with legal services (whether or not such services are performed for the payor), but not with respect to the portion of any payment which is otherwise required to be reported under § 6041(a) (or would be so required but for the dollar limitation contained in that section).

Section 1.6045-5(a)(1) of the proposed regulations provides in pertinent part that, except as provided in paragraph (c) of this section, every payor engaged in a trade or business who, in the course of that trade or business, makes payments aggregating \$600 or more during a calendar year to an attorney in connection with legal services (whether or not the services are performed for the payor) must file an information return for such payments. The information return must be filed on the form and in the manner provided by the Commissioner. The requirements of this paragraph (a)(1) apply whether or not a portion of a payment is kept by the attorney as compensation for legal services rendered, or other information returns are required with respect to some or all of a payment under other provisions of the Code and regulations.

Accordingly, if a payment is made to a claimant in settlement of the claimant's legal claims, and the payment is made in the course of the payor's trade or business and constitutes fixed or determinable income to the claimant of \$600 or more, then the payor is required to report this payment under § 6041(a) and § 1.6041-1(a)(1)(i).

Pursuant to § 6045(f), a payment made to the claimant's attorney in connection with the attorney's legal services is reportable to the attorney except to the extent that any portion of the payment is reportable to the attorney under § 6041(a), and notwithstanding the fact that such payment may be reportable to another person under § 6041(a). A payment made to a claimant's attorney may be reportable to the attorney under § 6045(f) and to the claimant under § 6041(a) to the extent the payment constitutes income to the claimant. See § 1.6045-5(a)(1)(ii) and (f) *Example 1* of the proposed regulations, § 1.6041-1(e)(5) *Example 7* and *Example 8*, and § 1.6041-1(f)(2) *Example 1* and *Example 2* (illustrating the application of various reporting requirements in situations where settlement payments are made to an attorney).

Backup Withholding Requirements

Payments that are reportable under § 6041 or § 6045(f) may be subject to backup withholding at a rate of 28 percent, pursuant to § 3406. Backup withholding applies if

GENIN-138530-05

the payee fails to furnish his taxpayer identification number (TIN) to the payor in the manner required, or if the Secretary notifies the payor that the TIN furnished by the payee is incorrect. See § 3406(a)(1)(A) and (B).

Under § 3406(e)(1) and § 31.3406(e)-1(b)(1)(i), a payor is required to withhold under § 3406(a)(1)(A) on any reportable payment at the time the payor pays the reportable payment to a payee if the payor has not received the payee's TIN in the manner required in § 31.3406(d)-1. Section 31.3406(e)-1(b)(2)(i) provides that the payor must stop withholding under § 3406(a)(1)(A) within 30 days after the payor receives the payee's TIN in the manner required under § 31.3406(d)-1.

Section 31.3406(d)-1(d) provides that for relationships subject to information reporting under § 6041, the payee must furnish the payee's TIN to the payor either orally or in writing. Except as provided in § 31.3406(d)-5 (regarding situations where the Service notifies the payor to withhold because the payee's TIN is incorrect), the payee is not required to certify under penalties of perjury that the TIN is correct regardless of when the account, contract, or relationship is established.

Section 31.6413(a)-3(a)(1) provides that if a payor or broker withholds under § 3406 from a payee in error or withholds more than the proper amount of the tax under § 3406, the payor or broker may refund the amount erroneously withheld as provided in § 6413 and this section. A payor or broker will be considered to have withheld erroneously under § 3406 only if the amount is withheld because of an error by the payor or broker (e.g., an error in flagging or identifying an account that is subject to withholding under § 3406). However, § 31.6413(a)-3(a)(2) provides that, for purposes of paragraph (a)(1) of this section, if a payor or broker withholds because the payor or broker has not received a TIN or required certification and the payee subsequently provides a TIN or a required certification to the payor, the payor or broker may not refund the amount to the payee.

I hope that this information is helpful. If you have any further questions, please contact _____, Identification Number _____, at (____) _____ or _____, Identification Number _____ at (____) _____.

Sincerely,

Michael J. Montemurro
Branch Chief
Office of Associate Chief Counsel
(Income Tax and Accounting)