

**Office of Chief Counsel
Internal Revenue Service
memorandum**

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to: Dale P. Lukas
Chief, Policy & Program Management, Accounts Management
(Wage & Investment)

from: Ronald J. Goldstein
Senior Technician Reviewer, Branch 4
(Income Tax & Accounting)

subject: Restoration of Back Pay to Exonerated Military Service Members

This memorandum provides non-taxpayer specific legal advice regarding the application of § 139F of the Internal Revenue Code. This advice may not be used or cited as precedent.

ISSUE

Are payments in the form of back pay made to United States military service members following the reversal of a court martial conviction considered a civil damage, restitution, or other monetary award related to the service member's wrongful incarceration for purposes of the exclusion from gross income under § 139F?

CONCLUSIONS

Yes. Payments in the form of back pay made to United States military service members following the reversal of a court martial conviction are considered a civil damage, restitution, or other monetary award related to the service member's wrongful incarceration under § 139F and may be excluded from gross income if all other requirements of § 139F are satisfied.

LAW

Section 61(a) of the Internal Revenue Code provides that, except as otherwise provided by the Code, gross income means all income from whatever source derived.

Section 104(a)(2) provides, in general, that gross income does not include the amount of any damages (other than punitive damages) received (whether by suit or agreement

and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness.

Section 139F(a) provides that a wrongfully incarcerated individual can exclude from gross income any civil damages, restitution, or other monetary award (including compensatory or statutory damages and restitution imposed in a criminal matter) relating to the incarceration of such individual for the covered offense for which such individual was convicted.

DISCUSSION

A United States military service member convicted in a court martial proceeding may be sentenced to incarceration and forfeiture of pay. The payment of back pay made to an exonerated service member may be reported as wages on the recipient's Form W-2 and is includible in gross income under § 61 unless excluded by another provision of the Code. As discussed below, back pay made to wrongfully incarcerated service members is not excludible under § 104(a)(2), but may be excluded under § 139F.

A payment is excludable from gross income under § 104(a)(2) if the payment is made on account of physical injury or physical sickness, which does not include emotional distress or symptoms thereof. The Supreme Court has interpreted "on account of" to require that a physical injury or physical sickness be the proximate cause of the damages being compensated. *Comm'r v. Schleier*, 515 U.S. 323 (1995). For example, damages that include back pay awarded as compensation for discriminatory employment actions and emotional distress are not excluded from gross income under § 104(a)(2). *Id.*; Rev. Rul. 96-65, 1996-2 C.B. 6. However, Rev. Rul. 85-97, 1985-2 C.B. 50, provides that the "on account of" requirement in § 104(a)(2) is met for payment of lost wages resulting from the time a taxpayer is out of work due to physical injuries. Therefore, service members who receive back pay solely as compensation for wages lost during a wrongful incarceration are not eligible for the exclusion from gross income under § 104(a)(2), because a physical injury or physical sickness is not the proximate cause of the payment.

Section 139F was enacted to specifically address payments made to wrongfully incarcerated taxpayers that are not excludible from gross income under § 104(a)(2). The legislative history notes that under prior law, compensation for non-physical injuries from wrongful incarceration, which include lost wages, are not excluded from income under § 104(a). The legislative history then sets forth Congress' intent to expand the § 104 exclusion through the enactment of § 139F. See Joint Committee on Taxation, *Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40)*, JCX-144-15 at 152-153 (Dec. 17, 2015).

Under § 139F(a), a payment of back pay to a service member may be eligible for the exclusion from gross income if the payment constitutes civil damages, restitution, or other monetary award that is related to the wrongful incarceration of the service

member. A service member's wrongful incarceration is the proximate cause of that individual's lost wages when the court martial sentence includes incarceration and forfeiture of pay so that the payment of back wages resulting from exoneration is related to and on account of the incarceration under § 139F. In addition, a payment of back wages to a service member represents compensation for amounts lost by that individual during a wrongful incarceration and, as such, qualifies as civil damages, restitution, or a monetary award (including compensatory or statutory damages) under § 139F. The fact that the exonerated service member's employer pays compensation in the form of back pay, which may be reported as wages on Form W-2, does not change our analysis or conclusion.

We conclude that payments in the form of back pay made to United States military service members following the reversal of a court martial conviction are considered a civil damage, restitution, or other monetary award related to the service member's wrongful incarceration under § 139F and may be excluded from gross income if all other requirements of § 139F are satisfied.

Please call James Yu at (202) 317-4718 if you have any further questions.