

Internal Revenue Bulletin: 2009-42

October 19, 2009

REG-127270-06

Notice of Proposed Rulemaking Damages Received on Account of Personal Physical Injuries or Physical Sickness

AGENCY:

Internal Revenue Service (IRS), Treasury.

ACTION:

Notice of proposed rulemaking.

SUMMARY:

This document contains proposed regulations relating to the exclusion from gross income for amounts received on account of personal physical injuries or physical sickness. The proposed regulations reflect amendments under the Small Business Job Protection Act of 1996. The proposed regulations also delete the requirement that to qualify for exclusion from gross income, damages received from a legal suit, action, or settlement agreement must be based upon "tort or tort type rights." The proposed regulations affect taxpayers receiving damages on account of personal physical injuries or physical sickness and taxpayers paying these damages.

DATES:

Written (paper or electronic) comments must be received by December 14, 2009.

ADDRESSES:

Send submissions to: CC:PA:LPD:PR (REG-127270-06), room 5203, Internal Revenue Service, Post Office Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-127270-06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at www.regulations.gov (IRS REG-127270-06).

FOR FURTHER INFORMATION CONTACT:

Concerning the proposed regulations, Sheldon A. Iskow, (202) 622-4920 (not a toll-free number); concerning the submission of comments and/or requests for a public hearing, Richard Hurst at Richard.A.Hurst@irs.counsel.treas.gov.

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) to reflect amendments made to section 104(a)(2) of the Internal Revenue Code (Code) by section 1605(a) and (b) of the Small Business Job Protection Act of 1996, Public Law 104-188, (110 Stat. 1838 (the 1996 Act)), and to delete the “tort or tort type rights” test under §1.104-1(c) of the Income Tax Regulations.

As amended, section 104(a)(2) excludes from gross income 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. These proposed regulations conform the regulations to these statutory amendments and clarify the changes for taxpayers and practitioners.

1. The 1996 Act Amendments

Section 1605(a) of the 1996 Act amended section 104(a)(2) to provide expressly that punitive damages do not qualify for the income exclusion. The amendment was a response to divergent court opinions, some holding that punitive damages are received “on account of” a personal injury. See H.R. Conf. Rept. 104-737 (1996) at 301. The amendment is consistent with *O’Gilvie v. United States*, 519 U.S. 79 (1996), holding that punitive damages are not compensation for personal injuries and do not satisfy the “on account of” test under section 104(a)(2). Section 1605(a) also amended section 104(a)(2) to provide that the income exclusion generally is limited to amounts received on account of personal “physical” injuries or “physical” sickness. Section 1605(b) of the 1996 Act further amended section 104(a) to provide that, for purposes of section 104(a)(2), even though emotional distress is not considered a physical injury or a physical sickness, damages not in excess of the amount paid for “medical care” (described in section 213(d)(1)(A) or (B)) for emotional distress are excluded from income.

The proposed regulations reflect these statutory amendments. The proposed regulations also provide that a taxpayer may exclude damages received for emotional distress “attributable” to a physical injury or physical sickness. See H.R. Conf. Rept. 104-737 (1996) at 301.

2. The Tort Type Rights Test

The proposed regulations also eliminate the requirement that “personal injuries or sickness” be “based upon tort or tort type rights.” That requirement in §1.104-1(c) was intended to ensure that only damages compensating for torts and similar personal injuries qualify for exclusion under section 104(a)(2). In *United States v. Burke*, 504 U.S. 229 (1992), the Supreme Court interpreted the tort type rights test as limiting the section 104(a)(2) exclusion to damages for personal injuries for which the full range of tort-type remedies is available. The Court held that section 104(a)(2) did not apply to an award of back pay under the pre-1991 version of Title VII of the 1964 Civil Rights Act because the damages awarded under the statute provided only a narrow remedy and thus did not compensate for a tort type injury. The Burke interpretation precluded section

104(a)(2) treatment for similar personal injuries redressed by “no-fault” statutes that do not provide traditional tort-type remedies. Many critics thought the Burke remedies test was too restrictive.

Later legislative and judicial developments eliminated the need to base the section 104(a)(2) exclusion on tort and remedies concepts. First, *Commissioner v. Schleier*, 515 U.S. 323 (1995), interpreted the statutory “on account of” test as excluding only damages directly linked to “personal” injuries or sickness. Second, the 1996 Act restricts the exclusion to damages for “personal physical” injuries or “physical sickness.”

Accordingly, under the proposed regulations, damages for physical injuries may qualify for the section 104(a)(2) exclusion even though the injury giving rise to the damages is not defined as a tort under state or common law. Nor does the section 104(a)(2) exclusion depend on the scope of remedies available under state or common law. In effect, the regulations reverse the result in *Burke* by allowing the exclusion for damages awarded under no-fault statutes.

Proposed Effective/Applicability Date

These regulations are proposed to apply to damages paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995, and received after the date these regulations are published as final regulations in the **Federal Register**. However, taxpayers may apply these proposed regulations to amounts paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995, and received after August 20, 1996. If applying the proposed regulations to damages received after August 20, 1996, results in an overpayment of tax, the taxpayer may file a claim for refund within the period of limitations under section 6511.

Notwithstanding the date these regulations are proposed to become effective, the 1996 Act amendments to section 104(a)(2), including the amendment restricting the exclusion to amounts received on account of personal physical injuries or physical sickness, are effective for amounts received after August 20, 1996, except for any amount received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995. Since the 1996 Act amendments, courts have applied the statutory effective date in holding that amounts received on account of nonphysical injuries are not excludable. *Hennessey v. Commissioner*, T.C. Memo 2009-132; *Green v. Commissioner*, T.C. Memo 2007-39. These regulations propose to conform existing regulations to amended section 104(a)(2). To the extent that existing regulations conflict with amended section 104(a)(2), the statute controls. See *Murphy v. Internal Revenue Service*, 493 F.3d 170, 176 n* (D.C. Cir. 2007).

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations,

and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (either a signed paper original with eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time and place for the hearing will be published in the **Federal Register**.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.104-1, paragraph (c) is revised to read as follows:

§1.104-1 Compensation for injuries or sickness.

* * * * *

(c) Damages received on account of personal physical injuries or physical sickness—(1) In general. Section 104(a)(2) excludes from gross income 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. Emotional distress is not considered a physical injury or physical sickness. However, damages for emotional distress attributable to a physical injury or physical sickness are excluded from income under section 104(a)(2). Section 104(a)(2) also excludes damages not in excess of the amount paid for medical care (described in section 213(d)(1)(A) or (B)) for emotional distress. For purposes of this paragraph (c), the term *damages* means an amount received (other than workers' compensation) through prosecution of a legal suit or action, or through a settlement agreement entered into in lieu of prosecution.

(2) Cause of action and remedies. The section 104(a)(2) exclusion may apply to damages recovered for a physical personal injury or sickness under a statute, even if

that statute does not provide for a broad range of remedies. The injury need not be defined as a tort under state or common law.

(3) *Effective/applicability date.* This paragraph (c) applies to damages paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995, and received after the date these regulations are published as final regulations in the **Federal Register**. Taxpayers also may apply these proposed regulations to damages paid pursuant to a written binding agreement, court decree, or mediation award entered into or issued after September 13, 1995, and received after August 20, 1996. If applying these proposed regulations to damages received after August 20, 1996, results in an overpayment of tax, the taxpayer may file a claim for refund before the period of limitations under section 6511 expires. Notwithstanding the date these regulations are proposed to become effective, the statutory amendments to section 104(a) under section 1605 of the Small Business Job Protection Act of 1996, Public Law 104-188, (110 Stat. 1838), are effective for amounts received after August 20, 1996, except for any amount received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

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Linda E. Stiff,
*Deputy Commissioner for
Services and Enforcement.*

Note

(Filed by the Office of the Federal Register on September 14, 2009, 8:45 a.m., and published in the issue of the Federal Register for September 15, 2009, 74 F.R. 47152)

Drafting Information

The principal author of these regulations is Sheldon A. Iskow of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.