PUBLICATION

Final Regulations on Judgments and Settlements Received Because of Physical Injury

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On January 23, 2012, final regulations (Final Regulations) were issued by the Internal Revenue Service (IRS) relating to the exclusion from gross income of amounts received due to personal physical injuries or physical sickness under Section 104 of the Internal Revenue Code of 1986, as amended (Code). The Final Regulations apply to damages paid or received pursuant to a written binding agreement, court decree or mediation award entered into or issued after September 13, 1995 and received after January 23, 2012. Taxpayers may file for a refund for damages received after August 20, 1996 so long as the payment was pursuant to a written binding agreement, etc. entered into or issued after September 13, 1995, and so long as the applicable statute of limitations has not expired.

The statute underlying the Final Regulations, Section 104(a)(2) of the Code, provides that a taxpayer may exclude from gross income any amount of damages (other than punitive damages) received (whether by suit or agreement and whether as a lump sum or periodic payments) because of personal physical injuries or physical sickness. Previous Regulations interpreted this statute to apply only to those damages received when the underlying claim involved "tort or tort-type rights." By limiting the application of Section 104(a)(2) to tort-based claims, the Treasury Department attempted to distinguish qualifying payments arising from personal injury from those resulting solely from financial loss, such as under a claim for breach of contract.

Since the date the tort-type analysis was introduced, the Supreme Court interpreted Section 104(a)(2) to apply only to those damages which are directly linked to "personal" injuries or sickness. See *Commissioner v. Schleier,* 515 U.S. 323 (1995). In adopting and issuing the Final Regulations, the IRS conformed its regulatory guidance in abandoning the focus on "tort or tort-type rights." Instead, the Final Regulations more closely follow the text of Section 104(a)(2) and rely simply on the *Schleier* decision for clarity as to the damages considered eligible for exclusion from gross income.

The Final Regulations also confirm a long-standing presumption that emotional distress, by itself, is not considered an excludable physical injury or physical sickness under Section 104(a)(2). Instead, the Final Regulations permit the exclusion of damages for emotional distress but only when they are attributable to a physical injury. For example, damages received by a plaintiff who sustains only reputational harm such as in an action for libel, slander or in a claim for discrimination, will not be excludable from gross income because no physical harm is recognized for these purposes as being suffered. On the other hand, any damages paid for emotional distress which result from increased pain and suffering a plaintiff endures due to a failed surgery should be excludable as such distress is recognized as being attributable to a physical injury.

By clarifying the tax treatment to the recipient of personal injury damages, the Final Regulations indirectly clarify the payor's reporting obligations. It remains the obligation of the payor to determine the taxability of the payment to the payee. An informational return (generally Form 1099-MISC) should be issued if the payment is taxable to the payee. If the payment is not taxable, the payor is not obligated to report the payment. Consequently, payors may benefit to some degree as they no longer need to determine whether the underlying claim involved "tort or tort-type rights."

In adopting the Final Regulations under Section 104(a)(2), the IRS has more closely conformed its regulatory language to that of the statutory Section. In doing so, the IRS has in essence endorsed an approach which instead looks to the nature of the injuries sustained by the plaintiff rather than on the type of claim upon which the damages are based. This clarification should be helpful in a claimant's characterization of such amounts for income tax purposes as well as in the fulfillment of reporting obligations by the payor.

Should you have questions or wish to discuss the issues addressed in this Alert, please contact an attorney in the Firm's Tax Department.