

LEXSTAT 2009 TNT 11-27

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Tax Notes Today

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DEPARTMENT: Administrative Rulings; IRS Letter Rulings

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HEADLINE: #27 2009 TNT 11-27 SETTLEMENT PROCEEDS ATTRIBUTABLE TO PHYSICAL INJURY ARE EXCLUDABLE. (Section 61 -- Gross Income Defined;) (LTR 200903073) (Release Date: OCTOBER 09, 2008) (Doc 2009-1070)

CODE: *Section 61* -- Gross Income Defined;
Section 104 -- Damage Awards/Sick Pay

ABSTRACT: The Service has determined that amounts received by an accident victim from the defendant's insurance company as part of an assignment agreement and a settlement agreement are excludable from gross income to the extent they are attributable to medical expenses, pain and suffering, and lost earnings.

SUMMARY:

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The Service has determined that amounts received by an accident victim from the defendant's insurance company as part of an assignment agreement and a settlement agreement are excludable from gross income to the extent they are attributable to medical expenses, pain and suffering, and lost earnings.

AUTHOR: Internal Revenue Service

GEOGRAPHIC: United States

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Person To Contact: * * *, ID No. * * *
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Date: October 9, 2008

Refer Reply To: CC:ITA:BR05 - PLR-132147-08

In Re: * * *

LEGEND:

A = * * * (Taxpayer) SSN: * * *

B&C = Defendants: * * *, manager, and * * *, employer

Company D = * * *

State M = * * *

Dates:

1 = * * * (Incident X)

2 = * * *

3 = * * *

4 = * * *

5 = * * *

6 = * * *

7 = * * *

Amounts:

\$ n = * * *

\$ o = * * *

\$ p = * * *

\$ q = * * *

\$ r = * * *

\$ s = * * *

\$ t = * * *

\$ u = * * *

Dear * * *

This is in response to your authorized representatives' letters and submissions of June 12, 2008, and other correspondence and submissions, in which they requested on your behalf private letter rulings regarding the proper federal income tax treatment of proceeds received in the settlement of certain litigation, as more fully discussed below. We are pleased to address your concerns.

FACTS

The information submitted indicates that A, (sometimes referred to herein as plaintiff or the "Taxpayer") was formerly employed as a highway construction worker. In the course of his employment, on Date 1, A was struck by a drunk driver, B, and left a quadriplegic (Incident X). B was the manager of a tavern, C. On the morning of Date 1, B had served himself an indeterminate number of drinks while on duty at C. A pursued personal injury tort claims against both defendants B and C.

As a result of his claims, A received a jury verdict on Date 2 of approximately \$ p, consisting of approximately \$ q in compensatory damages for personal physical injuries, past and present medical expenses, pain and suffering, and lost earnings, and approximately \$ r in punitive damages. After certain post-trial motions, on Date 3 the jury verdict was reduced to approximately \$ s, consisting of \$ t in compensatory payments and \$ u in punitive damages. Defendants appealed the verdict to the State M Supreme Court on Date 4.

Prior to the judgment award, C's insurer, Company D, had rejected an opportunity to settle the plaintiff's claim for \$ n, A's policy limit. Under State M law, the policy holder has a cause of action against an insurance company if the insurance company, acting in bad faith, fails to settle a claim. C believed it had such a cause of action against Company D.

As part of an agreement to stay execution of A's judgment, and while defendant's appeal was pending, C assigned its rights to pursue the bad faith claim it believed it held against Company D to A, the plaintiff, pursuant to an assignment and cooperation agreement ("Assignment Agreement") of Date 5. The Assignment Agreement provided, gener-

ally, for the assignment of all of B and C's claims against Company D relating to the bad faith defense claims, to A; for the stay of execution of the personal injury judgment against the assets of B and C by A; and for the cooperation of B and C with A in the pursuit of the litigation against Company D. The Assignment Agreement provided that within 30-days of the termination of the litigation against Company D, whether by final judgment or settlement, the judgment against B and C relating to all of A's personal injury claims would be marked "satisfied." A also entered into a contingency fee agreement with his attorneys to prosecute the bad faith action against Company D, a matter not at issue herein.

On Date 6, Company D and A settled the assigned bad-faith action ("Settlement Agreement"), with Company D agreeing to make a \$ 0 payment to A and his attorneys, which payment was made on Date 7. The Settlement Agreement provided that, upon receipt of payment, A would cause the bad faith insurance litigation to be dismissed with prejudice, and cause the personal injury judgment against B and C to be marked satisfied.

LAW & ANALYSIS

Section 61 of the Internal Revenue Code (Code) provides that, except as otherwise provided in subtitle A (relating to income taxes), gross income means all income from whatever source derived. The concept of gross income encompasses accessions to wealth, clearly realized, over which taxpayers have complete dominion. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); 1955-1 C.B. 207. Damage awards and insurance proceeds generally fall within the broad purview of gross income.

Section 104 of the Code provides certain exceptions to the generally inclusive rule of *section 61*, providing an exclusion from gross income for certain amounts received as compensation for personal injuries or sickness.

Section 104(a)(2) provides an exclusion from gross income for the amount of any damages (other than punitive damages) received (whether by suit or agreement, and whether as lump sum or as periodic payments) on account of personal physical injuries or physical sickness.

Section 1.104-1(c) of the Income Tax Regulations defines the term "damages received (whether by suit or agreement)" as an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort-type rights, or through a settlement agreement entered into in lieu of such prosecution.

In the instant circumstances, we conclude that those amounts (\$ 0) received by plaintiff A as a result of the Assignment and Settlement Agreements are properly includable in A's gross income in the year of their receipt, Date 7, for federal income tax purposes, subject to any exclusions available to A.

In general, the character of amounts received as proceeds from a lawsuit or a settlement depends upon the nature of the claims, and the actual basis for the recovery. Under the "origin of the claim" doctrine, it is a "well-settled rule" that the classification of amounts received in settlement of litigation is to be determined "by the nature and basis of the action settled," and that "amounts received in compromise of a claim must be considered as having the same nature as the rights compromised (emphasis added)." *Alexander v. IRS*, 72 F.3d 938 (1st Cir. 1995). The critical inquiry is . . . "In lieu of what were the damages awarded?" See *Raytheon Production Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944), cert. denied, 323 U.S. 779 (1944).

In the instant case, plaintiff A's recovery against D had its origin in the settlement of A's personal physical injury tort claims against B and C. A sued D only as an assignee of C to collect on A's judgment against B and C for damages awarded in a personal physical action. But for his personal injury claim and his rights as an assignee, A would be entitled to no recovery against D. Thus, such amounts are includable in A's gross income for federal income tax purposes, except to the extent they may be excluded under *section 104(a)(2) of the Code*.

CONCLUSIONS

Based upon the facts and representations presented and the above analysis of applicable law, we conclude as follows:

1. To the extent plaintiff A receives proceeds under the Assignment Agreement of Date 5 and the final Settlement Agreement of Date 6, resulting from his settlement of personal physical injury and sickness claims arising from Incident X, including amounts in settlement of his claims for past and

present medical expenses, future medical expenses, pain and suffering, and lost earnings, such amounts qualify for exclusion from A's gross income under *section 104(a)(2) of the Code*; and

2. To the extent plaintiff A receives proceeds under said Assignment and final Settlement Agreements resulting from his settlement of claims other than personal physical injury and sickness claims arising from Incident X, e.g., punitive or other damages, such amounts are properly includable in A's gross income under *section 61 of the Code*.

In this letter ruling, we express no opinion as to the proper allocation of the settlement proceeds as between personal physical injury and sickness damages, and amounts received for other reasons. See, section 4.02 (10) of *Rev. Proc. 2008-3*.

This letter ruling is based on facts and representations provided by the Taxpayer and its authorized representatives, and is limited to the matters specifically addressed. No opinion is expressed as to the tax treatment of the transactions considered herein under the provisions of any other sections of the Code or regulations which may be applicable thereto, or the tax treatment of any conditions existing at the time of, or effects resulting from, such transactions which are not specifically addressed herein, including those relating to any party other than A, the Taxpayer herein.

Because it could help resolve future federal tax issues, a copy of this letter should be maintained with the Taxpayer's permanent records.

Pursuant to a power of attorney on file with this office, copies of this letter ruling are being sent to the Taxpayer's authorized representatives.

This ruling is directed only to the taxpayer who requested it. *Section 6110(k)(3) of the Internal Revenue Code* provides that it may not be used or cited as precedent.

* * *

Associate Chief Counsel
(Income Tax & Accounting)

By William A. Jackson
Chief, Branch 5

Enclosures:
Copy of this letter
Copy for *section 6110* purposes

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