

104th Congress; 2nd Session, House Rpt. 104-586(Section 1 of 4;Due to its size, this report has been split into 4 sections.)

SMALL BUSINESS JOB PROTECTION ACT OF 1996

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Mr. Archer submitted the following Report together with Supplemental and Dissenting Views from the Committee on Ways and Means
(To accompany H.R. 3448)
(Including cost estimate of the Congressional Budget Office)

5. Modify exclusion of damages received on account of **personal injury** or sickness (sec. 1605 of the bill and sec. 104(a)(2) of the Code)

Present Law

Under present law, gross income does not include any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of **personal injury** or sickness (sec. 104(a)(2)).

The exclusion from gross income of damages received on account of **personal injury** or sickness specifically does not apply to punitive damages received in connection with a case not involving physical injury or sickness. Courts presently differ as to whether the exclusion applies to punitive damages received in connection with a case involving a physical injury or physical sickness.⁵²² Certain States provide that, in the case of claims under a wrongful death statute, only punitive damages may be awarded.

²²The Supreme Court recently agreed to decide whether punitive damages awarded in a physical injury lawsuit are excludable from gross income. *Ogilvie v. U.S.*, 66 F.3d 1550 (10th Cir. 1995), cert. granted, 64 U.S.L.W. 3639 (U.S. March 25, 1996)(No. 95-966). Also, the Tax Court recently held that if punitive damages are not of a compensatory nature, they are not excludable from income, regardless of whether the underlying claim involved a physical injury or physical sickness. *Bagley v. Commissioner*, 105 T.C. No. 27 (1995).

Courts have interpreted the exclusion from gross income of damages received on account of **personal injury** or sickness broadly in some cases to cover awards for **personal injury** that do not relate to a physical injury or sickness. For example, some courts have held that the exclusion applies to damages in cases involving certain forms of employment discrimination and injury to reputation where there is no physical injury or sickness. The damages received in these cases generally consist of back pay and other awards intended to compensate the claimant for lost wages or lost profits. The Supreme Court recently held that damages received based on a claim under the Age Discrimination in Employment Act could not be excluded from income.⁵²³ In light of the Supreme Court decision, the Internal Revenue Service has suspended existing guidance on the tax treatment of damages received on account of other forms of employment discrimination.

23Schleier v. Commissioner, 115 S. Ct. 2159 (1995).

Reasons for Change

Punitive damages are intended to punish the wrongdoer and do not compensate the claimant for lost wages or pain and suffering. Thus, they are a windfall to the taxpayer and appropriately should be included in taxable income. Further, including all punitive damages in taxable income provides a bright-line standard which avoids prospective litigation on the tax treatment of punitive damages received in connection with a case involving a physical injury or physical sickness.

Damages received on a claim not involving a physical injury or physical sickness are generally to compensate the claimant for lost profits or lost wages that would otherwise be included in taxable income. The confusion as to the tax treatment of damages received in cases not involving physical injury or physical sickness has led to substantial litigation, including two Supreme Court cases within the last four years. The taxation of damages received in cases not involving a physical injury or physical sickness should not depend on the type of claim made.

Explanation of Provisions

Include in income all punitive damages

The bill provides that the exclusion from gross income does not apply to any punitive damages received on account of **personal injury** or sickness whether or not related to a physical injury or physical sickness. Under the bill, present law continues to apply to punitive damages received in a wrongful death action if the applicable State law (as in effect on September 13, 1995 without

regard to subsequent modification) provides, or has been construed to provide by a court decision issued on or before such date, that only punitive damages may be awarded in a wrongful death action. The Committee intends no inference as to the application of the exclusion to punitive damages prior to the effective date of the bill in connection with a case involving a physical injury or physical sickness.

Include in income damage recoveries for nonphysical injuries

The bill provides that the exclusion from gross income only applies to damages received on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injury or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from gross income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from taxable income as under present law.

The bill also specifically provides that emotional distress is not considered a physical injury or physical sickness.²⁴ Thus, the exclusion from gross income does not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. Because all damages received on account of physical injury or physical sickness are excludable from gross income, the exclusion from gross income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness. In addition, the exclusion from gross income specifically applies to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress.

²⁴The Committee intends that the term emotional distress includes physical symptoms (e.g., insomnia, headaches, stomach disorders) which may result from such emotional distress.

The Committee intends no inference as to the application of the exclusion to damages prior to the effective date of the bill in connection with a case not involving a physical injury or physical sickness.

Effective Date

The provisions generally are effective with respect to amounts received after June 30, 1996. The provisions do not apply to amounts received under a written binding agreement, court decree, or

mediation award in effect on (or issued on or before) September 13, 1995.