

Section 104(a)(2), as amended by § 1605 of the Small Business Job Protection Act of 1996 (the 1996 Act) 110 Stat. 1755, 1838, provides generally that gross income does not include the amount of any damages received (whether by suit or agreement) on account of personal *physical* injuries or *physical* sickness. Section 104(a) further provides that, for purposes of paragraph (2), emotional distress is not treated as a physical injury or physical sickness except to the extent of damages paid for medical care (described in § 213(d)-(1)(A) or (B)) attributable to emotional distress. The 1996 Act amendments to § 104(a) apply to amounts received after August 20, 1996, but not to amounts received under a written binding agreement, court decree, or mediation award in effect on (or issued on or before) September 13, 1995.

Before its amendment by the 1996 Act, former § 104(a)(2) provided generally that gross income does not include the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness.

Section 1.104-1(c) of the Income Tax Regulations provides that the term “damages received (whether by suit or agreement)” means 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 *United States v. Burke*, 504 U.S. 229 (1992), the Supreme Court held that back pay received for disparate impact gender discrimination under Title VII was not excludable from gross income as damages received on account of personal injuries under former § 104(a)(2) because that part of Title VII did not compensate for a broad range of traditional tort harms.

In light of *Burke*, the Service issued Rev. Rul. 93-88, 1993-2 C.B. 61, which holds that compensatory damages and back pay are excludable from gross income as damages for personal injury under former § 104(a)(2) when received for: (1) disparate treatment gender discrimination under Title VII, as amended in 1991; (2) racial discrimination under § 16 of the Civil Rights Act of 1870, 42 U.S.C. § 1981 and Title VII; and (3) disparate treatment discrimination under the Americans With Disabilities Act, 42

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## Section 104.—Compensation for Injuries or Sickness

*26 CFR 1.104-1(c): Damages received on account of personal injuries or sickness.*

*(Also §§ 61, 3121, 3231, 3306, 3401, 7805; 1.61-1; 31-3121(a)-1; 31.3231(e)-1; 31.3306(b)-1; 31.3401(a)-1; 301.7805-1.)*

**Damages received on account of personal injuries or sickness.** Under current § 104(a)(2), back pay and damages for emotional distress received to satisfy a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the 1964 Civil Rights Act are not excludable from gross income. Under former § 104(a)(2), as in effect before August 21, 1996, back pay received to satisfy such a claim is not excludable from gross income. However, damages received for emotional distress under that statute are excludable. Rev. Rul. 93-88 obsoleted. Notice 95-45 superseded. Rev. Rul. 72-341 and 84-92 obsoleted. Rev. Proc. 96-3 modified.

### Rev. Rul. 96-65

#### ISSUE

Are amounts received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII of the Civil Rights Act of 1964, as amended in 1991 (Title VII), excludable from gross income under § 104(a)(2) of the Internal Revenue Code?

#### LAW AND ANALYSIS

In general, § 61(a) provides that, except as otherwise provided by law, gross income includes all income from whatever source derived.

U.S.C. §§ 12101–12213, as amended in 1991. All three of these statutes provide a broad range of compensatory damages of the type the Supreme Court focused upon in *Burke*.

In *Commissioner v. Schleier*, 515 U.S. \_\_\_\_\_, 115 S. Ct. 2159 (1995), the Supreme Court held that back pay and liquidated damages received to settle a claim under the Age Discrimination in Employment Act of 1967, 29 U.S.C. §§ 621–634 (ADEA), are not excludable from gross income under former § 104(a)(2). The Court concluded that former § 104(a)(2) and its regulations set forth two requirements for a recovery to be excludable from gross income: (1) it must be based on tort or tort type rights, and (2) it must be received “on account of personal injuries or sickness.” The Court held that back pay and liquidated damages received under the ADEA meet neither requirement because (1) the ADEA does not compensate for any of the other traditional tort harms associated with personal injury, (2) the back pay is completely independent of the existence or extent of any personal injury, and (3) the ADEA liquidated damages are punitive in nature.

Based on *Schleier*, Notice 95–45, 1995–2 C.B. 330, suspended Rev. Rul. 93–88, and added section 5.05 to Rev. Proc. 95–3, 1995–1 C.B. 385, to provide that pending issuance of published guidance, the Service will not issue rulings or determination letters on whether amounts received are excludable from gross income under § 104(a)(2) in situations affected by *Schleier*.

In light of *Schleier*, and the amendment of § 104(a)(2) by the 1996 Act, the Internal Revenue Service has reconsidered Rev. Rul. 93–88.

## HOLDINGS

(1) *Current § 104(a)(2)*. Back pay received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII is not excludable from gross income under § 104(a)(2) because it is completely independent of, and thus is not damages received on account of, personal physical injuries or physical sickness under that section. Similarly, amounts received for emotional distress in satisfaction of such a claim are not excludable from gross income under § 104(a)(2), except to the extent they are damages paid for medical care (as described in § 213(d)(1)(A) or (B)) attributable to emotional distress.

(2) *Former § 104(a)(2)*. Back pay received in satisfaction of a claim for denial of a promotion due to disparate treatment employment discrimination under Title VII is not excludable from gross income under former § 104(a)(2) because it is completely independent of, and thus is not damages received on account of, personal injuries or sickness under that section. However, damages received for emotional distress in satisfaction of such a claim are excludable from gross income under former § 104(a)(2) because they are received “on account of personal injuries or sickness.”

(3) *Wages and compensation*. Back pay includible in gross income under Holding (1) or (2) is “wages” for purposes of § 3121 (Federal Insurance Contributions Act (FICA)), § 3306 (Federal Unemployment Tax Act (FUTA)), and § 3401 (federal income tax withholding), and is “compensation” for purposes of § 3231 (Railroad Retirement Tax Act (RRTA)).

## EFFECT ON OTHER DOCUMENTS

Rev. Rul. 93–88 is obsolete. Notice 95–45 is superseded. Rev. Rul. 72–341, 1972–2 C.B. 32, and Rev. Rul. 84–92, 1984–1 C.B. 204, which hold that amounts received to settle a claim under pre-1991 Title VII are (1) includible in gross income as compensation, (2) “wages” for FICA, FUTA, and federal income tax withholding purposes, and (3) “compensation” for RRTA purposes, are obsolete. Rev. Proc. 96–3, 1996–1 I.R.B. 82, is modified to delete section 5.05.

## PROSPECTIVE APPLICATION

Pursuant to the authority contained in § 7805(b), this revenue ruling will not apply adversely to damages received under any provision of law providing tort or tort type remedies for employment discrimination for race, color, religion, gender, national origin, or other similar classifications, if the damages are received (1) on or before June 14, 1995, the date that *Schleier* was decided by the Supreme Court, or (2) pursuant to a written binding agreement, court decree, or mediation award in effect on (or issued on or before) June 14, 1995.

## DRAFTING INFORMATION

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