

## INTERNAL REVENUE SERVICE

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[REDACTED]

Dear [REDACTED]:

I am responding to your letter dated May 1, 2003, on behalf of your constituents, [REDACTED] and [REDACTED]. The [REDACTED] received \$140,000 from the United States Department of Agriculture (USDA) in settlement of a class action lawsuit by African-American farmers. They asked whether the amount is taxable.

The [REDACTED] award was made under "Track B" of the Consent Decree. Track B allowed a claimant to go before an arbitrator and, on the basis of extreme wrongdoing, to seek larger damages than were available under Track A. Track B provided for a tailored settlement based on individual circumstances, including a cash payment equal to actual damages, and forgiveness of outstanding USDA loans affected by discriminatory conduct. As discussed below, the tax consequences to the [REDACTED] depend on what their award was for.

In general, § 61(a) of the Internal Revenue Code provides that gross income includes all income from whatever source derived, except as otherwise provided by law. The Supreme Court of the United States has held that the concept of gross income includes accessions to wealth, clearly realized, over which the taxpayers have complete dominion. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), 1955-1 C.B. 207.

Section 104(a)(2) provides that a taxpayer can exclude from gross income any damages received on account of personal physical injuries or physical sickness. In 1996, the Congress amended § 104 to provide specifically that emotional distress is not considered a physical injury or physical sickness. According to the legislative history of the 1996 changes, the term "emotional distress" includes physical symptoms, such as insomnia, headaches, and stomach disorders that may result from emotional distress.

Whether a recovery received as a result of a settlement agreement is includible in gross income depends on the nature of the claim that was the basis for the settlement. The proper inquiry is "in lieu of what were damages awarded or paid". All factors, such as the allegations in the taxpayer's complaint, the arguments in the court proceeding, and

the payor's intent are considered in making this determination. If a recovery represents a reimbursement for lost profits, pain and suffering, or emotional distress, it is generally taxable income.

The Consent Decree provided that a Track B claimant who demonstrated that he or she was a victim of racial discrimination, and suffered damages therefrom, is entitled to actual damages and discharge of the claimant's outstanding debt to the USDA incurred under programs affected by claims resolved in the claimant's favor. An award under Track B made on account of racial discrimination is generally includible in a taxpayer's gross income.

Part of the settlement received by the [REDACTED] may have been for the discharge of indebtedness. Income from the discharge of indebtedness is included in gross income under § 61, unless it is excludable under § 108. The exclusions under § 108 apply on a case by case basis depending on the individual facts and circumstances of each taxpayer claiming the benefit of an exclusion. We do not have enough information to determine whether § 108 might provide an exclusion for the [REDACTED]. However, we have enclosed Publication 225, Farmer's Tax Guide, which provides further information on discharge of indebtedness income at pages 22 - 24.

I hope this information is helpful. If you have any questions, please call Sheldon A. Iskow, Identification Number 50-03546, at (202) 622-4920.

Sincerely,

Robert A. Berkovsky  
Branch Chief  
Office of Associate Chief Counsel  
(Income Tax & Accounting)

Enclosure