

INTERNAL REVENUE SERVICE

February 6, 2004

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Dear Ms. _____ :

This letter responds to your inquiry of November 30, 2003, to Senator John Kerry about the proper tax treatment of damages received from a settlement award. Senator Kerry asked us to respond to you directly.

_____ recently agreed to pay damages to all alleged victims of sexual abuse by _____. You were told that section 104 of the Internal Revenue Code (the Code) requires a physical injury or sickness in order for a settlement award to be excludible from taxable income. You object to settlement awards involving sexual abuse by _____ being subject to income tax and believe that settlement awards should be excluded from taxable income under section 104.

Under the law, the term "physical injuries or physical sickness" does not include emotional distress or any symptoms (e.g. insomnia, headaches, and stomach disorders) that may result. H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 301 n.56 (1996). For example, if a taxpayer receives damages solely on account of emotional distress, he or she cannot exclude the damages from taxable income. However, if a lawsuit originates from a physical injury or sickness, all resulting damages (other than punitive damages) are treated as payments received on account of the physical injury or sickness. For example, if a taxpayer receives damages (other than punitive damages) for a physical injury, he or she can exclude all damages, including those received for emotional distress, from taxable income. A taxpayer also may exclude from income an amount of damages that equals medical expenses incurred to treat emotional distress. Section 104 of the Code.

If a settlement award represents either damages for physical injury or sickness (other than for punitive damages) or reimbursement for medical expenses incurred to treat emotional distress, the damages can be excluded from taxable income. If a settlement award represents damages solely for emotional distress, (other than reimbursement of medical expenses) or other nonphysical injuries or sickness, the settlement award cannot be excluded from taxable income. The change you requested that would allow

a taxpayer to exclude damages for emotional distress or other nonphysical injuries or sickness from taxable income would requires a statutory amendment.

I hope this information is helpful. If you need further information, please contact me or
, Identification Number , at .

Sincerely,

/s/

Robert M. Brown
Associate Chief Counsel
(Income Tax and Accounting)