OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

April 30, 2010

Number: **INFO 2010-0123**
Release Date: 6/25/2010

UIL: 61.00-00

CONEX-114751-10

The Honorable Jerry F. Costello
Member, U.S. House of Representatives
144 Lincoln Place Court, Suite 4
Belleville, IL 62221

Attention:

Dear Congressman Costello:

I am responding to your inquiry dated March 12, 2010, on behalf of your constituent, of . asks whether plaintiffs must include in gross income a settlement award they receive to settle a class action lawsuit involving . It appears that the settlement award will include attorneys' fees, compensation for loss of property value, loss of enjoyment and use of property, and destruction of property due to fire or explosion, and reimbursement of medical expenses.

Gross income includes all income from whatever source derived, except as otherwise provided by law (section 61 of the Internal Revenue Code (Code)). Under section 61, Congress intends to tax all gains or undeniable 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).

Whether an award received under a settlement agreement is taxable depends on the nature of the claim that was the basis for the settlement. An award is generally taxable, unless it is specifically excluded from income by law or constitutes a return of capital. I hope the following information on the income tax treatment of different types of damage awards that plaintiffs may receive in a settlement of a class action is helpful.

Medical expenses. Taxpayers generally exclude from gross income a settlement award they receive (whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness (section 104(a)(2) of the Code). Thus, taxpayers generally exclude from gross income a settlement award that compensates them for amounts they pay for medical care due to a personal physical injury or physical sickness. However, a taxpayer must include in income an award attributable to (and not in excess of) of amounts that the taxpayer deducted as medical expenses in prior taxable years (section 104(a) of the Code).

Declines in property values. A taxpayer who receives an award for declines in the value of property must reduce the basis in the property by the amount of the award. If the award is less than the taxpayer's adjusted basis in the property, the award is not taxable. However, the taxpayer must include the award in gross income to the extent it exceeds the taxpayer's adjusted basis in the property.

Destruction of property. If a taxpayer properly claimed a casualty loss deduction for property destroyed by a fire or explosion, and in a later year receives an award to compensate for that loss, then the taxpayer includes the award in gross income in the year received to the extent that the casualty loss deduction reduced the taxpayer's income tax in the year that the taxpayer took the casualty loss deduction. If the award exceeds the amount of the casualty loss deduction, the taxpayer reduces basis in the property by the amount of the excess. The taxpayer includes such excess in income as gain to the extent that it exceeds the remaining basis in the property, unless the taxpayer can exclude the gain from income or defer its recognition. For example, if the taxpayer's principal residence was destroyed, the taxpayer may be eligible to exclude part of all of the gain from income (section 121 of the Code). In addition, a taxpayer may elect to defer recognition of gain on an involuntary conversion of property if the taxpayer meets certain requirements (section 1033 of the Code).

Attorneys' fees. The IRS has held that plaintiffs do not include in income an award of attorneys' fees to class counsel where the award was not made to the class counsel under any specific fee or retainer arrangement between the class counsel and the class members (including class representatives).

The IRS will generally issue a private letter ruling on the taxability of a settlement award that settles multiple claims. The ruling would explain the tax treatment of each element of the award. However, the IRS will not ordinarily issue a ruling on the proper allocation of a settlement award among multiple claims for federal tax purposes. Section 4.02(10) of Rev. Proc. 2010-3, 2010-1 I.R.B. 110, 119. The procedures for obtaining a private letter ruling are in Rev. Proc. 2010-1, 2010-1 I.R.B. 1, which taxpayers can find at the IRS website, irs.gov.

I hope that this information is helpful. If you have any further questions, please call me or at .

Sincerely,

Michael J. Montemurro
Chief, Branch 4
Office of Associate Chief Counsel
(Income Tax and Accounting)