Office of Chief Counsel
Internal Revenue Service
memorandum

CC:ITA:B05
PRENO-111606-07

UILC: 1001.02-00, 1016.00-00, 1033.00-00

date: May 18, 2007

to: National Disaster Assistance Coordinator
Communications Liaison and Disclosure
(Small Business/Self Employed Division)
Attn: Carol L. Polley

from: William A. Jackson, Chief Branch 05
(Income Tax & Accounting)

---

subject: Proper Federal Tax Treatment of Payments Under Settlement of Murphy Oil USA, Inc., Class Action Lawsuit

This is in response to your request of February 28, 2007. It should not be cited or relied upon as precedent.

ISSUES

This responds to your recent communication in which you requested guidance regarding the proper federal income tax treatment to be accorded certain payments (including settlement payments, attorneys' fees, litigation expenses, and certain other payments) paid or to be paid in connection with the settlement of Patrick Joseph Turner, Et Al., v. Murphy Oil USA, Inc., Civil Action No.: 05-4206 Consolidated Case Section "L" (2) (hereinafter "Litigation"), a class action lawsuit involving Murphy Oil USA, Inc., Tank 250-2, Meraux, St. Bernard Parish, LA, crude oil spill (August 29, 2005 – September 3, 2005) (hereinafter "Oil Spill").

BRIEF SUMMARY OF CONCLUSIONS

For reasons more fully addressed below, we have concluded that:

a) the amounts awarded under the settlement agreement for attorneys' fees and other litigation expenses are not income to the class members in the instant circumstances;

b) settlement funds paid as compensation to the subject property owners generally are not income to the owners, but instead represent a return of capital to each to

the extent each owner's portion of the recovery and other forms of compensation for the damaged property do not exceed that owner's adjusted tax basis in his or her property interest;

c) to the extent settlement proceeds and other forms of compensation for property damage received by an owner of damaged property exceed the property's adjusted tax basis, the provisions of section 1033(a)(2)(A) will apply to govern the recognition of any gain; and

d) certain sections of the Internal Revenue Code addressing damage caused by or as a result of 'Presidentially Declared Disasters' generally have no application to Oil Spill.

FACTS

The information submitted indicates that the plaintiffs in Litigation are St. Bernard Parish, LA (hereinafter "Area") residents, homeowners, and business owners whose property was damaged or destroyed as a result of Oil Spill. The plaintiffs allege that sometime within the period of August 29, 2005 – September 3, 2005, during the time of and concurrent with other damage caused by Hurricane Katrina, the defendant, Murphy Oil USA, Inc., (hereinafter "Company"), through its allegedly negligent, tortious, and otherwise wrongful conduct and omissions, caused to occur or failed to prevent the extensive damage and destruction to Area property, real, personal and business, caused by Oil Spill. Hurricane Katrina is a 'Presidentially Declared Disaster' within the meaning of section 1033(h)(3).

Numerous suits were filed against Company relating to Oil Spill. On various dates, culminating in January 2006, the U.S. District Court, Eastern District of Louisiana (hereinafter "Court") consolidated and certified approximately 30 plaintiffs' actions against Company arising out of Oil Spill, as a single, 'opt-out' class action lawsuit under FRCP Rule 23(b)(3). The Court permitted certain limited modifications to the 'opt out' procedure prior to its approval of the final settlement. The certified, settling class consists of approximately 6,200 claimants.

Although Company denies that the plaintiffs' property damage was caused by any acts or omissions on its part, attributing the causation to other factors, including Hurricane Katrina, the parties nonetheless reached an amicable resolution of the case in September 2006 (the Settlement Agreement). In the Settlement Agreement, preliminarily approved by the Court in October 2006, and finalized on January 30, 2007, Company agreed to settle all plaintiffs' property damage claims allegedly caused solely by Oil Spill, as further described below. Under the Settlement Agreement, Company is not required to accept liability or otherwise make any admission of wrongdoing related to Oil Spill.

Company has agreed to fund approximately $330,126,000 for various programs to address the damage and destruction allegedly caused by Oil Spill. Company agreed to fund approximately $120,000,000 in compensation for damage and destruction to real, personal, and business property of residents, homeowners and businesses caused by Oil Spill within the Area, approximately $55,000,000 for a 'Buyout' program for property owners within the worst affected parts of Area ('Buyout' zone), and approximately $71,862,000 to be expended in remediation costs of property damaged by Oil Spill ($51,862,000 has been spent to date, and approximately $20,000,000 remains to be spent under this program). 'Buyout' zone class members are not required to sell their properties to Company in order to participate in other compensation programs. The Settlement Agreement acknowledges past compensation paid by Company in the amount of approximately $83,264,000 (exclusive of remediation payments) under its voluntary settlement program, begun shortly after Oil Spill, as properly a part of Company's universal settlement with affected property owners. Finally, Company agreed to pay all common benefit fees and expenses of the class litigation, including $33,746,242 for attorneys' fees and $2,659,043 for related litigation expenses, as part of the settlement.

Under the programs providing compensation for property damage, the amounts of compensation each plaintiff will receive will depend upon factors such as where in the Area they resided or owned property, square footage of property, the number of persons residing at the property, and estimated losses. Some will receive flat payments (typically $15,000). Non-owner residents will typically receive compensation payments in the range of $2,500 -3,500. Commercial property owners are also entitled to compensation. In order to receive a settlement amount under the Settlement Agreement, a class member must submit a proof of claim, and agree to release all claims against Company. The amounts approved by the Court attempt to approximate the property damages caused solely by Oil Spill within various parts of Area.

LAW AND ANALYSIS

Section 61 of the Internal Revenue Code provides generally that, except as otherwise provided by law, gross income includes all income from whatever source derived, including gain derived from dealings in property. See § 61(a)(3). The concept of gross income encompasses accessions to wealth, clearly realized, over which taxpayers have complete dominion. *Commissioner v. Glenshaw Glass Co*., 348 U.S. 426 (1955); 1955-1 C.B. 207.

Gross income does not, however, include receipts of all kinds. For example, recoveries of capital, or basis, or amounts representing compensation for damages of property, are not accessions to wealth unless they exceed basis. Similarly, rebates, refunds or purchase price adjustments typically constitute a return of taxpayer capital, and are properly treated as adjustments to capital account rather than income. Other amounts may also be excludable.

Section 1016(a)(1) of the Code provides that proper adjustment shall be made to the basis of property for expenditures, receipts, losses, or other items properly chargeable to capital account.

Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in section 1011 for determining gain. Section 1011(a) provides generally that the adjusted basis for determining gain from the sale or other disposition of property is the basis determined under section 1012 (cost), adjusted as provided in section 1016. Under section 1016, basis is adjusted by expenditures, receipts, losses, and other items properly chargeable to capital account. Under section 1001(c), the entire amount of gain must be recognized, except as otherwise provided.

Section 1033(a)(2)(A) of the Code provides, in part, that if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted into money, and, during the period specified in section 1033(a)(2)(B), the taxpayer purchases property similar or related in service or use to the converted property, at the election of the taxpayer, gain will be recognized only to the extent that the amount realized upon the conversion exceeds the cost of the replacement property.

Section 1033(a)(2)(B) provides that the replacement period referred to in subparagraph (A) is the period beginning with the date of the disposition of the converted property, and ending two years after the close of the first taxable year in which any part of the gain upon the conversion is realized (*or such later date as the Secretary may designate upon application of the taxpayer*) (emphasis added).

Section 121(a) provides that a taxpayer may exclude gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, the taxpayer has owned and used the property as the taxpayer's principal residence for periods aggregating 2 years or more. Under section 121(b) of the Code, the amount of gain excludable under section 121 is limited to $250,000 for single taxpayers and $500,000 for married taxpayers filing a joint return. Section 121(c) permits pro-ratable exclusions in the case of certain sales or exchanges occurring by reason of unforeseen circumstances.

Under section 121(d)(5)(A) (Involuntary Conversions) the destruction, seizure or condemnation of property is treated as a sale of the property for purposes of section 121.

Treatment of Attorneys' Fees and Other Litigation Expenses

The Court approved Settlement Agreement provides that all administrative costs of the class action, all common-benefit fees, and all common-benefit expenses incurred in connection with prosecuting the subject litigation, were to be paid from the general

settlement fund created by Company under the general benefits or common fund doctrine.

When a payment is made to satisfy the obligation of a taxpayer to a third party, the amount of the payment is generally includible in the taxpayer's gross income. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929). Even though the taxpayer never actually receives such payment, he receives the benefit of the payment, and the amount is therefore gross income to him or her. Under the rationale of *Old Colony Trust,* a prevailing litigant must generally recognize gross income when another party pays attorneys' fees for which the litigant is liable.

Where a taxpayer may receive a benefit of litigation but is not liable for payment of attorneys' fees incurred in connection with such litigation, a different result may obtain, e.g., certain opt-out class action lawsuits where no express contractual liability for a fee exists between the class member and litigating counsel. In general, attorneys' fees awarded in opt-out class action lawsuits are not includible in a class member's gross income if the class claimant does not have a separate contingency fee or retainer agreement with counsel. We have determined that Litigation qualifies under this rule.

In Rev. Rul. 80-364, 1980-2 C.B. 294 (Situation 3), a union filed claims on behalf of its members against a company due to a breach of a collective bargaining agreement. Subsequently, the union and the company entered into a settlement agreement, later approved by a federal district court, that provided that the company would pay the union 40x dollars in full settlement of all claims. The union paid 6x dollars of the settlement for attorney's fees and returned 34x dollars to the employees for back pay owed to them. The ruling concluded that the portion of the settlement paid by the union for attorney's fees *was a reimbursement for expenses incurred by the union* (emphasis added) and was not includible in the gross income of the union members.

In the instant case, neither the amount of the attorneys' fees ($33,746,242) nor the related litigation expenses incurred by class counsel ($2,659,043) will be awarded or paid to class counsel pursuant to any specific fee or retainer arrangement between such counsel and the class members. Rather, the attorneys' fees and expenses will be awarded by the court having jurisdiction over the action under the "common fund doctrine," from the class-wide settlement fund. Because Litigation was certified a class-action lawsuit, no separate agreements remained or became operative, and no amounts of attorneys' fees and expenses will be paid pursuant to any separate contingency fee or retainer agreement with a class member. Thus, the payment of the attorney's fees and litigation expenses to class counsel from the settlement fund is similar to Situation 3 in Rev. Rul. 80-364.

Therefore, the amounts paid pursuant to the Settlement Agreement for attorneys' fees and litigation expenses for class counsel are not income to the class members in the instant circumstances. Our conclusion that the attorneys' fees and expenses paid pursuant to the Settlement Agreement are not income to the claimants herein is specific

to the facts of this case. *See Cf*. *Sinyard v. Commissioner*, T.C.M. 1998-264, *aff'd*, 268 F.3d 756 (9th Cir. 2001), *cert. denied sub nom, Sinyard v. Rossotti,* 122 S.Ct. 2357 (2002), *Fredrickson v. Commissioner*, T.C. Memo 1997-125, *aff'd* in unpub. opinion, 97- 71051 (9th Cir. 1998).

Compensation for Property Damage

The character of amounts received as proceeds from a lawsuit or a settlement depends upon the nature of the claim and the actual basis for recovery. If the recovery represents damages for lost income or profits, it is taxable to the recipient as ordinary income. U.S. v. Burke, 504 U.S. 229, 112 S. Ct. 1867 (1992). If, however, the recovery is received as a replacement of capital, it is not taxable to the extent that it does not exceed the taxpayer's basis in the property. Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 113 (1st Cir. 1944), cert. denied, 323 U.S. 779 (1944); Freeman v. Commissioner, 33 T.C. 323, 327 (1959); Rev. Rul. 81-277, 1981-2 C.B. 14. Thus, recoveries of basis are not taxable.

Litigation involves claims for damages to property. Plaintiffs allege and the settlement is based upon causes of action against Company asserting negligence, absolute and/or strict liability, nuisance, trespass, and groundwater contamination, resulting in damage and destruction of real, personal, and business property. The proceeds from settling the lawsuit represent amounts necessary to repair, replace, restore or rehabilitate class members' property that Company allegedly caused to be harmed. Proceeds or recoveries from this type of action are recoveries of property or capital assets.

Thus, settlement funds paid as compensation to property owners are not income to the owners, but instead represent a return of capital to each to the extent each owner's portion of the recovery and other forms of compensation for the damaged property do not exceed that owner's adjusted basis in his or her property interest. Consequently, property owners must reduce their bases in their property interests by an amount equal to their share of the recovery as they would do so for any other compensation for the damaged property. To the extent an owner repairs, restores, rehabilitates or replaces the damaged property, that owner shall increase his or her basis by the amounts so used.

As indicated, the character of settlement proceeds is generally determined based upon the origin and nature of the claim giving rise to the lawsuit or settlement. The instant case involves the owner's recovery of capital for damages resulting from allegedly wrongful damage to property. Accordingly, the recovery proceeds are generally to be treated as a recovery of basis to the owners of property. If settlement proceeds received by an owner of damaged property were to exceed the owner's then current adjusted tax basis, the provisions of section 1033(a)(2)(A) will apply to govern the recognition of any gain, because the payments under the Settlement Agreement for property damage are the result of an involuntary conversion.

Generally, gain (if any) is recognized to the extent that amounts received upon an involuntary conversion exceed the cost of replacement property acquired during the 'replacement period.' Under section 1033(b)(2), the taxpayer's cost basis in the repaired, reconstructed, or replacement property is reduced by any unrecognized (deferred) gain. In the case of a destroyed principal residence, section 121(d)(5)(A) provides that the destruction may be considered a 'sale' for purposes of section 121. Assuming that all of the requirements of section 121 are met, property owners may exclude up to $250,000 of gain ($500,000 in the case of a joint return) on such 'sales.'

Payments under the Settlement Agreement for Compensation and Remediation; Payments under the Voluntary Program

At the time of and shortly after Oil Spill, Company entered into a voluntary settlement program with numerous residents and homeowners of the areas affected by Oil Spill, providing property damage awards and settlements similar to those reached in Litigation. In the Settlement Agreement, the Court acknowledged this past compensation, in the amount of approximately $83,264,000, as properly a part of Company's universal settlement with affected property owners. Additionally, the Court permitted those otherwise within the affected class but who had previously settled with Company to opt back in to the suit to obtain certain benefits under various Settlement Agreement programs.

In addition, the Settlement Agreement addresses certain amounts spent and to be spent by Company for remediation costs of damaged properties. As of the date of the settlement, approximately $51,862,000 has already been spent in remediation costs by Company, and it is estimated that an additional amount of $20,000,000 remains to be spent, though the Settlement Agreement does not impose an upper limit on this sum.

The tax treatments of compensation received under any of these programs, e.g., the voluntary settlement program, the property remediation program, or the general Litigation settlement compensation fund (approximately $120,000,000), or combinations thereof, are identical to the tax treatment discussed above regarding 'compensation for property damage.' However, we note that the 'replacement period' for purposes of section 1033(a)(2)(B), if applicable, for Oil Spill compensation ends two years after the close of the first taxable year in which any part of the gain upon the conversion is realized (*or such later date as the Secretary may designate upon application of the taxpayer*) (emphasis added). See note below respecting extensions of the 'replacement period.'

The 'Buyout' Program

Company's 'Buyout Program' under the Settlement Agreement obligates Company to spend approximately $55,000,000 toward purchasing and remediating properties in the general Oil Spill zone, which generally includes those properties adjacent to and closest

to Company's facility that suffered the most damage and destruction as a result of Oil Spill.

The tax treatment of amounts received under this program may differ somewhat from other amounts received from Company under the Settlement Agreement. To the extent affected property is sold to Company or its designees under the program, the ordinary rules for determining gain or loss upon the sale or exchange of property will generally apply (Section 1001). Additionally, taxpayers satisfying certain ownership and use requirements for their principal residences may be entitled to exclude amounts of gain under sections 121(a) or 121(c) of the Code.

A more difficult, factual question arises where substantially damaged property is subsequently sold, whether to Company or otherwise. The question is whether proceeds from such sales are also amounts received from the involuntary conversion, and thus also entitled to section 1033 deferral treatment, or are simply receipts from an independent sales transaction. Section 1033 generally does not apply to gains from sales. Resolution of this factual question turns largely on whether the subsequent sale was necessitated by the property's damage, or was merely elective.
See C.G. Willis, Inc. v. Commissioner, 41 T.C. 468 (1964) stating that an 'involuntary conversion' within the meaning of section 1033(a) means that "the taxpayer's property, through some outside force or agency beyond his control, is no longer useful or available to him for his purposes"; see, also, Rev. Rul. 80-175, 1980-2 C.B. 230; and Williamette Indus., Inc. v. Commissioner, 118 T.C. 126 (2002). Generally, where it is economically feasible to repair or restore the damaged property, a subsequent sale will be deemed elective, and not within the scope of section 1033's deferral provisions. Where, on the other hand, repair is not possible or the costs of repair are economically prohibitive, the taxpayer may have no practical choice but to sell the destroyed property. The proceeds of such sales may qualify as amounts received from an involuntary conversion. These cases, if any, involve inherently factual determinations, and must be addressed on a case-by-case basis.

Presidential Disaster Relief Provisions Inapplicable

Although Oil Spill occurred at the time of and concurrently with damage caused by Hurricane Katrina, Litigation addresses only damage caused to plaintiffs' properties by Company's alleged wrongful conduct, as addressed earlier herein. The settlement amounts received thereunder do not compensate for Hurricane Katrina damage to plaintiffs' properties, and accordingly, certain Internal Revenue Code provisions addressing damage attributable to or as a result of 'Presidentially Declared Disasters' have no application to Oil Spill. For example, section 139, section 1033(h), and KETRA section 405 (relating to certain extensions of the section 1033 'replacement period') have no application to the subject recoveries.

Nonetheless, we note that section 1033(a)(2)(B) of the Code and section 1.1033(A)-2(c)(3) of the income tax regulations provide for certain extensions of the 'replacement

period' upon application by a taxpayer. We would anticipate, in view of the difficulties in obtaining adequate materials, supplies and suppliers, labor, and replacement property within the Hurricane Katrina disaster zone, that extensions would be liberally granted, where requested.

It should also be noted that other disaster relief provisions may be available to recipients of compensation under the Settlement Agreement where, for example, relief is based on the location of the recipient's principal residence or principal place of business in the disaster area. *See, e.g.*, section 7508A, Notice 2006-20, 2006-10 I.R.B. 560, and Notice 2006-56, 2006-28 I.R.B. 58.

Thank you for soliciting our views in this matter. If you have any questions concerning this memorandum, please contact us at (202) 622-4960.

cc: Susan S. Canavello
Associate Area Counsel, CC:SB:6:NOR