

**Office of Chief Counsel  
Internal Revenue Service  
Memorandum**

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date: July 28, 2015

to: Sungwook Choi

from: Andrew H. Travis  
General Attorney (Newark, Group 2)  
(Large Business & International)

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subject:

This memorandum responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUE

1. Was Taxpayer entitled to capital gain treatment with respect to amounts totaling \_\_\_\_\_, received by Taxpayer pursuant to the terms of an agreement purporting to be the sale of an interest in the proceeds of a litigation claim?

CONCLUSION

1. No. The amounts received by Taxpayer cannot represent a gain or loss to Taxpayer under section 1001 of the Internal Revenue Code because there is no associated sale or disposition of property.

FACTS

In \_\_\_\_\_, \_\_\_\_\_ (“Taxpayer”) entered into a “Purchase and Sale Agreement” with \_\_\_\_\_, by which Taxpayer “purchased” an interest in a contractual right to receive a percentage of any settlement covered thereunder (the “\_\_\_\_\_ Agreement”). The Taxpayer ultimately paid \_\_\_\_\_ pursuant to the Agreement. In \_\_\_\_\_, the taxpayer received a series of payments over totaling \_\_\_\_\_ in full satisfaction of his interests pursuant to the Agreement. Taxpayer reported the difference as Long Term Capital Gain.

Taxpayer was the founder of \_\_\_\_\_, a general service  
 . In \_\_\_\_\_, after transitioning out of the management of \_\_\_\_\_, Taxpayer  
 completely divested himself from the company, and began searching for investments for  
 the cash proceeds of the divestiture. According to Attachment "1" to Taxpayer's  
 response to \_\_\_\_\_ ("Attachment 1"), Taxpayer was introduced to  
 \_\_\_\_\_ in \_\_\_\_\_  
 \_\_\_\_\_ is a member of \_\_\_\_\_, a  
 consulting firm based in \_\_\_\_\_. The website for the company states that:

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According to Attachment 1, \_\_\_\_\_ had identified a \_\_\_\_\_ in the  
 calculation of an \_\_\_\_\_ formed  
 (an entity separate from the consulting firm) with the intent to facilitate the litigation of  
 claims by \_\_\_\_\_ estimated the legal costs of  
 litigating the \_\_\_\_\_ at \_\_\_\_\_, and needed investors.

In \_\_\_\_\_, Taxpayer established \_\_\_\_\_ for the  
 purpose of holding investments. \_\_\_\_\_ committed \_\_\_\_\_ to the funding of the  
 \_\_\_\_\_ via the "Purchase and Sale Agreement" (the " \_\_\_\_\_ Agreement").<sup>3</sup> In addition to  
 funding the \_\_\_\_\_ Agreement, \_\_\_\_\_ also invested \_\_\_\_\_ in \_\_\_\_\_, which was  
 formed to acquire an equity interest in \_\_\_\_\_.

Taxpayer established \_\_\_\_\_, In \_\_\_\_\_, also for the purpose of holding  
 investments.<sup>4</sup> \_\_\_\_\_ assigned the \_\_\_\_\_ Agreement to \_\_\_\_\_ in order to separate the  
 ownership of the \_\_\_\_\_ Agreement from the \_\_\_\_\_ investment.

**THE \_\_\_\_\_ AGREEMENT**

\_\_\_\_\_ and \_\_\_\_\_ entered into the \_\_\_\_\_ Agreement as of \_\_\_\_\_  
 According to the Recitals of the \_\_\_\_\_ Agreement:

<sup>1</sup> \_\_\_\_\_ is a separate entity from \_\_\_\_\_, formed for the purpose of administering \_\_\_\_\_

<sup>2</sup> \_\_\_\_\_ (last visited June 10, 2015).

<sup>3</sup> The \_\_\_\_\_ Agreement ultimately required only \_\_\_\_\_ of the committed amount to be funded.

<sup>4</sup> Both \_\_\_\_\_ and \_\_\_\_\_ are single member LLCs owned by the Taxpayer and are disregarded as separate from the Taxpayer for Federal tax purposes.

The Agreement refers to the acquired contractual right to receive consideration as the " " As consideration, section of the agreement required " "

" The Agreement refers to the amount to be funded as the " " However, section provided that these payments would be used by solely for the payment of . Moreover, section provided that these payments would only be made

ultimately paid pursuant to the terms of the . According to Taxpayer, Agreement.

Section of the Agreement provided that any received would be divided as follows<sup>5</sup>:

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<sup>5</sup> The Agreement also provided that in the event the " " exceeded , the

The “ ” was defined as

Between and , received wire transfers  
totaling , which amount was reported on the Form issued  
by . These payments were as follows:

<u>Entry Date</u>	<u>Transaction Description</u>	<u>Transaction Amount</u>
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By letter dated \_\_\_\_\_ informed  
that it had collected \_\_\_\_\_ of the \_\_\_\_\_, and  
requested a release acknowledging that with the final payment (ultimately made on  
\_\_\_\_\_) had fully performed its obligations under the  
Agreement. The \_\_\_\_\_ stated that:

On or about \_\_\_\_\_, Taxpayer signed the release on the signature line  
labeled “ \_\_\_\_\_.”

**TAXPAYERS POSITION**

The following is the legal argument provided by Taxpayer's POA:

## LAW AND ANALYSIS

Section 1001 of the Internal Revenue Code provides in part that the gain from the sale or other disposition of property is the excess of the amount realized therefrom over the adjusted basis provided ... for determining gain.

Section 1221(a) provides that the term "capital asset" means property held by the taxpayer ... but does not include certain items, such as the taxpayer's stock, depreciable business property, copyrights, accounts receivable, consumable supplies, etc. For the purpose of this analysis only, we will assume that Taxpayer is correct that the acquired right to consideration is not within the exceptions enumerated in section 1221(a).

Section 1222(3) provides in part that the term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 1 year. Thus, a "sale or exchange" is necessary for capital gain treatment. See *Estate of Nordquist v. Comm'r*, 481 F.2d 1058, 1061 (8th Cir. 1973), *affg.* T.C. Memo. 1972-198; *Ackerman v. United States*, 335 F.2d 521, 526-527 (5th Cir. 1964). Not every disposition under section 1001 constitutes a sale or exchange under section 1222; the term "sale or exchange" is narrower than the term "sale or other disposition." See *Patrick v. Commissioner*, 142 T.C. 124, 127-28 (2014). Generally, the words "sale" and "exchange" are to be given their ordinary meanings for purposes of determining whether a gain is a long-term capital gain. *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247, 249, 85 L. Ed. 1310, 61 S. Ct. 878 (1941). In certain circumstances, an event which does not qualify as a "sale" or "exchange" under those words' ordinary meaning can be statutorily deemed to be a "sale or exchange" for purposes of Section 1222. See e.g., I.R.C. §§ 302, 1234(a)(1) and (2), 1234A, 1241, 1271(a)(1).

Section 1234A(1) provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or a section 1256

contract which is a capital asset in the hands of the taxpayer, shall be treated as gain or loss from the sale of a capital asset.

As stated above, Taxpayer has taken the position that the legislative history of section 1234A, and in particular the modifications to that code section enacted by Congress in 1997,<sup>6</sup> provide for the repeal of the "extinguishment doctrine." Taxpayer argues that this legislative history requires that amounts received pursuant to \_\_\_\_\_ are capital gain under section 1234A.

Sections 1222 and 1234A address the character of a gain or loss under certain conditions. Both provisions are, by their terms, predicated on the existence of "gain" or "loss." However, a fundamental requirement of section 1001 is that in order to have a "gain or loss" there must be a sale or other disposition of property. With respect to Taxpayer's receipt of \_\_\_\_\_, the facts indicate that there is no associated disposition of property.

The \_\_\_\_\_ Agreement calls only for \_\_\_\_\_ purchase of "\_\_\_\_\_." It does not call for the subsequent transfer of such interest back to \_\_\_\_\_, in \_\_\_\_\_ or otherwise. The \_\_\_\_\_ is a right to receive a portion of the periodic income otherwise received solely by \_\_\_\_\_ upon the collection of \_\_\_\_\_ from the \_\_\_\_\_. The mere receipt of a portion of that income by Taxpayer, whether received from \_\_\_\_\_ or directly from \_\_\_\_\_, is not an amount realized from the disposition of Taxpayer's rights, for purposes of section 1001, and therefore cannot be "gain" potentially subject to characterization as capital gain under sections 1222 and 1234A.

Moreover, the language used in the \_\_\_\_\_ is inconsistent with the notion that there was an associated sale or disposition of the acquired rights. The letter refers to the \_\_\_\_\_

It further refers to the payments as the \_\_\_\_\_, and provides a signature line for the Taxpayer labeled "\_\_\_\_\_ " on which Taxpayer assented to the language used. The fact that the \_\_\_\_\_ takes great care to refer to the payments in this manner strongly suggests that the parties to the Agreement did not view the payments as amounts realized from the disposition of property owned by \_\_\_\_\_.

Finally, we note that the full amount of \_\_\_\_\_ paid pursuant to the agreement was transferred to Taxpayer in \_\_\_\_\_, each presumably accompanied by \_\_\_\_\_.

Of that amount \_\_\_\_\_ was paid prior to the \_\_\_\_\_. There is nothing to suggest that Taxpayer would not have been entitled to any of these amounts pursuant to section \_\_\_\_\_ of the \_\_\_\_\_ Agreement, including the \_\_\_\_\_ had the \_\_\_\_\_ not been signed. The \_\_\_\_\_ simply acknowledged that all payments due under the contract had been made.

<sup>6</sup> As referenced by the Taxpayer, S. Rep. No. 33, 105<sup>th</sup> Cong., 1<sup>st</sup> Sess. 132, 133 (1997).

Therefore, because Taxpayer did not realize gain from the disposition of property under section 1001, we conclude that its receipt of \_\_\_\_\_ does not result in a capital gain of \_\_\_\_\_ in \_\_\_\_\_ pursuant to the \_\_\_\_\_ Agreement. Rather, the payments should be taxed as ordinary income.<sup>7</sup>

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call 973-681-6640 if you have any further questions.

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