



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

OFFICE OF
CHIEF COUNSEL

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SPShepherd

LEGEND

Taxpayer :

Residence :

Contractor :

Architect :

Year 1 :

Year 2 :

Year 3 :

Dear :

This responds to your letter received on December 28th, 2004, amended on January 14th, 2005, requesting a ruling that the amounts received for reimbursement of legal fees, and litigation costs are a nontaxable return of capital that will decrease your basis in the Residence.

You hired Contractor to construct a residence in accordance with plans prepared by Architect. You moved into the Residence in Year 1. In Year 2, the Residence sustained water damage caused by faulty construction. You hired an attorney and agreed to pay the law firm on an hourly basis plus costs and a 10% contingency fee. You sued Contractor and Architect for breach of contract, breach of implied warranty for fitness, negligence, and faulty construction. You completed partial repairs in Year 3 for which you did not claim any losses. You were awarded damages, legal fees, litigation costs and interest. You requested a ruling that the amounts received for reimbursement of

legal fees and litigation costs are a nontaxable return of capital that will decrease your basis in the Residence.

Pursuant to section 4.02(1) of Revenue Procedure 2005-3, 2005-1 I.R.B. 118, the Internal Revenue Service will not issue letter rulings in certain areas because of the inherently factual nature of the problem involved. In your case, because of the inherently factual nature regarding the potential allocation of the settlement award between damages and legal fees, we will not issue the requested ruling. Below is a general discussion of the applicable law regarding the issue.

Under section 61 of the Internal Revenue Code, gross income means all income from whatever source derived.

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 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 1.1016-2(a) provides that the cost basis shall be properly adjusted for any expenditure, receipt, loss, or other item properly chargeable to capital account, including cost of improvements and betterments made to the property. No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to the capital account but is allowable as a deduction in computing net or taxable income for the taxable year.

Any receipt of funds or other accessions to wealth received by a taxpayer is presumed to be gross income unless the taxpayer can demonstrate that the funds or accessions fit into one of the exclusions provided by other sections of the Code. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430-31 (1955). However, a payment constituting a return of basis is generally not classified as income within the meaning of section 61 because it is not an accession to wealth. Raytheon Products Corp. v. Commissioner, 144 F.2d 110 (1st Cir. 1944), cert. denied, 323 U.S. 779 (1944).

In Rev. Rul. 81-277, 1981-2 C.B. 14, for a set price a contractor agreed to build a nuclear power plant for a taxpayer. Stricter regulatory environmental requirements were imposed during the construction period, and a dispute arose regarding the contractor's

construction obligations. The contractor paid the taxpayer the estimated cost to satisfy the stricter environmental standards and was thereby released from its construction obligations. The revenue ruling states that “[t]he determination of whether the proceeds received in a lawsuit or received in settlement of a lawsuit constitute income under section 61 of the Code depends on the nature of the claim and the actual basis for recovery. If the recovery represents damages for lost profits, it is taxed as ordinary income. If, however, the recovery is treated as a replacement of capital, the damages received from the lawsuit are treated as a return of capital and are not taxable as income.” Id. at 3-4. The ruling holds that because the taxpayer received no economic gain as a result of the estimated cost payment and was merely made whole under the contract, the payment was a return of capital, reducing the taxpayer’s basis in the plant. See also Rev. Rul. 81-152, 1981-1 C.B. 433. Thus, if a recovery is treated as a replacement of capital, the damages received from the lawsuit are treated as a return of capital and are taxable only to the extent that the damages exceed the basis of the property replaced. See United States v. Gilmore, 372 U.S. 39 (1963).

If all of the damages that you received in the lawsuit against Contractor and Architect are not income to you but are treated as a recovery of basis, you must reduce your basis in the Residence by the damages and to the extent that the basis of the Residence does not exceed the amount of the damages, the damages are not includible in your gross income.

This letter has called your attention to certain general principles of the law. It is intended for informational purposes only and does not constitute a ruling. See Rev. Proc. 2005-1, §2.04, 2005-1 I.R.B. 1. Because a letter ruling will not be issued, a refund of the user fee may be permitted under section 15.10(2)(e) of Rev. Proc. 2005-1, 2005-1 I.R.B. 1, if, taking into account all the facts and circumstances, including the Service’s resources devoted to the request, the associate chief counsel in his sole discretion decides a refund is appropriate. We believe that a refund of the user fee is appropriate in this case and will recommend to the associate chief counsel that the user fee be refunded to you.

If you have any additional questions, please contact our office at .

Sincerely,

Roy Hirschhorn
Assistant Branch Chief, Branch 5
(Income Tax & Accounting)