

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

Number: **201203013**

Release Date: 1/20/2012

CC:ITA:B04:

POSTF-112996-11

UILC: 61.28-00, 451.00-00

date: October 07, 2011

to: Associate Area Counsel, LBI
Jacksonville FL

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

subject:

This memorandum responds to your August 10, 2011, request for Chief Counsel Advice.

Legend

Taxpayer	=
Manufacturer #1	=
Manufacturer #2	=
Product # 1	=
Product # 2	=
Items	=
\$A	=
\$B	=
\$F	=
\$G	=
\$H	=
\$J	=
\$L	=
\$P	=
\$X	=
Date 1	=
Date 3	=

Date 4 =
Date 5 =
Date 6 =
Year 1 =
Year 2 =
Year 4 =
Year 5 =
Period 1 =
Period 2 =
Month a =
Month b =
Month c =
Month d =
Requirement =

ISSUES

1. Whether financial compensation received by Taxpayer from Manufacturer #1, including a returned deposit and interest earned on the returned deposit and consideration incident to the termination of a Purchase Agreement, constitutes gross income to Taxpayer.
2. If the financial compensation is gross income to Taxpayer, what is the proper year of inclusion of the income?

CONCLUSION

1. The returned deposit is not gross income to Taxpayer but the interest earned on the deposit is gross income. All other consideration received by Taxpayer from Manufacturer #1 incident to the termination of the Purchase Agreement does not constitute gross income to Taxpayer if certain factual preconditions addressed below exist.
2. The interest is taxable in Year 5.

FACTS

The Original Purchase Agreement

On Date 1, Taxpayer entered into a Purchase Agreement (Agreement) with Manufacturer # 1 for the purchase of Product #1 with an option to purchase additional Product #1. The purchase price for Product #1 and the option was \$A.

Pursuant to the Agreement, Taxpayer paid a total of \$B in _____ in Year 1 and Year 2. These deposits were nonrefundable except as provided under

Clause 10 () and Clause 11 () of the Agreement. The balance of the final contract price was to be paid proportionally in conjunction with the delivery of Product #1.

The first of the Product #1 was originally scheduled under the Agreement for delivery in Month a, with the remaining Product #1 to be delivered during Period 1. The first of the additional Product #1 was scheduled for delivery in Month b, with the remaining additional Product #1 to be delivered during Period 2.

The Settlement Agreement

Manufacturer #1 advised Taxpayer that deliveries of Product #1 would not occur as scheduled under the Agreement. In Year 4, Taxpayer informed Manufacturer #1 that it was cancelling the Agreement “primarily due to delays from [Manufacturer #1].” On Date 4, Manufacturer #1 and Taxpayer entered into a Settlement Agreement to terminate the Agreement and to provide that Taxpayer receive “certain financial compensation from [Manufacturer #1] in the form of and cash.”

The Settlement Agreement required Manufacturer #1 to provide Taxpayer with two , one for \$G to be delivered within days of execution of the Settlement Agreement and the second for \$F to be delivered on Date 3. The Agreement also required Manufacturer #1 to repay the Predelivery Payments of \$B, plus interest of \$H, and make six “ ” payments in the total sum of \$X. Of the six payments, five were in the form of and one was a cash payment.

The Settlement Agreement provided that the could be applied “exclusively towards the purchase of goods and services [of Manufacturer #1] (excluding [Items] currently on firm order)” and would not expire. Further, at Taxpayer’s sole option, any unused still available after Date 5 were redeemable by Taxpayer for cash equal to the balance as of the date of redemption.

Product #2 Purchase

On Date 6, Taxpayer entered into a Purchase Agreement with Manufacturer #2 for the purchase of Product #2 and the option to purchase additional Product #2 (Manufacturer #2 Agreement). Taxpayer stated that it entered into the Manufacturer #2 Agreement as a result of “Manufacturer #1’s breach of the Agreement due to delays” and failure to meet its Requirement needs.

The first of the Product #2 was scheduled to be delivered in Month c and the last was scheduled for delivery in Month d. The purchase price of Product #2 was \$J.

The Manufacturer #2 Agreement, similar to the Agreement (with Manufacturer #1), required a deposit and _____ for Product #2. The Manufacturer #2 Agreement also required an additional deposit for each of the optional Items. Accordingly, in Year 4, Taxpayer made payments to Manufacturer #2 of \$P, which exceeded the financial compensation later received by Taxpayer from Manufacturer #1 under the Settlement Agreement.

Taxpayer maintains that, due to Manufacturer #1's breach of the Agreement, its capital was impaired to the extent of \$L (the excess of the purchase price of Product #2 from Manufacturer #2 over the purchase price of Product #1 from Manufacturer #1). Taxpayer thus contends that the payments from Manufacturer #1 are nontaxable because the payments contributed to restoring Taxpayer to its pre-breach position.

APPLICABLE LAW and ANALYSIS

1. Includible Income

A. Taxability of return of deposit and interest on the deposit

Section 61 of the Internal Revenue Code and § 1.61-1(a) of the Income Tax Regulations generally provide, that, unless excluded by law, gross income means all income from whatever source derived. Under § 61(a)(4), interest is includible in gross income.

The term income is generally understood to mean "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). Accordingly, any receipt of funds or property by a taxpayer is presumed to be gross income unless the taxpayer can demonstrate that the income fits into one of the narrowly construed exclusions provided by law. *United States v. Burke*, 504 U.S. 229, 248 (1992).

In the case of proceeds from a lawsuit or a settlement, the taxability of the proceeds depends on the nature of the claim and the actual basis of the recovery. If the amount recovered is directly tied to and constitutes a replacement of capital destroyed or injured, then it is a return of capital and not taxable except to the extent the recovery exceeds the tax basis of what was lost. See, e.g., *Farmers' & Merchants' Bank v. Commissioner*, 59 F.2d 912 (6th Cir. 1932).

In the present case, the return by Manufacturer #1 of the \$B previously made by Taxpayer is not taxable to Taxpayer. The \$B is a return of Taxpayer's capital and not an accession to Taxpayer's wealth.

On the other hand, the \$H of interest Taxpayer received from Manufacturer #1 is gross income to Taxpayer. The interest payments were Manufacturer #1's payment to Taxpayer for the use of Taxpayer's money, not a return of Taxpayer's capital. Although

Taxpayer wouldn't have received the interest but for Manufacturer #1's breach, that fact does not make the interest payment a nontaxable return of capital. See *Kieselbach v. Commissioner*, 317 U.S. 399 (1943) and *Tiefenbrunn v. Commissioner*, 74 T.C. 1566 (1980), which deal with payments of interest in connection with a nontaxable involuntary conversion and hold that the interest is taxable even though it wouldn't have been received but for the conversion.

B. Taxability of financial compensation under the Settlement Agreement

In Rev. Rul. 81-277, 1981-2 C.B. 14, a contractor agreed to construct a nuclear generating plant for a taxpayer at a price of \$ 250x and to provide all upgrades as required by regulatory agencies so that the plant would be complete, safe, licensable and fully operational when delivered to the taxpayer. During construction, the regulators imposed stricter safeguards that the contractor was required by the contract to provide at no additional cost. The total cost of construction was now estimated to be \$ 270x. When a dispute arose due to these extra requirements, the parties entered into a settlement. Pursuant to the settlement, the contractor paid the taxpayer the estimated amount still needed to complete the construction of the plant to the standard agreed in the contract. Thereafter, the taxpayer hired a new contractor and fully completed construction of the plant at a total cost of \$280x. The revenue ruling holds that the cash payment from the contractor was a return of capital and not income to the taxpayer, citing *Freeman v. Commissioner*, 33 T.C. at 327; *Clark v. Commissioner*, 40 B.T.A. 333 (1939), *acq.*, 1957-1 C.B.4 and Rev. Rul. 57-47, 1957-1 C.B. 23 (compensatory payment by tax counsel for error in preparing tax return that resulted in greater tax liability was not includable in income so long as no loss was claimed that offset income for any prior year).

As the Service observes in Rev. Rul. 81-277, if A causes a loss to B and makes a payment to B that does no more than restore B to the position B was in before the loss, the payment is not includable in B's gross income because there is no economic gain to B. In that case, the recovery is directly tied to and constitutes a replacement of capital destroyed or injured and not taxable except to the extent the recovery exceeds the basis of what was lost. See *Farmers' & Merchants' Bank v. Commissioner*, *supra*.

However, if there is a loss from a contract breach and the payments do more than restore the taxpayer to its pre-breach position, the taxpayer has an accession to wealth and all or a portion of the recovery will be taxable. Similarly, if the payments are to compensate the taxpayer for lost income caused by the breach, then the payments are gross income to the taxpayer. *Freeman v. Commissioner*, *supra*. See also *Swastika Oil & Gas Co. v. Commissioner*, 123 F.2d 382 (6th Cir. 1941), *cert. denied*, 317 U.S. 639 (1943).

In the present case, Manufacturer #1 and Taxpayer, on Date 4, entered into a Settlement Agreement to terminate its purchase contract and to provide that Taxpayer receive “certain financial compensation from [Manufacturer #1] in the form of _____ and cash” (financial compensation). Under the authorities discussed above, the taxability of the financial compensation depends on whether the financial compensation restores Taxpayer to its pre-breach position or goes beyond restoring Taxpayer to its pre-breach position.

Prior to the Date 4 settlement with Manufacturer #1, Taxpayer entered into an agreement to purchase Product #2 from Manufacturer #2. The cost of Product #2 exceeds the cost of Product #1 that Taxpayer had contracted to purchase from Manufacturer #1 by \$L (the excess amount). The excess amount was more than the financial compensation Taxpayer was due under the Settlement Agreement. Also, by Date 4, Taxpayer had paid an amount to Manufacturer #2 for Product #2 that exceeded the financial compensation called for by the Settlement Agreement. Consequently, the taxability of the financial compensation depends on the reasons the cost of Product #2 exceeded the cost of Product #1.¹

If you determine that Product #1 and Product #2 are comparable Items, the excess amount Taxpayer is required to pay to Manufacturer #2 for Product #2, in all likelihood, results from Manufacturer #1’s breach of the Agreement. In that case, the financial compensation would not be taxable to Taxpayer because it does not go beyond restoring Taxpayer to its pre-breach position. However, if you determine that Product #2 is a higher quality product than Product #1, or the Manufacturer #2 Agreement includes upgrades not in the Agreement with Manufacturer #1, and all or part of the excess amount is attributable to the higher quality or the upgrades and not to Manufacturer #1’s breach, then the financial compensation under the Settlement Agreement does more than restore Taxpayer to its pre-breach position. In that case, all or a portion of the financial compensation under the Settlement Agreement is includible in Taxpayer’s gross income.

¹ In this memorandum, except as provided below, we express no opinion regarding whether the _____ given by Manufacturer #1 to Taxpayer as part of the financial compensation should be treated as a payment by Manufacturer #1 to Taxpayer. Because of the conditions placed on Taxpayer in using the _____, one or more of the _____ may not be a payment (or may be a payment that should be taken into account at a date later than Date 4). However, even if the face amount of the _____ is treated as part of the total financial compensation received by Taxpayer on Date 4, the financial compensation is less than the excess amount. To the extent one or more _____ was used by Taxpayer to purchase goods or services of Manufacturer #1, the _____ should be treated as a nontaxable purchase price adjustment to the cost of the goods or services of Manufacturer #1 and not as a payment by Manufacturer #1 to Taxpayer.

An evaluation of the specifications (e.g., the Requirement) of Product #1 and Product #2 would be critical in determining whether the financial compensation restores Taxpayer to its pre-breach position or goes beyond mere restoration. Very similar specifications would suggest that Product #1 and Product #2 are comparable, meaning that the excess amount is likely caused by the Manufacturer #1 breach. Another relevant factor would be the difference on Date 1 between the cost of Product #1 and the cost of Product #2 to Taxpayer.

If you find that all or a part of the excess amount was not caused by Manufacturer #1's breach, we can assist in determining the extent to which Taxpayer has gross income. However, if you determine that the excess amount results from Manufacturer #1's breach and the financial compensation is a nontaxable return of capital, Taxpayer must reduce its basis in Product #2 by the amount of the financial compensation .

Finally, you have stated that Taxpayer has not established that the financial compensation was either based upon, or measured by, the amount of Taxpayer's purported lost capital. Instead, you assert that the settlement was a freely made business decision rather than one of forced recovery of goodwill; that the settlement was made to resolve the matter between Taxpayer and Manufacturer #1 on an amicable basis; and that nothing in the Settlement Agreement suggests any impairment to Taxpayer's capital or that the agreed upon damages were tied to any such claimed impairment. Citing *Stocks v. Commissioner*, 98 T.C. 1 (1992), and *Armstrong Knitting Mills v. Commissioner*, 19 B.T.A. 318 (1930), it is your contention that whenever the reason for a settlement payment is unclear, or no allocation is included in a settlement agreement, the recovery should be treated as lost profits and taxed as ordinary income.

In *Stocks*, an allocation of a settlement amount was made by the court between breach of contract and racial discrimination claims, despite the absence of an allocation in the settlement between the litigating parties. In *Armstrong*, there was no assumption that the settlement was for lost profits merely because an allocation was not included in the settlement. Rather, the court looked to the declarations made by the parties and the totality of the facts and circumstances to arrive at the conclusion that the settlement was taxable compensation for lost profits of the petitioner's business.

As you note, the Settlement Agreement between Taxpayer and Manufacturer #1 does not stipulate the precise grounds or basis for the financial consideration, or the purpose for which the financial compensation is to be used by Taxpayer. However, that fact alone should not dictate the result that the financial compensation is, by default, consideration for lost profits and includible as ordinary income.

In our view, neither *Stocks* nor *Armstrong* are authority for treating settlement proceeds as consideration for lost profits includible as ordinary income merely because the reasons for the settlement are not clearly stated in an agreement. Moreover, it is very common for settlement agreements to be silent as to the reason for the payments called for by the agreement. Payors generally do not want to admit any wrongdoing. In

addition, in many cases it is in the best interest of the payee to not press the point of exacting an admission of wrongdoing in the interest of avoiding protracted settlement negotiations and getting on with their business. Thus, in the present case, the failure to provide the reason for, or an allocation of, the financial compensation is not a valid rationale for treating the financial compensation as lost profits includible in Taxpayer's gross income. Instead, as discussed above, the taxability of the financial compensation depends on the nature of the claim and the reason for the recovery.

2. Timing of income from taxable interest payments

Section 451(a) of the Code provides that the amount of any item of gross income must be included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for in a different period.

Section 1.451-1 of the Income Tax Regulations provides, in part, that under the accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy.

Under the facts presented, Taxpayer received \$H of interest on the returned deposits from Manufacturer #1 in Year 5. Further, Taxpayer had no right to receive the interest before Year 5, the year of the Settlement Agreement between Taxpayer and Manufacturer #1. Thus, Year 5 was the year in which all events occurred that fixed the right to receive the interest and the interest amount could be determined with reasonable accuracy.

Pursuant to § 6110(k)(3) of the Code, this document may not be used or cited as precedent. Please call (202) 622-4920 if you have further questions.