Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:
, ID No.
Telephone Number:

Refer Reply To:
CC:ITA:B01
PLR-161356-05
Date: March 1, 2007

Legend

Joint account:

Year 1:

Year 2:

Year 3:

$A:

$B:

$C:

$D:

$E:

Dear :

This letter responds to your correspondence, dated , requesting a ruling that an amount you received pursuant to a "Release and Settlement Agreement" (Settlement Agreement) is taxable as long-term capital gain in the year of its receipt. In your request was forwarded to our office for response.

BACKGROUND

You and your spouse established three accounts with a stockbroker and the firms at which the stockbroker worked while he managed your accounts (hereinafter collectively referred to as "stockbroker"). Two of the three accounts were Individual Retirement

Accounts (IRAs), one for you and one for your spouse. (The two IRAs and the amounts allocable to them under the Agreement are not part of this ruling request, and this ruling does not apply to them.)

The remaining account was a taxable investment account held in your joint names (hereinafter, joint account). In Year 1, you sustained a loss of $A with respect to the termination of the joint account that you treated as a long-term capital loss on your Year 1 federal income tax return. This loss, combined with the carryover of prior capital losses with respect to the same account, less the amounts you deducted in years prior to Year 3, was a total capital loss carryover of $B to Year 3.

You believed your stockbroker caused the losses by mishandling your account, and you contacted the stockbroker numerous times, trying to recoup your losses. To put an end to this dispute, you signed the Settlement Agreement, under which the stockbroker paid you $C in Year 3.

The $C was allocated proportionally among the three accounts based upon their fair market values at closing. The Agreement earmarked $D for the IRAs, effectuated by journal entries.

The remaining $E due under the Settlement Agreement was paid to you in cash in Year 3. Although the Agreement itself did not earmark this amount, you believe it is a partial recovery of the long-term capital losses that were claimed with respect to the joint account on your prior returns.

LAW AND ANALYSIS

Whether the Recovery is Includable in Gross Income.

Section 61 of the Code provides that, except as otherwise provided, gross income means all income from whatever source derived. Thus, gross income includes all receipts, except those not subject to tax.

Section 111 of the Code provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in a prior taxable year to the extent that amount did not reduce the amount of tax imposed in the prior year.

Section 111 (known as the tax benefit rule) may apply to exclude part, or all of a recovery from gross income. Although the rule is couched in terms of the amount that is excludable from income, by implication the rule affirms that the amount not excluded is included in gross income. The rule comes into play when a taxpayer recovers, in a subsequent year, all or part of an amount the taxpayer deducted in an earlier year. The amount of the recovery excluded in the subsequent year is that amount that did not reduce tax in a prior year. The rule strives to achieve the same tax effect, over two different years, as that obtained if both transactions had occurred in the same taxable year.

Section 111(c) of the Code provides that an increase in a carryover which has not expired before the beginning of the taxable year in which the recovery or adjustment takes place shall be treated as reducing the tax imposed. This provision deems a taxpayer to have received a tax benefit with respect to a carryover that can still be used.

You deducted part of your capital losses, attributable to your joint account, in Year 1 and prior years and carried over the unused portion of these losses. At the beginning of Year 3, the unused portion of the losses from the joint account was $B. In the same year, you received $E under the Settlement Agreement allocable to the joint account, which amount we agree was a recovery of $E of your previous capital losses. However, since your capital loss carryovers were increased by the $E, and the carryovers had not expired in Year 3, the $E is considered as having produced a reduction in your tax. Because of this tax benefit, under § 111 of the Code the $E recovery is not excludable from your gross income in Year 3. As discussed next, however, this amount is capital gain that may be used to absorb your loss carryover.

<u>Whether the Taxable Recovery is Ordinary Income or Capital Gain</u>.

Section 1211(b) of the Code provides that for taxpayers other than corporations capital losses for a year are allowed only to the extent of that year's capital gains, plus $3,000 ($1,500 if married filing separately). Excess losses are carried over to later years under § 1212.

In general, the character of settlement proceeds is determined under the principles developed by the Supreme Court in the case of *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), which held that a taxpayer who was required to pay a liability attributable to capital gain realized on the liquidation of stock in a prior year must treat the payment as a capital loss. The Supreme Court held that two transactions, one occurring subsequent to the other, and each integrally related, should be treated as parts of the same transaction, so that the subsequent event should relate back and be given the same character as the prior transaction. This relation-back doctrine is premised on the idea that the tax consequences should be roughly the same as if the prior and the subsequent transactions had occurred at the same time.

Rev. Rul. 79-278, 1979-2 C.B. 302, concerns the character of a payment received in settlement of a lawsuit with respect to an earlier capital loss. In 1974, the taxpayer incurred a short-term capital loss on the sale of stock in corporation M. In 1975, the taxpayer sued M alleging that the loss resulted from violations of securities laws by M. The case was settled in 1977 and the taxpayer received a payment from M in 1978. Citing *Arrowsmith* and *Bresler v. Commissioner*, 65 T.C. 182 (1975), which applied the

Arrowsmith principle to an item of income rather than expense, Rev. Rul. 79-278 holds that the settlement recovery is considered a short-term capital gain.

The reasoning of *Arrowsmith* and Rev. Rul. 79-278 applies in your case. Under your facts, the earlier transactions were the capital losses in your joint account, and the subsequent transaction was the Year 3 $E payment received under the Settlement Agreement. The Year 3 transaction derived its context and its meaning from the backdrop of the prior transactions; had the Year 3 transaction occurred in the year or years you sustained the prior losses, your prior long-term capital losses would have been that much less.

Accordingly, the $E payment in Year 3 is long-term capital gain, not ordinary income, and your Year 3 capital losses, including the amounts carried over from prior years, are deductible against the $E in Year 3 under § 1211 of the Code. Your capital loss carryovers to years after Year 3 are reduced accordingly.

You have already filed your tax return for Year 3. Because this request for a private letter ruling was submitted before you did so, however, your request was timely and you may file a claim for refund amending your Year 3 return to be consistent with this letter ruling. You should attach a copy of this letter ruling to your refund claim. *See* Rev. Proc. 2007-1, §§ 5.01, 7.05, 2007-1 I.R.B. 1, 10, 27.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Thomas Albert Luxner
Branch Chief, Branch 1
(Income Tax & Accounting)