Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

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Person To Contact:
, ID No.

Telephone Number:

Refer Reply To:
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PLR-136025-17

Date:
May 08, 2018

Legend

Tax Year =

Taxpayer =

Insured =

Date 1 =

Date 2 =

Date 3 =

Dear :

This letter responds to your ruling request submitted on behalf of Taxpayer by letter dated November 29, 2017. You request a ruling on the tax treatment of funds recovered in settlement of a lawsuit. You request a ruling that the funds recovered in the settlement be excluded from gross income, on the basis that funds are properly deemed a return of capital to compensate for a loss or destruction of capital.

FACTS

Taxpayer is a bankruptcy estate. Taxpayer was created in response to an unfavorable judgment against Insured, who fatally injured a party with his automobile. Insured was covered by an automobile insurance policy.

A wrongful death law suit was instituted by the fatally-injured party's family ("victim's family") against Insured, Insured's automobile insurance company ("Insurer"), and

Insured's employer. Insured was represented by the automobile insurance company's law firm ("Law Firm") in defending the wrongful death law suit. Law Firm failed to settle the lawsuit within the policy limits of the automobile policy.

The victim's family settled with Insured's employer but went to trial against Insured and Insurer. After trial, a significant judgment was granted against Insured. Stunned by the judgment against Insured, Insured filed for bankruptcy protection on Date 1. On Date 2, the victim's family filed a proof of claim with the bankruptcy court in the amount of the judgment, plus interest.

The only asset of significance Taxpayer obtained from Insured was a legal claim against Insurer and Law Firm. The legal claim was that Insurer and Law Firm failed to settle within the policy limits, exposing Insured to the large personal judgment. Taxpayer instituted a lawsuit against Law Firm and Insurer, alleging various errors, including professional negligence by Law Firm ("malpractice lawsuit").

On Date 3, the parties to the malpractice lawsuit executed a settlement, under which Taxpayer would receive a substantial payment from Law Firm's malpractice insurer ("Settlement Payment"). While Taxpayer made a claim for punitive damages in instituting the malpractice lawsuit, the Settlement Payment specifically does not include punitive damages. The settlement was approved by the bankruptcy court. While substantial, the Settlement Payment from Law Firm to Taxpayer is still insufficient to satisfy Insured's liability to the victim's family. As a fiduciary for the creditors of the bankruptcy estate, comprised almost exclusively of the victim's family, Taxpayer expects to distribute the proceeds of the Settlement Payment to the victim's family. Taxpayer wants to exclude the Settlement Payment from its income.

LAW AND ANALYSIS

Unless provided otherwise in subtitle A of the Internal Revenue Code, gross income includes "all income from whatever source derived." I.R.C. § 61(a). For a taxpayer to have income under § 61, there must be an economic gain that benefits the taxpayer personally. Rev. Rul. 81-277, 1981-2 C.B. 14, *citing United States v. Gotcher*, 401 F.2d 118, 121 (5th Cir. 1968). Thus, the concept of economic gain is inherent in § 61.

"When a claim is resolved by settlement, the relevant question for the tax treatment of a settlement award is: 'In lieu of what were the damages awarded?'" *Milenbach v. Commissioner*, 318 F.3d 924, 932 (9th Cir. 2003) (*quoting Raytheon Prod. Corp. v. Commissioner*, 144 F.2d 110, 113 (1st Cir. 1944)). *See also Getty v. Commissioner*, 913 F.2d 1486, 1490 (9th Cir. 1990). The payments are includible in gross income if they are to replace lost profits. *Milenbach*, 318 F.3d at 933; *Raytheon*, 144 F.2d at 113. The payments are excludible from gross income as a return of capital if they are to compensate for the loss or destruction of capital. *Milenbach*, 318 F.3d at 933; *Raytheon*, 144 F.2d at 113.

Taxpayers may exclude an amount they received from their tax counsel if the amount received is to compensate for additional income tax the taxpayers had to pay as a result of the tax counsel's error in return preparation. *Clark v. Commissioner*, 40 B.T.A. 333 (1939), *acq.* 1957-1 C.B. 4. In *Clark*, the tax counsel had prepared a joint return for the taxpayers, a husband and wife, and advised them to file it. It later turned out the joint return brought them a less favorable tax outcome than separate returns would have. The Board concluded that the payment was compensation for the taxpayers' "loss which impaired [their] capital," or a return of the lost capital, and was "not income since it was not 'derived from capital, from labor or from both combined.'" *Clark* at 335 (*citing Merchants' Loan & Trust Co. v. Smietanka*, 255 U.S. 509, 518 (1921), *which in turn quotes from Eisner v. Macomber*, 252 U.S. 189, 207 (1920)).

In Rev. Rul. 57-47, 1957-1 C.B. 23, issued concurrently with the acquiescence in *Clark*, the Commissioner analyzed nearly the same facts as in *Clark*. The Commissioner held (1) that no taxable income is derived from that portion of the settlement proceeds that does not exceed the amount of tax that the taxpayer was required to pay because of the return preparer's error; and (2) that the remainder of the proceeds that represented interest on the overpaid tax and the fees that the taxpayer paid to the preparer and deducted must be included in gross income.

Rev. Rul. 81-277 held that a payment received from a contractor, for failure to fulfill a contractual obligation and in an amount equal to the contractor's estimated cost to satisfy the obligation, was excludible as a return of capital.

A taxpayer who received $125,000 in settlement of a malpractice claim against an attorney who failed to file a notice of appeal from a Tax Court decision against the taxpayer was permitted to exclude a portion of the settlement as a return of lost capital. *Concord Instruments v. Commissioner*, T.C. Memo. 1994-248. The taxpayer in *Concord Instruments* had originally sought $466,034 for the attorney's failure to timely file the notice of appeal, which consisted of $160,000 in deficiency paid, $265,012 in interest on the deficiency, and $41,002 in interest paid to a third party that lent the money to pay the deficiency. Relying heavily on *Clark* and citing favorably Rev. Rul. 57-47 and Rev. Rul. 81-277, the Tax Court held that the portion of the $125,000 settlement attributable to the deficiency was excluded from the taxpayer's gross income as a restoration of capital. The court specifically rejected the Commissioner's argument that the tax paid by the taxpayer resulted from the adverse Tax Court decision and not from the attorney's failure to file a notice of appeal. Instead, the court looked to the taxpayer's claim against the attorney to characterize the nature of the payment received in the settlement, and it did not evaluate the validity of the claim or whether the taxpayer would have prevailed had a timely notice of appeal been filed.

The professional negligence of the Law Firm representing Insured resulted in a significant judgment against Insured, which is a loss or destruction of the capital of

Insured. As such, the subsequent Settlement Payment stemming from the malpractice lawsuit is a return of capital to compensate for a loss or destruction of the capital of Insured. No economic gain benefits Insured personally; rather, the Settlement Payment restores some of Insured's impaired capital. Consistent with the holdings of *Clark* and *Concord Instruments*, the recovery of impaired capital is excluded from Insured's gross income as a restoration of lost capital. Additionally, as successor to Insured's claim against Law Firm and in its capacity as Insured's bankruptcy estate,[1] the Settlement Payment in the hands of Taxpayer is also deemed as a return of capital to compensate for a loss or destruction of capital. Accordingly, the Settlement Payment is excludible from gross income of Taxpayer as successor.

CONCLUSION

Funds recovered in the settlement – the Settlement Payment – is excludible from gross income of Taxpayer, on the basis that funds are properly deemed a return of capital to compensate for a loss or destruction of capital.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

William A. Jackson
Branch Chief, Branch 5
(Income Tax & Accounting)

cc:

[1] Property of the bankruptcy estate is identified in 11 U.S.C. § 541 and generally includes all legal and equitable interests of the debtor in property as of the commencement of the bankruptcy.