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INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR DEPUTY AREA COUNSEL (TEGE)
NORTHEAST/MID-ATLANTIC
Attn: Claire J. Brooks

FROM: Associate Chief Counsel (Income Tax & Accounting)
CC:IT&A

SUBJECT:

This Field Service Advice responds to your memorandum dated September 15, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

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LEGEND

Partnership W =
Partnership X =

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Agency	=
Entity Y	=
Committee	=
A	=
B	=
C	=
Date h	=
Date i	=
Date o	=
Date p	=
Date t	=
j	=
k	=
q	=
w	=
x	=
zz	=
year m	=
year p	=
year r	=
year s	=
\$b	=
\$c	=
\$d	=
\$e	=
\$f	=
Facility(ies)	=
Agreement	=
Settlement	=
Item	=
Lease	=

ISSUE: Whether Entity Y's cancellation of Partnership X's debt service obligation of \$d was received by Partnership X as a contribution to capital from partner A under § 721 of the Internal Revenue Code, or as taxable damages from Entity Y under § 61.

CONCLUSION: Entity Y's cancellation of Partnership X's debt service obligation of \$d was received by Partnership X as taxable damages from Entity Y under § 61.

FACTS:

Partnership X, a successor to Partnership W, owns and operates a Facility in Entity Y. Entity Y built the Facility in year m and operated it until year p when it sold the Facility to Partnership X (hereinafter referred to as "the partnership").

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The partnership and Entity Y entered into the Agreement on Date h whereby the partnership agreed to dispose of Item for q years. In addition, Entity Y retained certain options to renew the Agreement. Under the Agreement, Entity Y was responsible for all of the operating, maintenance, and certain improvement costs for the Facility. However, upon expiration of the Agreement, the partnership would own the Facility for the remaining period of the Lease and be responsible for operating costs.

In accordance with a letter of intent on Date h, the partnership agreed to buy the Facility from Entity Y for a total purchase price of \$b, of which approximately \$c was paid at closing and the remainder was financed by notes held by Entity Y. The notes obligated the partnership or its partners to repay the amounts owed Entity Y over q years, with interest payable at k percent annually.

As a result of redemptions by the partnership in year r of interests held by several individual investors as limited partners, A's direct and indirect ownership interest in the partnership increased to approximately w percent. A's daughter and the other general partner owned the remainder of the partnership.

On Date i, the Agency ordered the partnership to take remedial action to bring the Facility into compliance with certain federal laws and regulations. The Agreement required the partnership to obtain approval from Entity Y for all improvements to the Facility. However, a representative of Entity Y stated in a letter that Entity Y would not reimburse the partnership for any expenses to retrofit the Facility. Based on that letter, the partnership recommended that a new Facility be built.

Opposition to the proposed new Facility resulted in Entity Y's enacting a zz on new Facilities for at least j years. The partnership, believing that Entity Y's actions deprived it of any realistic means to comply with Agency's order, sued Entity Y in year s for breach of Agreement and for illegally enacting the zz. The lawsuit sought the invalidation of the zz, and \$e in damages. Negotiations between the parties continued. In its Date o letter that was signed by A as general partner, the partnership proposed a settlement to Entity Y. The letter, which was read into the record at the Committee meeting on Date p, proposed that the partnership immediately terminate all obligations of both parties under the Agreement. Specifically, it proposed that (1) "[Entity Y] will forgive [the partnership's] debt service obligation pursuant to one of the mechanisms previously discussed to defer taxes, (2) the existing [Lease] will be extended for x years, and (3) the [partnership's] lawsuit against [Entity Y] will be dismissed." At the Committee meeting on Date p, B indicated that "formal documents will be presented after the lawyers write it all up." During this time period, legal bills paid by the partnership to its attorney mentioned §104 as part of its legal work in drafting the language on the forthcoming settlement agreement. However, as of the Date p meeting, no documents had mentioned the debt being released in consideration of personal injuries suffered by A.

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At a Committee meeting on Date t to discuss the Settlement, C, an attorney representing Entity Y, stated:

“... The ... feature of the Settlement Agreement, in consideration of [the partnership’s] release of [Entity Y’s] obligation to put or pay, [the partnership] is relieved of its obligation to pay the remainder of its pass-through mortgage.”

Further clarifying Entity Y’s intent, B stated the following on the same date:

“What we are doing here is settling a lawsuit that has the potential for [Entity Y] to be on the book for more than \$f in fines, retrofitting costs, all kinds of services, and we are settling this lawsuit that could drag on for years and years and paying off in this some of the bills that have been in dispute.”

We note that the Settlement was signed by both parties on Date t, the same date as the Committee meeting that contained no reference to personal injuries. In general, the Settlement terminates the responsibilities of both parties under the Agreement. Section 5(b) of the Settlement states:

“For and in consideration of the Managing General Partner’s release of any and all claims which he may have against [Entity Y] for damages suffered by the Managing General Partner from personal injury, [Entity Y] hereby releases the maker(s) of the Remaining Portion Personal Property Notes and maker(s) of the Remaining Portion Real Property Notes from any and all liability thereunder. All such notes outstanding on the date hereof shall be returned to [the partnership] as agent for such makers, mark ‘paid in full and discharged.’”

At no time did A file a claim with Entity A or with any court alleging a personal injury caused by Entity A. The partnership asserts, however, that A told Entity Y representatives that A would pursue claims for personal injuries to him caused by Entity Y and that the release of the debt was in satisfaction of those claims.

Similarly, the underlying information indicates that Entity Y had no knowledge of any personal injury lawsuit. Entity Y’s legal office answered questions from the Internal Revenue Service (the Service) about Entity Y’s intent in settling the dispute with the partnership. For example, Entity Y stated that it agreed to the insertion of Section 5(b) into the Settlement because it is a general release clause of the type that is normally included in contracts of this type. Entity Y’s primary purpose in settling the dispute was “to terminate the [Agreement].” Also, Entity Y stated that “[it] was not and is not aware of any personal injury legal actions by A against [Entity Y].”

LAW AND ANALYSIS:

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Section 61 provides, in general, that gross income means all income from whatever source derived. Thus, under § 61, an accession to wealth is presumed to be gross income unless the taxpayer can demonstrate that the accession fits into one of the specific exclusions created by other sections of the Code. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955), 1955-1 C.B. 207.

Prior to its amendment by § 1605 of the Small Business Job Protection Act of 1996, § 104(a)(2) provided generally that gross income did not include the amount of damages received (whether by suit or agreement) on account of personal injuries or sickness. Thus, under prior law, damages received on account of a nonphysical injury, such as defamation, were excludable from gross income.

The courts have restricted the § 104(a)(2) exclusion to human beings rather than business entities. For example, the term “personal injury” does not apply to a corporation. See P& X Markets, Inc. v. Commissioner, 106 T.C. 441 (1996), aff’d in unpub. order, No. 96-70719 (9th Cir. Feb. 13, 1998)¹; Boyett Coffee Co. v. United States, 775 F. Supp. 1001 (W.D. Texas 1991).

The partnership contends that the reference to personal injury in Section 5(b) of Settlement, which describes a release of the General Partner’s claims against Entity Y, supports a conclusion that the cancellation of the partnership’s debt service obligation of \$d was received by A on account of personal injuries and is, therefore, excludable under § 104(a)(2). In contrast, the Service takes the position that the amount was received directly by the partnership. As explained below, we agree with the Service’s characterization of the transaction.

The underlying cause of action at issue is the partnership’s lawsuit against Entity Y for breach of the Agreement and illegally enacting the zz. The lawsuit sought business remedies, such as an invalidation of the zz and monetary damages from Entity Y. As such, it addressed legal injuries to the partnership, not A. There is no evidence (other than A’s uncorroborated statements) that A either alleged personal injury damages against Entity Y or sought compensatory or punitive damages from Entity Y for such injuries. Thus, the underlying cause of action against Entity Y was brought by, and settled by, the partnership rather than by A as an individual.

The proper inquiry is to ask in lieu of what were the damages awarded. Raytheon Production Co. v. Commissioner, 144 F.2d 110 (1st Cir. 1944), aff’g 1 T.C. 952 (1943), cert. denied, 323 U.S. 779 (1944). All facts, including the allegations contained in the taxpayer’s complaint, the evidence presented, the arguments

¹The Tax Court failed to find a personal injury even though the corporation had only one shareholder. The court noted that in opting to incorporate, the petitioner assumed both the benefits and burdens of the corporate form.

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made in the court proceeding, and the intent of the payor must be considered in determining in lieu of what were the damages awarded. Church v. Commissioner, 80 T.C. 1104 (1983). The ultimate inquiry is to determine the reason why the payor made the payment, regardless of the payee's belief as to why the payment was made. Agar v. Commissioner, 290 F.2d 283 (2d Cir. 1961).

In such determinations, the form of an agreement may not necessarily govern when all of the underlying facts contravene the form. For example, in Peaco v. Commissioner, T.C.M. 2000-122, the plaintiffs contended that the settlement proceeds they received were excludable under § 104(a)(2) because the express terms of the settlement agreement, which included a general release stating that all funds paid to the plaintiff are for pain and suffering, reflect the intent of the parties. The Tax Court rejected the plaintiffs' contention, indicating that the terms of the settlement agreement did not reflect the realities of the settlement because a significant portion of the proceeds was paid for a loss of compensation claim. Thus, an express allocation in a settlement agreement will not necessarily be determinative if other facts indicate that the payment was intended by the parties for a different purpose. See Bagley v. Commissioner, 121 F.3d 393 (8th Cir. 1997), aff'g 105 T.C. 396 (1995).

From the facts presented, no indication existed that the debt was being released in consideration for personal injuries suffered by A. There is no direct causal link between the Settlement and any personal injury suffered by A, and the reference to personal injury in Settlement appears to be gratuitous. In fact, considering the purely contractual nature of the underlying cause of action, and the absence of any personal injury claims by A, the reference is strangely incongruous.

The underlying material, including minutes from the Committee meeting on Date t, is equally clear that Entity Y was settling a contractual dispute with the partnership, not a personal injury lawsuit with A. As stated above, discussion of the Settlement at that meeting was limited solely to the legal dispute involving Agreement; no reference was made to any pending personal injury action. A never filed a claim with Entity A or with any court alleging a personal injury caused by Entity Y.

In summary, the gravamen of the action is a breach of contract claim by the partnership. The complaint did not involve an action for personal injuries, and the facts do not indicate that any damages were paid on account of a personal injury to A. Evidence presented by the payor (Entity Y), whose intent controls in determining what the damages were awarded for, contradicts the partnership's views that Entity Y was settling a personal injury claim with A. Accordingly, based on the materials you have submitted, Entity Y's cancellation of the partnership's debt service obligation of \$d was received directly by the partnership as taxable damages from Entity Y under § 61.

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If you have any further questions, please contact Sheldon A. Iskow at (202) 622-4920.