

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:B05

PLR-140347-04

Date:

December 3, 2004

Legend

Taxpayer :

Residence :

Contractor :

Architect :

Amount \$1 :

Amount \$2 :

Amount \$3 :

Amount \$4 :

Year 1 :

Year 2 :

Year 3 :

Dear :

This responds to a letter received on July 28, 2004, requesting a ruling on the tax treatment of damages that the Taxpayer received in settlement of a lawsuit for faulty construction of his residence.

Taxpayer hired Contractor to construct a residence for Taxpayer in accordance with plans prepared by Architect. The lot cost Amount \$1 and the construction cost Amount \$2 for a total of Amount \$3.

Taxpayer moved into the residence in Year 1. In Year 2, the Residence sustained water damage caused by faulty construction. Taxpayer sued Contractor and Architect for breach of contract, breach of implied warranty for fitness, negligence, and faulty construction. Taxpayer completed partial repairs in Year 3 for which he did not claim any losses. Taxpayer was awarded damages of Amount \$4 in addition to legal fees and costs.

Taxpayer requests a ruling that the damages excluding the legal fees and costs are a nontaxable return of capital that will decrease his basis in the Residence.

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. For payments received in settlement of a lawsuit, payments by the one causing a loss that do no more than restore a taxpayer to the position he or she was in before the loss was incurred are not includible in gross

income because there is no economic gain to the recipient. 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). 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 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 "[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.

In Rev. Rul. 81-152, 1981-1 C.B. 433, a homeowners association instituted an action against the builder of a condominium development for damages arising from construction defects. The ruling holds that the settlement funds were not income to the unit owners but instead represented a return of capital to each unit owner to the extent the recovery did not exceed the owner's basis in his or her property interest.

Based on the above analyses, we conclude that the damages (excluding the attorney fees and costs) are not income to the Taxpayer but are treated as a recovery of the Taxpayer's basis and the Taxpayer must reduce the Taxpayer's basis in the Residence.

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.

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. Specifically, no opinion is expressed or implied concerning the tax consequences regarding the award of attorneys fees and costs.

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.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

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