

**Internal Revenue Service**

Department of the Treasury

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Washington, DC 20224

Person to Contact:

Telephone Number:

Refer Reply To:

CC:ITA:05-PLR-140554-02

Date:

April 8, 2003

Legend:

A =  
City B =  
\$C =  
Year D =

Dear :

This letter is in reply to your letter requesting a ruling that the receipt of a certain tax indemnity payment pursuant to a litigation settlement with the taxpayer's former employer is not includible in the taxpayer's gross income.

A was an employee of City B. A retired from City B under full duty disability. Because this retirement pay was considered from duty disability it was not taxable for federal income tax purposes to A or A's surviving spouse.<sup>1</sup> Under the terms of the retirement plan, a "conversion" from disability benefits to regular retirement benefits was to occur at some point in time. This eventual conversion would affect the amount of the payments as well as the tax treatment (i.e., making the benefits taxable after conversion). The original conversion dates used by City B resulted in a law suit being filed against it by affected employees, including A.

The law suit was subsequently settled. City B redetermined the correct date for conversion as it applied to A finding it should have occurred at a later date. As a

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<sup>1</sup> We make no determination herein as to whether that assertion is correct as a matter of law; however, we assume such for the purposes of this ruling on the basis of the representation you have made.

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consequence of using the later conversion date, payments made prior to the late conversion date are properly excludable from A's gross income.<sup>2</sup>

City B issued corrected information returns (Forms 1099R) for tax years still open to those affected former employees, including A. This, in turn, allowed them to file amended returns and claim tax refunds for those open tax years because such payments are properly excludable from gross income. For those with earlier years closed by the statute of limitations for which a refund was thus unavailable, the settlement called for a tax reimbursement.<sup>3</sup> A was also a recipient of this tax reimbursement. In Year D, A received \$C as "reimbursement for past federal income taxes paid on duty disability benefits that had been improperly classified as regular retirement." Your request specifically seeks a ruling as to the proper tax treatment of \$C.

Section 61 of the Internal Revenue Code provides that gross income means all income from whatever source derived. Section 1.61-14(a) of the Income Tax Regulations provides that the payment of a taxpayer's income tax constitutes gross income to the taxpayer, unless otherwise excluded. See also Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929); Silverstein v. Commissioner, 36 T.C. 438 (1961). Despite the broad scope of section 61 and the regulations thereunder, for the reasons stated below, the tax indemnity payment received by A should be excluded from income.

Whether the proceeds received in a lawsuit or the settlement thereof constitute income under section 61 depends on the nature of the claim and the actual basis for recovery. Rev. Rul. 81-277, 1981-2 C.B. 14. If the recovery represents damages for lost profits, it is taxed as ordinary income; similarly, replacement of lost capital is treated as a nontaxable return of capital. Id. at 15, citing Freeman v. Commissioner, 33 T.C. 323 (1959); see also Estate of Taracido v. Commissioner, 72 T.C. 1014, 1023 (1979). Payments by 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 income because there is no economic gain. Id., citing Clark v. Commissioner, 40 B.T.A. 333 (1939), acq., 1957-1 C.B. 4 (withdrawing earlier nonacquiescence) and Rev. Rul. 57-47, 1957-1 C.B. 23.

In Clark v. Commissioner, supra, the taxpayers, husband and wife, made an irrevocable election to file a joint federal income tax return rather than separate returns on the advice of their return preparer. Subsequently, the Service examined the return

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<sup>2</sup> A died prior to the settlement of the lawsuit and all monies were paid first to A's estate and then to his widow.

<sup>3</sup> There was also the provision for additional nontaxable disability benefits, regular retirement benefits, and interest on all these amounts. The treatment of these other components of the settlement is not in issue in this ruling.

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and assessed a deficiency against the taxpayers. The deficiency existed because the return preparer took a larger deduction from income for capital losses than was allowed by law. If the taxpayers had filed separate returns employing the proper deduction for long-term capital losses, their combined tax liability would have been \$19,941.10 less than the amount they paid on their joint return. As recompense for his error, the return preparer indemnified the taxpayers in that amount. The Service included the indemnification payment in taxpayers' income as an amount attributable to the return preparer's payment of the taxpayer's income tax liability. The Board rejected the Service's argument that this payment was income and stated that "[p]etitioner's taxes were not paid for him by any person . . . [h]e paid his own taxes. . . . The [money] was paid to petitioner, not qua taxes, . . . but as compensation for his loss." 40 B.T.A. at 335. The fact that the underlying obligation was for taxes "is of no moment here." Id.

In Rev. Rul. 57-47, 1957-1 C.B. 23, a tax consultant made an error in preparing and filing a taxpayer's individual income tax return. That error caused the taxpayer to pay more than her minimum proper income tax liability. By the time the error was discovered, the period of limitation for recovery of overpayment of tax had expired. The tax consultant, as recompense for the error, paid the taxpayer a sum of money that included a reimbursement of the additional tax. Rev. Rul. 57-47, citing Clark, concludes that the reimbursement of the additional tax paid earlier is not includible in the taxpayer's income.

The tax indemnity payment that A received in this case is indistinguishable from the indemnity payments in Clark and Rev. Rul. 57-47. The reimbursing payor here, City B, was the same entity responsible for the error that led to taxpayer overpaying his taxes. When A overpaid his taxes in those earlier years, he suffered a loss of capital. This loss is what was recompensed by City B. As in Clark, the fact that the underlying obligation was for income taxes is "of no moment" here as well. As in Clark, A, would be paying more than his minimum proper federal tax liability for the tax years for which the tax reimbursement relates.

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

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. As specifically stated above, while assumed correct for purposes of this ruling, we make no determination herein as to whether the purported disability benefits paid were taxable as a matter of law. 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.

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

Sincerely,

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

cc: