



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (LMSB)

FROM: ASSOCIATE CHIEF COUNSEL (INCOME TAX AND  
ACCOUNTING)

SUBJECT: Settlement Proceeds and Settlement Costs

This Chief Counsel Advice responds to your memorandum dated January 15, 2002. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =  
A =

Date 1 =

Date 2 =

x% =

\$a =

\$b =

\$c =

\$d =

\$e =

\$f =

\$g =

\$h =

\$j =

\$k =

\$l =

\$m =

\$o =

\$p =

\$q =

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\$r =

\$s =

\$t =

Year A =

Year B =

Year C =

Year D =

Year E =

Year F =

Year G =

Year H =

Year J =

Year K =

o =

p =

q =

r =

s =

t =

u =

v =

w =

x =

y =

z =

Location =

### ISSUES

1. Whether settlement proceeds received by Taxpayer should be treated as income to Taxpayer or as a reduction in the basis of Taxpayer's land.
2. Whether certain settlement costs, including legal fees and costs incurred for the acquisition of certain water rights and discharge units, should be treated as capital expenditures under § 263.

### CONCLUSIONS

1. The settlement proceeds received by Taxpayer should be treated as a nontaxable return of capital to the extent that they do not exceed Taxpayer's basis in the land Taxpayer purchased from A. The settlement proceeds should reduce Taxpayer's basis in the land. Any proceeds in excess of Taxpayer's basis in the land should be treated as capital gain.

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2. Legal fees and the cost of acquiring certain water rights and discharge units pursuant to the settlement should be capitalized under § 263.

### FACTS

On Date 1, Taxpayer entered into a settlement agreement with A regarding certain land contamination and water rights. Taxpayer received approximately \$r in Year J pursuant to the settlement. Of this amount, approximately \$h was paid by A in cash, approximately \$m was paid by A in shares of A's stock, and approximately \$h was paid by A after it received certain litigation proceeds from its insurance companies.

Taxpayer reported a net amount of \$j of the settlement proceeds on its Year J tax return. The amount reported represents the gross amount received by Taxpayer from the settlement less certain amounts paid by Taxpayer, including legal fees and the purchase price for the acquisition of certain water rights and discharge units from A.

From Year A to Year B, A operated a steel mill on y acres of land in Location (the "Original Property"). In Year K, a state court determined that A held the rights to water under the Original Property and that the overlying water rights were appurtenant to the land and could not be transferred apart from the land.

In Year C, Taxpayer purchased w acres of the Original Property (the "Purchased Property") from A.<sup>1</sup> A retained the water rights under the Purchased Property. A also retained certain pipelines and easements across the Purchased Property that were used for delivering water to and from the Purchased Property and for drainage. Instead of selling the water rights under the Purchased Property to Taxpayer in the Year C sale, A entered into a utility service agreement with Taxpayer. Until the execution of the settlement in Year H, A provided Taxpayer with certain utilities such as water and sewage disposal services under the service agreement. A pumped water from under both the part of the Original Property it retained (the "Retained Property") and the Purchased Property. The water pumps and sewage treatment plant were located on the Retained Property.

After Taxpayer purchased the Purchased Property, state governmental agencies found that the Purchased Property was contaminated and ordered Taxpayer to clean up the environmental waste. Taxpayer incurred clean-up costs for several years prior to the year of the settlement. Most of the clean-up costs were for testing, consultants, legal services, and other labor-related expenses.

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<sup>1</sup> In Year E and Year F, Taxpayer purchased from third parties u and t acres, respectively, of the Original Property previously owned by A. As of Year F, Taxpayer owned a total of x acres of the Original Property.

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Most of the clean-up costs were not used to make improvements or erect buildings on the land, except for the building of two drainage ponds.

In Year D, A filed a petition under Chapter 11 of the U.S. Bankruptcy Code. As a result of the contamination on the Purchased Property, Taxpayer filed a proof of claim in A's bankruptcy case for \$d for expenses incurred by Taxpayer and for an unstated amount of expenses that Taxpayer anticipated it would incur in the future because of the environmental damage. In Year E, A's plan of reorganization was confirmed by the bankruptcy court and Taxpayer's claim was discharged. Taxpayer appealed the bankruptcy court's decision and amended its claim to an amount in excess of \$t in Year G.

From Year D to Year H, A filed actions against Taxpayer alleging that Taxpayer was liable for certain environmental clean-up costs relating to A's wastewater treatment plant and ferrous chloride plant. A also alleged that Taxpayer was liable to A for certain costs relating to the service agreement. Moreover, A was pursuing recovery from certain general insurance carriers as a result of the property damage on the Original Property. Taxpayer asserted that it was entitled to a share of the proceeds of the insurance litigation.

On Date 1, prior to resolution of Taxpayer's bankruptcy claim, Taxpayer and A entered into the settlement agreement. The settlement agreement settled all claims and disputes between Taxpayer and A without either party admitting to any liability. The terms of the settlement agreement were as follows:

1. In resolution of Taxpayer's claim in A's bankruptcy case, A was to pay Taxpayer a total of \$s of which \$h would be delivered to Taxpayer in cash and the remaining amount in A stock (at least z shares of stock) which would be sold at its market value. On or about Date 1, the parties filed a "Stipulation To Order Allowing Claim of [Taxpayer]" in an amount of \$s in the bankruptcy court. According to the above stipulation, the cash and stock, worth \$s, was to be delivered to Taxpayer within q days following the date upon which the stipulation became effective. It was further agreed that A would make reasonable efforts to assist Taxpayer to sell the A stock that would be delivered to Taxpayer.
2. The parties entered into the Water Rights Acknowledgment and Water Rights Agreement under which Taxpayer was to receive certain water rights allowing Taxpayer to pump a certain amount of underground water and use A's water storage capacity. A conveyed the pipes by quit claim deed to Taxpayer. These pipes, located on Purchased Property, were used for delivering water and for drainage. Moreover, the water rights and easements on Purchased Property that had been reserved by A in the Year C sale were transferred to Taxpayer by

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executing an amendment to the Year C grant deed to the Purchased Property. The settlement does not state why the water rights and easements were being transferred to Taxpayer. Further, A agreed to sell approximately s discharge units to Taxpayer.

3. Taxpayer was to deliver to A \$f within p days of the execution of the settlement agreement to an agreed escrow holder. In addition to the above amount, Taxpayer was to pay a minimum of \$k and a maximum of \$o as follows: \$g upon the receipt of cash from A for the bankruptcy claim and the remaining amount within v days after A delivers its stock pursuant to the bankruptcy stipulation. The remaining amount was to be the amount equal to the average of the "bid" and "asked" price of the A stock o days prior to distribution of the stock to Taxpayer.
4. Any proceeds received by A as a result of the insurance litigation were to be shared with Taxpayer. A was to first retain any proceeds in an amount equal to all expenses incurred by A in pursuing the insurance litigation, excluding sums spent solely for the purpose of investigation or remediating any environmental property damage on the Original Property. In no event would these litigation expenses exceed \$p. After retaining proceeds in an amount equal to expenses for another litigation, A was to retain the first \$q. Then, one-third of any excess proceeds was to be paid to Taxpayer and the remaining two-thirds was to be paid to A.

Concurrently with the execution of the settlement agreement, Taxpayer and A entered into an amended service agreement. Under the amended service agreement, each party was to furnish all of its own utilities and services for its properties, except for certain services. A was to provide treatment of sewage water to Taxpayer and Taxpayer was to provide A with electrical energy. Under the amended service agreement, Taxpayer would pay A \$b to \$c per month during Year H and Year J, plus x% of A's labor and maintenance costs incurred in the operation of the sewage treatment plant.

In Year J, an amendment to the settlement agreement was executed in which A agreed to sell r, instead of s, discharge units to Taxpayer for \$e plus carrying costs.

In Year J, Taxpayer received \$h in cash from A and z shares of A stock pursuant to the settlement agreement. However, the value of the A stock was approximately \$a per share and yielded a total amount of \$m upon sale of all the stock. Taxpayer also received \$h of A's recovery from the insurance litigation pursuant to the settlement agreement.

Taxpayer claims that the amounts paid to A, as stated in paragraph 3 above, were not for the purchase of water rights but were for the continuation of the utility

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service relationship with A. Taxpayer claims that the water rights were appurtenant to its land and thus it already owned the water rights upon its purchase of the Purchased Property. A's Form 10-K for the year ended Date 2 stated that, as a part of the settlement agreement, A sold to Taxpayer certain water rights and discharge units for an amount in excess of \$I.

Contrary to the position taken in its Year J tax return, Taxpayer now claims that the amount of proceeds reported should be a return of capital rather than income. Taxpayer claims that the settlement proceeds should be treated as a return of capital to be applied as a basis reduction for its properties on the Purchased Property, including land, buildings, and equipment. Further, Taxpayer claims that the amount in excess of \$I paid to A was for the continuation of the service relationship with A and thus should be treated as a business expense under § 162.

In prior audits, the Service required Taxpayer to capitalize its clean-up costs and legal fees. Taxpayer and the Service agreed that Taxpayer would capitalize the clean-up costs to a phantom asset referred to as "land improvement" for tax return purposes using a 15-year life. Moreover, Taxpayer and the Service agreed to capitalize the legal fees to various assets on the Purchased Property.

## LAW AND ANALYSIS

### Issue 1: Treatment of Settlement Proceeds

Section 61(a) provides that, except as otherwise provided, gross income means all income from whatever source derived. Whether an amount received as settlement proceeds constitutes income depends on the nature, origin, and character of the claim giving rise to the settlement. See Byrne v. Commissioner, 90 T.C. 1000, 1007 (1988); Pistillo v. Commissioner, T.C. Memo 1989-329. In characterizing settlement payments, courts consider the question, "In lieu of what were the damages awarded?" Raytheon Prod. Corp. v. Commissioner, 144 F.2d 110, 113 (1<sup>st</sup> Cir. 1944). Settlement payments that represent reimbursement for lost profits, royalties, or other items of taxable income are generally taxable. See Raytheon, 144 F.2d at 113; Mathey v. Commissioner, 177 F.2d 259, 260-61 (1<sup>st</sup> Cir. 1949). However, if a payment represents a return of capital, it is not gross income to the extent of the taxpayer's basis in the capital asset. See, e.g., Wheeler v. Commissioner, 58 T.C. 459, 461 (1967); Big Four Indus., Inc. v. Commissioner, 40 T.C. 1055, 1060 (1963), acq., 1964-2 C.B. 4; Freeman v. Commissioner, 33 T.C. 323, 327 (1959).

The origin of Taxpayer's claim against A relates to the purchase of the Purchased Property. Taxpayer sought recovery for environmental damage to the land it purchased from A. Because land is a capital asset, the settlement proceeds represent amounts for injury or damage to a capital asset. Therefore, the proceeds

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should be treated as a recovery of Taxpayer's basis in the land. Any settlement proceeds in excess of Taxpayer's basis in the land should be treated as capital gain.

## Issue 2: Treatment of Purchases and Settlement Costs

Section 162(a) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Section 263(a), however, prohibits a deduction for capital expenditures, including amounts paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

Section 1.263(a)-1(b) of the Income Tax Regulations provides that capital expenditures include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Section 1.263(a)-2(a) provides that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

Expenditures that are otherwise deductible under § 162 are not currently deductible if they are also capital expenditures under § 263. In other words, § 263 takes precedence over § 162. See §§ 161; 261; *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 84 (1992).

The origin and character of the claim with respect to which an expenditure was incurred determines the tax treatment of the expense. See *United States v. Gilmore*, 372 U.S. 39, 49 (1963). Certain costs, such as legal fees, can be nondeductible capital expenditures if incurred in connection with the acquisition of a capital asset. See *Woodward v. Commissioner*, 397 U.S. 572, 574-79 (1970); *United States v. Hilton Hotels Corp.*, 397 U.S. 580, 583-85 (1970). However, if a claim arises from acts performed by a taxpayer in the ordinary course of its business operations, expenses related to the claim are generally deductible under § 162.

Thus, the deductibility of the payments and legal fees at issue depends on the origin of the claim from which the settlement arose. The origin of Taxpayer's claim against A was in the purchase of the Purchased Property, a capital transaction. Taxpayer incurred legal fees in its efforts to obtain recovery for the environmental damage to the Purchased Property that was allegedly caused by A. Therefore, those legal fees should be treated as capital expenditures.

To the extent that the approximately \$1 payment was for water rights and discharge units, that payment is also a capital expenditure. See *Niagara Mohawk*

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Power Corp. v. United States, 525 F.2d 1380, 1386 (Ct. Cl. 1975) (holding that water rights, like land, are a nondepreciable capital asset with an indeterminate useful life); Rev. Rul. 73-341, 1973-2 C.B. 306 (ruling that the sale of subsurface water rights qualifies for capital gain treatment under § 1231). Any legal fees attributable to the acquisition of water rights and discharge units are also capital expenditures.

#### CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

As your request indicates, the settlement agreement is not entirely clear as to what the approximately \$1 payment made by Taxpayer was for, although numerous facts suggest that the payment was for the water rights and discharge units. Assuming Taxpayer is correct in claiming that the payment was for continuation of the utility service relationship with A, it is still not clear that the payment would be deductible. The utility service agreement appears to provide Taxpayer with long-term benefits. Therefore, an argument could be made that expenditures for continuing that agreement are capital expenditures.

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Please call if you have any further questions.

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