Internal Revenue Service

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Department of the Treasury

Washington, DC 20224

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6-15-01

Re: Letter Ruling Request Regarding the Exclusion of Settlement Proceeds from Taxpayer's Claim against an Estate

LEGEND:

Taxpayer H =

Taxpayer W =

C =

D =

Business =

$X =

$Y =

Year 1 =

Dear :

This responds to your letter dated February 7, 2001, requesting a ruling on whether settlement proceeds from Taxpayer W's claim against an estate are excludible from gross income under section 102(a) of the Internal Revenue Code.

FACTS

C and D entered into an oral contract with Taxpayer H. H agreed to manage the Business owned by C and D for the life of C and D taking a significant reduction in salary. In return, C and D promised to make reciprocal wills, which would convey the Business first to each other and then to H's wife, W, at the death of the survivor. It was also agreed that C and D would pay H $X if his employment with the Business terminated for reasons other than H's voluntary action. The parties performed according to the terms of the oral contract. H started managing the Business, and C and D modified their wills to reflect the terms of the oral contract.

More than four years later, C died and D fired H. In accordance with their oral contract, H was paid approximately $X in exchange for executing a release that waived all rights he might have to sue the Business, C or D for any reason related to his employment.

Later D sold the Business to a third party. Taxpayer W filed a lawsuit against D pleading two alternative and mutually exclusive causes of action. The first cause of action was for breach of the oral contract between C, D, H and W. Alternatively, W asserted her rights as a third party beneficiary of the oral contract between C, D, and H.

After W filed the lawsuit but before the lawsuit had been tried on the merits, D died. The lawsuit proceeded with the executor of D's estate replacing the decedent as defendant. In Year 1, the executor entered into a settlement agreement in which the estate agreed to pay W $Y in exchange for W's release of all claims against D's estate.

LAW & ANALYSIS

Section 61 of the Internal Revenue Code provides that gross income means all income from whatever source derived unless specifically excluded by law.

One type of income that is specifically excluded by law is property received by inheritance. Section 102(a) of the Code provides that gross income does not include the value of property acquired by gift, bequest, devise or inheritance.

Section 1.102-1(a) of the Income Tax Regulations provides that property received under a will or under statutes of descent and distribution is not includible in gross income.

Taxability of an amount a taxpayer receives in settlement of a lawsuit is determined by reference to the origin and character of the claim which gave rise to the lawsuit. Lyeth v. Hoey, 305 U.S. 188, 196 (1938); Getty v. Commissioner, 913 F.2d 1486, 1490 (9th Cir. 1990)(citing Tribune Publishing Co. v. United States, 836 F.2d 1176, 1177 (9th Cir. 1988)). In characterizing the settlement payment for tax purposes, the critical question is in lieu of what was the settlement amount paid. Getty at 1490; Vincent v. Commissioner, T.C. Memo 1992-21; see also Roberts v. Commissioner, T.C. Memo 1995-171.

In the present case, breach of contract was the underlying cause of action. In the complaint, W alleged that D breached an oral contract to convey the Business to W by will. If W had received the Business under D's will in satisfaction of D's promise, W would have received the property by inheritance. The receipt of the settlement proceeds from D's estate is no different.

Based on the facts as represented and the relevant law as set forth above, we conclude that the proceeds received by W in the settlement of her claim against D's estate are excludible from gross income under section 102(a).

Except as specifically ruled upon above, no opinion is expressed or implied regarding the income tax consequences of any transaction, item discussed or referenced in this letter.

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. 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,
George Baker
Assistant to the Chief, Branch 5
Office of Chief Counsel
(Income Tax and Accounting)

Enclosures (2):
Copy of this letter
Copy for section 6110 purposes

cc: