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A Tale of Caps and Return of Capital

By Christopher A. Karachale • Wood LLP • San Francisco

Let's suppose that, like the protagonist of Esphyr Slobodkina's incomparable classic *CAPS FOR SALE*, you decide to become a peddler of caps. You intend to deal in gray caps, brown caps, blue caps and red caps. You research the best cap manufacturers and select Apex Hats to design and manufacture your gray, brown, blue and red caps. Apex makes caps specially designed to be marketed by travelling peddlers who walk about with as many as 15 caps stacked on their heads.

You and Apex enter into a purchase agreement for the production of 5,000 caps for the relative bargain price of \$0.50 a cap. The total purchase price is \$2,500. Pursuant to the terms of the purchase agreement, you make three nonrefundable deposits totaling \$1,500, with the balance of the purchase price to be paid proportionally in conjunction with the delivery of the 5,000 caps.

Things appear to be going swimmingly, capping a fair contract negotiation. You travel the countryside researching demographic interest in gray, brown, blue and red caps. Then disaster strikes.

Apex was scheduled to begin delivery of the caps in October, just when the cold winds begin to blow. Unfortunately, due to unforeseen manufacturing problems, Apex now advises you that it will not be able to deliver the gray caps, brown caps, blue caps or the red caps until January, at the earliest. You become very, very angry and march into Apex's offices demanding, "You give me my caps!" The Apex CEO just stares at you and then, inexplicably, says, "Tsz, tsz, tsz."

The Settlement Agreement and Resolution

After a protracted and expensive battle that does nothing to cover your pate, you settle. Your legal team and Apex enter into a settlement agreement providing that Apex will deliver 1,000 caps in November (worth \$500 under the contract), pay you back the balance of the nonrefundable deposits (\$1,000), and provide you with financial

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compensation of \$2,000 arising from the breach. This means the total compensation paid under the terms of the settlement agreement with Apex is \$3,500.

Given your concern about the quickly approaching winter, you fail to review the language of the settlement agreement to see if it says anything about the reason Apex is making the payments. The settlement agreement simply states that you are to receive "certain financial compensation from Apex Hats" amounting to \$2,000, plus the delivery of the 1,000 caps and the repayment of the nonrefundable deposits.

Of course, by this time, you are well aware that the demand for gray, brown, blue and red caps is going to be extensive this winter season. In fact, you know that through your itinerant peddling you will easily be able to unload the original 5,000 caps you planned to sell. You contact Apex's main competitor, Crown Hats, to see if you can obtain replacement caps.



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Crown, recognizing your dire straits, agrees to expeditiously manufacture the 4,000 additional caps you anticipate you will sell and deliver them by October. However, the cost of the Crown headgear will be \$1.25 for each gray, brown, blue and red cap, or \$5,000 total. Crown also requires a deposit of \$2,500 to commence manufacturing the headgear so as to provide the caps by October.

Monkey Business

Now that you have your caps and can begin peddling, the question, of course, is the tax treatment of the settlement payment you received from Apex. The original cost of the caps from Apex was to be \$2,500. Now, as part of the settlement agreement, you have received payments totaling \$3,500, or a refund of your \$1,500 deposit, plus financial compensation of \$2,000.

Of course, you have now had to pay Crown twice the amount you originally bargained to pay for the gray, brown, blue and red caps. In fact, you are now out \$5,000 to obtain the 5,000 caps you intend to peddle. Given the fact that you have been made whole only after paying Crown \$5,000, it seems reasonable to query the appropriate tax treatment of the settlement payment.

Is the \$2,000 financial compensation payment taxable as compensation for lost income caused by Apex's breach? Does the payment represent a replacement of capital? Is it not taxable to the extent it does not exceed the basis of the new Crown caps?

New Guidance

Luckily for cap peddlers across the land, CCA 201203013 (Oct. 7, 2011), written by IRS Branch Chief Michael Montemurro, sets the record straight. CCA 201203013, the facts of which serve as a model for our cap tale, begins by pointing out that the refund of your deposits (including the caps to be delivered in November) is clearly not income.

No one would question this. Such a refund is not an accession to wealth under *Glenshaw Glass Co.*, S Ct, 55-1 USTC ¶19308, 348 US 426, 431 (1955). It is clear that where the amount recovered is directly tied to and constitutes a replacement of destroyed or injured capital, it is a return of capital.

It is not taxable except to the extent the recovery exceeds the tax basis of what was lost. [See, e.g., *Farmers' & Merchants' Bank*, CA-6, 3 USTC ¶972, 59 F2d 912 (1932).] Since the \$1,500 refund replaces the capital initially invested with Apex as a deposit, such amount is not taxable.

Status Quo Ante

But what about the \$2,000 payment you received from Apex? In conjunction with the refund of the deposits, you have received \$3,500 from Apex. Plainly, that is *more* than the \$2,500 you actually intended to pay for the 5,000 caps when you entered into the purchase agreement with Apex. Of course, to obtain the 5,000 caps in time for winter, you have been required to pay Crown \$5,000.

CCA 201203013 helps to untangle the appropriate tax treatment. Citing Rev. Rul. 81-277, 1981-2 CB 14, the CCA sensibly states that the tax treatment of the \$2,000 depends on whether the financial compensation restores you to your pre-breach position or goes beyond restoring you to your pre-breach position.

Clearly, the financial compensation you received from Apex (\$2,000) is less than the difference between the replacement cost of the Crown caps (\$5,000) and the original price of the Apex caps (\$2,500). Had you received, for example, \$3,000 as a financial compensation payment from Apex, there would be a \$500 excess over replacement cost. That could represent something other than a payment to return you to your *status quo ante*.

Here, though, by paying you the \$2,000 of financial compensation, it appears that Apex has helped only to return you to your pre-breach position. It has not placed you in a position that is better than you were in prior to the breach.

Different Caps?

But here is the head-scratcher: How do we know if you have been restored to your pre-breach position? The CCA provides a helpful framework to determine the *status quo ante*. The key, according to CCA 2012203013, is to determine *why* Crown's caps cost more than Apex caps.

If Apex caps and Crown caps are comparable items, the CCA points out that Apex's breach

of the purchase agreement probably forced you to pay more for the Crown caps. Thus, the \$2,000 financial compensation payment you received from Apex as part of the settlement agreement would not be taxable. After all, it would not go beyond restoring you to the *status quo ante*. It should thus be treated as a return of capital, reducing your basis in the Crown caps.

But let's say that the price difference for the Crown caps is actually attributable to the fact that the Crown caps are higher quality caps. Instead of the gray, brown, blue and red caps you contracted to buy from Apex, you are now receiving multi-colored top hats from Crown of superior quality. These multi-colored top hats have special earflaps that make them particularly well-suited for winter weather.

If the higher price of the Crown caps is actually due to the higher quality of the caps, then, according to the CCA, the \$2,000 financial compensation payment made under the terms of the settlement agreement with Apex does not restore you to your original pre-breach position and is includible in gross income.

Quality Quantification

This distinction makes perfect sense. If the replacement caps from Crown are the same, then the financial compensation can be viewed as Apex's payment arising out of the breach and intended to place you back to the *status quo ante*. However, if the caps you receive from Crown are actually of a higher quality, then the \$2,000 you are receiving from Apex is actually doing more than restoring to you to your pre-breach position.

Here, CCA 201203013 offers helpful perspective. The guidance says that an "evaluation of the specifications" of the Apex and the Crown caps is critical to determining whether the financial compensation restores you to your pre-breach position or goes beyond mere restoration. If the caps are deemed to have "[v]ery similar specifications," then the financial compensation is probably a return of capital.

Additionally, the CCA advises that the cost of the Apex and Crown caps should be compared on the day that you initially purchased the Apex caps. Presumably, if there always was a large price differential between Apex and Crown caps, then this fact would

tend to suggest that the higher purchase price is attributable to some underlying quality difference. That makes sense.

However, if Apex and Crown caps are normally priced at the same general level, then Crown's higher cost after Apex's breach may actually be due to some factor *other* than the difference in quality. For example, recognizing your limited timeframe, Crown may have obtained the benefit of the bargain by charging you more for the same gray, brown, blue and red caps.

The Rabbit in the Hat

As part of your settlement with Apex, you should have paid attention to the language of the settlement agreement. The settlement agreement simply states that you received the \$2,000 as "certain financial compensation from Apex Hats." This generic language (as occurs in so many settlement agreements) makes it unclear in lieu of what Apex made the \$2,000 financial compensation payment. As with all settlement agreements, the failure to provide evidence of the payor's intent can undermine even the most bulletproof document.

Nevertheless, CCA 201203013 provides rather enlightened guidance on the tax treatment of settlement agreements that do not enunciate the specific grounds or basis for payments, including the \$2,000 in financial consideration you received. Responding to IRS Area Counsel's reading of the case law, Mr. Montemurro notes that certain authorities arguably could be read to mean that where the settlement agreement is unclear or includes no allocation, the recovery should not be treated as a return of capital. Rather, it should be considered lost profits and taxed as ordinary income. [*Citing Stocks*, 98 TC 1, Dec. 47,901 (1992); see *Freda*, CA-7, 656 F3d 570 (2011).]

However, the CCA states in no uncertain terms that silence in the settlement agreement as to the purpose of the payment does not alone dictate that the settlement payment is "by default" consideration for lost profits rather than a return of capital. Quite pragmatically, the CCA concedes that it is very common for settlement agreements to be silent as to the specified reason for the payments.

The rationale for the silence in a settlement agreement can vary. For example, sometimes

payors do not want to admit any wrongdoing. Alternatively, in many cases it is in the best interest of the payees not to press the point of exacting an admission of wrongdoing in the interest of avoiding protracted settlement negotiations and getting on with their business. Sometimes the settlement agreement is sloppily or hurriedly drafted. Just get the money, the plaintiff may say.

Head of the Class

The key insight in the CCA is that mere silence in a settlement agreement as to the purpose of a payment does not, *ipso facto*, make the consideration lost profits taxable as ordinary income. Rather, the taxability of the settlement payment depends on the underlying claim and the reason for the recovery.

Of course, CCA 201203013 can also be seen as a double-edged sword. By dispensing with the mere form of the settlement agreement, the CCA forces taxpayers and the IRS to look to the underlying substance of the transaction. Even if a settlement agreement overtly states that the payment is intended to return the payee to his pre-breach position and represents a return of capital, such statements will not necessarily secure the desired tax treatment.

Indeed, one should go considerably further. In a case such as this, it is the underlying use of the settlement proceeds (acquiring similar quality products or products of a higher quality) that will dictate the tax treatment. Consistency and follow-through count.

Conclusion

What are the lessons of CCA 201203013 for you and your cap business? There appear to be at least two. First, and most significantly, if you end up settling business litigation through a settlement agreement that includes certain financial compensation to be paid by the breaching party, do your best to ensure that the settlement agreement characterizes the nature of the payment.

If a financial payment is intended to make you whole, say so. If part of the payment is allocable to such restoration, the settlement agreement should overtly reflect this. Despite the favorable guidance in CCA 201203013, silence in a settlement agreement more often than not results in more questions and

less certainty about the tax character of the settlement payment.

Second, carefully calibrate the replacement property that you acquire after the breach. In the event that you receive financial compensation from the breaching party and apply those settlement monies to replacement property, ensure that the replacement property has “very similar specifications” to the property

you originally intended to acquire. If you plan to buy gray, brown, blue and red replacement caps, make sure they are of a similar quality to the original caps you set out the purchase. Such similar specifications help to show that you have used the settlement payment merely to return yourself to your pre-breach position. And such replacement property may help you avoid taxation of the settlement proceeds.