# FSA 948, Vaughn # 948

Some Settlement Discounts Are Income

## Headnote:

***Reference(s):*** IRC Sec(s). 61

In 1992 field service advice, the Service has advised that if settlement discounts are nontaxable returns-of-capital or reimbursements, amounts exceeding undepreciated basis or actual incurred costs should be treated as income.

A company designed nuclear power plants for utilities. Before the plants were completed, design flaws were discovered and at least one utility abandoned a plant. The designer and the utilities eventually reached undisclosed settlements, which the IRS couldn't access because the years weren't under audit.

When the settlement agreements became available, the Service advised that, to the extent the settlement amounts exceeded undepreciated basis or actual costs incurred, they should be treated separately as income items. Further, the Service said that abandonment of a plant would have no real effect on the tax treatment of the settlement discounts.

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## FULL TEXT:

INTERNAL REVENUE SERVICE

MEMORANDUM

CC:TL-N-9624-92

FS:IT&A:GJMerken

date: October 28, 1992

to: Utility Industry Specialist, Cleveland District

from: Assistant Chief Counsel (Field Service) CC:FS

subject: Settlement Discounts

This responds to your request for field service advice of July 28, 1992. This document may include confidential information subject to the attorney-client and deliberative process privileges, and may also have been prepared in anticipation of litigation. This document should not be disclosed to anyone outside the IRS, including the taxpayers involved, and its use within the IRS should be limited to those with a need to review the document in relation to the subject matter or case discussed herein.

## ISSUES

1. Whether settlement discounts and cash should be treated as reductions in basis or as items of income.
2. Whether settlement amounts should be bifurcated between amounts received that relate to additional costs incurred to correct design defects (cover) and other amounts.
3. Whether rights to settlement discounts become fixed when the settlement becomes final, or whether the amount of each discount accrues when the goods or services to which the discount relates are purchased.
4. Whether the facts and circumstances of whether a generating plant is operating or abandoned should affect the tax treatment of cash or discounts received.

## CONCLUSIONS

1. We are unable to conclude generally whether the subject settlement discounts and cash are income or should be treated as reductions in basis because the answer is fact-specific and each settlement agreement is not available for analysis.
2. If the settlement discounts and cash are nontaxable returns of capital or reimbursements, then amounts exceeding the undepreciated basis or actual incurred costs should be treated separately as items of income.
3. For the same reason as in Conclusion 1, above, we are unable to conclude when, if at all, the subject settlement discounts and cash should be recognized as and included in income.
4. Abandonment would have no effect on the tax treatment of cash and settlement discounts beyond increasing the amount of income should an abandonment loss have been taken by the time the discounts are exercised.

## FACTS

The facts as contained in your request for advice are as follows:

Several utilities 1 owned nuclear power plants for which **[redacted text]** designed the **[redacted text]** During the **[redacted text]** and the utilities in question discovered that the **[redacted text]** were prone to failure under certain emergency conditions. While the problem was fixed long before any of the power plants began operating, the question of who should pay for the repairs was never resolved.

Following years of ongoing negotiations and threatened lawsuits, **[redacted text]** and its various customers began settling the disputes. Most of the settlement terms remain confidential. According to an article in **[redacted text]** settled for $ **[redacted text]** for $ **[redacted text]** and **[redacted text]** settled for an undisclosed amount its $ **[redacted text]** lawsuit. However, some general terms of the **[redacted text]** settlement **[redacted text]** were reported in the **[redacted text]** the **[redacted text]** the **[redacted text]** and the **[redacted text]** at the end of **[redacted text]** This package, reportedly worth $ **[redacted text]** included discounts on **[redacted text]** equipment, service, and fuel purchased by the utility in the future. You indicate that other settlements may also contain cash payments, and may involve utilities which have abandoned the subject nuclear power plant. Because none of the listed utilities are currently under audit for the tax years these settlements were agreed upon, the settlement agreements are unavailable.

## DISCUSSION

1. Income or Basis Reduction

I.R.C. section 61 provides that except as otherwise provided, gross income means all income from whatever source derived. Whether the proceeds of a lawsuit or a settlement of a lawsuit are income depends on the nature of the claim and the actual basis of recovery. If the recovery represents damages for lost profits, then it is taxable; if intended to replace capital destroyed or injured, however, then it is a return of capital and not taxable. E.q., Freeman v. Commissioner, 33 T.C. 323, 327 (1959).

Furthermore, if the recovery represents reimbursement by another party for expenses incurred by a taxpayer on behalf of that other party, then the recovery is similarly excludable from gross income because the expenses are those of another rather than those of the taxpayer. E.q., Rev. Rul. 80-99, 1980-1 C.B. 10.

a. Return of Lost Capital

To determine whether an amount received represents a nontaxable return of lost capital, the Service has applied a three-part factual test contained in Clark v. Commissioner, 40 B.T.A. 333 (1939): (1) the reimbursing party committed a breach; (2) the breach caused an impairment of capital; and (3) the amount of the reimbursement is based upon, if not measured by, the amount of lost capital. Thus in Rev. Proc. 67-33, 1967-2 C.B. 659 and Rev. Rul. 68- 378, 1968-2 C.B. 335, for example, a

restoration of a taxpayer's capital is not taxable where (1) the reimbursing party engaged in illegal conduct by charging monopolistic prices for goods supplied; (2) that illegal conduct impaired the taxpayer's capital by forcing it to spend more for the goods than would have been necessary in the absence of the illegal conduct; and (3) the amount of the reimbursement was based upon the amount of lost capital.

Similarly, G.C.M. 38605, I-305-79 (Jan. 8, 1981), concluded that cash and discount rights taxpayer was entitled to receive was a nontaxable return of lost capital and reduced taxpayer's basis in cover nuclear fuel assemblies. There, a utility owned four nuclear reactors fueled by enriched uranium and contracted with a supplier for fuel and the fabrication of fuel assemblies. The supplier later breached the contract on the grounds of commercial impracticability. The utility was forced to buy substitute (cover) fuel at higher prices to replace that which its original supplier was obligated to supply. After a U.S. District Court found against the supplier, the parties entered a settlement agreement under which the utility would be entitled to receive cash, discounted goods and services, and a contingent interest in a portion of any proceeds the supplier might derive from an antitrust suit it had brought against its own suppliers.

The G.C.M. analyzed the underlying contracts and applied the three-part Clark test in the following manner: (1) the supplier breached the uranium supply contract; (2) the breach caused an impairment of the taxpayer's capital by forcing it to spend the difference between the price of the cover fuel and the contract price; and (3) the amount of the reimbursement was based upon, if not measured by, the amount of lost capital. Thus, the property and cash the taxpayer received did not initially constitute gross income, but first reduced its undepreciated basis in the cover nuclear fuel assemblies as a return of capital.

In this case, we do not know precisely for what the settlement discounts and cash were paid. We are reluctant to base general advice on press clippings. Analysis of each settlement agreement is required to determine whether the factors discussed above are present. If so, then we would agree that the amounts received are nontaxable returns of capital to the extent these do not exceed basis in the repaired **[redacted text]** because these amounts serve to make the taxpayers whole. If not, then the analysis contained in G.C.M. 38605 would not apply. There is some indication in the packet of press clippings you provided us that at least some of the amounts were paid not to return capital to the taxpayers but to preserve a business relationship between **[redacted text]** and its customers. See **[redacted text]** .

Furthermore, analyzing the agreements would reveal whether the settlement discounts are trade discounts or cash discounts. Trade discounts represent adjustments to the purchase price granted by a vendor. If a discount is always allowed irrespective of when payment is made, then it is a trade discount. Thomas Shoe Co. v. Commissioner, 1 B.T.A. 124 (1924), acq., IV-1 C.B. 3 (1925); Rev. Rul. 84-41, 1984-1 C.B. 130. Cash discounts represent a reduction in price attributable to advance payment or to payment within a prescribed time period, and the purchaser may either deduct the discount from the

purchase price or include the discount in income without reducing purchase price. See, e.g., Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), acq., 1982-2 C.B. 2. Although we believe the subject discounts are probably trade discounts, we hesitate to draw any conclusions therefrom until we can be certain this is so. b. Reimbursed Expenses

G.C.M. 38605 applies the reimbursement theory as an alternative line of support for excluding the cash and settlement discounts in that case. The G.C.M. explains this rationale as follows:

> The taxpayer has merely borne the expense of another and has been repaid therefor. In effect the taxpayer has loaned the amount of the expenses to the person obligated therefor, and has subsequently been repaid the amount of the loan by such person in the form of a reimbursement. Clearly, the repayment of a loan is not includible in a creditor's gross income. We think the same result obtains when a taxpayer is reimbursed for expenses he incurs on behalf of another by such other person. That is, the reimbursement is excludable from the taxpayer's gross income because economic gain is absent.

The reimbursement theory is fact-based. A detailed analysis of the settlement agreements is required to determine whether the taxpayers are being reimbursed for repair expenses they have incurred on behalf of **[redacted text]** If the initial contracts for the **[redacted text]** provided that **[redacted text]** was obliged to supply a working, error-free structure, then this theory might apply. Again, however, we are unable to conclude whether this theory applies absent a detailed analysis of the settlement agreements and initial contracts. 2. Bifurcation

If the settlement discounts and cash as analyzed under the above theories represent nontaxable return of capital or reimbursement, then these amounts would be nontaxable only up to the undepreciated basis or actual incurred costs. G.C.M. 38605. Amounts exceeding undepreciated basis or actual incurred costs should be treated separately as items of income. 3. Timing of Income

Under the all events test of Treas. Reg. section 1.451- 1(a), an accrual method taxpayer includes income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. All the events that fix the right to receive income occur when (1) the required performance occurs, (2) payment is due, or (3) payment is made. Rev. Rul. 74-707, 1974-2 C.B. 149. a. G.C.M. 38605

The third issue of G.C.M. 38605 holds that the right to settlement discounts is fixed at the time the settlement becomes final. This is the time the required performance occurs. Even though the right to receive a benefit from such discounts remains contingent until the option to buy future products is exercised, that contingency should not be treated as part of the required performance under the settlement agreement. The substance of the settlement is the customer's relinquishing its rights under the original contracts in consideration for an option to buy goods and services. Accordingly, the right to

the discounts is fixed when the settlement becomes final, because both the required performance (relinquishing the original contract rights) and payment (granting the option) will occur at that time.

G.C.M. 38605 opines that when a right is subject to an inherent contingency, the contingency should not be treated as part of the required performance. Under the G.C.M. facts (discounts provided in settlement of lawsuit for breach of contract for provision of uranium), purchasing goods and services under the option is held not part of the required performance, and the right to the discounts is not contingent thereon.

This conclusion, however, is contrary to Graf v. Commissioner, 39 B.T.A. 379 (1939) (discounts on future beer purchases do not accrue until related purchases made because supplier's liability to pay taxpayer is contingent), and Rev. Rul. 79-247, 1979-2 C.B. 24 (relying on Graf, interest on investor's deposit payable only against future commissions accrues as future trades are made). The G.C.M. 38605 states that the decision in Graf is wrong and the Service should not follow it. Thus, there exists a conflict between the Rev. Rul. and the G.C.M.

Following up on tax litigation advice regarding a utility's right to future rebates in exchange for relinquishing the right to buy fuel at below-market prices, the former Tax Litigation Division in 1988 requested that the former Interpretative Division reconsider G.C.M. 38605. Tax Litigation determined that the inconsistent treatment of the Graf case between the G.C.M. and the Rev. Rul. as well as other case precedents presented insurmountable litigating hazards. Further, Tax Litigation disagreed with the G.C.M. and requested it be modified to the extent it concluded that a utility's right to discounts is fixed when the settlement becomes final.

Tax Litigation's disagreement was grounded in the theory that although settlement agreements involve the exchange of valued rights, the option to purchase goods and services at a discount is inherently contingent and has no income tax consequences until the actual purchases are made. The first prong of the all events test, that all the events have occurred that fix the right to receive such income, is not met until purchase. Citing Graf and American Potash v. Commissioner, 7 T.C. 1113 (1946) (expense of discounts paid to customer accrues upon acceptance of delivery of product), Tax Litigation stated that a utility's right to discounts on goods and services remained contingent until the actual purchases are made, and it is premature to consider an estimated value of such future discounts as income in the year of settlement.

Other cases support by analogy the view that a utility's right to income from future discounts is an inchoate right subject to finality upon the occurrence of the purchase transactions to which the discount right attaches. See Lucas v. North Texas Lumber Co., 281 U.S. 11 (1930) (right to income not fixed by executory sale contract created by option but only upon delivery of deed and payment of purchase price); Chapin v. Commissioner, 180 F.2d 140 (8th Cir. 1950) (option agreement to buy land not fixed until whole purchase price tendered as required by contract); Perry v. Commissioner, 152 F.2d 183 (8th

Cir. 1945) (deferred payments not income in year contract executed because absent a closed transaction, contract had no ascertainable fair market value).

Furthermore, Tax Litigation also stated that the amount of the discount income fails the second prong of the all events test; i.e., the amount cannot be determined with reasonable accuracy. See Burnet v. Logan, 283 U.S. 404 (1931) (contingent payment obligations too uncertain to value). G.C.M. 38605 did not address this prong of the all events test, but the fourth footnote conceded that a present value calculation would be highly speculative because the quantity of future purchases and their fair market value would be unknown at the time of settlement.

b. G.C.M. 39812

Presumably in response to Tax Litigation's reconsideration request, G.C.M. 39812, TR-58-6-90 (Mar. 9, 1990), was issued. It modified the third issue of G.C.M. 38605, replacing the all events analysis with valuation principles.

G.C.M. 39812 noted initially that G.C.M. 38605 found in Issue 1 that the taxpayer had income only to the extent cash and discount rights exceeded applicable basis in the cover nuclear fuel assemblies. The amount applied against basis represented a replacement of lost capital forced to be paid by the supplier's breach of contract. Only the excess became income. Thus, the discount rights are not inherently income, and section 451 is not directly relevant in analyzing the timing of the customer's income recognition. Section 451 would not have arisen at all in G.C.M. 38605 if cover basis at the time of settlement had been sufficient to absorb all of the customer's settlement rights.

Furthermore, G.C.M. 39812 stated that the performance element under the all events test was inconsistent with the discount rights because the original contract was superseded by the settlement agreement, and the customer no longer had performance obligations.

G.C.M. 39812 proposed a valuation analysis: to the extent the discounts rights can be valued at settlement, these become part of the total amount first to be applied to reduce cover basis and then to be recognized immediately as income. To the extent these cannot be valued, these will be applied neither to cover basis nor recognized as income. With G.C.M. 38605 so modified, the approving reference to Graf in Rev. Rul. 79-247 would no longer conflict with the G.C.M. opinion. Finally, this G.C.M. declined to consider the rationale and result of Rev. Rul. 79-247.

c. G.C.M. 39816

Fewer than seven weeks after G.C.M. 39812 was issued, it was withdrawn by G.C.M. 39816,

TR-58-00015-90 (Apr. 24, 1990). No accompanying documentation exists to explain this withdrawal. Apparently it was thought that G.C.M. 39812 might conflict with the rebate provisions of the proposed section 461(h) economic performance regulations. No detailed analysis appears to exist explaining this potential conflict.

d. Present Opinion

With the withdrawal of G.C.M. 39612, G.C.M. 38605 arguably states Counsel's opinion regarding discount rights. As discussed above there is a glaring inconsistency between the approving reference to the Graf case in Rev. Rul. 79-247 and the disapproving reference to the case in G.C.M. 38605.

TAM 8525003 attempts to draw a distinction between Rev. Rul. 79-247 and the Graf case. Although TAMs apply only to the subject taxpayer and may not be used or cited as precedent, I.R.C. section 6110(j)(3), we believe it is important to comment on TAM 8525003. There, the Service held that the conclusion in Rev. Rul. 79- 247, supra, rests on a rationale different from the Graf case. The TAM reasoned that the investor in the Rev. Rul. had no right to receive the credited interest (in the form of discounted commissions) unless he fulfilled the additional contingency of entering into future stock transactions in which the broker could earn commissions. We note that the beer distributor in Graf was required to buy more beer in order to exercise its discounts and accrue income; thus, an additional contingency inhered in the transaction. If in the present context the utilities are required to make future purchases in order to exercise their discount rights, then the the taxpayer would rely on the analyses in the Rev. Rul. and Graf.

Assuming under an all events analysis that the first prong of the all events test is met, it is unlikely that the second prong of the all events test is met. The amount of the income may not be determinable with reasonable accuracy until the discounts are exercised. As discussed above, the failure to meet the second prong is not addressed in G.C.M. 38605 but merely hinted at in the fourth footnote. We believe this is a critical point which should not have been overlooked because the all events test is a conjunctive one: ". ...and the amount thereof can be determined with reasonable accuracy." (Emphasis added.) Absent clear contractual language spelling out when taxpayers must use their discounts or supporting evidence of the custom and practice of the industry, the amounts thereof cannot be determined with reasonable accuracy. This is not to say that in all situations valuation would pose a problem. In rare instances, perhaps, the second prong is satisfied at settlement because the discount rights are by contract readily transferrable, but that would presuppose a reasonably accurate value for the discounts. The hazards described above, however, may make G.C.M. 38605 indefensible.

Cash payments, of course, contain no inherent contingency, and their amounts can be determined with reasonable accuracy, All the events have occurred to fix the right to cash income when (1) the required

performance occurs, (2) payment is made, or (3) payment is due. Rev. Rul. 74-607, supra. This is essentially a factual determination. Whether payment is made (the second element) is relatively easy to ascertain; an examiner can look at the taxpayer's books. Whether the required performance has occurred or whether payment is due is more complicated. These events depend on the provisions of the settlement agreement to supply what the required performance is and when payment is due. Again, absent specific contracts, we are unable to draw general conclusions in this area. 4. Abandonment

The facts you presented indicated that the **[redacted text]** repairs were made long before any of the power plants began operating. We do not know whether any of the plants eventually began operating, and whether paying the settlement discounts and cash was contingent upon operation.

We believe that whether cash or settlement discounts represent income or basis reductions is unaffected by a taxpayer's abandoning its generating plant. Losing capital which must be replaced or incurring expenses which must be reimbursed occurs during the repair of the **[redacted text]** Repairing the **[redacted text]** clearly indicates the intent to bring the generating plants on line. If the settlement agreements provide for either capital replacement or expense reimbursement, then these relate back to a time when a taxpayer fully intended its plant to become operational. Subsequent abandonment is irrelevant in this determination. If, however, an abandonment loss were taken in the meantime, then no basis would remain to be reduced by the amount of the discounts when used, and the entire amount of the discounts would be includible in income.

As to timing, subsequent abandonment is similarly irrelevant. If the settlement discounts may only be applied toward goods and services related to these particular plants, and income accrues upon exercising the discounts, then subsequent abandonment results only in no income from the discounts. Abandonment would be evidence that the discounts were not used and thus no income was realized. If the settlement discounts may be applied toward goods and services that may be used with other generating plants, then subsequently abandoning the nuclear plants would have no effect on timing. Summary

We cannot make solid conclusions in these areas without knowing exactly what the settlement agreements provide. We hope these comments are helpful in identifying some areas that should be looked into when the settlement agreements become available, and we encourage you to request field service advice again at that time.

If you have any further questions, please contact Gary J. Merken of this office at FTS 622-7910.

By: Daniel J. Wiles Gerald M. Horan Senior Technician Reviewer Income Tax & Accounting Branch Field Service Division

cc: Cleveland District Counsel

Attn: Utility Industry Counsel

1 By **[redacted text]** the subject utilities were **[redacted text]** , and **[redacted text]**

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