T.C. Memo. 1947-68

Damages recovered for loss of profits are taxable as income to a taxpayer on the cash basis in the year of recovery, even if such damages are offset against a debt owed by the taxpayer.

Summary

Buffington, a partner in a partnership, received damages in 1941 for lost profits resulting from a breach of contract by British-American. Although British-American also obtained a judgment against the partnership, and the two judgments were offset against each other, the Commissioner determined that the damages received for lost profits were taxable income to the partnership in 1941. The Tax Court upheld the Commissioner's determination, holding that the damages were taxable as income in the year of recovery, regardless of the offset.

Facts

Buffington & Smith (the partnership) entered into a contract with British-American. Under the contract, the partnership transferred an interest in a lease to British-American in exchange for British-American drilling a producing well. The contract also provided that the partnership was to have the preference for all future drilling operations. British-American breached the contract by not giving the partnership the preference for future drilling. The partnership sued British-American and recovered damages for lost profits. British-American also prevailed on a cross-claim, and the amounts were offset. The Commissioner treated the damage award as income to the partnership.

Procedural History

The Commissioner assessed a deficiency against Buffington based on the inclusion of the partnership's damage award in income. Buffington petitioned the Tax Court for a redetermination of the deficiency. The Tax Court upheld the Commissioner's determination.

Issue(s)

Whether the Commissioner erred in adding $22,531.25 to partnership income for 1941, representing damages received for loss of profits, even though those damages were offset against a debt owed by the partnership.

Holding

No, because the recovery of damages for the loss of profits results in income to one on the cash basis in the year of recovery, and the fact that the damages were offset against a debt does not change this result.

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Court’s Reasoning

The court reasoned that the recovery of damages for the loss of profits results in income to a taxpayer on the cash basis in the year of recovery. The court rejected the taxpayer’s argument that the matter was one of accounting between mining partners, noting that the prior court decision finding a mining partnership was not binding and that the relationship was not in fact that of mining partners. The court emphasized that the litigation grew out of a breach of contract provision separate from any mining partnership relationship. The court found unpersuasive the argument that because the damages recovered were applied in payment of a debt on a cross-action, they should not be considered income. The court stated that the partnership “got full monetary benefit, in 1941, of the damages then recovered by the partnership. There was clearly constructive receipt of income.” The court cited United States v. Safety Car Heating & Lighting Co., 297 U.S. 88, and Hilda Kay, 45 B.T.A. 98, noting that “Congress intended to tax proceeds of claims or choses in action for recovery of lost profits.”

Practical Implications

This case reinforces the principle that damages received for lost profits are generally taxable as income in the year of receipt for cash-basis taxpayers. The key takeaway is that the form of the transaction does not control the tax consequences. Even if a damage award is immediately offset against a debt, the taxpayer is still considered to have constructively received the income and is therefore liable for the tax. This case highlights the importance of considering the tax implications of litigation settlements and judgments, especially when cross-claims or offsets are involved. Attorneys should advise clients to plan for the tax consequences of receiving damage awards, even if the net economic benefit is reduced by offsetting liabilities. Later cases would apply the constructive receipt doctrine broadly.

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