## *Booker v. Commissioner*, 27 T.C. 433 (1956)

Settlement proceeds from a breach of contract claim are generally treated as ordinary income, not capital gains, if the underlying claim is for lost profits or ordinary income.

### Summary

The case concerns the tax treatment of settlement proceeds received by the Bookers from Edward Dunklee to resolve a breach of contract claim. The Bookers argued the settlement was for the transfer of a capital asset and thus taxable as a capital gain, while the Commissioner asserted it was ordinary income. The Tax Court found that the settlement payment represented compensation for lost profits and increased rental expenses stemming from the breach of contract. Since these damages would have been taxable as ordinary income, the court held the settlement proceeds were also taxable as ordinary income. The case illustrates that the nature of the underlying claim, not the form of the settlement, determines its tax treatment.

### Facts

The Bookers entered into an option contract with Dunklee. The option agreement stipulated prior rights of possession of the premises for the Bookers. Dunklee breached the contract, and the Bookers sued, claiming $50,000 in damages, including lost profits and increased rental expenses from having to relocate their business. The case was settled for $15,000. The Commissioner determined this amount was taxable as ordinary income.

### Procedural History

The Commissioner determined a deficiency in the Bookers' income tax, treating the settlement proceeds as ordinary income. The Bookers petitioned the Tax Court, arguing for capital gains treatment. The Tax Court reviewed the facts and legal arguments and sided with the Commissioner.

### Issue(s)

1. Whether the $15,000 received by the Bookers from Dunklee in settlement of their claims against him is taxable to them as ordinary income?

### Holding

1. Yes, because the settlement proceeds represented compensation for lost profits and increased rental expenses that would have been taxed as ordinary income, they are also taxable as ordinary income.

### Court's Reasoning

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The court referenced the principle that the taxability of a settlement depends on the nature of the claim and the basis of recovery. If the claim is for ordinary income, the settlement is taxed as such. The court determined the settlement payment was for lost profits and additional rental expenses. The court also distinguished this situation from cases where payments were received for the cancellation or surrender of a lease, which involves the transfer of property rights and thus may be considered a capital asset. The court cited the principle that "amounts received pursuant to a settlement agreement on a claim for recovery of damages for loss of profits are taxable as ordinary income." Additionally, the court noted that the Bookers did not transfer any property right to Dunklee, but rather settled a claim for damages. The court also considered Dunklee's testimony, which confirmed he did not intend to purchase any rights under the option contract, only to settle the lawsuit.

**Practical Implications**

This case provides guidance on classifying settlement proceeds for tax purposes. The court emphasized that classifying the nature of the underlying claim is critical. Attorneys should carefully analyze the nature of the damages claimed to advise clients on tax implications. For example, if a settlement resolves a claim for lost profits or other income-related damages, it will likely be taxed as ordinary income. If the settlement involves the transfer of a capital asset (e.g., a lease), it may qualify for capital gains treatment. Businesses and individuals must maintain thorough records that support the nature of claims and the elements of damages sought. Later cases have reinforced this principle, emphasizing the

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