
SUPREME COURT OF THE UNITED STATES

October Term 2009

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

v.

No. 2009-15

Donald Dufont Testamentary Trust

Respondent

On Writ of Certiorari to the Court of Appeals

for the Thirteenth Circuit

UNITED STATES COURT OF APPEALS

For the Thirteenth Circuit

COMMISSIONER OF INTERNAL REVENUE SERVICE

Appellant

No. 2008-46

v.

Donald Dufont Testamentary Trust,

Appellee

Before: Mahogany, MacDonald and Pond, Circuit Judges

Mahogany, Circuit Judge

The taxpayer is a testamentary trust established under the will of Donald Dufont (Donald), a domiciliary of the State of Michigan who died on January 1, 2005.

Under the terms of the trust, the trustee, Main Bank, during the lifetime of Donald's daughter Dora, could, in its "sole discretion", distribute trust income to Dora, or accumulate it and add it to corpus. On Dora's death, the trust corpus and any accumulated income was to be distributed to Dora's son, John.

The corpus bequeathed to the trust under Donald's will consisted entirely of 100,000 shares of the common stock of Dufont, Inc. (Dufont), a publicly traded company founded by Donald's father, Charles.

At the date of Donald's death the trust corpus was worth \$2,000,000 (\$20 a share). During the year 2005 the Dufont common stock steadily increased in value to \$50 a share. Thereafter, however, it declined steadily so that at the end of 2006 it was back down to \$20 a share, at which level it has remained until the present date. Pursuant to the policy of the Dufont Board of Directors, the Dufont common stock has never paid a dividend.

None of the Dufont stock has ever been sold by the trustee, Main Bank.

In 2007, both Donald and John demanded an interim accounting from the trustee. After Main Bank filed the interim account with the O'Brian County Surrogate's Court describing the above-stated history of the Dufont stock, Donald and John objected to the account and asked that the trustee be surcharged for a breach of its fiduciary duty of care.

On December 15, 2007, the O'Brian County Surrogate, after a hearing, determined that the trustee, in compliance with its duty of care, specifically its duty, under the Mugal Prudent Investor Act¹, to diversify so-called "inception assets" within a reasonable time, should have sold the Dufont stock at the end of 2005 when it had a value of \$50 a share.

In the case of a fiduciary's imprudent failure to diversify a stock concentration, the State of Mugal follows the law of State of New York in calculating damages. The governing principles were stated in Matter of Janes, 90 N.Y.2d 40, 55 (1997) as follows:

Where... a fiduciary's imprudence consists solely of negligent retention of assets it should have sold, the measure of damages is the value of the lost capital..... In imposing liability upon a fiduciary on the basis of the capital lost, the court should determine the value of the stock on the date it should have been sold, and subtract from that figure the proceeds from the sale of the stock or, if the stock is still retained by the estate, the value of the stock at the time of the accounting. Whether interest is awarded, and at what rate, is a matter within the discretion of the trial court ... Dividends and other income attributable to the retained assets should offset any interest awarded.

¹ This statute is identical to the New York Prudent Investor Act, found in New York's Estates, Powers and Trusts Law 11-2.3.

Employing these principles the Surrogate Court determined that there was “lost capital” of \$3,000,000. To this amount the Court, in the exercise of its discretion, added interest of \$400,000, and entered judgment against the trustee, Main Bank, requiring it to restore to the trust a total of \$3,400,000. Main Bank satisfied the judgment almost immediately, paying to itself as trustee the sum of \$3,400,000 on December 31, 2007.

The trustee made no distribution to the trust beneficiaries in 2007. On its fiduciary return for 2007, the trustee treated the \$3,400,000 as follows:

- (a) 2,000,000 as a tax free return of capital (basis)
- (b) 1,000,000 as long term capital gain, and
- (c) 400,000 as ordinary income

The Commissioner assessed a deficiency against the trust for 2007, taking the position that the entire \$3,400,000 should be treated as ordinary income.

The trustee petitioned the Tax Court for a redetermination of this deficiency.

In the Tax Court the Commissioner contended that neither capital gain treatment nor basis offset was permissible because the trust still owned all of the Dufont stock it had received under Donald’s will. In the Commissioner’s view, since there had been no sale or exchange, the trust would continue to have a §1014 basis of \$2,000,000 in the stock, so that if the stock were sold at that value there would be no gain or loss.

The Tax Court rejected the Commissioner’s approach, stating :

The taxability of the proceeds of a lawsuit, or of a sum received in settlement thereof, depends upon the nature of the claim and the actual basis of recovery. If the recovery represents damages for lost profits, it is taxable as ordinary income. However, if it represents a replacement of capital destroyed or injured, the money received, to the extent it does not exceed the basis, is a return of capital and not taxable; to the extent of any excess over basis it would be taxable as capital gain. Sager Glove Corporation, 36 T.C. 1173, 1180, affirmed 311 F.2d 210 (C.A. 7); Ralph Freeman, 33 T.C. 323, 327; Raytheon Production Corp. v. Commissioner, 144 F.2d 110, 114 (C.A. 1), certiorari denied 323 U.S. 779, affirming 1 T.C. 952; Durkee v.

Commissioner, 162 F.2d 184, 187 (C.A. 6), reversing 6 T.C. 773; Telefilm, Inc., 21 T.C. 688, 694-695.; Big Four Indus., Inc. v. Comm'r, 40 T.C. 1055, 1060 (1963), acq., 1964-2 C.B. 3; State Fish Corp. v. Comm'r, 48 T.C. 465, 474 (1967), acq., 1968-2 C.B. 3; Inco Electroenergy Corp. v. Comm'r, 54 T.C.M. (CCH) 339, 363, 1987 T.C.M. (RIA) ¶ 87,437, at 2293 (1987).

We agree with the Tax Court.

In recent commentary, issue has been joined on whether capital gain treatment should be accorded to damage awards where the taxpayer continues to own the underlying property which has been damaged. For a thorough discussion of the cases and authorities, see and compare, Jensen, *Can You Have Your Cake and Eat It Too?: Achieving Capital Gain Treatment While Keeping the Property*, 5 Pitt. Tax. Rev. 75 (2008), with Wood, *Securities Lawsuit Recoveries: Capital Gain or Ordinary Income?*, 108 Tax Notes 767 (2005), *Litigation Settlements, Sales and Exchanges, and Section 1234A*, 109 Tax Notes 776 (2005).

In our opinion, the critical question is the identification of the nature of the damage award, a question which is necessarily determined by the Mugel state law governing damages, in this case the Janes formula. In substance, Janes hypothesizes a prudent sale of the stock which is the subject of an imprudent concentration, and subtracts from the hypothesized proceeds of that hypothesized sale (1) the actual proceeds of any pre-surge actual sale of the stock and (2) the date-of-surge value of any stock retained by the trust.

In our opinion, this hypothesized-sale measure of damages defines what the trust has received for tax purposes, regardless of whether the stock is actually sold or not. Put simply, just as the interest portion of the award is ordinary income because it represents what would be treated as ordinary income if it actually were interest on a debt, so also the lost capital portion of

the award represents capital gain because it represents what would be given capital gain treatment if there actually had been a prudent sale of the stock.²

As alternative support for our decision, we think this case comes within the spirit, if not the letter, of §1231(a)(3)(A)(ii) which accords capital gain treatment to involuntary conversions of capital assets held in a transaction entered into for profit. It is true that the parenthesis of that subdivision requires that the involuntary conversion take the form of a “destruction”, “theft”, “seizure”, “requisition” or “condemnation”. Here, however, we clearly deal with a destruction in value of the taxpayer’s capital asset. There is no reason in policy why Congress would want to differentiate between an involuntary physical destruction of the value of a taxpayer’s tangible asset, and an involuntary economic destruction of the value of a taxpayer’s intangible asset.³ The quasi-capital gain treatment of §1231 would appear equally applicable to both.⁴

Affirmed.

² It has been argued that basis offset can, and should, be allowed even if capital gain is denied because of the absence of a sale or exchange. Jensen, *Can You Have Your Cake and Eat It Too?: Achieving Capital Gain Treatment While Keeping the Property*, 5 Pitt. Tax. Rev. 75, at 110 (2008). Although we need not decide this issue, it is difficult for us to see how that can be so. Basis offset is another phrase for “return of capital”. If what is received represents a return of a capital nature any excess must also be a return of a capital nature. If the excess is not a return of a capital nature, the entire return must necessarily be non-capital.

³ It should be noted that if the Dufont stock had been sold prior to the damages award, the trust would have used its basis as an offset in calculating gain or loss and would not be entitled to any further basis offset against the damage award. However, where, as here, the stock has not been sold, the trust must be entitled to offset its basis against the award to determine the gain on the hypothesized sale. As a result, the basis of the trust in the retained stock will be reduced to zero.

⁴ The view we take on the issues renders it unnecessary for us to consider the relevance, if any, of §1234A.

ORDER
SUPREME COURT OF THE UNITED STATES

COMMISSIONER OF INTERNAL REVENUE,

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Respondent

The petition herein for a writ of certiorari to the Court of Appeals for the Thirteenth Circuit is granted in order that this court may consider all of the questions raised by the record, and it is

ORDERED, that this case be set down for argument in the October 2009 term of this Court.

June 15, 2008