

No. 2009-15

IN THE
SUPREME COURT OF THE UNITED STATES

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

DONALD DUFONT TESTAMENTARY TRUST,
Respondent.

On Writ of Certiorari to the United States
Court of Appeals for the Thirteenth Circuit

BRIEF FOR PETITIONER

Attorneys for Petitioner

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QUESTION PRESENTED

Whether judgment award paid to a trust, with original basis intact, and without sale, or exchange, or other disposal of the trust by beneficiaries, merits treatment partially as tax-free return of basis, and partially as capital gain.

PARTIES TO THE PROCEEDING

Petitioner is the Commissioner of Internal Revenue Service, plaintiff-appellant below.

Respondent is the Donald Dufont Testamentary Trust, defendant-appellee below.

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STATEMENT OF JURISDICTION

The United States Tax Court had rightful jurisdiction to review the assessment of deficiency made by the Commissioner of the Internal Revenue Service pursuant to I.R.C. § 7442. The United States Court of Appeals for the Thirteenth Circuit had rightful jurisdiction in this matter pursuant to I.R.C. § 7482(a)(1). The petition for a writ of certiorari was granted on June 15, 2008. This Court has jurisdiction in this matter pursuant to 28 U.S.C. § 1254(1).

STATEMENT OF THE CASE

Donald Dufont died on January 1, 2005 providing, in his will, for the creation the Donald Dufont Testamentary Trust (“Trust”); Trust, not beneficiaries, is Respondent in the case at bar. (R. at 2.) The Trust consists solely of 100,000 shares of Dufont, Inc. common stock. (R. at 2.) The value of the Trust at the date of Donald Dufont’s death was \$2,000,000, or \$20 per share. (R. at 3.) This quantity is also the beneficiaries’ basis in the Trust. (See R. at 2-7.) During the year 2005, the value of the Trust increased as the value of Dufont stock rose to a value of approximately \$50 per share. (R. at 3.) Over the year 2006, the value of the stock reverted to its original value of \$20 per share. (R. at 3.)

In 2007, the Trust’s beneficiaries requested an interim accounting by the trustee, Main Bank. (R. at 3.) Beneficiaries’ objected to the account after it was filed with the O’Brian County Surrogates Court. (R. at 3.) Beneficiaries requested the court award a “surcharge” for breach of fiduciary care for failing to diversity the constituent stock within a reasonable time as per the Mugal Prudent Investor Act. (R. at 3.) The court ultimately found that there has been “lost capital” of \$3,000,000. (R. at 4.) On its return for the year 2007, the Trust treated \$2,000,000 as a tax-free return or capital, or return of basis; and the remaining \$1,000,000 as long term capital gain. (R. at 4.) The court also awarded an additional \$400,000 of interest, which Respondent treated as ordinary income. (R. at 4.)

The Commissioner of Internal Revenue (“Commissioner”) then assessed a deficiency against the trust for \$3,400,000 finding the entire award should have been treated as ordinary income on the return. (See R. at 4.) The trustee petitioned the Tax Court for a redetermination of the deficiency. (R. at 4.) The Tax Court explained that the taxability of the award lies in the nature of the claim. (R. at 4.) If the award is for “damages for lost profits,” it is taxable as ordinary income; if,

instead, the award is for “capital destroyed or injured,” then the award, to the extent it does not exceed basis, is taxable as capital gain. (R. at 4.) However, the Tax Court ultimately found for Respondent. (See R. at 4-5.)

The Thirteenth Circuit Court of Appeals reviewed the decision of the tax court. In its decision the court looked to Matter of Janes, 688 N.E.2d 332 (N.Y. 1997), in determining what proportion of the award merited ordinary income treatment, and what, if any, merited treatment as capital gain. (See R. 5-6.) The circuit court agreed with the decision of the tax court, adding that the damages were the result of an involuntary conversion as outlined by I.R.C. § 1231(a)(3)(A)(ii), and were thus subject to tax as capital gains, not ordinary income. (R. at 6.)

SUMMARY OF THE ARGUMENT

After receiving a \$3.4M judgment award pursuant to finding of violation of Mugal's Prudent Investor Act, on its year end tax return, Respondent treated \$2M as return of capital, \$1M as capital gain, and \$400K as ordinary income. The treatment of this award is problematic for several reasons. First, Respondent is attempting to recoup lost capital when the Trust's original capital has in no way deteriorated. Second, capital gains treatment is only permitted when there has been either a sale or exchange of a capital asset or an involuntary conversion of such an asset. The treatment of any of the award as capital gain violates both the traditional conception of capital gain, which requires a sale or exchange, and the "involuntary conversion" doctrine, creating a dangerous precedent where the exception may devour the rule. Lastly, the basis offset effect which the return of capital has triggered will ultimately allow the beneficiaries to benefit from capital gains treatment twice. Trust and beneficiaries may dispose of the corpus with no tax liability whatsoever on the eventual sale or exchange of the Trust.

Commissioner contends the lower courts' reading of the applicable concepts and provisions to be erroneous in light of applicable law, and requests a remand of the case on three primary grounds. First, a *potential and speculative* loss of profits by the Trust is not akin to an *actual* loss of capital. Second, the "involuntary conversion" doctrine has always been read narrowly to include only extreme situations where taxpayer's property has been seized or destroyed without taxpayer's knowledge or consent. The case at bar shares no likeness with any situation previously found to have been an "involuntary conversion." Lastly, Commissioner requests a nullification of the application of basis offset to this award as it will yield unduly favorable tax treatment to Trust and beneficiaries, and will ultimately lead to unnecessary confusion, and conflict, and thus, exorbitant administrative costs the assessment and collection of tax in future cases involving basis offset.

ARGUMENT

THE LOWER COURTS ERRED IN DETERMINING INCOME RECEIVED AS PART OF A JUDGMENT BY THE TRIAL COURT MERITS TREATMENT AS TAX-FREE RETURN OF CAPITAL, OR REDUCED TAX AS CAPITAL GAIN.

A. The Judgment Award Does Not Qualify as Compensation for Involuntary Conversion

This Court has held that, at a minimum, the application of the involuntary conversion rule has historically been limited to seven situations: 1. destruction in whole or in part; 2. theft; 3. seizure; 4. requisition or condemnation; 5. threat or imminence; 6. sale pursuant to reclamation laws; 7. destruction or sale of diseased livestock; 8. livestock sold because of weather. Boris I. Bittker & Lawrence Lokken, ¶ 44.3.2 Scope of Term “Involuntary Conversion,” in Federal Taxation of Income, Estates, and Gifts (2009).

In the case at bar, the lower courts have attempted to justify the application of involuntary conversion to the present case as a “destruction in whole or in part.” (R. at 6.) Destruction in whole or in part would require that taxpayer’s asset is worth less at the time of conversion than at the time of acquisition. The facts do not support such a finding for Respondent as the current value of the Trust is equal to its value at the time of transfer.

All cases where courts have awarded a sum on the grounds of involuntary conversion resulting in capital gains treatment have dealt with a diminution in the taxpayer’s original basis. No court has ever found that a taxpayer may receive destruction of capital treatment on a compensatory award when the asset in question has retained its exact value from the time of acquisition.

The court in Williams v. J.P. Morgan & Co., Inc., 296 F.Supp. 2d 453 (S.D.N.Y. 2003), found that beneficiaries may be entitled to recover under New York’s Prudent Investor Act even though the value of the Trust had in fact grown in value. However, that court reasoned the increase was likely due to the fact the Trust had gained value at the rate of inflation, and perhaps not as a

result of prudent investing by the trustee, as the period in question spanned a period of over thirty years. *Id.* The case at bar concerns a period of just one year. (See R. at 1-3.)

B. The Degree to Which the Lower Court Applied Basis Offset Grossly Distorts the Reality of the Trust's Value; the Surrogate Court Erred in Characterizing the Potential Loss as "Lost Capital"

The basis offset must reflect economic reality. See Ronald H. Jensen, Can You Have Your Cake and Eat it Too?, 5 Pitt. Tax Rev. 75, 113 (2007). Because the beneficiaries' basis in the trust is \$2M, a basis offset of \$2M is equivalent to finding that the value of the trust has so been diminished that it is currently worthless. See id. However, the trustee was not found to have damaged the trust to the point of worthlessness, the trustee was found to have failed to invest the trust prudently, costing the beneficiaries' a potential profit of \$3M.

The apt measure for allocation of an award received is dictated by the taxpayer's remaining basis in the asset. Rev. Rul. 68-378, 1968-2 C.B. 335. In Rev. Rul. 68-378, the taxpayer brought antitrust suit for an asset which had been fully amortized. The I.R.S. found that because the taxpayer had already fully amortized its basis in the asset, thus recouping its original basis, the full award received was ordinary income. Id. Likewise in the present case, the taxpayer's basis in the Trust has remained intact and thus any amount awarded must receive treatment as ordinary income.

The viability of this concept is evidenced by the fact that no court has ever permitted a taxpayer to exclude, as return of capital, any amount in excess of the capital destroyed by the tortuous actions of another party. In fact, most courts call for an itemized accounting of which portion of assets were destroyed in determining the proper allocation of any award. See, e.g., Grant Oil Tool Co. v. U.S., 381 F.2d 389 (Ct. Cl. 1967) (excluding *only* the actual cost of tools and other assets lost from ordinary income).

The Trust cannot have any basis in itself. Where basis of a compromised claim is not an injury to capital but default in payment of money or delivery of property which would clearly have been gain in the first instance, settlement of the claim is not in “restoration of capital”, but rather is taxable as “income.” Swastika Oil & Gas v. Comm’r, 123 F.2d 382 (6th Cir. 1941).

Recovery for return of capital, excluded from income, are limited to basis. In the present case, the lack of destruction of capital, more aptly, *basis*, is evidenced by the amount granted to the taxpayers by the surrogate court. The damage award was for \$3M which represents the high price of the stock at the end of 2005, the time the surrogate court determined was the prudent time for the sale, minus the taxpayers’ basis in the stock which was \$2M. The surrogate court’s characterization of the quantity as “lost capital” was an improper use of a defined term. (See R. at 4.)

If in fact the surrogate court had found that there was a destruction of basis as defined in I.R.C. § 1033, the quantity awarded would have been three million dollars *plus* any amount which the court found was destroyed. For there to have been the intent to award taxpayers for the loss of capital, the amount would have to exceed three million dollars, it did not. The three million dollar award is precisely the quantity of lost profits calculated by the court given the time it determined as that of prudent sale. That quantity would ordinarily have been restored to the corpus of the trust under I.R.C. § 643(a)(3) and would have qualified for capital gain treatment at the time of sale. However, because this award has failed to meet both the requirements for treatment as an involuntary conversion, and has also not been transferred in sale or exchange, it must be treated as ordinary income.

C. In the Absence of the Application of the Involuntary Conversion Doctrine, The Award does not Meet Traditional Requirements for Capital Gain Treatment

The rate of tax on capital gains is currently 0%. I.R.C. § 1(h)(1)(B). Capital gains are taxed at a lower rate than ordinary gains or profits. See I.R.C. § 1. The rate of taxation on a capital gain cannot exceed 28%. I.R.C. § 1(h)(1)(E). However, capital gains on ordinary income or profits will always range from 15% to over 40%. I.R.C. §(a)-(e). The current treatment of the judgment award will yield a total of \$3M in untaxed income for the trust beneficiaries. Additionally, \$2M of the amount awarded to the trust beneficiaries has been characterized as a return of capital triggering a basis offset which reduces the beneficiaries' basis in the trust to zero, allowing the beneficiaries to benefit from capital gain treatment a second time, at the point of sale of the constituent corpus.

The provisions of the Internal Revenue Code create certain requirements for a taxpayer to claim the benefit of capital gains tax rates on a transaction. Specifically, I.R.C. § 1222(3) states that long term capital gains “means gain from the *sale or exchange* of a capital asset held for more than one year . . .” (emphasis added). The sale or exchange requirement has been widely discussed in numerous courts and a significant group has held that the requirement is paramount in allowing for capital gains treatment of income. There are also certain decisions that, instead of analyzing the sale or exchange requirement of the I.R.C., focus instead on the origin of a claim. If the claim is capital in nature, the recovery of that amount constitutes capital gains regardless of whether or not there has actually been a sale or exchange of the underlying property. It is vital to assess the Congressional purpose in enacting the capital gains provision to determine whether any exception should apply to the present case.

1. There Has Been Neither a Sale nor an Exchange as Required by the IRC.

In Helvering v. William Flaccus Oak Leather Co., this Court held that if there is no sale or exchange then there can be no capital gain. 313 U.S. 247 (1941). In Helvering, the taxpayer was the owner of real property that was destroyed in a fire. Id. at 248. The taxpayer received compensation from his insurance company for the loss and claimed that amount as capital rather than an ordinary

gain. The Commissioner of the I.R.S. disputed that characterization of the insurance payment and argued that the amount received constituted an ordinary gain because it did not meet the sale or exchange requirement of I.R.C. Id. This Court, in agreeing with the Commissioner’s position, made two important points.

The first point was that “[g]enerally speaking, the language of the Revenue Act, just as in any statute, is to be given its ordinary meaning, and the words ‘sale’ and ‘exchange’ are not to be read any differently.” Id. at 249. This ruling requires that a sale or exchange, based on the standard meaning of those words, exist if there is to be any benefit from the capital gains provisions. A sale requires a transaction where one party is given property in exchange for money, and an exchange “implies a reciprocal transfer of assets, not a single transfer to compensate for the destruction of the transferee’s asset.” Id. Therefore, if there is not a sale or exchange within the common meaning of those words, then there can be no application of the capital gains provisions. In the case at bar, there was clearly not a sale or exchange within the common meaning of those words. There was no reciprocal exchange; one party received money as the result of a lawsuit while the other party received nothing.

The second point this Court made was that any ambiguous transactions, where it would be difficult to discern whether a sale or exchange had occurred, had been specified by Congress, and that it was up to Congress to add other types of transaction if it wanted the capital gains provisions to be applied to them. Id. at 251. If Congress has not specified the particular type of transaction, then there has not been a sale or exchange and the income may not be characterized as capital gains. Congress has never, expressly or implicitly, declared that gains resulting from lawsuits—other than personal injury—should be granted the benefits of the capital gains provisions and, because Congress has not so specified, income derived from a lawsuit cannot be granted capital gains status. Steel v. Commissioner, 83 T.C.M. (CCH) 1608.

This Court has also had other opportunities to examine the sale or exchange requirement of the capital gains provisions. In Dobson v. Commissioner, the taxpayers received recovery from third parties for rescission of a stock purchase after some of the stock originally purchased had already been sold. 321 U.S. 231 (1944). The taxpayers attempted to tie in the recovery from the rescission of a prior sale of stock in order to gain the benefits afforded to capital gains. However, this Court found that “not every gain growing out of a transaction concerning capital assets is allowed the benefits of the capital gains provisions. Those are limited by definition to gains from ‘the sale or exchange’ of capital assets.” Id. at 231-32. This Court found it clear that without meeting the sale or exchange requirement there could be no capital gain as described in the I.R.C. In the present case, there was a gain that grew out of a capital asset but the gain was not associated with any sale or exchange, so that gain should not constitute a capital gain; it should be considered ordinary income.

In Commissioner v. Brown, this Court was again faced with the question of whether there was a sale or exchange of property that would allow for capital gains treatment. 380 U.S. 563 (1965). In that case, the taxpayer transferred ownership of a business in exchange for a percentage of the income produced by that business until the sale price had been fulfilled. However, the business collapsed and the property was liquidated. Id. The primary beneficiaries of the liquidation were the taxpayers, who had yet to recoup their full sale price as agreed upon. Id. The Commissioner argued that there was no real sale or exchange because the taxpayer retained all of the risk of the business operations. However, because the proceeds for the sale came from the business itself and not the purchaser; this Court disagreed. Id.

Based on the ruling in Helvering, the Brown Court examined whether a sale or exchange had taken place based on the common meaning of “sale” and “exchange.” See 380 U.S. 563. They

found that there was a bona fide transaction where property was exchanged for the promise of monetary compensation.

A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent,' . . . it is a contract 'to pass rights of property for money, -- which the buyer pays or promises to pay to the seller . . . ,' The transaction which occurred in this case was obviously a transfer of property for a fixed price payable in money.

Id. at 571 (citations omitted). The total amount gained on the sale of the business and subsequent liquidation of the property to the benefit of the taxpayer was granted capital gains status and the benefits accorded as a result. Again, if we assess the case at bar under the common meaning of "sale" and "exchange" it is obvious that the minimum requirement of a reciprocal asset transfer is not present and application of the capital gains provisions should not be permitted.

In each of these cases, this Court has plainly required the execution of a sale or exchange for the application of capital gains treatment. There have also been numerous decisions in lower courts that follow this line of cases. In particular, the Tax Court has made several determinations where it has required a sale or exchange and has denied taxpayers the benefits of the capital gains provisions because no sale or exchange was found.

In Fahey v. Commissioner, the taxpayer claimed capital gains on the collection of a contingent fee he had purchased an interest in. 16 T.C. 105 (1951). While the court found that the taxpayer had purchased a capital asset, they held that he was not entitled to the benefit of capital gains when he collected money based on that interest. The collection of the fee was not considered a sale or exchange, even though it stemmed from the purchase of a capital asset.

It is true, of course, that petitioner had owned and held his interest in the Parkerson fee for a period of more than 6 months, but in collecting it he did not sell or exchange anything. If, prior to the compromise . . . petitioner had sold or exchanged his interest in the Parkerson fee, then there might have been some force in his contention that his gain from the sale or exchange of his interest in such contingent fee would be taxable as capital gain As we have already pointed out, he

received his part of this \$ 10,500, not as a result of any sale or exchange of his interest in the Parkerson fee but as a collection or settlement of it. That sort of a situation does not bring the gain which he realized as a result of the collection which he made within the capital gains provision of section 117, I.R.C.

Id. at 109.

The facts of the present case resemble those of Fahey. See id. Fahey involved a capital asset that was initially purchased by the taxpayer which has provided income. Id. In addition, there has been no sale or exchange proximately related to the gain. Fahey makes it clear that if the capital asset that had been purchased was sold, as opposed to collected through a lawsuit or settlement, it would qualify for capital gains treatment. Id. Had the taxpayers in the present case elected to sell the remaining stock prior to or at the time of the judgment, then the entire amount awarded could properly be characterized as a capital gain because the requisite sale or exchange had occurred. As there has been no sale of the underlying asset, there has been no capital gain for purposes of taxation.

In Steel v. Commissioner, the taxpayer received income from a lawsuit based on an insurance claim that had been assigned to it in exchange for stock. 83 T.C.M. (CCH) 1608. The Tax Court looked at the constitution of the settlement as opposed to any intervening transactions and determined that there had been no sale or exchange that would allow for capital gains treatment. The court looked to the rulings from Dobson, 321 U.S. 231 and Pounds v. United States, 372 F.2d 342 (5th Cir. 1967), both of which make clear that barring a sale or exchange which gives rise to the gain, there is no capital gain.

In Pounds, the taxpayer had purchased a contingent interest in an asset which the court concluded bore strong resemblance to a capital asset. Id. at 348. When the taxpayer received income based on that interest when the asset was sold, he claimed it was capital gains and should be taxed as such. However, the court ruled that the amounts realized were ordinary income because the

taxpayer had not actually sold or exchanged anything despite the gain having grown out of a sale or exchange of property. The taxpayer had not actually passed any rights to another party in a manner which could be considered an exchange. As in the case at bar, there have been no rights exchanged that would allow for capital gains to be applied.

Commissioner v. Ray provides the clearest evaluation of whether or not a sale or exchange has taken place. 210 F.2d 390 (5th Cir. 1954). Before the transaction, one party had a right and the other party did not. When the party lacking the right exchanged some consideration for the right possessed by the other party, then there was a sale or exchange. Id. at 391-92. In the present case, only one of the parties, the taxpayer, had a right and they did not give up any of that right in exchange for the consideration it received. It follows that there could not have been any sale or exchange because property only passed in one direction.

The preceding authorities make it clear that a sale or exchange is specifically required for there to be a capital gain under I.R.C. §1222. Where there has not been a sale or exchange, such as in the present case, then there have been no capital gains for taxation purposes.

2. The Origin of the Claim Should be Applied, If At All, in Conjunction with the Sale or Exchange Requirement.

There are a number of decisions that examine what the origin of a claim is to determine whether capital gains taxation provisions should apply to certain income.

The object of the ‘origin of the claim’ test is to find the transaction or activity from which the taxable event approximately resulted, or the event that ‘led to the tax dispute.’ The origin is defined by analyzing the facts and determining what the basis of the transaction is, and does not rely on purpose, consequence or result.

McKeague v. United States, 12 Cl. Ct. 671, 675 (1987) (citations omitted).

The primary question for the case at bar, in applying the origin of the claim test, must be whether the basis of the transaction was a capital gains event, not what the resulting recovery was based upon or what it resulted in. Thus, if the event that led to the tax dispute is a sale or exchange, then capital gains should apply to any proceeds of a settlement or lawsuit. However, the event that initiated the lawsuit and eventual recovery in this case did not arise from a sale or exchange; it only resulted in recovery that, had there been a sale or exchange would constitute capital gains, so capital gains should not apply because that is not the true origin of the claim.

The tax court, in the present case, focused on the ruling in Sager Glove Corp. v. Commissioner, which found that “[t]he taxability of the proceeds of a lawsuit, or a sum received in settlement thereof, depends upon the nature of the claim and the actual basis of recovery.” 36 T.C. 1173, 1180 (1961). Following this test without also applying the definition of capital gains in the IRC, a sale or exchange being the major part, can lead to a result that contravenes the statute. If the IRC definition of capital gains is used in conjunction with the origin of the claim, then proceeds arising out of the litigation or settlement of a claim, if originating out of the sale or exchange of a capital asset, could be considered capital gain and taxed as such. If the proceeds from the lawsuit or settlement do not arise out of a sale or exchange, then capital gains cannot apply.

In Dye v. United States, there was a question as to the taxability of proceeds of a settlement where the claim arose as a result of a mismanaged securities account. 121 F.3d 1399 (10th Cir. 1997). The taxpayer in Dye, much like the one in the present case, suffered diminished value of capital assets due to that mismanagement. The court found that part of the claim, for the diminution of value of those assets, could be considered a capital gain for tax purposes. However, there is a fundamental difference between Dye and the case at bar. The manager of the taxpayer’s account in Dye had sold some of the account’s assets during the course of their business relationship, so the sale or exchange hurdle had already been cleared. In addition, the losses had previously been

written off as capital losses because of the prior sales, so it was proper for the gains from the lawsuit to offset them. In the present case there has been no reported capital loss, and none of the underlying assets have been part of a sale that could proximately be related to recovery on account of mismanagement.

Bresler v. Commissioner used the language from Sager Glove as its basis for examining the origin of the claim. 65 T.C. 182, 184-85 (1975). However, the court only used that doctrine after establishing that there had been a sale or exchange of the business; the question was whether the character of the income received from the subsequent settlement of a lawsuit, for the loss incurred in the initial sale, was capital in nature. Id. at 185. The court decided that for the settlement to receive the benefit of capital gains an independent sale or exchange was required. Id. at 188. In the case at bar, it could theoretically be argued that there had been a sale or exchange in the distant past as the original basis of ownership, but based on Bresler, that would not constitute an independent sale or exchange so capital gains would not apply.

In Keller Street Development Co. v. Commissioner, the court analyzed the origin of the claim in conjunction with the sale or exchange of the property at issue as required by the I.R.C. 688 F.2d 675 (9th Cir. 1982). In determining that the proceeds of the settlement were not capital gains, the court first noted that the original event which was the basis for the claim's existence, the sale of a brewery, would normally be an event to which the capital gains provisions would apply. Id. at 681. The court then examined how the payment of the settlement related to that sale and found that it was a payment of interest on the retained property, similar to rent, rather than a portion of the proceeds of the sale. Id. at 682. The court concluded that even though the claim arose out of a capital transaction, in this case, the capital gains provision did not apply because the sale or exchange was not related closely enough to the settlement of the lawsuit. In the present case, there

has also been no sale or exchange that is closely related to the lawsuit; therefore, capital gains do not apply.

In Nahey v. Commissioner, the court went a step further in determining that proceeds from the settlement of a lawsuit did not constitute capital gains, even though the lawsuit itself was a capital asset that had been purchased. 111 T.C. 256 (1998). Much as in the case at bar, the petitioners sought to “center their argument on the ‘origin of the claim’ test to determine whether the settlement proceeds should be characterized as capital gain or ordinary income.” Id. at 262. The Tax Court eschewed that test in favor of analyzing whether there had been sale or exchange, which “is a prerequisite to the rendering of capital gain treatment.” Id. The court found that there had been no sale or exchange because there was no reciprocal exchange of property; had the taxpayers sold their rights in the lawsuit prior to the settlement, then there could potentially have been a capital gain on that sale because the property (the lawsuit) that was sold would have continued to exist as property. Id. at 263-64. This line of reasoning, looking at the sale or exchange requirement itself, is vital to discerning whether or not capital gains can be applied in any situation. It is clear that no sale or exchange took place in the present case. The underlying asset is still owned by the taxpayer who has never made any effort to actually sell that asset.

3. The Claim in the Case at Bar is Based on a Breach of Fiduciary Duty, Not a Sale or Exchange.

Also, in the present case, the recovery resulted from a chose in action, and it is well settled that “when a taxpayer makes a gain from the sale or exchange of a claim or chose in action, this is taxable as a capital gain; while if the gain results from the collection of the claim or chose in action, this is taxable as ordinary income.” Osenbach v. Commissioner, 198 F.2d 235 (4th Cir. 1952). What the taxpayer had was the right to recover for the breach of a fiduciary duty, not the right to recover

capital. That the recovery takes the form of lost capital is not relevant; the lost capital was not the origin of this claim. McKeague, 12 Cl. Ct. at 675.

The only place capital gains actually comes into play in the present case is, as indicated above, in the measure of the damages. In a substantial number of the decisions that allow income to qualify as capital gains under the origin of the claim, the measure of damages, usually in the form of damage to goodwill, is based on lost profits. Of course, under normal circumstances, lost profits would constitute ordinary income. See Durkee v. Commissioner, 162 F.2d 184, 186 (6th Cir. 1947). The present case represents the inverse of this concept. The damages received by the taxpayer in computing the surcharge for the breach of fiduciary duty were merely measured by the damages to the capital asset. The court essentially argued that the gain from the theoretical sale would constitute capital gain; however, this misconstrues what the actual origin of the claim was in this case: a breach of fiduciary duty.

4. Application of Capital Gain Treatment in this Case Contravenes Congressional Intent

When Congress enacted the Income Tax shortly after the 16th Amendment was passed, there were significant disagreements as to what constituted income. This Court made it clear that this included income from capital gains in its earliest decisions on the subject. See Merchs. Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921). There were initially three reasons that Congress enacted the capital gains provisions: to eliminate bunching, to increase the mobility of property and reduce the lock-in effect, and to spur the economy through investment. See Louis A. Del Cotto, “Property” in the Capital Asset Definition: Influence of “Fruit and Tree.” 15 Buff. L. Rev. 1, 4 (1965).

The bunched income concept is not as important today as it once may have been. Id.; See also Note, Distinguishing Ordinary Income from Capital Gain Where Rights to Future Income Are

Sold, 69 Harv. L. Rev. 737, 739-43 (1956). The original concept of bunching was based on the idea that Congress did not want to force the gains that could potentially be accrued over multiple years to be bunched into a single year for taxation purposes. See H.R. Rep. No. 67-350 (1921), H.R. Rep. No. 67-1388 (1923). In Commissioner v. Gillette Motor Transport, Inc., this Court made it clear by stating that

the term ‘capital asset’ is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year.

364 U.S. 130, 134 (1960). This Court also recognized limitations on the bunching concept because there was a certain type of gain that was required, and the tax burden should only be limited to those specific cases. See Burnet v. Harmel, 287 U.S. 103, 106 (1932); Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46, 51-52 (1955). However, today, I.R.C. §1222(3) allows long term capital gains so long as the property has been owned for as little as six months, although it was originally two years, and so the gains are not necessarily those that would have previously been spread out over an investment of multiple years.

The goal of the reduction of a bunching penalty is better understood by the two other reasons Congress had in enacting the capital gains provisions: mitigating the lock-in effect and spurring investment. See H.R. Rep. No. 88-749 (1963). Because there was a problem with selling capital assets due to the excessive taxes levied, Congress rightfully believed that taxpayers would refuse to sell their capital assets so as to avoid that taxation. Instead, taxpayers were likely to hold those assets until death and transfer them at a stepped up basis to their devisees in order to avoid taxation on those assets. Note, Distinguishing Ordinary Income, 69 Harv. L. Rev. 737, 742. While there is certainly some risk involved with holding assets because they may decline in value, that risk may be considered acceptable when the taxation would essentially eliminate any realized gain.

This deterrent effect created a problem because as fewer sales of capital assets occurred, there was less potential tax revenue that could be taken in and less potential capital that could be injected into new ventures that could create economic growth. Id. By encouraging the mobility of capital through a reduction in capital gains taxes, Congress effectively made more transactions possible which increased the tax revenue that could be generated. In addition, because of the increased mobility, the capital could be spent on new investments that could spur the economy. Congress has also shown that it wants to spur the economy by continually decreasing the capital gains tax rate. In 1997 the capital gains tax rate was 20%; it was subsequently decreased to 15% in 2003, and there is currently no actual tax levied on capital gains. Ronald H. Jensen, Can You Have Your Cake and Eat It Too?: Achieving Capital Gain Treatment While Keeping the Property, 5 Pitt. Tax. Rev. 75 (2008). The primary reason the tax rate has been lowered is to increase the incentive buy and sell capital assets, which increases the mobility of capital making it easier for new capital to be injected into the economy.

When comparing the present case to the historical objectives of capital gains, it is clear that granting these preferential rates to this income does not fall within the intent of Congress. The taxpayer did not sell the asset because it was worried about the negative tax consequences, so the capital was not locked in. The taxpayer has given no indication that it intends to reinvest this money and so spur the economy. There is no aspect of this income that produces the effect Congress intended by allowing a tax benefit in certain limited situations.

CONCLUSION

The taxpayer must do more than “merely claim alternative designations what it recovered—it must prove a designation so that some orderly tax treatment may be accorded it.” Sager Glove Corp. v. C.I.R., 311 F.2d 210, 211 (7th Cir. 1962). In the present case, the taxpayer has neither proven there was a destruction of capital nor that capital gains should apply generally because there has not been a sale or exchange. Therefore, we request that this Court find the treatment of the award as return of basis and capital gain improper, and remand the case accordingly.