

No. 2009-15

IN THE
SUPREME COURT OF THE UNITED STATES

October Term 2009

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

DONALD DUFONT TESTAMENTARY TRUST,

Respondent

On Writ of Certiorari to
The Court of Appeals for the Thirteenth Circuit

BRIEF FOR PETITIONER

Attorneys for Petitioner

ORAL ARGUMENT REQUESTED

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QUESTIONS PRESENTED

- I. Whether a damage award may be characterized as a capital gain where the requirements of I.R.C. § 1222, the code section defining a capital gain, have not been satisfied and no exception to the Code section applies to the facts of the instant case.

- II. Whether a damage award should be characterized as compensation for a loss of capital warranting capital gains treatment for income tax purposes where the trust suffers no actual loss of property; the nature of the claim asserted by the taxpayer is for a breach of a trustee's fiduciary duty; and the damages are paid in lieu of the trustee's breach of that duty.

TABLE OF CONTENTS

QUESTIONS PRESENTED.....ii

TABLE OF CONTENTSiii

TABLE OF AUTHORITIES v

OPINIONS AND JUDGMENTS ENTERED BELOW..... 1

STATEMENT OF JURISDICTION..... 1

CONSTITUTIONAL & STATUTORY PROVISIONS 1

STATEMENT OF THE CASE.....2

SUMMARY OF ARGUMENT5

ARGUMENT 8

 I. THE THIRTEENTH CIRCUIT ERRED BY FAILING TO CONSIDER THE EXPRESS LANGUAGE
 OF THE INTERNAL REVENUE CODE IN ITS ANALYSIS OF THE PROPER TAX
 CHARACTERIZATION OF THE DAMAGE AWARD PAID TO THE TRUST..... 8

 A. The “Nature of the Claim” Test is Inadequate Because it Fails to Apply the
 Facts of the Case to the Applicable Code Section.....9

 B. I.R.C. § 1222 Requires the “Sale or Exchange” of a Capital Asset for a Gain
 to be Treated as a Capital Gain 10

 C. The Conversion of a Capital Asset into Cash is Not the Equivalent of a “Sale
 or Exchange” 12

 D. Stock that Suffers a Loss in Value As a Result of Normal Market Fluctuations
 is Not an Involuntary Conversion as Contemplated by I.R.C. § 1231(a)(3)(A)(ii) .. 14

 II. THE THIRTEENTH CIRCUIT ERRED BY CHARACTERIZING THE RESPONDENT’S DAMAGE
 AWARD AS LOST CAPITAL 18

 A. The Thirteenth Circuit Erred by Applying *Janes* to Define the Nature of
 Respondent’s Damage Award Because *Janes* is Not Controlling Authority and Does
 Not Extend to the Realm of Income Taxation 20

 B. The Thirteenth Circuit Erred in its Determination of the Nature of the Claim
 and Respondent’s Actual Basis for Recovery 22

1. The Nature of Respondent’s Claim is a Tortious Breach of the Trustee’s
Fiduciary Duty to Diversify the Trust, Not a Loss of Capital..... 22

2. The Respondent’s Actual Basis for Recovery Does Not Represent a Capital
Gain Because the Trust Suffered No Actual Loss of Property..... 24

3. Alternatively, the Respondent did Not Meet its Burden of Proof that the
Damage Award Represents a Capital Gain Because it Failed to Show the
Damages Sought Were for a Loss of Capital 26

C. Alternatively, the Thirteenth Circuit Erred in Applying Antitrust Case law to
the Present Case..... 27

CONCLUSION..... 29

TABLE OF AUTHORITIES

UNITED STATES SUPREME COURT CASES

<i>Cent. Tablet Mfg. Co. v. United States</i> , 417 U.S. 673 (1974)	16
<i>Comm’r v. Brown</i> , 380 U.S. 563 (1965).....	13, 14
<i>Comm’r v. Hansen</i> , 360 U.S. 446 (1959)	21
<i>Comm’r v. Jacobson</i> , 336 U.S. 28 (1949)	9
<i>Comm’r v. Korell</i> , 339 U.S. 619 (1950)	13, 14
<i>Crane v. Comm’r</i> , 331 U.S. 1 (1946)	13, 14
<i>Dobson v. Comm’r</i> , 321 U.S. 231 (1944).....	11
<i>First Options of Chicago, Inc., v. Kaplan</i> , 514 U.S. 938 (1995)	8
<i>Hanover Bank v. Comm’r</i> , 369 U.S. 672 (1962).....	13, 14
<i>Helvering v. William Flaccus Oak Leather Co.</i> , 313 U.S. 247 (1941)	9, 13, 14, 16
<i>Lang v. Comm’r</i> , 289 U.S. 109 (1933).....	13, 14
<i>Lyeth v. Hoey</i> , 305 U.S. 188 (1938).....	22
<i>Lykes v. United States</i> , 343 U.S. 118 (1952)	9
<i>New Colonial Ice Co. v. Helvering</i> , 292 U.S. 435 (1934)	9
<i>Old Colony R. Co. v. Comm’r</i> , 284 U.S. 552 (1932)	13, 14
<i>United States v. Burke</i> , 504 U.S. 229 (1992).....	9, 10, 26
<i>United States v. Centennial Savings Bank</i> , 499 U.S. 573 (1991)	9
<i>Welch v. Helvering</i> , 290 U.S. 111 (1933).....	26
<i>White v. United States</i> , 305 U.S. 281 (1938)	9

UNITED STATES CIRCUIT COURT CASES

<i>Durkee v. Commissioner</i> , 162 F.2d 184 (6th Cir. 1947)	9, 12, 18, 27
<i>Kamanski v. Comm’r</i> , 477 F.2d 452 (9th Cir. 1973).....	17
<i>Raytheon Production Corp. v. Comm’r</i> , 144 F.2d 110 (1st Cir. 1944).....	9, 18, 19

UNITED STATES DISTRICT COURT CASES

<i>Williams v. J.P. Morgan & Co. Inc.</i> , 248 F.Supp.2d 320 (S.D.N.Y. 2003)	21
---	----

UNITED STATES COURT OF CLAIMS CASES

<i>Pennsylvania Power & Light Co., v. United States</i> , 220-64, 1968 U.S. Ct. Cl. LEXIS 461 (Ct. Cl. July 30, 1968)	17
--	----

TAX COURT CASES

<i>Big Four Industries, Inc. v. Comm’r</i> , 40 T.C. 1055 (1963).....	9, 10, 13
<i>Freeman v. Comm’r</i> , 33 T.C. 323 (1959).....	9, 18
<i>Nestle Holdings, Inc. v. Comm’r.</i> , 94 T.C. 803 (1990)	17
<i>Sager Glove Corp. v. Comm’r</i> , 36 T.C. 1173 (1961).....	<i>passim</i>

<i>State Fish Corp. v. Comm’r</i> , 48 T.C. 465 (1967)	9, 19, 27
<i>Telefilm, Inc. v. Comm’r</i> , 21 T.C. 688 (1954)	9
<i>Wheeler v. Comm’r</i> , 58 T.C. 459 (1972).....	12, 13

STATE COURT CASES

<i>In re Saxton</i> , 274 A.D.2d 110 (N.Y. App. Div. 2000)	21
<i>Matter of Donner</i> , 626 N.E.2d 922 (N.Y. 1993).....	23
<i>Matter of Janes</i> , 90 N.Y.2d 41 (1997)	<i>passim</i>

FEDERAL STATUTES

I.R.C. § 1001(a).....	1, 15, 17
I.R.C. § 1033.....	<i>passim</i>
I.R.C. § 104(a).....	10
I.R.C. § 117(j) (1942).....	16
I.R.C. § 1222.....	<i>passim</i>
I.R.C. § 1231(a)(3)(A)(ii)	<i>passim</i>
I.R.C. § 1234(a).....	4
I.R.C. § 165.....	1, 16, 17
I.R.C. § 214(a)(12)(1921).....	17
I.R.C. § 61.....	1, 10, 25

TREASURY REGULATIONS

Treas. Reg. § 1.1231-1(a).....	16
--------------------------------	----

OTHER AUTHORITIES

14 AM. JUR. 2D <i>Proof of Facts</i> § 253 (I)(B) § 9.....	24
H.R. REP. No. 67-486, pt. 2 (1921)	17
JEROLD J. WALTMAN, POLITICAL ORIGINS OF THE U.S. INCOME TAX, (the University Press of Mississippi 1985) (1945)	15
<i>Managing Litigation Risks of Fiduciaries</i> , [2007] Tax Management Portfolios Estates, Gifts, and Trusts Series (BNA) No. 857.....	23
MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS, (2nd ed. 2008)	17
Mugel Prudent Investor Act is identical to the New York Prudent Investor Act, codified at N.Y. EST. POWERS & TRUSTS LAW § 11-2.3 (McKinney 2008).....	1, 3

Note, <i>Section 1231(a) and Uncompensated Losses – A Casualty of Statutory Interpretation</i> , 52 VA. L. REV. 90 (1966)	16
Ronald H. Jensen, <i>Can You Have Your Cake and Eat it Too? Achieving Capital Gain Treatment While Keeping the Property</i> , 5 Pitt. Tax. Rev. (2008).....	15, 25, 27
S. REP. No. 67-275, pt. 2 (1921).....	17
<i>The Uniform Prudent Investor Act</i> , [2008] Tax Management Portfolios Estates, Gifts, and Trusts Series (BNA) No. 861	21
UNIF. PRUDENT INVESTOR ACT § 3 (1994)	22

OPINIONS AND JUDGMENTS ENTERED BELOW

In 2007, the Trustee filed an interim accounting with the O'Brian County Surrogate pursuant to Dora and John's demand. On December 15, 2007, the O'Brian County Surrogate Court determined that the Trustee breached its duty of care, awarding damages to the Trust in the amount of \$3,000,000 plus \$400,000 in interest.

Subsequently, the Trust brought suit against the Commissioner of the Internal Revenue Service in the United States Tax Court for a determination of how to tax the damage award from the prior case. The Tax Court held in favor of the Trust as taxpayer, granting capital gains treatment to the damage award.

The Commissioner appealed the judgment of the Tax Court to the Thirteenth Circuit Court of Appeals. The Thirteenth Circuit affirmed the decision of the Tax Court, and the Commissioner petitioned for a writ of certiorari to this Court. This Court granted certiorari over two issues, and the Commissioner, as Petitioner in this action, seeks reversal of the decision of the Thirteenth Circuit.

STATEMENT OF JURISDICTION

Pursuant to Rule III (c) of the 2009 Albert R. Mugel Moot Court Competition a formal statement of jurisdiction in this case is waived by the parties and presumed proper.

CONSTITUTIONAL & STATUTORY PROVISIONS

The statutes involved in this case are, 26 U.S.C. §§ 61, 165, 1001, 1033, 1231 and the Mugel Prudent Investor Act , which is identical to the New York Prudent Investor Act, codified at N.Y. Est. Powers & Trusts Law § 11-2.3 (McKinney 2008).

STATEMENT OF THE CASE

The taxpayer in this action is a testamentary trust (the Trust) established under the will of Donald Dufont (Donald), a domiciliary of the state of Mugel. Donald died January 1, 2005. R. at 2.

Under the terms of the Trust the Trustee, Main Bank (the Trustee) has “sole discretion” to distribute Trust income to Donald’s daughter Dora, or accumulate the Trust income and add it to the corpus. *Id.* at 2. Upon Dora’s death, both the Trust corpus and any accumulated income are to be distributed to Dora’s son, John. *Id.*

The corpus of the Trust consists entirely of 100,000 shares of common stock of Dufont, Inc. (Dufont), a publicly traded company founded by Donald’s father. *Id.* At the date of Donald’s death, the shares were worth \$2,000,000 (\$20 per share). *Id.* at 3. Throughout 2005, the Dufont stock steadily increased in value to \$50 per share. *Id.* After 2005, the value of the Dufont shares steadily decreased. *Id.* At the end of 2006, the stock was once again worth \$20 per share. *Id.* The stock has remained at this value until the present date. *Id.* Main Bank has not sold any of the Dufont stock. *Id.*

In 2007, Dora and John demanded an interim accounting from the Trustee. *Id.* Main Bank filed the interim accounting with the O’Brian County Surrogate’s Court describing the history of the Dufont stock. *Id.* Dora and John objected to the account, asking that the Trustee be surcharged for a breach of its fiduciary duty of care. *Id.*

On December 15, 2007, the O’Brian County Surrogate determined after a hearing that the Trustee should have sold the Dufont stock at the end of 2005 when its value was \$50 per share, finding that Main Bank violated its duty of care under the Mugel Prudent

Investor Act¹, which imposes a duty to diversify “inception assets” within a reasonable time. *Id.*

The Surrogate Court calculated damages using the formula laid out in *Matter of Janes*. This opinion held that

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.

Matter of Janes, 90 N.Y.2d 41, 55 (1997).

Using this formula, the Surrogate Court determined a “loss of capital” in the amount of \$3,000,000 plus \$400,000 in added interest. R. at 4. The Surrogate Court entered judgment against Main Bank, requiring it to restore to the Trust a total of \$3,400,000. *Id.* Main Bank satisfied the judgment on December 31, 2007, paying itself \$as Trustee the sum of \$3,400,000. *Id.*

The Trustee made no distribution to the Trust beneficiaries in 2007. *Id.* On its fiduciary tax return for 2007, the Trust treated the \$3,400,000 as follows:

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

¹ The Mugal Prudent Investor Act is identical to the New York Prudent Investor Act, codified at N.Y. EST. POWERS & TRUSTS LAW § 11-2.3 (McKinney 2008).

The Commissioner assessed a deficiency against the Trust, taking the position that the entire sum of \$3,400,000 should be treated as ordinary income. *Id.* The Trustee subsequently petitioned the Tax Court for a redetermination of this deficiency. *Id.*

The Tax Court held in favor of the Trustee, 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. *Id.*

On appeal to the Thirteenth Circuit Court of Appeals, the Thirteenth Circuit agreed with the Tax Court, holding in favor of the Trustee. *Id.* at 5. The Thirteenth Circuit held that the damage award represented a capital gain to the Trust, and further held that the case came within the spirit and purview of I.R.C. § 1231(a)(3)(A)(ii) (2008) of the Internal Revenue Code. *Id.* at 5-6. § 1231(a)(3)(A)(ii) accords capital gains treatment to involuntary conversions of capital assets held in a transaction entered into for profit. § 1231(a)(3)(A)(ii). In a footnote, the Thirteenth Circuit acknowledged the possibility that I.R.C. § 1234(a) of the Internal Revenue Code held bearing on the issues, but did not address the merits of this issue. *R.* at 6.

This Court granted certiorari, and the Commissioner now seeks reversal of the Thirteenth Circuit's decision, as well as a clarification that the entire sum of the damage award be treated as ordinary income for tax purposes. *Id.* at 7.

SUMMARY OF ARGUMENT

The Respondent, has not demonstrated that a judgment award, received for a complaint of breach of fiduciary duty against its Trustee, is eligible for capital gains preferential rates. Therefore, the Thirteenth Circuit should be reversed for failing to hold the entire award is ordinary income.

Capital gains preferential rates are a legislative grace bestowed by Congress in limited circumstances. A taxpayer may not take advantage of the preferential rate without first demonstrating that each element of the section in Internal Revenue Code (the Code) authorizing the treatment has been met. The Thirteenth Circuit did not require strict application of the Code. To the Contrary, the Thirteenth Circuit held that a “sale or exchange” is not necessary for capital gains treatment. The holding is in direct contradiction with the language of I.R.C. § 1222 (2008) and this Court’s precedent in *Dobson v. Comm’r*.

Furthermore, the Thirteenth Circuit erred because it did not distinguish between a “conversion into cash” and a “sale or exchange.” The terms, and what they denote, are distinctly dissimilar and may not be interchanged. The concept of a “conversion into cash” is found in I.R.C § 1033 (2008) and contemplates the loss of an asset due to physical destruction, theft or seizure which is later compensated for by a party who does not receive any interest in the asset. The concepts of a “sale or exchange” is found in § 1222 and contemplates a transfer of interest from one taxpayer to another in exchange for compensation in money or money’s worth.

Moreover, the Thirteenth Circuit erred because it concluded that a destruction in economic value is an involuntary conversion as contemplated by § 1231(a)(3)(A)(ii).

However, § 1231(a)(3)(A)(ii) only involves physical destruction, a fact not present in the instant case. To give capital gains treatment to proceeds received as compensation for mere loss in value does nothing to further Congress's purpose and policy for enacting the capital gains sections. To the contrary, such an allowance serves to disregard the requirement in § 1033 that an asset must be sold, or otherwise disposed of, before a change in value may be realized by the taxpayer. As a result, investors will be encouraged to maintain ownership of assets rather than participate in the buying and selling of assets. The action of buying and selling assets is precisely what Congress intended to result from providing capital gains preferential rates, believing that investment is essential for this Countries' economic growth.

Additionally, the Thirteenth Circuit erred in characterizing the Respondent's damage award as a loss of capital deserving capital gains treatment under case law. First, the Thirteenth Circuit applied case law from New York state law to calculate the amount of damages owed to the Respondent. Regardless of the fact that this authority is not controlling in *Mugel* and the federal judiciary, the Thirteenth Circuit should not have relied on a state law formula for calculating damages for the purpose of federal income tax characterization. The case law used to characterize the damage award limits itself to the calculation of damages only, and the Thirteenth Circuit erred by applying it in its characterization of the damage award for tax purposes.

The Thirteenth Circuit further erred in its characterization of the Respondent's damage award because it failed to properly determine the nature of the Respondent's initial claim against the Trustee, and also failed to properly determine the Respondent's actual basis for recovery. In the present case, the nature of the Respondent's claim was

for the Trustee's tortious breach of its fiduciary duty to diversify the Trust. The Respondent's actual basis for recovery was for that breach, and the damage award was paid in lieu of that breach occurring. As such, the Respondent's damage award is not capital in nature as determined by the Thirteenth Circuit, but is properly considered ordinary income.

Alternatively, the Thirteenth Circuit erred in its analysis of the present case by applying antitrust case law to facts involving a breach of fiduciary duty committed by the trustee to a testamentary trust. The Respondent's claim was not for antitrust violations. It is better analogized to an action for damage to income producing property. In such cases, damage awards are treated as ordinary income. Thus, the Thirteenth Circuit committed error, and should be reversed.

ARGUMENT

I. THE THIRTEENTH CIRCUIT ERRED BY FAILING TO CONSIDER THE EXPRESS LANGUAGE OF THE INTERNAL REVENUE CODE IN ITS ANALYSIS OF THE PROPER TAX CHARACTERIZATION OF THE DAMAGE AWARD PAID TO THE TRUST

A taxpayer seeking special treatment of income must point to a particular Code section that authorizes that treatment and demonstrate how he fits within the distinct requirements of that section. In the instant case, The Thirteenth Circuit failed to require an analysis of the Internal Revenue Code (the Code) as a preliminary matter. However, this brief will apply a proper analysis by first addressing whether the facts in the damage award are applicable for capital gains treatment by the terms of the Code.

The Thirteenth Circuit's decision should be reversed and the damage award should be treated as ordinary income for the following reasons. First, the Thirteenth Circuit erred by applying the "Nature of the Claim" test because it fails to require the taxpayer to demonstrate authorization for special treatment of income within the terms the Code. Second, the Thirteenth Circuit erred by disregarding the requirement of a sale or exchange as expressly stated in § 1222. Third, the Thirteenth Circuit erred because it did not distinguish between a "conversion into cash" and a "sale or exchange" as found within the Code. Finally, the Thirteenth Circuit erred because it concluded that a destruction of economic value is an involuntary conversion as contemplated by § 1231(a)(3)(A)(ii). As this case raises only questions of law, the appropriate standard of review on appeal is *de novo*. *First Options of Chicago, Inc., v. Kaplan*, 514 U.S. 938, 947-48 (1995)

A. The “Nature of the Claim” Test is Inadequate Because it Fails to Apply the Facts of the Case to the Applicable Code Section.

In the present case, the Respondent, a trust, received proceeds arising out of a dispute regarding a breach of fiduciary duty for failing to diversify the Trust’s inception stock. R. at 3. The Thirteenth Circuit was asked to determine whether the award was “ordinary” or “capital” in nature. *Id.* In answer to this question, the Thirteenth Circuit concluded that if the nature of the claim is for lost profits, the damage award should be taxed as ordinary income. If, however, the “nature of the claim” is damage to a capital asset, an award should receive “capital” treatment. *Id.* This holding was in error because it failed to comply with the requirements for “capital” gains treatment as expressly provided in § 1222.

This Court stated in *White v. United States*, “every deduction from gross income is allowed as a matter of legislative grace,” and any taxpayer seeking special tax treatment “must be able to point to an applicable statute and show that he comes within its terms.” *White v. United States*, 305 U.S. 281, 292 (1938) (citing *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934)); *see also Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247, 249 (1941); *United States v. Burke*, 504 U.S. 229, 248 (1992); *United States v. Centennial Savings Bank*, 499 U.S. 573, 583-84 (1991); *Lykes v. United States*, 343 U.S. 118, 120 (1952); *Comm’r v. Jacobson*, 336 U.S. 28, 49 (1949).

The “nature of the claim” test used by the Thirteenth Circuit was taken from a number of cases that will be referred to as the *Sager Glove* line² for the sake of brevity.

² *Sager Glove Corp. v. Comm’r*, 36 T.C. 1173,1180 (1961), *aff’d*, 311 F.2d 210 (7th Cir. 1962); *Freeman v. Comm’r*, 33 T.C. 323, 327 (1959); *Raytheon Production Corp. v. Comm’r*, 144 F.2d 110,113 (1st Cir. 1944), *aff’g* 1 T.C. 952 (1943); *Durkee v. Comm’r*, 162 F.2d 184, 186 (6th Cir. 1947), *rev’g* 6 T.C. 773 (1946); *State Fish Corp. v. Comm’r*, 48 T.C. 465, 473(1967); *Big Four Industries*, 40 T.C. at 1060; *Telefilm, Inc. v. Comm’r*, 21 T.C. 688, 695 (1954).

A member of the *Sager Glove* line, *Big Four Industries*, used the “nature of the claim” test to conclude that compensation for damage to a company’s goodwill is taxable as capital gain to the extent that the compensation exceeds the basis. *Big Four Industries, Inc. v. Comm’r*, 40 T.C. 1055, 1060 (1963). The court in *Big Four Industries* did not seek support for this conclusion from any Code section.

The *Big Four Industries* conclusion was improper for reasons stated by this Court in *United States v. Burke*. In *Burke* this Court held,

The definition of gross income under the [Code] sweeps broadly . . . gross income means all income from whatever source derived subject only to the exclusions specifically enumerated elsewhere in the Code. . . there is no dispute that the settlement awards in [*Burke*] would constitute gross income within the reach of § 61(a) . . . The question . . . is whether the awards qualify for special exclusion from gross income under § 104(a).

Burke, 504 U.S. at 233 (quoting I.R.C. § 61) (internal quotations omitted).

Put simply, there is no dispute that any damage award is, by default, § 61 gross income. The question is, does the income qualify for special treatment under some other provision of the Code? In *Burke* the applicable Code section was I.R.C. § 104(a) (2008), which allows amounts received for personal injuries to be excluded from gross income. *Id.* In the instant case the applicable Code section is § 1222. This Section requires 1) a gain derived from, 2) the sale or exchange of, 3) a capital asset. The Thirteenth Circuit erred by not ensuring that each element of the Section was met. Therefore the Thirteenth Circuit’s decision should be reversed.

B. I.R.C. § 1222 Requires the “Sale or Exchange” of a Capital Asset for a Gain to be Treated as a Capital Gain

“Not every gain growing out of a transaction concerning capital assets is allowed the benefits of the capital gains tax provision. Those are limited by definition to gains

from the sale or exchange of capital assets.” *Dobson v. Comm’r*, 321 U.S. 231, 232 (1944). Therefore, and as a preliminary matter, a gain is not a “capital” gain if it did not arise from a “sale or exchange.” *Id.* at 232. Despite the express language of the Code and this Court’s holding in *Dobson*, the Thirteenth Circuit stated, “In our opinion, [a] hypothesized-sale measure of damages defines what the trust has received for tax purposes, *regardless of whether the stock is actually sold or not.*” R. at 5. (emphasis added). This conclusion was in error.

In *Dobson*, the taxpayer argued that amounts received as a settlement in an action for rescission of stock should be treated as a part of a prior transaction in which the taxpayer sold the stock. *Dobson*, 321 U.S. at 232. It was conceded that the settlement of a claim was related to the stock. *Id.* It was further conceded that the stock had been sold. *Id.* However, the gains arose out of a settlement not related to the sale or exchange of the stock and as such, could not be defined as a “capital” gain. *Id.*

As compared to the instant case, the Trustee paid a damage award for a breach of its duty related to the Dufont stock. R. at 3. Therefore the gain was related to the stock. However, the amount paid by the Trustee was not derived from the “sale or exchange” of the stock. *Id.* Based upon the basic principles enumerated in § 1222 and in *Dobson*, the Thirteenth Circuit should have concluded that the damage award was not a “capital” gain because it did not arise out of a “sale or exchange.” However, the Thirteenth Circuit did not make this conclusion. To the contrary, the Thirteenth Circuit concluded that the damage award was a “capital” gain irrespective of whether the stock was sold or exchanged. This conclusion is directly contradicted by the express language enacted by

Congress in the Internal Revenue Code. It is further contradictory to the precedent set forth by this Court. Therefore, the Thirteenth Circuit's decision should be reversed.

C. The Conversion of a Capital Asset into Cash is Not the Equivalent of a “Sale or Exchange”

The *Sager Glove* line asserts that if a recovery or judgment “substitutes for a capital asset the amount equal to the taxpayer’s basis in the asset is recoverable tax-free and any excess is taxable at capital gains rates.” *Wheeler v. Comm’r*, 58 T.C. 459, 461 (1972) (citing *Big Four Industries, Inc.*, 40 T.C. at 1060). It appears that the *Sager Glove* line has blended the principles of a § 1222 “sale or exchange” with that of a § 1033 “conversion into cash.” The two phrases and Code sections are distinctly different and the Thirteenth Circuit was in error for relying on case law that does not distinguish between them.

In *Durkee v. Commissioner*, the Sixth Circuit stated “a sale or conversion into cash of capital assets . . . is a realization of the gain in value over the cost of other applicable basis of such assets, and such realized gain becomes taxable income.” *Durkee v. Commissioner*, 162 F.2d 184, 187 (6th Cir. 1947), rev’g 6 T.C. 773 (1946) (emphasis added). The term used by the Sixth Circuit in *Durkee*, “sale or conversion into cash,” is similar to the language used when discussing an involuntary conversion under § 1033. Section 1033 provides for the recognition of gain if property is involuntarily converted into cash “as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof,” provided that the money is reinvested. Section 1033. Note however, that the *Sager Glove* line of cases do not seek treatment of the income under § 1033, which only applies to physical destruction cases.

For example, in *Wheeler v. Commissioner*, the taxpayer contracted with a third party to demolish a building belonging to the taxpayer. *Wheeler*, 58 T.C. at 461. The third party agreed to secure a loan for new construction on the site. *Id.* The third party breached the agreement and Wheeler received an award that compensated, in part, for the demolished building. *Id.* Wheeler sought to have the damage award offset as a casualty loss under § 1033. *Id.* at 462-63. The court held that the transaction was not within the “purview of section 1033” because it was not a “casualty or an event similar to one.” *Id.* Notwithstanding this holding, the court found that the portion of the damage award representing damage to the building should be treated as a “capital” gain to the extent that it exceeded the taxpayer’s basis in the property, citing *Sager Glove* and *Big Four Industries*. *Id.* at 463. This holding indicates that the *Wheeler* court based its conclusion on the belief that a “conversion into cash” is sufficient for qualification under § 1222, though not applicable under § 1033 without a casualty loss.

However, this Court has held that a payment made to compensate for the destruction of a capital asset is not a “sale or exchange.” *Flaccus*, 313 U.S. at 249.³ Furthermore, the term “sale or exchange” has been continuously read using its “common and ordinary” meaning. *Comm’r v. Brown*, 380 U.S. 563, 571 (1965), (citing *Flaccus*, 313 U.S. at 247, 249); *see also Hanover Bank v. Comm’r*, 369 U.S. 672, 687 (1962); *Comm’r v. Korell*, 339 U.S. 619, 627-28 (1950); *Crane v. Comm’r*, 331 U.S. 1, 6 (1946); *Lang v. Comm’r*, 289 U.S. 109, 111 (1933); *Old Colony R. Co. v. Comm’r*, 284 U.S. 552, 560 (1932). The “common and ordinary” meaning of a “sale,” is a transfer of ownership

³ In 1942, one year after *Flaccus* was decided, Congress enacted § 1231 that serves to draw transactions such as that in *Flaccus* into a netting function where gains are treated as capital assets. However, as described in the next section, § 1231 is limited to casualty losses such as those described under § 1033 and is not applicable to the instant case. Therefore, without application of § 1231, compensation for damage to a capital asset is not a “sale or exchange.”

for some monetary consideration. *Brown*, 380 U.S. at 563. An “exchange,” is a transfer of ownership through the “reciprocal transfers of capital assets.” *Flaccus*, 313 U.S. at 249.

A “conversion into cash” contemplates a payment made to compensate for physical damage to property. There is no transfer of ownership interest and as such a “conversion into cash” is neither a “sale” nor an “exchange” as defined by this Court. *Brown*, 380 U.S. at 563, 571; *Hanover Bank*, 369 U.S. at 687; *Korell*, 339 U.S. at 627-28; *Crane*, 331 U.S. at 6; *Flaccus*, 313 U.S. at 249; *Lang*, 289 U.S. at 111; *Old Colony*, 284 U.S. at 560.

In the case at hand, the Respondent is a trust that was funded with 100,000 shares of Dufont common stock. R. at 2. Today, the Trust owns the same 100,000 shares of Dufont stock. R. at 3. As such, there has been no “sale or exchange” of a capital asset. Therefore, for the reasons stated above, the Thirteenth Circuit was in error for relying on case law that does not distinguish between a “sale or exchange,” as required by § 1222, and a “conversion into cash.” For the aforesaid reasons, the Thirteenth Circuit’s decision should be reversed.

D. Stock that Suffers a Loss in Value As a Result of Normal Market Fluctuations is Not an Involuntary Conversion as Contemplated by I.R.C. § 1231(a)(3)(A)(ii)

The Thirteenth Circuit stated, “we think this case comes within the spirit, if not the letter, of § 1231(a)(3)(A)(ii).” R. at 6. The court went on to say, “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...and an involuntary economic destruction.” *Id.* (emphasis added).

However, the Thirteenth Circuit's conclusion was meritless as to whether an "involuntary destruction in value" keeps with the policy and purpose for allowing capital gains preferential rates. The conclusion was further in error as to whether the current facts are eligible for capital gains treatment by way of § 1231(a)(3)(A)(ii).

Capital gains preferential rates were enacted for the purpose of encouraging the purchase, sale and exchange of capital assets. JEROLD J. WALTMAN, *POLITICAL ORIGINS OF THE U.S. INCOME TAX* 10, (the University Press of Mississippi 1985) (1945). Without preferential rates, gains on the sale or exchange of capital assets would be taxed as ordinary income, or not taxed at all based on the British system. *Id.* at 9. Section 1001(a) provides that property will not be taxed as it appreciates in value. Rather, the accumulated gains will be added together and taxed when sold. I.R.C. § 1001(a). As a result the taxpayer will realize an increase in income in the year he sells the asset and thus, will be taxed at a higher marginal rate. Whereas, had the increase in value been taxed in the year it accrued, each accrual would be taxed at lower rates and the overall tax burden would be lower. WALTMAN, *supra*, at 8.

In 1921, Congress recognized that this disparate treatment was discouraging investment. *Id.* at 91. Furthermore, it was widely accepted that the economic growth of the nation was dependant on "[e]conomic productivity, which . . . is enhanced by capital investment,". *Id.* at 12. Because capital investment (the purchase and sale of capital assets) is the "engine of economic growth," Congress instituted a preferential rate for the "sale or exchange" of capital assets. *Id.* at 83; *cf.* 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). Therefore, the "sale or exchange" of capital assets is a crucial

component of economic growth and economic growth was the purpose and policy for permitting capital gain. In this vein, and as mentioned in the previous section, courts have fervently insisted on compliance with the “sale or exchange” requirement.

Congress has, in very limited circumstances, provided certain transactions to be deemed a sale or exchange.⁴ *Flaccus*, 313 U.S. at 251. One such exception to the “sale or exchange” rule is found in § 1231. Section 1231 (then I.R.C. § 117(j) (1921)) was added to the Code in 1942 as a response to this Court’s decision in *Flaccus*. *Cent. Tablet Mfg. Co. v. United States*, 417 U.S. 673, 683 (1974). This section is, in part, intended to allow capital gains treatment for certain casualty losses and involuntary conversions.

Note, *Section 1231(a) and Uncompensated Losses – A Casualty of Statutory Interpretation*, 52 VA. L. REV. 90, 90 (1966). It was enacted in order to allow the best positive tax treatment resulting from casualty losses and involuntary conversions. Treas. Reg. § 1.1231-1(a) (2009). Qualified losses are deducted against ordinary income, and qualified gains are taxed at capital rates. *Id.* The result is, if a taxpayer decides to invest in income producing property, which is later physically destroyed, stolen, or seized, the taxpayer will receive the best possible treatment on the loss. *Id.* Therefore, an investor is encouraged to invest, even in the face of catastrophe. Thus the “engine of economic growth” carries on.

Furthermore, there is nothing in the legislative history of I.R.C. § 165 (2008) or §§ 1033 and 1231 or the Code itself, that equates economic destruction with physical destruction. To the contrary, § 1231 contemplates casualty losses and involuntary

⁴ Another exception is contained in § 1234(A)(3)(b). The Thirteenth Circuit mentioned § 1234(A) in footnote 4 of the opinion stating “The view we take on the issues renders it unnecessary for us to consider the relevance, if any, of § 1234A.” R. at 6. The Petitioner concedes that the Thirteenth Circuit was correct in refusing to consider the applicability of the Code section because the section regards the sale or exchange of an option which is not present in the instant facts.

conversions that are physical and that divest the taxpayer of the investment.

Pennsylvania Power & Light Co., v. United States, 220-64, 1968 U.S. Ct. Cl. LEXIS 461, at *32 (Ct. Cl. July 30, 1968). Additional support that § 1231 contemplates physical destruction can be found in the Revenue Act of 1921 where the terms “destruction in whole or in part” was first seen in I.R.C. § 214(a)(12)(1921).⁵ Congressional reports indicate that the language was intended to allow a taxpayer to exclude gain “when property is involuntarily converted into cash as a result of fire, shipwreck, condemnation, or related causes,” if it is then reinvested into similar property. S. REP. No. 67-275, pt. 2, at 191 (1921); H.R. REP. No. 67-486, pt. 2, at 209 (1921). The examples provided by Congress all relate to physical damage. Notably, loss in value due to market fluctuations was not mentioned.

A casualty loss is defined in § 165. However, § 165 does not contemplate a mere loss in economic value. Rather, it is a “mere diminution of value caused by market forces unrelated to physical damage.” See MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶14.02, (2nd ed. 2008), (citing *Kamanski v. Comm’r*, 477 F.2d 452, 452 (9th Cir. 1973)) (Loss in the fair market value of the taxpayer’s home caused by a land slide in the area, with only minor physical damage, was not a casualty loss). The rationale for distinguishing between a casualty loss and an economic loss is simple. Section 1001(a) does not permit a taxpayer to realize a loss or a gain on an asset until it is sold or disposed of. *Kamanski*, 477 F.2d at 452; cf. *Nestle Holdings, Inc. v. Comm’r.*, 94 T.C. 803, 815 (1990). Present loss in value “may well be an accurate prediction Loss of value based upon such a prediction is not deductible as casualty loss. *Kamanski*, 477 F.2d at 453.

⁵ § 214(a)(12) is now § 1033

Similarly, the Respondent in the instant case still owns the Dufont stock. The current value of the stock does not predict the value of the stock when it is sold because the value of an asset, particularly stock in a small corporation, is continuously fluctuating. Therefore, the Dufont stock's loss in value did not divest the Trust of property. In contrast, a "destruction," as contemplated by § 1231, is an event that divests the taxpayer of his use and ability to transfer the property. For these reasons, § 1231 only applies to a "physical destruction." Therefore, the Thirteenth Circuit should be reversed for concluding that an "economic destruction" is the equivalent of a physical destruction.

In summary, the Thirteenth Circuit's decision should be reversed and the damage award should be characterized as ordinary income because it failed to require that the Respondent meet the strict requirements of § 1222. Furthermore, it held that a "sale or exchange" is not required for capital gains treatment. Additionally, the court failed to distinguish between a "conversion into cash" and a "sale or exchange." Finally, the court erred because it concluded that a loss in economic value is an involuntary conversion as contemplated by § 1231(a)(3)(A)(ii).

II. THE THIRTEENTH CIRCUIT ERRED BY CHARACTERIZING THE RESPONDENT'S DAMAGE AWARD AS LOST CAPITAL

Despite the Thirteenth Circuit's failure to require the Respondent to demonstrate the damage award is entitled to capital gains treatment under the express provisions of the Code, the Thirteenth Circuit committed further error in its characterization of the damage award pursuant to case law. When determining how a damage award should be taxed, courts traditionally apply a two part test. *See Sager Glove Corp.*, 36 T.C. at 1180; *see also Durkee*, 6 T.C. at 186; *Raytheon Production Corp. v. Comm'r*, 144 F.2d 110 (1st Cir. 1944), *aff'g* 1 T.C. 952 (1943); *Freeman v. Comm'r*, 33 T.C. 323, 327 (1959); *State*

Fish Corp. v. Comm’r, 48 T.C. 465, 473 (1967) (collectively, *Sager Glove*). Under the *Sager Glove* test, courts first look to the nature of the claim asserted by the taxpayer. *See, e.g., Sager Glove Corp.*, 36 T.C. at 1180; *see also Freeman*, 33 T.C. at 327. Second, courts look to the actual basis of recovery to determine what the damages were actually paid in lieu of. *See, e.g., Sager Glove Corp.*, 36 T.C. at 1180; *see also Freeman*, 33 T.C. at 327. Where a damage award represents lost profits, it is taxable as ordinary income. *See Sager Glove Corp.*, 36 T.C. at 1180; *see also Raytheon Production Corp.*, 1 T.C. at 113; *Freeman*, 33 T.C. at 327. Where a damage award represents a replacement of capital, any recovery in excess of the taxpayer’s basis in that property is taxed as a capital gain. *See Raytheon Production Corp.*, 1 T.C. at 113. The Thirteenth Circuit applied this test in the present case. However, in its analysis, the Thirteenth Circuit erred in characterizing the damage award as capital in nature.

The Thirteenth Circuit committed error in its characterization of the damage award for three reasons. First, the Thirteenth Circuit applied case law from New York that does not control in the state of Mugel, and does not extend to the realm of federal income taxation. Second, the Thirteenth Circuit improperly applied the *Sager Glove* test and made an erroneous determination as to the nature of the Respondent’s claim, as well as its actual basis for relief. Alternatively and finally, the Thirteenth Circuit improperly relied on case law arising out of antitrust violations, which are too dissimilar from the present case to adequately apply. Therefore, the Thirteenth Circuit’s decision should be reversed in favor of the Petitioner.

A. The Thirteenth Circuit Erred by Applying *Janes* to Define the Nature of Respondent's Damage Award Because *Janes* is Not Controlling Authority and Does Not Extend to the Realm of Income Taxation

In characterizing the damage award for tax purposes, the Thirteenth Circuit improperly relied on and extended the New York Supreme Court's opinion in *Matter of Janes*. *Janes* holds:

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.

Janes, 681 N.E.2d at 339. The Thirteenth Circuit erred in its application of the *Janes* formula for two reasons. First, *Janes* does not represent mandatory authority in this case because it was decided in New York state court, not in the state of Mugel. Second, *Janes* provides a formula limited to calculating damage awards. The formula does not account for taxation principles. Therefore, *Janes* should not have been relied upon for that purpose.

The Thirteenth Circuit should not have applied the *Janes* formula in the context of federal income tax because *Janes* is not mandatory authority in Mugel or federal court. As such, Mugel and federal courts are not bound by its holdings. Thus, the use of *Janes* in the instant case was not compulsory, and this Court is not required to limit its consideration of this issue to *Janes* to determine the nature of the damage award. To do so would value the form over the substance. *Cf. Comm'r v. Hansen*, 360 U.S. 446, 461-

62 (1959). Therefore, this Court should reverse the Thirteenth Circuit for relying solely on case law not controlling in Mugel or the federal system.

Assuming *arguendo* that the *Janes* formula applies for purposes of calculating damages in the present case, the Thirteenth Circuit still erred by applying its standard to characterize the damage award for tax purposes.⁶ The *Janes* formula operates only as a calculation of damages and stops at this point. Nowhere in the *Janes* opinion does the court indicate that its holdings should extend to the realm of federal income tax.

Furthermore, the use of state authority to characterize a damage award for federal tax purposes is not mandatory. Noticeably, those cases following *Janes* also limit its use to damage calculations. In *In re Saxton*, the court made note of the fact that *Janes* was not overly concerned with the issue of taxation, or the issue of capital gains taxation. *In re Saxton*, 274 A.D.2d 110, 121 n.8 (N.Y. App. Div. 2000). In applying the *Janes* formula, the *Saxton* court took into account capital gains taxes that would have been paid had the shares of IBM stock been prudently sold, but only made mention of taxation in the calculation of damages, not discussing how to tax the damage award. *Id.* Another case following in the wake of *Janes*, *Williams v. J.P. Morgan & Co. Inc.*, which dealt with determining damages owed for a trustee's breach of fiduciary duty to the trust beneficiaries, again limited its use of the *Janes* formula only to the calculation of damages. *Williams v. J.P. Morgan & Co. Inc.*, 248 F.Supp.2d 320, 333 (S.D.N.Y. 2003).

In *Lyeth v. Hoey*, this Court definitively held that the applicability of federal statutory law is a federal question, not to be determined "by local characterization." *Lyeth v. Hoey*,

⁶ *Janes* does provide a widely followed formula for calculating damages for a trustee's failure to diversify under the Prudent Investor Act. See *The Uniform Prudent Investor Act*, [2008] Tax Management Portfolios Estates, Gifts, and Trusts Series (BNA) No. 861 at § VI (B)(2), (explaining the significance of *Janes* as a leading case for calculating damages).

305 U.S. 188, 193 (1938). Thus, plucking language from *Janes* to characterize the nature of the damage award is erroneous, because the *Janes* formula does not consider tax characterization principles. *Janes*'s usefulness extends no further than providing a formula for courts to use when calculating damages. Therefore, the Thirteenth Circuit's decision should be reversed.

B. The Thirteenth Circuit Erred in its Determination of the Nature of the Claim and Respondent's Actual Basis for Recovery Under the *Sager Glove* Test

Because the *Janes* formula does not apply to determine the nature of Respondent's damage award, the *Sager Glove* test must be carefully reexamined. Considering both prongs of the *Sager Glove* test, the damage award must be treated as ordinary income. First, the nature of Respondent's claim is for a breach of fiduciary duty by the Trustee. Second, the damage award was paid in lieu of that breach, not for a loss of capital. Thus, the damage award should be taxed as ordinary income. Alternatively, the Respondent did not meet its burden of proof in the lower courts to warrant capital gains treatment of the damage award, therefore the damage award represents ordinary income to the Respondent.

1. The Nature of Respondent's Claim is a Tortious Breach of the Trustee's Fiduciary Duty to Diversify the Trust, Not a Loss of Capital

The claim asserted by the Respondent against the Trustee was for a breach of the Trustee's fiduciary duty to diversify the assets of the Trust. Section 3 of the Uniform Prudent Investor Act (adopted by Mugel) imposes a duty on the Trustee to "diversify assets unless the Trustee reasonably determines that it is in the interests of the beneficiaries not to diversify,". UNIF. PRUDENT INVESTOR ACT § 3 (1994). At the core of the Respondent's claim against the Trustee is an action to recover damages for the

Trustee's failure to act in the best interests of the beneficiaries. *See Managing Litigation Risks of Fiduciaries*, [2007] Tax Management Portfolios Estates, Gifts, and Trusts Series (BNA) No. 857 at § III (E) (stating “[i]f an investment fails and the trustee is found at fault, the question then of how a trustee will be punished centers on breaching the duty to invest prudently,”). Therefore, the true nature of the Respondent's claim was for a violation of the Trustee's duty to protect the assets of the Trust from risk. Thus, the damage award represents ordinary income for tax purposes.

The nature of the claim in this case is for a violation of the Trustee's duty to protect the Trust from risk. In order to maximize benefits for the beneficiaries, the Trustee should have ensured that the Trust corpus consisted of a diversified asset portfolio. Had the Trustee complied with this duty, the Trust would have been better able to withstand market fluctuations such as those suffered by the Dufont stock. In *Matter of Donner*, 626 N.E.2d 922, 923 (N.Y. 1993), the court held that damages are recoverable where the coexecutors of a decedent's estate fail to act prudently in compliance with the Prudent Investor Act. Their imprudence, as held by the court, resulted from a failure to preserve the assets of the Trust over which they had control. *Id.* at 923. This failure to preserve the Trust or adequately protect it from the risks of market fluctuation is the true nature of the claim in the present case. The Thirteenth Circuit committed error by glossing over this fact, asserting that the nature of the claim stems from a fictitious loss of capital. Therefore, the Thirteenth Circuit's decision should be reversed. Moreover, the Thirteenth Circuit's “loss of capital” characterization further suffers because the Trust has not suffered an actual loss of property.

2. *The Respondent's Actual Basis for Recovery Does Not Represent a Capital Gain Because the Trust Suffered no Actual Loss of Property*

In the present case, the Trust is in the unique position of having suffered no actual loss of property, but still collected a large damage award from the Trustee. This situation presents a question of first impression not answered directly by this or any other court. *See* 14 AM. JUR. 2D *Proof of Facts* § 253 (I)(B) § 9 (stating that “[w]hether the trustee might be liable for ‘paper losses,’ that is, for securities, still on hand at the close of the accounting period, which have depressed values, as distinct from realized losses, seems an open question.”). Because the Trust has suffered no actual loss of property in this case, the damage award cannot represent a recovery of lost capital. Thus, the damage award represents ordinary income to the Respondent.

In its analysis, the Thirteenth Circuit applied the second prong of the *Sager Glove* test to hold that Respondent’s actual basis for recovery was a loss of capital. The Thirteenth Circuit reached this conclusion by analogy, holding that because the Respondent treated the interest awarded by the Surrogate Court as ordinary income, then the rest of the damage award must represent a capital gain. *See* R. at 5-6 (“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,”). This analogy is not only without foundation in the law as described in part I this brief, it also concludes a loss of capital where none exists. Because the Thirteenth Circuit created this unfounded legal fiction, its decision should be reversed.

Furthermore, the Thirteenth Circuit’s reliance on *Janes* was also erroneous because it is distinguishable from the instant case. In *Janes*, the trust suffered an actual

loss of property. There, the trustee breached its duty to the trust by selling stocks worth less than a third of their peak value causing a recognized loss. *See Janes*, 681 N.E.2d at 334-35 (the shares sold declined in value after the beneficiary of the trust's interest vested, being valued originally at \$139 per share and eventually being worth only about \$47 per share). In contrast, the Trustee here failed to sell the stock and as such, there was no recognized loss. To the contrary, the Trust still has possession of all 100,000 shares of Dufont stock with which it was originally funded. Additionally, the Trust is now in possession of a cash judgment. Thus, the Respondent has realized income from the damage award which will presumably be used to diversify the Trust in the future and no actual harm to property has been suffered. While in *Janes*, the trust beneficiaries suffered actual harm, here, the Trust still contains all the shares of Dufont stock, and can only be truly said to have suffered a constructive harm to its assets. The actual harm suffered by the Respondent in this case was the Trustee's breach of its fiduciary duty. Thus, the damages paid to the Respondent represent a payment derived from the Trustee's failure to act dutifully to protect the Trust's assets. As such, the damage award must represent ordinary income under § 61 of the Internal Revenue Code.

Additionally, granting similarly situated taxpayers dissimilar treatment under the law is unwise as a matter of policy. If the Respondent is allowed capital gains treatment for a damage award bearing only a tangential relation to a capital asset which suffered no actual harm, other taxpayers recovering damages for similar tortious conduct who are unable to claim capital gains treatment on their damage awards will not be treated equally under the law. Therefore, the damage award should be treated as ordinary income for tax purposes. *Cf. Jensen, supra*, at 91 (explaining that there is no good reason to grant capital

gains treatment to damage awards otherwise taxable as ordinary income where capital gains treatment would not further congressional policies).

The Thirteenth Circuit's decision should be reversed due to the fact that the Trust in this case suffered no actual loss of property, and would result in the inconsistent treatment of similarly situated taxpayers under the Internal Revenue Code.

3. *Alternatively, the Respondent did Not Meet its Burden of Proof that the Damage Award Represents a Capital Gain Because it Failed to Show the Damages Sought Were for a Loss of Capital*

All income is ordinary unless otherwise provided by the Code. *Burke*, 504 U.S. at 233. The taxpayer has the burden of demonstrating that the income should be given some special treatment. *See Welch v. Helvering*, 290 U.S. 111, 115 (1933). Here, the Respondent failed to carry its burden, because the record does not show a definitive statement made by the Respondent or lower court allocating the type of damages sought and awarded. Thus, the damage award should be treated as ordinary income. In cases where there is no clear understanding of exactly what the damages awarded represent due to a lack of specificity either in the original complaint, judgment, or settlement instrument, courts generally treat the amount paid as ordinary income. For instance, in *Sager Glove* and *Freeman*, both courts held that the damage awards represented ordinary income for tax purposes because the taxpayers did not adequately prove that the damages they sought represented lost profits or capital losses. *Sager Glove Corp.*, 36 T.C. at 1182; *Freeman*, 33 T.C. at 329. Similarly in this case, the amount paid to the Respondent represents ordinary income. Here, just as in *Sager Glove* and *Freeman*, there is a dearth of information regarding what the Respondent actually sought from the Trustee in its original action. None of the lower courts in this action specifically allocated the damages

as a payment in lieu of any particular type of harm suffered, whether it be capital or ordinary. Thus, because the damages in this case were not specified as representing capital gains, the Respondent failed to meet its burden of proof, and the damage award must be treated as ordinary income.

While it may be argued that the Respondent's itemized allocation of the damage award on its income tax return for 2007 accomplishes this goal, this argument must fail. It cannot be argued that an allocation of the damage award after it had already been paid and received could feasibly justify such a characterization. If this were the case, every taxpayer receiving a damage award would wait to allocate the damages awarded until after judgment is entered or settlement reached, creating uncertainty for defendants in trying to determine what types of claims they are defending against, as well as courts and the IRS in determining what a damage award actually represents at the time of judgment. The Thirteenth Circuit's decision should therefore be reversed.

C. Alternatively, the Thirteenth Circuit Erred in Applying Antitrust Case law to the Present Case

The Thirteenth Circuit relied chiefly on antitrust cases which hold that damage awards and settlements paid for damage to the goodwill of a business represent a return of capital in concluding that the Respondent's damage award represents a loss of capital. *See Sager Glove Corp.*, 36 T.C. at 1175; *Durkee*, 6 T.C. at 185; *State Fish Corp.*, 48 T.C. at 467-68; *Freeman*, 33 T.C. at 324-25. However, this comparison lacks significant connection to the present case to characterize the Respondent's damage award as a return of capital. The present case is better analogized to cases involving damage to income producing investment property. In this scenario, a loss in value for an injury or damage to property reflects a loss in the property's earning capacity. *Jensen, supra*, at 94-95. In

such cases, the recovery should not be given capital gains treatment. *Id.* at 95. In the present case, the Trust existed as an income producing entity for the beneficiaries of the Trust. Thus, the property held by the Trust has as its primary function the production of income for the beneficiaries. Similarly, income producing property is held for the benefit of its owner and the value of real property fluctuates due to market conditions, but income is chiefly based on periodic payouts while the owner still owns the property. Thus, when the Trustee was held to have breached its fiduciary duty to the beneficiaries, damages were calculated and the award was paid in order for the Trustee to remedy its failure to diversify the Trust. Thus, the damage award represented the recovery of income for the benefit of the Trust beneficiaries. As a result of the Trust recovering the damage award, the beneficiaries would be able to realize regular payments from the Trust in the future. Thus, the damage award in the present case more closely represents a damage or quasi-damage to the income producing corpus of the Trust, which declined in value as a result of the Trustee's failure to diversify the Trust assets. As such, the damage award more closely resembles a payment for damage to future income and should similarly be treated as ordinary income.

In sum, the Thirteenth Circuit's decision should be reversed and the Respondent's damage award should be treated as ordinary income because the Thirteenth Circuit improperly relied on *Janes*, and erred in its determination of both the nature of the claim and the actual basis for the Respondent's recovery under *Sager Glove*. Alternatively, the Thirteenth Circuit erred in its application of antitrust case law, where the present case more closely resembles damage to income producing property.

CONCLUSION

For the foregoing reasons, the Petitioner respectfully requests that this Court reverse the judgment of the Thirteenth Circuit Court of Appeals, and grant any other relief it deems appropriate in this case.

Date: February 20, 2009

Respectfully submitted,
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