
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 THE PETITIONER

Counsel for the Petitioner

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QUESTIONS PRESENTED FOR REVIEW

- I. Can the Respondent treat proceeds from the beneficiaries' judgment as capital gain, even though there is no discernible sale or exchange of the underlying capital asset?
- II. Can the Respondent treat proceeds from the beneficiaries' judgment as a nontaxable return of capital when such proceeds represent gain above its I.R.C. § 1014 basis?
- III. Can the Respondent treat proceeds from the beneficiaries' judgment as capital gain under I.R.C. § 1231 when such proceeds arose out of trustee's breach of fiduciary duty and the inception assets remain intact for their intended purpose?

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OPINION BELOW

The opinions of the Tax Court and the United States Court of Appeals for the Thirteenth Circuit are unreported. This brief references the Thirteenth Circuit's opinion as it appears in the Record.

STATUTORY PROVISIONS

This case involves statutory provisions of the Internal Revenue Code of 1986, as amended, 26 U.S.C. § 1 *et seq* (2008) (hereinafter "I.R.C."). This brief cites the relevant provisions within its text.

STATEMENT OF THE CASE

A. Statement of the Facts

The Respondent in this case is the Donald Dufont Testamentary Trust, which was established pursuant to the last will and testament of Mr. Donald Dufont, a resident of the state of Mugel. (R. at 2.) The trust instrument named Main Bank as trustee. *Id.* The purpose of the trust was to provide income, at the discretion of the trustee, to Mr. Dufont's daughter, Dora. *Id.* Upon her death, the remainder of the trust's corpus was to be distributed to Dora's son, John. *Id.*

The entirety of the trust corpus consisted of 100,000 shares of Dufont Corporation common stock. *Id.* The fair market value of this stock at the date of Mr. Dufont's death was 2 million dollars (i.e., \$20 a share). (R. at 3.) During 2005 the Dufont stock increased to \$50 a share, making the corpus' value 5 million dollars. *Id.* But by the end of 2006 the stock had declined to its original price of \$20 a share. *Id.* To date, the stock has never paid a dividend, it has never been sold by the trustee, and, at the time of this action, the

trustee had made no distribution to the beneficiaries. (R. at 3-4.) Therefore, the trust corpus maintains its inception value of 2 million dollars. (R. at 3.)

Because of the above-described fluctuation in the stock's price, the beneficiaries, Dora and John, brought legal action against the trustee for breach of its fiduciary duty. (R. at 3.) The Surrogate Court determined the trustee had violated the Mugal Prudent Investor Act, which requires a fiduciary to diversify the trust estate within a reasonable period of time. *Id.* The court entered judgment against the trustee, and calculated damages pursuant to the formula described in *Matter of Janes*. (R. at 4.) Accordingly, the court ordered the trustee to pay 3.4 million dollars to the trust estate, \$400,000 representing interest. *Id.* The trustee immediately paid this judgment. *Id.*

B. Procedural History

On its fiduciary return for the 2007 tax year, the trustee characterized the judgment award in the following manner: (a) 2 million as nontaxable return of basis; (b) 1 million as long-term capital gain; and (c) \$400,000 as ordinary income. (R. at 4.) The Commissioner assessed a deficiency against Respondent in 2007, holding the judgment amount of 3.4 million was taxable as ordinary income. *Id.* The Respondent petitioned the Tax Court for a redetermination of this deficiency, and the court held in its favor. *Id.* The Tax Court based its decision on the origin of the Respondent's claim, reasoning that the judgment proceeds "represent a replacement of capital," and any gain above basis is capital gain. *Id.* On appeal, the United States Court of Appeals for the Thirteenth Circuit agreed with the decision of the Tax Court. (R. at 5.) The Commissioner appeals this decision because the Thirteenth Circuit erred.

C. Standard of Review

This case involves statutory interpretation and questions of law, which are reviewable by this Court pursuant to the *de novo* standard. See *GMC v. Darling's*, 444 F.3d 98 (1st Cir. 2006).

SUMMARY OF THE ARGUMENT

I. The Thirteenth Circuit erred when it allowed the Respondent preferential capital gains tax treatment without demonstrating an actual sale or exchange. The transaction leading up to the Respondent's receipt of the judgment proceeds does not fit within the plain meaning of sale or exchange, since the Respondent has not received one thing for another. Furthermore, it is contrary to the law and tax policy surrounding the treatment of capital gains to allow the Respondent capital gains tax treatment when it has retained its original interests. The Thirteenth Circuit also erred when it relied exclusively on the origin of the claim test to justify capital gains treatment of the Respondent's judgment proceeds. The judicially created origin of the claim test should not be used to supplant the statutory sale or exchange requirement. Rather, the Court should look at both tests in determining whether a taxpayer should be given preferential capital gains treatment. The Thirteenth Circuit further erred when it relied on precedent which overextended the origin of the claim test and when it considered the "hypothesized" sale contemplated in the *Janes* formula as a functional equivalent to a sale or exchange.

II. Additionally, the Respondent's recovery should not be considered a nontaxable return of capital because such treatment is inconsistent with the origin of the claim test and tax policy. The origin of the claim test treats litigation proceeds in the same manner as they would have been treated had they been received outside of litigation. Since the

proceeds received by the Respondent would have been taxable had the Respondent received them in the course of a sale or exchange, they cannot be considered a nontaxable return of capital. The treatment of the litigation proceeds also contradicts tax policy promoting taxation of economic gain. The Respondent realized the equity value of the stock and retained ownership of the stock, substantially improving its economic position without corresponding taxation. Further, allowing a nontaxable return of capital for the recovery of diminished stock value is the equivalent of allowing a deduction for the same, which is prohibited by the Code. Hence, treatment of the Respondent's recovery as a return of capital contradicts Congressional intent.

III. Finally, the Thirteenth Circuit incorrectly held the Respondent's judgment proceeds could be treated as capital gain under I.R.C. § 1231. An involuntary conversion may only be claimed if the property has been destroyed in a way that is unfit for the its intended purpose. But in the present case, the Respondent continues to own, possess, and actually use the inception assets of the trust for their intended purpose. Courts have also consistently denied non-recognition under § 1033, and its successor § 1231, to taxpayers receiving awards in securities dispute resolutions and lawsuits. The Respondent's case is analogous to cases where the courts have previously denied non-recognition treatment. Therefore, the Thirteenth Circuit was in error when it found § 1231 applied to the Respondent's case.

In summary, the Petitioner holds the Thirteenth Circuit was in error in its conclusion and analysis concerning the above-stated matters, and respectfully requests this Court overrule the decision.

ARGUMENT

I. THE RESPONDENT CANNOT TREAT PROCEEDS FROM ITS JUDGMENT AS CAPITAL GAIN BECAUSE IT HAS FAILED TO DEMONSTRATE THE SALE OR EXCHANGE OF A CAPITAL ASSET, A CONDITION PRECEDENT TO CAPITAL GAIN TREATMENT.

At the outset, the Respondent cannot seek capital gain treatment because it has failed to meet the statutory requirement of a “sale or exchange.” The proper analysis of the Respondent’s claim to capital gain treatment begins by looking at The Internal Revenue Code (“the Code”). The Code gives preferential tax rates for a taxpayer’s “net capital gain” in so far as its net long-term capital gain exceeds its net short-term capital loss. I.R.C. §§ 1(h)(1), 1222(11). The Code further defines long-term capital gain as “gain from the sale or exchange of a capital asset held for more than [one] year.” I.R.C. § 1222(3). Therefore, in order for any taxpayer to achieve preferential capital gain treatment for a taxable transaction, the taxpayer must demonstrate the (1) sale or exchange of (2) a capital asset (3) held for more than one year. I.R.C. §§ 1(h)(1), 1222(3), 1222(11). If the taxpayer fails to demonstrate any one of these elements in its transaction, the entire gain derived therefrom shall be treated and taxed as ordinary income. *See* I.R.C. § 61(a) (gross income includes “income from whatever source derived”).

It is important to note the Code recognizes a great variety of gain, and specific situations where gain is and is not recognized as gross income. *See e.g.*, I.R.C. § 61(a)(3) (includes in gross income “Gains derived from dealings in property”); I.R.C. § 102(a) (property attained through “gift, bequest, devise, or inheritance” not included in gross income). Generally, the Code broadly defines gain as accompanied by “the sale or *other disposition* of property.” I.R.C. § 1001(a) (emphasis added). With respect to preferential capital gain treatment, however, the Code narrowly characterizes such gain

as “gain from the *sale or exchange* of a capital asset.” I.R.C. § 1222(3) (emphasis added). Therefore, if a sale or exchange is not shown, it is possible under the Code for a taxpayer to recognize gain on a capital asset which does not warrant the preferential capital gain treatment. *See Dobson v. Comm’r*, 321 U.S. 231, 231-232 (1944) (“not every gain growing out of a transaction concerning capital assets is allowed the benefits of the capital gains tax provision”); *See also* Rev. Rul. 74-251, 1974-1 C.B. 41 (proceeds received in settlement of litigation represent ordinary income unless it is “clearly established that there has been a sale or exchange of property”).

The Respondent in the present case has failed to show how its transaction, which resulted in a taxable gain, meets the necessary requisite of a “sale or exchange” described above. In support of this position, the Petitioner will show in detail: (1) how the Respondent’s transaction does not fall within the plain meaning of the statutory sale or exchange requirement, nor does it fit within any of its exceptions; (2) that the Respondent cannot retain its interests in its trust assets and claim that gain therefrom should be treated as capital gain; and (3) how the public policy behind capital gain treatment does not support the Respondent’s position.

A. The Respondent Cannot Show the Transaction in Question was Within the Plain Meaning of the I.R.C. § 1222(3) Sale or Exchange Requirement, nor Within any of the Exceptions Promulgated by Congress.

The Respondent cannot show that its transaction fits within the plain meaning of a “sale or exchange,” therefore its judgment proceeds should be taxed as ordinary income. In its analysis of the sale or exchange requirement, this Court should consider the common and ordinary meaning of the statutory language, and what a “sale” or “exchange” means in its ordinary sense. *See Yarbrow v. Comm’r*, 737 F.2d 479, 483 (5th

Cir. 1984); *Helvering v. William Flaccus Oak Leather Co.*, 313 U.S. 247, 249 (1941). The phraseology the Respondent will likely rely on in meeting this requirement is the term “exchange,” since its judgment proceeds did not represent a “sale” in a traditional sense. (R. at 3-4.) This Court, then, should focus on the term “exchange,” and determine if the Respondent’s transaction fits within its meaning. Merriam-Webster’s Collegiate Dictionary defines “exchange” as “the act of giving or taking one thing in return for another” 435 (11th ed. 2003). Black’s Law Dictionary defines “exchange” as the “act of transferring interests, each in consideration for the other.” 604 (8th ed. 2004). In defining the sale or exchange requirement of the capital gains tax provisions, the Fifth Circuit has said the term “exchange” involves “the act of giving one thing in return for another thing regarded as an equivalent.” *Yarbro*, 737 F.2d at 483. Prior to this holding, the Supreme Court has held where a transaction does not fall within the “ordinary meaning” of an “exchange,” it is not entitled to capital gain treatment. *Flaccus*, 313 U.S. at 249-250; *see also Helvering v. Hammel*, 311 U.S. 504, 510-11 (1941); *Dobson*, 321 U.S. at 231-232.

While it is true “courts in the interpretation of statute have some scope for adopting a restricted rather than a literal or usual meaning of its words where acceptance would lead to absurd results,” it is not the role of this Court to reject a “meaning where . . . it appears to be consonant with the purposes of the Act as declared by Congress and plainly disclosed by its structure.” *Hammel*, 311 U.S. at 510-11. Such is the case with the statutory sale or exchange requirement for capital gain treatment. The Supreme Court has warned it is the role of Congress to specify “the ambiguous transactions which are to be regarded as sales or exchanges for income tax purposes.” *Flaccus*, 313 U.S. at 251. This is apparent upon examination of the Code. *See e.g.*, I.R.C. § 165(g)(1) (if a security that

is a capital asset becomes worthless, it is deemed to have been sold or exchanged); I.R.C. § 166(d)(1)(B) (if nonbusiness bad debt becomes worthless, resulting loss deemed to be loss from the sale of a capital asset); I.R.C. § 1234(a) (if option to buy a capital asset expires, option considered a capital asset and deemed to have been sold the day its expires); I.R.C. § 1241 (with respect to monies received for cancellation of a lease, an exchange is deemed to have occurred). It follows, therefore, if a taxpayer cannot demonstrate that its transaction fits within the plain meaning of a sale or exchange, or show how it falls within an exception promulgated by Congress, the taxpayer will not be entitled to capital gain treatment.

The Respondent's transaction in this case does not fall within the plain meaning of a sale or exchange discussed above. The judgment proceeds in question arose out a trustee's violation of state law. (R. at 4.) The Respondent did not give up something for something else, nor has it ever transferred and terminated its interest in its trust property. (R. at 3-4.) To date, none of the Respondent's original assets have been sold, transferred, or conveyed to a third party, and the title to the trust assets remains the same as the day they were transferred. (R. at 3.) Furthermore, the Respondent cannot get around the sale or exchange requirement in stating that its transaction falls within an exception created by Congress. Therefore, because the Respondent has not demonstrated a sale or exchange of its capital assets, or shown how its transaction is an exception to this general requirement, all gain received in its judgment must be treated and taxed as ordinary income.

B. The Respondent Cannot Retain its Interest in its Trust Property and then Claim that Gain Therefrom Should be Treated as Capital Gain, because a Sale or Exchange Inherently Requires a Taxpayer to Relinquish its Property Interests.

The primary reason why the Respondent should be denied capital gain treatment for its judgment proceeds is the fact the Respondent has never relinquished control over its capital asset. (R. at 3-4.) In cases where there is a question of control, and whether capital gain treatment should be granted, the courts will consider termination of the taxpayer's interests in the underlying property as effectively meeting the sale or exchange requirement. For example, in *Yarbro v. Comm'r* the Fifth Circuit considered whether "an abandonment of property . . . has the same practical effects" as a sale or exchange. 737 F.2d at 485. The court found that "abandonment followed by the mortgagee's foreclosure . . . is the functional equivalent" of a sale or exchange, because "the taxpayer-owner [was] . . . relieved of title in the property." *Id.* at 485-486. Courts follow this rationale in several cases. *See e.g., Hammel*, 311 U.S. at 506-508 (an involuntary foreclosure sale is considered a sale or exchange, and the loss is a capital loss); *Electro-Chemical Engraving Co. v. Comm'r*, 311 U.S. 513, 513-514 (1941) (loss on foreclosure sale of a mortgage acquired for profit was loss from "sale" of a capital asset).

But, in situations where there is no demonstrable "sale or exchange" or termination of a taxpayer's underlying property interests, gain on a capital asset is treated as ordinary gain. This was the main premise behind the Supreme Court's holding in *Dobson v. Comm'r*; since the taxpayers could not demonstrate the proceeds of their securities lawsuit constituted a sale or exchange, the court held the proceeds were taxable as ordinary income. 321 U.S. at 231-232; *See also* Rev. Rul. 74-251, 1974-1 C.B. 41

(proceeds received in settlement of litigation represent ordinary income unless it is “clearly established that there has been a sale or exchange of property”).

The Code further demonstrates the requirement that the taxpayer relinquish its interests in order to achieve capital gain treatment in a transaction. In I.R.C. § 1253(a), regarding the transfer of a franchise, the Code provides a “transfer of a franchise...shall *not* be treated as a sale or exchange of a capital asset if the transferor *retains any significant power, right, or continuing interest.*” (emphasis added). Thus, it follows from the above when a taxpayer retains its interest in the underlying property, any gain resulting from a transaction surrounding that property shall be taxed as ordinary income.

In the present case, the facts of the record demonstrate the Respondent has never relinquished its ownership interests over the capital asset in question. Pursuant to the record, shortly after Mr. Dufont’s death on January 1, 2005, the Respondent gained legal title to its inception assets. (R. at 2.) From the beginning of 2005 to the end of 2006, the inception assets fluctuated in value, but were never sold by the trustee. (R. at 3.) This fact gave rise to litigation, wherein the Respondent, or the trust corpus, received an increase of 3.4 million dollars, but not as a result of portfolio diversification through a sale or exchange. (R. at 3-4). To date, the Respondent retains its original interest in its inception assets, and maintains its I.R.C. § 1014 basis of 2 million dollars. (R. at 4.) These facts demonstrate that the chain of title for the capital asset in question begins and continues with the Respondent. Therefore, since a taxpayer cannot retain its underlying interests in property and claim that gain therefrom is capital gain, this Court should deny the capital gain treatment on taxpayer’s judgment proceeds.

C. The Public Policy behind Preferential Capital Gain Treatment does not Support Treating the Respondent's Lawsuit Proceeds as Capital Gain.

The Respondent's transaction is not congruent with the current policy on the preferential treatment of capital gains. One scholar commented on the policy problems of affording taxpayers the ability to retain their capital assets and then claim that gain therefrom should be treated as capital gain. Jensen, Ronald H., *Can You Have Your Cake and Eat it too?: Achieving Capital Gain Treatment While Keeping the Property*, 5 Pitt. Tax Rev. 75 (2008). The author argues that allowing such transactions does nothing to further the purposes behind the preferential tax treatment of capital gain, specifically, to "spur investment and to encourage the mobility of capital." *Id.* at 120.

In this case, allowing the Respondent to treat its lawsuit proceeds as long-term capital gain, while still retaining the interests in its capital assets, effectively gives the Respondent unintended preferential tax treatment. Such treatment is likely outside an investor's scope of thought concerning a for-profit transaction and its long-term capital gain impact. *See id.* at 86. A sound investment strategy would not involve the retention of a capital asset and the assumption all gain on those assets would be capital gain. The investor anticipates a sale or exchange at some point. Thus, allowing the preferential capital gain treatment in the Respondent's case does nothing to encourage further investment or the mobility of capital, as the Respondent to this date has not relinquished its interests in its capital asset. (R. at 3-4.) Therefore, this Court should not allow the Respondent to receive the preferential treatment it seeks because it is contrary to the investment underpinnings of capital gain tax policy.

D. This Court Should not use the Origin of the Claim Test to Supplant the Additional Statutory Requirement of Demonstrating a Sale or Exchange for a Capital Gain Treatment.

To counter the statutory requirement of a sale or exchange, the Respondent will likely rely on the “origin of the claim test,” which provides that 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.” *Sager Glove Corp. v. Comm’r*, 36 T.C. 1173, 1180 (1961). The Thirteenth Circuit based its opinion largely on the assumption that the Respondent’s judgment proceeds should be treated in the same manner as the item they were intended to replace. (R. at 4.) The court then upheld the Respondent’s position that its judgment proceeds should be treated as capital gain, pursuant to the damages formula in *Matter of Janes*, 90 N.Y.2d 41, 55 (1997) (the state of Mugel follows the law of New York on this point). (R. at 4-5.)

The Petitioner contends this position is incorrect, and urges the Court to consider: (1) that the sale or exchange requirement was established by Congress, and should not be supplanted by the judicially created origin of the claim test; (2) that precedent which diminishes the sale or exchange requirement was decided incorrectly, and is inferior to the precedent of the Code and Supreme Court; and (3) that this Court cannot rely on the *Janes*’ test as a functional equivalent of a sale or exchange.

1. This Court should consider the sale or exchange requirement along with its origin of the claim analysis, because this requirement was established by Congress.

This brief so far laid out the statutory underpinnings of the sale or exchange requirement, and has shown how a taxpayer must meet these requirements in order to gain the preferential tax treatment provided in I.R.C. § 1(h). This Court should consider

these requirements along with its analysis as to whether the Respondent's judgment proceeds warrant capital gain tax treatment. As noted, the origin of the claim test simply states 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." *Sager Glove*, 36 T.C. at 1180. Another court has said the "test is not whether the action was one in tort or contract but rather the question to be asked is 'In lieu of what are damages awarded?'" *Raytheon Prod. Corp. v. Comm'r*, 144 F.d 110, 113 (1st Cir. 1944).

Following this rationale, courts have held if "the recovery represents damages for lost profits, it is taxable as ordinary income," and if the recovery "represents a replacement of capital destroyed or injured, the money received, to the extent it does not exceed basis, is a return of capital and not taxable." *See Sager Glove*, 36 T.C. at 1180.

While the application of the origin of the claim test is relatively clear with respect to lost profits or recovery of basis, the test is not clear as to whether lawsuit or settlement recoveries can be entitled to preferential capital gain treatment. For example, *Raytheon Prod. Corp. v. Comm'r*, decided in 1944, was one of the first cases to put forth the origin of the claim test. 144 F.d at 113. That court considered the question of whether lawsuit "damages for the destruction of business and good will" represented a "return of capital." *Id.* at 114. The court did hold the taxpayer had demonstrated the proceeds represented a recovery of capital, but then vaguely stated: "Compensation for loss of . . . [goodwill] in excess of its cost is gross income." *Id.* at 114 (emphasis added). The court makes no distinction or further qualification as to whether the "excess" in "gross income" would be taxed as ordinary or capital gain. *Id.*

The Tax Court has demonstrated some confusion in applying the origin of the claim test with respect to gain on capital assets resulting from a lawsuit recovery. *Compare Inco Electroenergy Corp. v. Comm’r*, 54 T.C.M. (CCH) 359 (1987) (holding “amounts received for . . . damage to capital assets are taxable as capital gain” but mentions no “sale or exchange” requirement), *and Nahey v. Comm’r*, 111 T.C. 256, 262 (1998) (holding the focus in determining the proper tax treatment depends on whether “settlement of lawsuit constitutes a sale or exchange”). As already explained, this Court does not have to succumb to this confusion due to the Code’s treatment of taxable gains.

The Petitioner contends that a proper analysis of whether capital gain treatment should be afforded to gains resulting from damage to capital assets depends on whether the taxpayer still has a proprietary interest in the underlying property after the resolution of the lawsuit. In other words, with respect to the present case, this Court should conduct its origin of the claim analysis in concert with the statutory sale or exchange requirement. If the facts demonstrate the taxpayer has no remaining interest in the underlying property, and the taxpayer shows the origin of its claim was based on the replacement of that property’s gains, then it would be proper for a court to grant the taxpayer capital gains treatment on the resulting damage award.

Several cases support this type of analysis. In *Megargel v. Comm’r*, for example, the Tax Court considered the tax treatment of settlements proceeds derived from a fraudulently induced stock sale. 3 T.C. 238, 242 (1944). In this case, the taxpayer had transferred stock “upon representations she later considered fraudulently made.” *Id.* In her case, the taxpayer “sought to recover the stock, or, if not deliverable, its value.” *Id.* When the case eventually settled, “she received no stock, but was paid” instead. *Id.* The

court held that “the compromise worked in substance” as a sale of capital, “bringing into effect the law as to taxation of capital gain.” *Id.* at 246. It is important to note the taxpayer transferred the proprietary interests of her capital asset. *Megargel*, 3 T.C. at 242. After recognition of this fact, the court states: “[w]hen we consider the series of transactions here as a whole, it becomes obvious that they should be regarded as a disposition by sale.” *Id.* at 247. Only then does the court conclude “the amount . . . received . . . should be taxed as the proceeds of the sale of capital assets.” *Id.* at 248. Other courts have used a similar analysis in arriving at the conclusion that lawsuit proceeds should received capital gain treatment only after the demonstration of a sale or exchange. *See e.g., Wheeler v. Comm’r*, 58 T.C. 459, 460-461 (1972) (capital gain treatment given to a taxpayer whose building was demolished and land sold prior to settlement of his lawsuit).

In the present case, the Court should employ this analysis in determining whether the Respondent’s judgment proceeds are entitled to capital gain treatment. This court should not overlook the long-standing, statutory requirement that the Respondent demonstrate a sale or exchange. *See Hammel*, 311 U.S. at 507-508 (the “sale or exchange” requirement, as it pertains to capital gains and losses, was a component of the revenue laws of the Act of 1921). In answering this issue, this Court should find that since the Respondent cannot show its transaction is functionally representative of a sale or exchange, the Respondent’s request for capital gain treatment should be denied.

2. This Court should not rely on precedent which diminishes or overlooks the “sale or exchange” requirement in favor of the “origin of the claim” doctrine, because such precedent was decided incorrectly and is inferior to the authority and precedent of the Internal Revenue Code and Supreme Court.

In arriving at its decision, the Thirteenth Circuit relied heavily on the origin of the claim test and precedent it assumed supported the proposition that apparently all gain derived from a capital asset is necessarily capital gain. (R. at 4.) The court additionally gave little credence to the sale or exchange requirement, despite the Petitioner's position to the contrary. (R. at 4-5.) While the court's reliance on this precedent was not absolutely incorrect, it failed to see that the major opinions, which overlook or diminish the sale or exchange requirement, misread or overstate the precedent they rely on in arriving at their conclusions.

The first of these cases is *Big Four Indus, Inc. v. Comm'r*, 40 T.C. 1055 (1963), *acq in result.*, 1964-2 C.B. 3. This case dealt with a patent infringement suit, and the Tax Court considered whether the damages were taxable as ordinary income or capital gain. *Id.* at 1055-56. In arriving at its conclusion, the court held: “[t]o the extent that such amount did not exceed the basis of the capital interest or goodwill destroyed it would be nontaxable, but *it would be taxable as capital gain to the extent of any excess over basis.*” *Id.* at 1060. Now, this conclusion is not inherently wrong, but the court here goes a step further than the precedent it relies on in making its decision, and thereby leaves open the door for misunderstanding.

For instance, the *Big Four* court cites *Sager Glove* as precedent to its decision. *Id.* However, the court in *Sager Glove* only holds that if lawsuit proceeds “[represent] a replacement of capital destroyed or injured, the money received, *to the extent it does not exceed basis*, is a return of capital and not taxable.” 36 T.C. at 1180 (emphasis added). This court does not make the implication the excess of basis is necessarily treatable as capital gain. The same is the case when *Big Four* cites *Raytheon Prod. Corp.* 40 T.C. at

1060. The *Raytheon* court only vaguely holds that “Compensation for loss of . . . [goodwill] in excess of its cost is *gross* income.” 144 F.d at 114. The court makes no distinction as to whether the “excess” in “gross” income is treatable as capital gain or ordinary income. *Id.* It is important to indicate that *Big Four* has never been cited as precedential in a Supreme Court or a Circuit Court case, except in the Thirteenth Circuit’s decision for the present case. (R. at 5.) *Big Four* has only been cited as precedent twice, in *Wheeler*, 58 T.C. at 461, and *State Fish Corp. v. Comm’r*, 49 T.C. 13, 13 (1967).

The second case which overlooks the sale or exchange requirement, and is relied upon by the Thirteenth Circuit in making its decision, is *Inco Electroenergy Corp.*, 54 T.C.M. (CCH) 359. This case blatantly disregards the sale or exchange requirement and holds that “amounts received for injury or damage to capital assets are taxable as capital gain” without further qualification. *Id.* This court primarily relies on the holding in *State Fish Corp. v. Comm’r. Id.* The court in *State Fish*, however, does not reach the exact conclusion that the *Inco Electroenergy* court claims it does. In *State Fish*, the court states if recovery “represents a replacement of capital destroyed or injured, the money received, *to the extent it does not exceed basis*, is a return of capital and is not taxable.” 48 T.C. 465, 473 (1967) (emphasis added). The court then concludes that since the settlement amount “did not exceed [the taxpayer’s] basis . . . it is not taxable.” *Id.* at 477. This court does not suggest that gains on a capital asset automatically warrant capital gain tax treatment without a sale or exchange, as *Inco Electroenergy* does. With the exception of the Thirteenth Circuit, the *Inco Electroenergy* case has only been cited once, but not

directly on the issue of the sale or exchange requirement. *See Getty v. Comm’r*, 913 F.2d 1491, 1496 (9th Cir. 1990).

Based on the above precedent, the Thirteenth Circuit was in error when it announced its decision. (R. at 4-5). This Court should instead rely on the precedent of the Code and what the Supreme Court has held in the past, and overrule the Thirteenth Circuit on this matter. *See* I.R.C. § 1222(3); *Dobson*, 321 U.S. at 231-232.

3. The Thirteenth Circuit cannot rely on the formula in *Matter of Janes* to establish the Respondent’s judgment as comparable to a sale or exchange, because this formula only prescribes a method for calculating damages.

The Thirteenth Circuit inappropriately assumes the formula for calculating damages in a securities lawsuit in *Matter of Janes* is a functional equivalent to a sale or exchange. (R. at 5-6.) In *Janes*, the state court of New York holds that the “measure of damages is the value of the lost capital.” 90 N.Y. at 55. To determine this amount, the court, determines “the value of the stock on the date it should have been sold, and [subtracts] from that figure the value of the stock at the time of the accounting.” *Id.* In the present case, the Mugal Surrogate Court followed this calculation to the letter, and promptly ordered the trustee to add 3.4 million dollars to the trust estate of the Respondent. (R. at 3-4.)

Holding this formula comparable to a sale or exchange, however, is contrary to the precedent cited above. First, this manner for calculating damages does not fit within the plain meaning of a “sale or exchange” provided in I.R.C. § 1222(3). The fact remains that the Respondent to date has not given something in exchange for something else. (R. at 2-4.) Second, the *Janes* formula does not overcome the fact that the Respondent seeks capital gain treatment even though it still retains its original interests. The analysis above

shows granting capital gain treatment to taxpayer who retains its capital asset is contrary to law and capital gains tax policy. Lastly, the Code and the Supreme Court are clear that capital gain treatment necessitates an actual sale or exchange which relinquishes the taxpayer's proprietary interests in the capital asset. I.R.C. § 1222(3); *Dobson*, 321 U.S. at 231-232. Thus, this Court should not use the *Janes* "hypothesized-sale" formula, which is state law, to supplant the sale or exchange requirement. (R. at 5.) Therefore, because the *Janes* formula is insufficient in meeting the sale or exchange requirement, this Court should not allow the Respondent the capital gain treatment it seeks, and it should overrule the Thirteenth Circuit's decision.

II. NO PORTION OF THE RESPONDENT'S JUDGMENT PROCEEDS SHOULD BE CONSIDERED NONTAXABLE RETURN OF CAPITAL, BECAUSE SUCH TREATMENT IS INCONSISTENT WITH THE ORIGIN OF THE CLAIM TEST AND THE TAX POLICY SURROUNDING TAXATION OF ECONOMIC GAINS AND DISALLOWANCES FOR PROPERTY DEVALUATION DEDUCTIONS.

The Respondent cannot treat 2 million of the 3.4 million dollars received from the beneficiaries' judgment as a nontaxable return of capital. The Petitioner argues such treatment is inconsistent with the origin of the claim test, and the tax policies supporting taxation of all gain and disallowances of deductions for property value declination.

Therefore, this Court should overrule the Thirteenth Circuit's decision.

A. Under the Origin of the Claim Test, the Respondent's Recovery Is Taxable because the Actual Proceeds from the Sale of the Stock Would Have Been Taxable Gain.

The Respondent's recovery of lost gain, which would have arisen out of the timely sale of its stock, should be treated in the same manner as other realizations of gain. As stated previously, the determination of whether money received through litigation constitutes taxable income depends on the origin of the claim and the actual basis for

recovery. *Sager Glove*, 36 T.C. at 1180. To show litigation proceeds should be nontaxable as a recovery of basis, the taxpayer must demonstrate the proceeds received are a replacement of capital destroyed or injured. *Id.* The reasoning behind taxing damages that represent lost profits and not taxing damages representing a return of capital, is that the “proceeds of litigation which [act as a] . . . substitute [should be] taxable in a like manner.” *Raytheon*, 144 F.2d at 113. Thus, the ultimate inquiry to determine proper tax treatment is “[i]n lieu of what were the damages awarded.” *Id.*

In determining whether a recovery representing damaged capital is taxable income, proceeds representing lost profits are taxable because the profits would have been taxable; but recovery representing lost capital is nontaxable because it would be a return of capital. *Durkee v. Comm’r*, 162 F.2d 184, 186 (6th Cir. 1944). For example, in *United States v. Safety Car Heating & Lighting Co.*, settlement proceeds from a patent infringement action were taxable as lost profits. 297 U.S. 88 (1936). The court distinguished the case from “one where the basis of the suit is an injury to capital, with the result that the recovery is never income, no matter when collected.” *Id.* at 98. Similarly, courts have determined litigation proceeds should not be considered a return of capital where the basis of the claim “would clearly have been gain in the first instance.” *Swastika Oil & Gas Co. v. Comm’r*, 123 F.2d 382, 384 (6th Cir. 1941) (citing *United States v. Safety Car Heating Co.*, 297 U.S. 88, 98 (1936)). The court in *Durkee* re-emphasized the taxability of proceeds representing gains when it held the “conversion into cash of capital assets, which have increased in value over a period of time, is a realization of the gain in value over the . . . basis of such assets, and such realized gain becomes taxable income.” 162 F.2d at 186.

In *Swastika Oil & Gas Co.*, the petitioner challenged the taxability of settlement proceeds received for the failure to deliver capital stock to the petitioner as part of a contract. 123 F.2d at 383. The court based its decision to tax the proceeds on the premise that “[h]ad the stock been delivered as agreed, or had the petitioner then received its equivalent in money or other property, . . . it would have derived income.” *Id.* at 384. In addition, the court rejected the argument that the proceeds should have been a return of capital solely because the amount received represented capital stock. *Id.*

Likewise, the Respondent’s case presents a situation where if the proceeds had been received in the normal course of a sale or exchange, absent the negligence of the trustee, the Respondent would have recognized a taxable gain of 3 million dollars. (R. at 3.) The Dufont stock would have been exchanged for 5 million dollars, 2 million of which would have constituted a return of capital, and 3 million would have been taxable gain. *Id.* This is a similar scenario to that described in *Durkee* and *Swastika*, where the origin of the claim would have resulted in a taxable gain.

The Thirteenth Circuit’s decision realizes an unforeseen scenario that allows the Respondent to defer 2 million dollars of realized gain without an exchange. (R. at 4.) The Thirteenth Circuit’s analysis seems to derive not from the origin of the claim, or asking “in lieu of what were the proceeds received,” but from an analysis of the classification of these stocks as a capital asset. However, as was offered in *Swastika*, proceeds are not to be considered a return of capital just because they arise out of a capital asset. 123 F.2d at 384. Consequently, applying the origin of the claim test to this case, the value lost by the Respondent was more akin to lost profits than to lost capital.

Therefore, the recovery should not be treated as a nontaxable return of capital but should be taxed as ordinary income.

B. The Respondent's Recovery Cannot Be Treated as a Nontaxable Return of Capital because Tax Policy Supports Taxing all Economic Gain.

The litigation award received by the Respondent should be taxable because the proceeds represented economic gain. Inherent in the definition of income under the Code is the concept that taxation should correlate with economic gain. In *United States v. Gotcher*, the court said: "For a taxpayer to have income under section 61 . . . there must be an economic gain that benefits the taxpayer personally." 401 F.2d 118 (5th Cir. 1968).

Further, the economic benefit of the taxpayer is a controlling factor in determining taxable income. *Cent. Loan Inv. Co. v. Comm'r*, 39 B.T.A. 981, 984 (1939). The Treasury has distinguished a "return of capital" from situations which provide an economic gain to the taxpayer. For instance, the Treasury has held that a settlement was a return of capital since the taxpayer did not receive any economic gain from the settlement but was "merely [made] whole under the contract." Rev. Rul. 81-277, 1981-2 C.B. 14. Similarly, a recovery by a taxpayer as recompense for an error made by his tax preparer, which caused the taxpayer to expend more tax than he would have had the error not occurred, was held to be nontaxable because it represented a restoration and not economic gain. *See Clark v. Comm'r*, 40 B.T.A. 333, 335 (1939).

In contrast, the Respondent realized economic gain from the receipt of the judgment proceeds representing the decline in the value of the stock. (R. at 4.) The Respondent was not "merely made whole," but substantially improved its economic situation by realizing profit from the stock while retaining ownership. (R. at 4.) Not only did the Respondent receive substantial benefit by reaping the benefits of the stock

without having to sell it, the Thirteenth Circuit allowed the majority of the equity to pass to the Respondent tax-free. *Id.* This conflicts with precedent equating a return in capital with a restoration by not taxing a transaction that results in substantial economic gain.

C. The Thirteenth Circuit's Decision Contradicts Congressional Policy of Disallowing Deductions for the Declination of a Property's Value.

The Respondent's recovery should be taxable because treating the recovery as nontaxable is likened unto allowing a deduction for the diminution of the stock's value, contradicting the intent to disallow such deductions. The Code only allows deductions for uncompensated losses sustained in the taxable year. I.R.C. § 165(a). The mere reduction in value of property is not enough to establish a loss under 165(a). *See United States v. White Dental Mfg. Co.*, 274 U.S. 398, 401 (1927). Consequently, "[n]ot allowing a deduction for a loss, but treating [its] recovery . . . as a return of capital yields the same result . . . as allowing a deduction for the loss and taxing the recovery." Lawrence Zelenak, *The Taxation of Tax Indemnity Payments: Recovery of Capital and the Contours of Gross Income*, 46 Tax L. Rev. 381, 386-87 (1991).

Additionally, the Treasury and the courts have made it clear that a loss must actually be realized to be deductible. *See* Treas. Reg. § 1.165-1(b) ("a loss must be evidenced by closed and completed transactions"); *CRST, Inc. v. Comm'r*, 92 T.C. 1249, 1252 (1989) (holding diminution in value of operating authority was nondeductible because petitioner maintained its rights in the property); *Lakewood v. Comm'r*, 109 T.C. 450, 459 (1997) (holding diminution in value of land was nondeductible because the property continued to be held for future use or sale).

In the present case, the reduction in value of the Respondent's stock was never realized and thus not deductible. There was no fixed or closed transaction since the

Respondent retained the stock. (R. at 4.) Further, the Respondent was compensated for the loss in the stock's value. *Id.* Hence, allowing the recovery to be considered a return of capital would allow the Respondent to benefit from a loss that never actually occurred, creating an identical result to a deduction for diminution in value, which contradicts Congressional intent. Therefore, this Court should not allow this outcome and the entirety of the Respondent's recovery should be taxed.

III. THE RESPONDENT'S JUDGMENT PROCEEDS DERIVED FROM THE TRUSTEE'S BREACH OF FIDUCIARY DUTY DO NOT RESULT IN AN INVOLUNTARY CONVERSION OF PROPERTY UNDER I.R.C § 1231.

In the Respondent's case, the lapse of the trustee's duty to diversify property held in the trust, resulting in judgment proceeds being distributed back into the trust, does not constitute an involuntary conversion under the plain language of the I.R.C. § 1231.

Additionally, court precedent has consistently disallowed I.R.C. § 1231 treatment to taxpayers receiving awards from dispute resolutions and lawsuits involving securities.

Thus, the Petitioner argues that the Thirteenth Circuit cannot rely on I.R.C. § 1231 to justify capital gain treatment of the Respondent's judgment proceeds. (R. at 6.)

A. Property that has not Been Destroyed and Remains in its Original Condition cannot Be Recognized as an Involuntary Conversion Under the Plain Language of I.R.C. § 1231.

The Thirteenth Circuit cannot hold there has been a destruction of property, and the destruction has been compulsory and involuntary, when the Respondent's inception assets remain intact for their intended purpose. The Code maintains as a general rule the entire amount of the gain or loss on the sale or exchange of property shall be recognized as a taxable event. I.R.C. § 1001(c). However, I.R.C. § 1033 provides an exception to this rule, in that an involuntary conversion is untaxed or deferred at the taxpayers election.

Involuntary conversion under I.R.C. § 1033 occurs “if property (as a result of its destruction in whole or in part, theft, seizure, or requisition or condemnation or threat or imminence thereof) is compulsorily or involuntarily converted.” Most involuntary conversions fall under I.R.C. § 1231, adopted after I.R.C. § 1033, and include property “used in the trade or business, or any capital asset which is held for more than [one] year and is held in connection with a trade or business or a transaction entered into for profit.” I.R.C. § 1231(a)(3)(A)(ii). The Court of Appeals for the Thirteenth Circuit found I.R.C. § 1231(a)(3)(A)(ii) as offering alternative support to its position that the Respondent was entitled to capital gain treatment for its judgment proceeds. (R. at 6.)

As with all statutory analysis, this Court in its analysis of I.R.C. § 1231 should look to the plain meaning of the statute’s words. The Supreme Court in *F. Drew Caminetti v. United States* has said “[statutory] words are uniformly presumed, unless the contrary appears, to be used in their ordinary and usual sense, and with the meaning commonly attributed to them.” 242 U.S. 470, 485-86 (1917). Black’s Law Dictionary defines “involuntary conversion” as the “loss or destruction of property through theft, casualty, or condemnation.” 357 (8th ed. 2004). One scholar notes that under I.R.C. § 1231 the destruction to the property must be such that the property is unfit for its intended purpose. *Jensen*, 5 Pitt. Tax Rev. at 100. This thinking also underlies the principle that the taxpayer’s interest in the property must terminate to qualify for capital gain treatment. *Id.* at 101.

A leading case on the topic of involuntary conversions is *Willis v. Comm’r.* 42 T.C. 468 (1964). In *Willis*, a shipping vessel sustained damage that constituted a partial destruction of the property. 42 T.C. at 469. However, the owners sold the entire ship

without repairing the damage, and then claimed it had been involuntarily converted. *Willis*, *Id.* at 474. The court held “the wording of the statute makes it plain that it does not include conversions or sales of property where the owner had a choice of keeping the property or converting or selling [the property].” *Id.* The holding in *Mathey v. Comm’r*, supports the conclusion of the court in *Willis*. 10 T.C. 1099 (1948). In *Mathey*, the taxpayer claimed that recovery upon a patent infringement suit deserved treatment as an involuntary conversion. 10 T.C. at 1105. The taxpayer argued theft of his patent had rendered it worthless. *Id.* However, the court held that although the patent was stolen, the taxpayer had received adequate compensation, and “continued to own, possess, and actually use his patent” and therefore could not claim his lawsuit proceeds were nontaxable due to involuntary conversion. *Id.*

Based on the precedent above, the Respondent cannot claim the judgment proceeds represent involuntarily converted property. Like the taxpayer in *Willis*, the Respondent has yet to prove the property no longer serves its intended purpose, which is to provide income and an inheritance for Mr. Dufont’s beneficiaries. (R. at 2-3.) The Respondent’s inception assets had a value of 2 million dollars and have the same value to date. (R. at 3.) That amount is still available for the benefit of Donald Dufont’s beneficiaries. *Id.* Also, just as in *Mathey*, the Respondent was compensated for the tortious actions of the trustee, and continues to own, possess, and actually use the 2 million dollars for its intended purpose. (R. at 3-4.) Allowing the Respondent I.R.C. § 1231 treatment does not fall within the statute’s plain meaning. Therefore, the Respondent cannot rely on I.R.C. § 1231 treatment.

The Respondent could argue its judgment proceeds represent involuntarily converted property characterized as lost investment opportunity. Allowing I.R.C. § 1231 to apply in these situations, however, is inappropriate because there is not absolute assurance of the actual realization of gain in the Respondent's case. If the Respondent is allowed such treatment, it could open the door for taxpayers to claim capital gain treatment for lost investment opportunities, many of which include a great deal of speculation. Today's economic climate lends credence to this position, since the likelihood of taxpayers winning judgments for the mishandling of their securities is great. Many taxpayers could view this Court's acceptance of I.R.C. § 1231's application to the Respondent as justification to receiving capital gain treatment on settlement or litigation proceeds arising out of a speculative stock transaction. Regardless of whether this argument concerning involuntarily converted investment opportunities is accepted, the Respondent's property remains for its intended purpose, so the Respondent is still not entitled to I.R.C. § 1231 treatment.

B. Courts Have Consistently Denied Non-Recognition under I.R.C. § 1033 and its Successors, Including I.R.C. § 1231, to Taxpayer Awards in Securities Dispute Resolutions and Lawsuits.

Precedent limits the situations where I.R.C. §§ 1033 and 1231 qualify certain capital asset as involuntary conversions in securities lawsuits. For example, in *Carver v. Comm'r*, the taxpayer was involuntarily forced from his position as President. 50 T.C.M. (CCH) 929 (1985). In a subsequent lawsuit, the taxpayer was able to relinquish his stock for cash in a settlement against the corporate officials. *Id.* The court found the taxpayer was not compelled to sell his stock for settlement purposes, even though it may have been in his best economic interest. *Id.* The court reasoned that the "destruction contemplated

by I.R.C. § 1033(a) is something more than [the taxpayer's] subjective view that the value of his stock had diminished," and consequently the taxpayer could not rely on the statute for capital gain treatment. *Id.*

Similarly in *Hitke v. Comm'r*, the majority shareholders threatened to put the minority shareholder at a disadvantage. 296 F.2d 639, 641 (7th Cir. 1961). The court held that the resulting settlement, "although compelled by economic, business or personal considerations, is not an involuntary conversion within the purview of the statute." *Hitke*, 296 F.2d 639 at 644. It is common for courts to disallow involuntary conversions in transactions emanating from dispute resolutions and lawsuits related to securities. *See e.g., Dear Publication & Radio, Inc. v. Comm'r*, 274 F.2d 656, 660 (3rd Cir.1960) (holding a court order to auction stock, does not entitle a taxpayer to I.R.C. § 1231 tax treatment).

The commonality between these cases is (1) stock ownership, (2) stock damaged in a way contrary to the owner's interest, (3) settlement or judgment regarding the stock which is beneficial to the stockholder, and (3) denial of I.R.C. § 1231 treatment. In the present case, the Respondent owns 2 million dollars in stock, the trustee mishandled the stock, and the Surrogate Court entered a judgment in favor of the Respondent. (R. at 2-4.) Therefore, this Court should rely on this precedent and deny the Respondent I.R.C. § 1231 treatment of the judgment proceeds.

CONCLUSION

The Respondent is not entitled to the capital gains tax treatment it seeks. The Respondent has failed to demonstrate a sale or exchange, and cannot seek capital gains treatment when it retains its underlying property interest. Such treatment would be

contrary to law. The Thirteenth Circuit also erred when it set aside the sale or exchange requirement in favor of the origin of the claim tests. When it comes to capital gains tax treatment of lawsuit or settlement proceeds, the Court should consider both tests.

Furthermore, no portion of the recovery received by the Respondent should be considered a nontaxable return of capital. Applied correctly, the origin of the claim test would tax the Respondent's recovery since it represents lost gain and not a restoration of capital lost. Further, the Thirteenth Circuit's treatment allows the Respondent to realize substantial gain without corresponding tax, and creates a situation that contradicts congressional policy of disallowing deductions for the mere diminution in property value.

Lastly, the Thirteenth Circuit incorrectly held the Respondent could receive capital gains treatment of the settlement proceeds claiming the property had been involuntarily converted under I.R.C. §1231. This holding is in direct conflict with the plain language of the Code along with prior precedent involving analogous recoveries.

Therefore, for the aforesaid reasons, the Petitioner respectfully requests that this Court reverse the Thirteenth Circuit and rule in its favor.

RESPECTFULLY SUBMITTED THIS 10TH DAY OF FEBRUARY, 2009

Counsel for Petitioner