

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
UNITED STATES COURT OF APPEALS
FOR THE THIRTEENTH CIRCUIT

BRIEF FOR THE RESPONDENT

Counsel for the Respondent

QUESTIONS PRESENTED

1. Did the Thirteenth Circuit correctly hold that \$2 million of the litigation proceeds paid by the Trustee for injury and damage to the taxpayer's property constituted tax free recovery of the taxpayer's basis in such property?
2. Did the Thirteenth Circuit correctly hold that capital gain treatment applied to the remaining \$1 million of the litigation proceeds because it substituted capital gain from the prudent sale of a capital asset?

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Thirteenth Circuit is unreported. All references to the Thirteenth Circuit's opinion are cited as Comm'r v. Donald Dufont Testamentary Trust, No. 2008-46 at 2-6 (13th Cir. 2008). The decision of the Tax Court is unreported.

STATUTE INVOLVED

The cited Internal Revenue Code sections are listed in the Appendix A.

STATEMENT OF THE CASE

Statement of the Facts

Dora and John Dufont are the beneficiaries of the Donald Dufont Testamentary Trust (Trust). (R. at 2). The Trust's corpus consists of 100,000 common stock shares of the publicly traded company, Dufont, Inc. (the Dufont Stock) with an original basis of \$20.00 per share or two million dollars total. (R. at 3). By the end of 2005, the corpus was worth \$50.00 per share or \$5 million, but by the end of 2006 was back to its original value of \$2 million. (R. at 3.). Concerned about the Trust's performance, Dora and John demanded an interim accounting from the trustee, Main Bank (the Trustee). (R. at 3).

Dora and John objected to this accounting. (R. at 3). Believing the Trustee violated the Mugel Prudent Investor Act, they sought judicial review. (R. at 3); see Mugel Prudent Investor Act, [sic no citation] (following New York's Prudent Investor's Act, McKinney's EPTL § 11-2.3(b)(3)(C) & (D) (2008)). The Act mandates the Trustee to "diversify assets." (R. at 3). The O'Brian County Surrogate Court held the Trustee violated these mandates when it failed to sell the Dufont Stock at the end of 2005. (R. at 3).

As a result of this failure, the Trust was awarded \$3.4 million. (R. at 3). The Surrogate Court determined this amount under the Matter of Janes formula. (R. at 3.); see also 90 N.Y.2d 41, 55 (N.Y. 1997). Under this formula, the proceeds of the Dufont Stock sale should have been \$5 million. (R. at 4). From this amount, the court subtracted the value of the Dufont Stock at the time of the accounting (\$2 million). (R. at 4). Therefore, the proceeds from the deemed sale were \$3 million. (R. at 4). Exercising its discretion the court awarded \$400,000 in interest. (R. at 4). Therefore, the Trustee paid

\$3.4 million in order to make the corpus whole. (R. at 4).

After making this payment and continuing its practice of not making distributions to the beneficiaries, the Trustee filed its 2007 fiduciary tax return. (R. at 4). Consistent with the Surrogate Court's deemed sale, the tax return reflected the judgment as follows:

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

(R. at 4). In response to this filing, the Internal Revenue Service (Service) assessed a deficiency against the Trust based on its assertion that the entire judgment was ordinary income. (R. at 4). Finding this assertion incorrect, the Trustee filed a petition for redetermination with the Tax Court. (R. at 4).

Procedural History

The Tax Court rejected the Service's claim that the amount of the award represented ordinary income and found for the Trust. (R. at 4-5). The Tax Court relied on the recognized principle of taxation, which provides that taxability of the litigation proceeds depends upon the nature of the claim and the actual basis of recovery. (R. at 4-5). The court found that since here the recovery is for the injured or damaged property, the money received, to the extent of the taxpayer's basis in the Dufont Stock (\$2 million), is not income to the Trust. (R. at 4-5). The excess over basis (\$1 million) represents capital gain. (R. at 4-5).

The Thirteenth Circuit agreed with the Tax Court and found for the Trust. (R. at 5). The court determined the nature of the award by looking at what the litigation proceeds were replacing. (R. at 5). The court found since the award was based on the deemed sale of the Dufont Stock, "the award represents capital gain because it represents

what would be given capital gain treatment if there actually had been a prudent sale of stock.” (R. at 5-6). As a result, the court held the amount to the extent of the basis (\$2 million) was a tax-free recovery of the taxpayer’s basis in the Dufont Stock. (R. at 6). The court, therefore, reduced the basis in the Dufont Stock to zero and held that excess of basis (\$1 million) received capital gain treatment. (R. at 6, n.3).

To support its decision the court stated several policy arguments. (R. at 6). The court found its decision “comes within the spirit, if not the letter, of the Code,” including section 1231(a)(3)(A)(ii) which eliminated the “sale or exchange” language for capital gain treatment of involuntary conversions. (R. at 6). The court decided there was no sound justification to treat involuntary economic destruction of the value of the taxpayer’s Dufont Stock differently from physical destruction. (R. at 6). Therefore, the court held, the litigation proceeds (in excess of basis) for the economic destruction of the taxpayer’s property, including diminution in the Dufont Stock value, should receive capital gain treatment.

SUMMARY OF THE ARGUMENT

The Thirteenth Circuit affirmed the Tax Court's decision in favor of the taxpayer-respondent, the Donald Dufont Testamentary Trust (Trust), therefore, the Trust properly reported the litigation proceeds on its tax return. (R. at 4). The court correctly found \$2 million constitute a tax free recovery of basis in the Dufont Stock based mere compensation for an injury to its property. (R. at 5-6). The court properly held the excess of basis (\$1 million) was capital gain because it substituted for capital gain in lieu of the sale of the Dufont Stock. (R. at 5-6). There is no dispute that the \$400,000 in interest constitutes ordinary income. (R. at 5-6).

As to the \$2 million portion of the award there are several reasons for affirming the Thirteenth Circuit's decision. First, the Trust did not receive any economic gain from the proceeds because the Trustee paid \$2 million for causing an injury to the Trust's property. As a result, \$2 million in litigation proceeds did no more than restored the Trust to the position it would have occupied but for the Trustee's wrongdoing. Since there was no accession to wealth on the part of the Trust to the extent of its basis, \$2 million is a tax-free recovery of basis.

Second, since the Trust is allowed not to recognize income when there is no economic gain, under section 1016 of the Internal Revenue Code, the basis in the Dufont Stock must be adjusted and reduced to zero. As a result of the basis adjustment, when the taxpayer sells the Dufont Stock it will pay tax on the full amount of the sale price. Thus, the taxpayer will not receive any additional benefit. It is unjustified to punish the taxpayer for the wrongful conduct of the third party (the Trustee) by transforming a free recovery of basis into ordinary income.

As to the remaining \$1 million, it has consistently received capital gain treatment. It represents the proceeds from a deemed sale of the Dufont Stock. The deemed sale is a substitute for capital gain; therefore, it falls within the spectrum of recognition events that qualify for capital gain treatment. Neither the courts nor the Service pigeonhole litigation proceeds into an Internal Revenue Code section or simply deny capital gain treatment. Instead, when proceeds resemble or represent what would receive capital gain treatment external to litigation, the courts and Service accord the proceeds capital gain treatment. The proceeds resemble a sold capital asset; as opposed to something resembling ordinary income, like interest. The deemed sale washed away the wrongdoing and made the corpus whole. Both the courts and the Service have upheld similar treatment even when the taxpayer retained title to the capital asset. Litigation proceeds attached to a capital asset, like the Dufont Stock, retain the capital asset's tax attributes.

Additionally, the \$1 million taxed at capital gain rates upholds the congressional policies underlying capital gain treatment. Legislative history shows Congress firmly believes that similarly situated taxpayers need to receive the same tax treatment. An actual sale of the Dufont Stock and the Trustee's payment for failing to sell the Dufont Stock are economically equivalent. Therefore, based on congressional intent both receive capital gain treatment regardless of the precise language of the Internal Revenue Code. The Thirteenth Circuit recognized the overarching policies underlying capital gain by affirming the original reporting of the amount in excess of basis as capital gain. The Trust's original reporting of the \$1 million as capital gain also upholds court precedent and how the Service advises taxpayers. Affirming the Thirteenth Circuit is, therefore, proper.

ARGUMENT

I. THE AWARD EQUAL TO \$2 MILLION IS THE TAX FREE RECOVERY OF BASIS BECAUSE THIS AMOUNT REPRESENTS DAMAGE TO THE PROPERTY OF THE TRUST CAUSED BY THE TRUSTEE'S BREACH OF DUTY OF CARE.

The Thirteenth Circuit was correct in holding that the taxpayer, Donald Dufont Testamentary Trust (the Trust) properly reported to the Internal Revenue Service (the Service) the litigation proceeds as:

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

(R. at 4). The O'Brian County Surrogate Court awarded the litigation proceeds to the Trust because the Trustee, Main Bank, had failed under the Mugel Prudent Investor Act to sell the only capital asset in the Trust – the Dufont Stock. (R. at 3-4).

The court correctly found that \$2 million constitute the recovery of basis in the Dufont Stock because the Trust did not recognize any economic gain when the award represented an amount for injury or damage to the Dufont Stock. (R. at 5-6). The court properly held that the excess of basis (\$1 million) is capital gain because it was in lieu of the sale of the Dufont Stock and substituted for lost capital gain. (R. at 5-6). There is no dispute that \$400,000 in interest constitutes ordinary income. (R. at 5-6).

The Trust has met its burden of proof by a preponderance of the evidence at both the Tax Court and the appellate level. See Freeman v. Comm'r, 33 T.C. 323, 328 (1959) (stating the Service's determination is rebuttable by a preponderance of the evidence). The Supreme Court has recognized that the "findings of two courts should not ordinarily be disturbed." Corn Prod. Refining Co. v. Comm'r, 350 U.S. 46, 51 (1955). Affirming the Thirteenth Circuit's holding is proper.

As to the \$2 million portion of the award the Thirteenth Circuit properly held that since the Trust was compensated for the lost or damaged property, an amount equal to the Trust's basis in the Dufont Stock is a tax free recovery of basis. (R. at 5-6). There are several reasons why this Court should uphold the Thirteenth Circuit's decision. First, the \$2 million paid by the Trustee for causing a loss does no more than restore the Trust to the position it would have occupied but for the Trustee's wrongdoing. Since the Trust did not receive any economic gain to the extent of its basis in the Dufont Stock, there was no accession to wealth. Therefore, the amount recovered by the Trust to the extent of its basis is not income. Second, since under recently amended section 1016 the basis in the Dufont Stock has to be adjusted and reduced to zero, when the taxpayer does sell the Dufont Stock it will pay tax on the full amount of the sale price. See 26 U.S.C.A. § 1016(a)(1) (West 2008). Consequently, as a result of the basis adjustment the taxpayer will not receive any additional benefit. Finally, it is unjustified to tax the taxpayer who did not recognize any economic gain to the extent of its basis in the Dufont Stock.

The standard of review to be applied to this appeal from the Thirteenth Circuit is de novo because it involves only questions of law. Pierce v. Underwood, 487 U.S. 552, 558 (1988).

A. The Courts Have Long Held And The Internal Revenue Service Has Agreed That The Amount Of The Award Paid For The Replacement Of Lost Or Damaged Property Is Not Income To The Extent Of Basis In Such Property.

Since the law is clear that a judgment replacing damaged, lost, or unpaid property is not taxable to the extent of the basis, the Thirteenth Circuit correctly found \$2 million of the award represents the Trust's tax free recovery of basis. (R at 5-6); see also Rev. Rul. 73-161, 1973-1 C.B. 366 (stating that it is well established that where the award

equals compensation for lost or damaged property, the money received represents a tax free recovery of basis); see also United States v. Safety Car Heating & Lighting Co., 297 U.S. 88, 98 (1936) (concluding that if “the basis of the suit is an injury to capital, with the result that the recovery is never income, no matter when collected”); Farmers’ & Merchs’. Bank v. Comm’r, 59 F.2d 912, 914 (6th Cir. 1932) (stating that “one may be recompensed for an injury but it is a rare case in which one should have a profit out of it”).

The receipt constituting a recovery of basis is not income within the meaning of section 61, because there is no accession to wealth on the part of the taxpayer. See I.R.C. § 61 (2006). For example, here, to the extent of the basis in the Dufont Stock, the Trust did not recognize any economic benefit because it had only received back the property it had lost due to the Trustee’s wrongdoing. In order to recover the basis the taxpayer does not need to prove actual physical damage to the property; economic damage - loss caused by the failure to diversify and sell the Stock – will suffice. See Big Four Indus., Inc. v. Comm’r, 40 T.C. 1055, 1059 (1963) (holding the patent rights were damaged by the infringement). Regardless, under recently amended section 1016 the basis has to be adjusted and in this case reduced to zero. 26 U.S.C.A. § 1016(a)(1) (West 2008) (providing for the adjustment to the basis “for the expenditures, receipts, losses, or other items, properly chargeable to capital amount”). Due to this reduction in basis the Trust will not recognize any additional tax benefits upon the sale of the Dufont Stock because the Trust will have to pay tax on the full amount of the sale.

These fundamental principles regarding tax free recovery of basis apply to the payments received in litigation awards as well. See Sanders v. Comm’r, 255 F.2d 629, 635 (5th Cir. 1955) (holding the underlying principle of the taxation of litigation awards

provides that “[t]he fact that the sum was recovered in a lawsuit...does not change the character of the income regardless of the intervening time.”) (emphasis added); see also Spangler v. Comm’r, 323 F.2d 913, 919 (9th Cir. 1963) (same). Therefore, litigation payments that only restore a taxpayer to the position she would have occupied but for the defendant’s wrongdoing, do not constitute income because the taxpayer receives no economic gain. I.R.S. C.C.A. 200504001 (Oct. 12, 2004) (citing Raytheon Prod. Corp. v. Comm’r, 144 F.2d 110 (1st. Cir. 1944)).

The Surrogate Court, by applying the State of Mugel law, had determined that the nature of the award here is lost capital or in other words damages to the Trust’s property. (R. at 3-4). Under Matter of Janes, the court must restore lost capital to the Trust by awarding money damages which would return the Trust to its value had there been no breach of duty of care by the Trustee and had the sale taken place. 90 N.Y.2d 41, 55 (N.Y. 1997) (“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”); see also Matter of Garvin, 256 N.Y. 518, 521 (N.Y. 1931) (“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...., if the stock is still retained by the estate, the value of the stock at the time of the accounting”). Since the court had awarded the litigation payments for damages to the Dufont Stock, including diminution in its value, the \$2 million of the award constitute the taxpayer’s tax free recovery of basis in the Dufont Stock. This result is supported by the principles of taxation, a well established case law and the Service’s guidance.

In fact, in the first comprehensive American treatise on the law of income taxation, Henry Campbell Black wrote regarding the taxation of civil awards: “If the cause of action were an injury to property or contract rights, [the judgment] might be considered as . . . a replacement of [damaged property].” Henry C. Black, Income Taxation § 38 (1913). Since then, the courts have held that if the recovery represents a replacement of lost property, “the money received, to the extent it does not exceed the basis,” is a tax free recovery of basis. Sager Glove Corp. v. Comm’r, 36 T.C. 1173, 1180 (1961); see also Daugherty v. Comm’r, 78 T.C. 623, 638 -639 (1982) (holding that if the claim is for damage to a capital asset, the amount received only taxable if the recovery exceeds the asset's basis); Wheeler v. Comm’r, 58 T.C. 459, 461 (1972) (same); Big Four Indus., 40 T.C. at 1060 (finding that to the extent that damages to property, whether tangible or intangible, do not exceed the cost or other unrecovered basis of such property, they are merely a recovery of basis); see also Raytheon, 144 F.2d at 112 (holding that if the suit is for injury to the asset, the award represents a tax free recovery of basis).

In State Fish Corp. v. Comm’r, the court found the award constituted a tax free recovery of basis because the taxpayer received it for the seller’s violation of the non-compete agreement which diminished the goodwill of the taxpayer’s business. 48 T.C. 465, 477 (1967). The court relied on the nature of the lawsuit to conclude that the recovery was for damages to property rather than for lost profits. Id. at 474. Similarly, in Inco Electroenergy Corp. v. Comm’r, the court found that the claim of the taxpayer who sued Exxon for infringing on one of its existing trademarks was for actual damages to the trademark and associated goodwill. 54 T.C.M. (CCH) 339 (1987).

Here, the Trust, like the businesses in State Fish and Inco Electroenergy, was damaged by losing its capital due to the Trustee's failure to sell the Dufont Stock. The Dufont Stock - property retained by the Trust - was damaged when, similar to goodwill, it significantly decreased in value.

Moreover, the judgment of the Surrogate Court stemmed from a claim for lost capital or damaged property as opposed to lost profits or punitive damages, which are taxable as ordinary income. (R. at 4-5); see also Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955) (holding the punitive damages constitute ordinary income). In contrast to Carter's Estate v. Comm'r, where the taxpayer claimed that due to the antitrust violation she lost profits that she could have been receiving until her death, here beneficiaries claimed the actual damages – capital that they have lost due to the Trustee's breach. 298 F.2d 192, 194 (8th Cir. 1962); see also (R. at 3). Furthermore, under the Matter of Janes formula, the Surrogate Court did not award the taxpayer "what it might have expected to gain but only that which it had actually lost." Farmers' & Merchs'. Bank, 59 F.2d at 913-914; see also Perry v. United States, 160 F. Supp. 270, 271 (Ct. Cl. 1958) (holding the taxpayer recovered its basis when he received back the corpus of a trust after the donee refused to comply with the terms of the gift). As a result, the Thirteenth Circuit correctly followed a precedent, which provides that litigation awards do not change the character of income, and properly refused to transform the taxpayer's recovery of basis into ordinary income.

The Service's general position on this issue provides additional support for the Thirteenth Circuit's decision in favor of the taxpayer. Historically the Service conclusively treated judgments that awarded payments for damaged property as a tax free

recovery of basis. Charles R. Cuttler, Taxation of the Proceeds of Litigation, 57 Colum. L. Rev. 470, 499 n.5 (1957) (citing U.S. Treas. Reg. 33 (rev.) art. 94 (1918)); see also Rev. Rul. 73-161, 1973-1 C.B. 366 (“it is well established that a sum received in settlement based upon a claim of loss of business profits constitutes taxable income but where the settlement represents damage for lost capital, the money received may be a return of [basis]”) (citing Safety Car Heating and Lighting Co., 297 U.S. at 88; Raytheon, 144 F.2d at 110); I.R.S. P.L.R. 8134189 (May 29, 1981) (recognizing that the courts have consistently held that if the recovery is received for lost or damaged property, the money received is a recovery of basis in such property). In fact, the Service recognized the general rule that a litigation award is treated, for purposes of Federal income tax, in accordance with the type of claim to which it is attributable. Rev. Proc. 67-33, 1967-2 C.B. 659. To the extent that the award was attributable “to the assets that were involved in the suit and the actual damages determined with respect thereto,” the taxpayer was allowed to recover its basis in such assets tax free. I.R.S. P.L.R. 8134189 (May 29, 1981). However, in order for the taxpayer to treat the portion of the settlement as a recovery of basis, the taxpayer had to adjust the basis. Rev. Proc. 67-33, 1967-2 C.B. 659. Similarly, the Trust’s basis in the Dufont Stock was adjusted as well and reduced to zero. 26 U.S.C.A. § 1016 (a)(1) (West 2008); see also Rev. Rul. 81-152, 1981-C.B. 433 (finding that section 1016 applies to litigation or settlement awards).

For example, in the Field Service Advice Memoranda, the Service has been willing to find that the amount of the settlement from the acquisition of damaged property (land) constitutes tax free recovery of basis. I.R.S. F.S.A. 200228005 (Mar. 29, 2002); see also Rev. Rul. 81-152, 1981-C.B. 433 (ruling that the proceeds from litigation which

represent amounts to repair or replace the asset should be treated as a recovery of basis); I.R.S. L.T.R. 93 TNT 185-25 (Sept. 7, 1993) (stating the proceeds of the claim for defects in the asset represent a recovery of basis in such asset); see also Robert W. Wood, Securities Lawsuit Recoveries: Capital Gain or Ordinary Income?, 108 Tax Notes 767, 769 (2005) (finding that the Service has allowed recovery of basis when the taxpayer did not sell or exchange the asset). The Service had recognized that since “the land is a capital asset, the settlement proceeds represent an amount for injury or damage to a capital asset.” I.R.S. F.S.A. 200228005 (Mar. 29, 2002). Hence, “the proceeds should be treated as recovery of taxpayer’s basis in the land.” Id.

Similarly, here, the Dufont Stock (as land) is a capital asset, and the litigation proceeds represent amounts for lost capital or damage to the Dufont Stock, including diminution in its value. Consequently, the proceeds, to the extent of basis, are a recovery of the taxpayer’s basis in the Dufont Stock. In contrast to Rev. Rul. 74-251, where the taxpayer only claimed that its right to select an investment advisor and principal underwriter was damaged, here there was actual damage to the Dufont Stock when its value in the Trust was significantly decreased. See 1974-1 C.B. 234. Therefore, as correctly held by the Thirteenth Circuit, the \$2 million portion of the award is a tax free recovery of basis. (R. at 4, 6). The basis in the Dufont Stock should be adjusted and reduced to zero. See (R. at 6).

B. According To The Principle Stated By The Courts And Agreed By The Service, To The Extent Of Basis, The Restoration Of The Trust’s Property Which Would Not Have Been Lost In The Absence Of The Trustee’s Breach, Is Not Income To The Trust.

Since the property of the Trust was diminished in value due to the Trustee’s wrongdoing, the \$2 million portion of the award constitutes the tax free recovery of basis

or in other words restoration of the property value. The General Counsel acknowledged that both the courts and the Service “have concluded in a variety of contexts” that if, as here, “the taxpayer’s capital is diminished...*as a consequence of the improper action of another party and that other party reimburses or compensates the taxpayer for the lost capital, then the reimbursement or compensation is not includible in the taxpayer’s gross income.*” I.R.S. G.S.M. 38605 (Jan. 8, 1981) (emphasis added).

For example, in Clark v. Comm’r, the tax attorney compensated the taxpayer for the amount that the taxpayer had to pay in tax liability due to his attorney’s negligent mistake. 40 B.T.A. 333, 335 (1939). The Board of Tax Appeals found that the amount of reimbursement was not income to the taxpayer, because 1) the tax attorney breached the reasonable standard of care, 2) the breach caused the taxpayer to lose his property (money), and 3) the amount of reimbursement was measured by the amount of lost property. Id.; see also Rev. Rul. 57-47, 1957-1 C.B. 23 (the Service acquiesced to Clark). In the above mentioned General Counsel Memoranda (GSM), the Service relied on the Clark court’s reasoning to conclude that since the taxpayer lost property due to the breach of the reimbursing party, and the amount of the reimbursement was measured by the amount of lost capital, the taxpayer returned its capital to the extent of the basis. I.R.S. G.S.M. 38605 (Jan. 8, 1981); see also Rev. Rul. 68-378, 1968-2 C.B. 335 (finding that the restoration of the taxpayer’s capital that would not have been lost in the absence of wrongful or improper conduct by the restoring party is not income to the taxpayer); Rev. Proc. 67-33, 1967-2 C.B. 659 (same).

Here, as in Clark, the Trust received compensation for the Trustee’s breach of duty of care, which caused the loss of capital/ property when the Dufont Stock

significantly diminished in value. In addition, as in Clark and GSM, the Surrogate Court measured the amount of reimbursement by the value of the lost capital. Although, in contrast to the taxpayers in Clark and GSM, the Trust was not forced to spend an amount that would not have been spent had the reimbursing party not breached, the Trustee's breach caused an impairment of the Trust's capital, which significantly diminished in value. As a result, the Thirteenth Circuit correctly held that the \$2 million of the award constitute the taxpayer's recovery of basis in the Dufont Stock.

C. It Is Unjustified To Tax The Trust Who Did Not Recognize Any Economic Gain When The Trust Only Recovered Its Basis In The Dufont Stock.

This Court has when awarding compensatory damages, the courts should aim to place the injured party in the same pecuniary position she would have occupied but for the damaging act. Miller v. Robertson, 266 U.S. 243, 257 (1924) (“One who fails to perform his contract is justly bound to make good all damages that accrue naturally from the breach; and the other party is entitled to be put in as good a position pecuniary as he would have been by performance of the contract.”) Here, but for the Trustee's breach of duty of care, the Trust would not have realized any income to the extent of its basis in the Dufont Stock. As a result, if the entire amount of the award, including the Trust's recovery of basis, would be taxed as ordinary income (as proposed by the Petitioner), the injured taxpayer would not be made whole, but instead, would be unfairly punished for the wrongful conduct of the Trustee. In contrast, allowing the taxpayer to recover its basis, tax free, would put the Trust in a position similar to that which it would have occupied but for the Trustee's breach.

One might argue that this outcome is improper because the taxpayer had retained the asset and, consequently, received a prohibited deduction for a mere decline in value.

See 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, 111 (2008).

However, unlike the deduction, the basis offset is more limited and simply allows the taxpayer not to recognize income when there is no economic gain. Id. Moreover, section 1016, which provides for a reduction in basis, only requires that an item be “properly chargeable to capital account.” 26 U.S.C.A. § 1016(a)(1) (West 2008). The Service recognized that under section 1016, the amount of the award reduces the taxpayer’s basis. Rev. Rul. 68-378, 1968-C.B. 335 (stating that under section 1016 the amount of the award reduces the taxpayer’s basis). Due to the basis reduction to zero, the retention of the Dufont Stock by the taxpayer does not pose any harm to the theory that the litigation proceeds for the lost or damaged property constitute tax free recovery of basis.

As a result, by reducing the basis and taxing the taxpayer in the same manner it would be taxed but for the Trustee’s failure to sell the Dufont Stock, the Thirteenth Circuit put the taxpayer in a similar position to that which it would have occupied but for the Trustee’s wrongful conduct. The court reached a just and fair result by refusing to uphold the Respondent’s position and punish the taxpayer for the wrongful conduct of the third party.

II. \$1 MILLION OF THE LITIGATION PROCEEDS IN EXCESS OF BASIS MUST RECEIVE CAPITAL GAIN TREATMENT BECAUSE IT IS A SUBSTITUTE FOR CAPITAL GAIN FROM THE PRUDENT SALE OF A CAPITAL ASSET.

The Thirteenth Circuit held capital gain treatment applied to \$1 million of the proceeds. (R. at 5-6); see I.R.C. § 1(h) (2006) (defining the maximum capital gain rate). This is correct, because the deemed sale of the Dufont Stock represents a substitute for capital gain. (R. at 6). The courts uphold this treatment, the Service advises this treatment, and congressional intent mandates this treatment.

A. When Litigation Proceeds Are A Substitute For Capital Gain Precedent Requires Capital Gain Treatment.

What litigation proceeds represent determines their tax treatment. See Glenshaw Glass, 348 U.S. at 431 (stating proceeds “for unlawful conduct cannot detract from their character”). Here, the \$1 million of the deemed sale “represents what would be given capital gain treatment if there actually had been a prudent sale of stock.” (R. at 5-6). Therefore, consistent with court precedent, the Thirteenth Circuit held that \$1 million of the proceeds from the deemed sale received capital gain treatment.

This precedent acknowledges the spectrum of what rightfully qualifies as capital gain. The \$1 million fall within this spectrum, because it resembles capital gain arising from a sale. (R. at 6). Therefore, under the “family resemblance” test, these proceeds are capital gain. Lattera v. Comm’r, 437 F.3d 399, 405 (3rd Cir. 2006) (adopting the Supreme Court’s “family resemblance” test).

The “family resemblance” test places at one end of the spectrum “[s]everal types of *assets we know to be capital: stock, bonds, options, and currency contracts, for example.*” Id. (citing Ark. Best Corp. v. Comm’r, 485 U.S. 212, 222-223 (1986)) (stating “stock is most naturally viewed as a capital asset”) (emphasis added). At the other end of

the spectrum “are several types of rights we know to be ordinary income, e.g., rental income and interest income.” Id. (holding exchange of annual payments for a lump-sum was a “substitute[e] for something that would otherwise be received at a future time as ordinary income [, therefore, it] should be taxed the same way”). The test then sets forth two additional factors to analyze items, which “do not bear a family resemblance to the items in either category.” Id. These additional factors are unnecessary for the current analysis.

The Dufont Stock is a capital asset. It is “property held by the taxpayer (whether or not connected with his trade or business)” and has none of the characteristics of the eight exclusions found in §1221. I.R.C. § 1221 (2006). Therefore, the litigation proceeds attached to the Dufont Stock clearly fall on the capital asset side of the spectrum. Compare Ark. Best Corp., 485 U.S. at 222-223 (holding “[b]ecause stock is most naturally viewed as a capital asset,” recognizing events emerging from stock receive capital gain treatment), with Comm’r v. P.G. Lake, Inc., 356 U.S. 260, 265 (1958) (stating the right to income from the oil production was “essentially a substitute for what would otherwise be received at a future time as ordinary income”).

The “family resemblance” test is similar to the “nature of the claim” test used by the Thirteenth Circuit. Like the Thirteenth Circuit, this Court uses the “nature of the claim” test to address awards that cannot be pigeonholed into a single Internal Revenue Code section, like “Other Terms Relating to Capital Gains and Losses.” I.R.C. § 1222(3) (2006) (allowing long-term capital after “the sale or exchange of a capital asset held for more than 1 year” occurs); see Arrowsmith v. Comm’r, 344 U.S. 6, 8-9 (1952) (holding proceeds arising out of litigation regarding a capital asset retained its capital gain or loss

characteristics regardless of the intervening time); Lyeth v. Hoey, 305 U.S. 188, 194 (1938) (stating the underlying claim determines the character of the proceeds received). Both “look to the substance, rather than the form, of transactions to determine whether payments to a taxpayer constitute capital gain or ordinary income.” National-Standard Co. v. Comm’r, 749 F.2d 369, 372 (6th Cir. 1984) (disagreeing with the Service that the transaction “should be viewed as an exchange of francs for francs rather than as a discharge of an obligation;” therefore, the loss was a capital loss); see also Nahey v. Comm’r, 196 F.3d 866, 868 (7th Cir. 1999) (acknowledging there were exceptions to section 1222, but determined discharge of debt, a non-capital asset, was not one of them, because it had none of the characteristics of capital gain).

The “nature of the claim” test requires

[t]he 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.

(R. at 4-5); see also Victor E. Gidwitz Family Trust v. Comm’r, 61 T.C. 664, 673 (1974) (holding tax consequences are “controlled by the nature of the litigation”); Blain v. Comm’r, 8 T.C.M. (CCH) 540 (1949) (holding the settlement award in excess of salary and commission was capital gain, because “[t]he classification for tax purposes of amounts received in settlement of litigation is to be determined by the nature and basis of the action settled”).

Simply stated, the “question to be asked is ‘In lieu of what were the damages awarded?’” Raytheon, 144 F.2d at 112-13 (holding the settlement was “in lieu of” a

capital asset, goodwill, thus received capital gain treatment). When the award is “in lieu of” capital gain, the award receives capital gain treatment. Big Four Indus., 40 T.C. at 1060. The principle driving this is “amounts received in compromise of a claim must be considered as having the same nature as the right compromised.” Alexander v. Comm’r, 72 F.3d 938, 942, 944 (1st Cir. 1995) (holding the proceeds were “essentially a substitute for the salary and benefits” required under contract; therefore ordinary income rates apply).

For example, in Megargel v. Comm’r, the nature of the claim “was primarily an assertion of ownership in, and a demand for,” stock. 3 T.C. 238, 243 (1944). The Megargel court headed this Courts warning not to follow form at the expense of the substance of the matter. Id. (citing Helvering v. Safe Deposit & Trust Co. of Baltimore, 316 U.S. 56, 65 (1942)). Consequently, when evaluating litigation proceeds, “[t]he question of whether there was sale of capital assets was therefore not essential to the conclusion reached.” Id. at 244, 246. The court held the capital gain spectrum included the right to maintain and fulfill a right of action. Id. (finding all the cases that held settlement proceeds produced ordinary income involved noncapital asset claims). The court equated this to when a company paid stockholders for their stock, but allowed them to retain title. Id. at 247-48.

Applying these principles, the Megargel settlement proceeds were a recovery of basis and the excess received capital gain treatment, because it “could not . . . be considered to have any other nature” but capital gain. Id. at 245. Juxtapose this analysis onto the \$1 million and the same outcome occurs. In Megargel, as here, the damages arose out of a capital asset claim. The retention of title is not dispositive, but the fact that the \$1 million was a substitute for lost capital gain is. As a substitute, it must be capital gain.

Anytime proceeds substitute lost capital gain, they receive capital gain treatment. See e.g. Daugherty, 78 T.C. at 638-639 (stating “[i]f the claim is for damage to a capital asset, the amount received in settlement is treated as a return of capital, taxable at capital gain rates if the recovery exceeds the asset's basis”); State Fish, 48 T.C. at 477 (holding settlement proceeds compensated for the wrongdoing and damage to a capital asset; thus a substitute for capital gain); Big Four Indus., 40 T.C. at 1059 (holding the proceeds received capital gain treatment, because it was in lieu of the intangible capital asset, patent rights). For example, in Tribune Publ’g Co. v. Comm’r, the Service and the taxpayer agreed, “the nature of the underlying action determines the tax consequences of the resolution of the claim.” 836 F.2d 1176, 1177-78 (9th Cir. 1988). The proceeds were “in lieu of the additional consideration that Tribune would have received had it bargained with knowledge of the true value of Boise Cascade stock rather than the market value which was allegedly inflated by Boise Cascade's failure to disclose material facts.” Id. at 1178. The court “engage[d] in the fiction” of washing away the wrongdoing and recreating the transaction with the correct values. Id. at 1179; see also Durkee v. Comm’r, 162 F.2d 184, 186 (6th Cir. 1947) (stating “the allegations as to profits both before and after the acts complained of ‘were only an evidential factor in determining actual loss and not an independent basis for recovery.’”) (quoting Farmers’ and Merch.’ Bank, 59 F.2d at 913); Raytheon, 144 F.2d at 113 (stating the use of lost profits as a means of determining the damages to a capital asset does not alter the true nature of the claim); Inco Electroenergy, 54 T.C.M. (CCH) 339 (stating use of lost profits as an evidentiary factor in determining damage to goodwill has been held not to alter the true basis of the recover). Finding Tribune realized a profit above its basis in the stock, the

court required Tribune to pay capital gain on those profits. Id. at 1180. This is the exact process used by the Thirteenth Circuit. It held the “hypothesized-sale measure of damages defines what the trust has received for tax purposes, regardless of whether the stock is actually sold or not[, therefore] the lost capital portion of the award represents capital gain because it represents what would be given capital gain treatment if there actually had been a prudent sale of the stock.” (R. at 5-6).

Simply stated, the award was “in lieu of” a sale of the Dufont Stock; therefore, the \$1 million replaced lost capital gain. There simply is no evidence of correcting something that is ordinary income. Compare Raytheon, 144 F.2d at 113 (finding no evidence of a claim for lost business profits which are ordinary income; therefore the award was accorded capital gain treatment), with Freeman, 33 T.C. at 329-30 (stating “[t]here is no evidence in this record of a loss of capital, or goodwill, or any tangible or intangible capital asset or evidence of any closed transaction disposing of or destroying such an asset recognizable for tax purposes;” therefore the award is ordinary income); Sager Glove Corp., 311 F.2d at 211 (holding the litigation involved noncapital assets which ordinarily and therefore, through litigation, had the “orderly tax treatment” of ordinary income). This is not “[a] recovery for damage[s that] if received in the normal course, would be taxable as ordinary income.” Jensen, supra, at 88; see Big Four Indus., 40 T.C. at 1059 (holding the origin of the claim is a replacement of capital assets and had the taxpayer demonstrated a basis in that asset capital gain treatment would have occurred).

There is, however, evidence of a capital asset, the Dufont Stock, which requires capital gain treatment. See Republic Automotive Parts, Inc. v. Comm’r, 68 T.C. 822, 823-24 (1977)

(holding regardless of the claim arising in tort or contract the focus for characterization is the “character of the assets for which the amounts were paid”); State Fish, 48 T.C. at 477 (holding settlement proceeds compensated for the wrongdoing and damage to a capital asset; therefore had there been an excess of basis it would have received capital gain treatment). For example, in Inco Electroenergy, the court focused on the nature of the claim – damaged capital assets. 54 T.C.M. (CCH) 339 (rejecting the argument that the settlement represented “a normal commercial transaction constituting a sale or exchange of a capital asset”). The proceeds replaced the decreased value of these capital assets caused by the wrongdoing. Id. The court held, “[s]ince these items are capital assets the proceeds are taxable as capital gain.” Id. (stating “amounts received for injury or damages to capital assets are taxable as capital gain”). Likewise, the Thirteenth Circuit recognized the true nature of the judgment. The \$1 million substituted lost capital gain; therefore, it falls within the spectrum of capital gain treatment. The Trust’s original reporting of the \$1 million as capital gain was correct.

B. A Substitute Of Capital Gain Receives Capital Gain Treatment As Advised By The Service.

The complexity of capital gain treatment has not been lost on the Service. It has used the “nature of the claim” test in court and when giving advice or guidance to taxpayers. See e.g. Wachovia Bank & Trust Co. v. United States, 288 F.2d 750, 754 (4th Cir. 1961) (stating the government argued for capital gain treatment because “in substance, if not in form also,” the taxing event was “within the scope of” capital gain treatment); I.R.C. T.A.M. 200438038 (June 2, 2004) (determining the origin of the claim was a contract dispute that naturally received ordinary income, whereas tort claims are capital gain) (citing Durkee, 162 F.2d 184; Raytheon, 144 F.2d at 110; Freeman, 33 T.C. 323; Farmers and Merch.’s Bank, 58 F.2d 912); see also I.R.C. F.S.A. 1997 WL 33314788 (Mar. 6, 1997) (determining the origin of the claim governed

the “taxability of the proceeds of a lawsuit”). When proceeds substitute capital gain, the Service has agreed the proceeds receive capital gain treatment. Cf. Hanover Bank v. Comm’r, 369 U.S. 672 (1962) (acknowledging while the Service’s advise is not precedent, it does “reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws”).

For example, in a recent Field Service Advice Memoranda, the Service took the position that the nature of the claim was damages to a capital asset. I.R.S. F.S.A 200228005 (Mar. 29, 2002). The proceeds compensated the buyer (taxpayer) for injuries caused by contamination to his land. Id. The court awarded the difference between the value of the land before and after the contamination. Id. Based on this, the Service advised the taxpayer to treat the proceeds as capital gain, despite the taxpayer retaining title to the land. Id. This advice is interchangeable with the Thirteenth Circuit’s holding. The retention of the Dufont Stock, therefore, is not dispositive. The \$1 million compensated the Trust for the difference between the value before the wrongful retention of the Dufont Stock and the value after the wrongful retention. (R. at 5). This became the deemed sale proceeds. Id. These proceeds have received capital gain treatment continuously and correctly.

Another example is Rev. Rul. 74-251, 1974-1 C.B. 234. As compared to capital gain attributes, the proceeds in this Revenue Ruling had ordinary income attributes. The taxpayer’s litigation arose from purchasing future investment advice. Id. Ignoring the form of the transaction, a purchase, the Service determined the proceeds substituted future anticipated income. Id. Without the settlement, the anticipated income when recognized would be ordinary income. Id. A taxpayer cannot alter tax treatment based on when recognition occurs. Id. Therefore, the future anticipated income was ordinary income. Id. Unlike this taxpayer, the

Trust is not trying to alter the Dufont Stock's tax attributes. It is simply continuing to apply the tax treatment associated with the Dufont Stock – capital gain.

Finally, in Rev. Rul. 81-152, the nature of the claim required capital gain treatment. 1981-C.B. 433. The proceeds compensated the condominium development unit owners for the defective common areas. Id. The owners jointed owned these capital assets. Id. The judgment did not require the owners to give up any of their property rights or ownership. Id. The Service, relying on Rev. Rul. 73-161 and Raytheon, determined the proceeds substituted for lost capital gain, because it represented loss to a capital asset. Id.; see also Raytheon, 144 F.2d at 110; Rev. Rul. 73-161, 1973-1 C.B. 366 (stating the lump-sum represented lost future income, not damage to a capital asset; therefore, taxed as ordinary income). The Service acknowledged litigation proceeds attached to a capital asset, like the Dufont Stock, retain the capital asset's tax attributes. Under the Service's guidance, the taxpayers applied the award first to a recovery of basis and any excess received capital gain treatment. Id.

In each of these situations, the Service recognized the taxpayer became whole. Similarly, the Trust's corpus became whole. In all of these circumstances, the proceeds were a substitute for capital gain. Following the above advice and guidance provided by the Service, the litigation proceeds; therefore, represent a return on capital and any excess taxed at the capital gain rate.

C. Applying the Capital Gain Rate to Litigation Proceeds That Substitute Capital Gain From The Prudent Sale Of A Capital Asset Is An Outcome Congress Would Find Equitable And Just.

Everything on the capital gain spectrum must support the policies underlying capital gain. Two of these policies are preventing “bunching of income” and “facilitate[ing] movements of capital in the marketplace.” Jensen, supra, at 82-84. “Bunching of income” is “the hardship of the realization in one year of an advance in

value over cost built up in several years, which is what Congress sought to ameliorate by the capital-gains provisions.” Comm’r v. Gillette Motor Transp., Inc., 364 U.S. 130, 135 (1960). The \$1 million receiving capital gain treatment supports these policies. First, treating the \$1 million as capital gain avoids the “bunching of income” hardship by applying the lower capital gain rates. Additionally, the failure of the Trust to “facilitate movement[] of capital” is the only reason the \$1 million was awarded. Holding individuals accountable for actions adverse to a policy is one means of enforcing that policy.

In fact, these policies have been the driving force behind the last three amendments of section 1222. See e.g. H.R. Rep. No. 98-861 (1984) (Conf. Rep.) (amending to affirm the guiding principles and fill some loopholes); H. Rep. No. 94-1515 (1976) (Conf. Rep) (same); H.R. No. 91-413 (1969) (same); S. Rep. No. 91-552 (1969) (same). Interestingly, during all of these debates, Congress never once focused on the “sale or exchange” language. Id.; see also Helvering v. Morgan's, Inc., 293 U.S. 121, 126 (1934) (holding “the true meaning of a single section of a statute . . . however precise its language, cannot be ascertained [without its] history”). Yet, these amendments occurred under the backdrop of several prominent cases either not addressing a sale or exchange or liberally interpreting the “sale or exchange” language. See e.g. Comm’r v. Brown, 380 U.S. 563, 572 (1965) (holding a liberal interpretation of “sale or exchange” does not “thwart the obvious purpose of the statute”); Raytheon, 144 F.2d at 112-13 (giving no mention to a sale or exchange but instead holding the harming of a capital asset gave rise to capital gain treatment); Big Four Indus., 40 T.C. at 1059 (holding the proceeds received capital gain treatment, because it was in lieu of the intangible capital asset,

patent rights, even though the corporation maintained ownership of the right). Congress' decision not to raise concerns about these rulings is "almost conclusive evidence that [this] interpretation has congressional approval." Nichols v. United States, 260 F.3d 637, 650 (6th Cir. 2001).

Further evidence of Congress approving a capital gain spectrum is the enactment of sections 1231(a)(3)(A)(ii) and 1234A(1). I.R.C. § 1231(a)(3)(A)(ii) (2006); I.R.C. § 1234A(1) (2006). Neither mentions the need for a sale or exchange. Section 1231(a)(3)(A)(ii) allows capital gain for "involuntary conversion." I.R.C. § 1231(a)(3)(A)(ii) (2006). The only difference between an involuntary conversion, and the economic destruction caused by the failure to sell stock is the form of the damage. Id.; see e.g. Grant Oil Tool Co. v. United States, 381 F.2d 389, 391, 395-96 (Ct. Cl. 1967) (stating damage in the "economic sense" caused by action not controlled by the taxpayer also met the definition of "involuntary conversion," because section 1231(a) "only requires a lawful or tortuous taking of property," not "physical annihilation"); cf. Cox v. Comm'r, 78 T.C. 1021, 1027 (1982) (showing how one section of the Internal Revenue Code was a "congressionally created example of the 'substance over form' doctrine"). The Thirteenth Circuit confirmed the proceeds compensated the Trust for the destruction caused by a wrongful act; therefore, receiving capital gain treatment. (R. at 6) (stating treating the excess of basis as capital gain "comes within the spirit, if not the letter" of section 1231(a)(3)(A)(ii)).

Under section 1234A(1) the "cancellation, lapse, expiration, or other termination of a right or obligation" of a capital asset is treated as capital gain. I.R.C. § 1234A (2006). The enactment of section 1234A "ensure[s] that similar economic transactions

are taxed in the same manner.” H.R. Rep. No. 105-148; at 453-54 (1997). For example, the Committee found some transactions, “such as settlements of contracts to deliver a capital asset, *are economically equivalent to a sale or exchange* of such contracts since the value of any asset is the present value of the future income that such asset will produce.” Id. (emphasis added). These settlement awards fall on the capital gain spectrum, thus receiving capital gain treatment. Id. Taxing these and similar settlements the same “reduces the uncertainty concerning the tax treatment” they receive. Id.; see also Robert W. Wood, Litigation Settlements, Sales and Exchanges, and Section 1234A, 109 Tax Notes 776, 777 (2005). An actual sale or exchange of the Dufont Stock and the Trustee’s payment for failing to sell the Dufont Stock are economically equivalent. Therefore, both receive capital gain treatment.

Under Congress’ intended purpose, it is evident a substitute for what would have been capital gain under ordinary circumstances receives capital gain treatment. As the court stated in United States v. Maginnis,

[u]nless and until Congress establishes an arbitrary line on the otherwise seamless spectrum between [substitute for capital gain] transactions and conventional capital gain transactions, the courts must locate the boundary case by case, a process that can yield few generalizations because there are so many relevant but imponderable criteria.

356 F.3d 1179, 1183 (9th Cir. 2004) (citations omitted); see also Harrison v. Schaffner, 312 U.S. 579, 581 (1941) (stating “the operation of the statutes taxing income is not dependent upon such ‘attenuated subtleties,’ but rather on the import and reasonable construction of the taxing act”). The Thirteenth Circuit recognized the overarching policies underlying capital gain by affirming the original reporting of the amount in excess of basis as capital gain.

Finally, to tax the \$1 million as ordinary income unfairly punishes the beneficiaries for demanding the Trustees meet their fiduciary duties. See Biedenharn Realty Co. v. United States, 526 F.2d 409, 420 n.38 (5th Cir. 1976) (noting the Service’s concern over the unfair treatment of taxpayers engaged in similar transactions receiving different tax treatment). Statler Trust v. Comm’r, 361 F.2d 128, 132 (2d Cir. 1966) (holding “the letter of [a code section] must yield when it would lead to an unfair and unintended result based on Congress’ policy for enacting” the section). This would undermine the fundamental goal of the tax system to treat similarly situated taxpayers fairly and equitable. See Lettera, 437 F.3d at 410 (agreeing with other courts that taxpayers receive similar tax advantages under like situations).

Just like these three sections of the Internal Revenue Code clearly fall on the capital gain spectrum, so to do substitutes for capital gain. To fully implement Congress’ policies the full spectrum must be acknowledged. The \$1 million substitutes capital gain. It represented a hypothetical sale of the Dufont Stock. (R. at 3-4). For all of these reasons, the Supreme Court’s upholding of the Thirteenth Circuit’s decision to affirm the manner in which the Trust originally reported the \$1 million as capital gain is proper.

CONCLUSION

For the reasons stated above, the respondent, Donald Dufont Testamentary Trust (taxpayer), respectfully requests the Supreme Court of the United States to hold the tax treatment of the litigation proceeds as reported on the fiduciary tax return is proper thereby affirming the Thirteenth Circuit.

Respectfully submitted this 10th day of February 2009.
Counsel for the Respondent

APPENDIX A
INTERNAL REVENUE CODE SECTIONS

I.R.C. § 1(2006)

§ 1(h) Maximum Capital Gains Rate

- 1) In general.--If a taxpayer has a net capital gain for any taxable year, the tax imposed by this section for such taxable year shall not exceed the sum of—
 - A) a tax computed at the rates and in the same manner as if this subsection had not been enacted on the greater of—
 - i) taxable income reduced by the net capital gain; or
 - ii) the lesser of—
 - I) the amount of taxable income taxed at a rate below 25 percent; or
 - II) taxable income reduced by the adjusted net capital gain;
 - B) 5 percent (0 percent in the case of taxable years beginning after 2007) of so much of the adjusted net capital gain (or, if less, taxable income) as does not exceed the excess (if any) of—
 - i) the amount of taxable income which would (without regard to this paragraph) be taxed at a rate below 25 percent, over
 - ii) the taxable income reduced by the adjusted net capital gain;
 - C) 5 percent of the adjusted net capital gain (or, if less, taxable income) in excess of the amount on which a tax is determined under subparagraph (B);
 - D) 25 percent of the excess (if any) of—
 - i) the unrecaptured section 1250 gain (or, if less, the net capital gain (determined without regard to paragraph (11))), over
 - ii) the excess (if any) of—
 - I) the sum of the amount on which tax is determined under subparagraph (A) plus the net capital gain, over
 - II) taxable income; and
 - E) 28 percent of the amount of taxable income in excess of the sum of the amounts on which tax is determined under the preceding subparagraphs of this paragraph.

* * *

I.R.C. § 61 (2006)

§ 61(a) Gross Income Defined

- a) General definition. Except as otherwise provided in this subtitle [IRC Sections 1 et seq.] , gross income means all income from whatever source derived, including (but not limited to) the following items:
* * *

26 U.S.C.A. § 1016(a)(1) (West 2008)

§ 1016(a)(1) Adjustments to Basis

- a) General rule. Proper adjustment in respect of the property shall in all cases be made - -
1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made—
A) for taxes or other carrying charges described in section 266 or
B) for expenditures described in section 173 (relating to circulation expenditures),
for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years.

I.R.C. § 1221 (2006)

§ 1221(a) Capital Asset Defined

- a) In general. For purposes of this subtitle [IRC Sections 1 et seq.], the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include—
* * *

I.R.C. § 1222 (2006)

§ 1222(3) Other Terms Relating to Capital Gains and Losses

- For purposes of this subtitle [IRC Sections 1 et seq.]—
3) Long-term capital gain. The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income.

I.R.C. § 1231 (2006)

§ 1231(a)(3)(A)(ii)(II) Property Used in the Trade or Business and Involuntary Conversion

a) General rule.—

* * *

3) Section 1231 gains and losses.--For purposes of this subsection--

A) Section 1231 gain.--The term “section 1231 gain” means—

* * *

ii) any recognized gain from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) into other property or money of—

* * *

II) any capital asset which is held for more than 1 year and is held in connection with a trade or business or a transaction entered into for profit.

I.R.C. § 1234A (2006)

§ 1234A Gains or Losses from Certain Terminations.

Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—

- 1) a right or obligation (other than a securities futures contract, as defined in section 1234B [26 USCS § 1243B]) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
- 2) a section 1256 contract (as defined in section 1256 [IRC Sec. 1256]) not described in paragraph (1) which is a capital asset in the hands of the taxpayer,

shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement).