No. 2009-15

SUPREME COURT OF THE UNITED STATES

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

Brief for Respondent

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QUESTIONS PRESENTED

I. WHETHER A SETTLEMENT FOR ECONOMIC LOSS OF A STILL RETAINED CAPITAL ASSET SHOULD BE TREATED AS A LOSS OF CAPITAL OR AS ORDINARY INCOME.

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STATEMENT OF THE FACTS

The taxpayer respondent is a testamentary trust established under the will of Donald Dufont (Donald), a domiciliary of the State of Mugel who died on January 1, 2005. Under the terms of the trust, the trustee, Main Bank, during the lifetime of Donald's daughter Dora, could, in its "sole discretion", distribute trust income to Dora, or accumulate it and add it to corpus. On Dora's death, the trust corpus and any accumulated income was to be distributed to Dora's son, John. The corpus bequeathed to the trust under Donald's will consisted entirely of 100,000 shares of the common stock of Dufont, Inc. (Dufont), a publicly traded company founded by Donald's father, Charles.

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

None of the Dufont stock has ever been sold by the trustee, Main Bank, in compliance with the Mugel Investor Act. In 2007, both Donald and John demanded an interim accounting from the trustee. After Main Bank filed the interim account with the O'Brian County Surrogate's Court describing the above-stated history of the Dufont stock, Donald and John objected to the account and asked that the trustee be surcharged for a breach of its fiduciary duty of care.

On December 15, 2007, the O'Brian County Surrogate, after a hearing,

determined that the trustee, in compliance with its duty of care, specifically its duty, under the Mugel Prudent Investor Act, to diversify so-called "inception assets" within a reasonable time, should have sold the Dufont stock at the end of 2005 when it had a value of $50 a share.

The surrogate court adopted the following principals in classifying the loss that were stated in In the Matter of the Estate of Janes, 90 N.Y.2d 40, 55 (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 . . . . In imposing liability upon a fiduciary on the basis of the capital lost, the court should determine the value of the stock on the date it should have been sold, and subtract from that figure the proceeds from the sale of the stock or, if the stock is still retained by the estate, the value of the stock at the time of the accounting. Whether interest is awarded, and at what rate, is a matter within the discretion of the trial court . . . . Dividends and other income attributable to the retained assets should offset any interest awarded.

Id.

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

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

(a) 2,000,000 as a tax-free return of capital (basis)

(b) 1,000,000 as long term capital gain, and

(c) 400,000 as ordinary income

The Commissioner assessed a deficiency against the trust for 2007, taking the position that the entire $3,400,000 should be treated as ordinary income. The trustee petitioned the Tax Court for a redetermination of this deficiency. In the Tax Court the Commissioner contended that neither capital gain treatment nor basis offset was permissible because the trust still owned all of the Dufont stock it had received under Donald's will. In the Commissioner's view, since there had been no sale or exchange, the trust would continue to have a §1014 basis of $2,000,000 in the stock, so that if the stock were sold at that value there would be no gain or loss. The Tax Court rejected the Commissioner's contention. The Commissioner then appealed to The Thirteenth Circuit Court of appeals, which affirmed the Tax Court's ruling in that the $1,000,000 is capital gain and the $400,000 interest is ordinary income.

The Court opined that the prevailing view in both academia and the courts is that a taxpayer shall classify its damages with the "in lieu" test and ask what the damages were meant to replace. It the Appellate Court went on to find further support of its position in the idea that the taxpayer suffered an involuntary conversion and destruction to its property as under §1231 of the tax code.

LAW AND ARGUMENT

I. A SETTLEMENT FOR ECONOMIC LOSS OF A STILL RETAINED CAPITAL ASSET SHOULD BE TREATED AS A LOSS OF CAPITAL AND NOT AS ORDINARY INCOME.

Soon after advent of taxation, the government discovered a need to lower the rate of tax on assets that were held for a long period of time. Before 1921, gains from assets held for a long period of time, such as investment property and stocks, were taxed at the ordinary income tax rate. This created a disincentive to selling and ultimately

diversifying stocks because it created a tax penalty. Leonard Burman, The Labyrinth of Capital Gains Tax Policy, 5-7 (Brookings Institution Press) (1999). Economists referred to this phenomenon as a property becoming 'locked in' because the owner did not wish to incur taxation and therefore held the property indefinitely. Id. at 4. This 'locked in' trend worried economists and the government because it could have the effect of generating a stale economy. Id. Thus the capital gains tax was born. The tax has gone through numerous variations before it became the one known today. A capital asset is simply defined as "property held by the taxpayer." Internal Revenue Code §1221(a). There are numerous exceptions to the general definition leaving a capital asset to be one that is primarily investment purposes. Internal Revenue Code §§ 1221(a)(1)-(8).

Some of the most common modern capital assets are stocks, bonds and mutual funds. These are the assets that trigger the use of capital gains (or loss) treatment for most Americans. Since the instatement of a capital gains tax, there have been questions as to when it is triggered, in particular when a settlement or judgment is involved. The courts have found, and the Internal Revenue Service (hereafter 'Service') has not countered, that a sale or exchange is a prerequisite to capital gains treatment. Instead, courts have created a special method for assessing taxation of settlements involving loss of capital. This method has not been discouraged by the Service and should be applied to the case at hand.

A. In order to be considered a capital loss or gain there does not need to be a sale or exchange of assets.

The general mode of thinking requires that capital gains treatment is not triggered unless there is a sale or exchange of a capital asset. This arises from the treatment of

capital gains in the tax code that state that short and long term capital gain "means gain from the sale or exchange of a capital asset." Internal Revenue Code §§ 1221(1)-(4). However, courts have concluded that in many instances involving settlement or judgment, this is not a necessity. The few times that the court has strayed from this approach and required a sale or exchange are easily distinguishable from the facts of case of the Donald DuFont Testamentary Trust (hereafter 'Trust').

i. The court has often disregarded the need for a sale or exchange as a prerequisite for applying capital gains treatment.

The Internal Revenue Code's requirement of a sale or exchange as the necessary trigger for capital gains treatment has long been shunned by the court in cases involving settlements or judgments for loss of capital. Over the years, the court has allowed basis recovery and capital gains treatment for capital assets that the taxpayer still retained. Sometimes the court has simply not addressed the question of a sale or exchange requirement; in other cases, the court has simply disregarded the requirement.

Often the court has ruled that a settlement represented loss of capital of a still retained asset, and therefore achieved capital gains treatment, without even addressing the sale of exchange requirement of §1221. In Inco Electroenergy Corp. v. Comm'r, 54 T.C.M. (CCH) 359 (1987), Inco obtained a settlement from Exxon for trademark infringement but retained and continued to use the trademark. Id. The court stated that in order to assess the taxability of the settlement it would need to determine the nature of the assets. Id. In ruling that the claims was for damages to trademark and goodwill, both of which are capital assets, it found that the award deserved capital gains treatment. Id. Nowhere in the ruling did the court mention the sale or exchange requirement. In fact,

the court, in arriving at their holding, specifically disregarded an alternative argument from Inco that sale or exchange of a capital asset had occurred and therefore it could not be taxed as ordinary income. Id. Except for a difference in the 'type' of capital assets (stocks versus trademark and goodwill) the facts of Inco are very similar to those of the Trust. The court ruled the stock of the Trust was a capital asset. Therefore, abiding by the ruling of Inco the court did not need to address the issue of a sale or exchange requirement.

The court also ignored the sale or exchange requirement in State Fish Corp. v. Comm'r, 48 T.C. 465 (1967). In this case the taxpayers had purchased a business, including assets and goodwill, and imposed a non-compete agreement on the seller. Id. at 467. The seller violated the agreement and was sued for damages, including loss of goodwill. Id. at 471. The taxpayers attempted to apportion some of the damages received as a return on loss of capital even though they still retained the business. Id. Here, as in Inco, the court ruled that the nature of the assets were determined from the litigation and therefore the settlement was for a loss of capital. Id. at 476. In reaching this conclusion, the court did not only fail to invoke the sale or exchange requirement of § 1221, it did not even mention the requirement in its opinion. Again, except for the difference in the type of capital assets, this case is similar because the assets were still retained and yet accorded capital gains treatment.

Thus, by the examples of rulings from the courts above, it becomes apparent that the court is generally content to ignore § 1221 and instead give deference to the nature of the asset damaged regardless of whether or not it is still retained. The Service has not attempted to stop this practice by change to code or issuance of regulation. In fact, the

Service has issued a Field Service Advisory and a Revenue Rule using the same line of reasoning as the court. FSA 200228005 (2002); Rev. Rul. § 81-152,1981-22 I.R.B. 7. In the Field Service Advisory a taxpayer purchased contaminated real property and recovered monies from the seller for the diminution in value but still owned the property. The Service concluded that:

> [b]ecause land is a capital asset, the settlement proceeds represent amounts for injury or damage to a capital asset. Therefore, the proceeds should be treated as recovery of Taxpayer's basis in the land. Any proceeds in excess of Taxpayer's basis in the land should be treated as capital gain.

FSA 200228005 (2002). This is a clear adoption of the courts method of determine capital gain *sans* the sale or exchange requirement. The Service adhered to similar conclusions in Rev. Rul. § 81-152 (finding that an award for defects in still owned condominiums were a return on capital to the extent that it did not exceed the basis); PLR 9335019, 1993 (asserting capital gains treatment to homeowners in settlement for damages of still retained property); and PLR 9343025, 1993 (finding capital gains to homeowners for damages to common roads and lands).

All of the above have the same effect; they sustain the tax court's view that a sale or exchange is not required in a settlement for loss of capital. In fact, each of these rulings did not address the issue of sale or exchange, the regarding the test to be the determination of the type of the assets via the nature of the litigation and claims. Thus the Service itself has used the same reasoning as the courts and not adhered to the § 1221 requirements nor has it released any documentation in support of the requirement in cases similar to those above. Therefore, sale or exchange should not be considered a requirement for the Trust to assert capital gains treatment.

ii. The rare cases where the court has required a sale or exchange are easily distinguished from the case at hand.

There have been instances where the court has held that in the absence of a sale or exchange there could not be capital gain. However, these cases have fact patterns very different from those discussed previously and from the case of the Trust. The most notable authority is from Rev. Rul. § 74-251, 1974-1 C.B. 234. The facts of § 74-251 are very complex. Stated as simply as possible, X was the investment advisor for Y and entered into a new, exclusive and very profitable contract with Y. Shortly after this contract, majority shareholders in X, who just so happened to also be directors of Y, sold their stock in X for a substantial profit. Id. Shareholders of Y (hereafter Y) sued prior shareholders of X for the profits received from the sale of stock. Y alleged that they had an interest in choosing their investment advisor and that Y would have been able to enter into an agreement with X, or another investment advisor, that would have been reflective of the increase in value of X's stock price. Id. X and Y settled Y sought advice on the taxability of the settlement. In this case, the Service ruled that because Y still held the stock, the settlement would be taxed as ordinary income. Id. This case is very different from the Trust.

In Rev. Rul § 74-251, the court did not rule that there had been damage to a capital asset. In addition, the complaint of Y was that they should have received the profits that shareholders of X received when they sold their stock. Given the limited fact pattern, it appears that at no time did Y suggest that their stock values were reduced by the actions of shareholders of X. Rather, they allege that X used Y's right to select an investment advisor to X's betterment. Id. This is drastically different from the Trust loosing $30 per share of its value due to fiduciary slothfulness. Thus, this ruling points to

a situation in which a sale or exchange should be required to trigger capital rights usage but it is not on point with the fact pattern at question in this case.

There have been other situations when the court has required a sale or exchange for capital asset treatment but these cases still do not arise to a circumstance that should govern the Trust's case. One of these is the case of Steel v. Comm'r, T.C. Memo. 2002-113, 83 T.C.M. (CCH) 1608. In this case the taxpayers conveyed and then reacquired interest in a lawsuit. The taxpayer's viewpoint was that the interest was reacquired in exchange for divestment of their stock interests and thus was a sale or exchange and the proceeds from the lawsuit should be viewed as a capital gain. Id. However, the court found that there was no record of the interest in the lawsuit being additional compensation for the sale of stock and therefore the sale or exchange requirement was not met. Id. Once again, this case in no way reflects the facts or circumstances of the Trust's case. The question underlying Steel is whether an interest in a lawsuit derived from a business transaction can be retained by the selling company, yield capital gains, and yet not be documented to prove that it was consideration for a sale. As with all of the prior rulings and statements by the Service, there is scant information regarding the nature of the settlement and whether there was damage to a capital asset. Without these very important pieces of the puzzle, and with the great divergence of the fact pattern, Steel cannot be applied to the Trust's case because it does not even ask the Service to rule on similar questions.

Therefore, it is evident that the Service has applied the § 1221 requirement of a sale or exchange before capital gains treatment can be applied. However, in the instances where the court or Service has done so, the facts were widely different from those of the

case at hand. The main point of contention is that there was no claim, ruling or settlement which stated that there was a loss or damage to a capital asset. Instead, the Service attempted to unravel intricate and difficult business transactions in order to determine the taxability of settlements. In the Trust's case, the court found that there was loss or damage to a capital asset, therefore the rulings of the Service requiring a sale or exchange cannot be applied.

B. The Settlement was awarded as a loss of capital and should be taxed accordingly.

When a person or other taxable entity receives a settlement or a judgment a question arises as to whether the money received is taxable. In general, the Service finds that money received for litigation of a tortious act is taxable as ordinary income (unless the there was physical injury or physical illness). Internal Revenue Code §102(a)(2). However, it seems unfair to apply this tax structure to monies received for damage or destruction to tangible or intangible property. For instance, if contamination of property leads to a decrease in the value of the property, a settlement to reimburse for the lost value should not be taxed as ordinary income. Therefore, the court determined that in order to assess the taxability of a settlement, each case must be looked at according to the facts and circumstances therein. This caused the court to create a test to be applied to all cases.

In reviewing cases for loss of capital the courts use what has been called 'the replacement doctrine.' Robert Wood, Securities Lawsuit Recovery: Capital Gain or Ordinary Income?, 2005 105 Tax Notes 767, 767. The doctrine rests on the assumption that a settlement is a substitute and it should be taxed in the same manner as the item it was meant to substitute. Id. The first step in applying the doctrine is to establish what the

damages were awarded in lieu of. Raytheon Prod. Corp. v. Comm'r, 144 F.2d 110,113 (1st Cir. 1944). The method used to ascertain this is to look to the claim itself. Id. Thus, the taxability of a settlement is controlled by the nature of the litigation and not "whether the action was one in tort or contract." Id.

i. The nature of the litigation and settlement was for return of lost capital.

In this case at hand, the government contends that the money received should not be viewed as a return on basis or capital gains, but instead as ordinary income. However, the record clearly states that the O'Brian County Surrogate's Court calculated damages using the principles set forth in In the Matter of the Estate of Janes, 90 N.Y.2d 41 (N.Y. 1997). (R. at 3). The facts of Janes are extremely close to the fiduciary issues that the Trust faced. In Janes nearly half of the testamentary trust was in Kodak Stock. Id. at 47. The fiduciary sold a small percentage of the stock to pay for administrative expenses but left the rest of the stock undiversified. As a consequence, the value of the Kodak stock was a mere 1/5 of what it had been at the time of trust inception seventeen years earlier. Id. at 48. The New York Court of Appeals decided that the fiduciary had negligently retained assets it should have sold. Id. at 55. They applied a calculation for determining the amount of damages awarded for the lost value of the stocks due to fiduciary imprudence. The court did not use the formula to award the beneficiary lost profits but specifically expressed that this computation was being used to determine the value of lost capital. Id.

By using the Janes formula in their analysis, the O'Brian County Surrogate's Court was awarding the Trust for lost capital. Additionally, the record shows that this was

their intention. (R. at 4). In fact, no where in the record does the court discuss awarding the Trust damages for lost profits. Lost capital is what damages were awarded 'in lieu of'. Therefore, because the taxability of a settlement is controlled by the nature of the litigation, the settlement should be viewed one for lost capital for taxation purposes.

ii. The Trust correctly allocated the settlement as tax-free and capital gains.

Once the taxability of a settlement has been determined by the nature of the litigation, it is then for the taxpayer, or ultimately the court, to allocate the money correctly on their tax return. In the case of a settlement for capital destroyed or damaged, the choice of allocation rests between tax-free and capital gains. Money that does not exceed the basis is to be a return of capital and a tax-free transaction. Eg. Sager Glove Corp. v. Comm'r, 36 T.C. 1173, 1180 (1961); Rev. Rul. § 81-227, 1981-48 I.R.B. 5; FSA 200228005 (2002); Rev. Rul. § 81-152,1981-22 I.R.B. 7; Raytheon; State Fish Corp.; Inco Electroenergy Corp. Additionally, the taxpayer must sufficiently prove their basis in the capital in order to benefit from this rule. Raytheon, 144 F.2d at 113.

The Service defines basis, generally, as the cost of the property. Internal Revenue Code §1012. When the property in question has changed ownership via a testamentary instrument (or via intestacy statutes), the basis becomes the "fair market value of the property as the date of the decedent's death." Internal Revenue Code §1014(a)(1). In the Trust's case, the date of death value of the DuFont common stock was $20 per share, $2,000,000 total value. (R. at 3). This can be adequately shown to be the Trust's basis in the stock. The court determined that due to the fiduciary's breach of duty, there was a

loss of capital. Thus, by applying the theory that money not in excess of the basis is a return on capital, $2,000,000 of the settlement is tax free.

Next the taxability of the remaining settlement funds must be determined. When the court awards a settlement for loss of capital, money that is in excess over basis is taxable as capital gain. Eg. Big Four Indus. V. Comm'r, 40 T.C. 1055, 1060 (1963); State Fish Corp. v. Comm'r, 48 T.C. 465, 474 (1967). Consequently, the remaining $1,000,000 is taxable and given capital gains treatment.

Therefore, by looking at the nature of the litigation to establish that the settlement was awarded as a loss of capital and not ordinary income, the taxable allocation of funds becomes obvious. The Trust acted according to the established measures of the court by separating the settlement between a tax free return on basis and capital gains.

II. THE PURPOSE OF § 1231 IS TO PROVIDE CAPITAL GAIN TREATMENT FOR ASSETS THAT FIT WITHIN ITS GUIDELINES.

> It is undisputed that Section 1231 (a) in effect provides for the netting of gains and losses, recognized by other sections of the Revenue Code, arising out of certain types of transactions. These transactions are sales or exchanges of property used in trade or business, the compulsory or involuntary conversion, into other property or money, of property used in the trade or business and capital assets held for more than six months. If the recognized gains from such transactions exceed the losses from such transactions, the gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than six months. In other words, the taxpayer is allowed capital gains treatment which he would not be entitled to if it were not for Section 1231(a).

Morrison v. United States, 355 F.2d 218, 221 (6th Cir. Tenn. 1966).

26 USCS § 1231 (herein after "§1231) has clear language that provides what types of assets and under what circumstances those assets can have capital gain treatment.

The statute was initially was passed to aide capital-intensive businesses that either had their overseas or domestic assets seized by a foreign or the US Government during the Second World War. It afforded these businesses the opportunity to be taxed under the capital gain scheme rather than ordinary income for gains they might have involuntary received. Chewning v. Commissioner, 44 T.C. 678, 684 (T.C. 1965). Nevertheless, § 1231 has been subsequently construed to cover all capital assets and including those that are intangible such as goodwill. Bresler v. Commissioner, 65 T.C. 182, 188 (T.C. 1975).

§1231 allows certain assets that were involuntary disposed of to be treated as capital gains and non-capital losses. The statute covers "(I) property used in the trade or business, or (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." 26 USCA § 1231(A)(3)(i/ii).

A. §1231 covers all capital assets including equity losses.

Nowhere in the statutory language does §1231 infer that its encompassment is limited only to certain capital assets. In fact, it any applies to any "capital asset which is held for more than 1 year . . . [for the purpose of making a] profit." 26 USCS § 1231. The IRS has actually spoken to the issue and determined that §1231 includes properties that are "amortizable section 197 intangibles." The US Internal Revenue Service, Publication 554, 2007, Ordinary or Capital Gain or Loss for Business Property, *available at* http://www.irs.gov/publications/p544/ch03.html#d0e5023 (last visited January 26, 2009)., therefore, the taxpayers stock losses would be covered.

i. The Taxpayer's loss fits within §1231's definition of destruction.

Although when §1231's "destruction" application is applied, it is frequently applied to destruction of physical property, it is not limited to physical destruction. "While the term ordinarily implies complete or total destruction, it has on more than one occasion been construed to describe an act which while rendering the thing useless for the purpose for which it was intended, did not literally demolish or annihilate it." Henshaw v. Commissioner, 23 T.C. 176, 182 (T.C. 1954).

The taxpayer falls within the definition of destruction. The court in the underlying action determined that the taxpayer's assets were illegally mismanaged which lead to a destruction of value. (R. at 3.) The court's judgment laid out the amount of loss that the taxpayer incurred; there is no question that the taxpayer suffered an illegal loss of its capital assets. There is not question that the taxpayer received compensation for the destruction of value to a capital asset that it held for the necessary period. The taxpayer's assets were involuntary reduced in value while it had no control over them due to an illegal securities violation. The assets that were involuntary destructed were just those that fit into the framework of § 1231.

ii. The purpose of § 1231 is consistent with the destruction of stock loss.

"The purpose of § 117 [predecessor to § 1231] was 'to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion [or destruction] of capital investments.'" Comm'r v. P. G. Lake, Inc., 356 U.S. 260, 265 (U.S. 1958) (citing Burnet v. Harmel, 287 U.S. 103, 106 (U.S. 1932)). This is consistent with the taxpayer's position. The underlying law required the defendant in the underlying lawsuit to sell the securities in question, and the failure to sell said securities was a conversion of the

taxpayer’s capital assets. Furthermore, it would be very hard to imagine that the Legislature would not want relieve the taxpayer of unfair ordinary tax treatment of its lawsuit.

IV. CONCLUSION

For the foregoing reasons the appellate court’s decision to treat the taxpayers damages as capital gains should be affirmed.