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

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QUESTIONS PRESENTED FOR REVIEW

I. Whether Respondent's recovery amount from the trustee in excess of Respondent's basis was properly characterized as I.R.C. § 1222(3) long-term capital gain when the Respondent received such amount for replacement of the value of stock pursuant to the Mugel Prudent Investor Act.

II. Whether Respondent may invoke I.R.C. §§ 1231 and 1234A when its intangible asset was partially destroyed and when final judgment terminated its rights against the trustee.

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OPINIONS BELOW

The decision of the United States Court of Appeals for the Thirteenth Circuit [Docket No. 2008-46] appears on pages two through six of the Transcript of Record.

STATEMENT OF JURISDICTION

A formal statement of jurisdiction is waived pursuant to Rule III(C) of the 2009 Albert Mugel Tax Moot Court Competition.

STATUTORY PROVISIONS INVOLVED

The statutes involved in the case are the statutory provisions found in the Internal Revenue Code of 1986. 26 U.S.C. §1 *et. seq.* The relevant sections are noted within the text. Additionally, referenced in this case is the State of Mugel's Prudent Investor Act, which is identical to the New York Prudent Investor Act, found in New York's Estates, Power and Trusts Law § 11-2.3.

STATEMENT OF THE CASE

Respondent is a trust established on January 1, 2005, under the will of Donald Dufont in the State of Mugel. (R. at 2.) This trust was a discretionary trust, which could either distribute income to Donald's daughter Dora, or accumulate it and add it to corpus. (R. at 2.) Upon Dora's death, the trust corpus and income was to be distributed to John. (R. at 2.) These two individuals were the lone beneficiaries. (R. at 2).

Donald funded the trust with 100,000 shares of Dufont, Inc. stock ("Dufont"), with a value upon Donald's death of $2,000,000 ($20 per share). (R. at 2-3.) During 2005, the stock increased to $50 a share, but steadily declined down to $20 at the end of 2006. (R. at 3.) The stock has never paid a dividend. (R. at 3.)

In 2007, Dora and John demanded an interim accounting from Main Bank (hereinafter "trustee"). (R. at 3.) Upon receiving the interim accounting describing the history of the Dufont stock, Dora and John requested, in the O'Brian County Surrogate Court, that the trustee be surcharged for breach of its fiduciary duty of care. (R. at 3.) Relying upon the Mugel Prudent Investor Act, which requires trustees to diversify the trust portfolio to protect trust beneficiaries, the surrogate court found that the trustee breached its duty to diversify. (R. at 3.) In so finding, the surrogate court determined that the trustee should have sold the Dufont stock at the end of 2005, the point of its highest value at $50 per share. (R. at 3.)

The damage award followed the formula cited by In re Janes, a state of New York case regarding the calculation of damages. (R. at 3.) Relying upon this formulation, the surrogate court awarded $3,000,000 in "lost capital" damages. (R. at 4.) Interest of $400,000 was also awarded. (R. at 4.) The trustee satisfied the judgment, paying $3,400,000 to the trust on December 31, 2007. (R. at 4.)

In calculating its fiduciary return for 2007, the trustee treated the $3,400,000 as follows: $2,000,000 representing basis, $1,000,000 as long-term capital gain, and $400,000 ordinary income (interest). (R. at 4.) Petitioner assessed a deficiency against the Respondent for the 2007 return, characterizing the entire amount received in the judgment as ordinary income. (R. at 4.) Respondent petitioned the United States Tax Court for a redetermination of the deficiency. (R. at 4.)

In the Tax Court, Petitioner disagreed with the Respondent's characterization of the damage award. (R. at 4.) The Petitioner argued that because the trust still owned all of the stock, there had been no sale or exchange. (R. at 4.) Therefore, it contended that

neither capital gain nor basis offset was permissible. (R. at 4.) The Tax Court rejected Petitioner's reasoning, basing its decision on a long line of cases examining the nature of the claim and the basis for recovery to properly characterize the proceeds of the lawsuit. (R. at 4.)

The Thirteenth Circuit Court of Appeals affirmed the Tax Court's ruling by considering the nature of the damage award pursuant to In re Janes. (R. at 5.) The In re Janes formula hypothesizes a prudent sale of the stock, subtracting from the proceeds (1) the actual proceeds of any pre-surcharge, and (2) the date of surcharge value of any stock retained. (R. at 5.) The Thirteenth Circuit stated: "[T]his hypothesized-sale measure of damages defines what the trust has received for tax purposes regardless of whether the stock is actually sold or not." (R. at 5.) Therefore, the Thirteenth Circuit held that the Respondent properly characterized the amounts received in litigation. (R. at 5.) The interest was ordinary income, and lost capital, in excess of basis, was capital gain. (R. at 6.)

Alternatively, the Thirteenth Circuit determined that the damage award represented an involuntary conversion of capital assets held in a transaction entered into for profit pursuant to I.R.C § 1231. (R. at 6.) The Thirteenth Circuit found no policy reason to distinguish between economic destruction of a taxpayer's intangible asset and physical destruction of a tangible asset. (R. at 6.) Because of this conclusion, the court did not analyze the relevance of § 1234A. Id.

The Commissioner of the Internal Revenue Service appealed to this Court on a petition for writ of certiorari.

SUMMARY OF THE ARGUMENT

Respondent is entitled to capital gain treatment for its damage recovery subsequent to a state court judgment finding Respondent's trustee liable for failure to diversify in violation of the Mugel Prudent Investor Act. The Thirteenth Circuit properly affirmed the opinion of the United States Tax Court for the Respondent. The Thirteenth Circuit correctly determined that the Respondent's damage award from the O'Brian County Surrogate Court was in lieu of a capital asset. Therefore, pursuant to the replacement doctrine announced by this Court in United States v. Safety Car Heating & Lighting Company, the Thirteenth Circuit affirmed the Respondent's characterization of the amount received as capital gains. 297 U.S. 88, 98 (1935).

Internal Revenue Code section 1222(3) requires a sale or exchange for long-term capital gain treatment. I.R.C. § 1222(3) (2008). In addition to the Thirteenth Circuit's analysis, within the plain meaning of this statute, Respondent satisfied the exchange requirement of § 1222(3) because it received the judgment award in exchange for releasing the liability of the trustee. Further, Respondent satisfied the exchange requirement within § 1222(3) based on judicial precedent that settlement of litigation and release of liability constitutes an exchange. Turzillo v. Comm'r., 346 F.2d 884, 890 (6th Cir. 1965). Finally, the case at bar is an appropriate application of deeming the occurrence of a sale or exchange within I.R.C. § 1222(3) because Respondent's recovery was in lieu of a capital asset. This treatment is appropriate even when the underlying asset is retained.

The Thirteenth Circuit also appropriately utilized I.R.C. § 1231(a)(3)(A)(ii) to recognize Respondent's characterization of the damage award as capital gains. The

trustee's failure to diversify the trust assets destroyed the value of the portfolio, within the meaning "involuntary conversion" found in I.R.C. § 1231(a)(3)(A)(ii). I.R.C. §1231 (2008) Finally, statutory support for capital gain treatment is found within I.R.C. §1234A. I.R.C. § 1234A (2008). Under any of the forgoing, Respondent is properly entitled to capital gain treatment.

ARGUMENT

I. RESPONDENT'S RECOVERY PURSUANT TO THE MUGEL PRUDENT INVESTOR ACT REPRESENTS REPLACEMENT OF A CAPITAL ASSET, WITH THE EXCESS OVER BASIS PROPERLY CHARACTERIZED AS I.R.C. § 1222(3) LONG-TERM CAPITAL GAIN

"Amounts received in satisfaction of a judgment are taxed in the same manner as the proceeds would have been taxed if voluntarily paid." Wheeler v. Comm'r., 58 T.C. 459, 462 (1972) (citing Hort v. Comm'r., 313 U.S. 28 (1941)). The Respondent's Dufont stock is a capital asset pursuant to I.R.C. § 1221, and the Thirteenth Circuit appropriately affirmed the United States Tax Court ruling, determining that the damages received from the O'Brian County Surrogate Court were in lieu of a capital asset. Thus, the Thirteenth Circuit correctly held that the Respondent was entitled to recover its basis in the Dufont stock and was entitled to long-term capital gains treatment on the amount of the damage award that exceeded its basis. Basis is properly applied to the asset where the amounts received are not susceptible of allocation providing for deferral of gain. Inaja Land Co., Ltd. v. Comm'r, 9 T.C. 727, 735 (1947). This rule is applicable regardless of the retention of the underlying asset. Id. The fact that the amounts were received pursuant to a judgment does not alter the proper federal tax treatment. Raytheon Prod. Corp. v.

Comm'r, 144 F.2d 110, 113 (1st Cir. 1944). Therefore, the amount that the Respondent received in satisfaction of the judgment was properly taxed in the same manner that it would have been if the Respondent had voluntary chosen to divest itself of the Dufont stock after properly applying its basis in the underlying property.

A. Respondent's Dufont Stock Constitutes a Capital Asset Under I.R.C. § 1221.

Section 1221(a)(1) of the Internal Revenue Code provides, in part, that a "'capital asset' is property held by the taxpayer, whether or not connected with his trade or business" (with designated exceptions). I.R.C. § 1221(a) (2008). This Court has announced that the term "property," within the context of I.R.C. § 1221, most naturally includes stock. Arkansas Best Corp. v. Comm'r., 485 U.S. 212, 222-23 (1988). Therefore, stock held by a taxpayer, which does not trigger any designated exceptions under I.R.C. § 1221, is a capital asset. Kadillak v. Comm'r., 127 T.C. 184, 199 (2006).

Pursuant to Arkansas Best, because the Dufont stock held by the Respondent is property, it is a capital asset under I.R.C. §1221(a)(1). It is undisputed that any exception within § 1221 applies to the Respondent's Dufont stock.

B. Respondent's Damage Award Replaced a Capital Asset, Allowing Respondent to Reduce its Basis in the Asset

When amounts recovered in a lawsuit represent reparation of a capital asset, basis is properly used prior to any gain recognized upon the transaction. Pertinent is the partial disposition of the asset. Upon partial disposition, such as in lawsuits, proper apportionment is speculative, allowing for utilization of the "open transaction" doctrine. First, this Court has commanded that the tax treatment of such recovery is initially driven by the following question: "In lieu of what were the damages awarded?" Safety Car

Heating & Lighting Co., 297 U.S. at 98; see also Raytheon Prod. Corp. v. Comm'r, 144 F.2d 110, 113 (1st Cir. 1944) (citing Farmers' & Merchants' Bank of Catlettsburg, Ky v. Comm'r., 59 F.2d 912 (6th Cir. 1932)). This question, solidified in our federal common law by Raytheon, has been referred to as the "replacement doctrine." Robert Wood, Securities Lawsuit Recoveries: Capital Gain or Ordinary Income?, 108 Tax Notes 767, 767 (2005). The test for determining exactly what the recovery amount was intended to substitute is stated as follows: "The fund involved must be considered in light of the claim from which it was realized and which is reflected in the petition filed [wherein the taxpayer sought the damage award at issue]." Durkee v. Comm'r., 162 F.2d 184, 186 (6th Cir. 1947) (quoting Farmers' and Merchants' Bank, 59 F.2d at 913). The Internal Revenue Service (hereinafter "I.R.S.") has stated that the best evidence of what the recovery amount was intended to substitute is the taxpayer's complaint. Rev. Rul. 85-98, 1985-2 C.B. 51.

Next, it is incumbent upon the taxpayer to show that she held "cost or other basis" to offset any gains. Inaja, 9 T.C. at 724. Application of the basis to defer any recognition of the gain confronts Treasury Regulation § 1.61-6(a), requiring that when part of property is sold cost or basis must be "equitably apportioned" among the parts. Treas. Reg. § 1.61-6(a) (1960). If an accurate apportionment cannot be made, then payments received "must be treated as a return of capital and applied in reduction of petitioner's cost basis." Inaja Land Co., Ltd., 9 T.C. at 735 (citing Burnet v. Logan, 283 U.S. 404, 414 (1931)). This concept is generally referred to as the "open transaction" doctrine, allowing for reduction in basis upon a partial sale which still exists alongside Treas. Reg. § 1.61-6(a). Fisher v. U.S., 82 Fed.Cl. 780, 791 (Ct. Cl. 2008). In Fisher, the

Court of Federal Claims applied this doctrine to defer the gain on an insurance demutualization, allowing the taxpayer to first apply basis, rather than recognize gain. Id. at 799 (but cf. Fasken v. Comm'r, 71 T.C. 650, 660 (1979) (denying open transaction treatment when granted easements were properly allocable to the basis of the individual parts)). In conjunction, the two doctrines allow taxpayers continuing to hold an underlying asset to maintain the character of the asset, and apply cost basis to offset gains upon the amounts received.

Determining exactly what the damage award substituted, by applying the replacement doctrine, is pivotal because it dictates the appropriate method of federal taxation. If the recovery that the taxpayer received replaces capital that was either destroyed or injured, then the money received is a return of capital and is not taxable. Freeman v. Comm'r., 33 T.C. 323, 327 (1959) (citing Raytheon Prod. Corp. v. Comm'r., 1 T.C. 952 (1943), aff'd, 144 F.2d 110 (1944)). Instead, the only amount which is taxable is that amount which exceeds the taxpayer's basis in the asset. Big Four Industries, Inc. v. Comm'r., 40 T.C. 1055, 1060 (1963) (holding that partial damage to a taxpayer's goodwill shall be offset by its basis, if any, in that capital asset). In contrast, if the award represents damages for lost profits, then the amount recovered is taxable as ordinary income. Estate of Carter v. Comm'r., 298 F.2d 192, 194 (8th Cir. 1962); Sager Glove Corp. v. Comm'r., 36 T.C. 1173, 1180 (1961), aff'd, 311 F.2d 210 (7th Cir. 1962).

The Thirteenth Circuit Court of Appeals was correct in affirming the Tax Court's application of the replacement doctrine to the judgment for damages awarded by the O'Brian County Surrogate Court. Beneficiaries of the Respondent trust requested the surrogate court to surcharge the trustee for its failure to diversify the trust's inception

assets which consisted, solely, of 100,000 shares of Dufont stock. (R. at 3.) The surrogate court determined that surcharging the trustee was appropriate under the Mugel Prudent Investor Act for its failure to diversify. (R. at 3-4.) To avoid such liability, the trustee should have divested the trust of the high concentration of Dufont stock by selling it and reinvesting the gains in prudent investments. N.Y. Estates, Powers, and Trusts Law § 11-2.3 (McKinney 2008); In re Estate of Janes, 681 N.E.2d 332, 336-37 (N.Y. 1997). By properly considering the Respondent's complaint filed in the O'Brian County Surrogate Court and the judgment of that court, in accordance with the replacement doctrine, the Thirteenth Circuit correctly affirmed the Tax Court's determination that the Respondent received $3,000,000 damages in lieu of the Dufont stock which was lost through the trustee's failure to diversify. The amounts received are return of capital; hence the only question remaining is whether Respondent may appropriately reduce its cost basis.

Here, the Respondent had $2,000,000 of basis in the Dufont stock because on the inception date of the trust the stock had a value of $2,000,000. (R. at 3-4.) The $3,000,000 damage award represented injury to a capital asset, hence the appropriate tax treatment for the amount not exceeding basis is a return of capital. Raytheon, 144 F.2d at 113. Raytheon mandates that full loss of good will necessitates a consumption of basis. Id. at 114. The same rule should be applied here in a partial destruction, because it cannot be determined what portion of the stock would have been sold, or whether the amounts received, despite the specificity of the damage formula, represent a sale of the total or a partial amount, equitable allocation of basis cannot be achieved. The Raytheon rule as enunciated did not provide for any such distinction. Petitioner's position, not

allowing for reduction of basis and gain deferral, is inapposite to the facts. Respondent has lost value, similarly to the goodwill lost in Raytheon. Id. Here, it cannot be determined which portion was sold, and what is retained. Thus, deferral of gains because of inability to apportion the basis is warranted. The proper timing for taxation is upon a full and final disposition of the asset, not a judgment recovery. Id. Therefore, the Respondent respectfully requests this Court adopt the Inaja and Fisher deferral of gain for damage awards repairing a portion of lost capital.

C. The Amount Respondent Received in Excess of its Basis is Properly Characterized as Long-Term Capital Gain Pursuant to I.R.C. § 1222(3) Because Respondent Satisfied the Section's Sale or Exchange Requirement

Section 1222(3) of the Internal Revenue Code defines a long-term capital gain as a "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 taxable income." I.R.C. § 1222(3) (2008). Thus, the usual requirements for long-term capital gain treatment are as follows: (1) a capital asset as defined in I.R.C. § 1221, (2) a sale or exchange of that capital asset, (3) a gain on the sale or exchange, and (4) a holding period of more than one year. I.R.C. § 1222(3) (2008).

The Respondent's award for damages undeniably satisfies three of the four textual requirements to receive long-term capital gains treatment under I.R.C. § 1222(3). As demonstrated above, the 100,000 shares of Dufont stock is a capital asset within the meaning of I.R.C. § 1221. Further, the Respondent received $1,000,000 over its basis in that capital asset. Finally, the Respondent held the shares of Dufont stock for at least one year. Specifically, the stock was held for at least one full year because the stock was in the hands of the Respondent beginning on January 1, 2005, and it should have been sold

upon the date of the hypothesized sale, pursuant to the Thirteenth Circuit, at the end of 2005. (R. at 3.) At maximum, Respondent held the stock for two years, beginning on January 1, 2005, and ending on December 31, 2007, when the trustee satisfied the judgment. (R. at 4.) Therefore, the only remaining question is whether there was a sale or exchange of the capital asset.

1. Respondent satisfied the ordinary definition of "exchange" within the context of I.R.C. § 1222(3) because it received payment for lost capital in satisfaction of the trustee's liability under the Mugel Prudent Investor Act.

Within the context of I.R.C. § 1222, "[t]he term exchange, in its most common, ordinary meaning implies an act of giving one thing in return for another thing regarded as an equivalent." Yarbro v. Comm'r., 737 F.2d 479, 483 (5th Cir. 1984) (citing Webster's New International Dictionary (2d ed. 1954)). The Fifth Circuit, in Yarbro, stated that three things are required for an exchange: "a giving, a receipt, and causal connection between the two." Id. An earlier opinion in the Third Circuit similarly stated that an exchange means "to part with, give, or transfer to another in consideration of something received as an equivalent." Kessler v. U.S., 124 F.2d 152, 154 (3rd Cir. 1941). Finally, this Court in Helvering v. William Flaccus Oak Leather Co. held that the word "exchange," within the context of § 1222, should be given its ordinary meaning. 313 U.S. 247, 249 (1941). Therefore, if the transaction between the parties meets the above stated definition, there is an exchange for purposes of I.R.C. § 1222(3).

Respondent in the case at bar has satisfied the ordinary definition of an exchange as announced in Yarbro and Kessler. Respondent received $3,000,000 judgment to replace the lost capital resulting from the trustee's failure to diversify. (R. at 3.) However, by accepting this $3,000,000, the Respondent gave up any further right to

contest the trustee's liability. Further, the surrogate court's calculation of damages pursuant to In re Janes ensured that the exchange of money damages for the release of the trustee's liability is equivalent. (R. at 3.) Therefore, based on the ordinary definitions set forth in both Yarbro and Kessler, an exchange occurred within the context of I.R.C. § 1222(3).

2. Respondent further satisfied the exchange requirement because an exchange, within the context of § 1222(3), occurs when litigation is settled and liability is released.

Directly in line with the definitions of "exchange," as announced in Yarbro and Kessler, case law provides that settlement of litigation and payment of damages coupled with release of liability constitutes an exchange under I.R.C. § 1222(3). Turzillo v. Comm'r., 346 F.2d 884, 890 (6th Cir. 1965). For example, the Sixth Circuit Court of Appeals has held that settlement of litigation and release of liability constitutes an exchange under I.R.C. § 1222(3). Id. In Turzillo, a lawsuit was satisfied by a settlement agreement and not a court judgment. Id. at 887. However, the First Circuit Court of Appeals in Raytheon explicitly stated that the fact that a suit ends in a compromise settlement does not change the nature of the taxpayer's recovery. 144 F.2d at 114. Therefore, whether litigation between the taxpayer and the wrongdoer ends either through settlement, or court judgment, has no effect on the sale or exchange requirement of § 1222(3).

Respondent urges this Court to follow the Sixth Circuit's holding in Turzillo because it is equally applicable to the case at bar. As in Turzillo, this case involves a release of liability. (R. at 4.) Here, Respondent released the trustee from liability with respect to the breach of fiduciary duty claim concerning the imprudently held stock. (R.

at 4.) Thus, the disposition of the case by the surrogate court constituted a release of any further liability that the trustee may have faced with respect to the Dufont stock during the holding period from 2005 until 2007. Thus, Respondent urges the Court to adopt the rule announced in Turzillo, which states that the disposition of the cause of action, coupled with release of liability, constitutes an exchange within the context of I.R.C. § 1222(3).

Respondent recognizes that a few factually distinguishable cases, as well as an I.R.S. determination, have appeared to reach contrary conclusions to the Sixth Circuit in Turzillo. For example, in Sanders v. Commissioner, the Tenth Circuit Court of Appeals determined that a settlement for contractual claims was not a sale or exchange. 225 F.2d 629, 635 (10th Cir. 1955). Further, the United States Tax Court has held that a settlement of a lawsuit does not constitute a sale or exchange for purposes of § 1222(3). Nahey v. Comm'r., 111 T.C. 256, 266 (1998), aff'd, 196 F.3d 866 (7th Cir. 1999). Finally, an I.R.S. administrative ruling stated that "[u]nless it can be clearly established that there has been a sale or exchange of property, money received in settlement of a lawsuit does not itself constitute a sale or exchange. The mere settlement of a lawsuit does not in itself constitute a sale or exchange." Rev. Rul. 74-251, 1974-1 C.B. 234; but cf. Rev. Rul. 81-152, 1981-1 C.B. 433.

However, the cases and rulings above, which together appear to have held that a settlement agreement or payment made pursuant to a court judgment does not constitute an exchange under I.R.C. § 1222(3) are distinguishable upon their facts. First, the facts in Sanders are distinguishable from this case. The Tenth Circuit in Sanders applied the replacement doctrine but determined that the amount the taxpayer received was in lieu of

lost profits, rather than lost capital. 225 F.2d at 635. Therefore, the Tenth's Circuit's announcement regarding any requirements for long-term capital gain treatment, and specifically the exchange requirement under I.R.C. § 1222(3), is merely dicta.

Similarly, the I.R.S. determined in Revenue Ruling 74-251 that the taxpayer did not sustain damage to a capital asset when it applied the replacement doctrine. 1974-1 C.B. 234. Instead, the I.R.S. determined that the taxpayer only sustained damage to anticipated profits. Id. Any amounts received in lieu of anticipated profits are ordinary in nature, subject to ordinary treatment. Id. Thus, any pronouncement by the I.R.S. within this administrative decision regarding the requirements of I.R.C. § 1222(3) for capital gains treatment is superfluous to the factual holding.

Respondent further contends that although the United States Tax Court announced in Nahey that settlement of litigation does not constitute a sale or exchange, Judge Posner writing for the Seventh Circuit Court of Appeals affirmed the lower court's judgment on entirely different grounds. 196 F.3d 866 (7th Cir. 1999). In Nahey, the taxpayer held an interest in a settlement agreement because he purchased the lawsuit from an original party. Id. at 867. The taxpayer conceded that the original party to the suit would have recovered ordinary income upon the settlement agreement. Id. Yet the taxpayer argued that the purchase of the litigation from the original party transmuted what would have otherwise been ordinary income to the original litigant into long-term capital gains for the taxpayer. Id. at 868. Judge Posner declined to adopt the taxpayer's position because he concluded that the proper inquiry was to consider the origin of the claim, pursuant to he replacement doctrine. Id. at 868 (quoting Alexander v. Comm'r., 72 F.3d 938, 942 (1st Cir. 1995)). Judge Posner further recognized that "[a] settlement, or equally litigated

judgment, resembles a sale because it extinguishes the plaintiff's claim." Id. However, Judge Posner stated that a sale of the litigation, itself, did not satisfy the sale or exchange requirement for purposes of § 1222(3). Id. Therefore, the Seventh Circuit affirmed the Tax Court's ruling, but did so in light of the fact that the original litigant would have received ordinary income upon settlement of the suit, pursuant to the replacement doctrine.

Finally, the Respondent urges the Court to briefly consider the case of Parker v. United States. 573 F.2d 42 (Ct. Cl. 1978). In Parker, the Commissioner asserted that a settlement transaction between a beneficiary and an executor of an estate constituted a sale or exchange of a capital asset. Id. at 43. The Commissioner advanced this argument to obtain a higher deficiency against the taxpayer. Id. at 44. However, the Commissioner adopts the opposite position that there is no sale or exchange under the facts of the case at bar. (R. at 4). By advancing the argument that settlement of litigation constitutes a sale or exchange in Parker, the Commissioner has recognized the feasibility and correctness of this argument as well as the holding of Turzillo. Therefore, the Respondent requests that the Court affirm the Thirteenth Circuit's decision and hold that a sale or exchange occurs upon termination of litigation for purposes of § 1222(3).

3. Respondent satisfied the sale or exchange requirement of I.R.C. § 1222(3) because a sale or exchange is deemed to have occurred when the recovery received is in lieu of a capital asset, despite continued retention of that asset.

Even if the Court does not determine that the Respondent satisfied the ordinary definition of "exchange" within I.R.C. § 1222(3), Respondent urges the Court to find the Thirteenth Circuit properly deemed that a sale or exchange occurred satisfying this requirement of § 1222(3). Substantial case law and an I.R.S. administrative ruling have

implicitly recognized that a sale or exchange is deemed to have occurred when a taxpayer recovers damages in lieu of a capital asset, even when the taxpayer continues to hold the property. Durkee, 162 F.2d at 197; Gail v. U.S., 58 F.3d 580, 585 (10th Cir. 1995); Wheeler, 58 T.C. at 461; Rev. Rul. 81-152, 1981-1 C.B. 433. Therefore, by such authority deeming a sale or exchange to satisfy I.R.C. § 1222(3), a sale or exchange of the underlying asset, within the ordinary definition, is not required to obtain long-term capital gain treatment under § 1222(3).

Federal courts and the I.R.S. have implicitly deemed a sale or exchange to have occurred, within the context of § 1222(3), via the common law replacement doctrine for amounts received upon termination of litigation. Durkee, 162 F.2d at 197; Big Four Industries, Inc., 40 T.C. at 1060 (1963); Rev. Rul. 81-152, 1981-1 C.B. 433. The common law replacement doctrine does not supplant I.R.C. § 1222(3), however certain courts and the I.R.S. have used this doctrine to deem the sale or exchange requirement as satisfied when a taxpayer sustains loss to a capital asset, yet still holds the asset after the damage award has been paid. Id.

Use of the replacement doctrine to satisfy the sale or exchange requirement is accomplished by determining what the damage award was in lieu of, as set forth above. Wheeler, 58 T.C. at 461. If the award is in lieu of a capital asset, the court deems a sale or exchange to have occurred in order to provide the taxpayer with the tax treatment that it would have otherwise had, but for the unlawful damage or destruction to the capital asset. Id. The reason for deeming a sale or exchange, for purposes of I.R.C. § 1222(3), is the maxim that "[a]mounts received in satisfaction of a judgment are taxed in the same manner as the proceeds would have been taxed if voluntarily paid." Id. Therefore, by

using the replacement doctrine, in conjunction with I.R.C. § 1222(3), appropriate tax treatment is matched to the underlying asset.

The Sixth Circuit Court of Appeals, in Durkee v. Commissioner, deemed a sale or exchange occurred upon settlement of litigation, despite the fact that the taxpayer retained the underlying asset. 162 F.2d at 187. In Durkee, the taxpayer received an amount through the settlement of a lawsuit wherein the taxpayer alleged damage to his electrical company's goodwill. Id. at 185-86. After the taxpayer received the settlement amount, the Commissioner assessed a deficiency, alleging that the entire award was taxable income. Durkee v. Comm'r., 6 T.C. 773, 776 (1946), rev'd, 162 F.2d 184 (6th Cir. 1947). The Sixth Circuit Court of Appeals, in setting aside the Tax Court's judgment in favor of the Commissioner, implied that the sale or exchange requirement was deemed to have occurred by way of the conversion of the taxpayer's capital asset (the goodwill) into cash via the settlement. Durkee, 162 F.2d at 187. By deeming a sale or exchange to have occurred, the Sixth Circuit engaged in a factual determination that, first, the taxpayer's capital asset was converted involuntarily, and, second, that the cash the taxpayer received in-hand represented amounts that were capital in nature. Id. at 186-87. Therefore, the Sixth Circuit deemed a sale or exchange for purposes of I.R.C. § 1222(3) with respect to the underlying asset that the damage award was in lieu of ensuring consistent federal tax treatment.

The Thirteenth Circuit correctly affirmed the Tax Court's application of the replacement doctrine to deem the occurrence of a sale or exchange for purposes of I.R.C. § 1222(3) in the case at bar. The Tax Court properly deemed a sale or exchange under the facts of the case at bar because if the trustee had sold the Dufont stock, rather than

imprudently holding it in an undiversified manner, then the Respondent would have originally recognized long-term capital gains under I.R.C. § 1222(3). In affirming the Tax Court's decision, the Thirteenth Circuit found the O'Brian County Surrogate Court's process of damage calculation particularly persuasive. (R. at 4.) Specifically, the Thirteenth Circuit, citing In re Janes, found that Respondent's damage award required the surrogate court to hypothesize a prudent sale of the Dufont Stock. (R. at 4.) The Thirteenth Circuit expressly applied the replacement doctrine, and then implicitly deemed that a sale or exchange had occurred when it stated that "this hypothesized-sale measure of damages defines what the trust has received for tax purposes, regardless of whether the stock is actually sold or not." (R. at 4.) This statement, alone, shows that the Thirteenth Circuit found that the hypothesized sale requirement under In re Janes was sufficient to allow for capital gains treatment. Further, this ruling appropriately supports the purpose of the common law replacement doctrine, which is to match the appropriate tax treatment to the underlying asset as announced in Wheeler. 58 T.C. at 461.

Respondent further contends that policy considerations support deeming a sale or exchange to have occurred in compliance with I.R.C. § 1222(3). In situations where a taxpayer has been involuntarily forced to accept the fruits of another's wrongdoing by the wrongdoer's destruction of all or a portion of the taxpayer's capital asset, capital gain treatment for recovery of that injury is warranted. In the case at bar, without the breach of fiduciary duty, the trustee would have properly diversified the trust portfolio, yielding recognition of capital gains upon the sale of the stock. Yet, because of the trustee's breach, the Respondent engaged in costly and time-consuming litigation to enforce its rights under the Mugel Prudent Investor Act. Generally, if a taxpayer knew that if he sued

a wrongdoer who damaged his capital asset that he would face ordinary treatment on the recovery instead of capital gain, the taxpayer may forgo the lengthy process, cost, and frustration of litigation. The amounts received, if taxed at ordinary rates, is incongruent with consistent federal tax treatment, as advanced in Wheeler. Consistent treatment requires that the amounts received in litigation to repair loss to capital be taxed in the same manner as amounts recognized from the sale or exchange of capital assets. To hold otherwise would improperly penalize taxpayers whose assets were tortiously impaired.

In light of the forgoing, Respondent requests that this Court affirm the Thirteenth Circuit's opinion, deeming that a sale or exchange occurred in compliance with I.R.C. § 1222(3), yielding capital gain treatment for amounts received to repair its lost capital, even though it retained the underlying asset.

D. The Policy Argument Against Allowing Long-Term Capital Gain Treatment for Non-Income Producing Property is Irrelevant Because Respondent Received the Recovery Amount Pursuant to a Hypothesized Sale under the Mugel Prudent Investor Act.

Despite substantial authority deeming a sale or exchange under I.R.C. § 1222(3), one tax scholar explicitly argues for denying capital gain treatment without an overt sale or exchange. Ronald Jensen, Can You Have Your Cake and Eat it Too?: Achieving Capital Gain Treatment While Keeping the Property, 5 PITT. TAX REV. 75, 97 (2008). Pursuing uniformity, Ronald Jensen argues, even lawsuit judgments received in lieu of investment property without any income component should be denied capital gain treatment. Id. at 99.

Jensen proposes a fact situation where a taxpayer purchases growth stock that does not distribute dividends. Id. at 97. The overt sale of that stock would obviously yield capital gain treatment. Id. However, Jensen's example posits that the executives of

the company tortiously ruin the value of the stock, leading to a large cash settlement with stockholders. Id. Taxpayer, pursuant to the cash settlement, receives an amount in excess of her basis. Id. Clearly, the commentator notes that the taxpayer will object to characterization of the proceeds as ordinary because the amounts received are substituted for capital gain, not ordinary income. Id. Specifically, the taxpayer would claim that the amounts received were in lieu of recovery from the actions of others, thrusting the income upon her. Id. at 98.

However, Jensen defends ordinary gain treatment, stating that taxpayer's argument "depend(s) upon an unacceptable but unavoidable degree of speculation" because ultimately the company may institute a dividend policy, ending the growth-only nature of the investment. Id. Jensen does recognize the "certain unfairness" of taxing the amount received as ordinary income because the "gain has been transmuted into ordinary income." Id. However, Jensen concludes that "the taxpayers must be able to demonstrate their entitlement" to capital gain treatment for it is a "tax preference." Id. at 98-99. Thus, Jensen claims that a perfunctory sale of the assets would assure capital gain treatment. Id.

Jensen's example, cited above, is substantially similar to Respondent's situation. Investments, such as the no dividend Dufont stock, generate no current income, bringing Respondent squarely in line with the example. However, the Court can be certain that the concerns that Jensen advances are not at issue in the case at bar. Specifically, the calculation of the damage award is of utmost importance in the present case. The surrogate court held that a hypothesized sale is determined upon the date when diversification should have occurred in accordance with the Mugel Prudent Investor Act.

(R at 3.) Therefore, Respondent would have no difficulty proving that no dividend had been paid during that period. Hence, any argument that the Dufont Board of Directors might alter its distribution policy is inconsequential. Essentially, the Tax Court found that a sale should have occurred. Thus, because the date of the hypothesized sale is established, the amounts taxed are appropriate for capital gain treatment and any subsequent dividends reduce the amount of the recovery, rather than change the nature of the underlying asset. (R. at 3.)

II. RESPONDENT SATISFIES THE REQUIREMENTS OF I.R.C. § 1231, AND I.R.C. § 1234A, BECAUSE ITS INTANGIBLE ASSET WAS PARTIALLY DESTROYED AND THE JUDGMENT TERMINATED RESPONDENT'S RIGHTS AGAINST THE TRUSTEE

Assuming arguendo, that this Court does not agree that a sale or exchange occurred under § 1222(3), the amount received in excess of basis may still be treated as capital gain because it represents an involuntary conversion within the meaning of §1231(a)(3)(A)(ii) or a termination of a right or obligation pursuant to § 1234A. Both sections provide textual support for capital gain treatment with respect to certain assets. I.R.C. §§ 1231, 1234A (2008). Factually, Respondent's recovery fits within both sections. Therefore, the Thirteenth Circuit properly affirmed Respondent's characterization of the award as capital gain.

A. Respondent's Recovery Represents Gain From the Involuntary Conversion of an Intangible Asset, Allowing for Capital Gain Treatment Pursuant to I.R.C. § 1231(a)(3)(A)(ii).

Internal Revenue Code § 1231 provides capital gain treatment for involuntarily converted property so long as it is a capital asset, which is held for more than 1 year in connection with a profit motive. I.R.C. § 1231 (2008). Section 1231 gains are defined in two ways. Id. The first is through a traditional sale or exchange of "property used in the

trade or business, or 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. § 1231(a)(3)(A)(i) (2008). This type of gain yields capital treatment for business and investment property sold or exchanged. Id. However, more pertinent to the case at bar, section 1231 treatment is allowed upon receipt of "any gain recognized 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 of imminence thereof) into other property or money." I.R.C. § 1231(a)(3)(A)(ii) (2008). Therefore, if the amounts received are pursuant to an "involuntary conversion," the proper treatment is capital gain.

Underlying I.R.C. § 1231(a)(3)(A)(ii) is the rationale that an involuntary conversion represents a sale or exchange. Central Tablet Mfg. Co. v. U.S., 417 U.S. 673, 676 (1974); U.S. v. Morton, 387 F.2d 441, 444-45 (8th Cir. 1968). Therefore, the involuntary conversion obviates the need for a formal sale or exchange. Id. Rather, the involuntary act of the destruction followed by a cash reimbursement is deemed to represent a sale or exchange. Id.

1. Respondent's intangible asset was destroyed within the meaning of "casualty" under I.R.C. § 165.

To effectuate their purpose, relief provisions, such as § 1033 and § 1231, must be construed broadly. Taft Broad. Co. v. U.S., 929 F.2d 240, 246 (6th Cir. 1991). However, it is impermissible to stretch the words within the statute beyond their intended meaning. Id. Destruction for "involuntary conversion" purposes is closely linked to "casualty" as found within I.R.C. § 165(c)(3). Rev. Rul. 54-395, 1954-2 C.B. 143.

The Tax Court dealt with the definition of "destruction" in Broido v. Commissioner, finding that "fluctuations in value" do not permit a deduction under § 23(e)(3) (the predecessor to § 165). 36 T.C. 786, 792 (1961). Further, the court stated an event must be destructive of the property to fit within the casualty loss provision and "found no departure from the concept that the loss covered was that represented by physical damage, whether the result was partial or complete destruction." Id. at 793. In Broido, the taxpayer argued that a drought represented a casualty requiring taxpayer to invest in a new well. Id. The taxpayer sought to deduct the amounts expended on the new well, arguing that a drought was a casualty loss. Id. This case has wrongly been cited as persuasive authority limiting the applicability of the "casualty loss" provision in § 165 to economic losses. Jensen, 5 PITT. TAX REV. at 94. Instead, the taxpayer in Broido argued that a drought caused the reduction of the fair market value of his property and to compensate for this loss the taxpayer chose to purchase a new well. 36 T.C. at 793. In actuality, Broido stands for the proposition that economic costs not necessitated by destruction are prohibited from invoking the "casualty loss" deduction pursuant to § 165. Id.

However, I.R.C. § 165 does provide an important basis for analyzing § 1231. Section 165 provides for casualty losses arising from "fire, storm, shipwreck, or other casualty, or from theft." I.R.C. § 165(c)(3) (2008). A casualty loss "must result from some event that is (1) identifiable, (2) damaging to property, and (3) sudden, unexpected, and unusual in nature." Rev. Rul. 72-592, 1972-2 C.B. 101. The definitions for "sudden, unexpected, and unusual in nature" are summarily defined as follows:

> To be "sudden" the event must be one that is swift and precipitous and not gradual or progressive.

> To be "unexpected" the event must be one that is ordinarily unanticipated that occurs without the intent of the one who suffers the loss.
>
> To be "unusual" the event must be one that is extraordinary and nonrecurring, one that does not commonly occur during the activity in which the taxpayer was engaged when the destruction or damage occurred, and one that does not commonly occur in the ordinary course of day-to-day living of the taxpayer. Id.

Further, involuntary conversions must be the result of activities "wholly beyond control of the one whose property has been taken." Dear Publ'n & Radio, Inc. v. Comm'r, 274 F.2d 656, 660 (3d Cir. 1960).

However, the definition for "casualty" as used in § 1231 is not exactly the same as it is used § 165. Rev. Rul. 61-216, 1961-2 C.B. 134. Specifically, a 1961 Revenue Ruling stated that § 1231 did not require satisfying the suddenness test for casualty loss purposes. The ruling maintained the proposition that destruction must still fall within the general concept of a casualty found in § 165. Id. Therefore, the I.R.S. has specifically recognized that suddenness is not required for involuntary conversions under I.R.C. § 1231. Id.

Respondent's recovery complies with the general definition of "casualty loss" without the suddenness portion of the casualty test. First, Respondent has an identifiable injury to property. The amount received was a specific calculation of damages representing lost capital. (R. at 4.) Second, Respondent experienced damage to its property. The damage came in the form of the trustee's breach of fiduciary duty. (R. at 3.) Finally, the damage was "unusual" and "unexpected." Respondent never expected to incur such large losses as the result of the trustee's failure to diversify its assets. (R. at 3.) In that same vein, the loss occurred "wholly beyond the control" of the Respondent. Respondent relied upon trustee to uphold its fiduciary duties. The Respondent had no

power to diversify the assets itself; it was at the mercy of the trustee. The event is also unusual given the onerous burden of a trustee's fiduciary duties. N.Y. ESTATES, POWERS, AND TRUSTS LAW § 11-2.3 (McKinney 2008). Therefore, Respondent contends that because the trustee's breach of fiduciary duty constituted destruction of its capital asset, pursuant to the definition of "casualty," it sustained an involuntary conversion resulting in the receipt of cash. Accordingly, amounts received in excess of basis, are entitled to § 1231 gain treatment.

Further, Respondent's recovery does not represent the mere fluctuation of value in stock. Treasury Regulation § 1.165-4 provides that the mere fluctuation in the value of stock is not entitled to a deduction under I.R.C. § 165 "when the decline is due to a fluctuation in the market price of the stock or to other similar cause." Treas. Reg. § 1.165-4 (1960); Broido, 36 T.C. at 793 (citing the general proposition that mere fluctuation in value is not sufficient to invoke the casualty loss provisions). A loss on the stock is only allowable to the extent it represents a realization event within the meaning of Treasury Regulation §1.1002-1. Treas. Reg. § 1.165-4 (1960). Given this regulatory framework, if losses of the value of stock are the result of something more than a fluctuation in the market price, presumably they are outside the scope of this disallowance.

Respondent's loss in this case is predicated upon a breach of fiduciary duty, which was a violation of an enumerated Mugel state law. (R. at 3.) The amounts did not represent recovery for mere fluctuation of value captured pursuant to the Treasury Regulation § 1.165-4; instead, the amounts represented failure of the trustee to diversify inception assets. (R. at 3.) Therefore, within the textual and regulatory framework of §

165, Respondent's asset was destroyed as the result of a casualty, allowing for § 1231 gain treatment.

2. The destruction of the Respondent's intangible asset represents a quantifiable loss, allowing Respondent to invoke I.R.C. §1231(a)(3)(A)(ii).

Ronald Jensen, arguing that lawsuit recoveries received without a sale or exchange may not receive capital gain treatment, states that involuntary conversion is not applicable to an intangible asset. Jensen, 5 PITT. TAX REV. at 93 (citing Mathey v. Comm'r, 10 T.C. 1099, 1105 (1948)). Jensen engages in this line of reasoning to further dispel any possibility of reliance upon § 1231 to provide capital gain treatment when intangible assets are destroyed. Id. In Mathey, the Tax Court examined the case under I.R.C. § 117(j), the predecessor to §1231. 10 T.C. at 1099. The operative provisions of §117(j) were substantially similar to the subsequent code section. Comm'r. v. Gillette Motor Transp. Inc., 364 U.S. 130, 136 (1960). The issue decided in Mathey was whether the net proceeds of a patent infringement lawsuit constituted an involuntary conversion. 10 T.C. at 1100. The court answered that question in the negative, holding that while there is a possibility for a partial destruction of the patent, the taxpayer continued to use and receive income from the use of the patent. Id. at 1104. Important to the analysis, was the lack of an identifiable portion of the patent destroyed through the infringement, as the court stated: "there has been no showing that any particular part of the patent having a disclosed basis was destroyed or converted." Id. Inherent problems with valuation ultimately went against the taxpayer. Id. Therefore, the court denied finding an involuntary conversion because the destruction of the asset intangible asset was unquantifiable. Id.

Respondent here, in contrast to Mathey, experienced an appreciable destruction. Specifically, Respondent sustained a loss of $3,000,000 due to a breach of fiduciary duty. (R. at 4.) This exact figure represents an objective amount that clearly states what it was intended to remedy: the economic destruction of a capital asset. This amount represents an involuntary conversion of the value of the Dufont stock, thereby making §1231 gain treatment appropriate.

Respondent further urges that the utilization of §1231 in response to suits for failure to diversify or breach of fiduciary duty is an extremely limited and appropriate application of the statute. It is not the daily market shifts that trigger the application of this section, but rather the tortious violation of state law that §1231 may be construed to capture. Therefore, in light of the forgoing discussion, Respondent urges the Court to affirm the Thirteenth Circuit's decision relying upon I.R.C. §1231(a)(3)(A)(ii) to support capital gain treatment for lawsuit recoveries stemming from the tortious involuntary conversion of intangible assets.

B. Respondent is Entitled to Capital Gain Treatment Under I.R.C. § 1234A Because the Recovery Represents the Termination of its Rights Against the Trustee.

In addition to the arguments above, application of §1234A to the amount that Respondent received is appropriate. While pronouncements with respect to the scope of the provision are scarce, holding, pursuant to §1234A, that Respondent's litigation is a right that was terminated or expired upon conclusion of the suit is a logical reading of the statute. Wood, 109 TAX NOTES at 778. Section 1234A provides that any "gain or loss attributable to the cancellation, lapse, expiration, or other termination of …a right or obligation with respect to property which is a capital asset in the hands of a taxpayer

…shall be treated as gain or loss from the sale of a capital asset." I.R.C. § 1234A (2008). Therefore, a taxpayer experiencing a § 1234A event need not engage in a traditional sale or exchange to obtain capital gain treatment. Id.

Section 1234A was originally enacted to address contracts that could not be sold or exchanged because the contract had lapsed or had been cancelled or abandoned, necessitating ordinary income or loss. S. REP. NO. 97-144, at 170 (1981). Congress intended to normalize the treatment sought and to avoid inconsistent characterization for contracts depending on whether the contract would yield a gain or a loss. Id. In 1997, Congress broadened the scope of § 1234A to "include all property," not only "personal property that is actively traded." Wood, 109 TAX NOTES at 778. Therefore, this decision to expand the scope of § 1234A conveys the possibility of including litigation settlements within its purview.

To come within the scope of I.R.C. § 1234A, one must first show that the underlying lawsuit or "chose in action" is a capital asset. Id. Next, the taxpayer must demonstrate that a lawsuit recovery is either a "cancellation, lapse, expiration, or other termination" of a "right or obligation." Id. at 779. This two step analysis drives the application of § 1234A. Id. at 778-79.

To establish that a taxpayer's litigation is a capital asset, Respondent relies upon the Seventh Circuit's decision in Nahey, which concluded that a lawsuit is a "capital asset" because a capital asset is property held by the taxpayer. Nahey, 196 F.3d at 868 (citing I.R.C. § 1221); Arkansas Best Corp., 485 U.S. at 217-18. This suggests that lawsuits fit within the first textual requirement of I.R.C. § 1234A requiring a capital asset. Further, Judge Posner, in rendering his decision in Nahey, determined that a

"settlement, or equally a litigated judgment, resembles a sale because it extinguishes the plaintiff's claim." Nahey, 196 F.3d at 868. Therefore, according to Nahey, and the general usage of the terms within § 1234A, the litigation and eventual settlement of a lawsuit represents an extinguishment or termination of ones rights. Id.

Respondent held a capital asset, which was the right to litigate its claims against the negligent trustee. (R. at 3.) In litigating the claim, Respondent extinguished any future right to obtain a judgment against the trustee for failure to diversify. It follows, therefore, that §1234A may be applied to the judgment award, allowing the Respondent to report the $1,000,000 exceeding basis as capital gain. The Respondent contends that this reading is consistent with the scope and purpose of §1234A as described above. Applying §1234A is proper given the inevitable perception of ordinary gain treatment as a penalty, despite the unwanted nature of one's choice to litigate matters to enforce their rights. For policy reasons, it is important to avoid disincentivizing taxpayers from enforcing their rights through adverse and inconsistent tax treatment.

CONCLUSION

For the foregoing reasons, Respondent respectfully requests that this Court affirm the decision of the Thirteenth Circuit Court of Appeals because the amount that Respondent received is properly characterized as capital gains.