No. 2009-15

SUPREME COURT OF THE UNITED STATES

October Term 2009

COMMISSIONER OF INTERNAL REVENUE,

Petitioner

No. 2009-15

v.

Donald Dufont Testamentary Trust

Respondent

ON WRIT OF CERTIORARI TO THE COURT OF
APPEALS FOR THE THIRTEENTH CIRCUIT

Brief for Respondent

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QUESTIONS PRESENTED

I. Whether Respondent's classification of the settlement proceeds from the trustee's breach of its fiduciary duties owed to a trust are received in lieu of a return to capital and thereby receive capital gain treatment.

II. Whether the failure of a fiduciary to act as a prudent investor constitutes an involuntary conversion under 26 U.S.C. 1231 thus triggering capital treatment.

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OPINION BELOW

The order of the Tax Court below is unreported. The opinion of the United States Court of Appeals for the Thirteenth Circuit is unreported. All references to the Thirteenth Circuit Court of Appeals opinion are cited as Comm'r v. Dufont, No. 2008-46 (13th Cir. 2008) or Record.

STATUTORY PROVISIONS

The following authorities are relevant to the determination of the present case: 26 U.S.C. § 61 (1984); 26 U.S.C. § 1221 (2006); and 26 U.S.C. § 1231 (1999).

STATEMENT OF FACTS

Under the will of Donald Dufont, a domiciliary of the State of Mugel, a testamentary trust was established upon his death on January 1, 2005. Under the terms of the trust, the trustee, Main Bank, is allowed to distribute trust income to Donald's Daughter, Dora, at its "sole discretion." Upon her death, the trust corpus and any accumulated income to be distributed to Dora's son, John. The trust consisted entirely of 100,000 shares of common stock of Dufont, Inc. (Dufont), as a publicly traded company founded by Donald's father, Charles.

At the date of Donald's death, the trust was worth $2,000,000 ($20 a share). During the year 2005, the Dufont common stock steadily increased in value to $50 a share. After

a period of time, it declined steadily so that at the end of 2006 it reduced in value to $20 a share. The Dufont common stock has never paid dividend. None of the Dufont stock has ever been sold by the trustee.

In 2007, Donald and John Dufont requested an interim accounting from the trust. The trustee, 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 careless actions of the trustee who did not sell the stock when it reached its highest value. Donald and John requested 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, under the Mugel Prudent Investor Act, to diversity so-called "inception assets" within a reasonable time, breached its duty by not selling the Dufont stock within a reasonable time at the end of 2005 when it had a value of $50 a share.

In the case of a fiduciary's imprudent failure to diversify a stock concentration, the State of Mugel follows the law of State of New York in calculating damages. The governing principles were stated in In re Janes, 681 N.E.2d 332, 339 (N.Y. 1997) 55 as follows:

> 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.

The Surrogate Court determined that there was "lost capital" in the amount of $3,000,000. To this amount, the court added interest of $400,000 and entered a judgment against the trustee, Main Bank, requiring it to restore to the trust a total 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 Tax Court rejected the Commissioner's argument and ruled in favor of the respondent. The petitioner appealed to the Thirteenth Circuit Court of Appeals, which held in favor of the respondent. Petitioner then appealed to the Supreme Court.

SUMMARY OF THE ARGUMENT

Under 26 U.S.C.A. § 1221 (2006), the Internal Revenue Code (I.R.C.) defines capital assets as property held by the taxpayer, whether or not connected with his trade or business. Furthermore, it has been held that if a payment represents a return 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. The Respondent requests that this court affirm the Court of Appeals decision and deem the $2,000,000 recovery as a tax-free return of

capital to capital destroyed or injured. Also, the Respondent requests that this court affirm the Court of appeals decision and deem the $1,000,000 as capital gain. Being that the assets held in the trust are capital in nature and were identified properly by the Janes formula.

First, the proceeds of the lawsuit constitute a recovery of capital destroyed or injured. The stock held in the trust was originally valued at $20 a share. Subsequently, the stock raised in value to $50 a share. It soon dropped again to $20. The trust was financially damaged when the trustee failed to fulfill its fiduciary duty and diversify the stock when it reached $50 a share. Therefore, the trustee's actions injured the capital asset held in the trust.

Second, the excess proceeds of the lawsuit judgment are capital assets and subject to capital gains treatment. Since the trustee's breach of its fiduciary duty injured the trust's capital asset, any amount received in excess of the capital asset's basis should be taxed as a capital gain. The $1,000,000 in excess of the capital assets basis was calculated using the Janes formula as required by the State of Mugel. Therefore, the $1,000,000 should constitute a capital gain.

Finally, a continued possession of a capital asset does not preclude capital gains treatment. There are many instances where a party continually holds onto a capital asset, for example, good will and copyrights. These capital assets can be injured and damages. When settlement or judgments are rendered for injury to the capital asset, the recovery of basis is tax-free and any excess is capital gain. Likewise, the trust is still holding onto the capital asset. Any damages received in excess should be capital in nature. Therefore, the

settlement damages awarded should constitute a tax-free return of capital and long-term capital gain under the Janes formula.

In the alternative, this Court should uphold the Court of Appeals decision based on I.R.C. § 1231, involuntary conversions. When the trustee breached its fiduciary duty owed to the trust by failing in its duty to care, the trustee destroyed in part the assets within the trust. It is the Respondent's view that this Court should interpret the language of the I.R.C. according to its plain and ordinary mean, including an involuntary economic conversion. The Court, as well as a reading of the I.R.C., allows for an involuntary conversion to constructively act as a sale or exchange thus granting capital treatment. It is the Respondent's view, along with an alternative opinion of the Court of Appeals, that the trustee's breach would count as such an action.

In light of the harm that can be done to an individual through an involuntary conversion, it is further the Respondent's view that even if the plain and ordinary language of I.R.C. § 1231 does not include the notion of an involuntary economic conversion that it was Congress' intent so enacting the statute for such a conversion to be included. Equitably, it does not make sense for Congress to have wanted to protect against physical involuntary conversions and not economic ones.

ARGUMENT

I. THE SETTLEMENT DAMAGES AWARDED CONSTITUTE A TAX-FREE RETURN OF CAPITAL AND LONG TERM CAPITAL GAIN UNDER THE JANES FORMULA

The Court of Appeals was correct in agreeing with the Tax Court's conclusion that the settlement damages awarded constituted a tax-free return of capital and long-term capital gain under the Janes formula. The standard of review in regards to reviewing a Tax Court's legal conclusion is de novo. Musco Sports Lighting, Inc. v. Comm'r, 943 F.2d 906 (8th Cir. 1991).

This first issue in this case is whether the settlement damages awarded to Mr. Dufont's testamentary trust constitutes $2,000,000 as a tax-free return of capital and 1,000,000 as long-term capital gain. As a general rule, the capital gain provisions of the I.R.C. apply only to transactions involving capital assets. Slappey Drive Indus. Park v. United States, 561 F.2d 572 (5th Cir. 1977). The I.R.C. defines capital assets as property held by the taxpayer, whether or not connected with his trade or business. 26 U.S.C. § 1221 (2006). The I.R.C. also states exclusions from the definition five categories of property falling under these general headings: (1) inventory or property held primarily for sale in the ordinary course of business; (2) depreciable property and real estate used in the taxpayer's trade or business; (3) copyrights and similar property; (4) accounts receivable acquired in the ordinary course of business; and (5) certain obligations of the United States government. Id. It is clear that stock assets held in trust is do not fall under any of the I.R.C. § 1221 exceptions, so stocks are capital assets.

In regards to trust issues, the State of Mugel follows the Mugel Prudent Investors Act. This act requires a trustee, in compliance with its duty of care, to diversify so-called

"inception assets" within a reasonable time. In the case of an imprudent failure to diversify a stock concentration, the State of Mugel follows the law of State of New York in calculating damages. This formula is laid out in In re Janes, 681 N.E.2d 332, 339 (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 . . . 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.

These issues of proceeds of a lawsuit representing a replacement of capital destroyed or injured and capital gains treatment will be discussed in sections "A" and "B" respectively. The issue of precluding capital gains treatment by continually holding a capital asset will be discussed in section "C."

A. Proceeds of the lawsuit represent a replacement of capital destroyed or injured

I.R.C. § 61(a) states that, except otherwise noted, gross income means all income from whatever source derived. Whether an amount received from a judgment or settlement constitutes income depends on the nature, origin, and character of the claim giving rise to the settlement. Byrne v. Comm'r, 90 T.C. 1000, 1007 (1988). In characterizing settlement payments, courts consider the question, "[i]n lieu of what were damages awarded?" Raytheon Prod. Corp. v. Comm'r, 144 F.2d 110, 113 (1st Cir.

1944). Settlement payments that represent reimbursement for lost profits, royalties, or other items of taxable income are generally taxable. Raytheon, 144 F.2d at 113; Mathey v. Comm'r, 177 F.2d 259, 260-61 (1st Cir. 1949). However, if a payment represents a return 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. Sager Glove Corp. v. Comm'r, 36 T.C. 1173, 1180 (1961). The burden is on the respondent to prove what amount, if any, constitutes nontaxable income. Id. A recovery that compensates a plaintiff for injuries to a capital asset may recover a tax-free return of capital to the extent the taxpayer's basis in the injured asset. Rev. Rul. 81-277, 1981-48 I.R.B. 5.

First, in OKC Corp. & Subsidiaries v. Comm'r, 82 T.C. 638, 641-42 (1984), OKC entered into negotiations with Philips Petroleum to supply OKC with crude oil in exchange for a purchase of Philips output. Philips eventually could no longer subsidize OKC refinery operations. Id. at 644. The OKC refinery's value was only $2 million to $2.5 million. Id. OKC and Philips entered into a settlement agreement, which canceled most of Philips contracts with OKC. Id. at 645. In return, Philips agreed to forgive the debt of $1,397,567.73 and the inventory balance of $1,257,522.57. Id. OKC claimed that the settlement constituted recovery of the reduction in the refinery's basis. Id. at 646. The I.R.S. argues that it is income. Id.

The court held that since there was no dispute between the parties regarding the declining value of the refinery, the settlement proceeds could not have been for a decline in the refinery's basis. Id. at 652. Nor was the settlement of the lawsuit directly related to the value of the refinery. Id. The settlement dealt with an output contract; therefore, the settlement proceeds must be treated as a payment for OKC refinery's lost earnings. Id.

Also, in Morse v. United States, 178 Ct. Cl. 405 (1967), plaintiffs filed action against Sam Berger for money lent, money had and received, and money paid on open book account in regards to their joint business venture. Sam Berger entered into a settlement agreement with the plaintiffs. Id. Plaintiffs received $5,000 under the settlement agreement in 1958 and did not include it on their tax return. Id. The commissioner claimed a $3,644 deficiency. The court held that since the plaintiffs could not sustained their burden of proof by proving the I.R.S. was in error the $3,644 would be considered ordinary income. Id. at 483.

Finally, in State Fish Corp. v. Comm'r, 48 T.C. 465, 465 (1967), the taxpayer purchased all the assets of a company, including its goodwill in exchange for $25,000. The seller then violated a noncompete agreement that was entered into in connection with the sale and the taxpayer sued for injury to its good will. Id. at 467. They settled at $12,250. Id. at 469. The Commissioner filed suit stating that the settlement should have been included as ordinary income. Id. The court held that the $9,213 portion of the settlement represented damage to goodwill and diminution of its value since the amount did not exceed the taxpayer's basis. Id. at 477.

The settlement proceeds for the Testamentary Trust of the Estate of Mr. Dufont clearly represents a recovery of capital destroyed or injured. The fact that the judgment against the bank over the breach of fiduciary duty over the estate is evidence that shows the settlement proceeds were for a loss in capital. The present case is similar to the in OKC Corporation. The court would have ruled in the favor of the respondent if they could have proved that their settlement proceeds constituted a recovery of a capital asset. The Estate of Mr. Dufont was awarded a judgment for a breach of a fiduciary duty. A

judgment should hold more weight in the courts eyes than a mere settlement. The money damages were estimated using the Janes formula. The court calculated damages and made the judgment in this manner to be equitable and just. The Estate of Mr. Dufont was damaged to the extent of $3,400,000 when the Bank did not sell that stock at its peak. The recovery of $2,000,000 of the damages would therefore represent a replacement of capital destroyed or injured.

B. The excess proceeds of the lawsuit judgment are subject to capital gains treatment required by I.R.C. § 1222(3)

It is well established that settlement or judgment proceeds depends on the nature of the claim and the basis of recovery. Sager Glove Corp., 36 T.C. at 1180. Where there is an injury to an identifiable capital asset, the amount received in settlement, to the extent it does not exceed the basis, is a return of capital and not taxable. Freeman v. Comm'r, 33 T.C. 323, 327 (1959). Any amount received in excess of the basis is taxable at capital gain rates. Daugherty v. Comm'r, 78 T.C. 623, 639 (1982). A long term capital gain is defined in I.R.C. § 1222(3) as the gain on 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."

First, in Daugherty, petitioners had been in the real estate business and purchased 12 acres or less of waterfront property in 1966 or 1967. 78 T.C. at 625. On or about March 11, 1974, the state of Maryland filed a petition for condemnation to acquire the land from the petitioners. Id. In April of 1975, the parties reached a settlement agreement where the petitioners received $165,000 for their land. Id. at 626. Petitioners only claimed half the proceeds of the condemnation settlement on their 1976 tax return.

Id. at 627. The court stated that "[i]f the claim is for damages 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." Id. at 639. However, since the property held by the petitioner wasn't a capital asset, the capital received must be claimed as ordinary income. Id.

Also, in Inco Electroenergy Corp. v. Comm'r, 54 T.C.M. 359, 363 (1987), the petitioner reached a settlement agreement with Exxon Corporation over a trademark dispute. Exxon paid the petitioner $5,000,000 as per the settlement agreement. Id. On its income tax, the petitioner claimed the $5,000,000, less $225,000 in legal fees, as proceeds from the sale of a capital asset, or a capital gain. Id. Respondent filed a notice of deficiency determining that such proceeds are ordinary income. Id. The court held that they would treat the settlement agreement as if they had a judgment rendered over the issue. Id. Since the damages were done to a trademark and good will, which are considered capital assets, the settlement proceeds would be taxable as capital gains. Id.

Similarly, in Rev. Rul. 81-152, 1981-1 C.B. 443, a condominium management association recovered an award against a developer for defects in the units. No sale or exchange of a capital asset was involved in this damages award. Id. The Internal Revenue Service (I.R.S.) ruled that the award was received on behalf of each of the condos individual owners. Id. The ruling concluded that the proceeds of the award represented "a return of capital to each unit owner to the extent the recovery does not exceed that owner's basis in his or her property interest in the condominium development." Id.

Finally, in Big Four Indus., Inc. v. Comm'r, 40 T.C. 1055, 1055 (1963), taxpayer is a corporation who was sued in 1951 for patent infringement. They soon after filed a counter claim and won $1,200,000 in damages. Id. at 1058. Taxpayer claimed $323,893 of the $1,200,000 award as damage done to its corporate capital structure and goodwill. Id. at 1059. The Commissioner filed a claim stated that the $323,893 was for lost profits, which is taxable as ordinary income. Id. The court stated that "[t]o the extent that such amount did not exceed the basis of capital interest or goodwill destroyed it would be nontaxable, but it would be taxable as capital gain to the extent of any excess over basis." Id. at 1060. The court held that $128,568.40 of the remaining portion of the $1,200,000 in damages was recovery of damages in excess of the taxpayer's basis in goodwill. Id. at 1060. Therefore, it is taxable as capital gain. Id.

The excess gain of $1,000,000 in Mr. Dufont's trust should be taxed as a capital gains rate. The trust of Mr. Dufont originally had $2,000,000 in stock assets. The trustee should have sold the stock when it reached $5,000,000. In calculating the damages, using the Janes formula, it is clear that the trust is entitled to the amount that the trust would have been worth had the trustee not violated its fiduciary duty. In this case, there is $3,000,000 to be accounted for plus $400,000 in interest. As previously established, the $2,000,000 is a recovery of the basis for an injury to a capital asset. The remaining amount would therefore be additional gain in excess of the basis. As established in Daugherty, 78 T.C. 623 (1982), the amount in excess of basis recovered for damages to a capital asset should be taxed at a capital gain's rate. Further, it makes logical sense that if the item damaged was a capital asset that the amount received should also be capital in nature. Also, our case is similar to Big Four Indus., Inc., 40 T.C. 1055 (1963), where

they treated the excess amount recovered in damages to good will as capital gains. Good will is a capital asset as is the trust of Mr. Dufont. Therefore, the trust of Mr. Dufont was correct in reported the excess of basis as capital gain. The $1,000,000 should be taxed as a capital gain.

C. Continued possession of a capital asset does not preclude capital gains treatment

To identify the type of award received the question asked is "in lieu of what were the damages awarded?" Raytheon, 144 F.2d 110 at 113. Furthermore, if a payment represents a return 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. Sager Glove, 36 T.C. at 1180.

In State Fish, 48 T.C. at 466, the taxpayer had bought an established and ongoing business, with the seller agreeing not to open a similar business and compete with the taxpayer. The seller however, breached the covenant not to compete and the taxpayer brought suit stating damages to goodwill of the business. Id. at 467. After the taxpayer was awarded a judgment, the seller paid a lesser sum in settlement of the judgment. Id. at 469-70. The court held that a recovery received by a taxpayer constituted compensation for diminution in the goodwill of his business and therefore was taxable as capital gain. Id. at 477.

Furthermore, in Sager Glove, 36 T.C. at 1174, taxpayer was a corporation engaged in the business of manufacturing and selling safety material, equipment, clothing and protective apparel. Taxpayer alleged that Bausch & Lomb endeavored to destroy the taxpayer's business by monopolizing the business of safety materials and equipment. Id.

at 1175. A jury found Bausch & Lomb guilty and awarded taxpayer $478,142.00. Id. at 1178. The taxpayer stated that $318,762 constituted a nontaxable return of income. Id. at 1179. The Commissioner filed suit against the taxpayer. Id. The court could not conclude that the petitioner met the burden of showing that any portion of the amount received in settlement was paid as compensation for injury to goodwill or any other capital asset. Id. at 1182. Neither the complaint, nor the release, provided a basis for making an allocation of the recovery and finding that any part represented a return of capital. Id.

Also, in I.R.S. F.S.A. 200228005 (Mar. 29, 2002), the I.R.S. made a determination involving the tax treatment of settlement proceeds arising from a taxpayer's purchase of contaminated property. The taxpayer recovered the proceeds from the seller. Id. The I.R.S. found that the origin of the taxpayer's claim was the taxpayer's purchase of the property. Id. The I.R.S. ruled, "[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 the Excess of taxpayer's basis in the land should be treated as capital gain." Id.

Finally, in Inco Electroenergy, the taxpayer sued Exxon for infringing on one of its existing trademarks. Exxon agreed to pay the taxpayer $5,000,000 in damages, and the taxpayer continued to use the trademark. Id. The court first analyzed the origins of the claim and stated that "amounts received for injury or damage to capital assets are taxable as capital gains, whereas amounts received for lost profits are taxable as ordinary income." Id. The court found that the claim was for damages to the trademark and

associated good will. Id. Further, the court stated "we need only to characterize the nature of these assets," which it found were capital assets. Id.

The trust of Mr. Dufont should be allowed capital gains treatment on the excess of capital acquired from the judgment even though it still possess the capital asset. The Janes formula calculates the damages in cases where a fiduciary fails to diversify a stock concentration. As stated earlier, the amount recovered in excess of the basis is $1,000,000. Unlike Sager Glove, 36 T.C. 1173 (1961), the asset held by the taxpayer is a capital asset. Therefore, any amount received in excess should be capital in nature.

Furthermore, as seen in Inco Electorenergy and State Fish, it is possible to still maintain you capital asset, in their cases good will, and still have capital gains treatment for settlements or judgments. In those cases, the parties still had their capital assets, but they were damaged in some way. Similarly, in the present case the trust had its capital asset damaged when the bank failed to diversify the stock when it reached its peak for $50 a share. This was a breach of the bank's fiduciary duty and the trust of Mr. Dufont suffered the consequences. Therefore, by following the Janes formula in calculating and identifying the damages, a party can still possess a capital asset and have their settlement or judgment proceeds in excess of the basis taxed at the capital gains rate.

II. FAILURE OF A FIDUCIARY TO ACT AS A PRUDENT INVESTOR CONSTITUTES AN INVOLUNTARY CONVERSION UNDER I.R.C. § 1231

A. A Trustee has a fiduciary duty to act as a prudent person in their trust decisions

A testamentary trust is "[a] trust that is created by a will and takes effect when the settlor (testator) dies. -- Also termed *trust under will*." BLACK'S LAW DICTIONARY 1552 (8th ed. 2004). Donald Dufont's testamentary trust was comprised entirely of 100,000

shares of Dufont, Inc. common stock, for the benefit of Donald's daughter, Dora, during her life, and on her death to Dora's son, John. Record 2. Main Bank was appointed the trustee. According to the law of Mugel, the trustee had a fiduciary duty to act as a prudent person and a duty to diversify the stock concentration in the trust. "[T]he trustee is bound to employ such diligence and such prudence in the care and management [of the trust], as in general, prudent men of discretion and intelligence in such matters, employ in their own like affairs." In re Janes, 681 N.E.2d 332, 336 (N.Y. 1997).

In the case at hand, the trustee failed in his fiduciary duty when he not only failed to diversify the stocks within the trust, but he failed to sell the stocks when they had increased significantly in value. Record 2, 3. In determining liability on the part of the trustee, "[t]he inquiry is simply whether, under all the facts and circumstances of the particular case, the fiduciary violated the prudent person standard in maintaining a concentration of a particular stock in the estate's portfolio of investments." In re Janes, 681 N.E.2d 332, 337 (N.Y. 1997); see also Williams v. J.P. Morgan & Co., F. Supp. 2d 189 (S.D.N.Y. 2002). In the Surrogate Court, Main Bank, the trustee of Donald Dufont's trust was found in violation of this fiduciary relationship. The Tax Court upheld the findings of this lower court. The failure by the trustee to sell the stock resulted in a significant loss in the value of the holdings of the trust.

B. The Internal Revenue Code provides for special treatment of capital assets

While I.R.C. § 1221 provides an enumerated list of exceptions to capital assets, other sections of the I.R.C. help to clarify what are capital assets and what triggers capital treatment. In I.R.C. § 1222, setting forth other terms relating to capital gains and losses,

the I.R.C. clarifies the holding period and classification of capital assets for proper tax treatment. Stating in relevant part:

> (1) Short-term capital gain. The term "short-term capital gain" means gain from the sale or exchange of a capital asset held for not more than 1 year, if and to the extent such gain is taken into account in computing gross income…
> (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.

26 U.S.C. § 1222 (2008). This section clarifies the triggering of capital gain treatment and the type of treatment: short-term or long-term.

Additionally, section 1222 of the I.R.C. provides for one area of contention in this case as posed by the Commissioner in Tax Court. The Commissioner argued in Tax Court that there had been no sale or exchange with the breach of the fiduciary duty; therefore, the money received could not constitute a gain or a loss. It is our position, and that of the Tax Court, that the sale or exchange requirement has been met through I.R.C. § 1231, involuntary conversions. Section 1231 provides in relevant part:

> (a)(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.

26 U.S.C. § 1231 (1999) Italics added.

It is our position that even if this court were to find that the settlement itself did not satisfy the sale or exchange requirement, the breach of the fiduciary duty owed to the trust by Main Bank satisfies the I.R.C. § 1231 involuntary conversion requirements. As described in the parenthetical of I.R.C. § 1231, an involuntary conversion can include the

destruction of property in whole or in part. By failing to sell the stock in 2005, Main Bank destroyed part of the trust assets in what can be constituted an involuntary economic conversion.

C. This Court has the ability to interpret the language of I.R.C. § 1231

1. When interpreting statutes, words are given their plain and ordinary meanings

The general rule of statutory interpretation is that words contained within a statute are to be given their plain and ordinary meaning. See Caminetti v. United States, 242 U.S. 470 (1917) (cited in Cent. Trust Co. v. Official Creditors' Comm. of Geiger Enter., 454 U.S. 354, 359-60 (1982)). Looking at the plain an ordinary meaning of the words contained in I.R.C. § 1231, it is our position that the term "involuntary conversion" is applicable to the case at hand. By failing to act, Main Bank caused a decrease in the value of the underlying asset of the trust, which should be termed an "involuntary conversion," thus dealt with under I.R.C. § 1231.

First, the word "destruction," as used in I.R.C. § 1231, can be applied to the case at hand. By breaching its fiduciary duty, the trustee caused the destruction of the underlying asset of the trust. The term destruction has been found to mean "rendering the thing useless for the purpose for which it was intended." Henshaw v. C. I. R., 23 T.C. 176, 182 (1954), acq., 1955-2 C.B. 3; see also 4 JACOB MERTENS, JR., THE LAW OF FEDERAL INCOME TAXATION § 22:122. When Main Bank failed to sell the stock when it was at its peak value it thus rendered the trust asset useless for the purpose in which it was intended: to provide for future profits which would be paid to the beneficiaries of the trust.

2. When a word has more than one meaning the courts often rely of Congressional intent

Even if the plain and ordinary meaning of the words used in I.R.C. § 1231 do not explicitly include the involuntary economic conversions, it would not cause the section not to be applicable to the case at hand because it was the intent of Congress for this statute to cover such cases.

The I.R.C. is meant to be taken as a whole; however, it is internally inconsistent. The I.R.C. is commonly updated by specific provision, not as a whole. The means that even parts of the I.R.C. that are meant to internally reference each other were not all updated at the same time.

As stated in Samuel B. Sterrett, Use of Industry Definitions in Interpretation of the Internal Revenue Code: Towards A More Systematic Approach:

> [i]f legislative policy is couched in vague language, easily susceptible of one meaning as well as another in the common speech of men, we should not stifle a policy by a pedantic or grudging process of construction… For we are here not dealing with the broad terms of the Constitution "as a continuing instrument of government" but with part of a legislative code "subject to continuous revision with the changing course of events."

16 VA. TAX REV. 1, 3 (1996); see also Sirbo Holdings, Inc. v. Comm'r, 509 F.2d 1220, 1223 (2d Cir. 1975) (regarding definition of "sale or exchange," based on legislative history and purpose, refusing to give controlling weight to the usual presumption that the same words used in different sections of a statute have the same meaning); see also Bel v. United States, 452 F.2d 683, 690 (5th Cir. 1971) (refusing to read sections of the I.R.C. together, instead characterizing them as lemons and oranges because of their different purposes).

In Eisner v. Macomber, 252 U.S. 189, 207 (1920), the Supreme Court attempted to establish a principle of statutory interpretation when it stated that gain is "derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets . . . ." See Anthony P. Polito, Borrowing, Return of Capital Conventions, and the Structure of the Income Tax: An Essay in Statutory Interpretation, 17 VA. TAX REV. 467, 484 (1998) (quoting Stratton's Independence, Ltd. v. Howbert, 232 U.S. 399, 415 (1913)); see also Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918); see generally Charles L. B. Lowndes, Current Conceptions of Taxable Income, 25 OHIO ST. L.J. 151 (1964); Phillip Mullock, The Constitutional Aspects of Realization, 31 U. PITT. L. REV. 615 (1970). However, if you look at the I.R.C., it is made up of many individual parts each of which have been subject to many revisions, rarely at the same time. The fact that the I.R.C. is inherently inconsistent means that what can often be viewed as the "ordinary" meaning of words is often subject to judicial interpretations in light of congressional intent.

3. Congressional interpretation of I.R.C. § 1231 could be read as including involuntary economic conversions

In looking at the idea of an involuntary conversion, it is not the first time that the court system needed to interpret what was meant by legislative policy. In Towanda Textiles, Inc. v. United States, 149 Ct. Cl. 123 (1960), the Court found that "an involuntary conversion is not a sale … but … a conversion of a corporation's capital assets into cash, whether voluntary or involuntary, and the distribution of the cash to the stockholders." Id. at 129 (citing a Senate Finance Committee report later codified at 26 U.S.C. § 337 (1954)). While a section was eventually added to the I.R.C. in order to

clarify the procedure for the liquidation of a corporations and what taxation treatment the corporation and the stockholders were subject to, it followed from judicial interpretation of congressional intent. See United States. v. Morton, 387 F.2d 441 (8th Cir. 1968); see also Robert David Hendrickson, Taxation – Nonrecognition of Capital Gains – The Date of an Involuntary Conversion is the Date of the "Sale or Exchange" under Section 337, 49 TUL. L. REV. 243, 246 (1979). While this case does not involve liquidation but the involuntary economic conversion of stocks, the basic premise is important to the case at hand. While the current I.R.C. § 1231 does not specifically include an involuntary economic conversion, it would not be a stretch to argue that Congress intended for such an event to be included.

I.R.C. § 1231 specifically allows for capital gain treatment when there is an involuntary conversion. While it seems to be alluding to physical conversions, theft, loss, it does not specifically include these conversion or expressly exclude economic conversions. When Main Bank failed to sell the Dufont stock when a prudent individual would have done so, they took away from the trust their ability to make a profit. In doing so, the trustee produced a situation where an involuntary conversion took place. The fact that the trust later recovered these lost funds through a recovery suit shows an additional parallel to what might occur during a physical loss. Like insurance proceeds paid by a company, the lawsuit payment constituted that same relief: insurance proceeds from their failure to act prudently.

Additionally, section 1231 is not the only section in the I.R.C. where involuntary conversions are granted special treatment. For example, nonrecognitiion provisions exist for taxpayers "when property is lost through condemnation, theft or physical destruction

and the taxpayer receives (and then reinvests) compensation from the state, insurer or tortfeasor." Daniel N. Shaviro, An Efficiency Analysis of Realization and Recognition Rules Under the Federal Income Tax, 48 TAX L. REV. 1, 16 (1992); see also I.R.C. § 1022(a)(2). The fact that the I.R.C. provides for special treatment in particular circumstances in other parts of the code reflects highly on the idea that this is not a stretch of congressional intent.

While the provision does not specifically state that an involuntary economic conversion qualifies for such treatment, it does emphasize the importance of the involuntary. The financial loss by the taxpayer due to the trustee's failure to act in its fiduciary capacity cannot be considered a voluntary action. Therefore, the Court should interpret the actions by Main Bank in regard to the Dufont Trust to be an involuntary conversion.

D. Overcoming the sale or exchange requirement of capital treatment

Although the I.R.C. makes a "sale or exchange" a precondition to capital gain treatment, courts and the I.R.S. have frequently accorded such treatment to recoveries for damage to the taxpayer's property, even where the taxpayer retains the property and engages in no sale or exchange. While it is true that normally a sale or exchange is required to classify a sale or exchange it can also include an involuntary transfer of property. See Ronald Jensen, Can you have your Cake and eat it too? Achieving Capital Gain Treatment while keeping the Property, 5 PITT. TAX. REV. 75, 80 (2008) (citing Helvering v. Hammel, 311 U.S. 504, 510 (1941); Electro-Chem. Engraving Co. v. Comm'r, 311 U.S. 513, 514 (1941)).

Those who argue against capital treatment often draw conclusions based on what could be seen as arbitrary lines. For example, if a taxpayer receives a settlement based on stock that "lost value because of the fraud and mismanagement of corporate insiders" some argue that this recovery award should be characterized as ordinary income. See Jensen, supra, at 115. The main qualm with allowing the recovery to receive capital gain preference is often not the fact that the taxpayers held on to the underlying asset, thus not disposing of the property in an ordinary sense of sale or exchange, but that one could not be sure that the corporation would never have paid out a dividend. Id. Because of the fear that not all future income from the stock might have been capital in nature, it is argued that the entire award should be ordinary income. The rationale is that "the long-term capital gain tax rate is an extraordinary preference, and the taxpayer should clearly establish his or her entitlement to it." Id.

The case at hand, however, is distinguishable from this situation. While it is true that there was a possibility for a dividend because of the nature of stock, Dufont common stock never paid a dividend, which was the policy of the Board of Directors. Additionally, the trust established its entitlement to the treatment based on the "lost capital" award payment stemming from the mismanagement of trust funds. The trust received this payment solely for the loss that resulted from the failure to sell the stocks when they had the highest market value. By failing to sell the stocks, there was an involuntary economic conversion of trust funds.

It is our position that when addressing the sale or exchange issue, "[t]he better view is that a disposition of the stock isn't needed . . . ." Robert W. Wood, Securities Lawsuit Recoveries: Capital Gain or Ordinary Income?, 108 TAX NOTES 767, 768

(2005); see, e.g., Mitchell Pacelle, Citigroup's WorldCom Payment Is Finalized at $2.58 Billion, WALL ST. J., Nov. 8, 2004, at C5; Randall Smith, CIBC to Pay $2.4 Billion Over Enron, WALL ST. J., Aug. 3, 2005, at A3 (reporting that a Canadian bank paid $7.12 billion to settle investors' fraud claims). In fact, it is not always the case that the court requires a sale or exchange in the traditional sense of the word. Often, courts grant capital treatment without requiring the sale or exchange requirement, or at least just not mentioning it. Robert W. Wood, Securities Lawsuit Recoveries: Capital Gain or Ordinary Income?, 108 TAX NOTES 767, 770; see also Robert W. Wood, Litigation Settlements, Sales and Exchanges, and Section 1234A, 109 TAX NOTES 776 (2005).

As the petitioner will argue, generally the mere settlement of a lawsuit is not deemed to constitute a disposition. However, that brings up the question whether a disposition is even required. In the context of recovering damages in lawsuits, the courts and the I.R.S. have often allowed capital gain treatment even though there was no sale or exchange. Making the issue more puzzling, capital gain treatment is often accorded without any mention of the necessity for a sale or exchange. Wood, Securities Lawsuit Recoveries, supra, at 770; see, e.g., State Fish Corp., 48 T.C. at 477; Big Four Indus., Inc., 40 T.C. at 1060.

CONCLUSION

For all the foregoing reasons, the Respondent respectfully requests that the judgment of the United State Court of Appeals for the Thirteenth Circuit be affirmed.

Respectfully submitted,

Counsel for the Respondent