No. 99-1731

In the Supreme Court of the United States

BRIAN L. NAHEY AND CAROL J. NAHEY, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

SETH P. WAXMAN
Solicitor General
Counsel of Record
PAULA M. JUNGHANS
Acting Assistant Attorney General
DAVID I. PINCUS
DONALD B. TOBIN
Attorneys
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

QUESTION PRESENTED

Whether a payment received in settlement of a suit for damages for fraud, misrepresentation and breach of contract is ordinary income or capital gain to the recipient when the claim was acquired in conjunction with the purchase of a corporation's assets.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

In the Supreme Court of the United States

NO. 99-1731

BRIAN L. NAHEY AND CAROL J. NAHEY, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-15a) is reported at 196 F.3d 866. The opinion of the Tax Court (Pet. App. 17a-33a) is reported at 111 T.C. 256.

JURISDICTION

The judgment of the court of appeals was entered on November 17, 1999. A petition for rehearing was denied on January 28, 2000 (Pet. App. 34a). The petition for a writ of certiorari was filed on April 27, 2000. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner Brian L. Nahey was president, chief executive officer, and a director of Wehr Corporation.[1] Pet. App. 19a. In late 1983, Xerox Corporation entered into a contract to provide an integrated computer system to Wehr by January 1985. *Ibid.* After Xerox missed target dates, and Wehr withheld payments due, Xerox terminated its work on the project. *Id.* at 20a.

In February 1985, Wehr filed suit against Xerox alleging fraud, misrepresentation and breach of contract. Pet. App. 20a. The complaint sought actual and punitive damages in an amount in excess of $5,000,000. *Ibid.* In response, Xerox filed a counterclaim in the amount of $652,984 for the services for which Wehr had failed to pay. *Id.* at 2a, 20a. Petitioner acknowledges that the suit filed by Wehr was for lost profits and that any recovery from the lawsuit would have been taxed to Wehr as ordinary income. Pet. 7 & n.1.

In 1986, Xerox offered to pay Wehr $1.2 million to settle the suit. A Xerox representative also indicated at that time that the company "could go as high as $2 million" to settle the case. Pet. App. 21a. Petitioner rejected the offer on behalf of Wehr. *Ibid.* Petitioner advised the board of directors of Wehr that he believed that Wehr could recover as much as $10 million from the Xerox litigation. *Ibid.*

In the latter part of 1986, the majority owner of Wehr's stock offered to sell all of Wehr's assets to petitioner for $100 million. Pet. App. 21a. That price was based on a multiple of the company's historical

[1] Carol J. Nahey is a party to this action only because she filed a joint return with Brian L. Nahey. Because the pertinent facts and issues in this case relate to a payment made to Brian L. Nahey, we refer to him as "petitioner" throughout the brief.

earnings. *Id.* at 22a.[2] In December 1986, the majority owner agreed to finance the sale to petitioner as part of a leveraged buy out. *Ibid.*

Petitioner formed two S corporations—Venturedyne, Ltd. and Carnes Company, Inc.—to acquire and hold the assets of Wehr. Pet. App. 22a. These new corporations purchased all the assets and assumed all the liabilities of Wehr, and thereafter operated the business of the predecessor corporation. *Id.* at 22a-23a.

As part of this transaction, the new corporations acquired Wehr's claim against Xerox and assumed any liability arising from Xerox's counterclaim. Pet. App. 23a. The parties to the sale did not allocate the purchase price among the specific assets. The accounting firms that were involved in the transaction concluded that they could not assign a specific value to the claim against Xerox because the value of that claim was "too speculative." *Ibid.* Since no portion of the purchase price was specifically allocated to the Xerox lawsuit, neither of the new corporations booked the lawsuit as an asset. *Ibid.* These corporations deducted from ordinary income the legal expenses they incurred in pursuing the litigation against Xerox. Tr. 121.

After concluding their purchase of Wehr's assets, the S corporations announced that they were pursuing a new method of calculating damages in the suit against Xerox. The new method—which added the injuries allegedly suffered by the S corporations to those suffered

---

[2] Petitioner states that "the parties took into account the existence of the Xerox lawsuit as part of their financial analysis." Pet. 4. The Tax Court found, however, that, while petitioner considered the potential income from the lawsuit in his evaluation of the sale, the asking price was calculated by the seller based upon an analysis of the earnings of the corporation. Pet. App. 22a.

by Wehr—increased the damages estimate to a broad range from $20 million to $120 million. Pet. App. 24a. After the district court ruled that the S corporations would be allowed to introduce evidence at trial based on this new method of calculating damages, the parties agreed to a settlement under which Xerox dismissed its counterclaim and paid the S corporations the sum of $6,345,183. *Ibid*.

The S corporations reported the settlement proceeds as long-term capital gain received in 1992. As a shareholder of the S corporations, petitioner reported his allocable share of the settlement proceeds as capital gain on his federal income tax return for that year. Pet. App. 25a. In calculating the capital gain, neither the S corporations nor petitioner attributed any basis to the lawsuit. *Ibid*.

2. The Commissioner of Internal Revenue issued a notice of deficiency for petitioner's 1992 taxable year. The Commissioner concluded that petitioner should have treated the payment received by the S corporations from the settlement of the lawsuit as ordinary income rather than as a capital gain. Pet. App. 36a-46a.

When petitioner sought review of the asserted deficiency, the Tax Court upheld the Commissioner's determination. The court noted that the proceeds of the settlement of the Xerox lawsuit represented ordinary income because one of the prerequisites to capital gain treatment—the existence of a sale or exchange of a capital asset—was not present here. Pet. App. 31a. The court explained that "a compromise or collection of a debt is not considered a sale or exchange of property because no property or property rights passes to the debtor other than the discharge of the obligation." *Id*. at 26a, citing *Fairbanks* v. *United States*, 306 U.S. 436 (1939). The court concluded that the collection of this outstanding debt was not a "sale or exchange" of the debt, and that "[t]he treatment of the settlement proceeds as ordinary income" is not altered by "the fact that the S corporations acquired Wehr's assets in a capital transaction." Pet. App. 32a.

3. The court of appeals affirmed. Pet. App. 1a-15a. The court concluded that the proceeds from the settlement of a claim for the recovery of items of ordinary income do not constitute a "sale or exchange" of a capital asset. *Id.* at 3a-4a. The court noted that *if* the settlement of the suit for damages against Xerox constituted a "sale or exchange," as petitioner contends, then *Wehr* would have been entitled to capital gain treatment if the settlement had occurred before its assets were transferred to the S corporations. That conclusion would be illogical for, as petitioner acknowledges, these proceeds would necessarily be ordinary income to Wehr—for they simply replace the profits Wehr claims to have lost and the expenses Wehr claimed to have incurred from Xerox's breach. *Id.* at 4a; see also Pet. 7 & n.1.

The court concluded that the settlement did not give rise to a capital gain because the origin of the claim was a suit to recover items of ordinary income. The court explained that "the [tax] classification of amounts received in settlement of litigation is to be determined by the nature and basis of the action settled, and amounts received in compromise of a claim must be considered as having the same nature as the right compromised." Pet. App. 4a, quoting *Alexander* v. *IRS*, 72 F.3d 938, 942 (1st Cir. 1995). The sale of Wehr's assets to the S corporations did not alter the nature of the lawsuit, which was the recovery of items of ordinary income. Pet. App. 7a.

The court rejected petitioner's contention that the settlement proceeds constituted capital gains under the reasoning of *Arrowsmith* v. *Commissioner*, 344 U.S. 6 (1952). The court explained, as this Court has also held, that *Arrowsmith* stands for the "unexceptional proposition that 'if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments [of that money] were generally deductible from receipts taxable at the higher rate applicable to ordinary income.'" Pet. App. 8a, quoting *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 685 (1969). The court noted that the decision in *Arrowsmith* has no application to the present case, in which the Commissioner seeks to tax the amounts received at the *same* rate, not at a different rate, that those amounts would have been taxed in the hands of the entity that earned them. Pet. App. 8a.

The court also rejected petitioner's contention that the "open transaction" doctrine applies to the facts in this case. Pet. App. 9a. The court noted that the open transaction doctrine allows a person who *sells* property in exchange for a stream of contingent payments to treat the stream as relating back to the sale or exchange and thereby to represent capital gain to the extent that the seller's total receipts exceed his basis in the property sold. *Ibid*. The court pointed out that the "open transaction" doctrine does not apply to the facts of this case, which involves money received by a *buyer* of property upon a subsequent disposition of it. *Id*. at 10a.

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Section 1222 of the Internal Revenue Code describes a "capital gain" as the "gain from the sale or exchange of a capital asset." 26 U.S.C. 1222(1)-(11).[3] A settlement of litigation involving an obligation or chose in action is not a "sale or exchange" because no property passes to the debtor other than the discharge of the obligation. *Fairbanks* v. *United States*, 306 U.S. at 437-438. It has therefore long and consistently been held that a settlement of a lawsuit does not, by itself, represent a "sale or exchange" of a capital asset. See, *e.g.*, *Ogilvie* v. *Commissioner*, 216 F.2d 748, 749 (6th Cir. 1954); *Lee* v. *Commissioner*, 119 F.2d 946, 948 (7th Cir. 1941); *Hale* v. *Commissioner*, 85 F.2d 819, 821 (D.C. Cir. 1936).

As the court of appeals correctly held in this case, if a payment made in settlement of a lawsuit replaces or is a substitute for an item of ordinary income—such as lost profits or a reimbursement of business expenses — the payment must also be treated as ordinary income to the recipient. Pet. App. 4a. See also *Alexander* v. *IRS*, 72 F.3d at 942 ("amounts received in compromise of a claim must be considered as having the same nature as the right compromised"). When the "origin of the claim" is an action to recover a capital asset, the

---

[3] The Code also provides in a number of instances that specific transactions other than sales or exchanges of capital assets shall be "treated as" giving rise to "capital gains" or "capital losses", as the case might be. See, *e.g.*, 26 U.S.C. 165(g), 166(d)(1)(B), 1233, 1234 (1994 & Supp. IV 1998). None relates to this case.

proceeds of the recovery could then be capital in nature. But when, as in the present case, the "origin of the claim" is a right to recover an item of ordinary income (such as lost profits), then the proceeds of the recovery necessarily represent ordinary income in the hands of the recipient. See, *e.g.*, *Alexander* v. *IRS*, 72 F.3d at 942; *Estate of Carter* v. *Commissioner*, 298 F.2d 192, 194 (8th Cir. 1962) ("the classification for tax purposes of amounts received in settlement of litigation is to be determined by the nature and basis of the action settled"). See also *Woodward* v. *Commissioner*, 397 U.S. 572, 577-578 (1970).

Applying these consistent decisions, the court below correctly concluded (Pet. App. 3a-4a) that the "origin of the claim" involved in this case was the breach of contract by Xerox and that the recovery of lost profits sought under that claim was a recovery of an item of ordinary income. Indeed, petitioner has conceded (Pet. 7 & n.1) that the recovery of the settlement payment for "allegedly lost profits" is an item of "ordinary income" in the hands of Wehr. Since the underlying action was for the recovery of items of ordinary income, the settlement payment must also be treated as ordinary income when received. *Canal-Randolph Corp.* v. *United States*, 568 F.2d 28, 30 (7th Cir. 1977); *Estate of Carter* v. *Commissioner*, 298 F.2d at 194.

2. Petitioner errs in contending (Pet. 8-9, 17-20) that the decision in this case conflicts with *Arrowsmith* v. *Commissioner*, 344 U.S. 6 (1952). In *Arrowsmith*, this Court held that a shareholder who reported capital gain on the receipt of assets in a corporate liquidation could not thereafter claim an ordinary loss when he had to return the assets to satisfy a corporate debt. As this Court subsequently explained in *United States* v. *Skelly Oil Co.*, 394 U.S. 678, 685 (1969), the rationale of

Arrowsmith is that "if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayment were generally deductible from receipts taxable at the higher rate applicable to ordinary income."

As the court of appeals correctly explained (Pet. App. 8a), the decision in *Arrowsmith* has no application to the present case. In this case, in contrast to *Arrowsmith*, the earlier transaction—the purchase of Wehr's assets by the S corporations—was not a taxable event. The need stressed in *Arrowsmith* for consistent treatment of the transaction on the taxpayer's returns is thus not at issue here. Moreover, in the present case, the Commissioner's position requires "that the tax classification of [the] legal claim remain unaltered through transfer of the claim" (*ibid.*). As the court of appeals explained (*ibid.*), the Commissioner's consistent treatment of the item of income involved in this case thus plainly does not conflict with the rationale of the Court's decision in *Arrowsmith*.

3. Petitioner also errs in contending (Pet. 8, 15-17) that the decision in this case conflicts with the decision of the Ninth Circuit in *Pacific Transport Co.* v. *Commissioner*, 483 F.2d 209 (1973). In that case, a corporation that purchased the assets and assumed the liabilities of another corporation was later required to pay what had been a contingent liability of the transferring corporation. On the facts of that case, the Ninth Circuit held that the payment of the assumed contingent liability was to be treated as part of the purchase price of the assets and was therefore to be capitalized and added to the taxpayer's basis in those assets. *Id.* at 213.

The *Pacific Transport* decision concerns the analytically distinct issue of the proper characterization of expenses as either current or capital in nature. An expense incurred in connection with the acquisition of a capital asset is routinely treated as an addition to the basis of that asset in the hands of the taxpayer, and it was that reasoning on which the court relied in *Pacific Transport*. 483 F.2d at 213-214. The court concluded in *Pacific Transport* that the payment of the contingent liability was, in substance, part of the purchase price of the capital assets obtained in the sale. *Ibid*.[4] In the present case, by contrast, the taxpayer was not making an additional "payment * * * in connection with the acquisition of the property" (*ibid*.) but was recovering, through litigation, an item of ordinary income owed to its predecessor.

Petitioner is incorrect in stating that both the majority opinion of the court (by Chief Judge Posner) and the concurring opinion (by Judge Cudahy) "acknowledge * * * [that] the court of appeals' decision in this case is in *direct* conflict with [*Pacific Transport*]." Pet. 8, 15. Chief Judge Posner did not state that these decisions were in conflict. Instead, he stated that "we needn't decide" whether the *Pacific Transport* decision "may have misclassified an expenditure * * * and treated an ordinary expense as a capital one." Pet. App. 8a-9a. And, in the concurring opinion, Judge Cudahy noted that *Pacific Transport* differed from the present case in that "it involves the expense side rather than the income side" of the accounting of corporate acquisitions. *Id*. at 10a.

As both the majority and concurring opinions thus note, the present case addresses a question that was

---

[4] The court explained in *Pacific Transport* that "[t]he payment of a liability by a subsequent purchaser is not the discharge of a burden, which the law placed on him, but is actually as well as theoretically, a payment of the purchase price." 483 F.2d at 214.

not addressed or decided in the *Pacific Transport* case —the proper characterization of the recovery of an item of ordinary income obtained through a purchase of corporate assets. For the reasons described above (pages 7-8, *supra*), the decision of the court of appeals in this case is consistent with the decisions of this Court and of all of the other courts of appeals that have addressed that specific question.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

SETH P. WAXMAN
Solicitor General

PAULA M. JUNGHANS
Acting Assistant Attorney General

DAVID I. PINCUS
DONALD B. TOBIN
Attorneys

JUNE 2000