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Taxation - Federal Income Tax - Damages for Injury to Business as Return of Capital or Income

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TAXATION—FEDERAL INCOME TAX—DAMAGES FOR INJURY TO BUSINESS AS RETURN OF CAPITAL OR INCOME—The taxpayers, owners of two movie theatres, recovered $36,000 in a compromise settlement of a Clayton Act suit against the major distributors and exhibitors. The taxpayers claimed that the amount received was a return of capital. The Commissioner claimed the amount received represented the recovery of lost profits. *Held,* Commissioner upheld. The evidence presented did not warrant a finding that any part of the sum recovered represented a return of capital. *Chalmers Cullins,* 24 T.C. 322 (1955).

A recovery of lost profits is taxed as ordinary income in the year the damages are recovered.[1] A recovery of lost value of an intangible is treated as the realization of a capital asset. To the extent that the recovery exceeds the cost basis of the intangible, it is treated as a capital gain.[2] In the absence of a free market, intangibles, including goodwill, are often valued by a capitalization of the expected future profits to be derived from the asset.[3] An actionable business wrong which adversely affects future profits damages goodwill as of the date of the wrong. The profits lost between this date and the time of trial merely go to show the extent of the damage suffered.[4] As an alternative to recovery for injury to an intangible the damaged party could recover for the actual profits lost. The latter theory of recovery is confusingly similar in pleading and proof to the former unless carefully distinguished, but carries quite different tax results. These alternative bases for recovery were recognized in an early case in which the court, referring to the damages awarded, said that "the fund involved must be considered in the light of the claim from which it was realized. . . ."[5] A later case restated the same principle: "The test is not whether the action

[1] Swastika Oil & Gas Co. v. Commissioner, (6th Cir. 1941) 123 F. (2d) 382, cert. den. 317 U.S. 639, 63 S.Ct. 30 (1942); H. Liebes & Co. v. Commissioner, (9th Cir. 1937) 90 F. (2d) 932.

[2] Raytheon Production Corp. v. Commissioner, (1st Cir. 1944) 144 F. (2d) 110.

[3] A.R.M. 34, 2 Cum. Bul. 31 (1920); Durkee v. Commissioner, (6th Cir. 1947) 162 F. (2d) 184.

[4] Durkee v. Commissioner, note 3 supra; Farmers' & Merchants' Bank v. Commissioner, (6th Cir. 1932) 59 F. (2d) 912; Raytheon Producti6n Corp. v. Commissioner, note 2 supra.

[5] Farmers' & Merchants' Bank v. Commissioner, note 4 supra, at 913.

was one in tort or contract but rather the question to be asked is 'In lieu of what were the damages awarded?' "[6] Since a given damage recovery may be for either lost profits or a restoration of capital, the courts will look to the pleadings, the proof and the decree or settlement agreement to find the theory upon which the recovery was obtained.[7] In this area of the tax law probably more than in any other the courts are dependent upon the verbal formulations of the parties to a taxable transaction for the determination of the character of that transaction. However, in the typical litigated case neither the pleadings, the proof nor the decree or settlement agreement are specific enough to determine the theory of recovery. Other grounds for making a determination of the character of the transaction must be found. In many of these cases convincing proof of the capital nature of the recovery is lacking and the whole recovery is treated as a return of lost profits.[8] Another solution is illustrated by a recent Tax Court decision[9] which made an allocation of the damages to loss of profits and injury to goodwill where the complaint had been made for damages to both. A jury verdict of $250,000 compensatory damages and $50,000 punitive damages was given for unfair trade practices. Before appeal by the defendant, a settlement for $62,000 was agreed upon by the parties. The court found that since one-sixth of the jury verdict was for punitive damages, one-sixth of the settlement should be allocated to punitive damages and, therefore, not taxed.[10] Since the complaint had asked for $250,000 for lost profits and $250,000 for return of capital the court found that the remainder of the settlement amount should be split equally between ordinary income and a return of capital. At best, this is a crude method of allocation, and the courts have refused to follow it in cases where they have felt that the substance of the complaint was for lost capital or lost profits even though it also contained elements of the other.[11] Certain types of suits have given rise to uniform treatment. Suits for breach of contract,[12] for the seizure of vessels in the sealing trade,[13] and for

6 Raytheon Production Corp. v. Commissioner, note 2 supra, at 113.

7 Telefilm, Inc., 21 T.C. 688 (1954), non-acq. 1954-2 Cum. Bul. 6, revd. on other grounds without opinion (9th Cir. 1955) 1955 P-H Tax. Serv. ¶71,087; Anna Levens, 20 P-H T.C. Mem. Dec. ¶51,330 (1951); Arcadia Refining Co. v. Commissioner, (5th Cir. 1941) 118 F. (2d) 1010.

8 As illustrated by the principal case. But see Durkee v. Commissioner, note 3 supra.

9 Telefilm, Inc., note 7 supra.

10 This latter holding was reversed by the Ninth Circuit (see note 7 supra) on the basis of Commissioner v. Glenshaw Glass Co. and William Golden Theatres, Inc., 348 U.S. 426, 75 S.Ct. 473 (1955), noted in 54 MICH. L. REV. 151 (1955).

11 Durkee v. Commissioner, note 3 supra. Cf. Pennroad Corporation v. Commissioner, 21 T.C. 1087 (1954), non-acq. 1955 Cum. Bul. No. 13, p. 6 (March 28, 1955); Tygart Valley Glass Co., 16 T.C. 941 (1951).

12 Burnet v. Sanford & Brooks Co., 282 U.S. 359, 51 S.Ct. 150 (1931); Swastika Oil & Gas Co. v. Commissioner, note 1 supra; Herman J. Sternberg, 32 B.T.A. 1039 (1935), acq. XIV-2 Cum. Bul. 21 (1935); Armstrong Knitting Mills, 19 B.T.A. 318 (1930).

13 H. Liebes & Co. v. Commissioner, note 1 supra; J. R. Knowland, 29 B.T.A. 618 (1933). These cases suggest that temporary unlawful seizures of productive equipment give rise to lost profits.

patent infringement[14] have been held to be for lost profits. On the other hand, compensation for a revoked franchise[15] and damages received by a stockholder in a stockholders' derivative suit against a third party defendant have been held to be capital gain.[16] Although the courts have not felt that recoveries for antitrust violations are necessarily returns of capital,[17] the principal case does appear to be the first one holding that the antitrust recovery is for lost profits. However, the courts have not relied on any such grouping of cases and have talked in terms of "the fund involved" or the lack of evidence to refute the Commissioner's determination that the recovery was lost profits. No matter how the cases are analyzed it is difficult to find any real distinction between those cases which treat a recovery as return of capital and those which treat it as lost profits. Therefore, in prosecuting a case for damage to a business, counsel should clearly label his theory of recovery at every stage in the proceedings. This precaution, though it cannot assure favorable tax treatment of the recovery, will do more than any other factor to reduce the tax costs of a successful suit for a business wrong.

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[14] United States v. Safety Car Heating & Lighting Co., 297 U.S. 88, 56 S.Ct. 353 (1936); W. W. Sly Mfg. Co. v. Commissioner, 24 B.T.A. 65 (1931).

[15] Jones v. Corbyn, (10th Cir. 1950) 186 F. (2d) 450; Michael Berbiglia, 20 P-H T.C. Mem. Dec. ¶51,135 (1951). But cf. Commissioner v. Starr Bros., Inc., (2d Cir. 1953) 204 F. (2d) 673.

[16] Boehm v. Commissioner, (2d Cir. 1945) 146 F. (2d) 553, affd. on other grounds 326 U.S. 287, 66 S.Ct. 120 (1945); Henri Chouteau, 22 B.T.A. 850 (1931).

[17] Raytheon Production Corp. v. Commissioner, note 2 supra; Martin Brothers Box Co., 12 P-H T.C. Mem. Dec. ¶43,190 (1943), affd. (6th Cir. 1944) 142 F. (2d) 457.