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Capital-Gains Treatment A Hard Sell For M&A Litigation

Acquisition Litigation: Must There Be A Sale Or Exchange For Capital Treatment?

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Sale or exchange required for capital gains. Many M&A deals from the Nineties have not lived up to the buyer's expectations. In some cases, the acquiror has blamed the failure on target management's malfeasance or its failure to comply with the contract, and often buyers have resorted to litigation. Accompanying the settlements and damage awards are tax-recognition issues. Depending on the circumstances, the litigants have tried to classify the payments as capital gains or a return of capital (i.e., basis). Unfortunately for these taxpayers, the IRS has operated on the presumption that a taxpayer must complete a sale or exchange of property in order to generate capital gains. The tax court as well as various circuit courts agree with the IRS position, indicating that litigation settlements do not in themselves constitute a sale or exchange.

Beneficial treatment occasionally allowed. Occasionally the courts have found for a taxpayer challenging an IRS finding of ordinary income. One employee, denied the right to buy company stock, received a cash settlement instead from his former employer. The court viewed the case as a property settlement and allowed capital-gains treatment. In a 1987 case, the court found in favor of a claimant who had received a settlement for trademark infringement. The court considered the payment as damages to a capital asset rather than as profit replacement, and it allowed capital-gains treatment, making no mention of sales or exchanges in the decision. An earlier court accepted a non-compete settlement as capital gains by viewing the payment as damages to goodwill, a capital asset. Other recent cases, again without mentioning exchanges, have allowed homeowners' associations to treat settlements over construction defects as a recovery of basis rather than income, since the payments were for (potential) property damage.

Recent case brings bad news. One May 2002 case may have set the bar for capital-gains treatment in M&A litigation settlements. Two partners owned a corporation and sued its insurance company for the balance of an unpaid claim. The corporation had previously recognized the initial payment of the claim for profit replacement as ordinary income. The partners then sold their interest in the corporation but maintained their rights to the insurance claim. The partners and the insurance company settled, and the partners recognized the flow-through payments as capital gains. They considered these amounts additional consideration from the stock sale. The court disagreed, describing the partners' receipts as partnership distributions because the claimants anticipated the proceeds before the stock transfer. The more ominous result of the case is the judge's conclusion that a sale or exchange is required for capital-gains treatment and that a settlement or award does not constitute such an event. This finding holds considerable implications for future M&A litigation.

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