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Do You Want Capital Gain or Ordinary Income on That Pizza?

By Robert W. Wood

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Highlighting the continuing importance of distinguishing between capital gain and ordinary income, Wood looks at the Seventh Circuit's decision in *Freda v. Commissioner*. The appeals court upheld the Tax Court's holding that payments made to resolve trade secret litigation were ordinary. Better planning might have led to a better result.

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Almost 35 years ago, my law school tax professor Walter Blum told students that tax lawyers spend approximately a third of their time trying to convert ordinary income into capital gain. As with so much else he said, that seems true. The line between capital gain and ordinary income has always been important.

Throughout much of the history of our tax law, most taxpayers have received a tax rate preference, paying a decidedly lower rate on capital gain. Today, this 15 percent rate results in a huge rate preference, a full 20 percentage points below the ordinary income rate. The capital gain classification is also important to basis. The corollary to capital gain treatment is generally basis recovery even before one has gain.

Then too, there are capital losses to consider. Individual investors often find themselves trapped with large accumulated capital losses from which they can benefit only at a painfully slow pace, able to offset a mere $3,000 of ordinary income per year. Some taxpayers find themselves arguing for capital gain treatment for an income item not because they are trying to reap the advantage of the 15 percent rate, but rather, in seeking to soak up accumulated losses that might otherwise languish until the next ice age.

For entities, the focus on capital gain is mixed. S corporations, in my experience, seem preoccupied with it. Their shareholders benefit from the flow-through of these items on their Schedules K-1. That also is true with limited liability companies and partnerships. C corporations do not receive a tax rate preference, but even they can care about the distinction.

Thus, the distinction between capital and ordinary remains vital, not just for planners and those handling tax controversies, but for lawmakers, too. One need look no further than the carried interest debate to find emotional and heartfelt discussion. Of course, that discussion is not so much about whether capital gain treatment and rate preferences are a good idea, but rather about precisely what should be capital and what should be ordinary. Divining that line is how many in the trenches of tax practice spend considerable time.

And that brings us to our story. I was intrigued with *Freda v. Commissioner* when the Tax Court decided it in 2009.[1] The court held that a payment Pizza Hut made to settle a trade secret misappropriation suit was ordinary income rather than capital gain.[2] The Seventh Circuit has now agreed, albeit over one dissent. The case shows there is considerable room left for thoughtful planning.

Underlying Flavors

The lawsuit in question involved Pizza Hut as Goliath, and C&F Packing Co. as David. C&F was primarily owned by the Freda family. C&F may not be a well-known brand name, but it supplied an enormous volume of sausage for Pizza Hut pies.

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[1]T.C. Memo. 2009-191, *Doc 2009-19173*, *2009 TNT 163-18*, *aff'd* 2011 U.S. App. LEXIS 17872 (7th Cir. 2011), *Doc 2011-18349*, *2011 TNT 167-14*.

[2]For an analysis of the Tax Court decision, see Wood, "Sausage, Capital Gain, and Settlement Payments," *Tax Notes*, Oct. 26, 2009, p. 413, *Doc 2009-21922*, or *2009 TNT 207-14*.

C&F guarded a secret process that made garden-variety precooked sausage look and taste like homemade.

During negotiations in 1985, Pizza Hut pushed for C&F to disclose that secret to Pizza Hut's other suppliers. In 1985 the companies reached a confidential disclosure agreement requiring C&F to disclose its process but Pizza Hut to keep it confidential and not to exploit it. Pizza Hut's suppliers also entered into confidentiality agreements that allowed them to use the C&F process.

Despite the execution of a draft of those agreements, Pizza Hut did not enter into a long-term supply contract with C&F as it had promised. Pizza Hut's weekly purchases from C&F were only a fraction of what Pizza Hut had promised. By 1989 Pizza Hut had disclosed the trade secret to IBP, another sausage-maker. IBP's sales caused a significant drop in Pizza Hut's purchases from C&F.

Suspicious that IBP was using its secret recipe, C&F confirmed it in 1993 and filed suit against IBP for infringement. When Pizza Hut stopped purchasing entirely from C&F, C&F added Pizza Hut as a defendant. C&F claimed fraud, breach of fiduciary duty, unfair competition, unjust enrichment, patent infringement, tortuous interference, and misappropriation of trade secrets. Some claims were only against Pizza Hut, and some were also against IBP.

Meanwhile, in early 1997, C&F redeemed all the stock (one-third) owned by Gerald Freda. After many claims in the suit were dismissed, in March 1998, the court held C&F's patent was invalid. On December 9, 1998, after a trial on the misappropriation count against IBP, the jury returned a verdict for C&F for $10,939,391 in damages based on unjust enrichment.

The district court added prejudgment interest and denied various IBP post-trial motions. Both parties appealed. In 2000 the Federal Circuit affirmed the $10,939,391 award and affirmed the dismissal of most claims against Pizza Hut. However, it reversed the district court's award of prejudgment interest and reversed the dismissal of the misappropriation count against Pizza Hut.

After reinstating the misappropriation count, the Federal Circuit remanded to the district court. The only unsettled claim was C&F's misappropriation claim against Pizza Hut. IBP paid C&F the $10,939,391 judgment, of which $4,922,726 went to its attorneys (Niro Law Firm) and $2,005,555 to Freda, whose stock had been redeemed in 1997.

C&F retained the balance. The Federal Circuit determined that the company would have had approximately $2.86 million in additional profits if IBP had not misappropriated its trade secret. It therefore reported $2.86 million as ordinary income and the remainder as capital gain, an allocation the IRS did not contest.

In January 2002 C&F, Pizza Hut, and several current and former C&F shareholders reached a global settlement for $15.3 million. Unfortunately, the settlement agreement was bare-bones, reciting the payment of $15.3 million for a general release. Niro retained $6.12 million as legal fees, distributing $3.06 million to the previously redeemed shareholder, and the balance of $6.12 million to C&F.

C&F reported $6,112,347 as long-term capital gain on its 2002 S corporation return, including it on Schedule D as "trade secret sale." C&F passed the long-term capital gain through to its shareholders. The IRS determined that the settlement was ordinary income and that the $3.06 million distributed to the previously redeemed shareholder was also ordinary income to C&F.

Tax Court Tossed the Dough

Predictably, the Tax Court made it clear that the burden was on the taxpayers to prove that the underlying case was about damage to C&F's trade secret, a capital asset in its hands. The taxpayers and the IRS agreed on two fundamentals: Only the misappropriation claim remained outstanding at settlement time, and a trade secret (such as C&F's) is a capital asset. The critical factual question was whether Pizza Hut actually paid C&F for injury or destruction of its trade secret.

Arguing that this was precisely the nature of the payment, the taxpayers cited *Inco Electroenergy Corp. v. Commissioner*[3] and *State Fish Corp. v. Commissioner*.[4] Those are classic capital harm cases in which litigation proceeds received capital gain treatment. In response, the Tax Court pointed out that the complaint against Pizza Hut was replete with references to C&F's lost profits, lost opportunities, operating losses, and expenditures.

Besides, the settlement agreement said only that Pizza Hut was paying $15.3 million to get rid of the suit and all claims. Particularly given that ordinary income nomenclature, the Tax Court found no indication that Pizza Hut believed it was paying for harm to the trade secrets or compensating C&F for the sale of its trade secrets. Still, C&F's shareholders also argued that the settlement should be treated as proceeds from selling its trade secret. In the absence of at least some hallmarks of a sale, the Tax Court could not consider this a transfer of trade secrets.

Finally, the taxpayers had raised an independent statutory basis for capital gain treatment. Noting

[3]T.C. Memo. 1987-437.

[4]48 T.C. 465 (1967).

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that the termination of contract rights produces capital gain under section 1234A, the taxpayers argued that Pizza Hut made the payment to terminate C&F's rights under its 1985 confidentiality agreement. Rejecting that argument too, the Tax Court held the settlement proceeds to be ordinary income.

Seventh Circuit Bakes Its Own Pie

The Seventh Circuit found the origin of the claim doctrine "in its purest form" not directly applicable, but the court did find that it offered guiding principles. Accusing C&F of being overly simplistic, the appellate court said it was being asked to look no further than the title of C&F's claim: trade secret misappropriation. To the Seventh Circuit, that title signaled only that a capital asset was in some way implicated. It revealed little about the actual nature of C&F's original claim.

The appeals court was not about to decide that *any* recovery under a case involving trade secret misappropriation was by definition capital. The Tax Court had concluded that Pizza Hut paid the amount for lost profits, lost opportunities, operating losses, and expenditures. That finding of fact tracked the language of C&F's complaint. The Seventh Circuit could hardly call it clearly erroneous.

Although the appeals court noted that this finding of fact did not necessarily mean that the entire case was *all* about lost profits, the Tax Court did not err in concluding that the shareholders of C&F failed to carry their burden of proof. The appeals court called trade secret misappropriation recoveries "chameleonic." Injuries caused by trade secret misappropriation can take many forms and may be remedied by many types of relief.

The remedies to redress those injuries may include a variety of damages, including lost profits and royalties that are ordinary income. Against that ordinary income landscape, the taxpayers had the burden to demonstrate that the commissioner's view was wrong. The taxpayers pointed to the trade secret misappropriation claim, arguing that the claims for lost profits were mere metrics to measure the damage to the C&F trade secrets.

Yet the appellate court was persuaded that C&F was seeking lost profits and other ordinary items from the inception. Those were lost profits claims, not merely focusing on the damage to or destruction of its capital asset. The court referred to factual allegations in C&F's misappropriation claim about Pizza Hut's actions having cut its margins and reduced its sales. All of that made C&F unable to exploit its process.

The IRS reasonably viewed those damages as the main attraction rather than mere placeholders, the court said. Although it was the taxpayers' job to rebut that conclusion, they offered no evidence. Besides, the taxpayers had treated *some* of the money they received for a virtually identical claim (the trade secret misappropriation recovery from IBP) as ordinary income. The appeals court found that inconsistent with the capital gain theory it sought to apply to the Pizza Hut payment.

The appeals court also rejected the argument that Pizza Hut bought a capital asset when it misappropriated the C&F process, only completing the purchase years later on the settlement. Like the Tax Court, the appeals court concluded that the settlement did not represent the final phase of a 13-year asset transfer. In any event, there was no indication in the settlement agreement that Pizza Hut believed it was compensating C&F for the purchase or use of its trade secrets.

The Dissent: A Different Taste

One judge (Daniel A. Manion) dissented, stating that the nature of the claim brought against Pizza Hut was not for lost profits but was for the value lost when the trade secret was misappropriated by Pizza Hut. The dissent reasoned that C&F did not lose profits to Pizza Hut. Rather, it lost profits to IBP.

Moreover, there was nothing in the record to indicate that the parties understood the settlement proceeds to be a payment equivalent to C&F's lost profits. There were no calculations indicating the equivalency between C&F's lost profits and the settlement amount. The dissent even went as far as saying that the Tax Court had misread the complaint.

After describing the elements of its trade secret misappropriation claim against Pizza Hut, the complaint alleged that "as a result, C&F has been damaged, and has suffered, among other things, lost profits, lost opportunities, operating losses and expenditures." According to the dissent, the Tax Court incorrectly concluded from the "lost profits" phrase that C&F was *only* seeking lost profits against Pizza Hut. Plainly, that was not so.

The nature of C&F's claim against Pizza Hut was that it wrongfully acquired and disclosed a trade secret to IBP, a C&F competitor. Undoubtedly, that damaged C&F's property interest in the trade secret. The complaint used "lost profits" nomenclature simply as part of a nonexclusive list describing ways C&F had been injured by the misappropriation.

The lost profits phrase did not negate the fact that C&F's trade secret was severely damaged nor that C&F also sought payment for it. To the dissent, the Tax Court was wrong to discard "lost opportunities" too, including the lost opportunity to negotiate the transfer of the secret process to *another* pizza giant. The Tax Court was clearly wrong to conclude that the claim against Pizza Hut could

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only be for lost profits when the only profits lost were those transferred to IBP.

After all, when C&F settled with Pizza Hut, it had already received its lost profits via the jury award. To the dissent, both the Tax Court and the majority of the Seventh Circuit focused myopically on lost profits. There was nothing in the record (and no calculations) indicating that the parties understood the settlement to be equivalent to C&F's lost profits. Pizza Hut merely paid the proceeds to settle all past, present, and future claims. That was simply the kind of boilerplate language that appears in any release.

The only remaining issue following the IBP verdict was damage to the trade secret. Other than a single lost profits reference in the complaint, the Tax Court cited nothing in the record to support the position that C&F's *remaining* claim was for lost profits. In fact, the record contained direct testimonial evidence to the contrary. Given its fixation on the lost profits phrase, the Tax Court somehow rejected it as unreliable. The dissent thus firmly rejected the majority.

Carefully Place Your Order

The taxpayers in *Freda* had the burden of showing that their $15.3 million settlement payment terminated C&F's rights concerning its trade secret under the Pizza Hut confidentiality agreement. The Tax Court found they did not meet it, and the Seventh Circuit agreed. Perhaps that is correct, but the dissent is quite persuasive.

Indeed, this may be a case in which a few words in key documents could have made the difference. The case might well have come out differently with some simple drafting. There was no sale or exchange language in the settlement agreement. There was not even any ''harm to capital'' language. Whatever the Seventh Circuit may say about the origin of the claim doctrine, the genesis of the claim and the intent of the payer are always relevant.

Despite the dissent's correct observations and apparent frustrations, there was not much in the record to show what was intended. There should have been some ''harm to capital'' language. Concerning the section 1234A argument, too, the taxpayers needed specific language. They argued that the confidentiality agreement gave C&F the right to require Pizza Hut to keep the C&F trade secret confidential, refrain from using the trade secret except for purposes of evaluating the sausage product, and return all materials relating to the trade secret.

The contract was terminated by the settlement agreement, the taxpayers argued. C&F could point to some provisions in the settlement agreement, but it wasn't enough and was hardly specific. True, the settlement agreement resolved all past, present, and future claims. It also terminated any C&F claim against Pizza Hut and barred any future litigation. Bare-bones, that was all.

Clearly, the Tax Court was right to examine the litigation documents. In a complex case, there may be many causes of action, motions to dismiss, summary judgment motions, and more. As the scope of the litigation narrows, it may become increasingly difficult to argue that a payment relates to something particular, even though there may be multiple reasons a payment is made.

Optimally, the taxpayers in *Freda* should have been thinking about tax issues from the commencement of their case. Even if that is unrealistic, they should have been thinking about taxes when they were negotiating the settlement agreement. Unfortunately, they may not have considered taxes until tax return time. When the notices of deficiency were issued, it was too late.

Of course, it does not follow that an explicit settlement agreement with taxpayer-friendly language would not have been challenged. It still might have been. Yet if the settlement agreement had clearly stated that the $15.3 million payment was for a purchase and cancellation of the confidentiality agreement, it would have materially improved the taxpayers' posture. It would have been even better if the settlement agreement had clearly stated that Pizza Hut was buying the trade secret itself for the $15.3 million.

Alternatively (and preferably, from my point of view), there could have been an allocation between the amounts. Some portion of the consideration could have been allocated to one claim and some to another. Even the section 1234A argument, to which the Tax Court and the Seventh Circuit give short shrift, could have been greatly improved with a little drafting. The settlement agreement could have said it was explicitly terminating all contract rights regarding the secret process.

Any or all of those possibilities would have improved the taxpayers' position. We do not know whether any of them would have carried the day, but I think they would have. In fact, perhaps there would have been no case at all. Good settlement language can sometimes be convincing at audit and stop a case from becoming one.

In that sense, this case is a reminder of the need for diligence among tax professionals. Perhaps more acutely, it also may be a reminder that litigation lawyers and their clients could benefit from becoming more educated about these tax topics. Perhaps no tax professionals were involved in this case until after the settlement agreement was

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signed. Although no one wants to delay the settlement of an important case to get input from a tax lawyer, such a holdup might have prevented the mess that *Freda* became.

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