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The M&A Tax Report

April 2015 Volume 24, Number 9

The Monthly Review of Taxes, Trends & Techniques

Clawbacks, Code Sec. 1341, and the Item Concept

By Donald P. Board • Wood LLP

Clawbacks are becoming a regular feature of American corporate life. They are best known in the context of executive compensation, thanks to Section 304 of the Sarbanes-Oxley Act of 2002. Under Section 304 of that dreaded law, the CEO and CFO of a public company may be required to return bonus, incentive-based or equity-based compensation.

The trigger would be if the company is required to restate its financial results as a result of material noncompliance with financial reporting requirements under the securities laws. In 2015, the SEC took clawbacks to the next level, this time based on the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Under Proposed Rule 10D-1, all current and former executive officers of listed companies would be required to repay incentive-based compensation following an "accounting restatement" if it turns out that they did not really "earn" their compensation.

When one considers taxes, "earning" is a curious and consequential concept. And it does not necessarily have to refer to one single year. Clawbacks also have their place in corporate M&A.

Buyers and sellers often resolve disagreements about a target company's value by making part of the purchase price payable only if certain future objectives are met—the familiar earnout. It is also possible (though much less common) for the buyer to pay the full purchase price up front, subject to conditions. The seller might agree to a clawback of a portion of the consideration if future performance milestones are not met.

Buyers are typically more comfortable with earnout structures, for tax reasons and many others. However, clawbacks may still play a role. For example, an optimistic seller might push for an enhanced earnout payment if the company significantly outperforms the milestones set for Year 1.

A cautious buyer might go along on the condition that the seller agree to return some or all of the enhanced payment if the company ends up significantly *underperforming* in Year 2. Whatever the reason for a clawback, it can raise serious tax problems spanning multiple years. Suppose an executive receives a large bonus in one year and pays a correspondingly large amount of tax.

In a later tax year, the bonus is clawed back. Apart from cash flow, that will raise tax issues.

Deductions and Code Sec. 1341

Normally, the executive should be able to deduct the clawback in the later year as a business expense under Code Sec. 162 or perhaps as a loss under Code Sec. 165(c)(2). A deduction in the year of the clawback may provide the executive with a tax benefit that pretty much makes up for the tax paid on the bonus that he or she was not allowed to keep.

But there can be many situations where the deduction provides incomplete relief. The most obvious is when tax rates have gone *down* between the two tax years. Suppose the executive paid tax on a $1 million bonus at a 40-percent rate.

If the executive is required to return the bonus in a later year, when the tax rate is only 30 percent, deducting the clawback will recover only $300,000 of the $400,000 in tax paid in the earlier year. If a clawback is a wound, an incomplete tax deduction is putting salt in that wound. Section 1341 of the Code was adopted in 1954 with exactly such problems in mind.

When it applies, Code Sec. 1341 gives the taxpayer what is in effect a refundable credit for the tax paid in the *earlier* year. The executive described above, for example, would forgo his $1 million deduction (worth only $300,000) in favor of a $400,000 credit. The tax problem seems relatively simple, doesn't it?

Unfortunately, the statutory solution has proven to be surprisingly difficult to implement. In fact, one could write a treatise on the baroque jurisprudence that has grown up around Code Sec. 1341. And the real-life fact patterns can be messy.

The *Nacchio* Case

To keep one's bearings, it is important to stay focused on the fundamental structure of Code Sec. 1341. But this can be easier said than done. *Nacchio* [115 Fed. Cl. 195 (2014)], an $18 million refund case recently decided by the Court of Federal Claims, illustrates how even sophisticated judges and litigants can gloss over basic statutory requirements.

Joseph Nacchio was the CEO of Qwest Communications, a telecommunications carrier that enjoyed meteoric growth starting in the late 1990s. Unfortunately, word leaked out that the company had misrepresented the sources and nature of its revenues. That resulted in Quest's equally meteoric fall to earth.

When the SEC investigated the smoking crater, it discovered, among other things, that Mr. Nacchio had exercised options to purchase several million Qwest shares early in 2001. He had immediately sold these shares at the still-inflated market price, pocketing over a $100 million. Within 18 months, Qwest's stock price had fallen by 95 percent.

Mr. Nacchio was indicted and convicted in 2007 on 19 counts of insider-trading. He was sentenced to serve 70 months in federal prison and ordered to pay a $19 million fine. To top it all off, he was ordered to disgorge $44.6 million in illegal trading profits. This $44.6 million forfeiture was, in effect, a "clawback" of Mr. Nacchio's profits imposed by the federal securities laws.

The $44.6 million was eventually deposited in a fund for investors who had purchased Qwest shares during the period when Mr. Nacchio was selling them.

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THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by Wolters Kluwer, 4025 W. Peterson Ave., Chicago, Illinois 60646. Subscription inquiries should be directed to 4025 W. Peterson Ave., Chicago, IL 60646. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

A Trifling Amendment?

In the wake of the $44.6 million forfeiture, Mr. Nacchio and his wife amended their 2007 federal income tax return. As Mr. Nacchio saw it, he had reported $44.6 million on his 2001 return in connection with his stock transactions and paid $18 million in tax.

However, he had forfeited his $44.6 million in insider-trading profits in 2007. Simply deducting his $44.6 million loss would not have done him much good because Mr. Nacchio's annual income had declined sharply since his departure from Qwest. So Mr. Nacchio looked to Code Sec. 1341 to try to get a credit for the $18 million in tax he had paid in 2001.

This is the kind of story ("*Convicted CEO Demands $18 Million Tax Refund*") that pushes people's buttons. The government appears to have been no exception, and the IRS declined to hand over the money. When Mr. Nacchio sued for his refund in the Court of Federal Claims, the government showed no interest in discovery, and simply moved for summary judgment.

The government's motion focused squarely on Mr. Nacchio's well-publicized criminal conviction and its implications for his right to invoke Code Sec. 1341. Under Code Sec. 1341(a)(2), a taxpayer cannot claim a credit for taxes previously paid unless he has an independent basis for deducting the amount surrendered in the current tax year. Thus, Mr. Nacchio would have had to establish his right to deduct a $44.6 million criminal forfeiture.

Code Sec. 162(f), however, bars the deduction of "any fine or similar penalty paid to a government for the violation of any law." As the government noted, this rule reflects a broad public policy against letting wrongdoers use the tax system to "reduce the sting" of sanctions intended to punish them. Mr. Nacchio was seeking to reduce his own sting by $18 million.

Claim of Right or Wrong?

The government also pointed out that Mr. Nacchio faced a problem under Code Sec. 1341(a)(1), which imposes the so-called "claim-of-right" requirement. Under the statute, it must have appeared that the taxpayer had an "unrestricted right" to the item in question in the earlier year. But a jury had found Mr. Nacchio guilty of willfully violating the securities laws.

Willfulness requires knowledge that one is violating a legal duty, so the jury's verdict would seem to have established that Mr. Nacchio *knew* his stock sales were illegal in 2001. Citing the doctrine of collateral estoppel, the government insisted that Mr. Nacchio could not now argue that he had received his $44.6 million insider-trading profit under a claim of right. But Mr. Nacchio argued it, and the Court of Federal Claims was sympathetic.

Judge Williams flatly denied the government's motion for summary judgment on both of the issues it raised. She then entered partial summary judgment for Mr. Nacchio. She held that he could deduct his $44.6 million criminal forfeiture as a loss under Code Sec. 165(c)(2).

In reaching this conclusion, Judge Williams relied heavily on the fact that Code Sec. 162(f)'s disallowance of a deduction for the payment of a fine or similar penalty literally applies only to deductions of business expenses under Code Sec. 162(a). The government, anticipating this objection, had cited Treasury Regulation Sec. 1.162-1(a). This provision states that losses can be deducted under Code Sec. 165, but that that any such deduction is "subject to any provision of the internal revenue laws which prohibits or limits the amount of the deduction." Code Sec. 162(f), according to the government, was one of those provisions to which Code Sec. 165(c)(2) is subject.

The Court of Federal Claims was not convinced by the government's argument, which does seem a good deal less than watertight. Judge Williams also declined to bar the deduction on general public policy grounds. Interestingly, she did not automatically dismiss public policy as a basis for limiting a deduction set forth in the Code. Instead, she insisted that it was necessary to consider whether permitting Mr. Nacchio to deduct his $44.6 million loss would in fact frustrate a sharply defined public policy.

The question, as Judge Williams saw it, was whether letting Mr. Nacchio deduct his loss would really undermine the enforcement of the federal securities laws. She pointed out that the $44.6 million forfeiture was just one of the sanctions imposed on Mr. Nacchio. He had, after all, been sentenced to spend 70 months in federal prison and pay a $19 million fine. In view of the "stern" sentence already imposed on Mr. Nacchio, how much would really be gained by denying him a deduction under Code Sec. 165(c)(2)?

Not enough, in the Court of Federal Claim's view, to justify denying Mr. Nacchio an $18 million credit under Code Sec. 1341. Judge Williams' assessment was that "[a]llowing the deduction would not increase the odds in favor of insider trading or destroy the effectiveness of the securities laws." The government has "ample weapons to combat insider trading without adding taxation of unretained income to the arsenal."

The Court of Federal Claims also questioned whether Mr. Nacchio's $44.6 million criminal forfeiture should be treated on a par with a straightforward fine. When a court sentences a convicted criminal to make restitution to victims, there is authority under Code Sec. 162(f) for allowing the payor to deduct the restitution paid. The theory is that such payments are remedial rather than punitive, even though they are imposed as part of a criminal sentence.

The judge in Mr. Nacchio's criminal case did not ordered him to pay restitution. But, in the end, the SEC deposited Mr. Nacchio's $44.6 million in a fund to compensate the victims of his insider trading. That was the large class of persons who purchased Qwest shares during the period when Mr. Nacchio was selling shares without disclosing the material nonpublic information in his possession. Judge Williams was plainly sympathetic to Mr. Nacchio's argument that what mattered was how the funds were actually used, not whether the sentencing judge had specifically ordered that use.

Finally, the Court of Federal Claims held that Mr. Nacchio was entitled to a trial on the question of whether he had received his insider-trading profits under a claim of right. Judge Williams acknowledged that Mr. Nacchio would have been estopped to deny that he knew he had obtained his profits illegally if he had pleaded guilty to insider trading. But Mr. Nacchio had pleaded innocent. True, a jury had convicted him of willfully violating the securities laws, but Judge Williams did not think that established what Mr. Nacchio *actually* believed.

Judge Williams noted that there had been a lengthy criminal trial, but that she had found nothing in the record before her that "sheds any light on the bona fides of Mr. Nacchio's belief." She pointed out that Mr. Nacchio had not even testified at his trial, invoking his Fifth Amendment privilege against self-incrimination. So the question of whether Mr. Nacchio knew that he had received his $44.6 million in insider-trading profits illegally had not really been adjudicated in his criminal trial. Hence, the doctrine of collateral estoppel did not apply.

The *Nacchio* decision is now before the U.S. Court of Appeals for the Federal Circuit. The parties agreed to skip a trial on the claim-of-right issue and go straight to the appeal. It does not seem out of the question that the Federal Circuit will reverse one or both of the lower court's holdings.

But the case raises a more fundamental question regarding the application of Code Sec. 1341. Let us assume that Mr. Nacchio was entitled to deduct his criminal forfeiture, and even that he received his illegal profits under a claim of right. However, even with those assumptions, did Mr. Nacchio really have a case under Code Sec. 1341?

Approaching Code Sec. 1341(a) Through the "Item" Concept

Because we are dealing with a statute, we need to look closely at the actual language and structure of Code Sec. 1341. We can then analyze the *Nacchio* situation using the concept that is central to the operation of Code Sec. 1341, the "item" of income.

To claim a credit under Code Sec. 1341, a taxpayer must satisfy two basic requirements:

- Under Code Sec. 1341(a)(1), there must be "an item [that] was included in gross income for a prior taxable year … because it appeared that the taxpayer had an unrestricted right to such item."
- Under Code Sec. 1341(a)(2), there must be a deduction "allowable for the taxable year because it was established after the close of such prior taxable year … that the taxpayer did not have an unrestricted right to such item."

If these two requirements are met, the tax due for the current tax year is the lesser of two amounts:

- The tax for the current tax year calculated with the deduction, as described in Code Sec. 1341(a)(4).
- The tax for the current tax year calculated without the deduction but reduced by the amount of tax that the taxpayer would have saved in the prior tax year "solely from the exclusion of such item … from gross income for such prior taxable year," as described in Code Sec. 1341(a)(5).

This second alternative—reducing the current year's tax by the amount of tax the taxpayer *would have saved* if he had not included the item in a prior year—is the Code Sec. 1341 "credit." If the taxpayer does not have that much income to reduce, the excess amount of the Code Sec. 1341 credit will be refunded. That is why Mr. Nacchio was suing for a refund.

Accurate application of Code Sec. 1341 requires us to identify the "item" to which the statute refers in the two threshold requirements and in the operative provision determining the credit. Whatever item we identify must be able to play three roles.

First, the item must have been included in gross income in an earlier tax year under a claim of right. Second, it must be established that the taxpayer did not have an unrestricted right to the item. Plus, this fact must trigger a deduction in the current tax year. Third, the Code Sec. 1341 credit must be calculated by determining how much the taxpayer would have saved if he had not included the item in gross income in the earlier year.

The tax law does not provide an official, comprehensive definition of "item." Still, this is a term (and a concept) in frequent use. Of course, an item included on a tax return is not simply a number of dollars. Code Sec. 1341(a) requires us to consider not just *how much* the taxpayer included in gross income in the prior year but also to keep track of what any such amounts *represent*.

What Were the "Items Included in Gross Income"?

The government did not conduct any discovery, so Mr. Nacchio's tax return for 2001 never made it into the record in the Court of Federal Claims. Judge Williams had to rely on the parties' pleadings, motions and briefs, supplemented by accounts of that year's events in the judicial opinions from Mr. Nacchio's criminal case. The big picture must have seemed clear enough.

Mr. Nacchio had been convicted of insider-trading in connection with his sale of 1,330,000 Qwest shares in 2001. He had made a $44.6 million profit from the sales, which he forfeited in 2007. He was now seeking a refund of the $18 million in tax he had paid on the gain he made when he sold the shares.

Given the state of the record, Judge Williams concluded that Mr. Nacchio had "reported [$44.6 million] in net gain from these stock sales in [his] 2001 joint tax return and paid [$18 million] in taxes on this gain." On this view of the facts, the "item" that Mr. Nacchio included in 2001 was $44.6 million in capital gain. The issue under Code Sec. 1341(a)(1) was whether Mr. Nacchio had included this massive item under a claim of right.

The issue under Code Sec. 1341(a)(2) was whether Mr. Nacchio was entitled to a deduction because it had been established in 2007 that he did not have an unrestricted right to this item. If Mr. Nacchio prevailed on both these issues, he could claim a credit under Code Sec. 1341(a)(5) for the $18 million in tax he would have saved if he had not initially included this item in income. This all sounds plausible enough.

However, it misunderstands the underlying facts. Even if we do not have Mr. Nacchio's 2001 return, it was clear that he never reported anything close to $44.6 million in gain from his illegal stock sales. The 1,330,000 Qwest shares that Mr. Nacchio sold were not sitting in a brokerage account.

If he wanted to sell, say, 100,000 Qwest shares, Mr. Nacchio would order his broker to sell 100,000 shares *short*. Simultaneously, he would cover his position by exercising 100,000 of his million Qwest *options*. The options had been granted to Mr. Nacchio as part of his CEO compensation package.

Options and Exercise

Every time he exercised an option, Mr. Nacchio realized *compensation income* equal to the current option spread, *i.e.*, the excess of the market value of the share he received (which fluctuated between about $37 and $41 per share) over the price he paid Qwest to get it ($5.50). Even if Mr. Nacchio had exercised all of his options when Qwest shares were trading at the bottom of this range ($37), the spread per share would still have been $31.50. Multiplying that by 1,330,000 shares suggests that Mr. Nacchio realized at least $41.9 million in compensation income upon exercise.

Thus, whatever else Mr. Nacchio may have reported in 2001, his return would have included a very large item of compensation. Moreover, Mr. Nacchio would have reported this compensation income even if he had decided not to sell a single Qwest share he purchased in 2001. As it turned out, of course, Mr. Nacchio sold 1,330,000 of them, which is what caused all the trouble with the SEC.

These stock sales, legal or not, were also taxable events. This means that Mr. Nacchio would have reported a *second* tax "item" in 2001, namely, the capital gain or loss he realized from his stock sales. How much gain or loss did Mr. Nacchio actually report?

Without access to his 2001 tax return, there is no way to know for sure. However, it was certainly not the $44.6 million gain the Court of Federal Claims assumed. The most likely answer is that Mr. Nacchio reported a small capital *loss*.

Mr. Nacchio exercised his options and sold the resulting shares almost immediately. Because he was taxable on his receipt of the shares, Mr. Nacchio would have held them, however briefly, with a basis equal to their fair market value upon purchase. When he sold the shares, his amount realized for tax purposes would have been the total sale proceeds (the market value of the shares at the time of sale), reduced by his selling expenses—$60,081 in brokerage fees.

If Mr. Nacchio had actually managed to purchase and sell his Qwest shares simultaneously, the two market values would have been same. In that case, his amount realized from the sales would have been equal to his basis *minus* $60,081. Mr. Nacchio's 2001 return would therefore have reported a $60,081 item of short-term capital *loss*.

Nevertheless, for the sake of illustrating the operation of Code Sec. 1341, it is useful to assume that Mr. Nacchio's purchases and sales were not quite simultaneous. That would provide an opportunity for the market price of Qwest stock to increase slightly during the gap periods. Let us therefore assume that Mr. Nacchio sold his shares for $560,081 more than he paid for them.

This is just enough to leave Mr. Nacchio with a short-term capital *gain* of $500,000. In 2001, the top individual tax rate for ordinary income (including short-term capital gain) was 39.6 percent. Combined with the 1.45-percent hospital insurance tax, Mr. Nacchio would have faced a 41.05-percent marginal rate.

So, Mr. Nacchio's sales of his Qwest shares would have cost him about $200,000 in tax. To be consistent, let us assume that the aggregate spread on Mr. Nacchio's options was about $44.1 million—*i.e.*, $500,000 less than the full $44.6 million that Mr. Nacchio said he reported in 2001. Let us also assume that he paid about $17.8 million in tax in connection with their exercise—*i.e.*, $200,000 less than the full $18 million in tax he said he paid.

To summarize, Mr. Nacchio included *two* items in gross income for purposes of Code Sec. 1341(a)(1). The first was $44.1 million in compensation realized when he exercised his options and received his 1,330,000 shares of Qwest stock. The second was $500,000 in short-term capital gain realized when he sold those same shares a short time later.

Linking the 2007 Deduction to Specific Items

Tax law and securities law are distinct. As far as the IRS is concerned, Mr. Nacchio's stock sales netted him only a small gain—$500,000, if we use the assumed figure. But from a nontax perspective, the stock sales generated a $44.6 million profit.

That is the full difference between what Mr. Nacchio paid for the shares and what he got when he sold them. Let us call this Mr. Nacchio's "SEC gain" to distinguish it from his gain in the tax sense. In 2007, Mr. Nacchio was convicted of insider-trading and was required to surrender his $44.6 million SEC gain.

The Court of Federal Claims held that he was entitled to deduct his loss under Code Sec. 165(c)(2), despite the fact that the entire amount represented a criminal forfeiture. The Federal Circuit will decide whether this was the correct result. For present purposes, however, let us assume that Mr. Nacchio was entitled to the deduction.

According to Code Sec. 1341(a)(2), an item included in a prior tax year cannot trigger a credit under Code Sec. 1341(a)(5)(B) unless the taxpayer is able to identify a deduction to which he is entitled in the current tax year "because it was established … that the taxpayer did not have an unrestricted right to such item." As a relatively unproblematic example, suppose that Qwest had simply awarded Mr. Nacchio stock worth $44.6 million in 2001 and that he had not sold any shares. Mr. Nacchio would have included a $44.6 million item of compensation in gross income in 2001, as described in Code Sec. 1341(a)(1).

This would have triggered $18 million in tax. Further suppose that, in 2007, Qwest shareholders had successfully challenged the stock award under a previously unnoticed provision of the corporate charter prohibiting such awards and that Mr. Nacchio had surrendered the shares. From Mr. Nacchio's perspective, this $44.6 million clawback would have been a Code Sec. 162 business expense or a loss described in Code Sec. 165(c)(2).

Either way, he would have been entitled to deduct an amount equal to his $44.6 million basis in the shares surrendered. This would be a textbook case of a deduction to which the taxpayer became entitled because it was established that he lacked an unrestricted right to an item ($44.6 million in compensation income) that he had included in a prior tax year, as required by Code Sec. 1341(a)(2). Mr. Nacchio would then have been entitled to claim a credit under Code Sec. 1341(a)(5)(B) for the tax he would have saved if he had not included this item—$44.6 million of compensation—in gross income back in 2001.

Just the Facts?

On these facts, Mr. Nacchio would have had every right to a credit for the $18 million in tax he had paid. But Mr. Nacchio's actual case was different. He reported *two* items in gross income in 2001, but his 2007 conviction and forfeiture established that he lacked an unrestricted right only to *one* of them.

The first item was $44.1 million in compensation, on which Mr. Nacchio paid $17.8 million of tax. To satisfy Code Sec. 1341(a)(2), Mr. Nacchio would have had to identify a deduction to which he became entitled because it was established that he did not have an unrestricted right to that $44.1 million item.

That was impossible because it was never established (and apparently never even alleged) that Mr. Nacchio lacked an unrestricted right to the 1,330,000 shares he received as compensation when he exercised his options. Mr. Nacchio's conviction for insider-trading established that he had illegally *sold* his Qwest shares and that he consequently lacked an unrestricted right to his $44.6 million *SEC gain*. But it established nothing concerning Mr. Nacchio's *receipt* of the shares.

This stands in sharp contrast to the hypothetical situation described above, in which shareholders invoked a by-law provision to invalidate the issuance of the shares. If the shares were invalidly issued, this would establish that the recipient did not have a right to the compensation item he reported in connection with his receipt.

Receiving 1,330,000 Qwest shares was the event that required Mr. Nacchio to report his $44.1 million compensation item. But the SEC's insider-trading case had nothing to do with Mr. Nacchio's receipt. The case against Mr. Nacchio would have been exactly the same if he had inherited the shares from a rich aunt and never paid a cent in tax.

The consequences for Mr. Nacchio (imprisonment, fine and forfeiture) would have been the same as well, except that he would forfeited even *more* because his illegal SEC gain would have been $7.3 million *higher*. This is because Mr. Nacchio would not have had to pay the option exercise price to inherit the shares from his aunt.

So even assuming that that Mr. Nacchio was entitled to deduct his forfeited SEC gain, this was definitely *not* a deduction to which he became entitled because it was established that he lacked an unrestricted right to his 2001 compensation. Accordingly, there was no way for Mr. Nacchio to satisfy Code Sec. 1341(a)(2)'s "deduction" requirement with respect to his $41.6 million compensation item. Hence, there was no statutory basis for giving him a credit for the $17.8 million in tax he paid on that item.

Pyrrhic Victory?

Mr. Nacchio does better with his second item, the $500,000 of short-term capital gain realized when he sold his shares. The sales that generated Mr. Nacchio's $500,000 tax gain were the same sales that generated his $44.6 million SEC gain. The modest item of capital gain he included in 2001 was simply the portion of the SEC gain that constituted "gain" for tax purposes.

Mr. Nacchio forfeited $44.6 million in 2007 because it was established that he did not have an unrestricted right to his $44.6 million SEC gain. This is what triggered his $44.6 loss deduction. Although Mr. Nacchio did not include the full $44.6 million as capital gain on his 2001 return, he did report $500,000 of it.

Hence, it is accurate to say that Mr. Nacchio became entitled to a relevant deduction in 2007. It was established that he did not have an unrestricted right to the $500,000 item of capital gain that he included in income in 2001. Thus, Code Sec. 1341(a)(2) was satisfied with respect to this item.

Mr. Nacchio was therefore entitled to a credit under Code Sec. 1341(a)(5)(B) for the amount of tax he would have saved if he had not included "such item" in gross income in 2001. That would have been about $200,000, the tax he paid on his $500,000 short-term capital gain. Although $200,000 is real money, it is good deal less than the $18 million that Mr. Nacchio stands to receive if he prevails on the legal issues on appeal to the Federal Circuit.

Court TV?

The *Nacchio* case illustrates one of the risks posed by high-profile cases that involve dramatic or morally charged issues. The court and the litigants already "know" what the case is really about. Pausing to conduct discovery may seem like a distraction.

However, something as basic as obtaining and looking closely at Mr. Nacchio's 2001 tax return could have made a big difference. Instead, the case was evidently decided based primarily on the pleadings. These are, needless to say, documents with axes to grind. When the stakes are high, one has to wonder whether a court should be asked to make a decision on that basis.

Article Submission Policy

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