23 T.C. 176 (1954)

Compensation received for damages to property used in a trade or business, representing a recovery of capital, is treated as capital gain rather than ordinary income under Section 117(j) of the 1939 Internal Revenue Code.

Summary

Walter and Paul Henshaw, partners in an oil and gas business, received a settlement from Skinner & Eddy Corp. for damages to their oil in place caused by Skinner & Eddy's negligent operations. The Henshaws reported this settlement as capital gain, but the Commissioner of Internal Revenue argued it was ordinary income. The Tax Court held that the settlement represented compensation for the destruction of part of their business property (oil in place) and qualified as capital gain under Section 117(j) of the 1939 Internal Revenue Code, which pertains to gains from involuntary conversions of business property.

Facts

The Henshaw brothers operated an oil and gas partnership, owning interests in the Thigpen Lease and T.& N.O. Railroad Lease.

Skinner & Eddy Corporation operated a recycling plant in the same oil field.

The Henshaws sued Skinner & Eddy for damages, alleging both lost profits and damage to oil in place due to Skinner & Eddy's negligence.

The District Court instructed the jury to consider only damages to the market value of the oil interests before and after the injury, excluding lost profits.

The jury awarded damages to the Henshaws.

Skinner & Eddy appealed, but the case was settled out of court for $74,738.30, with net proceeds after litigation expenses of $59,211.11.

The Henshaws reported the net settlement as long-term capital gain.

The Commissioner determined this settlement to be ordinary income under Section 22(a) of the Internal Revenue Code of 1939.

Procedural History

The Henshaws initially sued Skinner & Eddy in the District Court of the United States for the Southern District of Texas.

The District Court jury found in favor of the Henshaws and awarded damages.

Skinner & Eddy appealed the District Court judgment.

© 2025 SCOTUSreports.com. All rights reserved.

Prior to a decision on appeal, the parties settled, and Skinner & Eddy paid $74,738.30 to the Henshaw partnership.

The Commissioner of Internal Revenue later assessed a deficiency, reclassifying the settlement income as ordinary income.

The Henshaws petitioned the Tax Court to contest the Commissioner's determination.

Issue(s)

1. Whether the settlement payment received by the Henshaw partnership from Skinner & Eddy Corporation constituted ordinary income under Section 22(a) of the Internal Revenue Code of 1939, as determined by the Commissioner?

2. Alternatively, whether the settlement payment represented gain from the involuntary conversion of property used in their trade or business, taxable as capital gain under Section 117(j) of the Internal Revenue Code of 1939?

Holding

1. No, the settlement payment did not constitute ordinary income because it was compensation for damage to a capital asset, not lost profits.

2. Yes, the settlement payment represented gain from an involuntary conversion of property used in their trade or business and is taxable as capital gain under Section 117(j) because it compensated for the destruction (rendering immobile and unextractable) of oil in place, a business asset.

Court's Reasoning

The Tax Court reasoned that the jury instructions in the original tort case clearly limited damages to the decrease in market value of the oil interests due to injury, explicitly excluding lost profits. The court stated, "The issue which was submitted to the jury was the amount of money which would compensate petitioners for the damages which Skinner & Eddy had inflicted upon their property…it was upon that issue that the jury's verdict was based. We therefore conclude that the compromise settlement which was effected by the payment of the money in question was in settlement of the judgment for damages to the oil in place and was not for a restoration of profits."

The court addressed the Commissioner's argument that the oil was still in place and not destroyed, stating, "That, of course, is true but the jury under the charge of the court has in effect found that certain portions of petitioners' oil have been rendered immobile by the negligent acts of Skinner & Eddy and cannot be extracted. It was for that damage the judgment was awarded." Referencing dictionary definitions and case law, the court interpreted "destruction" in Section 117(j) to include rendering

© 2025 SCOTUSreports.com. All rights reserved.

property useless for its intended purpose, even if not physically annihilated. The court quoted, "'While the term ordinarily implies complete or total destruction, it has on more than one occasion been construed to describe an act which while rendering the thing useless for the purpose for which it was intended, did not literally demolish or annihilate it.'"

Because the oil leases were used in the Henshaws' trade or business and held for more than 6 months, and the settlement compensated for the damage (partial destruction) to the oil in place, the court concluded that the gain fell under the involuntary conversion provisions of Section 117(j) and was taxable as capital gain.

Practical Implications

Henshaw v. Commissioner clarifies that compensation for damages to business property, when representing a return of capital rather than lost profits, can qualify for capital gain treatment. This case is important for determining the tax character of litigation settlements and judgments, particularly in cases involving damage to business assets.

Legal practitioners should carefully analyze the nature of damages sought and awarded in litigation to properly classify settlement proceeds for tax purposes. If damages are for the diminution in value of a capital asset, as opposed to lost income, capital gain treatment may be appropriate under Section 117(j) (and its successors in later tax codes, such as Section 1231 of the current Internal Revenue Code).

This case has been cited in subsequent tax cases to distinguish between compensation for lost profits (ordinary income) and compensation for damage to capital (capital gain), emphasizing the importance of the underlying nature of the claim and the measure of damages in determining tax treatment.

© 2025 SCOTUSreports.com. All rights reserved.