Robert A. Connell and Ann P. Connell v. Commissioner of Internal Revenue, T. C. Memo. 2018-213 (U. S. Tax Court, 2018)

In a pivotal ruling, the U. S. Tax Court decided that the extinguishment of a financial advisor's debt by a FINRA arbitration panel should be treated as ordinary income, not capital gain. Robert Connell, a former Merrill Lynch advisor, argued that the forgiven debt was compensation for his book of business, but the court found his claims insufficient to support this characterization. This decision clarifies the tax treatment of debt cancellation in employment disputes and underscores the importance of the origin of the claim doctrine in determining income characterization.

Parties

Robert A. Connell and Ann P. Connell were the petitioners. Robert Connell filed individually for the years 2010 and 2011. The respondent was the Commissioner of Internal Revenue. The case involved consolidated docket numbers 14947-16 and 14948-16 before the U. S. Tax Court.

Facts

Robert Connell, a financial advisor with over 35 years of experience, joined Merrill Lynch in June 2009 after leaving Smith Barney. As part of his employment package, Merrill Lynch provided him with a forgivable loan of $3,637,217, to be repaid through monthly deductions from his compensation over a period from October 2009 to June 2017. Connell's departure from Merrill Lynch was contentious, leading to an arbitration before the Financial Industry Regulatory Authority (FINRA) Dispute Resolution Panel. The FINRA Panel awarded Connell the right to retain $3,285,228. 26, effectively extinguishing the remaining balance of the loan. The issue before the Tax Court was whether this extinguishment should be treated as ordinary income or capital gain.

Procedural History

The Commissioner of Internal Revenue determined deficiencies in Connell's federal income tax for the years 2009, 2010, and 2011. Connell filed a petition with the U. S. Tax Court challenging these deficiencies. The parties stipulated to certain concessions, including the proper amount of cancellation of indebtedness income at $3,242,248. The Tax Court consolidated the cases and proceeded to address the remaining issue of the characterization of the extinguished debt.

Issue(s)

Whether the extinguishment of the debt owed by Robert Connell to Merrill Lynch, as determined by the FINRA arbitration panel, should be characterized as ordinary income or capital gain under the Internal Revenue Code?

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Rule(s) of Law

Under section 61(a) of the Internal Revenue Code, gross income includes all income from whatever source derived unless specifically excluded. Cancellation of debt income is taxable under section 61(a)(12). The taxability of lawsuit proceeds depends on the nature of the claim and the actual basis of recovery, as per the origin of the claim doctrine. See Commissioner v. Schleier, 515 U. S. 323 (1995); OKC Corp. & Subs. v. Commissioner, 82 T. C. 638 (1984); Sager Glove Corp. v. Commissioner, 36 T. C. 1173 (1961).

Holding

The U. S. Tax Court held that the extinguishment of the debt owed by Robert Connell to Merrill Lynch constitutes cancellation of debt income, which is taxable as ordinary income under section 61(a)(12) of the Internal Revenue Code. The court found that Connell failed to establish that the FINRA Panel's award was solely for the acquisition of his book of business, thus justifying a capital gain treatment.

Reasoning

The court applied the origin of the claim doctrine to determine the nature of the recovery from the FINRA arbitration. It examined Connell's pleadings and arguments before the FINRA Panel, which included claims of breach of contract, unjust enrichment, and other tortious actions by Merrill Lynch. The court noted that Connell's filings emphasized multiple arguments, not just the acquisition of his book of business. The court concluded that Connell did not meet the burden of proving that the award was exclusively for the taking of his book of business. The court also considered the contractual terms of the employment agreement and promissory note, which did not mention Connell's book of business, reinforcing the ordinary income characterization. The court's reasoning included an analysis of legal precedents, such as Commissioner v. Schleier, OKC Corp. & Subs. v. Commissioner, and Sager Glove Corp. v. Commissioner, which support the application of the origin of the claim doctrine in determining the tax treatment of lawsuit proceeds.

Disposition

The U. S. Tax Court sustained the Commissioner's determination, ruling that the extinguishment of the debt should be treated as ordinary income. Decisions were to be entered under Rule 155, reflecting the court's findings and the parties' concessions.

Significance/Impact

This case is significant for clarifying the tax treatment of debt cancellation in the context of employment disputes and arbitration awards. It reinforces the importance of the origin of the claim doctrine in determining whether proceeds from litigation or arbitration should be treated as ordinary income or capital gain. The decision may

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impact how financial advisors and other professionals structure their employment agreements and handle disputes with employers, particularly regarding the tax implications of forgiven debts. Subsequent courts may reference this case when addressing similar issues of income characterization from arbitration awards. Practically, it serves as a reminder to taxpayers and their counsel to clearly articulate the basis for recovery in legal pleadings to support desired tax treatment.

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