Litigation Settlements, Sales and Exchanges, and Section 1234A

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Recently, I tried to address the tax treatment of recoveries in investment disputes.[1] The taxpayer/plaintiff is usually hoping to achieve either recovery of basis treatment, capital gain treatment, or some combination of the two. One of the historical bugaboos of that area has always been whether a sale or exchange is required in connection with such a settlement. Some authorities suggest that a sale or exchange is required,[2] while others either explicitly say one is not or ignore the sale or exchange notion altogether.[3] Occasionally, taxpayers have lost the capital gain versus ordinary income fight because they have not been able to demonstrate that a sale or exchange has occurred.[4]

Statutorily, of course, a ticket to the land of capital gain requires a sale or exchange.[5] It is nearly axiomatic that capital gain (or loss) treatment requires a special type of recognition event. Of course, in the settlement of a lawsuit there is no sale or exchange in the usual sense.

Nonetheless, courts have found capital gains in some lawsuit settlements by either deeming a sale or exchange or just not discussing the requirement. For example, in *Inco Electroenergy Corp. v. Commissioner*[6] the Tax Court found a recovery in an intellectual property dispute to be capital in nature and simply did not mention whether there was (or needed to be) a sale or exchange.

Section 1234A to the Rescue

I was recently asked how that jurisprudence is affected by section 1234A. It is an interesting (if offbeat) question. From what I can tell, that section has not been mentioned by any court in deciding between ordinary income and capital gain treatment in the context of a lawsuit settlement. Section 1234A is entitled "Gains or Losses From Certain Terminations" and is sufficiently brief to merit quoting in full:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of —

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[1]*See* Wood, "Securities Recoveries Lawsuits: Capital Gain or Ordinary Income?" *Tax Notes*, Aug. 15, 2005, p. 767.

[2]*See* Rev. Rul. 74-251, 1974-1 C.B. 234.

[3]*See State Fish Corp*, 48 T.C. 465 (1967), *acq.* 1968-2 C.B. 3, *modified* 49 T.C. 13 (1967).

[4]*See, e.g., Sanders v. Commissioner*, 225 F.2d 629 (10th Cir. 1955), *cert. denied*, 350 U.S. 967 (1956).

[5]Section 1222.

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

> (1) a right or obligation (other than a securities futures contract, as defined in section 1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
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> (2) a section 1256 contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer, shall be treated as gain or loss from the sale of a capital asset. The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or other participation arrangement).[7]

There have been a sufficient number of taxpayer victories on capital gain treatment in lawsuit recoveries, so I (most of the time) don't worry too much about lingering authorities erecting a sale or exchange hurdle. However, it is always nice to have multiple arrows in a quiver, strings to a bow, and layers of Kevlar in a bulletproof vest.

With that in mind, litigants who are resolving disputes and who hope for capital gain treatment might look to section 1234A to support the notion that a particular litigation settlement gives rise to capital gain treatment. After all, some litigation in which the capital versus ordinary dichotomy arises involves the status of contracts. Contracts are often terminated, either explicitly or implicitly. Even in cases in which a contract is not being terminated by the litigation or its settlement, it does not seem much of a stretch to imagine taxpayers attempting to terminate contracts that might otherwise be irrelevant (for example, brokerage relationship or money management contracts) in an effort to get the capital gain treatment that section 1234A affords.

However, there seems to be nothing in the legislative history (or the decided authority thus far) to suggest that this fits within the intent of section 1234A. Section 1234A was enacted in 1981. The Senate Finance Committee report noted the following:

> The definition of capital gains and losses in section 1222 requires that there be a ''sale or exchange'' of a capital asset. Court decisions have interpreted this requirement to mean that when a disposition is not a sale or exchange of a capital asset, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss [*Commissioner v. Pittston*, 252 F.2d 344 (2d Cir. 1958)]. This interpretation has been applied even to dispositions which were economically equivalent to a sale or exchange of a capital asset.
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> **Reasons for the Change**
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> Some taxpayers and tax shelter promoters have attempted to exploit court decisions holding that ordinary income or loss results from certain dispositions of property whose sale or exchange would produce capital gain or loss. . . . The Committee considers this ordinary loss treatment inappropriate if the transaction, such as settlement of a contract to deliver a capital asset, is economically equivalent to a sale or exchange of the contract.[8]

The case law also suggests that section 1234A was designed to address a rather narrow set of circumstances. Before the 1981 law change, there was an anomaly in the taxation of straddles. Closures of futures and forward contracts were not taxed in the same manner as cancellations of futures and forward contracts. In a closure, both contracts under the straddle continued to be open until the settlement date, at which time the underlying commodities or securities were deemed to be delivered under each contract. That satisfied the sale or exchange requirement.[9]

In contrast, when a contract is closed by cancellation, the contract simply ceases to exist. All rights and obligations under the contract are released and extinguished. As such, taxpayers took the position that the cancellation of a future or forward contract produced ordinary income or loss, because there was no ''sale or exchange.'' Indeed, in *Wolff v. Commissioner*[10] the court held that pre-1981 contract cancellation losses were ordinary income. Section 1234A was designed to fix that problem.

One commentator has noted that ''section 1234A was apparently enacted to prevent taxpayers from taking ordinary losses on losing futures contracts. Before the enactment of section 1234A, if a futures contract had a gain, the taxpayer would sell the contract, ensuring capital gain treatment; but if it had a loss, the taxpayer would extinguish the contract, claiming ordinary loss treatment for the payment.''[11]

The tax publishers seem to agree that this provision is to forestall a taxpayer from claiming ordinary losses. According to CCH, ''capital gain treatment generally requires that there be a 'sale or exchange' of a capital asset. However, because certain types of dispositions are not sales or exchanges, the IRC contains provisions that deem certain transactions to be a sale or exchange in order to prevent taxpayers from claiming ordinary losses on transactions that should more appropriately be characterized as capital losses.''[12] CCH provides four examples: (1) the decreed disposition treatment of section 1234A, (2) cancellation of leases and distributorships under section 1241, (3) transfers of patent rights under section 1235, and (4) the retirement of debt obligations under section 1271.

The history surrounding the enactment of section 1234A suggests that it targeted financial contracts. Indeed, a section 1256 contract includes a regulated futures contract, a foreign currency contract, a nonequity option, and a dealer equity option. Moreover, the only regulations that exist under section 1234A (which are still in

[7]Section 1234A.

[8]S. Rep. 97-144, 170 (1981).

[9]*Commissioner v. Covington*, 120 F.2d 768 (5th Cir. 1941).

[10]148 F.3d 186, *Doc 98-22306, 98 TNT 134-5* (1998).

[11]Lee Sheppard, ''Should Contingent Income Be Accrued on Equity Swaps?'' *Tax Notes*, Feb. 9, 1998, p. 661.

[12]*See 2005 Standard Federal Tax Reporter* (CCH), para. 30,422.028, Sept. 30, 2005.

proposed form) apply only to notational principal contracts (that is, derivatives), bullet swaps, and forward contracts.

Before 1997, paragraph 1 of section 1234A applied only to personal property that is actively traded. Believing that a loophole still existed for other types of property, Congress enlarged section 1234A to include all property.[13]

Scope of Section 1234A?

The original intent of a statute does not necessarily mean it cannot be used elsewhere and for other purposes. Indeed, more recent legislative history suggests that section 1234A may have a wider application than just to financial contracts. Examples provided in the legislative history include not only the forfeiture of a down payment under a contract to purchase stock, but also the receipt of amounts from a lessee to release the lessee from a requirement that premises be restored (to their prelease condition) on termination of a lease.[14]

I'm not sure how far that gets us. Although section 1234A may sound simple, it is unclear how the IRS or the courts apply it. There are no cases dealing with section 1234A and few rulings. In LTR 9631010 the IRS ruled that income recognized by a regulated public utility corporation from the termination of a natural gas purchase contract is gain from the sale of a capital asset.[15] More recently, in TAM 200452033 the IRS concluded that amounts a corporation receives as section 72 income from the termination of its corporate-owned insurance contracts aren't — when amounts are ordinary income accretion to the contracts' value — property subject to section 1234A.[16] That lack of authority suggests that there has been little disagreement over the application of section 1234A.

Sale or Exchange Requirement

Returning to the sale or exchange requirement in the context of litigation settlements, does section 1234A bear on the issue? The legislative history of the Taxpayer Relief Act of 1997[17] contains the following descriptions of court decisions affecting the sale or exchange requirement:

> There has been a considerable amount of litigation dealing with whether modifications of legal relationships between taxpayers are to be treated as a ''sale or exchange.'' For example in *Douglass Fairbanks v. U.S.*, 306 U.S. 436 (1939), the U.S. Supreme Court held that gain realized on the redemption of bonds before their maturity is not entitled to capital gain treatment because the redemption was not a ''sale or exchange.''[18] Several court decisions interpreted the ''sale or exchange'' requirement to mean that a disposition, that occurs as a result of a lapse, cancellation, or abandonment, is not a sale or exchange of a capital asset, but produces ordinary income or loss. For example, in *Commissioner v. Pittston Co.*, 252 F. 2d 344 (2d Cir), *cert. denied*, 357 U.S. 919 (1958), the taxpayer was treated as receiving ordinary income from amounts received for acquisition from the mine owner of a contract that the taxpayer had made with mine owner to buy all of the coal mined at a particular mine for a period of 10 years on the grounds that the payments were in lieu of subsequent profits that would have been taxed as ordinary income. Similarly, [in] *Commissioner v. Starr Brothers*, 205 F. 2d 673 (1953), the Second Circuit held that a payment that a retail distributor received from a manufacturer in exchange for waiving a contract provision prohibiting the manufacturer from selling to the distributor's competition was not a sale or exchange. Likewise, in *General Artists Corp. v. Commissioner,* 205 F. 2d 360, *cert. denied*, 346 U.S. 866 (1953), the Second Circuit held that amounts received by a booking agent for cancellation of a contract to be the exclusive agent of a singer was not a sale or exchange. In *National-Standard Company v. Commissioner*, 749 F. 2d 369, the Sixth Circuit held that a loss incurred [in] the transfer of foreign currency to discharge the taxpayer's liability was an ordinary loss, since transfer was not a ''sale or exchange'' of that currency. More recently, in *Stoller v. Commissioner*, 994 F. 2d 855, 93-1 U.S.T.C. par. 50349 (1993), the Court of Appeals for the District of Columbia held, in a transaction that preceded the effective date of Section 1234A, that losses incurred on the cancellation of forward contracts to buy and sell short-term Government securities that formed a straddle were ordinary because the cancellation of the contracts was not a ''sale or exchange.''
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> The U.S. Tax Court has held that the abandonment of property subject to nonrecourse indebtedness is a ''sale'' and, therefore, any resulting loss is a capital loss. *Freeland v. Commissioner*, 74 T.C. 970 (1980); *Middleton v. Commissioner*, 77 T.C. 310 (1981), *aff'd per curiam*, 693 F.2d 124 (11th Cir. 1982); and *Yarbro v. Commissioner*, 45 T.C.M. 170, *aff'd*, 737 F.2d 479 (5th Cir. 1984), *cert. denied*, 105 S.Ct. 959.

Conclusions

Considering the relatively scant authority under section 1234A, I doubt there will be a groundswell of authority dealing with taxpayers' attempts to apply section 1234A to litigation recoveries. Still, it seems possible that the IRS or a court could apply section 1234A to a lawsuit settlement. For that to occur, at least two requirements will probably have to be met.

First, the IRS or a court would have to find that the underlying lawsuit (or perhaps the chose in action) was a capital asset in the hands of the plaintiff. Although at this point I am not certain whether the underlying suit could be viewed as a capital asset, that determination appears to be a separate issue from whether the ultimate monetary recovery from the suit would produce capital gain.

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[13]*See* Senate Report to P.L. 105-34, Aug. 5, 1997.

[14]H. Rep. 105-148 (P.L. 105-34), Aug. 5, 1997, p. 454.

[15]*Doc 96-21880, 96 TNT 152-57*. That ruling relied on a slightly different version of section 1234A, so it is unclear how authoritative the ruling remains.

[16]*Doc 2004-24263, 2004 TNT 248-9*.

[17]P.L. 105-34, Aug. 5, 1997.

[18]The result in this case was overturned by enactment in 1934 of the predecessor of current section 1271(a).

Second, the IRS or a court would also have to find that there was a cancellation, lapse, expiration, or other termination of the contract. With a lawsuit settlement, that second requirement is likely to be met, or perhaps could be met with minimal effort.

If those two requirements are met, and the IRS or a court finds that section 1234A applies to a lawsuit settlement, the consequences could be enormous. The plaintiff could treat the recovery as capital gain. That could statutorily remove the sale or exchange requirement that (depending on whom you listen to or which authorities you read) has sometimes been viewed as one of the prerequisites to achieve capital gain.

I find the sale or exchange requirement in the context of lawsuit settlements less troubling than I used to, perhaps because I see the IRS agreeing (on an informal level at least) that a sale or exchange is often not required. Plus, even apart from that informal experience, I am comforted by the authorities that accord capital gain treatment to lawsuit recoveries even though no one refers to it as a sale or exchange. Yet a new avenue to redemption is nothing to scoff at. That makes section 1234A intriguing.

Contract cancellations are implicit in many disputes involving capital assets. Further, it would not be difficult for the parties in a settlement agreement to refer to the underlying contract under which the events took place and to agree that the contract was being canceled. All of that may make section 1234A worth exploring. I have no doubt that section 1234A was not intended for that purpose, but it is certainly worth a closer look.