Viewpoint

I.R.C. Section 1234A Could Impact Taxation of Litigation Settlements

BY ROBERT W. WOOD

In September, BNA published an article I wrote that discussed how investment loss lawsuits should be taxed,[1] and although common sense dictates that both defendants and plaintiffs want to minimize taxes associated with any lawsuit, this plays out somewhat differently for each party.

Defendants, while not wanting to make payment, if required to do so will want to be able to claim a deduction for the payment. On the other hand, plaintiffs, while hoping to exclude any recovery from gross income, often realize that the best result is to claim recovery of basis and/or capital gain treatment.

The lack of a sale or exchange in connection with a settlement has been an Achilles' heel of plaintiffs' tax positions for decades, and has created work for more than a few courts.

Of course, plaintiffs sometimes find it difficult to obtain certainty when seeking recovery of basis or capital gain treatment.

Normally, capital gain (or loss) treatment requires some sort of recognition event. The Internal Revenue Code does not provide any help to taxpayers. In plain language, it indicates that a sale or exchange is required to obtain capital treatment.[2] In the settlement of a lawsuit, however, there is no sale or exchange in the usual sense.

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Although the Internal Revenue Service may tell us that judicial clarity exists, practitioners know otherwise. Some courts believe that a sale or exchange is required.[3] For example, taxpayers have been unable to secure capital gain treatment because they have not been able to demonstrate that a sale or exchange has occurred.[4]

Other courts either explicitly say a sale or exchange is not required or just ignore the sale or exchange requirement completely, allowing capital treatment without any discussion of the statutory requirement.[5]

Some courts have found capital gains in some lawsuit settlements by deeming a sale or exchange. 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.

There have been a sufficient number of taxpayer victories on capital gain treatment in lawsuit recoveries that I (most of the time) do not worry too much about lingering authorities erecting a sale or exchange hurdle.

Impact of Section 1234A

Although courts appear to be finding reasons for avoiding the sale or exchange requirement, it is always nice to have multiple arguments like several arrows in a quiver.

Recently, a tax practitioner asked me how might code Section 1234A affect the sale or exchange requirement regarding litigation settlements. On its face, it appears that Section 1234A could negate the sale or exchange requirement altogether in certain situations. Thus, this could be more than an immaterial inquiry which I did not cover in my prior article and which I would like to cover here. Section 1234A is sufficiently brief that I quote it in full:

> Gains or Losses from Certain Terminations
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> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of–
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> (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

[1] See Wood, *Stakes Loom Large in Determining Taxation of Investment Loss Lawsuit Recoveries*, 171 DTR J-1, 9/6/05.

[2] I.R.C. Section 1222.

[3] See *Sanders v. Commissioner*, 225 F.2d 629 (10th Cir. 1955), *cert. denied* 350 U.S. 967 (1956). See also Revenue Ruling 74-251, 1974-1 C.B. 234.

[4] Id.

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

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

Robert W. Wood practices law with Robert W. Wood P.C. in San Francisco (http://www.rwwpc.com). He is the author of **Taxation of Damage Awards and Settlement Payments** *(3d Ed. 2005), published by Tax Institute and available at http://www.damageawards.org.*

> 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]

Prior to 1997, paragraph 1 of Section 1234A only applied 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.[8]

Section 1234A is an obscure section that most practitioners may not have heard of. It would not surprise me if the code section were also unknown to some tax court judges. From what I can tell, this section has not been mentioned by any court in deciding between ordinary income and capital gain treatment in the context of a lawsuit settlement. Nevertheless, 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.

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Litigation frequently involves the status of contracts in which the capital versus ordinary dichotomy arises. Contracts are often canceled or terminated, either explicitly or implicitly. Sometimes, contracts just lapse or expire through inaction. Even in cases where a contract is not being either actively terminated or canceled pursuant to the litigation or its settlement, it hardly takes much imagination to envision the situation of a taxpayer attempting to terminate a contract that might otherwise be irrelevant (i.e., brokerage relationship or money management contracts), in an effort to afford himself the capital gain treatment under Section 1234A.

Case law suggests that Section 1234A was tailored to address a rather narrow set of circumstances. Prior to its enactment in 1981, material differences existed in the taxation of straddles as the closures of futures and forward contracts were not taxed in the same manner as cancellations of futures and forward contracts. These differences arose from an analysis based on form, not substance. Thus, when a contract was closed by cancellation, taxpayers said that the contract simply ceased to exist. All rights and obligations under the contract were released and extinguished.

As such, taxpayers took the position that the cancellation of a future or forward contract produced ordinary income or loss, since there was no ''sale or exchange.''

Indeed, in *Wolff v. Commissioner*,[9] the court held that pre-1981 contract cancellation losses were ordinary income. Congress perceived this as an abuse, and Section 1234A was the designed fix. In enacting Section 1234A, Congress hoped to achieve parity between cancellations and closures. To be complete, in a closure, both contracts under the straddle continue to be open until the settlement date, at which time the underlying commodities or securities are deemed to be delivered under each contract. This type of arrangement has historically satisfied the sale or exchange requirement, and capital treatment was appropriate.[10]

Tax publishers seem to agree that Section 1234A was enacted to forestall taxpayers from claiming ordinary losses on losing futures contracts. 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 I.R.C. 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.''[11]

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.

Although Section 1234A seems like it could be a potent weapon, the legislative history (and the decided authorities thus far) suggest that Section 1234A has narrow focus. 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.[12]

Based on this legislative history, it seems that Section 1234A was aimed at financial contracts. Indeed, a Section 1256 contract includes a regulated futures contract, a foreign currency contract, a non-equity option and a dealer equity option. Moreover, the only Treasury regulations (REG-166012-02) under Section 1234A (which are still in proposed form) support this inference, as they only apply to notional principal contracts (i.e. derivatives), bullet swaps, and forward contracts.

Application of 1234A

It is fair to say that the application of Section 1234A is a gray area outside of the realm of financial products. Although Section 1234A appears to have originally

[7] I.R.C. Section 1234A.
[8] See Senate Report to Public Law No. 105-34, Aug. 5, 1997.
[9] 148 F.3d 186 (1998).
[10] *Commissioner v. Covington*, 120 F.2d 768 (5th Cir. 1941).
[11] See *2005 Standard Federal Tax Reporter* (CCH), Paragraph 30,422.028, Sept. 30, 2005.
[12] S. Rept. No. 97-144, 170 (1981).

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been a narrowly tailored statute, this does not necessarily mean it could not be used elsewhere for other purposes.

Recent legislative history based on slight changes to Section 1234A suggests that it may have a wider application than just financial contracts. For example, legislative history indicates that Section 1234A applies to at least the following two scenarios: the receipt of amounts from a lessee to release the lessee from a requirement that premises be restored to pre-lease condition on termination of a lease, and the forfeiture of a down payment under a contract to purchase stock.[13]

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Astute practitioners may notice that this does not leave us much further down the road than where we started. Fair enough. Section 1234A may sound simple, but it is uncertain when, how, or if the IRS or the courts may apply it. No cases deal with Section 1234A and only a few rulings exist. This lack of authority suggests that there has been little disagreement over the application of Section 1234A. Of course, depending on your outlook, this dearth of authority may actually be beneficial.

In Private Letter Ruling 9631010, the service 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.[14] More recently, in Technical Advice Memorandum 200452033, the service concluded that amounts a corporation receives as Section 72 income from the termination of its corporate-owned insurance contracts are not property subject to Section 1234A, when amounts are ordinary income accretion to the contracts' value.

Is Sale or Exchange Required?

After the exposition on Section 1234A, readers may be wondering how this fits into litigation settlements. More specifically, does Section 1234A somehow affect the thorny sale or exchange requirement? The legislative history of the Taxpayer Relief Act of 1997,[15] 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 is 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.[16] 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 non-recourse 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

It is axiomatic that contract cancellations are involved in many disputes involving capital assets. Even if the cancellation is implicit, the parties in a settlement agreement could still refer to the underlying contract under which the events took place and agree that the contract was being canceled.

I have no doubt that Section 1234A was not intended to be used for the settlement of lawsuits. Nevertheless, settlements seem to be a natural extension, thus meriting a closer look. Considering the relatively scant authority under Section 1234A, I doubt there will be much authority dealing with taxpayers' attempts to apply Section 1234A to litigation recoveries. However, it still seems possible that IRS or a court could apply (or may not object to taxpayers' application of) Section 1234A to a lawsuit settlement.

[13] H. Rept. No. 105-148 (Pub. L. No. 105-34), Aug. 5, 1997, p. 454.

[14] This ruling relied on a slightly different version of Section 1234A, so it is unclear how authoritative this ruling remains.

[15] Pub. L. No. 105-34, Aug. 5, 1997.

[16] The result in this case was overturned by enactment in 1934 of the predecessor of present law Section 1271(a).

For this to occur, at least two requirement will probably have to be met. If these two requirements are met, and IRS or a court finds that Section 1234A applies to a lawsuit settlement, the consequences could be enormous. The statutory sale or exchange requirement would be removed and the plaintiff could treat the recovery as capital gain. Historically, this has sometimes been viewed, depending on whom you listen to and/or which authorities you read, as one of the prerequisites to achieve capital gain.

The first requirement is that IRS or a court find that the underlying lawsuit (or perhaps the chose in action) was a capital asset in the hands of the plaintiff. While I have yet to come to conclusion whether the underlying suit could be viewed as a capital asset, this determination appears to be a separate issue from whether the ultimate monetary recovery from the suit would produce capital gain.

The second requirement is that IRS or a court find that there was a cancellation, lapse, expiration or other termination of a contract. I am much less hesitant about this second requirement. After all, upon a lawsuit settlement, frequently there is an explicit or implicit cancellation, lapse, expiration or other termination of a contract. I would think that the second requirement is often likely to be met outright, or perhaps could be met with minimal effort.

Today, I am finding the sale or exchange requirement in the context of lawsuit settlements less troubling than in years past. This turn of heart probably stems from my seeing the service agreeing (on an informal level at least) that a sale or exchange is often not required. Even apart from this informal experience, I am comforted by the authorities that accord capital gain treatment to lawsuit recoveries even though no one even mentions the sale or exchange requirement. All of this makes Section 1234A intriguing.

Thus, to me at least, Section 1234A is a potential new avenue to redemption and practitioners should now think of having a new tool in their tool chest.

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