Sales and Code Sec. 1234A

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There's some poetic justice in the antiquated notion of being hoist by your own petard. Lexicographers will know this antiquated phrase refers to the French bomb of yore, often swung over castle walls to injure others. It had an annoying tendency of ensnaring the perpetrator in the ropes, turning victimizer into victim.

Tax luminary Martin Ginsburg once noted its tax equivalent, that "every stick crafted to beat on the head of a taxpayer will metamorphose sooner or later into a large green snake and bite the [IRS] Commissioner on the hind part." [*See http://taxprof.typepad.com/taxprof_blog/2008/01/tax-prof-quotat.html.*]

Enacted in 1981, Code Sec. 1234A is sufficiently brief to permit quoting in full:

- Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—
  (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
  (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).

The Senate Finance Committee Report noted that:

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

Prior to 1981, closures of futures and forward contracts were not taxed as cancellations. In a closure, both contracts under the straddle continued to be open until the settlement date. At that time, the underlying commodities or securities were deemed to be delivered under each contract. This satisfied the sale or exchange requirement. [*See Covington*, CA-5, 41-2 USTC ¶9522, 120 F2d 768 (1941).]

In contrast, when a contract is closed by cancellation, the contract simply ceases to exist. That means all rights and obligations under the contract would be 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. In *J.P. Wolff*, CA-2, 98-2 USTC ¶50,526, 148 F3d 186 (1998), the court held these pre–1981 contract cancellation losses were ordinary income. Code Sec. 1234A was designed to fix this problem.

Ordinary Losses

The tax literature seems to state consistently that this provision is to forestall the taxpayers from claiming ordinary losses. The history surrounding the enactment of Code Sec. 1234A suggests it was aimed at financial contracts. Indeed, a Code Sec. 1256 contract includes a regulated futures contract, a foreign currency contract, a nonequity option and a dealer equity option.

Moreover, the only regulations extant under Code Sec. 1234A are still in proposed form. Besides, they only apply to notional principal contracts (*i.e.* derivatives), bullet swaps and forward contracts. Prior to 1997, paragraph 1 of Code Sec. 1234A only applied to personal property which is actively traded. In 1997, Congress enlarged Code Sec. 1234A to include all property. [*See Senate Report to Public Law 105-34*, Aug. 5, 1997.]

Scope of Code Sec. 1234A?

The original intent of a statute does not necessarily mean it cannot be used elsewhere and for other purposes. Code Sec. 1234A may have a wider application than just financial contracts. Examples in the legislative history include the forfeiture of a down payment under a contract to purchase stock and the receipt of amounts from a lessee to release the lessee from a requirement that premises be restored (to their pre-lease condition) on termination of a lease. [H. REPT. NO. 105-148 (P.L. 105-34), Aug. 5, 1997, at 454.]

Moreover, what about fundamental issues? After all, Code Sec. 1234A may have been designed to dictate capital treatment so that taxpayers didn't claim ordinary losses, but can't Code Sec. 1234A be applied to gains? The answer is clearly yes, although just how expansively that capital treatment may extent is not clear. There are few Code Sec. 1234A authorities.

In LTR 9631010 (Apr. 29, 1996), 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. This ruling relied on a slightly different version of Code Sec. 1234A, so it is unclear how authoritative this ruling remains. More recently, in TAM 200452033 (Sept. 27, 2004), the IRS concluded that amounts a corporation receives as Code Sec. 72 income from the termination of its corporate-owned insurance contracts were ordinary income. The IRS seemed to focus on the ordinary income to capital gain conversion feature. These insurance contracts, said the IRS, were not capital assets, at least to the extent the accretions in their value were attributable to ordinary income. If that sounds circular and a bit confusing, you are not alone. In any case, it meant Code Sec. 1234A could not apply.

Contract cancellations are implicit in many disputes involving capital assets. Furthermore, it would not be difficult to make a good record, noting in writing the underlying contract under which the events took place, and agreeing that the contract was being cancelled. One could even refer to Code Sec. 1234A treatment in the agreement.

Freda Case

The recent case of *J.A. Freda*, 98 TCM 120, Dec. 57,913(M), TC Memo. 2009-191, involved the tax treatment of a settlement payment. C&F Packing Co. supplied sausage to Pizza Hut. C&F had a secret process making pre-cooked sausage take on the appearance and taste of home-cooked.

During negotiations in 1985, Pizza Hut pushed for C&F to disclose the secret process to Pizza Hut's suppliers. C&F was willing to share its secret process with other suppliers only if C&F would receive a royalty on all sausage sales made with the process. A 1985 Confidential Disclosure Agreement required C&F to disclose confidential information to Pizza Hut, and required Pizza Hut to keep it confidential.

Pizza Hut's suppliers also entered into third-party confidentiality agreements with C&F allowing the third parties to use the C&F process. Despite the execution of these agreements, Pizza Hut did not enter into a long-term supply contract with C&F as it had promised. By 1989, Pizza Hut had disclosed the C&F trade secret to IBP, which also sold sausage to Pizza Hut.

C&F filed suit against IBP for infringement and against Pizza Hut for inducing the infringement. Many counts in the complaint were dismissed, but in December of 1998, a jury trial was conducted on the misappropriation count against IBP. The jury returned a verdict in C&F's favor for $10,939,391 based on unjust enrichment. The district court added prejudgment interest and denied various IBP post-trial motions.

IBP appealed the prejudgment interest and the denial of its post-trial motions. C&F appealed the dismissals of its claims against Pizza Hut for fraud, breach of fiduciary duty, unfair competition, unjust enrichment and misappropriation. In 2000, the Federal Circuit affirmed the $10,939,391 damage award. Thereafter, the only unsettled issue was C&F's claim against Pizza Hut for misappropriation.

Settling up

In January of 2002, C&F, Pizza Hut and several current and former C&F shareholders entered into a global settlement calling for Pizza Hut to pay $15.3 million jointly to C&F and its lawyers.

C&F reported only the net (after legal fees) as long-term capital gain. It denominated the payment on its Schedule D as a "trade secret sale," passing through the long-term capital gain to shareholders *pro rata*. Predictably, the IRS argued it was all ordinary income.

The taxpayers argued that their underlying case was about damage to the C&F trade secret, and this was a sale or exchange of that trade secret to Pizza Hut. Alternatively, they claimed, the monies were for C&F's rights under the Pizza Hut confidentiality agreement with respect to this trade secret. Among other arguments, they claimed Code Sec. 1234A confirmed capital gain treatment.

Tax Alternatives

The Tax Court rejected all the taxpayers' arguments, finding that the settlement agreement did not transfer *any* rights to Pizza Hut, let alone the rights to the C&F trade secret. The Tax Court dismissed the argument that the settlement was for contract rights under Code Sec. 1234A. The taxpayers argued that the confidentiality agreement gave C&F the right to require Pizza Hut to:

- keep the C&F trade secret confidential;
- refrain from using the trade secret except for purposes of evaluating the sausage products; and
- return all materials relating to the trade secret.

Did this $15.3 million settlement payment terminate C&F's rights under the Pizza Hut confidentiality agreement with respect to the C&F trade secret? The Tax Court said no.

Conclusion

Given Code Sec. 1234A's statutory clarity, it is worth considering how strong the 1234A argument would have been in *Freda* if there had been good drafting. Suppose the settlement agreement had explicitly terminated all contract rights regarding the process. In that event, the Code Sec. 1234A argument might have been more well-received. With all the same claims in the lawsuit, suppose the documents had been more precisely tailored to characterize payments for particular capital assets and/or for contract termination. The court might have reacted very differently. But there is an even more fundamental point.

All audits must start somewhere. At the agent or IRS Appeals level, with more explicit drafting, the issue might simply have been entirely avoided (or favorably compromised). The language of a settlement agreement is not binding on the IRS or the courts, but very often the IRS does accept it.

In any event, I predict we'll see more Code Sec. 1234A arguments, and that many will succeed. Good documentation is one key.