Section 1234A and the Taxation of Gains and Losses From Terminated Agreements

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An evolving tax provision seeks to provide consistent capital vs. ordinary characterization for both income and losses attributable to the termination of contracts.

Unlike capital losses, which can be used to offset only capital gains,[1] ordinary losses can be used to offset both ordinary income and capital gains.[2] With respect to income, because of the rate differential between ordinary income and capital gain, the Government takes a much bigger piece of an individual taxpayer's ordinary income pie than of an individual taxpayer's capital gains pie.[3] All other things being equal, then, individual taxpayers prefer ordinary losses to capital losses and capital gains to ordinary income.[4] The offsetting potential of ordinary losses creates opportunities (and some harmful temptations) for taxpayers. This is where Section 1234A enters the picture. Congress enacted Section 1234A as part of the Economic Recovery Tax Act of 1981 (ERTA) to rein in taxpayers from electing either capital or ordinary tax treatment with respect to the same asset.

For example, suppose that a taxpayer, Randolph Duke, executes two forward contracts, one to buy and one to sell pork bellies for future delivery on a specified date.[5] If the price of pork bellies falls, the contract to sell pork bellies will be more valuable to Mr. Duke. He might therefore sell that contract for a gain equivalent to the excess of the contract price over the lower market price. Mr. Duke would of course prefer capital tax treatment with respect to his gain. Mr. Duke contemporaneously with the sale might also cancel his obligation to buy pork bellies by pay-

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ing a termination fee specified in the contract. He would prefer to characterize the termination fee as an ordinary loss.

This scenario presents a conundrum, at least from the IRS's perspective. Mr. Duke would characterize a gain and a loss with respect to the same asset, i.e. pork bellies, as being different in nature. He would characterize his gain as "capital" and his loss as "ordinary."[6]

Since the passage of Section 1234A, contracts implicating Section 1234A have expanded beyond simple forward contracts like Mr. Duke's. Merger agreements, for example, almost always provide for a termination fee that raises Section 1234A questions, and since the takeover boom of the mid-1980s, M&A agreements have become fractal-like in their detail and complexity. Naturally, when a complex agreement is terminated, it leaves complex tax questions in its wake. The termination of partnership and management agreements also gives rise to Section 1234A questions. Even litigation finance and settlement agreements can get tangled up in Section 1234A.

These four categories are not all-encompassing. Section 1234A is sufficiently broad to cover a wide variety of transactions. However, the four categories—merger, partnership, management, and litigation finance agreements—discussed here will hopefully show how Section 1234A plays out in a variety of disparate scenarios. First, though, a survey of Section 1234A's mechanics is in order.

Mechanics of Section 1234A

As noted above, Congress enacted Section 1234A in 1981 to prevent companies from electively characterizing gains and losses with respect to the same asset as either "capital" or "ordinary." Originally, Section 1234A applied only to actively traded personal property as defined in Section 1092(d)(1).[7] However, Congress amended the statute five times since 1981,[8] expanding the scope of Section 1234A with each amendment. The 1997 amendment marks the most notable change, whereby the reference to "personal property" was replaced with simply "property."

The legislative history behind the 1997 amendment describes the change as an unqualified expansion of Section 1234A "to all types of property that is a capital asset in the hands of the taxpayer."[9] Congress also amended Section 1234A in 2000, but then repealed that amendment in 2002. Current-form Section 1234A is thus identical to the 1997 amended version in all material respects.

Section 1234A provides:

> 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).

Section 1234A contains three basic parts:

1. There must be a gain or loss.
2. The gain or loss must be attributable to a cancellation, lapse, expiration, or other termination of a right or obligation.
3. The terminated right or obligation must be with respect to property which is (or would be on acquisition) a capital asset in the hands of the taxpayer.

Part one—gain[10]—and Part two—termination of a right or obligation[11]—

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[1] Individual taxpayers may deduct up to $3,000 of any excess capital losses from ordinary income, but must carry forward amounts above $3,000 to the following tax year subject to the same strict limitations.

[2] Technically, because of the effective 40.8% rate on non-compensatory ordinary income and effective 23.8% rate on capital gains for individual taxpayers taxed at the highest marginal rates, taxpayers receive a greater benefit when they use ordinary losses to offset ordinary income. Still, it is beneficial to use ordinary losses against capital gains.

[3] Individuals earning more than $500,000 per year face the highest marginal rate of 37% federal income tax on ordinary income and a 3.8% net investment income tax. The capital gains rate on long-term capital gains greater than $426,700 is 20%, but capital gains will likely also be subject to the 3.8% net investment income tax, hence the 23.8% effective rate.

[4] Notably, however, this general rule does not apply to every taxpayer.

[5] These hypothetical forward contracts are similar but not identical to "put" and "call" rights. A put right is an *option* to sell an asset, and a call right is an *option* to buy an asset. The forward contracts described above impose *obligations* on Mr. Duke to buy and sell.

[6] In the "General Explanation of the Economic Recovery Tax Act of 1981 (H.R. 4242, 97th Congress, Public Law 97-34)," the Senate Joint Committee on taxation provided a similar example:

> [A] taxpayer might have simultaneously entered into a contract to buy German marks for future delivery and a contract to sell German marks for future delivery with very little risk. If the price of German marks thereafter declined, the taxpayer sold his contract to sell marks to a bank or other institution for a gain equivalent to the excess of the contract price over the lower market price and cancelled his obligation to buy marks by payment of an amount in settlement of his obligation to the other party to the contract. The taxpayer treated the sale proceeds as capital gain but treated the amount paid to terminate his obligation to buy as an ordinary loss.S. Rep. No. 97-144, at 171.

[7] H.R. J. Res. 266, 97th Congress, section 501(a) (6/25/1981) (defining personal property as "any personal property (other than stock) of a type which is actively traded.").

[8] Congress amended Section 1234A in 1982, see Technical Corrections Act of 1982, H.R. 6056, 97th Congress, section 105(e) (1983); 1984, see Deficit Reduction Act of 1984, H.R. 4170, 98th Congress, section 102(e)(9); 1997, see Taxpayer Relief Act of 1997, H.R. 2014, 105th Congress, section 1003(a)(1) (1997); 2000, see Community Renewal Tax Relief Act of 2000, H.R. 5662, 106th Congress, section 401(b) (2000); and 2002, see Job Creation and Worker Assistance Act of 2002, H.R. 3090, 107th Congress, section 412(d).

[9] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997*, JCS-23-97, at 188 (1997).

[10] The meaning of gain and loss are not entirely devoid of nuance. Before a taxpayer can claim capital gain or loss, there has to be some actual gain or loss. Section 1222(3) defines "long-term capital gain" as gain from the sale or exchange of a capital asset held for more than one year. Section 1001(a) and its predecessors have defined gain on the sale or disposition of property as the excess of the amount realized over the taxpayer's adjusted basis in the property. "Amount realized" generally refers to the consideration received by the taxpayer for the property he disposed. See Section 1001(b); *Chapin*, 12 TC 235, 238 (1949), *aff'd* 180 F.2d 140 (CA-8, 1950). Moreover, the taxpayer need not have a tax basis in the property to have an amount realized (i.e., gain). Usually the existence of consideration has not been an issue because the taxpayer is typically paid in cash or a note which suffices as proof of such consideration. The gain, however, has to be derived from the disposition of "property."

[11] Essentially, the meaning of "cancellation, lapse, expiration, or other termination of a right or obligation" within the meaning of Section 1234A mirrors the ordinary meaning of those terms. For example, a breach of contract would be a termination of a right or obligation.

are relatively straightforward. Part three—the terminated right must be with respect to a capital asset—raises thornier questions, like, "what is a capital asset, and what does it mean for a terminated right to be *with respect to* a capital asset?"

What is a Capital Asset?

A "capital asset" is defined in Section 1221 as "property held by the taxpayer," with certain exclusions. Examples of such exclusions include "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."[12] Patents,[13] certain notes receivable,[14] and many other assets are also identified as exclusions under Section 1221. However, if an asset is not excluded by Section 1221, it is a capital asset within the meaning of Section 1234A. Courts have long held that "the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital gains treatment only in situations typically involving value appreciation accrued over a substantial period, and thus to ameliorate the hardship of taxation of the entire gain in one year."[15]

Beyond the exclusions enumerated in Section 1221, the characterization of assets as "capital" or otherwise may be a function of various judicial capital assets tests. For example, in *Maginnis*, [16] the Ninth Circuit considered two factors in determining whether a right to receive future lottery payments qualified as a capital asset:

1. The court asked whether the taxpayer had made an underlying investment of capital in the right.
2. The court asked whether the right appreciated in value over time.

In *Maginnis*, the taxpayer invested effectively nothing in the right; he merely purchased a lottery ticket. The court also held that the right did not appreciate in value over time. Rather, the right simply ensured that the purchaser of the winning lottery ticket would receive specified payments over a period of time. Therefore, the right lacked the requisite "realization of appreciation in value accrued over a substantial period of time that is typically necessary for capital gains treatment."[17]

Congress amended the statute five times since 1981, expanding the scope of Section 1234A with each amendment.

More recently, in ***CRI-Leslie, LLC***,[18] the Tax Court weighed in on the definition of a capital asset. In *CRI-Leslie*, the taxpayer purchased hotels, restaurants, and other real estate in 2005 for $13.8 million and agreed to sell the real estate in 2008 for $39.2 million. The taxpayer also received a $9.7 million deposit from the purchaser. The purchaser subsequently defaulted on the agreement, thereby forfeiting the deposit. The taxpayer characterized the forfeited deposit as a capital gain within the meaning of Section 1234A.

The Tax Court held that Section 1234A did not apply to the forfeited deposit because the parties had stipulated that the real estate at issue was "property used in a trade or business, as defined by section 1231(b)(1), of [the taxpayer] for the 2008 tax year."[19] The court reasoned that Section 1234A should be interpreted narrowly to apply to terminations only with respect to capital assets as defined by Section 1221. "Since the [real estate] was section 1231 property, it by definition was not a capital asset as defined in section 1221 and thus cannot fall under section 1234A."

When is a Termination "With Respect to" a Capital Asset?

Just as there is no one-size-fits-all approach for determining whether an asset is a capital asset, whether a terminated right is "with respect to" a capital is far from clear-cut. For example, past guidance on the tax treatment of breakup fees in merger agreements suggested that breakup fees would receive ordinary treatment.[20] At one time, the IRS concluded that breakup fees were substitutes for lost profits, which are not capital assets, and breakup fees were therefore not paid or procured with respect to capital assets.[21] However, the IRS seems to have reversed course here. Recent guidance suggests that breakup fees paid or procured with respect to another entity's stock are necessarily paid or procured with respect to capital assets and thus subject to Section 1234A.[22] The Government's present position is that, in the stock-for-stock merger context, a breakup fee is always paid or procured with respect to an entity's stock, not with respect to lost profits.[23]

The Fifth Circuit Court of Appeals recently weighed in on the "with respect to" debate. In *Pilgrim's Pride Corp.*,[24] the court overturned the Tax Court's ruling that losses attributable to abandoned securities were subject to Section 1234A. The IRS had argued that, because the taxpayer had terminated its rights with respect to the securities by abandoning them, Section 1234A should apply. The taxpayer, on the other hand, argued that Section 1234A applies to gains and losses attributable only to the

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[12] Section 1221(a)(1).

[13] Section 1221(a)(3).

[14] Section 1221(a)(4).

[15] *Gillette Motor Transport, Inc.*, 364 U.S. 130 (1960); see also *Brown*, 380 U.S. 563 (1965), quoting *Helvering v. Hammel*, 311 U.S. 504 (1941) wherein the Supreme Court stated that the courts, in interpreting a statute, have some "scope for adopting a restricted rather than a literal or usual meaning of its words where acceptance of that meaning would lead to absurd results ... or would thwart the obvious purpose of the statute."

[16] 356 F.3d 1179, (CA-9, 2004).

[17] *Id.* (internal quotation marks omitted).

[18] 147 TC 217 (2016), *aff'd* 882 F.3d 1026 (CA-11, 2018).

[19] *Id.* (internal quotation marks omitted).

[20] Ltr. Rul. 200823012.

[21] See *id.* ("[T]here is prevailing support for Taxpayer's position that the receipt of the termination fee is for the recovery of lost profits.").

[22] CCA 201642035.

[23] *Id.*

[24] 779 F.3d 311 (CA-5, 2015), *rev'g sub nom.* 141 TC 533.

[25] Goldsmith, "Fox, Disney Shareholders to Vote on Merger July 10," Forbes (5/30/2018), www.forbes.com/sites/jillgoldsmith/2018/05/30/fox-disney-shareholders-to-vote-on-meger-july-10/#17d1347048f6.

termination of "a contractual or other derivative right to property and not property rights inherent in the ownership of the property." In other words, the taxpayer argued that its losses were attributable to the termination of rights inherent in the securities, not to contractual rights with respect to the securities.

The Fifth Circuit agreed with the taxpayer's position. The court reasoned that Section 1234A "does not apply to the termination of ownership of the capital asset itself. Applied to the facts of this case, [the taxpayer] abandoned the Securities, not a 'right or obligation ... with respect to' the Securities." The court further noted that the IRS's position would render Section 1234(A)(2) superfluous because "Section 1234A(2) mandates capital gain or loss treatment for the termination of 'a section 1256 *contract* ... not described in paragraph (1) which is a capital asset in the hands of the taxpayer'" (emphasis added). Accordingly, Section 1234A does not require taxpayers to treat abandonment losses as capital losses.

Areas of Application

The contexts in which Section 1234A may apply have grown more numerous. The discussion below is not all-encompassing. However, the areas of application surveyed will hopefully shed light on the diversity of scenarios that might implicate Section 1234A.

Merger Breakup Fees

A breakup fee is a common bid protection in an M&A agreement. Essentially, a breakup fee is a penalty for backing out of a deal. For example, if either party to the 21st Century Fox merger with Walt Disney backs out of the deal, a $1.525 billion breakup fee will be imposed.[25] The relevant question, then, is whether the jilted party, i.e., the party receiving the fee, should receive capital or ordinary tax treatment for the fee. Relatedly, would the party paying the fee deduct the expense at ordinary rates or claim a capital loss? Noncorporate recipients of such fees will naturally argue for Section 1234A's application, preferring to receive capital gains treatment. Payers of breakup fees, on the other hand, will argue the opposite, preferring to receive ordinary treatment for their deductible losses.

Recent IRS memoranda suggest that an acquirer's procurement or payment of a breakup fee may always be subject to Section 1234A. In every conceivable merger scenario, the merger agreement entails rights or obligations with respect to the target's stock, which is a capital asset in the acquirer's hands. However, the IRS has left unanswered questions involving the taxation of targets. In any event, three scenarios are discussed below to illustrate how Section 1234A might apply in disparate merger termination contexts:

1. A reverse triangular merger with stock as consideration.
2. A cash-for-stock merger.
3. A merger with a mix of stock and cash as consideration.

Reverse Triangular Merger with 100% Stock Consideration. In a reverse triangular merger, the acquirer creates a subsidiary that merges into the target, with the target surviving the transaction. Assume here that the target's shareholders will receive the acquirer stock and the acquirer will receive the target's stock as consideration. Section 1234A will likely apply to breakup fees in this context regardless of whether the taxpayer is the acquirer or the target.

In CCA 201642035, the IRS addressed Section 1234A's application in a stock-for-stock deal mirroring the facts above. CCA 201642035 concludes that Section 1234A applied to a breakup fee paid by the target to the acquirer because the fee was paid "with respect to the Target's stock…." Because the target's stock in the hands of the acquirer would be a capital asset, Section 1234A applied, and the acquirer's gain was characterized as a capital gain.

CCA 201642035 also addresses losses suffered by the acquirer. In a merger breakup, a party often suffers losses and realizes gains. For example, an acquirer might be paid a termination fee if the target backs out of the deal (gain), but the acquirer will have incurred cost to facilitate the merger (loss). CCA 201642035 concludes that, because the "loss was attributable to the termination of Acquirer's right with respect to target's stock—property that would have been a capital asset in Acquirer's hands—the loss is treated as a loss from the sale of a capital asset under section 1234A." Section 1234A is a two-way street. If the merger consideration is (or would be) a capital asset in the taxpayer's hands, Section 1234A applies to gains and losses attributable to a termination of the merger.

Recent guidance suggests that breakup fees paid or procured with respect to another entity's stock are necessarily paid or procured with respect to capital assets and thus subject to Section 1234A.

CCA 201642035 discusses only the acquirer's tax treatment. It is reasonable to assume, though, that the target would be treated similarly in a stock-for-stock deal. The acquirer's stock would be a capital asset in the target's hands, just as the target's stock would be a capital asset in the acquirer's hands. So, if the target is paid a termination fee in the stock-for-stock context, the fee is paid with respect to a capital asset, i.e., the acquirer's stock. Likewise, any losses suffered by the target because of its efforts to facilitate the deal are suffered with respect to the same capital asset. Surely, then, targets will receive the same Section 1234A tax treatment as acquirers when stock-for-stock deals are terminated.

Cash for Stock Deal. Assume the same facts as CCA 201642035—the acquirer creates a subsidiary that will merge into the target—except that the acquirer pays *cash* for the target's stock. Here, Section 1234A almost certainly applies to the acquirer, but may not apply to the target. The critical

question is whether the breakup is with respect to a capital asset in the taxpayer's hands. Since cash is not a capital asset but stock is, the answer to this question is not so straightforward.

Let's turn first to the acquirer's tax treatment. Suppose that the target pays a breakup fee. Section 1234A will apply to the acquirer's procurement of the fee (gain) and any incurred costs related to the merger (loss), because the acquirer's gains and losses would be attributable to a termination of an agreement with respect to the target's stock. As mentioned above, the target's stock is a capital asset in the hands of the acquirer. Therefore, the acquirer's gains and losses arising from the termination will be taxed at the capital rate.

The target's tax treatment in the cash-for-stock context is less certain. There is no IRS guidance from which to draw. However, the text of Section 1234A suggests that gains and losses accruing to a target when a cash-for-stock merger is terminated are not capital in nature. From the target's perspective, a cash-for-stock merger is with respect to cash, and cash is not a capital asset. Therefore, gains and losses attributable to the breakup of a cash-for-stock merger are *not* with respect to capital assets in the target's hands. The target's gains and losses will thus receive ordinary treatment.

Conceivably, a target that holds significant capital assets could argue that gains and losses attributable to the breakup of a cash-for-stock merger are with respect to its capital assets. Whether the IRS would accept such an argument remains unclear. If the IRS were to focus on the cash consideration, then the target's gains or losses would be subject to ordinary treatment. If the IRS accepts that a target's own stock implicates capital assets, then the IRS might extend Section 1234A treatment to the target in a cash-for-stock merger.

Mix of Stock and Cash Merger Consideration. Assume the same facts discussed above, except that merger consideration is some mix of cash and stock. In other words, the acquirer will provide the target with both the acquirer's stock and cash as consideration for the target's stock. The mix of cash and stock begs the question whether a termination fee would be paid with respect to just the stock, just the cash, or some combination of the two.

It is tempting to argue here that a termination fee should be divisible into capital and ordinary components corresponding to the mixture of stock and cash offered as consideration. For example, suppose that the stock in consideration is worth \$6 million and the cash is worth \$4 million. A reasonable taxpayer might argue that 60% of any breakup fee should be taxed at capital rates, and the remaining 40% should be taxed at ordinary rates. However, the text of Section 1234A does not support such a divisibility argument.

Section 1234A applies when a gain or loss is "attributable to the termination of a right or obligation with respect to" a capital asset, not *only* with respect to a capital asset. Where both stock and cash are merger consideration, a termination fee is necessarily with respect to at least some stock. Therefore, Section 1234A should apply when consideration is a mixture of cash and stock.

Are there any workarounds? Perhaps a merger agreement could contain two separate breakup-fee provisions—one with respect to the stock consideration and one with respect to the cash consideration. But mergers do not work like this. It is inconceivable that the cash portion of a merger might succeed, while the stock portion is terminated. When a merger sinks, the whole ship sinks. When it floats, the whole ship floats. So, even if a merger agreement contains separate termination fees with respect to different assets, each of the termination fees is effectively related to the same merger transaction, which involves at least some stock as consideration. Accordingly, the cash termination fee would be paid with respect to the stock termination fee which, in turn, would be paid with respect to a capital asset, i.e., stock.

If courts apply the Fifth Circuit's reasoning in *Pilgrim's Pride* to abandoned partnership interests, then such abandonments should result in ordinary losses.

Partnership Interests

The IRS has issued some guidance related to abandoned partnership interests. Ironically, the Fifth Circuit cited the IRS's guidance on abandoned partnership interests to enter judgment against the IRS in *Pilgrim's Pride*. In Rev. Rul. 93-80,[26] the IRS advised that a partner who abandons her partnership interests recognizes an ordinary loss because, in cases of abandonment, there is no sale or exchange of property. Rev. Rul. 93-80 was published before the 1997 amendment, however, which extended Section 1234A to "property," as opposed to just "personal property." Regardless, if courts apply the Fifth Circuit's reasoning in *Pilgrim's Pride* to abandoned partnership interests, then such abandonments should result in ordinary losses. In *Pilgrim's Pride*, losses attributed to abandoned securities were deemed deductible at ordinary rates, not just because there had been no sale or exchange of a capital asset, but because Section 1234A does not apply to losses or gains attributable to rights that inhere in assets. Rather, Section 1234A applies to losses and gains attributable to the termination of rights with respect to a capital asset. Admittedly, this is a tough needle to thread. That said, given the IRS's guidance and the Fifth Circuit's opinion in *Pilgrim's Pride*, abandoned partnership interests likely generate losses that the taxpayer is entitled to deduct at ordinary rates unless the partner is also relieved from a share in the partnership's liabilities.[27]

When addressing Section 1234A issues, the "substitute for ordinary income doctrine" should also be taken

into account. The substitute for ordinary income doctrine stands for the proposition that when a party receives a lump-sum payment as "essentially a substitute for what would otherwise be received at a future time as ordinary income" that lump-sum payment is taxable as ordinary income as well.[28] For example, in *Holt*,[29] Holt agreed to produce a certain number of movies for Paramount Pictures in return for a fixed production fee plus 25% of the excess gross box office receipts. Holt then formed a partnership with his attorney and contributed to the partnership his right to receive the 25% interest in the excess gross box office receipts. At some point during the term of the Paramount agreement, the demand for Holt's films diminished, and Paramount desired to terminate the arrangement. Holt and the partnership agreed to be relieved from any obligations in the Paramount agreement in exchange for a $153,000 lump-sum payment to the partnership. The Ninth Circuit applied the substitute for ordinary income doctrine to the lump-sum payment, reasoning as follows:

> The Tax Court properly characterized the $153,000 transaction in this case as a lump sum payment in consideration for the right to receive income in the future. It is well settled that a right to receive future income which is commuted into a lump sum payment results in ordinary income just as the income if actually received in the future in several payments would be ordinary income. The nature of the right to receive future income as ordinary income does not change into capital gain by the mere receipt of a lump sum in lieu of such future payments.

However, some commentators have argued that *Holt* and the substitute for ordinary income doctrine have been silently overturned by Section 1234A.[30] This position makes sense in light of the effect Congress anticipated from the 1997 amendments to Section 1234A. Congress anticipated that "[a] significant effect of the Committee bill would be to reduce the uncertainty concerning the tax treatment of modifications of property rights."[31] Consistency could not be accomplished if some cancellations of rights with respect to a capital asset produce capital gain and others do not due to the application of judicial constructs like the "substitute for ordinary income doctrine."

Management Contracts

In FSA 20023804, the IRS addressed whether a payment to terminate a management agreement was ordinary income to the recipient. In this Advice, a parent company controlled two wholly owned subsidiaries, "Sub 1" and "Sub 2." Sub 2 had a management agreement to provide management services to a real estate investment trust (REIT) for a pre-defined term. At one point, the REIT terminated the management contract and paid Sub 2 in REIT shares and certain other REIT assets in exchange for the termination.

The IRS concluded that Section 1234A may be applicable to the management agreement termination.

The IRS concluded that Section 1234A may be applicable to the management agreement termination, because Section 1234A was enacted to ensure that certain cancellations and similar transactions would be treated as a "sale or exchange." In other words, the IRS suggested that Section 1234A could cause the cancellation of the contract to be taxed as capital gain even if, arguendo, "substitute for ordinary income" disqualified the contract as property for Section 1221 purposes.[32] The IRS stopped short from overtly saying this, however, and did not provide a definitive conclusion one way or another regarding the capital gain character of the payment.

For the "substitute for ordinary income" doctrine to apply, there has to be some ascertainable right to income in a management agreement. It is clearly the case that many (perhaps most) management agreements contain ascertainable rights to income. However, some management agreements do not. For example, in the entertainment industry, there is an echelon of managers whose primary objective is to secure recording contracts or other lucrative deals for their clients. Upon securing such a deal, these managers subsequently terminate their contracts for a fee paid by the recording company or other entity. The primary goal of these managers is not to earn income from management per se. Rather, they invest resources in multiple artists wagering that at least one of their management contracts will be purchased or terminated at a price that outweighs the managers' investments. These kinds of management contracts seem to pass the Ninth Circuit's two-factor test in *Maginnis*.[33] First, these managers make underlying capital investments in their contracts. Second, their contracts appreciate in value over time, at least one would hope. Within the meaning of *Maginnis*, certain management contracts in the entertainment context appear to be capital assets. Such contracts, as detailed above, also do not run afoul

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26 1993-2 CB 239.

27 See Rev. Rul. 93-80, 1993-2 CB 239; see also CCA 200851054.

28 See *Womack*, 510 F.3d 1295 (CA-11, 2007).

29 303 F.2d 687 (CA-9, 1962).

30 For an explanation of the implications of Section 1234A for the *Hort* decision, see generally Roche, "Lease Cancellation Payments Are Capital Gain? Yes! The TRA '97 Change to 1234A Overturned *Hort*," 102 JTAX 364 (June 2005).

31 S. Rept. PL 105-34, 8/5/1997.

32 Ultimately, the IRS did not rule whether the management contract was "property"—it merely flagged the issue and contemplated that the contract could qualify as property. Further, the IRS did not analyze whether the management contract was "property" specifically for Section 1001 purposes or whether the termination payment was "gain." This suggests that the IRS has not developed a definitive theory with respect to the "property" and "gain" issues in the Section 1234A context.

33 356 F.3d 1179 (CA-9 2004).

of Section 1221's capital assets exclusions.

Extending the example, suppose that an artist manager signs ten management agreements with up-and-coming rock bands. The manager then subsequently secures deals for its portfolio of artists with a television and video games licensing entity. Suppose also that the deal requires that the management company terminate its contracts with the bands in exchange for a fee. Such a fee procured by the management company might not be construed as a substitute for ordinary income. It is thus conceivable that the management company would be entitled to capital gains treatment for the gain attributable to the termination of its management agreements.

Litigation Finance and Settlement

Litigation finance is the enterprise of providing third-party financing for lawsuits unrelated to the third party in exchange for a portion of the judgment or settlement. Field Attorney Advice 20154701F discusses the purchase of a litigation financing agreement by a taxpayer who, upon settlement of the litigation, reported his share of the settlement as a capital gain for tax purposes. In the advice, the IRS notes that the taxpayer's settlement proceeds were not taxable as capital gains because there had been no sale or exchange of a capital asset.

Pilgrim's Pride may also be instructive in the litigation finance context. Remember, in *Pilgrim's Pride*, the Fifth Circuit Court of Appeals held that Section 1234A applies only to terminations of rights with respect to capital assets, not to terminations of rights that inhere in capital assets. Applying the Fifth Circuit approach, courts might conclude that the right to receive proceeds from settlement inheres in a litigation financing agreement. Therefore, the right to receive proceeds from settlement are not with respect to the litigation agreement. Rather, such a right is essentially the purpose of the agreement. However, *Pilgrim's Pride* technically applies only to abandoned securities, and its persuasiveness outside the Fifth Circuit is uncertain.

Conclusion

Section 1234A seeks to ensure uniform tax treatment of gains and losses attributable to the termination of contracts with respect to a capital asset. Since capital gains for individual taxpayers are taxed at lower rates than ordinary income, and ordinary losses for individual taxpayers are deductible at higher rates than capital losses, taxpayers should pay attention to how Section 1234A interacts with contract termination. In the merger context, parties receiving another party's stock as merger consideration are likely entitled to capital treatment in the event of termination. When merger consideration is cash, Section 1234A's applicability is less certain. Similarly complex issues arise in the management and litigation finance contexts, and indeed will arise in many other contexts.

The takeaway is that Section 1234A is an evolving statute applicable to evolving contractual scenarios. Accordingly, taxpayers with terminated contracts (or taxpayers considering terminating contracts) should be aware of Section 1234A's amorphous shadow.