Gain or Loss on Termination

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Linda E. Carlisle
White & Case

Before 1981, commodity transactions were used to create "silver butterflies," "gold cash-and-carry transactions," and "T-bill rolls" to defer and convert ordinary income into capital gains. In June 1980, however, the process of tax reform in the commodity area began, and the butterflies began to take flight.

The Economic Recovery Tax Act of 1981 (ERTA) enacted a set of new rules to reform the world of financial transactions, which at that time consisted mainly of commodity derivative transactions. ERTA dealt comprehensively with commodity transactions by imposing the recognition of losses on straddle positions under section 1092, requiring regulated futures contracts to be marked to market under section 1256, requiring the capitalization of interest and carrying charges for straddle positions under section 263(g), and settling the "confusion" that had arisen regarding the treatment of some contract rights under section 1234A. Rather than undergoing reform, however, section 1234A has increased uncertainty and muddied the treatment of some contract rights.

The original version of section 1234A provided that gain or loss from the termination of rights or obligations with respect to actively traded personal property that is, or on acquisition would be, a capital asset in the hands of the taxpayer was treated as a capital gain or loss. Thus, it would apply to assets that would qualify as positions in a straddle. The legislative history provided that ordinary loss treatment from the termination of such a contract is inappropriate because the settlement of a contract to deliver a capital asset is economically equivalent to the sale or exchange of the capital asset.

Section 1234A was amended in 1982 to add section 1234A(2), which provides capital gain and loss treatment for the termination of a section 1256 contract if that contract is a capital asset in the hands of the taxpayer. Congress was concerned that those contracts, which settle only in cash, would not be treated as rights or obligations regarding capital assets because cash is not a capital asset. The legislative history makes it clear that capital gain or loss treatment under section 1234A(1) was based on the termination of contracts with respect to *property* that is, or on acquisition would be, a capital asset in the hands of the taxpayer.

In 1997 Congress amended section 1234A to expand its application by deleting the "actively traded personal property" restriction (thereby eliminating a cross-reference to section 1092). Thus, section 1234A applies to the termination of rights or obligations with respect to any property, not just publicly traded property.

Proposed regulations addressing the character of income deductions, gains and losses from notional principal contracts (NPCs), bullet swaps, and forwards contracts were promulgated in February 2004. Under the proposed regulations, payments to terminate NPCs, bullet swaps, and forward contracts are deemed to constitute the termination of a right or obligation with respect to the contract and therefore give rise to capital gain or loss if the contract is a capital asset in the hands of the taxpayer.

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This regulatory interpretation is based on the view that section 1234A(1) provides that the termination of a contract that is a capital asset gives rise to gain or loss regardless of whether the contract is with respect to property that is or would be a capital asset in the hands of the taxpayer. Thus, it is unclear whether these regulations, which have been proposed for almost a decade, comport with the legislative history of section 1234A.

Section 1234A continues to be a source of confusion for taxpayers. If section 1234A is applied to the termination of a contract that is not held by a dealer in those contracts (that is, is a capital asset) without regard to whether the contract relates to property that is a capital asset, section 1234A would apply to all terminations of regular business service and inventory contracts and would convert gain or loss on the terminations of those contracts to capital gain or loss. This is contrary to some private rulings the IRS has issued dealing with payments to terminate burdensome uneconomic fuel transportation contracts (see, for example, TAM 200452033[55]). Moreover, it is worrisome if section 1234A applies to convert an ordinary loss into a capital loss in all situations in which a burdensome contract is terminated at a loss.

__Linda E. Carlisle__ is a partner in the Washington office of White & Case LLP. Ms. Carlisle practices international and domestic tax law and concentrates within the areas of taxation of corporations and corporate reorganizations, flow-through entities, such as partnerships, limited liability companies, as well as Subchapter S corporations. She also focuses on Public-Private Partnerships (or PPPs) and infrastructure transactions, and is one of the foremost practitioners in this area. In addition, Ms. Carlisle assists clients with employee stock ownership plans (ESOPs), intercompany pricing issues, financial derivative product issues and legislative, regulatory and administrative tax matters.

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