Capital Ideas: The Taxation of Derivative Gains and Losses

By Michael S. Farber

Michael S. Farber is a partner at Davis Polk & Wardwell LLP.

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This report explores the history of the taxation of derivative gains and losses — primarily section 1234A — as well as the capital gains preference, the straddle rules, the sale or exchange requirement, the extinguishment doctrine, the assignment of income and substitute for ordinary income doctrines, the capital loss limitation, and various statutory ''cousins'' of section 1234A. The report begins by reviewing the implications of Rev. Ruls. 2009-13 and 2009-14 (dealing with the sale/surrender of life insurance policies) for section 1234A, concluding that section 1234A is largely unnecessary and, as drafted, undermines the application of the straddle rules (which themselves are in need of some basic repair).

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I. Introduction

This report explores the history of the taxation of derivative gains and losses, in the hope of making some sense of where we are now, as well as some suggestions about improving the state of the law. The primary focus is on section 1234A, although in reaching some conclusions on that provision, this report will explore several features of the code that bear on its origins and its current role: the capital gains preference; the definition of capital asset; the sale or exchange requirement and its corollary, the extinguishment doctrine; the assignment of income (AOI) and substitute for ordinary income (SOI) doctrines; the hedging, integration, and straddle rules; and the limitation on deductibility of capital losses.

Several relatively recent developments have drawn attention to the problems with section 1234A. First, Rev. Rul. 2009-13, 2009-21 IRB 1029, *Doc 2009-9967*, *2009 TNT 83-11*, and Rev. Rul. 2009-14, 2009-21 IRB 1031, *Doc 2009-9965*, *2009 TNT 83-10*, have reminded the tax bar that the focus in section 1234A on rights or obligations ''with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer'' makes no sense in the current environment (if it ever did). Second, 2004 proposed regulations under section 1234A highlighted the starkly different treatments that can rationally be given economically similar instruments, despite what one might have hoped was the intention of the drafters of section 1234A to eliminate those distinctions.

Not surprisingly, I conclude that section 1234A makes no sense and should be overhauled or repealed (probably the latter). Along the way, I make several observations and suggestions about other provisions relating to the taxation of derivatives. It's worth noting at the outset, however, some things I won't do, either because they've already been done or because the topic is too big or too futile to take on in this report. I won't make arguments suggesting better ways to tax income generally. I won't

address the appropriate taxation of time value. I won't address the merits of the capital gains preference. I won't comment on section 1256, beyond saying that I view it as a non sequitur in any discussion of the logic or coherence of the current tax rules. And I won't try (very hard) to fix the straddle, hedging, or integration rules.

This report starts from several narrow premises. First, section 1234A was enacted to avoid a form of taxpayer electivity commonly called ''whipsaw'' — the phenomenon in which a taxpayer can decide *ex post* the most tax-advantageous way to terminate his exposure to a position. For section 1234A, the relevant whipsaw involved positions with a finite duration that on settlement would generate ordinary income or ordinary loss but that on disposition would generate capital gain or capital loss. In a world where this is possible, rational taxpayers will tend to prefer to hold the position to maturity and settle it by its terms when the position is at a loss to the taxpayer, but to dispose of the position before its stated maturity when the position is at a gain to the taxpayer, at least when a disposition is reasonably possible without undue transaction costs.

Before diving into the rules and the issues, it's worth exploring further why that is the case, and what considerations this observation entails. The first thing to note is that I haven't specified whether the position at issue is an asset from the taxpayer's perspective. Nor have I specified whether capital gains are subject to a rate preference. When a taxpayer can achieve a rate preference for capital gains (as described in the next paragraph), he will obviously be even more motivated to act as I've described. However, in any case, taxpayers will tend to act as I've described, as long as the deductibility of capital losses is essentially limited by the taxpayer's currently includable capital gains.[1] In other words, even if capital gains are taxed at the same rates as ordinary income, as they generally are for corporations, taxpayers will tend to prefer capital gains to ordinary income at a margin, because capital gains increase the marginal value (or more properly, reduce the marginal economic cost, in that they force the government to bear a greater percentage) of unrelated capital losses. And obviously, taxpayers will in general prefer to avoid capital losses when possible.

Under current law, however, gains attributable to capital assets are subject to rules even more favorable than capital gains generally. That is because as long as they're not subject to limitations such as the hedging or straddle rules, gains from the sale or exchange of capital assets of most noncorporate taxpayers are taxed at preferential rates after a period of time (currently one year). What is an asset, and what can be a capital asset, can both be difficult questions, as I'll discuss in parts V through VII. In general, however, many positions that generate capital gains and losses due to section 1234A and similar rules are not capital assets, and it isn't always clear whether gains from those positions are ever entitled to preferential rates. Obvious examples include liabilities like short sale positions and written options. As discussed in Part V, particular rules (sections 1233(b) and 1234(b), for example) often prevent taxpayers from attaining preferential capital gains rates for these types of positions, for policy reasons that I think are debatable.[2]

Second, as we'll see, section 1234A as originally constituted was largely a straddle rule. That is, it was explicitly written in such a way that losses from positions to which it applied would be subject to the loss deferral rules of section 1092(a). Put differently, as originally enacted, section 1234A did not apply to prevent taxpayer electivity regarding the character of a loss that would not have been subject to the straddle rules in any event. It is reasonably clear that the straddle rules as originally enacted (at the same time as section 1234A) — and indeed even now — defer or capitalize losses that are, or are treated as being, from the sale or exchange of property,[3] and that are attributable to positions for ''personal property of a type which is actively traded.''[4] As I'll discuss, tying section 1234A to the straddle rules probably never made much sense.

Thus, we have a rule that was originally intended to prevent whipsaw and straddle games. For many reasons, the straddle purpose no longer exists, but as we'll see, there is a significant residual interrelationship between sections 1234A and 1092 that could unnecessarily limit the scope of the latter. And as I'll discuss, it is far from clear that the best way to avoid whipsaw — even in 1981 — was the way chosen by the drafters of section 1234A. In any event, it's since become abundantly clear that whipsaw can be avoided without the need for a rule such as section 1234A.

So section 1234A has long since been unmoored from its original reasons for being. Yet it continues to drive the taxation of derivative instruments and to require tax professionals to perform a series of unnatural analyses in order to determine its applicability to a wide variety of common market transactions. And worse still, it never

[1]Plus $3,000 in the case of individuals. *See* section 1211(b).

[2]Without addressing the merits of the rate preference, I can observe that whatever its reasons for being, its inapplicability to short positions is difficult or impossible to justify on pure tax policy grounds. *See* Michael R. Powers, David M. Schizer, and Martin Shubik, ''Market Bubbles and Wasteful Avoidance: Tax and Regulatory Constraints on Short Sales,'' 57 *Tax L. Rev.* 233 (2004). The principal tax policy defense of the preference is that it mitigates what's been termed the ''lock-in'' effect. *See* Noel B. Cunningham and Deborah H. Schenk, ''The Case for a Capital Gains Preference,'' 48 *Tax L. Rev.* 319 (1993). The principal actual defenses of the preference are (1) the public overwhelmingly favors it; (2) it almost certainly raises tax revenue at a margin inducing people to dispose (or at least not discouraging them from disposing) of capital positions held for a sufficiently long period; and (3) by enhancing liquidity, the rate preference adds to the efficiency of the capital markets. Unless one wants to argue that the preference should apply only to undated (perpetual) positions — an argument that has some intuitive appeal to me (and even then, many short positions, notably securities borrowings, are by their terms perpetual) — the lock-in effect argument applies equally to short positions. And a rate preference for ''long-term'' gains on short positions would seem to have the same tendency to raise revenue and enhance efficiency as for long positions.

[3]*See, e.g.*, reg. section 1.1092(b)-5T(d).

[4]Section 1092(d)(1).

fully accomplished its intended result, as the aforementioned revenue rulings remind us, so that many of the whipsaws it sought to eliminate continue to exist. If one were looking for low-hanging fruit that could be relatively easily picked from the code, it's hard to imagine a better example.

I think a close review of the broad history of section 1234A is instructive, and so this report sets out to provide one. It will show that section 1234A was conceived and then modified in response to several competing and often confused lines of thinking, and that a little bit of housekeeping around various judicial doctrines might have prevented its enactment (its reasons for being) in the first place. Most notably, in 1981 the law regarding when a capital asset was sold or exchanged, as opposed to being canceled or extinguished, had reached the height of absurdity, as reflected in the *Wolff* and *Stoller* cases. And as was later made clear in Rev. Rul. 88-31, none of it ever had to happen. A close look at the evolution of the extinguishment doctrine reveals that it had no basis in any articulable policy; it simply evolved, with seeming inevitability and arguably by accident, out of the sale or exchange requirement of section 1222, first enacted in 1921. The drafters of that rule seem to have wanted to ensure that abandonment losses would be treated as ordinary losses, but there is evidence that they otherwise intended that any disposition of a capital asset (including by settlement with its obligor) ought to generate capital gain or loss. And it's clear that they were not thinking about the myriad of situations in which a liability might be terminated by settlement with its counterparty. The rest, as they say, is history, which I'll lay out in more detail below.

Adding to the confusion are various strains of thought (and strained thoughts) surrounding the difference between capital and ordinary assets (the core of the 30-plus-year frolic that was the *Corn Products* doctrine), and the difference between the sale of a right to earn ordinary income in the future and the sale of a right to earned (that is, economically accrued but not yet included for tax purposes) ordinary income, particularly when both of these things are happening at the same time. Even more complicating has been the continuing confusion between these issues and the ''assignment of income'' (AOI) doctrine, which has nothing to do with any of this — although almost no court has recognized that fact in any clear way.

Some of this confusion may have been cleared up by Rev. Rul. 2009-13 and Rev. Rul. 2009-14; unfortunately, those rulings don't get the distinctions right either, and in any event they do little to contribute to the debate about what section 1234A was really about, or how to achieve its intended purposes in situations when it arguably fails to do so.

To recap where I'm going: First, I don't think section 1234A was needed to prevent the obvious whipsaw it was by all accounts enacted to prevent, because one could with the stroke of a pen have concluded that the settlement of a capital asset with the counterparty is a sale or exchange. Second, the expediency of treating losses as capital in order to ensure that they are subject to the straddle and loss limitation rules is debatable, and I think it should be eliminated in any analysis of whether section 1234A makes sense. Without it, I think it's clear that section 1234A doesn't make much sense. And finally, section 1234A was in any event not well crafted enough to achieve its intended result, in that it tied its fate to personal property that is a capital asset, rather than to indices that can form the basis for, or linkage of, capital assets. The latter is a fatal flaw that has serious ramifications for the integrity of the straddle rules.

II. Rev. Rul. 2009-13 and Rev. Rul. 2009-14

Rev. Rul. 2009-13 and Rev. Rul. 2009-14 dealt with several aspects of the taxation of income connected with life insurance policies. Broadly, Rev. Rul. 2009-13 addressed questions associated with the surrender and sale of policies by persons with insurable interests in them, while Rev. Rul. 2009-14 dealt with similar issues with life insurance policies in the hands of persons with noninsurable interests (that is, pure profit motives). While many of the issues addressed in the rulings are beyond the scope of this report, the rulings provide a surprising number of insights into the taxation of derivative gains and losses, which I'll discuss in some detail in this part.

Rev. Rul. 2009-13 described three situations: (1) the surrender of a whole life policy by its owner/insured (the taxpayer); (2) the sale of the same policy by the taxpayer; and (3) the sale of a 15-year level-premium ($500 per month) no-surrender-value term life policy by the taxpayer halfway through its term. In situations 1 and 2, the taxpayer had paid $64,000 in premiums and had never received distributions or borrowed against the contract's surrender value. In situation 1, the taxpayer surrendered the policy for its $78,000 surrender value. In situation 2, the taxpayer sold the policy to an unrelated third person (3P) with no insurable interest for $80,000. In situation 3, the taxpayer sold the policy to 3P for $20,000.

The ruling held that the taxpayer in situation 1 recognized $14,000 of ordinary income on the surrender of the whole life policy, that the taxpayer in situation 2 recognized $14,000 of ordinary income and $12,000 of long-term capital gain on the sale of the policy,[5] and that the

[5]The origin of this additional $12,000 of gain, relative to situation 1, is as follows: First, the contract in situation 2 was sold for $2,000 more than its cash surrender value, presumably because the right to pay premiums in the future at the specified rate in the contract in exchange for the contract's death benefit was considered ''cheap'' by 3P. This might be because the taxpayer was less healthy at the time than his contractual premiums would have indicated or, more likely, because of the nature of a life insurance contract. Insurance companies build into their pricing (actuarial) models an assumption that a certain percentage of contracts will be surrendered without any death benefit ever being paid, simply because policyholders, even if acting rationally, don't have infinite cash. Unless the phenomenon of selling contracts to avoid surrender becomes so prevalent that it gets ''capitalized'' into the insurance companies' pricing (*i.e.*, until the insurance companies cease making, or materially lower the number associated with, this assumption, and thus raise premiums), this presents a natural arbitrage opportunity for profit-driven investors in life insurance contracts.

Second, the drafters of the ruling explain in a somewhat esoteric analysis that the basis in an insurance contract with an

(Footnote continued on next page.)

taxpayer in situation 3 recognized $19,750 of long-term capital gain on the sale of the policy.

In Rev. Rul. 2009-14, a U.S. investor with no insurable interest purchased a 15-year level-premium ($500 per month) term life insurance policy from the insured for $20,000 approximately halfway through its duration, renamed itself as the beneficiary of the policy, and then paid $9,000 in premiums to maintain the policy. In situation 1, 18 months later the investor receives a death benefit of $100,000. In situation 2, 18 months later the investor resells the policy to 3P for $30,000.

The ruling concludes that the investor has $71,000 of ordinary income on receipt of the death benefit in situation 1 (and, according to the analysis of situation 3, that this amount is fixed or determinable annual or periodical (FDAP) income) and that the investor has $1,000 of capital gain on the sale of the contract in situation 2.[6]

The rulings thus collectively provide that regardless of whether the owner of a policy has an insurable interest or a pure profit motive, the character of income from an insurance policy is ordinary when paid by the terms of the contract[7] or (on sale) in lieu of that ordinary income and is otherwise capital.

Both rulings conclude that a life insurance policy is a capital asset (at least in the hands of someone not in the business of buying and selling life insurance contracts). However, Rev. Rul. 2009-13, relying on Rev. Rul. 64-51, concludes that the proceeds received by an insured on the surrender of a life insurance policy constitute ordinary income ''to the extent such proceeds exceed the cost of the policy,'' adding somewhat cryptically that ''Section 1234A, originally enacted in 1981, does not change this result.'' That perhaps suggests a view of the drafters that life insurance represents a special case, governed by law that predates and operates outside the usual interpretive parameters of section 1234A. Moreover, Rev. Rul. 2009-14 states that ''neither the surrender of a life insurance or annuity contract nor the receipt of a death benefit from the issuer under the terms of the contract produces a capital gain,'' without mentioning section 1234A. These conclusions point clearly to Treasury and the IRS's view that the settlement by terms of an insurance contract (by surrender or payment of a death benefit) does not constitute the ''cancellation, lapse, expiration, or other termination'' of a right or obligation with respect to a capital asset under section 1234A.

Yet both rulings conclude that the sale of an insurance policy can produce capital gain, although Rev. Rul. 2009-13 muddies the water by reaching a compromise whereby the amount treated as capital gain is only the excess over the amount that would have been ordinary income on surrender of the contract (that is, the income attributable to the contract's cash surrender value).[8] This is an invocation of what the ruling calls the ''substitute for ordinary income'' (SOI) doctrine, for which it cites, among other authorities, *Midland-Ross*,[9] *P.G. Lake*,[10] and *Arkansas Best*.[11]

There are significant conceptual problems with the rulings' SOI analysis. The first stems from the fact (consistently ignored in the authorities) that SOI analysis amounts to bifurcation of a single asset into two things: the component reflecting amounts attributable to earned but untaxed ordinary income, and the rest of the asset. It is obvious that there were not two assets (even under the fiction of the bifurcation) when the policyholder bought the policy. It is also obvious that if there are two assets, it becomes — at least theoretically — necessary to explain how and when they arose and how to allocate the investor's basis between the two assets. So, for example, situation 2 of Rev. Rul. 2009-13 tacitly concludes that the taxpayer's basis in the contract (as reduced to reflect his enjoyment of life insurance protection; see note 5) should be allocated to the policy's surrender value (his ordinary asset), treating the ''separate'' asset (essentially the amount attributable to the value of the death benefit, less the cash surrender value and less the value of the taxpayer's obligations to make ongoing premium payments) as having no basis. Indeed, we'll see in the

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insurable interest must be adjusted under section 1016 for the ''cost of insurance'' already benefited from. That is, someone with an insurable interest in an insurance policy must somehow amortize a portion of his basis in the contract over its duration to reflect that he has already had the benefit of insurance protection during that term. This topic is beyond both my comprehension and the scope of this report.

[6]Again beyond the scope of this report is an interesting discussion of why the cost of insurance does not affect the basis of a purely profit-motivated policyholder. Also beyond the scope of this report is what seems to be a tortuous analysis of why the investor's payment of $9,000 of premiums to maintain the contract should be included in his basis in the contract on sale.

[7]Except that when someone with an insurable interest receives a death benefit by the terms of an insurance contract, it's generally excluded altogether under section 101.

[8]Some have argued that this result may be necessary in light of section 72(e), which (perhaps) treats as ordinary income the excess of cash surrender value over the investment in the contract. *See* New York State Bar Association Tax Section, ''Report on Investor-Owned Life Insurance'' (2008), *Doc 2008-25683, 2008 TNT 236-46*, p. 17 and n. 37. *But see* Rev. Rul. 2009-13. (''Section 72(e) does not specify whether income recognized on surrender of a life insurance contract is treated as ordinary income or as capital gain,'' although concluding it's ordinary for the reasons discussed in the preceding paragraph.)

[9]381 U.S. 57 (1965).

[10]356 U.S. 260 (1958).

[11]485 U.S. 212 (1988). The ruling invokes ''footnote 5,'' which said only that whatever this doctrine is, it didn't apply in that case:

> Petitioner mistakenly relies on cases in which this Court, in narrowly applying the general definition of capital asset, has ''construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income,'' even though these items are property in the broad sense of the word. [Citations to *Midland-Ross*, *Gillette Motor*, *P.G. Lake*, and *Hort* omitted.] This line of cases, based on the premise that section 1221 ''property'' does not include claims or rights to ordinary income, has no application in the present context. Petitioner sold capital stock, not a claim to ordinary income.

discussion of *Midland-Ross* in Part VI that this is consistent with the courts' treatment of the ordinary assets that result from SOI analysis, although the reasons are not entirely clear to me.

More fundamentally, both rulings seem inadequate or incomplete in their failure to explain why sales proceeds attributable to the right to receive a death benefit produce capital gain (that is, why this too is not a SOI). The unstated premise is that the right to receive the surrender value is a current right — the policyholder could choose to have it now, and in that event, according to the rulings' drafters, it would generate ordinary income if any gain were realized, whereas the right to the death benefit is contingent on a future albeit inevitable event. But this seems unsatisfactory in several respects. First, a policyholder can have the cash surrender value now only if he sacrifices the policy (that is, the death benefit and the right to pay a specified premium therefor, which itself may have economic value). It seems inappropriate to ignore this reality in determining that the cash surrender value has in any meaningful sense been earned. More importantly, the rulings don't ask whether it's possible that the cash surrender value could *decline* if the policyholder surrendered later (for example, because the surrender value is invested in risky assets, and the insurance company has not guaranteed or locked in a specified amount). If not, again because there is a material cost to claiming the surrender value now, it seems incorrect to conclude that any gain inherent in the surrender value constitutes earned income.

In any event, some might say gain on the sale of a life insurance policy should be all ordinary, at least for third-party investors in whose hands the income ultimately earned thereon (that is, resulting from the death benefit) will be ordinary. This position would be based on a strong version of the SOI doctrine adopted by some courts (but not the Supreme Court, as I will explain in Part VI), and I think it's helpful that Rev. Rul. 2009-13 rejects this strong form of the SOI doctrine.

For another sense in which the rulings' SOI analysis is questionable, consider that the inside buildup in many life insurance policies is determined by reference to one or more assets that may be capital assets — for example, mutual funds and bonds. This raises the question: What if a typical life insurance policy owner (the insured or someone with an insurable interest in the insured) buys a policy the buildup in which is linked to, say, a mutual fund, and the policyholder hedges that exposure? Are we happy with the conclusion that the insurance policy in this case is per se not a position with respect to a capital asset? As we'll see, it seems to follow from this conclusion that the policy is not a straddle position, which causes me to doubt its merits.

Indeed, a precursor to the rulings, TAM 200452033 (Sept. 27, 2004), *Doc 2004-24263*, *2004 TNT 248-9*, seems to have adverted to this issue by concluding that on termination or surrender of a whole life policy, to the extent of amounts "attributable to ordinary income accretions to the [policies'] value," that much of the policy is not a capital asset, and the associated payment is therefore ordinary. It seems that the memorandum intended to suggest that "accretions to value" attributable to capital assets might be treated differently (that is, might be treated as subject to section 1234A and therefore potentially the straddle rules).

Also, the rulings do not address the calculation or treatment of losses from the sale or settlement of insurance policies, for example, when the amount of a death benefit payment or sales proceeds is less than a policy's cost (or basis, which the rulings indicate may be a different amount). Further, a profit-motivated investor could suffer a loss when a policy lapses. Losses generally result when the insured lives or (in the case of sales losses) is expected to live longer than what was originally expected at the time of entry into the contract (that is, pricing) or (again in the case of sales proceeds) when market factors change sufficiently. For example, an increase in interest rates would presumably decrease the market value of a policy with a multiyear expected time horizon. The rulings certainly suggest (strongly, I think) that losses on settlement or lapse of an insurance policy would be ordinary.[12] This is exactly the kind of whipsaw potential that section 1234A was enacted to prevent. So why doesn't it?

III. Summary of Section 1234A and Its Problems

As discussed throughout this report, section 1234A has problems. It applies only to (1) the "cancellation, lapse, expiration or other termination" of rights or obligations with respect to property that is, or on acquisition would be, a capital asset and (2) section 1256 contracts that are capital assets in the taxpayer's hands. One issue that this framing has caused practitioners to struggle with is what "cancellation, lapse, expiration, or other termination" is intended to mean, and why it doesn't include the seemingly important terms "exercise" and "settlement." Some believe the implication of the statutory language is that only unnatural events trigger the rule and that by-terms settlements do not.[13] I think it's clear that that was not intended, as my discussion of the history of section 1234A and its predecessors in parts IV and IX will show.

On a related note, many have said that section 1234A(1) could be applied in a bootstrap fashion: The termination of any contract that is a capital asset (or that would be a capital asset in the taxpayer's hands) — including the contract on which you're performing your section 1234A analysis — is the termination of a right or obligation regarding a capital asset (the contract itself). I have some doubt as to whether this "strong form" of bootstrap argument would be persuasive if challenged. (As discussed below, there's another form of bootstrap argument associated with section 1234A, which I'll call

[12]One can imagine arguments to the contrary. For example, it might be argued that section 1234A doesn't apply to gains from settlement of insurance contracts (*i.e.*, on death or surrender) because of the historical treatment given insurance, but that losses therefrom are subject to that section. This seems disingenuous, or at least not well grounded in any policy I know of.

[13]*See, e.g.*, Mark Leeds, "Providing Certainty on Death and Taxes: IRS Issues Initial Guidance for Sellers and Purchasers of Life Insurance Policies" (May 2009).

the ''weak form.'') As we'll see, the existence of section 1234A(2), relating to section 1256 contracts, seems to call the argument into question. (It would be unnecessary if the ''bootstrap'' reading were correct.[14])

And absent the strong form of bootstrap argument, section 1234A doesn't seem to apply clearly to many things that one might conclude it should apply to (because without application of the rule, the very whipsaw the section was intended to prevent is available to taxpayers). And as we'll see, section 1234A doesn't apply to many things that one might conclude it *needs* to apply to (because if section 1234A doesn't apply to a position, it all but follows that the straddle rules can't either). One of the things in the former camp is life insurance, because as we've seen, absent section 1234A, an investor can, at least in theory, sell life insurance and generate (at least partially) capital gain, or instead hold it to maturity (the death of the insured), or let it lapse for what is presumably an ordinary loss.[15]

Among the things to which section 1234A needs to apply are inflation-linked products — for example, contracts linked to the Consumer Price Index.[16] Indeed, any index or linkage to which investors are willing and readily able to gain exposure through financial instruments should be subject to the straddle rules if those rules are to serve their intended purposes. And, as discussed below, the straddle rules apply only to positions with respect to actively traded personal property (PsWRATPP). So while its drafters may not have been aware of this fact, Rev. Rul. 2009-13 seems like strong support for the proposition that life insurance cannot be a straddle position.[17] The reason may appear obvious, and the result at first glance appears sensible: Life insurance is a position with respect to the duration of a specified person's life. And life insurance itself is not actively traded.[18] Accordingly, it might appear to make sense to conclude that life insurance is not a PWRATPP.

Yet, as discussed above, life insurance often *is* linked to capital assets or to indices that themselves form the bases or linkages of capital assets (the linkages forming the basis for the cash surrender value buildup). What if a taxpayer has a life insurance policy the buildup in which is linked to, say, an S&P mutual fund, and the taxpayer also shorts the S&P through a forward or futures contract? Is that a straddle? Alternatively, consider that investors do buy life insurance, often in large pools, and then hedge the resulting (surprisingly predictable) ''mass asset'' with actuarial positions, including swaps. Indeed, there is at least one publicly available investable life settlement index.[19] If investors do this, can there be a straddle? In both cases, I think Rev. Rul. 2009-13 says no.[20] As a policy matter, this is a very debatable result.

In fact, the drafters of the straddle rules have shown an awareness of the need to take an expansive approach to what constitutes a PsWRATPP. The straddle rules have strained (some would say have strained credulity) to reach the conclusion that positions on things like interest rates are PsWRATPPs. For example, reg. section 1.1092(d)-1(c) treats a swap as a straddle position if ''contracts based on the same or substantially similar specified indices are purchased, sold or entered into on an established financial market.''[21] This is a weak form of a bootstrap argument, which basically treats an index as actively traded personal property (ATPP) if ATPP linked to that index is relatively prevalent. However, the only way this argument makes any sense, as a matter of the literal requirements of the straddle rules, is if you believe that a swap linked to an index (other than of ATPP) is a position with respect to some other publicly traded asset that is also linked to that index — even if the parties to the swap have no idea whether that other asset exists.[22]

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[14]*See, e.g.,* David C. Garlock, ''The Proposed Notional Principal Contract Regulations — What's Fixed? What's Still Broken?'' *Tax Notes*, Mar. 22, 2004, p. 1515, *Doc 2004-5397*, or *2004 TNT 56-26*; David H. Shapiro, ''Venture Capital Tax Manual — A Brief Guide to the Tax Issues Associated With Financial Investments in Life Settlements,'' 6 *J. Tax'n Fin. Prods*. 43, 47 (2007).

[15]As discussed below, there are circumstances in which I think section 1234A needs to apply to life insurance.

[16]*See* http://www.bls.gov/CPI/.

[17]A possible counterargument is that the rulings stand for the proposition that life insurance income is ordinary on settlement or surrender even though that settlement or surrender might also constitute the cancellation, lapse, expiration, or termination of a right regarding one or more capital assets for straddle purposes, for example. *See supra* note 12. The only apparent basis for this position would be the assertion that life insurance taxation is sui generis and so should be unaffected by section 1234A; however, that assertion is supported by nothing that I know of in the legislative history of section 1234A or elsewhere.

[18]Indeed, I believe there are laws against active trading of life insurance. Most states require that insurance contracts be sold by licensed insurance brokers or agents.

[19]*See* http://www.qxx-index.com.

[20]I am here passing on the question (a difficult one, in the latter case) whether there would be a straddle on either of the fact patterns described in the text, even if life insurance could be a PWRATPP. One problem with the straddle rules is their inability to deal well with mass assets like life insurance and debt pools. Except for some stock straddles (see reg. section 1.246-5(c)(ii)), the straddle rules require a position-by-position analysis of whether one or more positions substantially diminish the risk of loss of another. *See, e.g.,* TAM 200033004 (May 1, 2000), *Doc 2000-21554*, *2000 TNT 162-21* (S&P put does not straddle a diversified stock portfolio).

[21]An established financial market is defined in reg. section 1.1092(d)-1(b) to include exchanges, commodities boards, some qualifying foreign exchanges, and interbank, interdealer, and debt markets (for property that is debt). An interbank market isn't defined. An interdealer market is a system of general circulation that provides a reasonable basis for determining fair value by disseminating either actual prices of recent transactions or recent price quotations of one or more identified brokers, dealers, or traders. With some exceptions, a debt market requires readily available price quotations from brokers, dealers, or traders.

[22]It's perhaps not entirely immaterial that the straddle rules' defined term here is actually ''personal property *of a type* which is actively traded.'' (For purposes of this report, I chose to simplify because ''PPoaTWIAT'' is so obviously unwieldy.) Thus, in theory there could be a basis for distinguishing between property that forms the basis for a section 1092 straddle position and property that forms the basis for a section 1234A deemed sale. The straddle rules can apply to positions with respect to nontraded property if it's of a type that is traded. *See*

(Footnote continued on next page.)

As a case in point, consider the three-month U.S. dollar London Interbank Offered Rate. LIBOR is published by the British Bankers' Association and is basically an average of the rates at which the ''middle'' 8 of 16 self-reporting banks say at a specified time that they're borrowing or are able to borrow money on an unsecured basis (take deposits) from other banks for a three-month term. Not one of those banks necessarily stands ready to borrow at its own or the composite rate; indeed, by the time a LIBOR rate is published, the component and the composite rates have in all likelihood changed. Thus, if any asset is linked to or based on that published rate (as many are), it's because one or more parties unrelated (or at least only coincidentally related) to the British Bankers' Association or its members choose to create the linkage. So we have no way to know (or at a minimum, nobody checks to see, in performing a straddle analysis), at the time a position linked to LIBOR is entered into whether any person actually holds any LIBOR-linked positions as ATPP. Which, of course, we aren't required to do — that would be silly.

So are swaps linked to LIBOR really PsWRATPP? It is sufficient to say yes — indeed, they must be — because the straddle rules are drafted the way they are. We know that because if a LIBOR swap isn't a potential straddle position, the system doesn't work. And that is simply because if offsetting LIBOR positions are not a straddle, taxpayers could freely do all the things the straddle rules were enacted to prevent — generate artificial tax losses and interest deductions, defer income indefinitely, and convert ordinary income into long-term capital gain without risk. Thus, offsetting positions with respect to LIBOR are — must be — straddle positions. So they're PsWRATPP. And it follows that they are (must be) rights or obligations with respect to property that on acquisition would be a capital asset, at least in the hands of a nondealer in that property.[23]

In the case of debt instruments and in some other contexts, the IRS has other weapons at its disposal that can obviate the need to engage in this analysis, including the hedging and integration rules, but these are narrowly drafted. Both sets of rules by their terms can apply whether a taxpayer wants them to or not. But as drafted, both regimes are fatally limited in the context of typical investor hedging activities. The hedging rules apply only to positions entered into in the normal course of a business primarily to manage risk with respect to assets that produce only ordinary income and loss or ordinary liabilities. For taxpayers that are ''typical investors,'' this rule serves little or no useful purpose. The integration rules apply (for reasons unclear to me) only to instruments that in the first instance are indebtedness and to a narrowly defined universe of hedges thereof. Thus, these rules fall woefully short of providing the kind of protection needed to address the concerns raised by instruments linked to investable rates and indices.

It's also easy to observe that the straddle rules didn't need to be designed this way. The words of reg. section 1.1092(d)-1(c) make perfect sense, regardless of whether it's easy or credible to conclude that the particular instrument is a PWRATPP. Indeed, this concept should not be limited to notional principal contracts (NPCs). If investors can easily get exposure to a particular index through available public products, the straddle rules (assuming we all agree they serve a useful purpose) should apply to any instrument linked to that index.[24]

But because the straddle rules are designed the way they are, *if* we are to conclude that a position with respect to LIBOR — or life settlements, or inflation — can be a straddle position, we are *required* to conclude that it is a PWRATPP. And it is absurd to conclude that a position that *is* with respect to ATPP is *not* a position with respect to ''property which is (or on acquisition would be) a capital asset,'' assuming the taxpayer isn't a dealer in the property. So any index or linkage that can form the basis for a straddle position must be subject to section 1234A — whatever one has to do to reach that result.

Edward D. Kleinbard in ''Examining the Straddle Rules After 25 Years,'' *Tax Notes*, Dec. 21, 2009, p. 1301, *Doc 2009-26203*, or *2009 TNT 242-5* (lamenting the missed opportunity of Rev. Rul. 2000-12, 2000-1 C.B. 744, *Doc 2000-5720*, *2000 TNT 40-21*, which held that two purchased but offsetting ''contingent interest'' bonds, which were privately placed, were analyzed under the original issue discount abuse and integration rules rather than the straddle rules, because the bonds were obviously ''of a type'' that is actively traded — and noting that this would make almost every purchased debt instrument a straddle position, thereby properly causing debt traders to make a section 475(f) mark-to-market election). Kleinbard seems to have glossed over an important issue: The straddle rules would apply to the bonds described in the ruling if they were positions with respect to property of a type that is actively traded, without regard to whether they themselves are personal property of a type that is actively traded. The ruling doesn't say what the contingency was. It says only that if some ''event'' happens on a specified date, one bond's interest rate would go up a lot and the other's would go down a lot, and vice versa. But for Kleinbard to be right, either the contingency would have to be PPoaTWIAT (and even that seems like a tough case to make, as it's merely a trigger that causes an otherwise fixed interest rate to change), or one would have to conclude that the bonds were positions with respect to each other, which is a nice hybrid of the two section 1234A bootstraps discussed in this part.

In any event, given that section 1234A no longer turns on active trading, and the only question under that section is whether a contract involves rights or obligations with respect to ''property'' that is or would be a capital asset in the taxpayer's hands, I think the syllogism that to be a straddle position, something must also be subject to section 1234A, is sound.

[23]Garlock makes this point but notes that after the 1997 amendments to section 1234A, discussed in Part IV, which disconnected that section from the straddle rules, nothing in the section (other than a proposed and proposed-to-be-prospective regulation) provides that a LIBOR swap is subject to section 1234A. *See* Garlock, *supra* note 14, at 1519. *See also* Thomas A. Humphreys, ''Gambling on Uncertainty — the Federal Income Tax Treatment of Weather Swaps, Cat Options and Some Other New Derivatives,'' *Tax Forum* No. 528, at 31-34 (Nov. 2, 1998) (concluding that the straddle rules and section 1234A do not apply to many weather derivatives).

[24]*See also* the discussion in Part IV of the proposed section 1234A regulation's reference to a ''specified index,'' and of the NPC regulations' use of that term. That also might form a solid basis for the applicability of the straddle rules.

Indeed, this mare's-nest of a result is not an accident — it was originally intended that section 1234A would follow the straddle rules in this regard. When section 1234A was untethered from the straddle rules in 1997 in an effort to broaden the statute's antiwhipsaw scope, it was not redrafted to prevent the need for this rather inane analysis.

There's a second sense in which section 1234A could have been born from a defect in the straddle rules. In general, the straddle rules apply to defer losses (or to require capitalization of losses if an election is properly made[25]), which means losses described in section 165.[26] It's at least possible that the drafters of section 1234A believed it was unclear whether the settlement of a position other than by sale or exchange would be treated as a loss for purposes of the straddle rules,[27] although I know of no basis for that concern.

As we'll see, what's more frustrating is that it seems none of this ever had to happen. The choices made by the drafters and amenders of section 1234A were debatable. If we were to start over, I doubt we'd reach the rule we have now. And looking back at it, it's very hard to see what remains that's worth preserving.

IV. History of Section 1234A

Section 1234A was originally enacted under the title "Tax Straddles" as part of a set of provisions in the Economic Recovery Tax Act of 1981[28] that were designed to counter then-prevalent tax arbitrage transactions. This set of provisions also included the original straddle provisions, sections 1092 and 263(g), and the original mark-to-market and loss carryback provisions for regulated futures contracts, sections 1256 and 1212(c).[29]

While the congressional record describes a variety of tax arbitrage strategies that prompted the straddle legislation, the core strategy targeted by section 1234A involved economically offsetting futures and forwards contracts, similar to those at issue in *Wolff* and *Stoller*, described in Part V below. The Joint Committee on Taxation's general explanation of section 1234A gives a simple example of a transaction producing a character difference without a timing difference:

> For 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.[30]

Unlike that simple fact pattern, the examples used in the hearings and related reports leading up to the 1981 act more commonly included deferred recognition of the gain leg of a straddle in addition to character differences, with elaborate variations.[31]

The initial legislative proposal was simply to expand the sale or exchange requirement of section 1222 so that it would be satisfied by any disposition. Through the course of the committee prints and congressional hearings, this sale or exchange proposal received relatively little attention, and no alternative approaches were suggested. However, without discussion in the congressional record, this proposal was replaced with the original section 1234A, which remains the core of current section 1234A.

The first straddle-related legislative proposal was made in the House in January 1981 and did not address the sale or exchange requirement of section 1222. In March 1981, Sen. Daniel P. Moynihan introduced a sister bill in the Senate that would have added a new definition in section 7701(a):

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[25]*See* section 1092(a)(2).

[26]*See* reg. section 1.1092(b)-5T(d).

[27]Proposed regulations promulgated in 2001 would significantly expand the scope of the section 263(g) "carry charge" capitalization rule to include all expenses associated with positions that offset a straddle position that is "personal property" (*i.e.*, that is not a pure liability). A broad capitalization rule like this, while itself of debatable merit, can go a long way toward mitigating some of the straddle concerns that motivated the drafters of section 1234A.

[28]Economic Recovery Tax Act of 1981, P.L. 97-34, 95 Stat. 324.

[29]*Id.*

[30]JCT, "General Explanation of the Economic Recovery Act of 1981," JCS-71-81, at 314 (1981) (herinafter JCT Recovery). Before the enactment of section 988 in 1986, there was no general requirement that gain or loss on foreign currency transactions be treated as ordinary. *See* JCT, "General Explanation of the Tax Reform Act of 1986," JCS-1-03, *Doc 2003-2529, 2003 TNT 24-31*, at 1096.

[31]*See, e.g.*, JCT, "Background on Commodity Tax Straddles and Explanation of S. 626," at 11-16 (1981), *reprinted in* "Hearing Before the Subcomm. on Taxation and Debt Management and the Subcomm. on Energy and Agricultural Taxation of the Senate Committee on Finance on S. 626," 97th Cong. (the 1981 Senate hearings) 27-32 (1981). Deferral of gains through simple straddles had been a target of the IRS for several years preceding the 1981 act, and taxpayers had responded with increasingly complex structures. Rev. Rul. 77-185, 1975-1 C.B. 43, held that a taxpayer who purchased and sold short silver future contracts with delivery dates in different months was disallowed a deduction for a short-term capital loss on subsequently closing the losing position and replacing it with a similar position that required delivery in a different month. Rev. Rul. 77-185 reached this holding on the basis that the lack of "real change" in the taxpayer's overall position at the time of closing and replacement of the loss position precluded treatment of the loss transaction as closed. Rev. Rul. 77-185 also cited the lack of economic effect of the full set of transactions and the absence of a reasonable expectation of profit by the taxpayer. Rev. Rul. 77-185 did not, however, address the character whipsaw issue, which was irrelevant under its facts. *See also* Rev. Rul. 78-414, 1978-2 C.B. 213.

> The term ''sale or exchange'' when used with reference to any capital asset means any disposition of such asset.[32]

The JCT print providing background for the Senate subcommittee hearings on the Moynihan bill included a straightforward explanation of the provision:

> 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, for example, a lapse, cancellation, or abandonment, the disposition produces ordinary income or loss. This interpretation has been applied even to dispositions which are economically equivalent to a sale or exchange. If a taxpayer can choose the manner of disposing of a capital asset, he may sell or exchange it, if it has appreciated in value, to realize capital gains, but he may choose to dispose of it in some fashion other than a sale or exchange, if its value has decreased in order to realize a fully deductible ordinary loss.[33]

Treasury endorsed that approach in general and the Moynihan provision specifically.[34] The provision received minimal attention in both the House and Senate subcommittee hearings. Nonetheless, the version of the Economic Recovery Tax Act reported by the Senate Finance Committee in June 1981 (the Senate version) dropped the Moynihan provision in favor of the language that would ultimately be enacted as section 1234A:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to personal property (as defined in section 1092(d)(1)) which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset.[35]

Under the Senate version, section 1092(d)(1) defined personal property as ''any personal property (other than stock) of a type which is actively traded.''[36]

The congressional record does not explain this replacement of the Moynihan provision. Indeed, the Finance Committee's concurrently released summary of the Senate version includes a description that appears more applicable to the original Moynihan provision:

> The bill provides that a disposition of a capital asset which gives rise to taxable income or recognizable loss would qualify as a capital transaction without regard to whether the transaction otherwise qualified as a sale or exchange.[37]

So the change to the provision appears to have been made at the last minute, possibly without full coordination with the Finance Committee and its staff. The Senate version was later adopted in the version passed by the House, except that the House version extended the provision to apply to a right or obligation with respect not only to actively traded personal property (other than stock), but also to ''(A) a futures contract, (B) a forward contract, (C) a commodity (including any metal), (D) a Treasury bill or other evidence of indebtedness, (E) currency, or (F) any interest in any of the foregoing.''[38] The Senate later amended the House version, bringing it in line with the narrower approach of the Senate version, and the conference agreement followed the Senate amendment — a point noted without discussion in the joint explanatory statement of the conference committee.

The JCT's general explanation of the 1981 act described section 1234A without reference to its development from the Moynihan provision. However, the JCT borrowed language from the committee reports on the Moynihan provision, including the language about the reasons for change, stating that section 1234A was added to the code ''to insure that gains and losses from transactions economically equivalent to the sale or exchange of a capital asset obtain similar treatment.''[39]

While the congressional record and contemporaneous commentary on the 1981 act do not explain the shift from the Moynihan provision to the language of section 1234A

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[32]Commodity Straddles Tax Act of 1981, S. 626, 97th Cong. (the Moynihan bill), section 6.

[33]JCT, *supra* note 31, at 44.

[34]We propose that the sale or exchange requirement of current law be eliminated. . . . Our proposal on this point is identical to the provision contained in [the Moynihan bill]. . . . Although this change may appear far reaching, we believe that it reaches the appropriate result without undue consequences. The character of the gain or loss ought to depend on the character of the underlying assets, not the method of disposition. This change might have consequences for the abandonment or assets and for casualty losses. Casualty losses generally produce an ordinary loss under current law and we would not propose changing this characterization. In the case of abandonment losses, however, to the extent that such losses may be recharacterized as ordinary under current law if a sale or exchange is avoided, we believe that the proposed change would achieve the proper tax result. The bulk of abandonments typically involve property used in a trade or business where a sale of such property also produces ordinary loss.

1981 Senate hearings, at 65 (statement of Hon. John E. Chapoton, assistant secretary for tax policy).

[35]H.R.J. Res. 266, section 507 (June 25, 1981).

[36]*Id*. Section 501(a). This definition was ultimately enacted. The Moynihan bill had more broadly defined personal property, without an ''actively traded'' concept: ''The term 'personal property' means — (A) commodities, (B) evidences of indebtedness, and (C) any other type of personal property (other than stock in a corporation).''

[37]Staff of the Senate Comm. on Finance, 97th Cong., Summary of Economic Recovery Tax Act of 1981, Doc. No. CP 97-6, at 21 (Comm. Print 1981).

[38]H.R. 4242, 97th Cong., section 505 (as passed by the House on July 29, 1981). *See also* H.R. Rep. No. 97-201, at 213 (July 24, 1981).

[39]JCT Recovery, *supra* note 30, at 314 (1981). (''Some of the more common of [the] tax-oriented ordinary loss and capital gain transactions [that Congress sought to prevent] involved cancellations of forward contracts for foreign currency or for securities. The Congress considered this ordinary loss treatment inappropriate if the transaction, such as settlement of a contract to deliver a capital asset, was economically equivalent to a sale or exchange of the contract.'')

as enacted, there are several possible explanations. First, it is clear that a primary concern of the drafters of section 1234A was the interaction of the sale/settlement whipsaw with the then-prevalent tax-motivated practice of entering into offsetting positions (straddles) with respect to, for example, currencies. However, it's also clear that despite its implications for the straddle rules, section 1234A was not so limited. Indeed, it's not at all clear why tying section 1234A to the straddle rules would be thought to improve the usefulness of the latter regime.

However, there appears to have been a desire to avoid unintended consequences in enacting the straddle-related rules. Much of the criticism of the straddle legislation during the congressional hearings related to concerns about overbreadth of application and unintended consequences.[40] For example, Moynihan's proposed version of section 1092 contained a broad definition of personal property that included all personal property other than stock.[41] This definition was narrowed to ATPP other than stock, which was also picked up in section 1256. As originally enacted, section 1256 applied only to contracts that required "delivery of personal property (as defined in section 1092(d)(1)) or an interest in such property" and that satisfied other requirements concerning variation margin rules and trading on a qualifying market.[42] In this context, the drafting of section 1234A may simply have been an attempt to narrow the Moynihan provision to conform with the changes to the other straddle-related provisions.

It also could have been feared that the Moynihan provision would have upended the existing law on things like abandonment, which until 2008 generally produced ordinary losses. Before then, courts and the IRS had consistently held that abandonment of a capital asset is not a sale or exchange and therefore produces ordinary loss. Indeed, the desire to preserve this result seems to have been a motivating factor in the drafting of several provisions concerning capital assets.[43] However, in 2008 Treasury promulgated reg. section 1.165-5(i), which provides that abandonment of a security (generally, stock, a stock right, or debt) is subject to the rules relating to worthlessness. Those rules provide that the resulting loss is treated as from a capital asset sold or exchanged on the last day of the tax year of the worthlessness (abandonment),[44] except that securities of some affiliates of corporate taxpayers are not treated as capital assets for that purpose.[45]

Finally, there may have been a concern that the Moynihan provision would have had no effect on liabilities, because it would have applied only to the sale or exchange of assets.

A. 1982 Amendment

In 1982 Congress amended section 1234A to include terminations of regulated futures contracts not otherwise covered by the provision:

> Gain or loss attributable to the cancellation, lapse, expiration, or other termination of —
>
> (1) a right or obligation with respect to personal property (as defined in section 1092(d)(1)) which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or
>
> (2) a regulated futures 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.[46]

At the same time, Congress expanded the definition of a regulated futures contract by striking the requirement that the contract require delivery of personal property (as defined in section 1092(d)(1)) or an interest therein.[47] The committee reports indicate that the purpose of this change was to pick up cash-settled contracts.[48] Those reports make no reference to section 1234A. In describing present law, the conference report stated: "Settlement or other termination of a contract results in capital gain or loss notwithstanding the absence of a sale or exchange only if the contract is with respect to personal property that would be a capital asset in the hands of the taxpayer." It explained that the House revision "adds an amendment providing that capital gain or loss will result

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[40]*See, e.g.*, 1981 Senate hearings, at 67-78 (panel of Robert K. Wilmouth, president, Chicago Board of Trade; Lee H. Berendt, president, Commodity Exchange Inc.; and Clayton Yeutter, president, Chicago Mercantile Exchange). The New York State Bar Association, in commenting on the Moynihan provision, reserved on the question whether the elimination of the sale or exchange requirement should apply universally with respect to capital assets. The NYSBA Committee on Financial Institutions and Financial Futures said it "agrees that taxpayers should not be permitted to claim ordinary losses by disposing of capital assets such as forward contracts or notes [by closing out the contracts by private settlement]. . . . The Committee is expressing no view on whether the 'sale or exchange' requirement should be retained with respect to the disposition of capital assets other than those discussed in this Report." NYSBA, "Report on Pending Legislation Dealing With Commodity Tax Straddles and Related Matters" (May 27, 1981), *in* 1981 Senate hearings, at 180. The House committee report on the 1981 act noted that under section 1234A, "the tax treatment of such transactions as abandonment losses on trademarks, now treated as ordinary losses, is not changed." H.R. Rep. No. 97-201, at 213 (1981).

[41]Moynihan bill, section 2(a).

[42]Section 1256(b) as enacted by the 1981 act.

[43]*See, e.g.*, H.R. Rep. No. 97-201, at 213 (July 24, 1981). *See also* reg. section 86, art. 117-4 (1934) (the sale or exchange criterion had "no application to loss of useful value upon the permanent abandonment of the use of property . . . or loss sustained as a result of corporate stock or debts becoming worthless"). *But see supra* note 34.

[44]Section 165(g)(1).

[45]Section 165(g)(3).

[46]Technical Corrections Act of 1982, 96 Stat. 2387 (1983) (the 1982 act), section 105(e).

[47]The definition was also expanded to include some foreign currency contracts that would not otherwise satisfy its requirements. 1982 act, section 105(c).

[48]H.R. Rep. No. 97-794, at 24 (1982); S. Rep. No. 97-592, at 27 (1982).

from termination of a contract which does not require delivery of personal property even though there is no sale or exchange, if the contract itself is a capital asset in the hands of the taxpayer. . . . The conference agreement follows the House bill amendment.''[49]

Section 1234A(2) could have been intended merely to accommodate the fact that, by virtue of the 1982 act, there could be regulated futures contracts that were not with respect to ATPP and to which section 1234A therefore wouldn't apply. However, this amendment seems to indicate that Congress did not believe in (or was not confident of) the efficacy of the strong form section 1234A bootstrap argument — that is, that all regulated futures contracts are themselves ATPP.

B. 1984 Amendment

In 1984 Congress added a carveout for retirements of debt at the end of section 1234A:

> The preceding sentence shall not apply to the retirement of any debt instrument (whether or not through a trust or participation agreement).[50]

The 1984 act gave this provision retroactive effect ''as if included in . . . the Economic Recovery Act of 1981.''[51] Before the enactment of section 1271 in the 1984 act, retirements of debt had already been treated as sales or exchanges, and sales or exchanges of debt had been subject to special rules.[52] The exclusion of debt retirements from section 1234A may have been simply a technical correction, given the existence of section 1271(a), or more likely it was intended as a clarification that debt that had been grandfathered from the predecessors of section 1271(a) was not subject to section 1234A. However, this amendment seems curiously inconsistent with the addition of section 1234A(2) in 1982, in that it seems to reflect a (perhaps dawning) awareness that section 1234A might be read very broadly, either through the strong form of bootstrap (retirement of a debt instrument is a termination of it) or, perhaps as likely, the weak form (a debt instrument is a position with respect to an interest rate, if nothing else, and that rate has to be considered ATPP if the straddle rules are to work).

C. 1997 Amendment

In 1997 Congress amended section 1234A(1) by replacing the reference to ''personal property (as defined in section 1092(d)(1))'' with a reference to ''property.''[53] While the legislative history discusses this amendment as an unqualified expansion of section 1234A,[54] the effect of the change was complicated by the previous interpretation of personal property under section 1092(d)(1) to include NPCs linked to readily available indices.[55]

The committee reports contain the same key interpretive statements regarding the 1997 amendment. Several of them indicate an intention for section 1234A to apply when a contract is a capital asset, regardless of the underlying property. At the most basic level, both the House and Senate reports make clear that the purpose of the 1997 amendment was to apply the same tax treatment to similar economic transactions and to eliminate the character electivity that can result from different treatments of contract terminations and sales[56]: ''Courts have given different answers as to whether transactions which terminate contractual interests are treated as a 'sale or exchange.' This lack of uniformity has caused uncertainty to both taxpayers and the Internal Revenue Service in the administration of the tax laws.''[57]

It's interesting that in describing then-current law, both committees referenced cases in which there was no property underlying the terminated contract, such as *General Artists*, discussed in Part IV below.[58] Thus, at a policy level, the reports appear to reflect the goal of broadly eliminating the uncertainties of the extinguishment doctrine through legislation. However, elsewhere the reports reflect a focus on the application of section 1234A to contracts in which the underlying property is a capital asset: ''The committee believes that some transactions, such as settlements of contracts to deliver a capital asset, are economically equivalent to a sale or exchange of such contracts since the value of any asset is the present value of the future income that such asset will produce.''[59]

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[49]H.R. Rep. No. 97-986, at 26 (1982) (Conf. Rep.).

[50]Deficit Reduction Act of 1984, 98 Stat. 625 (1984 act), section 102(e)(9). The 1984 act also replaced the reference to ''regulated futures contracts'' in section 1234A(2) with ''Section 1256 contracts,'' conforming to section 1256's expansion under the 1984 act to cover specified options. 1984 act, section 102(e)(4).

[51]1984 act, section 102(f)(4).

[52]*See* Part IX below.

[53]Taxpayer Relief Act of 1997, 111 Stat. 909 (1997 act), section 1003(a)(1).

[54]''The [1997 act] extends to all types of property that is a capital asset in the hands of the taxpayer the rule of present law.'' JCT, ''General Explanation of Tax Legislation Enacted in 1997,'' JCS-23-97, at 188 (1997).

[55]Adopted in 1993, reg. section 1.1092(d)-1(c) provides: ''For purposes of section 1092(d) — (1) [a] notional principal contract (as defined in section 1.446-3(c)(1)) constitutes personal property of a type that is actively traded if contracts based on the same or substantially similar specified indices are purchased, sold, or entered into on an established financial market within the meaning of paragraph (b) of this section; and (2) [t]he rights and obligations of a party to a notional principal contract are rights and obligations with respect to personal property and constitute an interest in personal property.''

[56]H.R. Rep. No. 105-148 (1997 House report), at 453; S. Rep. No. 105-33 (1997 Senate report), at 134. The reports interestingly contrast Congress's broad initiative in 1997 with its more limited goals in the 1981 act: ''Since straddles were the focus of the 1981 legislation, that legislation was limited to types of property which were the subject of straddles, *i.e.*, personal property (other than stock) of a type which is actively traded which is, or would be on acquisition, a capital asset in the hands of the taxpayer. The provision subsequently was extended to section 1256 contracts.'' 1997 House report at 453; 1997 Senate report at 134.

[57]*Id.*

[58]1997 House report at 452; 1997 Senate report at 133.

[59]1997 House report at 453; 1997 Senate report at 134.

D. 2000 and 2002 Amendments

In 2000 Congress amended section 1234A in connection with the enactment of section 1234B, which provided rules for the treatment of gain or loss from securities futures contracts.[60] The 2000 amendment added a new clause (3) to section 1234A, addressing securities futures contracts, and it carved those contracts out of clause (1), so that section 1234A then read:

> 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,
>
> (2) a regulated futures contract (as defined in section 1256) not described in paragraph (1) which is a capital asset in the hands of the taxpayer, or
>
> (3) a securities futures contract (as so defined) 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 participation agreement).[61]

The conference report provides little explanation for or interpretation of this amendment, stating:

> The bill provides that any gain or loss from the sale or exchange of a securities futures contract (other than a dealer securities futures contract) will be considered as gain or loss from the sale or exchange of property which has the same character as the property to which the contact relates has (or would have) in the hands of the taxpayer. Thus, if the underlying security would be a capital asset in the taxpayer's hands, then gain or loss from the sale or exchange of the securities futures contract would be capital gain or loss. The bill also provides that the termination of a securities futures contract which is a capital asset will be treated as a sale or exchange of the contract.[62]

Among other oddities of the 2000 amendment is that section 1234B(b), as enacted, generally mandated that capital gain or loss recognized on the sale or exchange of securities futures to sell property (short positions) be treated as short-term capital gain or loss. While the conference report suggests that this result was intended for terminations of securities futures contracts to which new section 1234A(3) applied,[63] that was not evident from section 1234A as amended.

In 2002 Congress removed clause (3) of section 1234A and amended section 1234B(a)(1) and (b) to provide the same treatment for a termination as for a sale or exchange of a securities futures contract.[64] The JCT's general explanation of the amendment states that it ''*clarifies* that the termination of a securities futures contract is treated in a manner similar to a sale or exchange of a securities futures contract for the purposes of determining the character of any gain or loss from a termination of a securities futures contract'' (emphasis added).[65]

E. 2004 Proposed Regulations

Prop. reg. section 1.1234A-1 provides that some events will be treated as terminations of NPCs, bullet swaps, and forward contracts. The proposed regulation also specifies that a bullet swap is an instrument that isn't an ''excluded contract'' under the NPC regulations that ''provides for the computation of an amount or amounts due from one party to another by reference to a specified index upon a notional principal amount, and that provides for settlement of all the parties' obligations at or close to the maturity of the contract.''[66] The proposed regulation would be effective for contracts entered into on or after 30 days after the publication of final regulations.[67]

This provision is puzzling. It doesn't say that the instrument described will always be considered to be described in section 1234A — that is, that a bullet swap necessarily constitutes ''a right or obligation with respect to property which is (or on acquisition would be) a capital asset.'' It merely says the settlement by terms of a bullet swap as defined will constitute a termination of the bullet swap (thus obviously assuming that ''settlement''

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[60]Community Renewal Tax Relief Act of 2000, 114 Stat. 2763A-648 (2000 amendment). Section 1234B(a)(1), as enacted under the 2000 amendment, partly echoes the language of section 1234: ''Gain or loss attributable to the sale or exchange of a securities futures contract shall be considered gain or loss from the sale or exchange of property which has the same character as the property to which the contract relates has in the hands of the taxpayer (or would have in the hands of the taxpayer if acquired by the taxpayer).'' Section 1234B(a)(2), as originally enacted and currently, provides that the general rule of section 1234B(a)(1) does not apply to ''(A) a contract which constitutes property described in paragraph (1) or (7) of section 1221(a), and (B) any income derived in connection with a contract which, without regard to this subsection, is treated as other than gain from the sale or exchange of a capital asset.'' Section 1234B(b), as originally enacted, generally provided that ''if gain or loss on the sale or exchange of a securities futures contract to sell property is considered gain or loss from the sale or exchange of a capital asset, such gain or loss shall be treated as short-term capital gain or loss.'' Securities futures contracts are defined in section 1234B by reference to section 3(a)(55)(A) of the Securities Exchange Act, which generally describes futures contracts on a single stock or narrow-based security index.

[61]2000 amendment, section 401(b).

[62]H.R. Rep. No. 106-1033, at 1034 (2000).

[63]*Id.*

[64]Job Creation and Worker Assistance Act of 2002, 116 Stat. 53, section 412(d).

[65]JCT, ''General Explanation of Tax Legislation Enacted in the 107th Congress,'' JCS-1-03, *supra* note 30, at 255.

[66]Prop. reg. section 1.1234A-1(c)(2). An excluded contract is generally a section 1256 contract, a futures contract, a forward contract, an option, or debt.

[67]*Id.* Reg. section 1.1234A-1(d).

is subsumed in the phrase ''cancellation, lapse, expiration or other termination''). However, the preamble seems to make that assumption:

> The proposed regulations under section 1234A . . . apply to any gain or loss arising from the settlement of obligations under a bullet swap or forward contract. A payment in settlement of obligations under a bullet swap or forward contract, including a payment pursuant to the terms of the bullet swap or forward contract, is treated as gain or loss from a termination of the bullet swap or forward contract.[68]

The implication is clear: A bullet swap would produce capital gain on settlement, whether or not it references property that is, or on acquisition would be, a capital asset. And all that's required to be a bullet swap (apart from not being debt or a forward contract) is (1) a specified index, applied to (2) a notional principal amount, and (3) all payments due at or near maturity. What for this purpose should we assume is meant by a ''specified index''? The term is used elsewhere, notably in reg. sections 1.446-3 and 1.863-7. However, it's actually defined only in the reg. section 1.446-3 regime. Reg. section 1.446-3(c)(2) defines a specified index to include a fixed rate, price, or amount (although different ones may apply in different periods); any current, objectively determinable financial or economic information not within the control of the parties and not unique to one of their circumstances (explicitly giving as examples a broad-based equity index or the outstanding balance on a mortgage pool); and any interest rate index regularly used in normal lending transactions between a party to the contract and unrelated parties. Should we assume the term is to be used in prop. reg. section 1.1234A-1 as it is in reg. section 1.446-3? I'm not sure that would be a bad thing.

Another oddity of the proposed regulation is its treatment of NPCs, which are essentially bullet swaps in which at least one party makes periodic payments to the other. The proposed regulation was part of a package of regulations that also prescribed the taxation of NPCs with contingent nonperiodic payments, such as ''back-end value payment'' equity swaps,[69] which Treasury believed were being treated inappropriately by many taxpayers. As part of the effort to eliminate aggressive tax positions with respect to those instruments, the proposed regulation includes a provision to the effect that all payments under contingent NPCs would be treated as ordinary income or loss,[70] other than ''termination payments,''[71] which are defined in reg. section 1.446-3(h) to include only payments that extinguish or assign all or a portion of a party's remaining rights or obligations under an NPC (whether the payments are between the original parties or by one party to a third party). Indeed, the proposed regulation goes further, specifying that no payment made by the terms of an NPC terminates or cancels a right or obligation. I believe this is patently false, but at the least flatly inconsistent with the position that the payment at maturity of a bullet swap is subject to section 1234A (that is, that it terminates the bullet swap). How and why did we get to a point at which the drafters of a short regulation could not only condone but require such wildly disparate treatments of two almost identical instruments — an NPC and a bullet swap with respect to the same specified index?

F. Summary

This has been a brief overview of what was being considered as section 1234A evolved, including concerns relating to the sale or exchange requirement of section 1222, the extinguishment doctrine, the capital loss limitations, the straddle rules, and some sense of disillusionment (in 1997) and uncertainty (in 1982, 1984, 2000, and 2002) as to how the rule does and should work. There follow more detailed discussions of several aspects of the history that fed into section 1234A as it was enacted and amended.

V. The Extinguishment Doctrine

The extinguishment doctrine holds that gain or loss from the cancellation or termination of contractual or similar rights is ordinary income or loss. Section 1222 provides that capital gain or loss results only from the sale or exchange of a capital asset. Under the doctrine, the requisite sale or exchange does not exist if a property or contractual right is ''extinguished,'' because one may not convey an interest that has ceased to exist. As mentioned in Part IV, Congress in enacting section 1234A was aware that this creates a character arbitrage opportunity for taxpayers:

> If a taxpayer can choose the manner of disposing of a capital asset, he may sell or exchange it, if it has appreciated in value, to realize capital gains. However, a transaction in which a taxpayer has suffered an economic loss may be determined in a manner which produces a fully deductible ordinary loss, even though the loss economically is the equivalent of a loss from the disposition of a capital asset.[72]

Thus, section 1234A, like several other code sections, clearly was intended to minimize the effects of the extinguishment doctrine.

A form of the extinguishment doctrine first emerged in *Fairbanks v. United States*,[73] in which the Supreme Court confirmed that gain derived from the redemption of a note before maturity represents ordinary income because ''payment and discharge of a bond is neither sale nor exchange within the commonly accepted meaning of the words.''[74] Premised largely on the Court's logic in *Fairbanks*, the extinguishment doctrine developed in the

[68]69 *Fed. Reg.* 8,886, 8,892 (2004).
[69]Prop. reg. section 1.446-3(g).
[70]Prop. reg. section 1.1234A-1(b).
[71]*Id.* Reg. section 1.1234A-1(a).

[72]H.R. Rep. No. 97-201, at 212 (1981).
[73]306 U.S. 436 (1939).
[74]*Id.* at 438. *See also Hale v. Helvering*, 85 F.2d 819, 819 (D.C. Cir. 1936) (compromise settlement of mortgage notes that maker was able but unwilling to pay did not constitute a ''sale or exchange of capital assets entitling the taxpayer to a capital loss''); *Felin v. Kyle*, 102 F.2d 349, 350 (3d Cir. 1939) (''When it is

(Footnote continued on next page.)

1950s through a series of courts of appeal cases that characterized as ordinary income payments received in consideration of contract terminations.

First, in *Commissioner v. Starr Brothers, Inc.*,[75] the Second Circuit held that consideration received by a taxpayer for agreeing to terminate a negative covenant entitling it to be a drug manufacturer's sole distributor was ordinary in character. Analogizing the facts of the case to a bond redemption, the court found that no sale or exchange existed if a pre-existing right was not transferred but ''merely came to an end and vanished.''[76]

Next, the Second Circuit extended this reasoning to a three-party contractual arrangement in *General Artists Corp. v. Commissioner*.[77] In that case, the taxpayer was contractually entitled to exclusive representation of a singer and purportedly sold the entitlement to a third party, treating the consideration as capital gain. The court rejected this treatment on the grounds that the transaction was in substance a cancellation (and a corresponding novation of a contract between the third party and the singer) and not a sale of taxpayer's right to exclusive representation.[78] Therefore, the amount received in exchange for the relinquished exclusivity was ordinary.

Third, in *Commissioner v. Pittston Co.*,[79] the Second Circuit applied the extinguishment doctrine to the termination of a long-term output contract despite circuit precedent indicating that some more-enduring property rights are by nature inextinguishable. The first such precedent was *McAllister v. Commissioner*,[80] in which the court had held that payment received by a taxpayer for the ''surrender'' of her life estate in a trust to a remainderman was capital in nature because ''she held a fee interest, the assignment [of which] would unquestionably have been regarded as the transfer of a capital asset.''[81] Similarly, in *Commissioner v. McCue Bros. & Drummond, Inc.*[82] the court had treated as capital gain a payment received by a lessee from its landlord in exchange for vacating a premises to which, under rent control laws, it had a legal right to possession. The court noted that ''the right of possession under a lease or otherwise, is a more substantial property right which does not lose its existence when it is transferred.''[83] In *Pittston*, the taxpayer received payment from a coal company in exchange for the cancellation of the taxpayer's exclusive right to purchase the output from a mine. The Tax Court held the payment to be capital, noting that the cancellation was effectively a ''transfer to the one formerly bound a right to deal with all the world.''[84] The Second Circuit disagreed, reasoning that the taxpayer's relinquished right to exclusivity was not a ''direct interest in the mine itself'' and therefore more closely resembled the extinguished negative covenant in *Starr* than the more durable or ''substantial'' property rights at issue in *McAllister* and *McCue*.[85]

The Ninth Circuit's view of requirements contracts in *Leh v. Commissioner*[86] conformed to that of the *Pittston* court. In *Leh*, the taxpayer had a right to purchase petroleum products from a corporation, which in turn had a corresponding right to purchase those products from a supplier. When the price of gasoline rose, the taxpayer's rights under its contract with the corporation increased in value, and the corporation paid the taxpayer to terminate the agreement. The taxpayer sought to treat this income as capital gain under the theory that in substance it represented a sale to the corporation of *the corporation's* right to purchase petroleum products from *its* supplier — an interpretation the Ninth Circuit rejected, noting that the corporation's contract with the supplier was distinct from and unaltered by the transaction with the taxpayer. In holding the termination payment to be ordinary income, the court reasoned that the transaction was not a sale or exchange, but that its effect was ''to terminate rights, not continue them, nor transfer them — nor sell them — nor exchange them.''[87] Acknowledging that the extinguishment doctrine enabled inconsistent character treatment of economically identical transactions, the court remarked that ''recognizing economic realities does not permit us to rewrite the law, nor to avoid the plain meaning of contractual obligations clearly expressed.''[88]

The *Starr*, *General Artists*, *Pittston*, and *Leh* line of cases represents a high-water mark of the extinguishment doctrine, which was later restrained by the Second Circuit's decision in *Commissioner v. Ferrer*.[89] In that case, the taxpayer held stage rights to a novel, including the right

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applied to a transaction in which a corporation redeems certain outstanding bonds or notes, for the purpose of cancelling them, the word 'redemption' carries with it the idea of 'paying back' or 'satisfying one's indebtedness,' rather than any thought of 'buying' or 'purchasing'''); *Bingham v. Commissioner*, 105 F.2d 971, 972 (2d Cir. 1939) (no sale or exchange occurred when a note ''simply vanished'' on surrender to its maker).

[75]204 F.2d 673 (2d Cir. 1953).

[76]*Id.* at 674.

[77]205 F.2d 360 (2d Cir. 1953).

[78]*Cf. Commissioner v. Ferrer*, 304 F.2d 125 (2d Cir. 1962) (using substance over form to characterize a two-party cancellation as a sale to a third party, resulting in capital gain); *Bisbee-Baldwin Corp. v. Tomlinson*, 320 F.2d 929 (5th Cir. 1963) (same).

[79]252 F.2d 344 (2d Cir. 1958).

[80]157 F.2d 235 (2d Cir. 1946).

[81]*Id.* at 236. *See also Bell's Estate v. Commissioner*, 137 F.2d 454 (8th Cir. 1943) (treating as capital consideration received for the relinquishment of a life tenant's interest in a trust to the remainderman); *Allen v. First Nat'l Bank & Trust Co.*, 157 F.2d 592 (5th Cir. 1946) (same).

[82]210 F.2d 752 (2d Cir. 1954).

[83]*Id.* at 753. The *McCue* court relied on *Commissioner v. Golonsky*, 200 F.2d 72 (3d Cir. 1952) (characterizing as capital gain income paid from landlord to lessee in exchange for lease cancellation and lessee's vacating the premise). *See also Commissioner v. Ray*, 210 F.2d 390 (5th Cir. 1954); *Metropolitan Bldg. Co. v. Commissioner*, 282 F.2d 592 (9th Cir. 1960). *But see* Rev. Rul. 56-531, 1956-2 C.B. 983 (confirming the holdings in *McCue* and *Golonsky*, but noting that the ''Service will continue to regard the relinquishment of simple contract rights as not involving the sale or exchange of a capital asset'').

[84]*Pittston*, 252 F.2d at 347.

[85]*Id.* at 348.

[86]260 F.2d 489 (9th Cir. 1958).

[87]*Id.* at 494.

[88]*Id.*

[89]304 F.2d 125 (2d Cir. 1962).

to prevent film adaptation. He relinquished these rights in exchange for a series of payments from a director who wished to turn the novel into a film, and he contracted to receive a percentage of the film's profits. Echoing the *Leh* court's unease with according disparate character treatment to economically identical transactions, the *Ferrer* court appealed to substance over form in insisting there was ''no sensible business basis'' for distinguishing between an ''annulment'' and a ''conveyance'' of the production rights.[90] The court distinguished *Starr*, *General Artists*, *Pittston*, and *Leh* on the ground that those cases each concerned an asset that was nothing more than ''an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another'' and therefore didn't rise to the level of an interest in property that, if itself held, would be a capital asset.[91] This focus on the nature of the assets at issue led the court to conclude that gain from the taxpayer's surrender of stage and film rights was capital, while payments related to the percentage of film profits he contracted to receive would be ordinary when received. The *Ferrer* court cited a perceived increase in ''Congressional disenchantment'' with the extinguishment doctrine's formalistic distinctions in justifying its holding.[92]

The Second Circuit's decision in *Ferrer* would seem to have signaled a retreat from the robust version of the extinguishment doctrine promoted in *Starr*, *General Artists*, *Pittston*, and *Leh*.[93] However, less than a decade after *Ferrer* was decided, the Second Circuit revived the doctrine in *Billy Rose's Diamond Horseshoe, Inc. v. United States*,[94] holding that payments received from a lessee for release from an obligation to restore leased premises did not constitute a sale or other disposition of personal property, which would have permitted the taxpayer to use the installment method of section 453. While its analysis seemed to be confined to the context of section 453,[95] the court stated in dictum that *Ferrer* did not overrule *Starr* and *General Artists*, and it acknowledged that the Second Circuit ''has long held that cancellation or release of a contract right does not transfer the rights to the transferee-payor and thus is not a 'sale.'''

The IRS also resurrected the extinguishment doctrine four years later in Rev. Rul. 75-527,[96] relying on *Pittston* and *Leh* to assert that ''the cancellation or release of a contract right does not transfer the right to the transferee-payor and is therefore not a sale.'' Despite the Service's position, on the eve of the enactment of section 1234A, the strength of the extinguishment doctrine was uncertain, having been undermined in *Ferrer* and not strongly reaffirmed by courts in subsequent decisions.

The motivation behind, and effects of, section 1234A are illustrated by two cases concerning a common set of facts that arose before the provision's enactment. The cases were decided well after the enactment, retrospectively interpreting pre-1981 law in light of section 1234A's impact.

The first was *Stoller v. Commissioner*.[97] Stoller's investment partnership engaged in a series of bull and bear straddles of Treasury bonds. The partnership's investment strategy took advantage of the extinguishment doctrine's divergent treatment of offsets versus cancellations. The partners (including Stoller) reported as capital the gains and losses from contracts the partnership closed by entering offsetting positions, and they reported as ordinary those gains and losses resulting from cancellations. The Tax Court found that some of the allegedly cancelled contracts should have resulted in capital rather than ordinary losses because they were followed by the purchase of replacement contracts and so were economically equivalent to offsets. On appeal, the IRS relied on *Ferrer* to challenge the taxpayer's treatment, while the taxpayer relied on *Leh* in its defense. The D.C. Circuit reversed the Tax Court, explaining:

> The problem with the Tax Court's reasoning is that cancellation and offset are different in substance as well as in form. When a contract is cancelled it simply ceases to exist. When a contract is offset, both the original contract and the offsetting contract remain in effect until the date for delivery. . . . The subsequent purchase of a replacement contract cannot . . . transform a cancellation into an offset. Therefore, the Stollers properly treated the losses incurred in cancelling the contracts as ordinary losses.[98]

The *Stoller* court found the legislative history of section 1234A instructive, regarding it as a ''careful and contemporaneous account'' of pre-1981 law.[99] The court

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[90] *Id.* at 131. *Cf. General Artists Corp.*, 205 F.2d 360; *Paul Small Artists, Ltd. v. Commissioner,* 37 T.C. 223 (1961) (finding no sale or exchange when a taxpayer assigned its contracts with a movie actor to another company in exchange for payment).

[91] *Ferrer*, 304 F.2d at 130-131.

[92] *Id.* at 131. The court based this perception on the 1954 enactment of section 1241, which effectively codified the holdings in *McCue* and *Golonsky*, treating amounts received by a lessee or distributee from a lessor or distributor of goods for cancellation of a lease or distributor's agreement as in exchange for the lease or distribution agreement. But the *Ferrer* court did not address the alternative inference that the enactment of section 1241 indicates a willingness to dictate when a cancellation should be deemed an exchange. The court intentionally confined its designation to the lessor-lessee and distributor-distributee contexts. *See, e.g., Billy Rose's Diamond Horseshoe, Inc. v. United States,* 448 F.2d 549, 552 n.1 (2d Cir. 1971). (''The comment of Judge Friendly in *Ferrer* . . . that section 1241 indicates a Congressional disenchantment with the *Starr* line of cases must be confined to the sale-of-leaseholds and distribution-rights areas.'')

[93] *See, e.g., Bisbee-Baldwin Corp. v. Tomlinson*, 320 F.2d 929 (relying on *Ferrer* to characterize as capital some portions of payments received by the taxpayer in exchange for terminating a mortgage servicing contract).

[94] 448 F.2d 549.

[95] *See, e.g., Sibro Holdings, Inc. v. Commissioner,* 509 F.2d 1220 (2d Cir. 1975).

[96] 1975 C.B. 30.

[97] 994 F.2d 855 (D.C. Cir. 1993).

[98] *Id.* at 857-858.

[99] *Id.* at 858.

relied in particular on the following ''Reasons for Change'' in the Senate's explanation of the code provision[100]:

> 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, was economically equivalent to a sale or exchange of the contract.[101]

The court concluded that, while not authoritative, this legislative history suggests that ''prior to the 1981 amendment the prevailing rule was that the cancellation of a contract resulted in an ordinary loss for tax purposes.''[102]

Defying the D.C. Circuit's holding in *Stoller*, the Tax Court held in *Estate of Leon Israel*[103] that canceled legs of commodity forward contracts entered into by Stoller's investment partners gave rise to capital, not ordinary losses. Following a thorough explanation of the economics of the partnership's investment strategy, the Tax Court explained that ''the benefit of further analysis'' permitted it to conclude that the D.C. Circuit had ''erred in not recognizing the fundamental sale or exchange nature of these transactions.''[104]

The Second Circuit, in *Wolff v. Commissioner*,[105] reversed *Estate of Israel*, rejecting the Tax Court's repudiation of *Stoller*:

> We disagree with the Tax Court's conclusion. As the D.C. Circuit held in *Stoller*, there is at least one important difference in form and substance between closing a contract by offset and closing a contract by cancellation. When a contract is closed by offset, both contracts (the original and the mirror-image offsetting contract) continue to be ''open.'' . . . By contrast, when a contract is closed by cancellation, it simply ceases to exist and an immediate ''cancellation fee'' is paid at the date of cancellation. All rights and obligations under the contract are released and extinguished on that date.[106]

Like the *Stoller* court, the *Wolff* court viewed the legislative history of section 1234A as supportive of the taxpayer's position, noting, ''Whether the 97th Congress intended to affect a change in the law or merely clarify it by enacting section 1234A, [Congress] at least recognized that authority had developed which supports the taxpayers' position in this case.''[107] In remanding the case to be decided in accordance with *Stoller*, the Second Circuit confirmed what it had suggested in *Billy Rose's Diamond Horseshoe*: that the extinguishment doctrine the circuit had promoted decades earlier through *Starr*, *General Artists*, and *Pittston* had survived *Ferrer*[108] and was still applicable at least up until the enactment of section 1234A.

A. Summary

The extinguishment doctrine arose out of section 1222, originally enacted in 1921, which provides that gain or loss from the sale or exchange of capital assets produces capital gain or loss. Thus, the courts took as a given that income or loss from the abandonment, annulment, cancellation, elimination, expiration, lapse, retirement, settlement, or termination (collectively, extinguishment) of a capital asset does not, absent an explicit rule, produce capital gain or loss. As the above summary of some of the seminal cases shows, it caused many smart people to spend substantial amounts of time and resources attempting to distinguish between the termination of a contract (including through a three-party arrangement often referred to as a novation) and the mere sale of an asset to a third party, which, while a realization event to the seller, typically has no effect on the counterparty/obligor thereof.

And yet in 1988 Treasury and the IRS concluded, without fanfare and with no discernible effect on the integrity of the code or the space-time continuum, that the settlement by terms of a cash-settled option to sell stock of a corporation to that corporation is in fact nothing more than the sale of the option back to its issuer, even though the consequence of that sale is that the option ceases to exist.[109] (The instrument described was actually a ''put spread,'' which is simply a put option the payout on which is limited to a specified dollar amount.)

Then there's section 1001, which stands for the proposition that if a capital asset is modified sufficiently by the parties, it's deemed a disposition of the ''old'' asset in exchange for a ''new'' one, even when the old one disappears. This doesn't seem to have bothered anyone, as far as I can tell.[110] And that result would seem to apply

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[100]*Id.*

[101]*Id.* (quoting S. Rep. No. 97-144 (1981)).

[102]*Stoller*, 994 F.2d at 858.

[103]108 T.C. 208 (1997), *Doc 97-9274, 97 TNT 63-8*.

[104]*Id.* at 221-222.

[105]148 F.3d 186 (2d Cir. 1998).

[106]*Id.* at 189 (citing *Commissioner v. Covington*, 120 F.2d 768 (5th Cir. 1941)).

[107]*Wolff*, 148 F.3d at 190.

[108]Citing the *Stoller* opinion, the *Wolff* court distinguished *Ferrer* on the grounds that in *Wolff*, ''the underlying contracts were cancelled in substance as well as in form [and] did not merely change hands [but] ceased to exist altogether.'' *Wolff*, 148 F.3d at 189 (citing *Stoller*, 994 F.2d at 857).

In 2000 the IRS said in TAM 200049009 (Aug. 9, 2000), *Doc 2000-31669*, *2000 TNT 238-17*, that while a minority of courts ''regard *Ferrer* as having eliminated the extinguishment doctrine altogether — leaving the nature of the asset as the only relevant inquiry,'' that is neither the majority view nor the position of the IRS. The IRS did note, however, that *Ferrer* had in any event (1) ''shifted the primary thrust of the analysis away from the nature of the transaction and towards the nature of the asset,'' and (2) promoted a substance-over-form approach ''in which rights are more likely to be viewed as having, in substance, survived a transaction, even though the transaction took the form of a cancellation or termination.''

[109]Rev. Rul. 88-31, 1988-1 C.B. 302.

[110]*See* James M. Peaslee, ''Modifications of Nondebt Financial Instruments as Deemed Exchanges,'' *Tax Notes*, Apr. 29, 2002, p.

(Footnote continued on next page.)

even if the amendment is done through a separate arrangement.[111] So if by a separate arrangement between two parties (such as the forward seller and forward buyer under a forward contract) the preexisting rights and obligations of the parties cease to exist (for example, an offset), section 1001 would evidently treat that as an exchange of the old asset for the new asset. Unless cash or other consideration is paid, that asset would necessarily be a commitment of one party to pay what's then currently due at the maturity date of the offsetting contracts — that is, a debt instrument. In other words, this arrangement would be deemed a sale or exchange (perhaps an installment sale or exchange). And everything would be fine. The one situation that section 1001 does not address is abandonment, which is now deemed a sale or exchange in any event, at least in the case of securities.[112]

Would it be possible to avoid the whipsaw at which section 1234A was directed without enacting that section? I think so. Were and are there other reasons for section 1234A to exist? One obvious possibility is that a liberal reading of section 1001 and the logic of Rev. Rul. 88-31 lead to the result that the extinguishment (including abandonment, unless section 165(g)(3) applies) of *any* capital asset would produce capital gain or loss — at least for the holder.[113] This would presumably include life insurance contracts, NPCs, and a variety of other instruments.[114] Section 1234A, as we've seen, has a narrower scope than that. Do we want the broader Rev. Rul. 88-31/section 1001 result?[115]

Another obvious concern is that without a rule like section 1234A, nothing would cause the settlement by terms of a liability to produce capital gain or loss. The logic of section 1001 and Rev. Rul. 88-31 applies only to assets. However, we already have several equivalent rules for liabilities. First, section 1233(a) provides that gain or loss from the short sale of property (stocks, securities, and commodity futures to which the straddle rules don't apply) is considered from the sale or exchange of a capital asset when the property used to close the short sale is a capital asset in the short seller's hands. The courts have consistently held that the term ''short sales'' for this purpose includes short forward contracts, that is,

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737, *Doc 2002-10327*, or *2002 TNT 83-25*, citing GCM 35,918 (July 26, 1974), which found that the treatment of a modification of an option as a deemed exchange does not violate the extinguishment doctrine, although the GCM noted that its result was consistent with section 1234, discussed in Part IX below, which generally treats option extinguishments as producing capital gains and losses. The analysis of the GCM is curious in that it finds an exchange from the option holder's perspective and then says this exchange might be inconsistent with the extinguishment doctrine. The gist of the extinguishment doctrine, as I understand it, is that section 1222 requires a ''sale or exchange,'' whereas (1) there can be no sale of something that thereby ceases to exist, and (2) there can be no exchange of something when the purported exchanger doesn't get anything other than cash. (In effect, my argument in the text is that an exchange for cash is still an exchange, even if not a sale.) A taxable modification seems to avoid these problems. The premise of the GCM's extinguishment concern seems to be that an exchange might be good under section 1222 only if the exchanged asset (as well as the one for which it is exchanged) continues to exist.

[111]*See, e.g.*, reg. section 1.1001-3(a)(1) (admittedly applying only by its terms to indebtedness).

[112]Reg. section 1.165-5(i), discussed in Part IV above.

[113]There are many circumstances in which the treatment of the parties to a capital asset is not symmetrical. When the asset is stock, one party (the issuer) is generally exempt from any taxation under section 1032, while the other generally recognizes capital gain or loss on taxable dispositions. When the asset is debt, the issuer generally never recognizes capital gain or loss, and the rules for what it does recognize and when (cancellation of debt, repurchase premium, section 249) are almost divorced from the rules applicable to holders (generally, capital gain or loss, subject to the market discount rules or other special rules like the contingent payment debt rules). When the issuer is a dealer in the issued instrument, it may be subject to all-ordinary mark-to-market treatment under section 475, or to special rules under section 1256.

[114]A bilaterally executory financial instrument, even if in the nature of an obligation (*e.g.*, a contract to sell property), still is generally considered an asset as long as it also could have value in the hands of its holder. *See Stavisky v. Commissioner*, 34 T.C. 140 (1960), *aff'd*, 291 F.2d 48 (2d Cir. 1961) (assignment of futures contract at a loss is not an ''ordinary'' release of an obligation but sale of a capital asset, because if the value of the futures contract had risen, the resulting sale of the contract would have produced capital gain, and whether the contract produces ordinary income or capital gain should not depend on day-to-day market movements). *See also* FSA 1999-733 (Aug. 6, 1993), *Doc 1999-2851*, *1999 TNT 35-22* (following the reasoning of *Stavisky*, concluding that an interest rate swap is property because it ''fluctuates in value due to market forces'' and ''can flip from an obligation to make a payment to a right to receive a payment, and back again''); FSA 1998-237 (Mar. 22, 1993), *Doc 98-24924, 98 TNT 182-58* (same). *Cf.* Rev. Rul. 78-414 (commodity futures contracts are capital assets); TAM 8601007 (treating a futures contract as composed of both a property right and an offsetting obligation for purposes of computing a decedent's gross and taxable estates, and for purposes of the step-up in basis under section 1014). The IRS also acknowledged, in a since-revoked private ruling (LTR 9228024 (Apr. 13, 1992)), that nonprepaid forward contracts (including contracts to sell property) are capital assets. *See* LTR 8714023 (Dec. 31, 1986) (citing the cases listed in note 116 *infra*).

[115]For some things, the answer might well be no. For example, the IRS has in several private rulings concluded that transfers of supply or requirements contracts by power companies produce capital gain. *See, e.g.*, LTR 200215037 (Jan. 14, 2002), *Doc 2002-8807*, *2002 TNT 72-44*; TAM 200049009. The idea that the termination of business-related contracts can produce capital losses is disturbing. At least one commentator has said that ''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,'' focusing specifically on terminations of ''regular business service and inventory contracts.'' Linda E. Carlisle in ''Examining the Straddle Rules After 25 Years,'' *supra* note 22. The inventory rules are beyond the scope of this report, and the business hedging rules are alluded to only briefly in Part VII, but my reaction is that this is a case in which section 1234A is not the problem — if we want business-related contracts to produce ordinary income or loss, that should be addressed in section 1221 and its regulations.

contracts under which the taxpayer agrees to sell property.[116] Second, section 1234(b) treats the grantor of an option on property (stocks, securities, commodities, and commodity futures) as having sold or exchanged a capital asset held for a year or less. Third, section 1234B provides that short securities futures contracts with respect to capital assets produce (short-term) capital gain. Section 1234(b) and 1234B are not limited to cases in which the taxpayer/obligor holds or delivers the underlying property.

So perhaps it could be argued that section 1234A does serve the purpose of ensuring that capital gain or loss is generated on the extinguishment of written options with respect to capital assets other than section 1234(b) securities and the extinguishment of short sales of capital assets (other than short securities futures contracts addressed by section 1234B) that (1) are not themselves capital assets to which the section 1001/Rev. Rul. 88-31 logic could be applied (which written nonprepaid forward contracts would be[117]) and (2) to which section 1233(a) does not apply because the seller never owns the underlying property. However, if one wished, it would be easier simply to fix section 1233(a) to eliminate the requirement that the taxpayer deliver the underlying property in order to have capital gain or loss treatment, and to fix section 1234 to provide that gain or loss from a nondealer's writing of options on property has the same character as the underlying property.

In any event, none of this answers whether the right way to solve the whipsaw to which section 1234A was ostensibly addressed is to cause extinguishment to produce capital gain or loss.

VI. Assignment of Income

The AOI doctrine developed in the early days of the federal income tax. In the context of a graduated income tax, the ability to shift income to another family member could lower the aggregate tax paid on that income by the family unit.[118] While the early cases do not specifically discuss the potential reduction in the sum total of tax paid on assigned income, or the motivations of the taxpayers involved, the potential harm to the fisc remains. The doctrine that emerges significantly limits the ability to choose which taxpayer (often among related taxpayers) recognizes an item of income. This section will explore the AOI doctrine, both in its original form as it related to gratuitous transfers and as it evolved and expanded to address the character of gain arising from transfers of rights for consideration.

A. Gratuitous Transfers

In *Lucas v. Earl*,[119] the Supreme Court considered a contract between a husband and wife to hold all property received by them as joint tenants. The taxpayer argued that as a result of the contract, half of his salary was beneficially received by his wife and should not be taxable to him. Using his now-famous metaphor, Justice Holmes, writing for the Court, rejected all "arrangement[s] by which the fruits are attributed to a different tree from that on which they grew."[120] Instead, salary was to be recognized by the person who earned it, irrespective of the motivation underlying the income transfer.[121]

The idea that one could not escape taxation by transferring income was expanded beyond salary to cover transfers of income produced by property over which the taxpayer retained ownership. *Helvering v. Horst*[122] involved a father who separated interest coupons from bonds that he owned and gave the coupons to his son. The Court provided two lines of thought in concluding that the interest income should be taxable to the father. First, it reasoned that the gratuitous disposition of the interest was a type of economic consumption by the father:

> Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself he has nevertheless, by his act, procured payment of the interest, as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son. Even though he never receives the money he derives money's worth from the disposition of the coupons which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named.[123]

Second, the Court adverted to the idea that income tax should be imposed on the person who produces the

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[116]*See, e.g.*, *Hoover Co. v. Commissioner*, 72 T.C. 206 (1979), *acq.*, 1984-2 C.B. 1; *American Home Prods. Corp. v. United States*, 601 F.2d 540 (Ct. Cl. 1979); *The Carborundum Co. v. Commissioner*, 74 T.C. 730 (1980), *acq.*, 1984-2 C.B. 1.

[117]As discussed in *supra* note 114, "executory" contracts such as nonprepaid forwards, futures, and swaps are generally capital assets.

[118]For a discussion of the importance of graduated tax rates to the development of the AOI doctrine, see Ronald H. Jensen, "*Schneer v. Comm'r*: Continuing Confusion Over the Assignment of Income Doctrine and Personal Service Income," 1 *Fla. Tax Rev.* 623 (1993).

[119]281 U.S. 111 (1930).

[120]*Id.* at 115.

[121]Earl and his wife entered into the contract in 1901, well before the enactment of the modern-day income tax (the 16th Amendment, authorizing a direct federal income tax, was ratified in 1913), leading some commentators to conclude that tax avoidance was not the motivation for the arrangement. *See* Charles S. Lyon and James S. Eustice, "Assignment of Income: Fruit and Tree as Irrigated by the *P.G. Lake* Case," 17 *Tax. L. Rev.* 293, 297 (1962).

[122]311 U.S. 112 (1940).

[123]*Id.* at 117.

income. Invoking the fruit tree metaphor, the Court ruled that the owner of the bond recognizes the interest income produced by it.[124]

In *Blair v. Commissioner*,[125] the Court took up the problem of an underlying tree that was nothing more than the right to receive income, and it drew limits on the AOI doctrine. The taxpayer in *Blair* had a life estate in the income of a testamentary trust created by his father's will. The taxpayer assigned interests in the trust to his children, providing each with the right to receive a fixed amount of money annually for the rest of the taxpayer's life. The IRS argued that under the *Earl* principle, the taxpayer should bear the tax burden of the income assigned to his children. The Court disagreed, reasoning that income received from the trust was taxable to the owner of the related beneficial interest in the trust. It viewed the assignment of interests in the trust as making the assignees ''owners of the specified beneficial interests of income.''[126] The Court thus concluded that the taxpayer's children, and not the taxpayer, were to be taxed on the income they received from the trust as a result of the assignments.

Harrison v. Schaffner[127] involved a taxpayer who attempted to extend the *Blair* holding too far. In *Schaffner*, the holder of a life estate in a testamentary trust made assignments of specified dollar amounts from the trust to be paid during a particular year. The taxpayer argued that, as in *Blair*, the assignment gave each assignee an interest in the property of the trust, which would be treated by courts as an equitable estate in the trust and that as a result, income deriving from that property should be taxable to each assignee. The Court acknowledged ''the logical difficulties of drawing the line between a gift of an equitable interest in property for life effected by a gift for life of a share of the income of the trust and the gift of the income or a part of it for the period of a year.''[128] Implicitly rejecting the idea that the characterization of this interest as an estate under the law governing trusts should settle the question, the Court concluded that the taxpayer had merely transferred a specified amount of income from property that he in substance retained, with the consequence that he should recognize that transferred income.

The Court's acknowledgment in *Schaffner* of the difficulty involved in drawing a line between a transfer of property and a transfer of income would prove prescient. As discussed below, as the AOI doctrine developed, the courts often struggled with the effort to draw this distinction,[129] as well as the related distinction between capital and noncapital assets.

Taken together, these cases suggest the following rationales for the conclusion that a gratuitous transferor should recognize a transferred item of income. First, the person who earns an item of income should be taxed on it. This includes the idea that the owner of property is the person who earns the income produced by that property. Second, the disposition of income by gratuitous transfer is merely another way of benefiting from that income, and the transferor should be taxed accordingly.

B. Transfers for Consideration — the SOI Doctrine

While the AOI doctrine began in the context of gratuitous transfers, the courts also looked to it when addressing sales of items of income. Those cases were complicated by the need to account for the income tax treatment of not only the transferred item of income, but also the amount received by the taxpayer in exchange for the transferred item. The transferor could not be treated as recognizing the full amount of both the payment and the transferred income items; seemingly as a consequence, the doctrine adapted to fit this different economic reality.

In a 1941 case, *Hort v. Commissioner*,[130] the Supreme Court extended the scope of the AOI doctrine to a case that was not about a gratuitous transfer of income. Indeed, it also wasn't an SOI case, although the Court so described it. The result could have been defended on the grounds of the extinguishment doctrine, but that doesn't appear anywhere in the Supreme Court's analysis.[131] In *Hort*, the taxpayer, a landlord, received a lump sum payment from his tenant to release the tenant from a long-term lease. The taxpayer claimed a capital loss of $21,494.75, the amount by which he claimed the $140,000 payment received in termination of the lease fell short of the excess of (1) the present value of the future payments due under the lease, over (2) the fair rental value of the property for the remaining term of the lease (which excess effectively represented the value of the lease to the taxpayer). The Court rejected that argument, noting that even if the lease was ''property,'' that did not lead to the conclusion that it was a capital asset. Instead the Court ruled that the taxpayer should recognize the full $140,000 payment as ordinary income, viewing the amount as a substitute for future rental payments that when received, would have been characterized as ordinary.

Assuming this was not merely an ''extinguishment'' conclusion, it would be a remarkable result, which perhaps explains much of the ensuing confusion. Why is the right to receive future ordinary income (in exchange for future services) an ordinary asset? Is it because the income was ''inevitable''? What if the lessee had died

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[124]The first of *Horst's* two lines of reasoning has been widely criticized as ''proving too much,'' in that it would lead to the conclusion that a gratuitous assignment of income is a taxable event for the assignor, a result that is widely considered inappropriate. *See* Brant J. Hellwig, ''The Supreme Court's Causal Use of the Assignment of Income Doctrine,'' 2006 *U. Ill. L. Rev.* 751, 783-787 (2006).

[125]300 U.S. 5 (1937).

[126]*Id.* at 14.

[127]312 U.S. 579 (1941).

[128]*Id.* at 583.

[129]For a discussion of a judicial attempt to draw this distinction, see James S. Eustice, ''Contract Rights, Capital Gain, and Assignment of Income — the *Ferrer* Case,'' 20 *Tax L. Rev.* 1 (1964).

[130]313 U.S. 28 (1941).

[131]The Board of Tax Appeals in considering the case mentioned extinguishment as a basis for its conclusion. *See Hort v. Commissioner*, 39 B.T.A. 922, 926 (1939).

before maturity, or the lessor had breached? And even if we assume the stream of income was inevitable, how is that different from the sale of a debt instrument, a share of fixed-rate preferred stock, or a life insurance contract's death benefit? These instruments are nothing but rights to future ordinary income (plus, at least in the case of debt, the taxpayer's investment). And if it's the right to get the investment back that matters, why do we allow capital gain on the sale of common stock? That is in essence nothing more than the right to future ordinary income (plus, typically, some theoretical and presumably valueless claim in a liquidation). In the case of common stock, of course, future dividends are ostensibly uncertain — but how so? What if the issuer has paid dividends consistently for 40 years? And again, why then do we allow capital gain on the sale of fixed-rate debt? These questions make me think *Hort* should be considered a simple extinguishment case.

Commissioner v. P.G. Lake,[132] widely recognized as the progenitor of the modern AOI doctrine, is similarly not about the AOI doctrine. It calls itself a substitute for ordinary income case, but its conclusion, if not its facts, go beyond the narrow instance of a substitute for currently earned but as yet untaxed ordinary income. Indeed, later cases describe it as standing for the proposition that the sale of a right to future ordinary income is not a capital asset. However, it reads more narrowly as an antiabuse case, like *Schaffner*, and that may be why subsequent courts have tended to follow it, or not, as their facts seemed to warrant.

In *P.G. Lake*, the taxpayer was a corporation that owed its president $600,000. In satisfaction of that debt, the company transferred to its president the right to receive payments from a portion of some oil interests it held, with the $600,000 amount to be received by him increasing at an annual interest rate of 3 percent on the unpaid balance. As the Court described it, ''at the time of the assignment it could have been estimated with reasonable accuracy that the assigned oil payment right would pay out in three or more years. It did in fact pay out in a little over three years.'' The taxpayer claimed the transfer was the sale of property and reported the $600,000 as long-term capital gain. The Supreme Court rejected that characterization, viewing the payment as a substitute for future ordinary income:

> The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.[133]

Relying on the reasoning of the AOI cases to reach its conclusion, the Court observed:

> We have held that if one, entitled to receive at a future date interest on a bond or compensation for services, makes a grant of it by anticipatory assignment, he realizes taxable income as if he had collected the interest or received the salary and then paid it over. That is the teaching of *Helvering v. Horst* and *Harrison v. Schaffner*, and it is applicable here.[134]

Note that treating P.G. Lake as if it received the oil interest payments and then paid them over is not the same as treating the company as if it still owned the oil interests when the payments thereon were later made. In effect, the Court treated the portion of P.G. Lake's oil interests that it transferred to its president as noncapital (which I'll call ''ordinary'') assets. Note that the Court did so in a narrow circumstance in which the payments that were transferred ''could be estimated with reasonable accuracy,'' and in which the Court found the arrangements to be ''transparent devices'' for the conversion of that predictable (near-term) future ordinary income into current capital gain.

In 1960, in *Commissioner v. Gillette Motor Co.*,[135] the Supreme Court more clearly articulated the view that the case before it (and *P.G. Lake*) were not about AOI, but about whether an item of property is a capital asset, although *Gillette Motor* was itself not about whether an item is a capital asset; that statement in the case is mere dictum. There the Court analyzed a payment by the federal government as compensation for having seized the taxpayer's factory during wartime and returned it to him after it was no longer needed. The taxpayer argued that the payment was in exchange for the ''involuntary conversion of property''[136] and should therefore be taxed as long-term capital gain. The Court disagreed, reasoning that many things that are property in the ordinary sense are not capital assets. The Court noted that it had previously held that the lease in *Hort* and oil payment rights in *P.G. Lake* were not capital assets, even though they were property. Along these lines, the Court held that compensation received by the taxpayer was in substance payment for use of the property for a specified period, with the consequence that the payment should be seen as a rental equivalent and therefore ordinary.

It's worth noting that *Gillette Motor* also reflects the beginning of a conflation of two lines of authorities. One line of authorities dealt with whether an asset is capital. A similar line of authorities, discussed below, dealt with whether an asset was sold, as opposed to being used as collateral for a loan,[137] or, as in *Gillette Motor*, was itself lent to the counterparty (in *Gillette Motor*, the federal government). It's obvious that nothing was sold in *Gillette Motor*; indeed, the holding of that case is nothing more than a refutation of the taxpayer's clever and

[132]356 U.S. 260 (1958).
[133]*Id.* at 266.
[134]*Id.* at 267 (citations omitted).
[135]364 U.S. 130 (1960).
[136]*Id.* at 132.
[137]*Stranahan v. Commissioner*, 472 F.2d 867 (6th Cir. 1973); *Martin v. Commissioner,* 56 T.C. 1255 (1971), *aff'd without opinion*, 30 AFTR 72-5396 (5th Cir. 1972); *Mapco Inc. v. United States*, 556 F.2d 1107 (Ct. Cl. 1977); *Hydrometals, Inc. v. Commissioner*, T.C. Memo. 1972-254, *aff'd,* 485 F.2d 1236 (5th Cir. 1973), *cert. denied,* 416 U.S. 938 (1974).

perhaps academically interesting assertion that the reparations payment was for an involuntary conversion of a ''capital asset'' — a term-of-years leasehold interest in the taxpayer's property.

In 1965, in *Midland-Ross*,[138] the Supreme Court took up the question of a taxpayer who (before the enactment of the original issue discount rules) purchased non-interest-bearing promissory notes at a discount to face and then sold them at a profit later in the same year.[139] The taxpayer maintained that the sale generated capital gain, even though the gain was conceded to be the economic equivalent of interest. It was agreed that the increase in value of the bond was due solely to the passage of time and closer proximity to the due date of the promissory note, rather than market fluctuations in interest rates or the borrower's credit risk, for example. The Court rejected the taxpayer's characterization, noting that because the increase in value over time of a note issued with OID is similar to interest, which is taxed as ordinary income, the gain should also be treated as ordinary income.

The Court explained that it ''has consistently construed 'capital asset' to exclude property representing income items or accretions to the value of a capital asset themselves properly attributable to income.''[140] However, the Court did not conclude that the promissory notes themselves were not capital assets, but in essence concluded that the accretion to the value of the note over the period it was held by the taxpayer (which the Court termed ''earned original discount'') ''serves the same function as stated interest, concededly ordinary income and not a capital asset.''[141]

The first observation about *Midland-Ross* is that it by its terms involved only economically accrued income, a true instance of the SOI doctrine as I've narrowly described it. The second is that this analysis, unlike that in the prior cases, depended on a bifurcation of the note into two parts: (1) the note, stripped of the right to earned OID, which presumably is a capital asset in the hands of the taxpayer, and (2) the earned OID, which is not a capital asset and the sale of which generates all the income recognized by the taxpayer on sale of the notes. It's unclear what, in the Court's view, permitted this bifurcation (although I have no doubt the Court had the common-law authority to do it). And it is unclear in ''typical'' cases what (basis and income) would or should be allocated to each of the two components. This issue is left unexplored in the revenue rulings, discussed in Part II.

Thus, we have a series of cases that might appear to stand for the proposition that a right to future ordinary income is not a capital asset and produces ordinary income on a sale. As we've seen, however, this is not quite what the cases did. *Hort* was arguably an extinguishment case. *Midland-Ross* and *P.G. Lake* said broad things but held only that earned ordinary income, or a predictable stream of soon-to-be-earned ordinary income, cannot be converted to capital gain through a sale. *Gillette Motor* held only that reparations for a prior use of property are not gain from the sale of a capital asset. Perhaps not surprisingly, the circuit courts have not always followed the broadest reading of *P.G. Lake* and its progeny.

For example, in 1963 the Fifth Circuit in *United States v. Dresser Industries, Inc.*[142] addressed the character of gain on a payment received by an exclusive holder of a patent in exchange for allowing the payer to practice the patent. The court rejected the IRS's argument that the payment was nothing more than a substitute for ordinary income to be earned from the patent. It distinguished *P.G. Lake*, noting that there the transferee's right to receive oil payments terminated (and the right to oil payments reverted to the transferor) once a specified amount of money was received, whereas here the right to use the patent would never revert to the seller. Further, following *Ferrer*, the court emphasized that the fact that income earned from the patent would be ordinary did not settle the treatment of the proceeds of the sale of a right to practice the patent.[143] It argued instead that the important distinction is ''between the present sale of the future right to earn income and the present sale of the future right to earned income.''[144] The sale of the right to practice the patent did not also transfer any income, but like any valuable business asset, gave the purchaser something it could use to earn future income. Drawing on Justice Holmes's metaphor in *Lucas v. Earl*, the court concluded, ''The tree was sold, along with the fruit, at least insofar as that branch was concerned.''[145] As a result, the sale generated capital gain.

Similarly, in 1966 in *Guggenheim v. Commissioner*,[146] the Tax Court considered the sale by a horse breeder of what were, in form, ownership interests in a racehorse, Turn-To, that was out to stud. The IRS contended that each interest should be recharacterized as the sale of a right to breed one mare per year with Turn-To. The Service also argued that because income earned from Turn-To's stud fees (had the seller retained full ownership) would have been ordinary, the payments should be seen as a substitute for ordinary income, as in *P.G. Lake*. Following *Ferrer* and *Dresser*, the court noted that the fact that income produced by the transferred property would be ordinary did not necessarily mean that income from the transfer of the property was ordinary. In distinguishing the ownership interests (metaphorically) carved out of Turn-To from the portion of P.G. Lake's oil interests transferred to its president, the court argued that the relevant factor was the transfer of risk:

> In *Lake*, essentially what was transferred was the right to receive ordinary income, and few of the risks involved in holding the property or asset that

[138]381 U.S. 54 (1965).
[139]But more than six months later (which at the time was the required holding period for long-term capital gains treatment).
[140]381 U.S. at 57.
[141]*Id.*
[142]324 F.2d 56 (5th Cir. 1963).
[143]*Id.* at 59.
[144]*Id.*
[145]*Id.* at 58.
[146]46 T.C. 559 (1966).

was the source of the income were transferred. However, in this case, petitioner transferred all investment risks in a three-sevenths interest in Turn-To. If the value of Turn-To had subsequently increased (and there is evidence that it did), petitioner would not have shared in this increase to the same extent as he would have.[147]

However, in 1973 the Sixth Circuit in *Estate of Stranahan v. Commissioner*[148] followed *P.G. Lake*'s broad language in concluding — or at least in not disputing — that an item of future ordinary income is not a capital asset. In *Stranahan*, the IRS challenged the sale of $122,820 worth of future dividends from father to son for $115,000, which the father treated as ordinary income (enabling him to use other deductions he had for the year of sale). The court viewed the *Horst* line of cases as standing for the proposition ''that a taxpayer cannot escape taxation by legally assigning or giving away a portion of the income derived from income producing property retained by the taxpayer.''[149] The court saw the taxpayer not as escaping taxation, but as merely changing the time at which he was taxed. The transfer of the income item (the dividends) in this case for adequate consideration distinguished it from the *Horst* line of cases involving gratuitous transfers. Relying on *P.G. Lake* and *Hort*,[150] the court noted (apparently agreeing with the taxpayer, who does not appear to have argued that the sale might have generated capital gain) that ''a taxpayer who assigns future income for consideration in a *bona fide* commercial transaction will ordinarily realize ordinary income in the year of receipt,''[151] and it allowed the taxpayer to recognize the $115,000 payment as ordinary income when received.[152]

Another interesting case is *Estate of Bloch v. Commissioner*,[153] in which the Tax Court considered whether the taxpayer, an individual U.S. citizen, was required to withhold tax on the purchase of some detached dividend coupons. The coupons had been attached to bearer stock certificates issued in France that represented ownership of shares of stock of a U.S. corporation. The taxpayer purchased the dividend coupons from foreign banks, which had obtained them (directly or indirectly) from foreign holders of the stock certificates, who were unknown to him. Had the dividends been paid directly to the foreign stockholders, they would have been U.S.-source FDAP.

The court concluded that the taxpayer was not responsible for withholding, because the certificate holders were at all times unknown to the taxpayer,[154] and so the taxpayer was not acting in collusion with them. However, the court stated that by selling the dividend coupons in this manner, the unknown foreign stockholders were improperly avoiding U.S. withholding tax and thus thwarting the intent of section 1441.[155] This raises a question: If the right to a near-term, future U.S.-source dividend is not a capital asset, which *P.G. Lake* and *Midland-Ross* and their progeny (sometimes) say, weren't the proceeds of the sale of such a right to Bloch ordinary income? And if those proceeds were ordinary income, were they U.S.-source, even though they were gain from the sale of property, which would generally be sourced by reference to the residence of the seller under section 865 (in this case, foreign-source)?[156] If so, why wasn't Bloch a withholding agent when he paid a non-U.S. entity for the coupons without proper forms, such as a treaty claim? And if the proceeds were not U.S.-source income (as the court perhaps tacitly held), what really is the scope of the SOI doctrine as intended by the Supreme Court in *P.G. Lake* and *Midland-Ross*?

This distinction between the right to a future item of ordinary income and the item itself has been recognized and codified in the case of bonds. Under section 1286, when the holder of a bond sells the right to one of the interest payments on the bond, the seller is not treated as having either borrowed the purchase price against the future coupon payment (with the result that the seller would recognize the coupon in income when paid, as in the ''true'' AOI cases and *Martin*) or received a payment that is a substitute for the future ordinary coupon payment (with the result that the purchase price would be recognized in income when received, as in *Stranahan*). Instead, a pro rata portion of the seller's basis in the bond

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[147] *Id.* at 569.

[148] 472 F.2d 867.

[149] *Id.* at 869.

[150] Discussed *supra* text accompanying notes 131-132.

[151] *Stranahan,* 472 F.2d at 869 (emphasis in original).

[152] By contrast, in *Martin* the Tax Court considered the sale by an owner of property of the right to certain future rents. In 1966, in exchange for $225,000, the taxpayer purported to sell the right to receive all rents from the property beginning on January 1, 1967, until the purchaser had received $225,000 in rents plus 7 percent annual interest on the outstanding balance. The taxpayer argued that it should recognize the $225,000 payment as ordinary income in 1966, as a substitute for rental payments; however, the court recharacterized the purported sale as a loan, noting that the assignment had been only of a right to receive a specified dollar amount plus interest. Also, the court noted that the sale did not affect the taxpayer's ''dominion and control over the property'' and that the purported buyer had not acquired any indicia of ownership. Finally, the court, citing *Horst*, concluded that there had ''been no effective separation of the 'fruit' from the 'tree,'" so that the taxpayer was required to recognize rental income from the property in 1967 when it was received. *See also Mapco*, 556 F.2d 1107; *Hydrometals*, T.C. Memo. 1972-254. *Martin* and its progeny reject the SOI doctrine as articulated in *P.G. Lake*, reaching a result (even though value was paid for the stream of income) that is very similar to the AOI doctrine as expressed in, e.g., *Horst*. They also form one of the underpinnings of the recent *Schering-Plough* decision; *see*

(Footnote continued in next column.)

Schering-Plough Corp. v. United States, 651 F. Supp.2d 219 (D.N.J. 2009), *Doc 2009-19512*, *2009 TNT 167-3*.

[153] 44 T.C. 815 (1965).

[154] *Id.* at 819.

[155] *Id.* at 820.

[156] This raises a nice question under *Bank of America v. United States*, 680 F.2d 142 (Ct. Cl. 1982). This item feels like U.S.-source income (dividends), but it isn't — it's gain, even though perhaps ordinary gain. Does the ''closest analogy'' logic of *Bank of America* apply to ordinary gains? One would have thought not, as without more this item isn't even FDAP.

is allocated to the coupon, effectively treating the coupon as a piece of property that is being separated from the bond.

This raises another question, mentioned above: If a sale of something like a dividend or rental stream is a separate asset that isn't a capital asset, why isn't any basis allocated to it (and away from the tree from which it was picked)? And when both the tree and its fruit get sold together, like the zero coupon bond in *Midland-Ross* and the insurance policy in Rev. Rul. 2009-13? Note that in *Midland-Ross*, all the basis was in effect allocated to the capital component of the unit that was sold (presumably because the parties agreed that all the gain was attributable to the accrued discount), whereas in the revenue ruling, all the basis was allocated to the ordinary component of the unit, in that it (the cash surrender value) was reduced by the amounts paid for the policy to determine the amount of ordinary income realized by the taxpayer.

C. Summary

As we can see, the AOI doctrine in its narrowest form is simply an antiabuse rule intended to prevent people from gaming the progressive rate system by gratuitously transferring income to family members, friends, or subordinates in lower tax brackets. There is a nominal variant of the doctrine, the SOI doctrine (also an antiabuse rule), which says the effort to sell a stream of ordinary income at capital gain rates is unavailing and in fact produces ordinary income. But this is not about assignment of income; indeed, the case law in this area is confused and often wrong (like *Stranahan*'s treatment of gain from the sale of future dividends as ordinary income). Even when it's correct, the case law often fails to articulate what appears to be a variety of underlying motives for the conclusions reached. Principal among them is the courts' consistent refusal to allow taxpayers to sell earned but untaxed, or soon-to-be-earned ordinary income, at capital gains rates. The courts do this by either determining that the item is not a capital asset or concluding that it wasn't sold but was borrowed against.

The SOI doctrine has obvious ramifications for section 1234A, in the sense that courts and the IRS will work hard to ensure that taxpayers do not succeed in converting earned but untaxed ordinary income into capital gain through a rule like section 1234A. However, the SOI doctrine has an *ipse dixit* aspect to it that can lead to questionable results. When combined with the extinguishment doctrine (which itself is questionable), the SOI doctrine can easily lead to the double-bootstrapped argument that because extinguishment would produce ordinary income, sale should as well. That is in essence the result reached in Rev. Rul. 2009-13 and in many cases following the broad logic of *P.G. Lake*. The SOI doctrine isn't necessarily wrong in all cases; it makes a lot of sense in cases like *Midland-Ross*, in which economically earned income has for whatever reason not yet been taxed. But the SOI doctrine isn't necessarily correct either, and in cases dealing with speculative future income, it's wrong. Moreover, when it is correct (as in *Midland-Ross*), the doctrine need not affect the general rule for taxing derivative gains, because it stands as a judicially imposed and limited exception to any such general rule.

In any event, this somewhat metaphysical analysis of the ordinary asset that results from application of the SOI doctrine has a real effect on the straddle rules. When and how can we logically conclude that something is an ordinary asset because it's a right to earned or future ordinary income, but that it is at the same time a PWRATPP?

VII. Hedging

A separate line of thinking that may have led to some confusion around what is a capital asset involves business hedging. Because income earned in the ordinary course of business is generally ordinary in character, there has long been an intuitive sense that some business hedging activities, even though undertaken through the purchase and sale of assets that would normally be considered capital, should generate ordinary income or loss. If not, companies that hedge their exposure to the price of a key input to their business activity could end up with a character mismatch between income or loss from their business and gain or loss from hedging. This section will explore the taxation of hedging activities as it developed from the 1950s to the 1980s from *Corn Products*[157] *to Arkansas Best*.[158]

In *Corn Products Ref. Co. v. Commissioner,* the Supreme Court considered a taxpayer that processed and sold products derived from corn. The taxpayer was able to store only about three weeks' worth of the corn it needed for its production, and so entered into corn futures contracts in order to ensure a stable price for its corn supply. The taxpayer's contracts to sell its products generally provided for the purchaser to pay the lower of the price at the contract date or the delivery date. As a result, the taxpayer's hedges protected it only during increases in corn prices, not declines. If the price of corn rose, gains on the futures contracts would offset the added costs required to fulfill the taxpayer's delivery obligations. But if the price of corn fell, losses would not be made up by additional profits on the sales contracts, because the sales price would be reduced accordingly.

The Supreme Court rejected the taxpayer's contention that hedging was not within the exclusions of the statutory predecessor of section 1221,[159] but it also noted that the particular corn futures were not within the literal statutory language of the exclusion. Still, the Court reasoned that ''Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by [the statutory predecessor of section 1221] applies to transactions in property which are not the normal source of business income.''[160]

Because the Court thought that the gains from Corn Products' hedging activity should be ordinary rather than capital, it concluded that the commodity futures Corn Products was trading in were not capital assets in

[157]350 U.S. 46 (1955).
[158]485 U.S. 212 (1988).
[159]*Corn Products,* 350 U.S. 46 at 51.
[160]*Id.* at 52.

its hands. And because the futures were not within the literal language of the exclusions set out in the statutory predecessor of section 1221, the Court had to search for an explanation for why the futures were not capital assets — because ''Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss.''

Following *Corn Products*, a lot of judicial and administrative law developed around the idea that property ''arising from the everyday operation of a business''[161] should not be considered capital assets. The holding was applied to everything from government bonds[162] to stock of a subsidiary.[163]

In *Arkansas Best Corp. v. Commissioner*, the Supreme Court rejected the notion that the taxpayer's intent in purchasing property should be relevant to whether that property was considered capital. Arkansas Best, a holding company, originally purchased stock in a bank for investment purposes. But later, to protect its business reputation, the company made additional capital contributions to the bank to keep the bank from failing. Relying on *Corn Products*, Arkansas Best claimed, and the Tax Court upheld, an ordinary loss on the sale of some of its stock in the bank.[164] The Supreme Court reversed, holding that a taxpayer's purpose in acquiring an asset is irrelevant to whether the asset is a capital asset. The Court instead argued that an asset is a capital asset unless it falls within one of the exceptions listed in section 1221, which the stock obviously did not.[165] The Court also stated that its *Corn Products* decision should be read to rely on the specific exclusion from capital treatment for inventory.[166]

After *Arkansas Best*, Treasury promulgated reg. section 1.1221-2, permitting (and in some circumstances requiring) taxpayers to elect out of capital asset treatment for some types of assets that hedge ordinary business assets or liabilities under limited circumstances. This regulation was later ''ratified'' by what is now section 1221(a)(7).

I raise the history of *Arkansas Best* both because it's an example of a court reaching to conclude that something wasn't a capital asset when it believed that was an appropriate result (as with many of the AOI and SOI cases), and also to give an idea of some of the problems that can be caused by the application of otherwise harmless rules in the context of hedging transactions. As mentioned above, part of the motivation for section 1234A was clearly that derivative instruments were being used as hedges — not of ordinary business assets, but of other capital assets, that is, as straddles. Broadly speaking, the code often reflects a tendency to try to ensure that assets and liabilities that hedge other assets and liabilities match each other as well as possible in terms of character and timing. And the *Corn Products* saga is a reminder of the unintended consequences that can flow from seemingly good ideas if they aren't carefully considered and implemented.

[161]For a more detailed description of this history, see Edward D. Kleinbard and Suzanne F. Greenberg, ''Business Hedges After *Arkansas Best*,'' 43 *Tax L. Rev.* 393, 410-414 (1988).
[162]Rev. Rul. 58-40, 1958-1 C.B. 275.
[163]*Campbell Taggart*, 744 F.2d 442 (5th Cir. 1984).
[164]*See Arkansas Best*, 485 U.S. 212 at 214-215.
[165]*Id.* at 215-218.
[166]*Id.* at 219-222.

VIII. Capital Loss Limitation

Section 1211 limits capital losses to capital gains (plus $3,000, in the case of noncorporates).[167] Corporations can carry most excess capital losses back three years and then forward five.[168] Other taxpayers generally can carry unused capital losses forward indefinitely but cannot carry them back[169]; net section 1256 contract losses may be carried back for three years.[170] There's little doubt that the primary impetus for section 1234A as it was drafted was to ensure that losses from cancellations and terminations of capital asset-linked derivatives would be subject to the capital loss limitations. There follows a brief discussion of the history of those rules and their reasons for being.

The Revenue Act of 1913 permitted a deduction for losses incurred in trade, but not for nontrade or nonbusiness investment losses.[171] In 1916 Congress expanded the loss deduction allowance to include investment losses, but only to the extent of ''profits arising therefrom.''[172] The Revenue Act of 1918 removed that limitation and permitted the full deduction of losses from investment transactions ''entered into for profit,'' even if those losses exceeded investment gains for that year.[173] Capital gains were first given preferential treatment in 1921, when noncorporate taxpayers were subjected to a rate of 12.5 percent on capital net gain resulting from the sale or exchange of capital assets,[174] which were defined as held for profit or investment for more than two years.[175] In 1924 Congress correspondingly limited the deduction for capital losses to 12.5 percent of the noncorporate taxpayer's capital net loss,[176]

[167]Section 1211(a) and (b).
[168]Section 1212(a).
[169]Section 1212(b).
[170]Section 1212(c).
[171]17 Treas. Dec. Int. Rev. 2135 (1915).
[172]Revenue Act of 1916, section 5(a), 39 Stat. 756.
[173]Revenue Act of 1918, ch. 18, 40 Stat. 1057.
[174]Revenue Act of 1921, section 206, 42 Stat. 227, 232-233.
[175]The act defined a capital asset as:

> property acquired and held by the taxpayer for profit or investment for more than two years (whether or not connected with his trade or business), but . . . not . . . property held for the personal use or consumption of the taxpayer or his family, or stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year.

Id. at section 206(a)(6).
[176]Revenue Act of 1924, section 208(c), 43 Stat. 253, 262-263. Section 208(c) of the act provides that a taxpayer with a capital net loss shall be taxed as follows:

> A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in section 210 and 211, and the total tax shall be this amount minus 12½ per centum of the capital net loss;

(Footnote continued on next page.)

which the House described as a natural corollary to the treatment of capital gains.[177]

Congress first considered limiting capital losses to capital gains in 1932, when the House proposed to limit the deduction of losses from sales or exchanges of stocks and bonds to the extent of the taxpayer's gains from sales or exchanges of those securities.[178] It explained that many taxpayers "have been completely or partially eliminating from tax their income from salaries, dividends, rents, etc., by deducting therefrom losses sustained in the stock and bond markets, with serious effect upon the revenue."[179] The Senate Finance Committee removed the limitation as applied to stocks and bonds that *were* capital assets (that is, those that were held for more than two years). The committee said that while it was "in general agreement with the purpose of the House bill," it believed the House version of the limitation was "somewhat too drastic" and that:

> Securities held for more than two years have been in the hands of investors. The losses they have suffered are decidedly real losses. Investments of this nature normally have been made from income upon which a tax was paid at the time it was earned. The shrinkage in the value of these investments is in every sense of the word a true loss actually sustained by the investor. The existing limitation that capital losses can not reduce the tax by more than 12½ percent, is adequate protection against excessive deductions.[180]

And so the limitation was imposed only on losses from the sale or exchange of stocks and bonds owned for two years or less (which were not capital assets),[181] with a carryforward.[182] "Capital losses" as then defined were first limited to capital gains by the Revenue Act of 1934. There have obviously been many changes to the capital loss limitation, but it has been largely in place since then.

While a thorough analysis of the capital loss limitation is well beyond the scope of this report,[183] I am unsure I see the merit of these rules as they are now — as opposed to, for example, a net capital loss deduction rate like that under the 1924 regime, or a rule limiting investment expenses to investment income like under the 1916 regime (with carrybacks and carryforwards) and like section 163(d) and the passive activity loss rules now. Indeed, section 1234A itself seems a good example of a reason not to favor the current capital loss limitation. It seems clear that when section 1234A was enacted, making losses capital was considered the only way (or at least the only considered way) to avoid the whipsaw that is otherwise endemic to the extinguishment doctrine. If an asset produces ordinary income or loss on settlement but capital gain or loss on sale, taxpayers will in general manage their affairs so as always to end up with capital gains and ordinary losses. As we've seen, it wasn't necessarily (and in any event didn't need to be) the case that capital assets always produce ordinary income or loss on settlement, and it isn't always true that a capital asset produces capital gain on sale. But if that can happen, a rational system needs a rule to prevent it. So the drafters chose to make capital *all* losses — and all gains — from cancellations and terminations of things they thought could be used to whipsaw the government. That, as I've now observed many times, was unfortunate.[184]

IX. The Precursors and Siblings of Section 1234A

A. Section 1271

The first congressional attempt to block the courts' efforts to develop the extinguishment doctrine was reflected in what is now section 1271(a). In 1934 Congress added section 117(f),[185] later recodified as section 1232(a), which provided that the retirement of corporate or government "bonds, debentures, notes, or certificates or other evidences of indebtedness" would be treated as an exchange for purposes of determining capital gain or loss. Section 1232 was repealed in 1984, but the substance of the exchange rule was expanded and moved to section 1271(a), which now provides: "Amounts received by the holder on retirement of any debt instrument shall be considered as amounts received in exchange therefor."[186] Original section 117(f) was intended to change the result reached in several court decisions later affirmed by the Supreme Court in *Fairbanks*,[187] which, as discussed in

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but in no case shall the tax under this subdivision be less than the taxes imposed by sections 210 and 211 computed without regard to the provisions of this section.

[177]H.R. Rep. No. 68-179, at 57 (1924). ("If the amount by which the tax is to be increased on account of capital gains is limited to 12½ percent of the capital gain, it follows logically that the amount by which the tax is reduced on account of capital losses shall be limited to 12½ percent of the loss.")

[178]H.R. 10,236, 72d Cong. section 23(r) and (s) (1932).

[179]H.R. Rep. No. 72-708, at 12-13 (1932).

[180]S. Rep. No. 72-665, at 10 (1932).

[181]Revenue Act of 1932, section 23(r)(1), 47 Stat. 169, 183.

[182]*Id.*

[183]For an interesting discussion of the regime and a proposed alternative, see Robert H. Scarborough, "Risk, Diversification and the Design of Loss Limitations Under a Realization-Based Income Tax," 48 *Tax L. Rev.* 677 (1993).

[184]This raises a question, alluded to in earlier discussions: Why did section 1234A encompass liabilities (obligations) as well? Could one then (or now) assign a liability and get capital gain or loss in a case in which settlement would produce ordinary income or loss?

[185]Revenue Act of 1934, section 117(f), 48 Stat. 680, 715. ("For the purposes of this title, amounts received by the holder upon the retirement of bonds, debentures, notes, or certificates or other evidences of indebtedness issued by any corporation (including those issued by a government or political subdivision thereof), with interest coupons or in registered form, shall be considered as amounts received in exchange therefor.") The Internal Revenue Code of 1954 removed the requirement that the instruments have interest coupons or be in registered form.

[186]Tax Reform Act of 1984, section 42, 98 Stat. 556 (1984).

[187]*Fairbanks*, 306 U.S. at 438. ("The Circuit Court of Appeals below was right in holding that by the Act 1934 Congress did not attempt to construe the prior Acts and purposely made a material addition thereto.") Interestingly, section 117(f) appears to have been intended as a clarification of section 1222, enacted in 1921. Although, as discussed above, that section requires a sale or exchange of a capital asset as a precondition to capital

(Footnote continued on next page.)

Part V, held that the redemption of a debt instrument was not a sale or exchange and therefore gave rise to ordinary gain or loss.[188] Section 1271(a) and its predecessors do not apply to issuers of debt, which generally recognize ordinary income (cancellation of debt) or loss (repurchase premium) on debt retirement.

B. Section 1234

Section 1234(a) provides in general that a holder's gain or loss from the sale or exchange of an option to buy or sell property, or loss attributable to failure to exercise the option (which is treated under section 1234(a)(2) as from the sale or exchange of the option), is considered gain or loss from the sale or exchange of property that has the same character that the property to which the option relates has in the hands of the taxpayer. Section 1234(b) provides that gain or loss incurred by a nondealer grantor of an option from any ''closing transaction with respect to,''[189] or gain on lapse of, an option with respect to stock, securities, commodities, or commodity futures is considered to be from the sale or exchange of a capital asset held for not more than one year.[190]

The earliest precursor to section 1234 was the short sale provision of the Revenue Act of 1932, which provided that gains or losses (1) from ''short sales of stocks and bonds,'' (2) ''attributable to privileges or options to buy or sell such stocks and bonds,'' or (3) ''from sales or exchanges of such privileges or options'' would be considered ''gains or losses from sales or exchanges of stocks or bonds which are *not* capital assets.''[191] The committee reports indicate that Congress introduced this provision, and the limitation on losses from the sale of stocks and bonds that were not capital assets,[192] because too many taxpayers were eliminating their income taxes by deducting losses sustained in the depressed stock market.[193]

The Revenue Act of 1934 changed the short sale provision to provide that (1) gains or losses from short sales of property would be considered to be from sales or exchanges of capital assets, and (2) gains or losses attributable to the failure to exercise privileges or options to buy or sell property would be considered to be from sales or exchanges of capital assets held for one year or less.[194]

Section 1234 was introduced in 1954 and provided that gain or loss from the sale or exchange of, or loss from the failure to exercise, a ''privilege or option to buy or sell property'' would be considered capital gain or loss only if the property would be a capital asset in the taxpayer's hands. According to the Senate report, this change was implemented to eliminate an inconsistency under existing law whereby ''in the case of the failure to exercise an option the holder of the option always realizes a short-term capital loss and the grantor a short-term capital gain; [whereas] in the case of the sale of an option the

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gain or loss, its legislative history explained that the intent was to include any disposition (evidently including a redemption) thereof. *Compare Werner v. Commissioner*, 15 B.T.A. 482 (1929) (holding that gain from bonds called before maturity were capital, relying on the legislative history of the 1921 code, which showed that Congress intended the capital gain provision to apply to the ''sale or other disposition of capital assets,'' despite the statutory ''sale or exchange'' language) *with Watson v. Commissioner*, 27 B.T.A. 463 (1932) (overruling *Werner*, reasoning that the statutory language was too ''clear and unambiguous'' to resort to a reliance on legislative history).

[188]Section 1232(a) also included some of the first rules relating to OID. For example, Congress amended the section in 1954 to provide that gain in excess of OID from the sale or exchange of a corporate debt instrument that was a capital asset in the hands of the taxpayer and was held for more than six months would be considered gain from the exchange of a capital asset held for more than six months. Section 1232(a)(2) (repealed). To the extent of OID, gain was considered ordinary income, while loss was capital. S. Rep. No. 83-1622, at 433-436 (1954). Section 1232(a)(3), introduced in 1969, provided that regardless of his method of accounting, a holder of a corporate debt instrument must include in income his ratable monthly portion of OID. Tax Reform Act of 1969, 83 Stat. 487.

[189]Section 1234(b)(2)(A) defines a closing transaction as ''any termination of the taxpayer's obligation under an option in property other than through the exercise or lapse of the option.''

[190]Thus, I believe it is section 1234A that (after 1997) treats the grantor of an option with respect to, *e.g.*, real estate or partnership interests, as having capital gain or loss on lapse or assignment thereof.

[191]Revenue Act of 1932, section 23(s), 47 Stat. 169, 183 (1932) (emphasis added). To be capital assets, stocks and bonds then had to be held for more than two years.

[192]*See* Revenue Act of 1932, section 23(r), 47 Stat. 169, 183; *see supra* also the discussion text accompanying notes 178-182.

[193]H.R. Rep. No. 72-708, at 12-13. *See supra* text accompanying notes 178-182.

[194]Revenue Act of 1934, section 117(e), 48 Stat. 680, 715. The 1934 act also changed the definition of a capital asset to eliminate the two-year holding period. It's unclear why the 1934 act treated gains and losses from short sales of, and lapses of options on, ''property'' as from the sale or exchange of a ''capital asset.'' Nothing in the act or existing law suggested that property was coextensive with capital assets. The premise seems to have been that anything anyone was short-selling would in reality be a capital asset. But that doesn't explain why the statute didn't just say that short sales of capital assets are treated as sales of those assets (except perhaps that that would have looked as tautological as it was; *see infra* note 200.

Another interesting aside on why the original short sale rule didn't simply provide for a short-term holding period in all cases, as the written option lapse rule did: Under the House version of the provision, gains or losses from short sales of property would also have been considered short term. However, it was ultimately agreed that this limitation would not be imposed on short sales, because the House version would have created the following result:

> Under the House bill, a man with a long-term loss could change it into a short-term loss and utilize it against his gains to the full 100 percent by simply making a short sale. On the other hand, a man living in some distant city who desired to sell some stock he had held for 5 years would have to pay a tax on 100 percent of the profit if he wired his order for the immediate sale of such stock.

S. Rep. No. 73-558 (1934).

holder (unless a dealer in options) realizes a long or short-term capital gain or loss depending on how long he held the option.''[195]

The 1954 provision did not address gain realized by the grantor on lapse of an option, which was considered ordinary income. To deal with a resulting practice that it disliked, Congress in 1966 modified section 1234 to provide that gain realized by the grantor of a lapsed option that is part of a straddle would be considered short-term capital gain.[196] The Tax Reform Act of 1976 expanded this short-term treatment beyond the straddle context, in what is current section 1234(b).[197]

The Deficit Reduction Act of 1984 introduced section 1234(c), which provides that for purposes of section 1234(a) and (b), a cash settlement option is treated as an option to buy or sell property.[198] The conference committee report explained that for cash settlement options not subject to mark-to-market, section 1234(c) clarifies ''that gain or loss on the sale, exchange, lapse, or exercise of the option is capital gain or loss with respect to grantors or holders.''[199]

C. Section 1233

Section 1233(a), the early history of which is discussed above, provides that gain or loss from the short sale of property is considered gain or loss from the sale or exchange of a capital asset to the extent that the property used to close the short sale constitutes a capital asset in the hands of the taxpayer.[200] Section 1233(b)(1) contains a complicated rule that is somewhat similar to section 1234(b), providing that gain that is from a short sale of (including exercise of an option to sell) stock, debt, or a commodity future and that isn't part of a straddle[201] is short-term capital gain if the taxpayer held the underlying property or substantially identical property with a short-term holding period at any time during the term of the short sale.

D. Section 1234B

Section 1234B, discussed in Part IV, sets forth the treatment of securities futures contracts. As drafted, it provides that gain or loss attributable to the sale, exchange, or termination of a securities futures contract will be considered to be from the sale or exchange of property that has the same character as the property to which the

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[195]S. Rep. No. 83-1622, at 113 (1954).

[196]Another interesting tangent, and a look into one of the ''accidents'' by which the taxation of derivative gains and losses has evolved: As a result of the 1954 provision, straddle writers (grantors of both an option to buy and an option to sell the same asset for the same price — otherwise known as a volatility option, because the buyer simply hopes the asset's price moves a lot) would allocate the entire straddle premium to the exercised option to avoid the otherwise resulting ordinary income. *See* S. Rep. No. 89-1707 (1966). The IRS challenged this practice in Rev. Rul. 65-31, 1965-1 C.B. 365, which held that the straddle premium must be allocated between the put and call components based on their relative market values. The Service later conceded that in lieu of a relative market value allocation, it would accept an allocation of 55 percent of the premium to the call component and 45 percent to the put component. Rev. Proc. 65-29, 1965-2 C.B. 1023. The committee reports for the 1966 act critiqued the revenue ruling as follows:

> The difficulty with the present tax treatment of premium income from the writing of straddles lies in the fact that by dividing the premium income into two parts, one part may be reported as ordinary income (the portion allocated to the lapsed option) while the other portion may merely decrease a capital loss. Your committee believes that it is hard to justify treating part of the transaction as resulting in ordinary income, while the other portion may give rise to a capital loss which cannot be offset (apart from the $1,000 per year deduction of net capital losses against ordinary income) against ordinary income.
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> . . .
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> Assume that a straddle writer issues a straddle for a stock when its price is $100 a share and this is the option price. Assume that the straddle premium is $8 per share. Assume further that the put component of the straddle is exercised by the purchaser when the price of the stock is $80 per share. As a result, the writer of the straddle must buy stock at a price of $100 per share when its market value is $80 per share. If the straddle premium allocable to the put component is $3.60 per share [i.e., a 45 percent allocation], the short-term capital loss for the writer of the straddle will be $16.40 per share if he disposes of the stock shortly after receipt, when the market price is still $80 per share. At the same time, the remainder of the straddle premium, $4.40 a share, is allocated to the call component, which in such a case presumably was allowed to lapse. The $4.40 per share would be ordinary income while the capital loss of $16.40 a share attributable to the put side of the option would result in a short-term capital loss, which, except to the extent of the $1,000 a year, could not be netted with the ordinary income attributable to the premium income of the other side of the straddle.

S. Rep. No. 89-1707 (1966). The committee believed this divided premium allocation was inconsistent with the option writer's view, and the market's treatment, of a straddle as a single transaction, noting that while ''it is desirable to provide for this netting of a gain or loss arising from the two components . . . the netting of the two components in a straddle can be achieved and still have any net premium gain result in what is *essentially ordinary income*, by treating the premium income allocated to the lapsed option as short-term capital gain.'' *Id.* (Emphasis added.)

(Footnote continued in next column.)

[197]Tax Reform Act of 1976, 90 Stat. 1525, 1930 (1976).

[198]Section 1234(c)(2)(B) defines a cash settlement option as ''any option which on exercise settles in (or could be settled in) cash or property other than the underlying property.''

[199]H.R. Rep. No. 98-861 (1984).

[200]Why this rule was considered necessary has always been a mystery to me, given that closing a short sale with property identical to that sold short is actually a sale of the delivered property, which was clear even before the rule was enacted. *See Provost v. United States*, 269 F.2d 443 (1926); S-1179, 1 C.B. 60 (1919); I.T. 2187, IV-2 C.B. 25 (1925). One possibility put forth by commentators is that section 1233(a) was intended to clarify that a short sale is not closed until the redelivery of the borrowed property to the lender, even though one might already own a like amount of the property that is the subject of the short sale at the time it is entered into (i.e., might have done a short sale ''against the box''). *See* Alex Raskolnikov, ''Contextual Analysis of Tax Ownership,'' 85 *B.U.L. Rev.* 431, 439 n. 25 (quoting to this effect Lee A. Sheppard, ''Fixes to Ensure That Tax Is Paid on Capital Gains,'' *Tax Notes*, Dec. 4, 1995, p. 1165, *95 TNT 236-5*).

[201]*See* section 1233(e)(2)(A).

contract relates in the hands of the taxpayer (or would have if acquired by the taxpayer). This rule is structurally similar to section 1234(a). Section 1234B(b) provides that gain or loss from a short securities futures contract is always short-term gain or loss.

E. Section 1241

Section 1241 provides that amounts "received by a lessee for the cancellation of a lease, or by a distributor of goods for the cancellation of a distributor's agreement (if the distributor has a substantial capital investment in the distributorship), shall be considered as amounts received in exchange for such lease or agreement." Congress introduced the provision, as currently worded, in 1954 in response to doubt arising from the Second Circuit's holding in *Starr Brothers*,[202] which, as discussed in Part V, held that amounts received on termination of a negative covenant in a distribution contract were ordinary income.[203] The committee reports explain, "As to leases and distributor's agreements, this uncertainty is removed by expressly providing that cancellation constitutes an exchange."[204] Introducing section 1241 as a clarifying provision, Congress regarded it as a codification of "results [already] achieved in the courts at present" (*Starr Brothers* notwithstanding).[205] For example, a year earlier, the Third Circuit held in *Golonsky*[206] that amounts received by a lessee on cancellation of a lease were to be considered capital gains.

Section 1241 applies only to payments received by the lessee (and thus would seem not to apply to losses). Interestingly, the committee reports specify that the provision is not intended to overrule the Court's holding in *Hort*,[207] discussed in Part VI, that amounts received by the lessor in cancellation of a lease are ordinary income.[208] Here, then, we have an instance of Congress permitting a divergence of treatment between the parties to a contract, apparently on the conceptual ground that a lease is in the nature of a capital asset in the lessee's hands but not in the lessor's hands.

F. Summary

Section 1234A is unique among its progenitors in that it applies equally to rights and obligations, although it shares that trait with its much younger sibling, section 1234B.[209] The precursors of section 1234A seemed focused on the holders of capital assets. There's some indication that when they dealt with obligors (for example, sections 1233 and 1234(b)), they did so to avoid a specific resulting whipsaw or to address some other undesirable effect. Sections 1271(a) and 1241 deal with specific events (retirements and cancellations, respectively) relating to specific instruments (debt and leases/distributor agreements). Section 1233(a) is mechanically similar to section 1234A, although it applies only to a narrow class of transactions and only if underlying property is actually acquired and used to close a short sale.

Thus, section 1234 is for our purposes the most interesting precursor of section 1234A. And it is curious that sections 1234 and 1234A took such different approaches to the mechanics of their applications. For example, section 1234 applies (on the holder's side) to options with respect to any property, and treats gain or loss from the sale, exchange, or lapse of an option as if it were from property having the same character as the underlying property.[210] And section 1234 deals with holders and writers (long and short parties) very differently. Section 1234A, as we've seen, applies only to rights or obligations with respect to capital assets, but applies equally to either side of the transaction. It's unclear why these differing approaches were taken, given that the drafters of section 1234A (erroneously) assumed that the provision should apply to rights and obligations with respect to property, like section 1234. And it's unclear why the drafters of section 1234B in 2002 and 2004 modeled that provision on the basic mechanics of section 1234, without bothering to fix some of the obvious problems with section 1234A.

As this part illustrates, what is clear to me is that many different and often conflicting steps have been taken over the years to "solve" the extinguishment problem and that some of the resulting exigencies have led to a fractured set of rules addressing seemingly similar issues. The purposes of and reasons for some of these rules are better than those of and for others, and some of the rules work better than others at achieving their intended purposes. But it seems apparent that section 1234A isn't one of the brighter lights in the pantheon.

X. Conclusion

Section 1234A causes far more problems than it solves (if indeed it solves any). It treats all gain or loss from rights or obligations with respect to capital assets as capital gain or loss to ensure that those losses will be subject to the capital loss limitation (to avoid whipsaw) and, when appropriate, the straddle rules. But it's not obvious that the extinguishment doctrine, which created the whipsaw effect, ever needed to exist (at least in the case of instruments that are themselves capital assets in the taxpayer's hands). And the whipsaw effect can be avoided on the settlement of capital assets and almost all

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[202]204 F.2d 673 (2d Cir. 1953).

[203]S. Rep. No. 83-1622, at 444 (1954). ("Some doubt has arisen from the decision in *Starr Bros* . . . as to the application of the sale or exchange concept when a lease or distribution agreement is cancelled.")

[204]*Id.* at 444.

[205]*Id.* at 115.

[206]*Supra* note 84.

[207]*Supra* note 131.

[208]S. Rep. No. 83-1622, at 444 (1954). ("This section does not change the treatment of payments paid to a lessor as decided in *Hort*.")

[209]Section 1234B, however, took the added and ill-advised step of prohibiting long-term capital gain on short positions.

[210]Thus raising the unanswerable question: What is the character of an item of property, as opposed to that of the income or loss from its sale, exchange, or disposition? Is an option on the issuer's own stock treated by section 1234 as subject to section 1032? (I'm indebted to Sam Dimon for raising this question.) Is an option on a collectible taxable at collectibles rates?

liabilities without recourse to section 1234A, by virtue of the logic of Rev. Rul. 88-31 and section 1001. As for positions that aren't capital assets in the taxpayer's hands, many rules provide that gains or losses therefrom are capital, and any remaining holes in those rules should perhaps be filled in. As for straddles and loss limitations: (1) the integration and hedging rules should probably be broadened to eliminate some of the resulting problems, and (2) the capital loss limitation should also be revisited, and perhaps augmented by a derivatives loss basket rule. And as far as section 1234A goes, to decide whether it applies to something, first we must decide whether that something is a right or obligation with respect to a capital asset, which in many cases is the wrong question (as is the equivalent PWRATPP analysis in the straddle rules themselves). The wrong answer to that question will tend to eviscerate the straddle rules, as the interpretation in Rev. Rul. 2009-13 arguably does in the case of life insurance.

I don't know whether a derivative settlement should produce capital gain or loss, as a pure tax policy matter. I do know that it should do so if and to the extent that the sale or assignment of the derivative would (that is, it should under current law). Any rule performing this function (and capital asset hedging, including straddle and integration rules) should apply as broadly as possible to derivatives, whether linked to capital assets or to any index or indices to which capital assets are commonly linked. This latter concept needs to be very broad and flexible to adapt as the markets do. The differing approaches taken to achieving these results in sections 1233, 1234, 1234A, 1234B, and 1271 should be reconsidered and rationalized, and the special treatment of long-term ''short'' gains should be eliminated. And the SOI doctrine has to be clearly understood as a narrow exception to any of these rules, addressing only earned but as yet untaxed ordinary income at the time of a disposition.