

February 20, 2018

Eleventh Circuit Affirms Ordinary Income Treatment of Forfeited Deposits on Lapsed Sale of Real Estate

Eleventh Circuit Affirms Tax Court Ruling That Gain Attributable to Forfeited Deposits With Respect to Sale of Hotel Is Ordinary Income

SUMMARY

In *CRI-Leslie, LLC, Donald W. Wallace, Tax Matters Partner v. Commissioner of Internal Revenue*, 11th Cir., No. 16-17424, February 15, 2018, the Eleventh Circuit affirmed the Tax Court's earlier decision, holding that the taxpayer was required to recognize ordinary income—not capital gain—in respect of forfeited deposits relating to a lapsed contract for the sale of a hotel.¹ This decision rejects the position previously taken by many taxpayers that gain recognized with respect to forfeited deposits should be treated as capital gain, consistent with the treatment that would have applied had the sale been completed.

BACKGROUND

In *CRI-Leslie*, the taxpayer entered an agreement to sell land, a hotel and various improvements on the land. In connection with the agreement, the taxpayer received deposits from the buyer that would have been applied to the purchase price had the sale closed. Ultimately, however, the agreement was terminated and the taxpayer retained the deposits.

The taxpayer took the position that the property was subject to a specific set of generally taxpayer-favorable rules under Section 1231 of the Internal Revenue Code of 1986, as amended (the "Code"). These rules apply to real property used in a trade or business and held for more than one year, among other things. Under this regime, a taxpayer's net gains on the disposition of "Section 1231 property" in a

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given taxable year are treated as long-term capital gains, but if a taxpayer has net losses from the disposition of “Section 1231 property,” the losses are treated as ordinary losses.

Under Section 1234A of the Code, gain from payments on the termination of a contract to sell a capital asset is treated as capital gain. The taxpayer took the position—which we understand has been common practice—that since gain recognized on the sale of “Section 1231 property” is treated in the same manner as the sale of a capital asset, gain recognized on the lapse of a contract for the sale of “Section 1231 property” should follow this treatment as well. The IRS, however, asserted that Section 1234A does not apply to “Section 1231 property” because “Section 1231 property” is not technically a capital asset. Accordingly, the IRS argued that the taxpayer was required to treat the forfeited deposits as ordinary income.

In the original case, the Tax Court relied on a literal reading of the Code to hold that an asset that qualifies as “Section 1231 property” is not a capital asset, and therefore Section 1234A does not apply and, as a result, the taxpayer’s gain is ordinary.

THE ELEVENTH CIRCUIT’S DECISION

The Eleventh Circuit, reviewing the case *de novo* on appeal, applied essentially the same literal reading adopted by the Tax Court to conclude that an asset that qualifies as “Section 1231 property” is not a capital asset. The taxpayer again argued that this result runs contrary to the legislative history of Section 1234A, which indicates that Congress intended for similar economic transactions to be taxed in the same manner. The Court acknowledged that this argument was “not without foundation” and had attracted scholarly supporters as well, but ultimately rejected it.

IMPLICATIONS

The Eleventh Circuit’s affirmation of the Tax Court’s earlier decision rejects the otherwise common practice of treating “Section 1231 property” as a capital asset for purposes of determining the character of gain on a terminated contract. Taxpayers should therefore be aware that gain from the termination of a contract for real estate or other assets used in a trade or business and held for more than one year is more likely to be treated as ordinary income rather than long-term capital gain.

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ENDNOTES

- ¹ For additional background on the Tax Court's earlier decision, please see the Sullivan & Cromwell LLP publication entitled "[Tax Court Decision Addresses Tax Treatment of Forfeited Deposits on a Lapsed Sale of Real Estate](#)" (September 8, 2016), which may be obtained by following the instructions at the end of this publication.

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