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Characterization of Forfeited Deposits and Break Fees

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The distinction between "capital" gain or loss and "ordinary" income or loss is fundamental to our current income tax system. "Capital gain"—"gain from the sale or exchange of a capital asset"—is taxed more favorably to individuals than "ordinary income," while "capital losses" are of less tax benefit than "ordinary losses" (in part because, but for very limited exceptions, ordinary income cannot be offset with a capital loss). Real property used in a trade or business is excluded from the definition of "capital asset," but gain from such property's sale or exchange is nevertheless generally "treated as" capital gain.

Internal Revenue Code ("Code") section 1234A governs the character of gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to "property which is (or on acquisition would be) a capital asset." That provision has recently given rise to some surprising and unfavorable results.

Specifically, in a Tax Court decision (*CRI-Leslie, LLC v. Commissioner*, 147 T.C. No. 8 (2016)), section 1234A was determined not to apply to gain from the retention of deposits under a terminated contract to sell real property, and such gain was therefore characterized as ordinary income, even though the sale of the real property would have resulted in gain treated as long-term capital gain. Separately, in an IRS Office of Chief Counsel Memorandum (LAFA 20163701F, May 3, 2016), a loss attributable to the payment of a "break fee" incurred in connection with the termination of a corporate merger transaction was characterized under section 1234A as a capital loss.

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Background

Section 1234A was added to the Code in 1981 to treat as capital gain or loss "gain or loss attributable to the cancellation, lapse, expiration, or other termination" of rights with respect to actively traded personal property (such as stock or securities). The provision was substantially expanded in 1997 to cover rights with respect to all "property which is (or on acquisition would be) a capital asset in the hands of the taxpayer." But for section 1234A, extinguishment of a right would not generally be viewed as a "sale or exchange," and the gain or loss on such extinguishment would fail to fit the definition of "capital gain" or "capital loss." The legislative history of section 1234A indicates that the provision was intended to help ensure that certain transactions that were economically similar – for example, a loss from the sale of an option, as compared to a loss from the extinguishment of the option in a manner not constituting a sale or exchange – would be taxed similarly (S. Rep. No. 105-33 (1997), at 135).

CRI-Leslie, LLC v. Commissioner

In *CRI-Leslie*, a limited liability company ("LLC") owned a hotel in Florida, including the underlying land and related improvements. The hotel was managed by a third party. In 2008, which was the year at issue, LLC claimed deductions under Code section 162 (relating to expenses of a trade or business) for expenses relating to the operation of the hotel and depreciation deductions under Code section 167.

In 2006, LLC entered into a contract to sell the hotel for $39,000,000, and the buyer made $9,700,000 of deposits in connection with that contract. The buyer ultimately defaulted and the deposits were forfeited to LLC in 2008.

LLC reported the $9,700,000 of income resulting from the forfeiture of the deposits as long-term capital gain on its 2008 partnership return. The IRS issued a notice of final administrative adjustment characterizing that amount as ordinary income.

The case was submitted for decision by the Tax Court on a fully stipulated basis and without a trial. Among the stipulations were that the property to which the contract related was "real property used in a trade or business," as suggested by the nature of the deductions claimed by LLC, and that, if the property had been sold pursuant to the contract, LLC would have reported the gain as gain that could be "treated as" long-term capital gain.

Section 1234A on its face relates only to property that is (or on acquisition would be) a "capital asset" in the hands

of the taxpayer. Because the definition of "capital asset" in Code Section 1221(a) excludes "real property used in [the] trade or business," the property subject to the contract was not a "capital asset" in the hands of LLC. Therefore, the court concluded, section 1234A could not apply, and, as there had been an "extinguishment," rather than a "sale or exchange" of LLC's rights and obligations, LLC's gain was characterized as ordinary income.

LLC made a number of arguments, including that the legislative history of section 1234A indicated a congressional purpose to tax similar economic transactions in the same way; that a sale of the property would have resulted in gain taxed as capital gain; and, therefore, that the statute should be interpreted in a manner supporting treatment of income from the forfeited deposits as capital gain.

The court concluded, however, that the plain meaning of section 1234A made it inapplicable where the underlying property was not a capital asset, and that there was nothing in the legislative history amounting to a "clear and unambiguous expression of legislative purpose" that would justify an interpretation of the statute in a manner inconsistent with the plain meaning of the provision. It is not clear whether LLC drew the court's attention specifically to an example in the 1997 Senate Report (cited above) relating to the termination of a lease that, without mentioning the technical issue inherent in the statute, seems to apply the provision to a right relating to real property used by a corporation in a trade or business.

The Tax Court opinion also notes that the wording of a provision (section 1234) adjacent to section 1234A in the Code suggests that Congress was perfectly capable of expanding the applicability of a provision to cover gain "treated as" capital gain when it wanted to do so. Since section 1234A was not written in such an expansive fashion, it would not be applied in this case.

Observations: *CRI-Leslie* addresses an issue that has been of concern to practitioners for many years. The decision of the court does not seem surprising, but only time will tell whether a contrary result will be reached in similar circumstances by another court or whether the holding of *CRI-Leslie* will be overturned by legislative action.

LAFA 20163701F

Based on such facts as are set forth in the severely redacted memorandum, it appears that advice was requested from the IRS National Office regarding a "Taxpayer" that had entered an agreement to combine with "Target." Pursuant to the merger agreement, Taxpayer formed a new company as an initial step, and the stockholders of Target and Taxpayer were ultimately to receive stock in the new company or some other company, with Target and Taxpayer becoming subsidiaries of an entity having stock listed on an exchange.

Following the issuance of a notice by the U.S. Treasury that adversely affected the anticipated tax consequences of the merger transaction, Taxpayer's board withdrew its recommendation to its shareholders that the merger be approved, and the transaction was not consummated. Under the merger agreement, the withdrawal of the recommendation caused Taxpayer to be required to pay a fee to Target, and such a fee was ultimately paid pursuant to a second agreement between Taxpayer and Target to terminate the merger agreement. That "break fee" was Target's sole remedy for the abandonment of the merger transaction.

The circumstances did not suggest any doubt as to whether a loss in the amount of the break fee had been incurred by Taxpayer, and the memorandum responds affirmatively to the question directed to the National Office of whether the payment of the break fee gave rise to a capital loss under section 1234A.

The brief analysis in the memorandum states that the merger agreement provided Taxpayer with rights and obligations with respect to stock of Target and stock that was to be issued to stockholders of Taxpayer, and observes that stock is generally considered a capital asset. Presumably all such stock would be capital assets upon "acquisition" (as that term is used in section 1234A) if the stock had been acquired by the Taxpayer (although the memorandum does not focus on the incongruity of applying such a test when Taxpayer itself had neither the expectation nor the right to acquire stock of Target or of any resulting corporation).

Without much further analysis, the memorandum then states: "Consistent with the purpose of section 1234A, any gain or loss realized by Taxpayer on the termination of the contract, which provides Taxpayer with rights and obligations with respect to [redacted] stock, a capital asset, would be capital in nature. Therefore, section 1234A applies and Taxpayer's loss on paying the break fee is a capital loss."

Observations: In general, amounts expended by a would-be acquirer in pursuit of a transaction that does not ultimately close, and that does not otherwise result in any identifiable asset or benefit for the acquirer, are not required to be capitalized (see Reg. § 1.263(a)-5) and are deductible as an ordinary loss not later than the taxable period in which the transaction is abandoned (see, e.g., *Sibley, Lindsay & Curr Co. v. Commissioner*, 15 T.C. 106 (1950), and Rev. Rul. 73-580, 1973-2 CB 86). Where the matter goes beyond mere discussions and a taxpayer enters into an acquisition agreement that is ultimately not consummated, the LAFA illustrates that, in addition to the potentially greater expenditure—in the form of a break fee or other damages—associated with termination of such an agreement, the loss resulting from the termination may itself be a capital loss by reason of section 1234A.

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