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Subject: Jeffrey A. Galant and Dana L. Mark on *CRI-Leslie* - Musings on Plain Meaning, Absurdity and Capital Gain

"The importance of capital gain treatment may have lessened under the new tax law (PL 115-97)[i] due to the reduction in the corporate tax rate to 21% and the 20% pass through deduction.[ii] However, capital gain treatment is certainly still meaningful. That being said, a recent noteworthy case is CRI-Leslie, LLC v Commissioner.

CRI-Leslie found against capital gain treatment in a matter of first impression. However, the decision's greater importance may be its illustration of the methodology used by the courts to interpret the relevant Code provisions. Or, more to the point, whether the courts were justified in relying on the plain meaning rule rather than the legislative history in determining what the Code provisions mean."

Jeffrey A. Galant and **Dana L. Mark** provide members with commentary on *CRI-Leslie*, a case that teaches us much about statutory interpretation as well as which transactions deserve capital gain treatment.

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Here is their commentary:

EXECUTIVE SUMMARY:

"There is no surer way to misread any document than to read it literally. ... As nearly as we can, we must put ourselves in the place of those who uttered the words, and try to divine how they would have dealt with the unforeseen situation; and, although their words are by far the most decisive evidence of what they would have done, they are by no means final."

Learned Hand, J (concurring) *Guiseppe v. Walling*, 144 F2d 608, 624 (2d Cir. 1944)

Interpreting a statute is not necessarily a simple endeavor, especially when it concerns what income is afforded capital gain treatment. In this regard, it is important to know why the tax law provides a preferential rate for realized capital gains. However, this article will avoid that thicket other than to say that the preferential rate is thought to help the economy by incentivizing capital investment.[iii]

Construing the Internal Revenue Code, needless to say, can be a complex undertaking.[iv] As with other statutes, if the result of the interpretation of the Code would be socially undesirable or otherwise absurd, a more appropriate interpretation should be found.[v]

Generally, interpreting a Code provision, as with any statute, first requires consideration of the actual language. If the language is clear and unambiguous then its plain meaning would apply. If, however, the language is not clear, then it would be appropriate to examine other sources such as the legislative history.[vi]

But even when the language is clear,[vii] the so-called "plain meaning rule" will not apply if the outcome would be unreasonable or absurd.[viii] In such case a court would need to look beyond the language to determine the intent of the legislature or the purpose of the legislation.[ix]

Now, considering the matter at hand, the importance of capital gain treatment may have lessened under the new tax law (PL 115-97) due to the reduction in the corporate tax rate to 21% and the 20% pass through deduction. However, capital gain treatment is certainly still meaningful. That being said, a recent noteworthy case is *CRI-Leslie, LLC v Commissioner.*[x]

CRI-Leslie found against capital gain treatment in a matter of first impression. However, the decision's greater importance may be its illustration of the methodology used by the courts to interpret the relevant Code provisions. Or, more to the point, whether the courts were justified in relying on the plain meaning rule rather than the legislative history in determining what the Code provisions mean.

FACTS:

CRI-Leslie was a Florida limited liability company taxed as a partnership (hereinafter, the "Taxpayer"). On February 25, 2005, the Taxpayer acquired for $13.8 million the Radisson Bay Harbor Hotel in Tampa, Florida. The property consisted of land and improvements and included the hotel, Crabby Bill's Restaurant, a swimming pool, a parking lot, and landscaping (collectively, hereinafter referred to as the "Radisson").

After purchasing the Radisson, the Taxpayer hired a third party to manage the operations of the hotel and restaurant.

On July 10, 2006, approximately a year and a half later, the Taxpayer agreed to sell the Radisson to the buyer, RPS, LLC, for $39 million and received a down payment of $9.7 million.[xi] The agreement was revised and amended several times over the next two years, including an increase in the purchase price to $39.2 million. However, the sale collapsed in 2008 when the buyer defaulted on its obligation to close the transaction. As a result, the buyer forfeited the $9.7 million down payment.

The Taxpayer reported the $9.7 million as net long-term capital gain on its 2008 partnership income tax return.

The parties stipulated that the Radisson was real property used in the Taxpayer's hotel and restaurant business within the meaning of section 1221(a)(2),[xii] and, therefore, not a "capital asset". The parties further stipulated that the Radisson constituted "property used in a trade or business", as defined by section 1231(b)(1),[xiii] and, finally, that the Taxpayer would have realized capital gain pursuant to section 1231 had it actually sold the Radisson.[xiv]

COMMENT:

The issue before the Tax Court and the 11th Circuit, which was of first impression in each court, was whether the Taxpayer was entitled to capital gain treatment under section 1234A for its receipt of the $9.7 million payment as a result of the canceled sale.

Section 1221 defines capital assets as being all property except the types of property expressly excluded by that section. Assets so excluded include property used in a trade or business subject to the allowance for depreciation and real property used in a trade or business. However, section 1231 provides for capital gain treatment when such assets ("section 1231 property") are sold at a gain.

Inasmuch as the deal fell through, and the Radisson remained unsold, the tax treatment of the Taxpayer's receipt of the buyer's $9.7 million down payment is not governed by section 1231, but rather falls under section 1234A, which is titled "Gains or losses from certain terminations."

In relevant part, section 1234A provides as follows:

> 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 in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset.

Literally, then, gain realized[xv] upon the cancellation of a sale will be treated as capital gain, as if such gain was realized upon a sale, but only if the underlying property constituted a capital asset.

So the question is whether, upon the cancellation or termination of a sales agreement, capital gain treatment is precluded under section 1234A where the underlying property although not a capital asset qualifies as section 1231 property.[xvi]

Opinion is divided with respect to whether section 1234A means what it literally says. Legislative intent requires capital gain treatment in such circumstance says the commentators. For example, the 11th Circuit quotes Boris I. Bittker, Martin J. McMahon & Lawrence Zelenak, Federal Income Taxation of Individuals ¶ 32.01[4][b] (hereinafter, "Bittker II")[xvii] as follows:

> Congress concluded that ... payments related to the lapse, expiration, or other termination of a right or obligation with respect to a capital **(*or § 1231*)** asset should result in capital gain or loss. . . . (*emphasis added*).

The legislative intent conclusion is based upon the lack of a policy reason to distinguish between gain realized upon the sale of a capital asset and gain realized upon the sale of a section 1231 asset, since in each case capital gain treatment applies. And, therefore, there is no justification under section 1234A to distinguish between the gain realized upon the termination of a sales agreement based upon whether the underlying property is either a capital asset or section 1231 property.

Notwithstanding the clear legislative intent, the 11th Circuit and the Tax Court held to the contrary based upon the plain meaning rule.[xviii] According to the 11th Circuit, the rule requires that legislative intent be ignored no matter how compelling[xix] when the statutory language is clear on its face, so long as such language does not compel a ridiculous outcome.[xx] It would seem that the 11th Circuit was understating the absurdity exception. For example, in *United States v. American Trucking Associations* the Supreme Court stated that the exception applied if the outcome was merely unreasonable.[xxi]

It is a given that section 1234A expressly refers only to the case where the underlying property constitutes a "capital asset". Section 1231 property is not mentioned.

The 11th Circuit did not challenge the legislative intent of section 1234A as set forth in Bittker II, rather it held that it was not relevant where the statute was clear on its face[xxii] and the result was not absurd.[xxiii]

Why absurd? It would be nonsensical says the Taxpayer to treat the amount received on the cancellation of a sale of section 1231 property as ordinary income when the sale itself would result in capital gain treatment. Furthermore, the Taxpayer says that such disparate treatment would for no policy reason penalize taxpayers who were operating businesses as opposed to those who were passive investors.[xxiv]

It seems that the reason for the 11th Circuit's adherence to the plain meaning rule was its apparent fixation with the perceived benefits accruing to the Taxpayer from the cancelled sale.[xxv] According to Circuit Judge Newsom, since the Taxpayer, although not at fault for the cancellation, was reaping more than sufficient economic reward from the cancellation, the result was not absurd and, therefore, following the plain meaning of section 1234A, capital gain treatment was not warranted. Judge Newsom was obviously impressed by the fact that in addition to receiving $9.7 million as a result of the cancellation, the Taxpayer also retained ownership of the presumably quite valuable Radisson. Recall that the Taxpayer had acquired the Radisson in 2005 for $13.8 million and in 2006 it agreed to sell the Radisson for at least $39 million, a potential gain of around $25 million in little more than a year.[xxvi]

Judge Newsom's view clearly implies that if the Taxpayer had an economic loss on the transaction (for example, if it was shown that due to the financial crisis in 2008 the Radisson had substantially declined in value) perhaps the absurdity exception would have applied.[xxvii] This would be a strange application of the plain meaning rule. Also, it just does not seem reasonable in such circumstances to basically force a taxpayer to sell its section 1231 property which has declined in value.[xxviii]

Generally, a tax provision is not applied based on the plain meaning rule for one taxpayer and based on the legislative history for another. Uniformity, consistency and equal treatment of taxpayers are bellwether terms used in applying the Code. The plain meaning rule should either apply or not apply to the interpretation of a statute. Regardless, once a statute has been authoritatively interpreted, whether through the plain meaning rule or otherwise, its actual application may affect different parties differently.[xxix]

The Takeaway

Income realized on the sale of a capital asset is taxed as capital gain, and income realized on the sale of property used in a trade or business that qualifies as section 1231 property, is also taxed as capital gain. If the

taxpayer contracts to sell a capital asset and the buyer defaults leaving the taxpayer with the down payment, those proceeds are treated as capital gain under section 1234A. If the taxpayer is selling section 1231 property and the buyer defaults, logically the down payment proceeds should be treated as capital gain. However, neither the Tax Court nor the 11th Circuit accepts the syllogism because section 1234A says in plain English that the underlying property must be a capital asset. Is this the result Congress intended? Not likely, but until we have other Circuits weighing in on the issue, this is where things stand.

In the meantime, if practical, a taxpayer finding itself in such position should consider realizing a loss by selling the underlying property within the same taxable year that the cancellation payment was received.[xxx]

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Jeff Galant

Dana Mark

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CITATIONS:

[i] All section references are to the Internal Revenue Code of 1986, as amended ("Code"), unless provided otherwise.

[ii] See sections 11(b) and 199A(a), respectively.

[iii] For an elucidating discussion of these matters see Bittker & Lokken, Federal Taxation of Income, Estates and Gifts (Thomson Reuters/Tax & Accounting, 2d/3d ed. 1993-2018, updated February 2018 and visited on March 22, 2018 (hereinafter, "Bittker I") ¶¶ 3.5, 3.5.4, and 3.5.7.

[iv] An obvious example is the recently enacted 2017 tax legislation, PL 115-97.

[v] See e.g., *Riggs v. Palmer*, 115 N.Y. 506 (1889). In *Riggs v Palmer*, a much cited case, the New York Court of Appeals held that a bequest under a valid Will was not enforceable by the legatee because he murdered the testator. Although the applicable statute had no such prohibition, the court based its decision upon the common law and the social mores of the day.

[vi] "The text, structure, and the overall statutory scheme are among the pertinent 'traditional tools of statutory construction.'" See *Chamber of Commerce, et.al. v. United States Department of Labor, et.al,* Case:17-10238, 5th Circuit, March 15, 2018, quoting *Chevron U.S.A.., Inc. v. NRDC, Inc*., 467 U.S. 837, 843 n. 9 (hereinafter, "*Chevron*").

[vii] Sometimes what is clear to one person may be ambiguous to another. See, *Heen, Plain Meaning*, footnote 22 *infra*. In determining clarity, courts, recognizing the importance of context, will investigate legislative history. See footnote 7, *infra*. See also *Kohl's Department Store, Inc. v. Virginia Department of Taxation*, Record No. 160681, March 22, 2018, ("statute is ambiguous when its language is capable of more senses than one, difficult to comprehend or distinguish, of doubtful import, of doubtful or uncertain nature, of doubtful purport, open to various interpretations, or wanting clearness or definiteness, particularly where its words have either no definite sense or else a double one.")

[viii] *United States v. American Trucking Associations*, 310 U.S. 534 (1940). "In the interpretation of statutes, the function of the courts is easily stated. It is to construe the language so as to give effect to the intent of Congress. There is no invariable rule for the discovery of that intention. To take a few words from their context, and, with them thus isolated, to attempt to determine their meaning certainly would not contribute greatly to the

discovery of the purpose of the draftsmen of a statute, particularly in a law drawn to meet many needs of a major occupation.

There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient, in and of themselves, to determine the purpose of the legislation. In such cases, we have followed their plain meaning. When that meaning has led to absurd or futile results, however, this Court has looked beyond the words to the purpose of the act. Frequently, however, even when the plain meaning did not produce absurd results but merely an unreasonable one "plainly at variance with the policy of the legislation as a whole," this Court has followed that purpose, rather than the literal words. When aid to construction of the meaning of words, as used in the statute, is available, there certainly can be no "rule of law" which forbids its use, however clear the words may appear on "superficial examination." The interpretation of the meaning of statutes, as applied to justiciable controversies, is exclusively a judicial function. This duty requires one body of public servants, the judges, to construe the meaning of what another body, the legislators, has said. Obviously there is danger that the courts' conclusion as to legislative purpose will be unconsciously influenced by the judges' own views or by factors not considered by the enacting body. A lively appreciation of the danger is the best assurance of escape from its threat, but hardly justifies an acceptance of a literal interpretation dogma which withholds from the courts available information for reaching a correct conclusion. Emphasis should be laid, too, upon the necessity for appraisal of the purposes as a whole of Congress in analyzing the meaning of clauses or sections of general acts. A few words of general connotation appearing in the text of statutes should not be given a wide meaning, contrary to a settled policy, "excepting as a different purpose is plainly shown." [Footnotes omitted.]

Of course, in examining legislative history a court needs to weigh its reliability and accuracy. See, e.g., *Exxon Mobil Corp. v. Allapattah Services, Inc*., 545 U.S. 546 (2005).

[ix] The foregoing is but a summary from at least fifty thousand feet. The reader is referred to the vast amount of scholarly literature that is available regarding legislation and the interpretation of statutes. It is worth noting that in applying the plain meaning rule courts frequently look for context by examining the legislative history. See, e.g., Debra Lyn Bassett, *In The*

Wake of Schooner Peggy: Deconstructing Legislative Retroactivity Analysis, 69 U. Cin. L. Rev. 453, at footnote 304. " . . .However, a provision's 'plain meaning' does not always reflect legislative intent. See *Guiseppi v. Walling*, 144 F.2d 608, 624 (2d Cir. 1944) (Hand, J., concurring) ('There is no surer way to misread any document than to read it literally . . . .'). Thus the Supreme Court traditionally has reviewed the legislative history to ensure that 'its confidence in the clear [statutory] text did not misread the legislature's intent.' William N. Eskridge, Jr., *The New Textualism*, 37 UCLA L. Rev. 621, 627 (1990). . . . ."

[x] *CRI-Leslie, LLC v Commissioner*, 2018 U.S. App. LEXIS 3504 (11th Cir. 2018), affirming 147 T.C. 217 (2016). ("*CRI-Leslie"*).

[xi] Although the courts characterize the $9.7 million as a nonrefundable deposit, for convenience the amount is referred to herein as a down payment.

xii Section 1221(a) "In general. For purposes of this subtitle, the term 'capital asset' means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

*** (2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;"

[xiii] Section 1231(b). "Definition of property used in the trade or business. For purposes of this section—

(1) General rule. The term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year, which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,

(C) a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section 1221(a), or

(D) a publication of the United States Government (including the Congressional Record) which is received from the United States Government, or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by a taxpayer described in paragraph (5) of section 1221(a)."

[xiv] Apparently, the government would not stipulate that the taxpayer's receipt of the $9.7 million down payment as a result of the buyer's default was section 1231 gain.

[xv] The court decisions assume that the $9.7 million down payment is the gain for section 1234A purposes. Section 1234A is not a specimen of clarity. For example, it refers to "gain or loss attributable to the cancellation . . . ." How can there be a gain or loss when no sale or other disposition of property has occurred? See e.g., section 1001.

[xvi] An alternative argument that was belatedly raised by the Taxpayer, rejected by the Tax Court as not timely and given short shrift by the 11th Circuit, was that the "property" for purposes of section1234A referred to the Taxpayer's contract rights under the sales agreement rather than the Radisson. According to the argument, such contract rights would be considered a capital asset under section 1221 and, therefore, eligible for capital gain treatment under section 1234A.

[xvii] Note that Tax Court Judge Laro repeatedly refers to Bittker I when describing the interplay of sections 1221 and 1231. See Bittker I (3d ed. 2000) at ¶ 50.1 at 50-2. Also, at ¶ 47.3, at 47-29.

[xviii] For a scholarly defense of relying on legislative intent in interpreting the Internal Revenue Code see Mary L. Heen, *Plain Meaning, the Tax Code, and Doctrinal Incoherence*, 48 Hastings L.J. 771 (1997) ("*Heen, Plain Meaning*"). "The Supreme Court has turned increasingly to a "plain meaning" approach in statutory interpretation cases. (footnote omitted) This approach poses special dangers for tax law because of the rich range of contextual and policy considerations that inform the Internal Revenue Code. (footnote omitted)"

[xix] "In a contest such as we have here, between clear statutory text and (even compelling) evidence of sub- or extra-textual "intent," the former must prevail [citations omitted]." *CRI-Leslie*, 11th Circuit. It is noteworthy that although relying on the plain meaning rule both the 11th Circuit and the Tax

Court reviewed the legislative history of section 1234A. See footnote 7, *supra*.

[xx] See footnote 23, *infra.*

[xxi] See *United States v. American Trucking Associations*, at footnote 4, *Supra*. See, also, *Chevron*, which applies the reasonableness standard to an agency's interpretation of a statute that it administers.

[xxii] "Whether the language of a statute is ambiguous or not may depend upon the background and knowledge of the interpreter as well as the skill of the drafter. It may also depend upon the sources consulted to aid in interpretation." *Heen, Plain Meaning* at pp. 774-775.

"'When I use a word,' Humpty Dumpty said in rather a scornful tone, 'it means just what I choose it to mean — neither more nor less.'

'The question is,' said Alice, 'whether you can make words mean so many different things.'

'The question is,' said Humpty Dumpty, 'which is to be master — that's all.'" Lewis Carroll, *Through the Looking Glass and What Alice Found There*, Chapter 6, Macmillan, UK 1872.

[xxiii] "While '[t]here is an absurdity exception to the plain meaning rule,' it is necessarily 'very narrow,' *United States v. Nix*, 438 F.3d 1284, 1286 (11th Cir. 2006), and applies only when a straightforward application of statutory text would compel a truly ridiculous—or to use Justice Story's word, 'monstrous'—outcome. We are not in that ballpark here—particularly given that, when the sale fell through, CRI-Leslie got to keep not only the $9.7 million deposit (albeit at an ordinary-income tax rate) but also the Radisson Bay Harbor." *CRI-Leslie*, 11th Circuit.

[xxiv] It does seem illogical to exclude section 1231 property from capital gain treatment under section 1234A for another reason. That is, it is clear that Congress favors section 1231 property even more than it does capital assets since in the case of dispositions of section 1231 property it provided for ordinary loss treatment when there are net losses. Section 1231(a)(2).

[xxv] *Ibid*, footnote 23.

[xxvi] Sophistry may be at work here. Neither the legislative intent nor the plain meaning rule would seem to require an economic benefit analysis of the outcome in a particular case in construing the meaning of section 1234A. It would seem that the inquiry into whether the result of applying the plain

meaning rule is absurd or not should be focused on determining the potential outcomes and whether any of them makes no sense. For example, see *United States v. Kirby*, 74 U.S. 7 Wall. 482 (1868). “The common sense of man approves the judgment ***, ‘that whoever drew blood in the streets should be punished with the utmost severity’ did not extend to the surgeon who opened the vein of a person that fell down in the street in a fit. The same common sense accepts the ruling, *** that a prisoner who breaks prison shall be guilty of felony does not extend to a prisoner who breaks out when the prison is on fire – ‘for he is not to be hanged because he would not stay to be burnt.’"

[xxvii] In such case a taxpayer should consider disposing of the underlying property in order to realize an offsetting ordinary loss and thereby avoid the section 1234A issue altogether. Section 1231(a)(2).

[xxviii] *Ibid*.

[xxix] Although the tax consequences of the application of a Code provision may differ for different taxpayers, the meaning of the provision does not vary based on the identity of the taxpayer. For example, the sale of a painting by a collector will result in capital gain since the painting is a capital asset in the collector’s hands. To the contrary, when a dealer sells the same painting ordinary income will result since the painting is not a capital asset in the dealer’s hands (nor is it section 1231 property).

[xxx] *Ibid*. footnote 27.