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Federal Taxation

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by Robert Beard*

I. INTRODUCTION

The past year saw few significant tax cases decided in the United States Court of Appeals for the Eleventh Circuit.[1] However, the court did issue two interesting opinions: one dealing with the characterization of a real estate developer's gain as ordinary income and another dealing with a statutory interpretation question relating to the first-time homebuyer tax credit. These two cases, both reversals of the United States Tax Court, are discussed below.

II. REAL ESTATE DEVELOPER'S GAIN AS ORDINARY INCOME

In *Long v. Commissioner*,[2] the taxpayer was an individual who owned 100% of the stock of Las Olas Tower Co., Inc. (LOT). LOT's primary business activity was designing and developing a luxury, high-rise, residential condominium building known as the Las Olas Tower. The taxpayer consistently disregarded the existence of LOT by failing to file tax returns for LOT and reporting all of its income on his personal return.[3] The Internal Revenue Service (IRS) apparently acquiesced in this treatment.[4]

The land on which the Las Olas Tower was to be constructed was owned by the Las Olas Riverside Hotel (Hotel). In 2002, LOT and the Hotel entered into an agreement (Purchase Agreement) for LOT to purchase the land for a price of approximately $8.3 million with a

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1. For an analysis of federal taxation cases decided during the prior survey period, see Robert Beard, *Federal Taxation, Eleventh Circuit Survey*, 65 MERCER L. REV. 1013 (2014).
2. 772 F.3d 670 (11th Cir. 2014).
3. *Id.* at 672.
4. *See id.*

closing date of December 31, 2014. After entering into the Purchase Agreement, LOT began to develop the condominium project, including developing construction plans, getting zoning approvals, and marketing units to purchasers.[5]

Subsequently, the Hotel, which was under new ownership, terminated the Purchase Agreement. LOT promptly commenced litigation (Property Litigation) to enforce the Purchase Agreement.[6] In November 2005, LOT obtained a judgment requiring the Hotel to consummate the sale "within 326 days from the date of entry of the final judgment."[7] The Hotel was also required to pay monetary damages in an unspecified amount.[8] The Hotel appealed the judgment.[9]

During the pendency of the appeal, LOT entered into an agreement to sell its position in the Property Litigation to Louis P. Ferris, Jr. Ferris agreed to pay $5.75 million for the taxpayer's position as the plaintiff in the Property Litigation. This sale was consummated in September 2006. Ferris dismissed the lawsuit shortly after acquiring it.[10]

The taxpayer was obligated to make payments of approximately $3.96 million to a lender and his ex-wife. He reported the remaining amount received from the sale as ordinary income, but improperly omitted and claimed a deduction for cost of goods sold of approximately $2.4 million. The IRS asserted that the entire $5.75 million should have been reported as gross receipts. The IRS also adjusted the claimed cost of goods sold. In the tax court, the taxpayer asserted, among other claims, that the character of his gain recognized should be capital and not ordinary.[11]

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5. *Id.* at 672, 673.
6. *Id.* at 673.
7. *Id.*
8. Long v. Commissioner, 106 T.C.M. (CCH) 409, 411 (2013).
9. *Long*, 772 F.3d at 673.
10. *Long*, 106 T.C.M. (CCH) at 412. One interesting facet of this case that was not discussed by either court was the dismissal of the land sale litigation by the purchaser shortly after the taxpayer sold its position in the case. *See* Case Docket, The Las Olas Riverside Hotel Co. v. Ferris, No. 4005-827 (2006), *available at* http://199.242.69.70l/pls/ds/ds_docket. A review of the public docket of The Las Olas Riverside Hotel v. Louis P. Ferris, Jr., No. 4D05-4827, indicates that Ferris moved to voluntarily dismiss the litigation immediately after he was substituted for LOT as the plaintiff-appellee. *Id.* The Broward County land records (where the Hotel is located) do not indicate that the land was ever transferred to a purchaser. *See Official Records Search*, BROWARD.ORG, www.broward.org/recordstaxestreasury/records/pages/publicrecords-search.aspx (last visited Apr. 23, 2015). These facts raise the possibility that the payment from Ferris was in the nature of a settlement of the lawsuit and not a purchase of the underlying right to acquire the property.
11. *Long*, 106 T.C.M. (CCH) at 412. The taxpayer's other main claim in the tax court was that a workout arrangement entered into with a lender should have been regarded as a joint venture, with the result that some of the income earned with respect to the sale of

Long-term capital gains received by non-corporate taxpayers are subject to preferential tax rates. The Internal Revenue Code (I.R.C.) § 1222(3)[12] defines "long-term capital gain" as "gain from the sale or exchange of a capital asset held for more than 1 year."[13] Section 1221[14] defines the term "capital asset" as any property other than certain excluded types of assets.[15] Section 1221(a)(1) provides that inventory and other "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" (dealer property) are not capital assets.[16] Gain from the sale of dealer property is ordinary income.[17]

Depreciable, non-inventory property used in a trade or business is also excluded from the definition of capital assets, but § 1231[18] treats gain from the sale of such property, under certain conditions, as long-term capital gain unless the taxpayer has a net loss on such property for the taxable year.[19]

Finally, gain from the sale of certain property that would otherwise be classified as a capital asset can be treated as ordinary income if the property represents a right to receive future ordinary income.[20] The "substitute for ordinary income doctrine" was espoused in two United States Supreme Court cases where taxpayers sold contractual rights to receive ordinary income payments (in one case, payments under an above-market lease, and in the other case, mineral royalty payments) and claimed capital gain treatment.[21] A recent Eleventh Circuit decision held that the substitute for ordinary income doctrine applies where a payment is "essentially a substitute for what would otherwise be received at a future time as ordinary income."[22]

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the interest in the property litigation should have been allocated to the lender. *Id.* at 413. The tax court rejected this claim. *Id.* In the Eleventh Circuit, the taxpayer argued that the payment made to the lender under the workout arrangement was a deductible expense. *Long*, 772 F.3d at 674-75. This claim was also rejected. *Id.*

12. I.R.C. § 1222(3) (2012).

13. *Id.* Unless otherwise indicated, all "section" references are to sections of the Internal Revenue Code of 1986, as amended (the Code).

14. I.R.C. § 1221 (2012).

15. I.R.C. § 1221(a).

16. I.R.C. § 1221(a)(1).

17. *See Long*, 106 T.C.M. (CCH) at 415.

18. I.R.C. § 1231 (2012).

19. I.R.C. § 1231(a).

20. *See* Hort v. Commissioner, 313 U.S. 28, 32-33 (1941).

21. *See id.*; Commissioner v. P.G. Lake, Inc., 356 U.S. 260, 268 (1958).

22. Womack v. Commissioner, 510 F.3d 1295, 1299 (11th Cir. 2007) (quoting *P.G. Lake*, 356 U.S. at 265) (internal quotation marks omitted).

The scope of the definition of dealer property set forth in § 1221(a)(1) has been the subject of exhaustive litigation and commentary.[23] One context where issues frequently come up is real estate development.[24] Developers who purchase tracts of land and subdivide it into individual lots are often treated as dealers, as are condominium developers who construct a condominium and sell units to residents.[25]

Ultimately, the question of whether property is dealer property is a factual question that depends on a variety of factors.[26] One commonly cited list of factors identifies the following seven relevant criteria:

> (1) the nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales.[27]

The facts of *Long* called for this dealer analysis to be applied in an unusual context.[28] Long recognized gain by selling an interest in ongoing litigation, as opposed to real property.[29] Section 1221(a)(1) speaks of "property held . . . primarily for sale to customers."[30] In this case, should the "property" described in § 1221(a)(1) be the interest in the litigation or the underlying property?

The tax court's opinion glosses over this issue, concluding with no analysis that the character of the taxpayer's gain "depends upon whether [the taxpayer] intended to acquire the Las Olas Boulevard property for investment."[31] Thus, the court seems to have assumed that the § 1221(a)(1) test should be applied with respect to the underlying property.[32] The parties appear to have accepted this formulation in the

23. *See, e.g., Womack*, 510 F.3d at 1303-04.
24. *See, e.g.*, Graves v. Commissioner, 867 F.2d 199, 203 (4th Cir. 1989).
25. *See, e.g.*, Ferguson v. Commissioner, 53 T.C.M. (CCH) 864, 865 (4th Cir. 1987).
26. *See* United States v. Winthrop, 417 F.2d 905, 910 (5th Cir. 1969).
27. *Id.* at 910; *see also* Case v. United States, 633 F.2d 1240, 1245 (6th Cir. 1980) (offering a similar list of factors).
28. *See Long*, 106 T.C.M. (CCH) at 414-15.
29. *Id.* at 415.
30. I.R.C. § 1221(a)(1).
31. *Long*, 106 T.C.M. (CCH) at 414.
32. *Id.*

tax court proceedings, though they disagreed about what property the taxpayer ultimately hoped to acquire.[33]

The IRS took the position that the relevant property, which the taxpayer was attempting to acquire, was the completed condominium units in the fully constructed Las Olas Tower project. The taxpayer, on the other hand, claimed that he intended to sell the land immediately prior to commencing construction to another developer. For this reason, the taxpayer claimed that the undeveloped land should be the relevant property in the analysis.[34]

The tax court accepted the taxpayer's argument and concluded that the relevant question was whether the land itself would have been held as a dealer asset if acquired by the taxpayer.[35] The court concluded that it would have been dealer property.[36] Several factors supported this conclusion.[37]

According to the taxpayer's own testimony, his intention was to resell the land after performing the preconstruction development work. The taxpayer was engaged full-time in development work for the Las Olas Tower project before the commencement of the Property Litigation. The taxpayer arranged a number of presales of condominium units, and, even after he decided to sell the land prior to beginning construction, the facts indicated that he expected to make a profit primarily from his development efforts. The taxpayer, a full-time real estate developer, substantially improved the property and engaged in significant marketing efforts.[38]

Based on these factors, the tax court agreed with the IRS and held that the land would have been dealer property if it was acquired.[39] Therefore, gain from the sale of the interest in the Property Litigation was held to be ordinary income.[40]

The taxpayer appealed, and the Eleventh Circuit ultimately reversed the tax court on the capital gains issue.[41] At the tax court level, the IRS argued that the character of the taxpayer's gain should be determined by the taxpayer's purpose for holding the condominium units that he intended to construct eventually. The taxpayer argued, and the tax court agreed, that the character of the gain should be determined based

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33. *Id.*
34. *Id.*
35. *Id.*
36. *Id.* at 415.
37. *See id.* at 414.
38. *Id.* at 410, 414.
39. *Id.* at 415.
40. *Id.*
41. *Long*, 772 F.3d at 679.

on the holding purposes for the unimproved land that the taxpayer hoped to acquire.[42]

The Eleventh Circuit took a third view—that the relevant property was the taxpayer's right, pursuant to the court's judgment, to purchase the land for the Hotel in accordance with the terms of the Purchase Agreement.[43] Under this view, the only question was whether "Long entered into the [Purchase Agreement] with the intent to assign his contractual rights in the ordinary course of business."[44] Clearly this was not the case. Thus, the Eleventh Circuit concluded that the taxpayer disposed of a capital asset when he sold his interest in the litigation.[45]

The Eleventh Circuit's approach focused on an important aspect of the case that was glossed over by the tax court opinion.[46] There is an important qualitative difference between acquiring property and acquiring a contingent interest in the Property Litigation that could result in the eventual acquisition of such property.[47] The Eleventh Circuit was also correct to conclude that the taxpayer did not hold its interest in the Property Litigation "primarily for sale [of the litigation] to customers" as required by § 1221.[48] Nevertheless, it seems equally clear that the taxpayer *did* become the plaintiff in the Property Litigation primarily for the purpose of acquiring land that would then be subdivided and sold to customers in the ordinary course of his trade or business.[49] Should this fact mean that the interest in the Property Litigation should have been treated as dealer property? The Eleventh Circuit concluded that it should not, but its opinion gives the issue little analysis.[50]

The IRS made two secondary arguments against treating the taxpayer's gain as long-term capital gain.[51] First, it argued that the taxpayer's holding period in its right to purchase the land dated to September 13, 2006, when the trial court issued its judgment in favor of the taxpayer. Since that date was less than a year before the sale, the IRS argued that any capital gain should be considered a short-term

42. *Long*, 106 T.C.M. (CCH) at 414, 415.
43. *Long*, 772 F.3d at 676.
44. *Id.*
45. *Id.* at 677.
46. *See id.* at 676.
47. *See id.*
48. *Id.* at 675 (quoting I.R.C. § 1221(a)(1)).
49. *See id.* at 676.
50. *See id.*
51. *Id.* at 676-77.

capital gain.[52] The court rejected this argument, holding that the taxpayer's holding period extended back to at least March 2004, when the lawsuit was initially filed, and possibly back to 2002, when the Purchase Agreement was entered into.[53]

The IRS's second argument was that the taxpayer's gain was a "substitute for ordinary income" and should therefore be taxed as ordinary income.[54] The court held that the taxpayer's right to receive any income from the condominium project was too contingent for the sale to be a substitute for ordinary income.[55] In the court's words, "Long's rights in the [Hotel] property represented the potential to earn income in the future based on the owner's actions in using it, not entitlement to the income merely by owning the property."[56] The court's analysis of this issue is persuasive. As the court noted, the substitute for ordinary income doctrine is a judicial doctrine that is intended to apply when a taxpayer monetizes a right to receive future income payments that have more or less crystallized, though they may not have accrued under tax accounting principles.[57] The taxpayer in this case was very far from receiving any actual income from the Las Olas Tower project because he had not even acquired the land, let alone begun constructing the condominium units that would eventually be sold.[58]

III. FIRST-TIME HOMEBUYER TAX CREDIT

In *Packard v. Commissioner*,[59] the court dealt with a statutory interpretation question relating to § 36 of the Code[60] and its definition of a "first-time homebuyer."[61] Section 36 allowed for a credit of up to $8000 for first-time homebuyers who purchased a primary residence after April 9, 2008, and in most cases, prior to May 1, 2010.[62] The taxpayers, Robert Packard and Marianna Packard, were married on November 22, 2008. Marianna Packard owned her principal residence prior to the marriage and continued to own it through November 17,

52. *Id.* at 676.
53. *Id.*
54. *Id.*
55. *Id.* at 677.
56. *Id.* (emphasis omitted).
57. *Id.*
58. *Id.*
59. 746 F.3d 1219 (11th Cir. 2014).
60. I.R.C. § 36 (2012).
61. *Packard*, 746 F.3d at 1220.
62. *Id.*; *see also* I.R.C. § 36.

2009. Robert Packard rented his primary residence. On December 1, 2009, the Packards jointly purchased a new residence.[63]

Section 36(a) allows first-time homebuyers a credit of 10% of the purchase price of a principal residence.[64] Section 36(b) limits the amount of the credit to $8000 in most cases, or $6500 in certain cases.[65] Section 36(c), which was at issue in this case, defines the term "first-time homebuyer."[66] Under § 36(c)(1), an individual is a first-time homebuyer "if such individual (and if married, such individual's spouse) had no present ownership interest in a principal residence during the 3-year period ending on the date of the purchase of the principal residence to which this section applies."[67]

When the current § 36 was added to the Code in 2008, § 36(c)(1) was the sole category of first-time homebuyers.[68] With the Worker, Homeownership, and Business Assistance Act of 2009,[69] Congress expanded the availability of the first-time homebuyer credit by adding § 36(c)(6) to the Code, permitting certain long-time residents to qualify.[70] Under § 36(c)(6),

> [i]n the case of an individual (and, if married, such individual's spouse) who has owned and used the same residence as such individual's principal residence for any 5-consecutive-year period during the 8-year period ending on the date of the purchase of a subsequent principal residence, such individual shall be treated as a first-time homebuyer- . . . .[71]

Taxpayers who qualify as first-time homebuyers under § 36(c)(6) are allowed a maximum credit of $6500.[72]

The Packards claimed a first-time homebuyer tax credit of $6500 on their 2009 joint return. The IRS disallowed the credit. In the tax court, the IRS argued that the taxpayers failed to satisfy either prong of the definition of first-time homebuyer.[73] The taxpayers were not first-time homebuyers under § 36(c)(1) because Marianna Packard owned her primary residence for most of the three-year period leading up to the

63. Packard v. Commissioner, 139 T.C. 390, 391 (2014).
64. I.R.C. § 36(a).
65. I.R.C. § 36(b)(1)(A)-(D).
66. I.R.C. § 36(c); *see Packard*, 746 F.3d at 1220.
67. I.R.C. § 36(c)(1).
68. *See Packard*, 139 T.C. at 392.
69. Pub. L. No. 111-92, 123 Stat. 2984 (2009).
70. *Id.* at § 11(b).
71. I.R.C. § 36(c)(6).
72. I.R.C. § 36(b)(1)(D).
73. *Packard*, 139 T.C. at 391.

couple's purchase of their new home.[74] Likewise, the taxpayers were not first-time homebuyers under § 36(c)(6) because Robert Packard did not own his primary residence for any consecutive five-year period during the eight-year period prior to the purchase of the new home.[75] In essence, each taxpayer would have qualified under one prong or the other, but taken together, they did not literally qualify under either.[76]

The tax court concluded that Congress did not intend to require that each spouse in a married couple qualify as a first-time homebuyer under the same prong of § 36(c).[77] The court interpreted § 36(c) in light of its history.[78] Congress originally adopted § 36(c)(1) and clearly intended that both spouses would be required to satisfy § 36(c)(1) in order to qualify for the credit.[79] When the Worker, Homeowner, and Business Assistance Act of 2009 was passed, Congress intended, in the court's view, to expand the definition of first-time homebuyers to include long-term residents, but still require that both spouses satisfy one of the two prongs of § 36(c).[80] To achieve this end, Congress borrowed the "and, if married, such individual's spouse" parenthetical from § 36(c)(1) and added it to § 36(c)(6).[81] The tax court concluded that reading this parenthetical to require both spouses to qualify under the same prong would be contrary to the intent of Congress and "absurd."[82]

The IRS appealed the tax court's decision. The taxpayers, who were represented pro se in the tax court, did not participate in oral arguments or file a brief in the appeal.[83] The Eleventh Circuit took a more literal approach to interpreting § 36(c).[84] The court concluded, quoting the United States Supreme Court's opinion, *BedRoc Ltd., LLC v. United States*,[85] that the inquiry should "[begin] with the statutory text, and [end] there as well if the text is unambiguous."[86] Applying this standard, the court had little trouble concluding that § 36(c) unambiguously required both spouses of a married couple to satisfy the same

74. *See id.* at 392.
75. *See id.*
76. *See Packard*, 139 T.C. at 393.
77. *Id.* at 395.
78. *Id.* at 394.
79. *Id.*
80. *Id.* at 395.
81. *Id.* at 394-95 (internal quotation marks omitted); *see also* I.R.C. § 36(c)(6).
82. *Packard*, 139 T.C. at 394.
83. *Packard*, 746 F.3d at 1221.
84. *Id.* at 1222.
85. 541 U.S. 176 (2004).
86. *Packard*, 746 F.3d at 1222 (quoting *BedRoc Ltd., LLC*, 541 U.S. at 183).

prong of § 36(c) to qualify as first-time homebuyers.[87] The Eleventh Circuit also dismissed the tax court's conclusion that the outcome would be "absurd," stating,

> Here, the plain language in [§ 36(c) of the Code] makes clear Congress's intent to treat married couples as a single inseparable unit for purposes of determining first-time homebuyer eligibility. While the effect of enforcing the statute as written may seem inequitable in light of the facts of this case, it does not shock general moral or common sense.[88]

The Eleventh Circuit accordingly reversed the tax court's decision.[89]

The subject matter of *Packard* is of little practical interest, as the first-time homebuyer tax credit has now expired, but the approach taken by the two courts provides useful guidance for tax practitioners interpreting tax statutes. In interpreting the language of § 36(c), the tax court paid close attention to its understanding of the congressional intent behind the statutory language and, arguably, showed itself willing to strain the literal language of the statute to ensure that that intent was achieved.[90] In stark contrast, the Eleventh Circuit rejected the idea that a court should look beyond the language of a statute to infer congressional intent, unless the language is ambiguous or its literal interpretation "shocks the general moral or common sense."[91] The Eleventh Circuit's analysis in this case should be considered as a cautionary note before concluding that a counterintuitive, but literally unambiguous, provision can be disregarded as a statutory "glitch," even if there is evidence that the glitch was not intended.

87. *Id.* at 1222-23.
88. *Id.* at 1222.
89. *Id.* at 1223.
90. *See Packard*, 139 T.C. at 394-95.
91. *Packard*, 746 F.3d at 1222.