Forbes

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THE TAX LAWYER

Feb. 8 2012 — 6:08 am

Contract Cancellations Trigger Taxes

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If you cancel a contract and no money changes hands, do you have taxable income? It's counterintuitive, but you may. Most deposits don't count as income. But if you are holding a deposit from a buyer and the buyer forfeits it, that deposit is income to you. Even more clearly, if a contract is terminated and money changes hands you must consider how to report it.

These situations can be complex, as the IRS explains in IRS Chief Counsel Advice 201203013. The IRS considers deposits returned on termination of a purchase agreement. The returned deposit wasn't taxable—it was the buyer's ***own*** money—but ***interest*** earned on that deposit was.

Start with a key rule: any money or property you receive is presumed taxable unless you can prove it falls into a recognized exception. The burden is on ***you*** to prove it is nontaxable. So if you cancel a purchase contract and receive back your own money, is that income?

The IRS says no as long as you can prove you made the initial deposit and are getting your own money back. Whether it is a commercial or consumer matter, be as clear as you can in the documents. If buyer and seller sign contracts, there will probably be a document unwinding or terminating the contract. Whenever possible, address the tax issues there.

If the buyer is getting his deposit back, say so, and note that it simply is the return of the buyer's ***own*** money so not taxable. If money is paid for the buyer's inconvenience, damages, etc., consider what it is. In most cases it will be taxed.

Similarly, if the buyer is receiving interest on its deposit, that interest is taxed. The IRS is inclined to tax ***everything*** unless the termination document makes clear what is being paid and why. Nevertheless, the IRS can take notice of the surrounding circumstances and the nature of the money—like the taxpayer's own deposit—being returned.

If a payment on termination simply puts the taxpayer back in the position he was in before, that's not income. If the payment goes beyond it so there is an economic gain, that excess would be taxed. A payment to compensate for lost income would be taxed too.

How You Settle Matters. It can be tempting to simply bring your dispute to an end and let the tax chips fall where they may. But before you resolve it, consider the tax aspects. See Don't Fail To Consider Taxes When Settling Litigation. You have more flexibility to reduce taxes if you settle, especially if you negotiate with an eye on the tax rules. The IRS isn't bound by an agreement's wording, but it can help.

For more, see:

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