

A quarterly newsletter examining recent tax developments for the business professional.

“THROWING IN THE TOWEL” – TAX PLANNING OPPORTUNITIES ASSOCIATED WITH THE ABANDONMENT OF PROPERTY

Between the current credit crunch and the decline in property values, many companies are struggling, especially those heavily invested in real estate. As a result, many investors are asking themselves whether the time is right to “throw in the towel.” Although abandoning real property or an interest in a partnership gives rise to a host of legal and financial considerations, careful tax planning for such an “abandonment” can result in the ability to claim an ordinary loss for federal income tax purposes.

Internal Revenue Code (“IRC”) § 165 allows taxpayers to claim a deduction for any “loss sustained during the taxable year and not compensated for by insurance or otherwise.” In the case of individual taxpayers, the loss must be a business loss, a loss incurred in connection with a transaction entered into for profit, or a casualty or theft loss. IRC § 165(c).

In general, losses arising from a capital asset, such as a real estate project or a partnership interest, are capital losses that may only be used to offset capital gain. See IRC § 165(f). However, if a real estate project or partnership interest is “abandoned” for tax purposes, the taxpayer may be able to treat the loss as an ordinary loss and use it to offset ordinary income. *Id.*

An abandonment loss requires both an intent to abandon an asset and an affirmative act of abandonment. See, e.g., *Echols v. Comm’r*, 935 F.2d 703 (5th Cir. 1991). In addition, the loss must be “evidenced by closed and completed transactions, fixed by identifiable events, and ... actually sustained during the taxable year.” Treasury Regulation (“Treas. Reg.”) § 1.165-1(b). Whether an “abandonment” meets these requirements is determined on the basis of all of the facts and circumstances.

Unfortunately, the mere act of abandoning a capital asset does not guarantee that the resulting loss will be ordinary. In particular, taxpayers are not entitled to claim an ordinary abandonment loss if the transaction giving rise to the loss is treated as a sale or exchange for federal tax purposes. Treas. Reg. § 1.165-2(b). For these purposes, if a taxpayer receives any value as a result of the transaction, no matter how minimal and including the relief from or cancellation of all or any portion of a liability, the transaction will

be treated as a sale or exchange. Thus, involuntary foreclosure sales of real property and tax forfeitures of real property are considered a “sale or exchange.” See *L&C Springs Associates v. Comm’r*, T.C. Memo 1997-469. Likewise, the conveyance of real property by a deed in lieu of foreclosure or the abandonment of property subject to nonrecourse debt are treated as a “sale or exchange” for these purposes. *Id.*

When a taxpayer has invested in real estate projects through a partnership, abandoning the partnership interest may be a viable alternative to abandoning the real property. Nevertheless, if the abandoning partner receives any consideration, the abandonment will be treated as a sale or exchange and, consequently, will result in a capital loss. For these purposes, the IRS has made clear that any actual or deemed distributions (i.e., a reduction in the partner’s share of the partnership liabilities) from the partnership preclude capital loss treatment. Revenue Ruling 93-80, 1993-0 C.B. 239. Therefore, the abandoning partner cannot be relieved of any liabilities nor can his or her share of the partnership’s liabilities be reduced as part of the abandonment in order to claim an ordinary loss. In addition, an effective abandonment in these cases requires that the abandoning partner notify the other partners that he or she is abandoning his or her interest, that he or she does not intend to make any further capital contributions, and that he or she will no longer participate in the management of the entity.

Although a taxpayer’s ability to claim an ordinary loss upon abandonment of a real estate project or a partnership interest is subject to significant limitations, in some circumstances, careful planning can result in considerable tax benefits.

RECENT HIGHLIGHTS & HOT TOPICS

Recent Highlights & Hot Topics provides a brief summary of the latest breaking tax developments and happenings on a taxpayer-by-taxpayer basis.

INDIVIDUAL INCOME TAX: In a recent decision, Merrill v. Commissioner, T.C. Memo 2009-166, the Tax Court ruled that a same sex couple was not entitled to joint filing status. The case involved a same sex couple who, while living in a state that does not recognize same-sex marriages, participated in a commitment ceremony. The issue before the court was whether the taxpayers were entitled to file joint income tax returns. In reaching its decision, the Tax Court noted that the issue of whether a taxpayer is married for federal income tax purposes is determined under the laws of the state of the taxpayer's domicile. As the taxpayers' domicile did not recognize same-sex marriages, the Tax Court held that the taxpayers were not entitled to file joint income tax returns. Interestingly, the decision did not mention the fact that, even if state law permits a same-sex marriage, the federal Defense of Marriage Act does not permit same-sex couples to file joint income tax returns.

BUSINESS TAX/ELIGIBLE ENTITIES: In recently issued Revenue Procedure ("Rev. Proc.") 2009-41, the IRS again liberalized relief for late entity-classification elections. Pursuant to Rev. Proc. 2009-41, eligible entities now have 3 years and 75 days from the requested effective date of an initial classification election or a change in classification election to request relief for a late entity-classification election. In order to request late entity-classification relief, the eligible entity must file a Form 8832 within 3 years and 75 days of the requested effective date. The Form 8832 must state that it is being filed pursuant to Rev. Proc. 2009-41 and include a declaration that all of the requirements set forth in Rev. Proc. 2009-41 have been satisfied.

EMPLOYEE BENEFIT PLANS: According to two new Revenue Rulings (Rev. Rul. 2009-31 and Rev. Rul.

2009-32) employees are entitled to make annual contributions of their unused paid time off to a qualified retirement plan.

CIVIL TAX PENALTIES: In a letter to Congressional leaders dated September 24, 2009, IRS Commissioner Doug Shulman announced that the IRS will suspend its collection enforcement actions on IRC § 6707A penalties through December 31, 2009 for the failure to disclose a listed transaction with respect to smaller transactions. The transactions qualifying for the suspension are those where the annual tax benefit was less than \$100,000 for individual taxpayers or \$200,000 for other taxpayers.

TAX-EXEMPT ORGANIZATIONS: The IRS recently announced updated procedures for use by IRC § 509(a)(3) supporting organizations when requesting a change in their public charity classification. The new procedures can found in Announcement 2009-62.

REAL ESTATE TAX: In several recent Information Letters to Congressmen and Senators (Information Letter 2009-0063 and 2009-0066), the IRS reiterated its intent to provide relief to taxpayers who have been unable to timely complete a like-kind exchange due to the bankruptcy of their qualified intermediary ("QI"). Under current law, if a taxpayer fails to complete a timely like-kind exchange, even if that failure is due to the bankruptcy of the QI, the taxpayer is not entitled to defer the recognition of gain under IRC § 1031. In the Information Letters, the IRS indicated that it is sympathetic to the plight of real property owners who have been unable to complete a like-kind exchange due to the bankruptcy of their QI and that, given "current economic conditions, [the IRS is] considering the tax policy implications of current law and evaluating ... [its] authority in this area to issue administrative guidance."

Please be advised that this newsletter only provides brief descriptions of tax information of general interest and that any tax information contained herein was not intended and cannot be used for the purpose of: (1) avoiding penalties that may be imposed by the Internal Revenue Service; or (2) supporting, promoting, or marketing any transaction(s) or matter(s) addressed herein.

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