



April 24, 2013

Giving Up is Hard to Do: IRS Addresses Abandonment of Property Rules

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Many have heard that it is possible to abandon a failed investment in order to recognize a tax loss without actually selling the investment. For example, a partner in a partnership owning an underwater property might desire to abandon its partnership interest and recognize a loss. However, most people do not realize how hard that can be to accomplish! A recent memorandum by the IRS Office of Chief Counsel provides taxpayers with a reminder of the circumstances in which a loss may be recognized upon abandonment of property.

Background

Internal Revenue Code section 165 allows a deduction for “any loss sustained during the taxable year and not compensated for by insurance or otherwise.” In the case of an individual, this deduction is limited to (i) losses incurred in a trade or business, (ii) losses incurred in a transaction entered into for profit (although not connected with a trade or business), and (iii) certain casualty losses. A deduction for a loss under section 165 is allowable only in the year in which the loss is sustained. The amount of the deduction is equal to the taxpayer’s adjusted basis in the property.

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The Treasury Regulations provide that a loss recognized under section 165 must be “evidenced by closed and completed transactions, fixed by identifiable events, and ... actually sustained during the taxable year.” One way to have a “closed and completed” transaction generating a loss is for a taxpayer to abandon its property.

In order to establish the abandonment of an asset for purposes of claiming a loss under section 165, a taxpayer must show both (i) an intention to abandon the asset and (ii) an affirmative act of abandonment. Courts have held that the affirmative act of abandonment can be a statement to a third party where the statement is made in a context such that it demonstrates that the property is being abandoned (e.g., a case where a limited partner abandoned its partnership interest by making a statement about the abandonment at a meeting of the partners). A taxpayer does not need to formally divest itself of legal title to property in order to be considered to have abandoned the property.

IRS Chief Counsel Memorandum 20124603F

A recent field attorney advice memorandum issued by the IRS Office of Chief Counsel (FAA 20124603F) involved a taxpayer that had been the seller of “active adult homes in a golf course community.” The taxpayer (the “Taxpayer”) had entered into an agreement with the developer who owned the real

estate (the “Developer”) pursuant to which the Taxpayer would acquire developed lots from the Developer as completed and then sell them to the ultimate purchasers of homes in the community. The Taxpayer would also build an “amenity center” with money from the Developer. The Taxpayer paid the Developer an upfront deposit, a portion of which would be allocated to each property as transferred from the Developer to the Taxpayer. While heavy redaction in the IRS memorandum makes many of the facts difficult to discern, it appears that the project collapsed after events which included the death of the principal of the Developer. The Taxpayer stopped selling homes in the community, and did not recover any portion of the deposit that it had paid to the Developer.

The Taxpayer contended that, in the tax year in which it considered itself to have abandoned the project, it was entitled to recognize a deduction of an amount equal to the unused portion of the deposit that it had made. The Taxpayer supported this determination by asserting that it had terminated its selling efforts, closed the sales center, and ceased construction of the amenity center in that year. In addition, the Taxpayer contended that it had informed the Developer of its intent to “walk away” from the project (although the Taxpayer does not appear to have contended that it had informed the Developer of having actually walked away from the project).

The IRS disagreed with the Taxpayer, concluding that the Taxpayer had not yet abandoned the project and, as a result, could not recognize a loss with respect to the unused deposit that it failed to recover.

- The IRS based this determination on the fact that, notwithstanding the actions that the Taxpayer had taken in the year in question, continued negotiations between the Taxpayer and the Developer relating to the project demonstrated that the Taxpayer had not yet abandoned the project.
- The IRS also found it relevant that the Taxpayer had continued to provide services to existing homes which had already been sold.

- In addition, the IRS noted that the Taxpayer had continued to pursue litigation against the Developer throughout the year in question.

In light of the foregoing, the IRS determined that there had been no “closed and completed” transaction in the year in question and, as a result, the Taxpayer was not entitled to recognize a loss under section 165.

Character of an Abandonment Loss

Losses under Regulation section 165 are generally ordinary losses and it appears that, if the Taxpayer had been entitled to recognize its loss relating to the deposit upon abandoning the project, the loss would have been ordinary. However, it is important to recognize that, if a taxpayer receives any consideration in connection with an abandonment of property, the transaction would constitute a sale or exchange. In fact, it

appears that receipt of even a *de minimis* amount of consideration would cause a loss from the abandonment of a capital asset to be a capital loss from a sale or exchange. Thus, for example, in a case where the abandoned property is a partnership interest, a loss recognized by the taxpayer on the abandonment would be a capital loss from a sale or exchange if the partner is relieved of *any* nonrecourse debt of the partnership.

While the IRS’s conclusion in the field attorney advise memorandum may not be surprising, it provides taxpayers with a reminder that abandoning property for tax purposes may not be as simple as one would think. Taxpayers who are expecting an ordinary loss from an abandonment may be rudely awakened to the realization that their loss is a capital loss—or that they have no loss at all.

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