

Accelerating Losses with an Assignment for the Benefit of Creditors

When a flow-through entity for federal income tax purposes (such as a partnership or Subchapter S corporation) has losses, such losses are allocable to the entity's owners. If the owners have sufficient tax basis in their equity to utilize such losses and such losses are not otherwise limited by at-risk or passive activity loss rules, owners typically desire to accelerate the recognition of such losses because such losses may be able to reduce their income taxes for the year in which such losses are recognized or may generate a tax refund by being carried back to the two prior tax years under §172(b)(1)(A) of the Internal Revenue Code of 1986, as amended.¹

For developers and home builders, many of these losses are attributable to the economic downturn and financial troubles that commenced in 2006 and 2007. This article examines the impact of the differences in the timing of loss recognition events by a developer seeking to sell or otherwise transfer real estate assets, file bankruptcy or commence an assignment for the benefit of creditors (an ABC proceeding) or that is subject to a foreclosure action, and how an ABC proceeding may be modified to constitute an abandonment loss and accelerate the timing of the loss recognition event.

Income Tax Treatment for Developers

A developer is prohibited from depreciating real estate assets and must capitalize expenses with respect to such assets pursuant to I.R.C. §263A(b)(2). The requirement by a developer to capitalize expenses results in a deferral

of any deduction or loss to the developer until such real estate assets are transferred. Such real estate assets are considered as inventory and subject to ordinary income or loss when sold. If the fair market value of such real estate assets has decreased below the developer's adjusted tax basis, the sale or transfer of such assets will generally trigger an ordinary loss to the developer. If the developer has generated taxable income in the prior two tax years, such loss could be carried back on an amended tax return and would generate an income tax refund for the developer.

Timing of the Recognition of Loss Due to a Sale, Bankruptcy, or Foreclosure

The recognition of a loss resulting from a sale or other transfer occurs upon the closing of the event under I.R.C. §1001. However, the real estate closing event can be delayed due to many factors, including a lack of potential purchasers, unstable market conditions with declining real estate values, issues with a financial institution that may be funding a portion of the purchase price and due diligence, which could include an environmental audit and an appraisal if the purchase price is being financed by a financial institution. This delay results in a delay in the recognition of a loss. If the delay causes the sale to occur in a subsequent tax year, then the developer will lose the opportunity to carry back the loss to an earlier tax year that could have resulted in a larger tax refund.

The commencement of a bankruptcy does not create a loss recognition event for the developer pursuant to I.R.C. §1398.² The developer is treated as

continuing to own the assets contributed to the bankruptcy estate until the estate disposes of such assets. Accordingly, there is no recognition of a loss until such disposition occurs as is similar for a transfer occurring due to a sale or exchange of property. Although the bankruptcy sales process may be more accelerated than the typical non-bankruptcy sales process, it may still be delayed due to the appointment of a bankruptcy trustee, the marketing of real estate assets by the trustee, and the negotiations of a purchase and sale agreement by the trustee with an initial buyer followed by a bankruptcy auction of the real estate assets pursuant to 11 U.S.C. §363. This process can take between six to 12 months. If the §363 sale occurs in a subsequent year, then the developer will lose the opportunity to carry back the loss to an earlier year that could have resulted in a larger tax refund.

The recognition of a loss resulting from a transfer due to a foreclosure sale occurs upon the closing of such foreclosure sale under I.R.C. §1001. The developer has discharge of indebtedness income under I.R.C. §61(a)(12) equal to the difference between the debt being discharged and the fair market value of the real estate. The developer has an ordinary loss equal to the difference between the developer's adjusted tax basis in the real estate and the fair market value of such real estate. The winning bid in an auction held pursuant to the foreclosure sale may be helpful in determining the fair market value of the real estate. A foreclosure sale requires the holder of the mortgage to commence the foreclosure action, which could be delayed by a bankruptcy that could be

commenced either by the developer or other creditors of the developer. The foreclosure sale is the result of a judicial process that could also delay the timing of the loss recognition. If the foreclosure sale occurs in a subsequent year, then the developer will lose the opportunity to carry back the loss to an earlier year that could have resulted in a larger tax refund.

Timing of the Recognition of Loss Due to an ABC Proceeding

The recognition of a loss under I.R.C. §165(a) resulting from an abandonment occurs at the time of the abandonment. The developer need not sell the real estate assets, either voluntarily or through a bankruptcy or foreclosure sale, for an abandonment to occur. The developer must 1) have the intention to abandon the real estate assets, and 2) must take an affirmative act to evidence such abandonment.³ A taxpayer who abandons property held for use in a trade or business or in a transaction undertaken for profit is entitled to a loss based on the property's adjusted tax basis. For an abandonment to occur, the developer must also establish the following: the loss incurred in a trade or business or in an activity entered into for profit and the amount of the loss.

An abandonment generally results in an ordinary loss by the abandoning party. However, an abandonment will be treated as a capital loss resulting from a sale or exchange if the taxpayer receives any consideration in connection with the abandonment or the abandoned asset is a I.R.C. §1234A asset.⁴ These additional requirements make it difficult for the disposition of a capital asset via an abandonment to create an ordinary loss rather than a capital loss. Capital losses are less beneficial to a taxpayer than ordinary losses.⁵ However, these requirements do not delay the timing of the recognition of the loss by the developer due to an abandonment and do not cause the abandoned real estate to be treated as a capital asset or a capital loss for the developer. Such abandonment causes the developer to incur an ordinary loss.

For a developer attempting to abandon real estate assets to accelerate the recognition of loss to create a tax refund due to the loss carryback to the preced-

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ing two years, the key components are the intent to abandon and the affirmative act to evidence such abandonment. By modifying the sample form of the assignment shown in the Florida Statutes for an ABC proceeding, the developer can use the assignment of assets to the assignee in an ABC proceeding as an abandonment. Such planning accelerates the timing of the loss recognition to the date of such assignment, which will be much sooner than a sale, foreclosure, or bankruptcy confirmation.

The real estate that is being abandoned by the developer may be subject to outstanding, unpaid mortgages and may have a tax basis that exceeds such unpaid mortgage balance. Although the issue is not clearly resolved, the developer abandoning such real estate may choose to treat such unpaid mortgage as consideration received in the abandonment that would reduce the developer's loss rather than as discharge of indebtedness income.⁶

Avoiding the Grantor Trust Rules in an ABC Proceeding

In order to abandon the real estate assets, the developer cannot maintain any interest, domain, or control in such assets after the abandonment. The sample form of assignment in an ABC proceeding pursuant to F.S. §727.104(b) provides as follows: "If all debts and liabilities are paid in full, any funds of the estate remaining shall be returned to the assignor." Such provision would hinder a developer's abandonment for tax purposes because the developer has

retained a right to any excess residual proceeds. This right to residual proceeds could cause the ABC to be treated as a grantor trust in which the developer would not sustain a loss recognition event until the property is sold or abandoned by the assignee.⁷ By waiving any opportunity to receive residual proceeds of the property transferred to the assignee in the ABC proceeding, it is unlikely that the IRS can argue that the assignee is a grantor trust created for the benefit of the developer.

Modifications to Sample Form of Assignment and Disclosure to IRS

In order for an ABC proceeding to result in an abandonment loss allowing acceleration of the recognition of a loss by the developer, the form of assignment should be modified as follows:

The Assignor hereby disclaims and abandons all rights in the assets being assigned herein to the Assignee, including without limitation, any funds in the Estate remaining after payment in full of all debts and liabilities. The Assignor desires that this Assignment and the proceedings commenced under Chapter 727, Florida Statutes, (a) constitute an abandonment loss for federal income tax purposes under Section 165(a) of the Internal Revenue Code of 1986, as amended, (b) clearly evidence Assignor's intent to abandon the assets of the Estate and (c) result in an affirmative act of abandonment and relinquishment of possession, control and ownership of the assets of the Estate. All rights, title, claims, interest and income to the assets of the Estate are irrevocably assigned to the Assignee who will act in accordance with Chapter 727, Florida Statutes, and not as an agent or trustee for the Assignor.

This modification eliminates the assignor's residual rights created under F.S. §727.104(b), and can be used by the developer to establish his or her intent and affirmative act of abandonment as required under Treas. Reg. §1.165-1(b).

There is not a significant amount of tax law addressing abandonment losses. Accordingly, a taxpayer may choose to disclose the abandonment loss on Form 8275 to minimize the imposition of possible penalties under I.R.C. §6662(d)(2)(B) for substantial understatement of income tax. A sample disclosure of an abandonment loss is as follows:

Disclosure on Form 8275 as to Code Section 165(a) Abandonment Loss

Insert a description of the developer and the economic factors leading to the abandonment. Also attach a copy of the assignment from the ABC and specifically set forth the

paragraph that describes the release and waiver of any residual right.]

Section 165(a) of the Internal Revenue Code of 1986, as amended (the Code), permits a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise. The loss must be evidenced by a closed and completed transaction, fixed by identifiable events. Treas. Reg. §§1.165-1(b) and (d). A loss incurred in a business, or in a transaction entered into for profit, and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed a deduction under Code Section 165(a) for the taxable year in which the loss is actually sustained. *FRGC Investment LLC v. Commissioner*, T.C. Memo 2002-226; *Chevy Chase Land Co. v. Commissioner*, 72 T.C. 481, 487 (1979); Treas. Reg. §1.165-2(a). To be entitled to an abandonment loss, a taxpayer must show 1) an intention on the part of the owner to abandon the asset and 2) an affirmative act of abandonment. *United States v. S.S. White Dental Manufacturing Co.*, 274 U.S. 398 (1927); *A.J. Indus., Inc. v. United States*, 503 F.2d 660, 670 (9th Cir. 1974); *Middleton v. Com'r*, 693 F.2d 124 (11th Cir. 1982), *aff'g* 77 T.C. 310 (1980); and *CRST Inc. v. Commissioner*, 92 T.C. 1249, 1257 (1989), *aff'd* 909 F.2d 1146 (8th Cir. 1990).

All liabilities attributable of the Taxpayer encumbering assets that were subject to the Assignment have been included as proceeds derived from the disposition of such property and reduced the Taxpayer's basis in such assets. *Freeland v. Com'r*, 74 T.C. 970 (1980); and *Middleton v. Com'r*, 693 F.2d 124 (11th Cir. 1982), *aff'g* 77 T.C. 310 (1980). By commencing the Assignment for the Benefit of Creditors proceeding and filing the Assignment that relinquished, disclaimed, and abandoned all of its rights in its assets, the Taxpayer (a) showed its intention to abandon all of its assets and (b) took an affirmative act of abandonment. Accordingly, the Taxpayer is entitled to an abandonment loss under Code Section 165(a). In that the Taxpayer was a developer and the disposition of its assets pursuant to the Assignment was not a disposition of capital assets under Code 1221, Code Section 165(f) is not applicable.

Conclusion

During this difficult economic period, developers and home builders will be looking to generate cash from sources other than the development of real estate, including recognition of loss to be carried back to a prior tax year to generate an income tax refund. If the equity in real estate assets has deteriorated and the developer is considering accelerating the loss recognition event with respect to the disposition of such assets, tax counsel and accountants to the developer should consider using

an ABC proceeding to effectuate such acceleration of the loss recognition event via an abandonment loss under I.R.C. §165(a). The assignment by the developer to the assignee in the ABC proceeding should be modified as referenced above to eliminate any residual benefits to the developer which could cause the ABC proceeding to be taxed as a grantor trust rather than an abandonment loss. Due to the lack of tax law

addressing an abandonment loss and to minimize potential penalties for substantial understatement of tax income, the developer may consider disclosing the abandonment loss on Form 8275 in a manner as set forth above. □

¹ Earlier this year, the Senate had proposed to increase the period for which losses could be carried back from two years to four years. That provision did not pass as part of the Housing and Economic Recovery Act

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of 2008. Accordingly, any losses incurred in 2008 can only be carried back to 2006 and 2007. If a taxpayer had net income in 2006 but did not have any net income in 2007 or 2008, it becomes critical for the taxpayer to take steps to cause such losses to be recognized in 2008 rather than in 2009 so that such net operating loss (NOL) can be carried back by the taxpayer to 2006 and used to generate an income tax refund. If the loss recognition event does not occur until 2009, then the taxpayer that did not have any net income in 2007 and 2008 would not derive any benefit from the two-year loss carryback under I.R.C. §172(b)(1)(A) and could not use the NOLs to create an income tax refund for taxes paid in 2006.

² I.R.C. §1398 is only applicable to an individual debtor in a liquidating bankruptcy under Ch. 7 or a reorganization under Ch. 11. See I.R.C. §§1398(a) and 1398(b)(2). However, the principle that the filing of a bankruptcy does not trigger a loss recognition event should apply to the bankruptcy filing of a partnership or Subchapter S corporation.

³ TREAS. REG. §1.165-1(b). See also *United States v. S.S. White Dental Manufacturing Co.*, 274 U.S. 398 (1927); *A.J. Indus., Inc. v. United States*, 503 F.2d 660, 670 (9th Cir. 1974); *Chey Chase Land Co. v. Com'r*, 72 T.C. 481 (1979); *CRST, Inc. v. Com'r*, 92 T.C. 1249, 1257 (1989), *aff'd*, 909 F.2d 1146 (8th Cir. 1990); and *Echols v. Com'r*, 935 F.2d 703, 706 (5th Cir. 1991), *reh'g denied*, 950 F.2d 209 (5th Cir. 1991).

⁴ An I.R.C. §1234A asset is either 1) a right or obligation (other than a securities futures contract, as defined in I.R.C. §1234B) with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer, or 2) an I.R.C. §1256 contract (as defined in §1256) not described in paragraph one, which is a capital asset in the hands of the taxpayer. The disposition of an I.R.C. §1234A asset shall be treated as gain or loss from the sale of a capital asset. Real estate owned by a developer that is held by the developer for sale to customers in the ordinary course of his or her trade or business is not a capital asset in the hands of the developer. See I.R.C. §1221(a)(1).

⁵ Capital losses for corporations are limited to capital gains pursuant to I.R.C. §1211(a) and for individuals are limited to capital gains plus \$3,000 per year pursuant to I.R.C. §1211(b). In addition, under I.R.C. §1221(10), net capital losses must be offset against capital gains which are only subject to a maximum capital gains rate of 15 percent for individuals.

⁶ See *Freeland v. Com'r*, 74 T.C. 970 (1980); and *Middleton v. Com'r*, 693 F.2d 124 (11th Cir. 1982), *aff'g* 77 T.C. 310 (1980). Note that if the developer's adjusted tax basis in the real estate is less than the outstanding unpaid balance of the mortgage, no loss would be triggered upon the abandonment of such asset.

⁷ See G.C.M. 39368 (Feb. 21, 1984) (In that case, the issue was whether a fund that was set aside for the benefit of creditors during a

bankruptcy reorganization of the debtor was taxable as a trust under I.R.C. §641. G.C.M. 39368 concluded that the fund was taxable as a trust under I.R.C. §641). Further, TREAS. REG. §1.641(b)-2(b) provides that the estate of an individual or corporation in receivership or a corporation in bankruptcy is not a taxable entity separate from the person for whom the fiduciary is acting. I.R.C. §673 provides that a grantor shall be treated as the owner of any portion of the trust in which he or she has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust. I.R.C. §677 provides, in pertinent part, that the grantor shall be treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party, is, or, in the discretion of the grantor or any nonadverse party, or both, may be distributed to the grantor, or held or accumulated for future distribution to him or her. TREAS. REG. §1.677(a)-1(d) provides that a grantor is treated as the owner of a portion of a trust whose income is or may be applied in discharge of a legal obligation of the grantor. See also *Matter of Cusato Bros. Intern., Inc.*, 750 F.2d 887, 891 (11th Cir.), *cert. denied*, 472 U.S. 1010 (1985) (with respect to a liquidating trust); *In re Donald L. Sonner*, 53 B.R. 859 (1985) (with respect to a bankruptcy proceeding); and *Stockton v. United States*, 335 F. Supp. 984, 986 (C.D. Cal. 1971) (with respect to an ABC proceeding in which the taxpayer retained the right to receive the residual proceeds after payment of claims by creditors).

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This column is submitted on behalf of the Tax Section, David Pratt, chair, and Michael D. Miller and Benjamin A. Jablow, editors.