AUGUST 2008 TAX SERVICES NEWSLETTER

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This issue of the WKBK&Y newsletter addresses:

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1. Tax Treatment of Losses from an Abandonment or Worthlessness of a Partnership Interest—Capital or Ordinary

INTRODUCTION

With the October 15 tax filing deadline approaching, we are reproducing this article, originally printed in our November 2007 edition, which discusses the availability of a tax deduction resulting from either the abandonment or worthlessness of a partnership interest. Notwithstanding the general guidance provided below, it is important to recognize that the tax implications of abandoning or declaring a partnership interest worthless can be different for each partnership and partner. Accordingly, it is recommended that you review each particular partnership situation with your client.

DISCUSSION

Partners can offset the losses they incur from partnerships by abandoning interests and claiming a loss under IRC Sec 165(a). This code qualifies an individual to a deduction for losses obtained upon abandonment or from a property's worthlessness. Generally, investors are entitled to a deduction for losses provided that they do not receive insurance reimbursement or any other compensation for the losses. The loss is recognized for a deduction only for the taxable year in which it was incurred. Moreover, closed and completed transactions, and identifiable events should be provided as evidence for the loss. In claiming a loss deduction, taxpayers should also determine the point at which the property became worthless or abandoned, and whether the loss should be characterized as ordinary or capital.

Depending on a partner's financial position, it may be more advantageous simply to abandon his or her interest than contribute additional cash to a failing enterprise. However, to succeed in claiming a loss deduction, several tax issues must be addressed. The issues include the point at which the property became worthless or abandoned, and whether the loss should be classified as ordinary or capital. An analysis of case law provides some guidance in making these determinations.

Statutory Authority

Generally, a taxpayer is entitled to a deduction for losses sustained upon the abandonment, or from the worthlessness of property, provided he or she is not reimbursed by insurance or given some other compensation for the loss. The loss is allowed for a deduction only for the taxable year in which it is sustained, and it must be evidenced by closed and completed transactions and fixed by identifiable events. The taxpayer is entitled to a loss equal to the adjusted basis of the property. For individuals, such losses are deductible only if incurred in a trade or business, in a transaction entered into for profit, or from casualty or theft.

Generally, a loss allowed under IRC Sec. 165(a) is an ordinary loss because a capital loss results from the sale or exchange of a capital asset. Therefore, even in the case of capital assets, the loss may still be characterized as ordinary because abandonment or worthlessness is not a sale or exchange.

If the taxpayer receives some form of consideration for abandoning the asset, regardless how nominal the consideration, the transaction becomes a sale or exchange, and the loss is a capital loss. Additionally, if the abandoned asset is encumbered by a liability and relinquishment of the asset relieves the taxpayer of the liability, the transaction is considered a sale or exchange, any loss is a capital loss subject to IRC Secs. 1211 and 1212. Pursuant to IRC Sec. 1211, a taxpayer may deduct capital losses only to the extent of capital gains incurred during the year plus up to an additional $3,000. Given this limitation on capital loss deductions, it is usually more beneficial to characterize the loss as ordinary rather than capital.

While a partnership may not be prepared to abandon its assets, courts have permitted a partner to abandon his or her partnership interest or claim a loss from its worthlessness. Unfortunately, there is very little statutory authority regarding the conditions or method under which a partner is allowed to claim a deduction for the abandonment or worthlessness of a partnership interest. However, two cases make it clear that a partner (limited or general) may abandon a partnership interest and claim a loss not to exceed the unrecovered basis of the partnership interest. In Echols v. Commissioner, (935 F 2d 703, 1991) the Fifth Circuit Court of Appeals reversed the judgment of the Tax Court and allowed Echols, a general partner in a real estate partnership, to deduct a loss from the abandonment of his partnership interest. In Citron v. Commissioner, (97 TC 200, 1991) the Tax Court permitted Citron, a limited partner, to deduct his unrecovered investment in a partnership as an abandonment loss and addressed the issue of how such a loss is characterized.

The Echols Case

Prior to 1974, John C. Echols owned a 37.5% interest in a partnership known as Freeway. An identical interest was owned by Scott Mann with the remaining 25% partnership interest owned by Joe Smith. Freeway's only

asset was an unimproved tract of land in Houston, Texas. Mann obtained a loan (guaranteed by Echols) for the down payment on the property. The remainder of the purchase price was financed by the seller of the land on a nonrecourse basis. Freeway planned to resell the land at a profit, based on a new highway proposed to be built adjacent to the land, which Freeway's partners expected would attract development to their property.

In May of 1976, Echols called a meeting of the partners, at which time he informed them he would not continue to make his share of the mortgage payments, or the ad valorem tax payments on the land. Echols offered to convey his interest in Freeway to anyone who would "step forward and assume his portion of the nonrecourse payment obligation," but no one showed any interest. By this time, the fair market value of the land was less than the principal balance of the outstanding mortgage. Subsequent efforts to restructure the debt failed, and efforts to sell the land ceased. The land was foreclosed on by its mortgagees in February 1977.

Echols claimed a capital loss deduction from the abandonment of his partnership interest. The Tax Court denied the deduction, focusing on the lack of identifiable steps taken by the partnership to manifest its abandonment of the land. However, the Fifth Circuit reversed the decision, noting that the Tax Court failed to make two very important distinctions in analyzing the case. First, this case involves the income tax returns of Mr. and Mrs. Echols as individual taxpayers, not those of the Freeway partnership. The second distinction was between "abandonment" and "worthlessness." Either concept can justify a deduction pursuant to IRC Sec. 165(a) under the proper circumstances. Each is separate in theory. The elements of one are separate and distinct from the other and must be addressed separately. The Tax Court and the IRS failed to recognize these distinctions that resulted in a reversible error. In reversing the Tax Court decision, the Court did not address, or even acknowledge, that Echols had claimed a capital loss rather than an ordinary loss.

There is no requirement that a taxpayer relinquish title to an asset to establish a loss if such loss is reasonably certain in fact and ascertainable in amount. However, the Tax Court focused on Freeway's abandonment of the real estate and not, as was required, on Echols' abandonment of his interest in the Freeway partnership. The Court concluded the Tax Court was clearly in error by taking this approach. Therefore, the Court considered the facts surrounding Echols' abandonment of his interest in the partnership.

Focusing on the actions of Echols, the Court concluded he had sufficiently manifested his intent to abandon and did in fact abandon his partnership interest in 1976. He was entitled to a loss deduction under IRC Sec. 165(a). The Court ruled that to establish an abandonment loss, the taxpayer must manifest an intent to abandon by some overt act or statement reasonably calculated to notify a third party of the abandonment. As noted by the Tax Court, conveyance or even tender of title is not necessary to consummate an abandonment. The announcement by Echols at the partnership meeting, combined with the overt act of refusing to make further mortgage and tax payments, comprised a clear indication to others he was relinquishing his partnership interest and were sufficient to establish the abandonment.

The Tax Court entirely failed to address the issue of worthlessness, which is an alternate ground for a loss deduction under IRC Sec. 165(a). As an alternative holding, the Court concluded the facts found by the Tax Court evidenced the worthlessness of the partnership interest to Echols, thereby qualifying him for a loss deduction on the grounds his interest was worthless. While the abandonment test is objective, the test for

worthlessness is based on a combination of objective and subjective criteria. To illustrate the subjective nature of worthlessness as a tax term, the Court quoted James Russell Lowell, "one man's trash is another man's treasure."

The Court used a two-prong test to determine if Echols was entitled to a loss deduction for worthless property. First, Echols must have determined subjectively during 1976 that his partnership interest had become worthless during that year, and, second, it must be objectively true the interest was essentially valueless to Echols at that time. The fact the interest might be of value to some other investor, or determined to be worthless in an earlier year is irrelevant. Unlike abandonment, the timing of worthlessness is largely a judgment call by the taxpayer based on his own particular circumstances, including the tax effects of any decision.

The Court concluded that when Echols took a loss deduction on his amended tax return for 1976, he manifested his subjective determination that his interest in the partnership had become worthless in that year. He also manifested his subjective determination of worthlessness at the partnership meeting when he acknowledged the fair market value of the partnership's only asset was less than the mortgage owed on it, declared he would no longer contribute funds to the partnership, and tendered his interest to anyone free of charge. To determine if Echols had met the second prong of the test, the Court looked to the fair market value of the land that was less than the outstanding mortgage on it. This satisfied the court that the property was essentially valueless.

Just as a taxpayer is entitled to exercise his or her own judgment in the timing of an overt act of abandonment, he or she is also entitled to exercise the same judgment in determining when an asset is worthless to him or her, provided it can reasonably be shown the asset was in fact valueless at the time selected to claim a loss deduction. Valueless does not require an asset's value to decline to or below zero in the year a taxpayer elects to make a loss deduction under IRC Sec. 165(a). It should be noted only a bona fide loss is allowable, substance and not mere form shall govern in determining a deductible loss.

The Citron Case

Citron borrowed $60,000 and, along with three other limited partners, invested in a partnership formed to produce a motion picture. The partnership did not borrow any money. A completed film was produced, but a controversy developed with the executive producer about who had rights to the negative. The partnership was unable to obtain the negative, and although it possessed a copy of the film, only poor quality reproductions could be made. The general partner a corporation, decided to make an X-rated film from the copy. At the partnership meeting in 1981, Citron and the other limited partners advised the general partner they would have nothing to do with an X-rated film, and voted to dissolve the partnership. At that time, the partnership had no liabilities, and Citron made it clear he wanted nothing further to do with the partnership. He then reported an ordinary loss for his investment in the venture for that year on the grounds of theft or embezzlement (due to the withholding of the negative), or in the alternative, abandonment.

The IRS argued the loss occurred from a sale or exchange and should be characterized as capital loss and

limited to $3,000 for 1981. However, the Tax Court (the Court) held the loss was by virtue of abandonment and not theft or embezzlement. It also held it was an ordinary loss and not a capital loss.

The court contrasted the result with other cases where partners were deemed to have incurred capital losses when they were relieved of partnership liabilities in connection with abandonment of their interest. Consequently, the Court found Citron did manifest his intent to abandon his interest by voting to dissolve the partnership and expressing to the partners his intent not to contribute additional funds or be associated with an X-rated movie production. Therefore, the Court allowed Citron to claim a loss deduction as an abandonment loss.

To reach this determination, the Court focused essentially on the same elements as did the Fifth Circuit Court in its review of Echols. Accordingly, the Court had to determine the character of the loss. If no consideration is paid to the taxpayer, the loss is generally all ordinary loss because there is no sale or exchange of the partnership interest. If the taxpayer is relieved of liabilities, the debt relief constitutes consideration in exchange for the partnership interest, and the loss is a capital loss. The Court, in the context of the IRC of 1954 and precedent in other courts, decided abandonment of a partnership interest was not a sale or exchange and could be accorded ordinary rather than capital loss treatment. The Court, however, stated abandonment could be deemed as a sale if the partner's share of partnership liabilities was decreased. In this case, the partnership had no outstanding liabilities.

Citron's victory must be viewed with caution -- i.e., the victory is not exactly cause for celebration. The Tax Court specifically limited its ordinary-loss holding to situations where there are no partnership liabilities. In that event the taxpayer does not receive anything of value, so the abandonment is not a sale or exchange.

The Treatment of Partnership Liabilities

When a partner abandons an interest in a partnership, IRC Sec. 752(b) may apply In accordance with this section, a decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities due to the assumption of such liabilities by the partnership, is treated as a distribution of money to the partner by the partnership. The partner's share of liabilities in the partnership is reflected in the adjusted basis of the partner's interest in the partnership.

Nonrecourse Debt

If a partner shares a portion of the partnership's nonrecourse debt, an abandonment of the partnership automatically reduces his or her share of the liabilities to zero, resulting in a distribution under IRC Sec. 752(b). Additionally, if the partner has claimed deductions in excess of capital contributions, the distribution resulting from the reduction of the share of liabilities will generate a capital gain because the distribution will exceed his or her basis in the partnership interest. Therefore, a taxpayer must carefully weigh the benefits of any distribution upon abandonment against the tax effect of such distributions. Depending on a taxpayer's circumstances, it may be more advantageous to avoid any type of distribution from a partnership upon abandonment to claim an ordinary loss deduction under IRC Sec. 165(a).

Recourse Debt

The encumbrance of partnership liabilities by recourse debt indicates withdrawal of a general partner from a partnership will not automatically relieve the partner of his or her share of partnership liabilities. Therefore, barring some expressed arrangement that relieves the abandoning partner of his or her share of partnership liabilities, the withdrawal does not trigger a deemed distribution under IRC Sec. 752(b). Accordingly, the partner is entitled to an ordinary loss deduction for abandonment under IRC Sec. 165(a).

If a partnership is declared bankrupt, whether IRC Sec. 752(b) applies to the withdrawal of a partner depends on the disposition of partnership liabilities. If there is no relief of liabilities, the withdrawal of the partner should not subject him or her to IRC Sec. 752(b), and no distribution will have been deemed to occur. So long as there is no other consideration paid to the withdrawing partner, the loss should be characterized as ordinary. However, if partnership liabilities are paid or assumed in connection with liquidation of the partnership, IRC Sec. 752(b) applies, resulting in deemed distributions, and an loss incurred is considered capital.

Limited Partners

Generally, limited partners have no obligation to contribute additional capital to the partnership and therefore do not bear the economic risk of loss for any partnership liability. Accordingly, withdrawal from a partnership cannot relieve the limited partner of liabilities since he or she had no obligation to service any partnership liabilities. However, if a partner whether limited or general, could be required to make a contribution to the partnership or a payment to a creditor to discharge a partnership liability, the partner may be considered to bear the economic risk of loss. In this case, the limited partner must be careful to avoid any debt relief or other compensation for withdrawal from the partnership if he or she wants to claim an ordinary loss deduction. Additionally, a limited partner must weigh the tax advantages of including a share of the partnership liabilities in basis, against the tax effects such a decision has, should he or she want to withdraw from the partnership.

On November 10, 1993, the IRS issued Rev. Rul. 93-80, which discusses the issue of classification of loss on the abandonment or worthlessness of a partnership interest. The ruling gives a fact pattern in two situations to illustrate when such a loss might be ordinary or capital. In Situation 1, the partnership had nonrecourse debt at the time of abandonment by one of three general partners of an interest in the partnership. In Situation 2, a limited partner with no responsibility for any of the partnership's liabilities similarly abandoned an interest.

The ruling concluded that where a partner abandons an interest in a partnership that has liabilities in which the partner shares -- as in Situation 1 -- upon abandonment a deemed distribution of that partner's share of the liabilities is made. IRC Sec. 731(a) applies, and the loss is capital in nature. In Situation 2, where the partner did not benefit from a reduction in liability, there is no distribution and the loss is ordinary.

Rev. Rul. 93-80 also states that the IRS will no longer follow Rev. Rul. 76-189 which denied ordinary loss

treatment to the abandonment of a partnership interest even though no distribution was made or deemed to have been made. Rev. Rul. 93-80 also serves to clarify and supersede Rev. Rul. 70-355, which concluded ordinary loss treatment was appropriate with regard to a partnership interest without discussing the relevance of partnership liabilities.

It is uncommon for a partnership not to have liabilities. If that is the case, or the partner's basis does not include any partnership liabilities, IRC Sec. 752(b) does not apply. Under these circumstances, providing there is no consideration paid to the abandoning partner, Citron indicates the partner is entitled to an ordinary loss.

<u>2. Accrual Accounting of Rebate Offers – CCA 200826006</u>

Facts

Taxpayer is a retailer of consumer products which uses the accrual method of accounting. Taxpayer offers a rebate program to its customers whereby a retail customer pays the full retail price at checkout but receives a rebate offer for a stated amount. If the customer timely and properly submits the requisite rebate request form, Taxpayer issues a check to the customer in the amount of the rebate offer.

Based on experience, Taxpayer estimates that it pays or redeems only X% of the total rebate offers. For financial accounting and tax accounting purposes, Taxpayer records the purchase price by subtracting from the gross receipt X% of the rebate offer. When a rebate expires, Taxpayer records income equal to the amount of its previously estimated rebate payment. Similarly, if a rebate request is timely submitted, Taxpayer reduces its gross receipts by an amount equal to the difference between the face amount of the rebate offer and Taxpayer's earlier estimated rebate payment.

Issue

Whether Taxpayer's method of accounting for its cash rebate liability is permitted under Regulations section 1.461-4(g)(3).

Holding

Taxpayer's method of accounting for its cash rebate liability is not permitted under Regulations section 1.461-4(g)(3).

Law

The amount of any deduction or credit must be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income. (Code § 461(a).) Under an accrual method of accounting, a liability is incurred and taken into account for tax purposes in the year in which all events have occurred that (1) establish the fact of the liability; (2) the amount of the liability can be determined with reasonable accuracy; and (3) economic performance has occurred with respect to the

liability. (Code § 461(h); Regs. § 1.461-1(a)(2)(i).) This "all events test" is not met any earlier than when economic performance occurs. (Code § 461(h)(1).)

If the liability of a taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property or money or as a reduction in the price of goods to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to which the liability is owed. (Regs. § 1.461-4(g)(3).)

Analysis

Taxpayer's method of accounting for the cash rebates is expressly prohibited by Regulations section 1.461-4(g)(3). Taxpayer may not treat its liability for a cash rebate as incurred prior to payment of the cash rebate.

Taxpayer attempted to argue that the rebate offer was a trading stamp or premium coupon, the value of which is excludable under the accrual method of accounting pursuant to Regulations section 1.451-4(a)(1). IRS rejected this argument because a single-coupon rebate is really a "discount coupon" rather than a "premium coupon," which refers to coupons intended to be collected and redeemed in large numbers for a single product.

Taxpayer also tried to apply a case, Texas Instruments, Inc. v. Comm'r, 98 T.C. 628 (1992), in which the taxpayer offered a rebate program nearly identical to that at issue in CCA 200826006. In that case, the Tax Court held that the proofs of purchase that were part of the purchased goods and that were required to be submitted to the taxpayer to entitle consumers to a rebate, were coupons under Regulations section 1.451-4. However, the issue of the distinction between a discount coupon and a premium coupon was not at issue in Texas Instruments, and the opinion predated the economic performance rules of Code section 461. Accordingly, IRS determined that the case had no precedential value to Taxpayer's situation.

Because Regulations section 1.461-4(g)(3) clearly controls Taxpayer's situation, the IRS held that its method of accounting was invalid.

3. Two Bills in Congress to Reform the Estate Tax

Two bills are currently before the Congress—one in the Senate (S. 3284) and one in the House (H.R. 6499)—which would permanently change the Estate Tax.

H.R. 6499 would set the lifetime exemption at $2 million, indexed for inflation, and adopts other reform, such as the reunification of the estate and gift taxes. The bill would increase the applicable exclusion for the gift tax to $2 million (from $1 million) to match the gift with the estate tax. The exclusion amount for the estate tax would also be increased by any unused exclusion from a deceased spouse. The bill would impose an estate tax rate of 45% on estates between $1.5 and $5 million, 50% for estates between $5 and $10 million, and 55% for estates over $10 million. The bill would also provide for a return to the state death tax credit, as opposed to the deduction which was implemented in its stead in 2001. The provisions of the bill would take

effect in 2009.

S. 3284 would permanently fix the lifetime estate tax exemption at $3.5 million, indexed for inflation, and impose a top marginal rate of 45%. Essentially, the bill would freeze the exemption amount and marginal rate in the current Code applicable to 2009. This bill would not, as does H.R. 6499, reunify the estate and gift tax exemptions—the gift tax exemption amount would remain at $1 million. However the top gift tax rate would only be 35%. The bill would also amend current law, which requires the use of the gift tax rates at the time of the gift and instead apply a gift tax rate equal to that in effect at the time of the decedent's time of death.

The Senate Finance Committee has held a hearing on its bill in April, but the House Ways & Means Committee has not held a similar hearing. While it is not anticipated that either bill will pass prior to the November election, congressional discussion of the bills will elucidate congressional attitudes on amendment proposals. Practitioners have anticipated and speculated for some time that the current estate tax structure would be amended prior to 2010, and these are likely the first steps in that direction. WKBKY will follow these and any related bills and report on major developments or trends.

4. IRS Considering Benefits for Private Trust Companies Serving as Trustees

IRS has issued a proposed revenue ruling that would provide a number of benefits to families that own all or part of a private trust company ("PTC"). The ruling would give family members much control over a family trust while also minimizing exposure to estate, gift, and generation-skipping transfer taxes.

Since the ruling is only proposed at this point, it is premature for taxpayers to rely too much on its holding. The purpose of the ruling is to provide the same benefits to the use of a PTC as a taxpayer could achieve directly. The IRS will be accepting public comments until November 4, 2008.

Background

Husband and Wife establish separate irrevocable trusts for the benefit of each of their three children and grandchildren. Each child or grandchild is the primary beneficiary of his/her respective trust. Only the grantors make contributions. Each trust instrument give the trustee discretionary authority to distribute trust income and principal to the primary beneficiary over his/her life. Each primary beneficiary has testamentary power to appoint the trust corpus to or for the benefit of one or more family members or charities.

In Situation 1, Pecs are governed by state law, which requires the PTC establish a discretionary distribution committee ("DDC"). There are no restrictions on who can be a member of the DDC, but no family member on the DDC may make discretionary distribution decisions with respect to any trust of which that person is either a grantor or beneficiary or to whom he or she owes an obligation of support.

In Situation 2, no statutes govern the formation or operation of a PTC, but the PTC's governing document imposes the same restrictions and rights as the statute in Situation 1.

Notice 2008-63

Under the proposed revenue ruling, neither the appointment nor service of the PTC as trustee will, by itself, cause the value of the family trust's assets to be included in the grantor's or beneficiary's gross estate under Code sections 2036, 2038 or 2041. A grantor or beneficiary who is also an owner, shareholder, manager or employee of a PTC will not be subject to estate tax under these sections merely because of their position in or relationship to the PTC.

The proposed ruling would provide that the value of property transferred to a trust of which a PTC is a trustee in either situation will not be deemed to be completed gifts for Code section 2501 gift tax purposes. Distributions will not be deemed to be a gift by any member of the DDC. In addition, the proposed ruling would provide that a PTC's trustee status will not by itself subject that trust to GST taxes.

WKBKY Takeaway

This proposed ruling is important because it provides family members the flexibility to retain control over trust investments and discretionary distributions without triggering negative estate, gift, or GST tax consequences. Assuming the ruling, or something substantially similar is issued by the IRS, the most important thing is to ensure that the requisite restrictions are in place for these benefits to be reaped. Though not explicit in the proposed ruling, failure to comply with these restrictions will likely trigger substantial tax consequences due to the extent of the grantor's control over the distributions. So, for any clients considering use of PTC as part of their estate plan, proper drafting is absolutely vital, or at the very least, verification that the state's PTC statute, if any, conforms to the standards of the proposed ruling.