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Using - And Not Losing - Tax Losses, Part 2 (Slides)

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Using – and Not Losing – Tax Losses

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Why is this topic important to my clients or my company?

- The economy continues to sputter.
- Significant systemic, company and individual financial distress.
- Profits, under GAAP, in many cases continue to be poor.
- Taxpayers are generating substantial losses – realized and unrealized.
- Traditional lending sources aren't.
- Taxpayers are searching for cash – from any and all sources.
- Yet, many taxpayers in prior years paid significant taxes.
- This creates an interesting opportunity . . .

Overview: Net operating losses

- The net operating loss (NOL) rules: §172(b).
- If available, an NOL carry back claim is a relatively quick way to generate cash flow through the recovery of prior federal income taxes.
- General rules:
  - Historic rule of §172(b)(1)(A) : NOLs generally may be –
  - Carried back 2 years, and carried forward 20 years.
  - Elective rule of §172(b)(1)(H): For losses in 2008 or 2009, NOLs may be carried back 5 years.
  - §172(b)(1)(H)(iv): Carry back to 5^{th} preceding year limited to 50% of taxable income.
- Will elective rule be extended to losses in 2010?

Overview: Net operating losses

- Mechanics of the NOL carry back claim.
- Individuals: Form 1045, *Application for Tentative Refund*.
- Corporations: Form 1139, *Corporation Application for Tentative Refund*.
- Timing, Part 1.
  - General rule: Forms 1045 or 1139 must be filed within one year of the end of the year in which the loss arose.
  - Exception: If electing a 3-, 4- or 5-year carry back for a loss incurred in 2009, the taxpayer has until the extended due date of the 2009 tax return for filing Forms 1045 or 1139.
- Miss the deadline? Alternative is filing Forms 1040X or 1120X, as appropriate.

Overview: Net operating losses

- Timing, Part 2.
  - Forms 1045 and 1139: Carry back claims, on average, seem to be processed through the IRS Centers in about 8 – 10 weeks or so.
  - Amended returns on Forms 1040X and 1120X seem to be taking significantly longer.
- Caveat: Refund claims are subject to possible subsequent examination and review by the Joint Committee on Taxation (refund amounts of more than $2 million).

Overview: Net operating losses

- Joint Committee jurisdiction over the refund claim may have collateral – and unintended – consequences.
  - Taxpayer, NYSE-listed company, files refund claims to carry back its NOL.
  - Refunds require Joint Committee review and approval.
  - Separately, carry back years are under IRS exam.
  - Form 8-K: "As previously disclosed, the company reached a settlement with the IRS on the audit of its 2004 and 2005 federal income tax returns, which settlement was subject to review by the Joint Committee on Taxation. The company received a letter from the IRS communicating that the IRS Appeals Office cannot enter into the settlement on the basis reached in the post-appeals mediation. The company currently is considering its options."
  - Corollary question: What should a company disclose and when?

Compare: Capital losses

- In contrast to NOLs, consider the rules for capital losses.
- General rules: §1212.
- Corporations: §1212(a) –
- Capital loss carry back 3 years; and
- Capital loss carry forward 5 years.
- Individuals: §1212(b) –
- No capital loss carry back; but
- Unlimited capital loss carry forward.
- What's the lesson? Another reason why choice of entity matters!

Monetizing tax losses: Some of the statutory traps

- §§1221 and 1231: Character of the asset sold.
- §§ 61 and 1001: Fully taxable disposition.
- §§ 267 and 707: The related party rules.
- § 469: Passive activity rules (huh?).
- Watch the potential disconnect: Many states have decoupled from the federal NOL rules – the state carry back rules very well may differ.

First step: Character of the property

- Sale of a capital asset, as defined in §1221(a), generally results in a capital gain or loss.
- Recall that §1221 is an exclusionary definition.
- Thus, everything is a capital asset unless it meets one of the exclusions. Principal carve-outs (not capital assets):
  - Stock in trade or inventory or property held for sale in the ordinary course of the taxpayer's trade or business.
  - Depreciable property used in a trade or business.
  - Real property used in a trade or business.
  - Intangibles created by the taxpayer's personal efforts.
  - Receivables acquired in the ordinary course of a trade or business.

First step: Character of the property

- Can the taxpayer convert capital loss to ordinary loss by abandoning the property?
- General rule: Abandonment results in an ordinary loss.
  - *Rev. Rul. 57-503*, 1957-2 C.B. 139.
  - Rationale: No sale or exchange.
- Exception: Sale or exchange if the property is encumbered.
  - Recourse debt: *Rogers v. Commissioner*, 103 F.2d 790 (9th Cir. 1939)(*cert. denied*).
  - Nonrecourse debt: *Rev. Rul. 78-164*, 1978-1 C.B. 264; *Milledge L. Middleton*, 77 T.C. 310 (1981), *aff'd*, 693 F.2d 124 (11th Cir. 1982).

First step: Character of the property

- Abandoning a partnership interest.
- No partnership liabilities in the partner's basis? No sale or exchange, ordinary loss.
  - *Rev. Rul. 93-80*, 1993-2 C.B. 239.
  - *B. Philip Citron*, 97 T.C. 200 (1991).
- Partnership liabilities in the partner's basis? Sale or exchange, no ordinary loss.
  - Liability relief is a constructive distribution under §752(b).
  - *Andrew O. Stillwell*, 46 T.C. 247 (1966).
  - *Rev. Rul. 93-30*.

Second step: Sale or exchange

- The transaction between the buyer and seller needs to be a taxable disposition – a recognition event and not a deferral transaction.
- The benefits and burdens of ownership of the asset must shift to the buyer.
- Yes, this sounds oh so simple, but consider:
  - §351(a) transfers to corporations;
  - §721(a) transfers to partnerships;
  - §1031 like-kind exchanges;
  - Financing arrangements;
  - Options; and
  - Guarantee arrangements.

Second step: Sale or exchange

- Disguised sales under §707(a)(2)(B) are still sales!
  - Documentation questions.
  - Consistency between contracting parties.
- Complicating things: The "cake" factor – having it and eating it, too.
- Taxpayer wants to recognize the loss, but not surrender the upside to the asset . . .

The "cake" factor: Change in form of ownership – S corporation

- Sam the Shareholder owns all the stock of an S corporation.
- S corporation owns a single, economically depreciated asset that is not a capital asset.
  - Example: Land held for development.
  - Example: Inventory that may not be price competitive.
- Sam wants to trigger a loss, but retain ownership of the asset.
- What happens if Sam liquidates the S corporation?

The “cake” factor: Change in form of ownership – S corporation

- §§336 and 337: Fully taxable loss on liquidation.
- The S corporation realizes and recognizes the loss, which passes through to Sam.
- Deemed sale of the assets for fair market value.
- Here, the assets are NOT capital assets – loss is ordinary.
- Sam gets fee title to the assets in liquidation.

The “cake” factor: Change in form of ownership – S corporation

- Things to consider:
- Liability risk and insurance considerations.
- Practical consideration: What if Sam isn’t the sole shareholder?
- Interpose a Qualified Subchapter S Trust (§1361(d))?
- Use separate shareholder single member limited liability companies?
- Resulting tenancy in common?
- Liquidation-reincorporation doctrine.

The "cake" factor: Change in form of ownership – C corporation

- Carl the Shareholder owns all the stock of a C corporation.
- C corporation owns a single, economically depreciated asset that is not a capital asset.
- Example: Land held for development.
- Example: Inventory that may not be price competitive.
- Carl wants to trigger a loss, but retain ownership of the asset.
- What happens if Carl liquidates the C corporation?

The "cake" factor: Change in form of ownership – C corporation

- §§336 and 337: Fully taxable loss on liquidation.
- The C corporation realizes and recognizes the loss, but the loss belongs to the C corporation.
- Deemed sale of the assets for fair market value.
- Here, the assets are NOT capital assets – loss is ordinary, but trapped in corporate solution. . . . Losses in excess of income disappear.

The "cake" factor: Change in form of ownership – C corporation

- Carl gets fee title to the assets in liquidation.
- But the liquidation is a sale or exchange – Carl is deemed to exchange the stock – a capital asset, resulting in a capital loss.
- All the business issues that confronted Sam will confront Carl.
- Again, choice of entity makes a difference.

Shedding non-strategic assets

- So far, we've been discussing business assets.
- Let's move to personal or non-strategic assets.
- Consider an example:
- Eric Executive owns a yacht (or a vacation home).
- Eric purchased the yacht some 12 years ago for $15 million.
- At the time, the yacht broker gave Eric a series of financial assumptions showing leasing the yacht would generate a profit.
- Eric has maintained a full-time crew and the yacht has been available for charter at all times in the Caribbean.

Shedding non-strategic assets

- Example facts, continued:
- Eric and his family use the yacht for no more than one week per year.
- Eric treats the yacht as a passive activity and has suspended passive losses of $15 million – heavy operating costs.
- The yacht is fully depreciated, but its FMV is $9 million.
- The yacht is security for a $5 million nonrecourse note.

Shedding non-strategic assets

- Base case: Eric sells the yacht for its fair market value in a fully taxable disposition.
- Gain on sale = $9 MM ($9 MM - $0).
- Gain is likely all ordinary – §1245 depreciation recapture.
- Suspended passive loss converted to ordinary loss – §469(g)(1), so $15 MM loss.
- $15 MM loss – $9 MM ordinary gain = $6 MM net loss.
- $6 MM loss x assumed 40% tax rate = $2.4 MM savings.
- Tax savings pay 48% of remaining loan.

Shedding non-strategic assets

- Now, Eric makes things more complicated . . .
- Eric thinks yacht values are at bottom.
- Eric finds a buyer – two brothers.
- The buyers will pay FMV, but they want Eric to remain a one-third owner, so . . .
- Eric will sell today to Newco, a partnership equally owned by the brothers.
- Eric has a right to buy a one-third interest in Newco for the yacht's FMV one year from today.
- Eric pays $1 million for his option. The payment is nonrefundable, but will be applied to purchase price.

Shedding non-strategic assets

- Analytical framework –
- Is the loss disallowed? No, not related parties – §§267(b) or 707(b).
- Are the suspended losses freed up?
- A sale related parties continues to defer the suspended losses – §469(g)(1)(B).
- Presumably, a sale to unrelated parties suffices.

Shedding non-strategic assets

- Has there, in fact, been a sale, given the option?
- Economic compulsion? $1MM option payment/$3MM asset FMV today.
- Has there been a fully taxable disposition – §469(g)(1)?
- Only guidance: Conference Committee Report from 1986.
- "A transaction constituting a sale in form, to the extent not treated as a taxable disposition under general tax rules, does not give rise to the allowance of suspended deductions. For example, sham transactions, wash sales and <u>transfers not properly treated as sales due to . . . a put, call</u> . . . Conf. Comm. Rep. p. II-143.

Shedding non-strategic assets

- What else can trip up Eric's use of his suspended losses?
- Hobby loss rules under §183(a): No deduction (unless allowed by another Code section) for expenses in incurred in activities that aren't in a trade or business or activity engaged in for profit.
- §183(d) presumption: Hobby loss rules don't apply if the activity generates taxable income in 3 out of the last 5 years.
- *Donald A. McCormick*, TC Memo. 1969-261: Shockingly, yacht charter held a hobby.

Shedding non-strategic assets

- Eric's last gasp . . . Hey, he's creative!
- Sell the dang yacht, trigger the loss, repay the debt, and buy a NEW yacht!
- Two avenues of concern –
- The wash sale rules – not a problem, as they only apply to stock or securities – §1091(a).
- The bigger issue: Does the purchase of the new yacht taint Eric's fully taxable disposition of the yacht charter *activity*?
- What if the new yacht is purchased on the same day as the sale of the old yacht and Eric uses the same crew?

Snatching defeat from the jaws of victory . . .

- Watch for IRS attempts to recharacterize transactions!
- Example: Affiliated group of corporations file a consolidated return.
- The group is engaged in the trucking business. Old trucks economically depreciated; company needs new trucks.
- Parent sells old trucks, subsidiary buys new trucks.
- Result: Recognized loss to Parent; subsidiary takes cost basis in new trucks, right?

Snatching defeat from the jaws of victory . . .

- Wrong! Court held transaction was a like-kind exchange!
- *Redwing Carriers, Inc. v Tomlinson*, 399 F.2d 652 (5^{th} Cir. 1968).
- Opening sentence of opinion: "This case involves another attempt by a taxpayer to insulate himself from the incidence of taxation by means of paper armor."
- Some of the taxpayer's errors:
- Contractual interdependency.
- No separate indicia of sale.
- Single bank account.
- Seller viewed transaction as single integrated deal.

The “super NOL” – a 10-year carry back

- §172(b)(1)(C): Elective 10-year carry back for “specified liability losses.”
- §172(f): Specified liability losses –
- Losses or expenses attributable to product liability; and
- Among other things, deductions in settlement of a liability for federal or state law for:
  - Land reclamation;
  - Environmental contamination remediation; or
  - Payments under workers’ compensation acts.
- State law is not determinative.
- Provision doesn’t apply to warranty claims.

The “super NOL” – a 10-year carry back

- What’s a “product liability”?
- Liability of the taxpayer for damages on account of physical injury or emotional harm to individuals, or damage to or loss of the use of property, on account of any defect in any product which is manufactured, leased, or sold by the taxpayer, but only if such injury, harm, or damage arises after the taxpayer has completed or terminated operations with respect to, and has relinquished possession of, such product.
- Example – Physical injury: Appliance manufacturers sells a water heater that explodes, injuring the homeowner. Payment of injury award or settlement for injury qualifies.

The "super NOL" – a 10-year carry back

- Example – Services: Surgeon commits medical malpractice. Amounts paid to settle the suit do not qualify – not a "product liability."
- Most recent example: Contaminated drywall installed in new homes.
- Caveat: Not every cost qualifies. Examples –
- Legal fees.
- Temporary housing and meals.

Buyer's remorse – a tool for the seller

- Thus far, focus has been on sellers who want to retain the economics of the asset, albeit in a different form.
- Here: Seller sold to buyer and there is a tension.
- Typical fact pattern: *Bramblett v. Commissioner*, 960 F.2d 526, 91-1 USTC ¶50,252 (5th Cir. 1992).
  - Plan: Rate arbitrage: Ordinary v. capital.
  - "Investment" partnership sells land for development on an installment basis to "dealer" S corporation.
  - Goals: Lock in capital gain to investors; dealer generates development profit as ordinary income.
  - Front end planning: Investor and dealer are not related parties.
  - Installment note structured not to be recast as stock of dealer.

Buyer's remorse – a tool for the seller

- Fundamental economic premise: The land will continue to go up in value, or at least hold steady.
- What happens if it doesn't?
- Example –
  - In 2005, investor partnership (P) sold investment land to developer S corporation (S) for $100 million, $20 million cash at closing, $80 million purchase money nonrecourse note due in 5 years, with interest at 8%.
  - It's 2010 and the note is now maturing.
  - S hasn't started development, but has made interest payments. The land is now worth $70 million.
  - Investors in P also own 75% of the stock of S.
  - What do you tell the parties?

Buyer's remorse – a tool for the seller

- One option: Deed in lieu of foreclosure.
- Tax result – Asset sale for $80 million.
- §7701(g): The full balance of the outstanding debt is included in the amount realized.
- Second option: Write down the principal balance of the debt from $80 million to the property FMV, $70 million.
- Tax result: $10 million of cancellation of debt income.
  - *Rev. Rul. 91-31*: The fact the debt is nonrecourse is irrelevant; the reduction of the principal amount of under-secured debt results in COD.
  - Interestingly, *Rev. Rul. 91-31* carves out seller-financing from its application.

Buyer's remorse – a tool for the seller

- §1038: "Certain Reacquisitions of Real Property."
- Controlling facts –
  - Seller sells real property to buyer on an installment basis and secures the installment loan with the real property, and
  - Seller reacquires the real property in full or partial satisfaction of the installment debt.
- Tax result: General rule –
  - Seller has no gain or loss on reacquisition of the property, and
  - Importantly, the debt is <u>not</u> treated as worthless or partially worthless, so no bad debt deduction.
  - Seller's basis in the reacquired property generally is the adjusted tax basis in the debt.

- Questions?
- Thank You!

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