Making Chicken Salad - Monetizing Tax Losses (Slides)

Steven M. Friedman
Glenn M. Johnson

Copyright © 2009 by the authors. This article is brought to you by the William & Mary Law School Scholarship Repository.
Making Chicken Salad – Monetizing Tax Losses

William & Mary Tax Conference
12 November 2009

Steven M. Friedman, Partner
Glenn M. Johnson, Partner
Why is this topic important to my clients or my company?

- To quote a former president, “it’s the economy, stupid.”
  - Many taxpayers are feeling substantial financial stress in the current economic downturn.
  - Businesses and individuals are suffering cash flow declines.
  - Profits, under GAAP, have declined dramatically.
  - Taxpayers are generating substantial losses – realized and unrealized.
  - There is enormous pressure to generate or increase cash flow.
  - This downturn follows an almost-unprecedented period of economic growth, and that creates . . .
Two other interesting considerations . . .
Net operating loss carry backs

► The net operating loss (NOL) rules – §172(b).
► If applicable, NOL carry back claims are a relatively quick way to generate cash flow through the recovery of prior federal income taxes.
► In general:
  ► NOLs generally may be carried back 2 years.
  ► NOLs may be carried forward 20 years.
► Small business exception: §172(b)(1)(H).
  ► In general, elective 6-year carry back for 2008 losses.
  ► Gross receipts test of §448(c), except $15 million limitation, rather than $5 million.
Two other interesting considerations . . .
Net operating loss carry backs

► Signed into law by President Obama on 11/06/2009.
► Taxpayer may elect – irrevocably – one-time NOL carry back for 3, 4 or 5 years.
► No gross receipts limitation; TARP recipients excluded.
► Applies to NOLs arising in tax years beginning or ending in either 2008 or 2009.
► 5th year carry back limited to 50% of taxable income.
► Suspends AMT (90%) deduction limitation for extended carry back period.
Two other interesting considerations . . .
Net operating loss carry backs

► Mechanics of the carry back claim:
  ► Individuals: Timely file Form 1045, Application for Tentative Refund.
  ► Corporations: Timely file Form 1139, Corporation Application for Tentative Refund.

► Timing: On average, IRS Centers seem to be processing refund claims in about 10 weeks or so.

► Caveat: Refund claims are subject to possible subsequent examination and review by the Joint Committee on Taxation (refund claims of more than $2 million).

► H.R. 3548 mandates IRS issue guidance on 5-year carry back.
Two other interesting considerations . . .
Interplay with the financial reporting rules

► SFAS No. 144: Accounting for the Impairment or Disposal of Long-Lived Assets.

► Financial reporting rules may require a current charge (expense) for a decline in the value of long-lived assets, including certain property held for sale in the ordinary course.

► The charge does not require a sale/exchange of the economically depreciated asset.

► Thus, a charge to the financial statements, but there hasn’t been a recognition event for income tax purposes.
Two other interesting considerations . . .
Interplay with the financial reporting rules

► The GAAP expense likely will require the establishment of a deferred tax asset (DTA) under SFAS No. 109.
► Rationale: A temporary book/tax difference, with the GAAP charge preceding the tax deduction, thus creating a DTA.
► If it is not “probable” (more likely than not) that the DTA will be realized, the accounting rules mandate a valuation allowance against the DTA.
► The GAAP test of “probable” realization generally doesn’t have a 20-year forward look.
Two other interesting considerations . . .
Interplay with the financial reporting rules

► What does all this accounting-speak mean?
► The net effect of a valuation allowance against a DTA effectively means a current dollar-for-dollar reduction to reported equity in the financial statements.
► This net reduction in GAAP equity may result in negative business consequences – e.g., loan covenant net worth violations.
► Query: Does this create a substantial non-tax business reason to accelerate the economic depreciation of the business’s assets? Does the taxpayer need one?
The tax law framework – Navigating the road map

- Whew, accounting stuff . . . Right after lunch . . .
- Assume –
  - The taxpayer had federal taxable income and previously paid income taxes against which a carry back claim can be applied.
  - The taxpayer wants to recoup some of those previously paid federal income taxes.
  - The taxpayer has economically depreciated assets.
  - There is a buyer willing to buy one or more of those assets.
- What are the federal income tax hurdles to overcome?
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.
► § 1031: Sale Leaseback recharacterization.
► Note the potential disconnect: Many states have “decoupled” from the federal NOL rules – the state carry back rules very well may differ!
Hurdle #1 – Character of the property

► Goal: Taxable dispositions of economically depreciated assets that result in an ordinary – rather than capital – loss. Why?

► §1211 limits the annual amount of capital losses:
  ▶ Corporations: Losses allowed only to extent of gains.
  ▶ Individuals: Losses allowed only to the extent of gains + $3,000 (MFJ) or $1,500 (MFS).

► §1212 limits a capital loss carry back and carry over.
  ▶ Corporations: Generally 3-year carry back and 5-year carry over for net capital losses.
  ▶ Individuals: Unlimited carry forward, but no carry back.
Hurdle #1 – Character of the property

- The 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 excluded.
- Principal carve-outs (so, 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.
Hurdle #2 – 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 elementary, but consider and distinguish:
  ► Capital contributions to corporations and entities treated as partnerships under §§351(a) and 721(a) (but excluding “disguised sales” under §707(a)(2)(B)).
  ► Financing arrangements.
  ► Options.
  ► Guarantee arrangements.
Hurdle #2 – Sale or exchange – Leasing techniques

- Prepaid lease acquisitions and dispositions.
  - Seller wants to avoid current sale but obtain use of funds.
  - Buyer wants to accelerate rent deductions rather than depreciation.
  - Application of §467 stepped rent arrangements.

- Sale and leasebacks to trigger taxable losses.
  - Long-lived property with built-in losses.
    - Fee ownership of property.
    - Leasehold improvements.
  - True sale and true lease issues.
  - §1031 recharacterization.
Hurdle #2 – Sale or exchange – “Real world” examples . . .

➤ Example 1: The real estate “dealer.”
  ➤ Seller is a real estate developer seeking to monetize the economic decline in value of some of its projects.
  ➤ At acquisition, seller put each new project – newly acquired, unentitled land – into a newly formed LLC treated as a partnership for tax purposes. Seller typically funded the acquisition with 80% debt, 20% investor capital.
  ➤ Seller treats each new project as an investment through the entitlement phase so that it can treat the interest as investment interest expense.
  ➤ Seller sells the land for its fair market value to a third party.

➤ What’s the character of the sale of the land owned by the LLC?
Hurdle #2 – Sale or exchange – “Real world” examples . . .

► Example 2: The S corporation.
  ► SuckingWind Corp. (“SWC”) is an S corporation that is owned by the Wind family.
  ► SWC has been losing money for the past several years and those losses have been funded by capital contributions by the Wind family shareholders.
  ► SWC now has economically depreciation assets.

► What happens if SWC liquidates?
  ► §§336 and 337: Taxable loss on liquidation – deemed sale of assets for fair market value.
  ► Caveat: Business and tax considerations – for example:
    ► Business liability risk.
    ► Liquidation/reincorporation doctrine.
Hurdle #2 – Sale or exchange – “Real world” examples . . .

► Compare: What happens if SWC is an LLC treated as a partnership for federal income tax purposes?
  ► §§731 and 732.
  ► Often times, result is NO taxable loss on liquidation.

► Query: What if a partner exchanges his or her partnership interest for an interest in another partnership?
  ► General rule: §1031(a) like kind exchange rules are mandatory.
    ► If the property is like-kind, no loss results.
  ► Exception: §1031(a)(2)(D) – Congress decreed that interests in different partnerships are NOT like kind property.
    ► Query: What about different interests in the same partnership?
Hurdle #2 – Sale or exchange – "Real world" examples . . .

- Example 3: “Sale or exchange”?
  - Seller wants to sell economically depreciated property to buyer for its fair market value so seller can trigger a tax loss.
  - Buyer is willing to buy the property, but . . .
    - Buyer is unwilling to pay cash and wants substantial seller financing; or
    - The credit markets are closed and seller needs to provide seller-financing.
  - Has there been a taxable loss to seller if seller finances 100% of buyer’s purchase price?
  - What if seller finances “only” 90% of the purchase price?
  - What if a bank loans buyer 50% of the purchase price and seller finances the remainder (secured but subordinated)?
Hurdle #2 – Sale or exchange – “Real world” examples . . .

▶ What if the taxpayer **abandons** property?
▶ General rule: Abandonment results in an ordinary loss.
▶ Rationale: No sale or exchange, ordinary loss.
  ▶ Rev. Rul. 57-503, 1957-2 CB 139.
▶ What if the property is encumbered?
  ▶ Recourse debt: Sale or exchange, not ordinary loss.
  ▶ **Rogers v. Commissioner**, 103 F.2d 790 (9th Cir. 1939) (**cert. denied**).
  ▶ Nonrecourse debt: Sale or exchange, no ordinary loss.
Hurdle #2 – Sale or exchange – “Real world” examples . . .

- What if the property the taxpayer wishes to abandon is a partnership interest?
- No partnership liabilities included in partner’s basis: No sale or exchange, ordinary loss.
- Partnership liabilities included in partner’s basis: Sale or exchange, no ordinary loss.
  - Theory: Liability relief is a constructive distribution under §752(b), so §§731 and 741 apply.
  - Rev. Rul. 93-80.
Hurdle #2 – Sale or exchange – "Real world" examples . . .

- Option forfeitures – this one has come up a number of times.
- Typical facts:
  - Homebuilder makes a nonrefundable payment to a land owner or developer.
  - The option gives the builder the right to buys \( x \) lots for \( y \) dollars on or before \( z \) date.
  - The lots now have economically depreciated and the builder wants to deduct the cost of the option payment.
Hurdle #2 – Sale or exchange – “Real world” examples . . .

► §1234 generally governs options to buy or sell.
► §1234(a)(1) general rule: Loss attributable to the failure to exercise an option is the same as the character of the property to which the option relates.
► §1234(a)(2) timing: Failure to exercise deemed sold or exchanged on day the option expires.
► §1234(a)(3) exception: §1234 does not apply to 1221(a)(1) property – stock in trade or inventory.
► A dealer’s failure to exercise an option results in an ordinary loss. Reg. § 1.1234-1(g), Example (3).
Hurdle #2 – Sale or exchange – “Real world” examples . . .

► The problem: Business guys negotiate long term options, but the finance guys want and need the ordinary loss NOW!
► The option holder terminates the option – before year end and in writing!
► What happens if the option holder doesn’t?
  ► A client who doesn’t follow instructions?
  ► Current Joint Committee exam . . .
Hurdle #3 – The related party rules – Section 267

- “No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). The preceding sentence shall not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.”
Hurdle #3 – The related party rules – Section 267

- §267(b): Relationships (1 of 3 slides).
- The persons referred to in subsection (a) are:
  - (1) Members of a family, as defined in subsection (c)(4);
  - (2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
  - (3) Two corporations which are members of the same controlled group;
  - (4) A grantor and a fiduciary of any trust;
  - (5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
  - (6) A fiduciary of a trust and a beneficiary of such trust;
Hurdle #3 – The related party rules – Section 267

- §267(b) relationships (2 of 3).
  - (7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
  - (8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
  - (9) A person and an organization to which §501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
Hurdle #3 – The related party rules – Section 267

- §267(b) relationships (3 of 3).
  - (10) A corporation and a partnership if the same persons own—
    - (A) more than 50 percent in value of the outstanding stock of the corporation, and
    - (B) more than 50 percent of the capital interest, or the profits interest, in the partnership;
  - (11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;
  - (12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or
  - (13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.
Hurdle #3 – The related party rules – Section 267

► Family members under §267(c)(4) include:
  ► Brothers and sisters (whole or half blood).
  ► Spouse
  ► Ancestors.
  ► Lineal descendants.

► Family members under §267(c)(4) do NOT include relatives by marriage.
  ► Business risk?
Hurdle #3 – The related party rules – Section 707(b)

- Watch for the related party rules in a partnership context!
- §707(b)(1) provides:
- "No deduction shall be allowed in respect of losses from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between—
  - (A) a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or
  - (B) two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests."
Hurdle #3 – The related party rules – Section 707(b)

► Typical proposal: Owner ("O") of economically depreciated ordinary income property believes the property’s value with recover.

► O finds a money partner ("M") and suggests –
  ► M will contribute 51% of capital to a newly formed partnership; O will contribute 49% of capital.
  ► Partnership will buy depreciated assets from O for their FMV.
  ► M & O will share profits and losses 51%/49%.

► O thinks this allows full recognition of the tax loss on the sale of the assets. Is O right?
Hurdle #3 – The related party rules – Section 707(b)/267 interplay

- Reg. § 1.267(b)-1(b) provides:
- Since section 267 does not include members of a partnership and the partnership as related persons, transactions between partners and partnerships do not come within the scope of section 267. Any transaction described in section 267(a) between a partnership and a person other than a partner shall be considered as occurring between the other person and the members of the partnership separately. Therefore, if the other person and a partner are within any one of the relationships specified in section 267(b), no deductions with respect to such transactions between the other person and the partnership shall be allowed—
  - (i) To the related partner to the extent of his distributive share of partnership deductions for losses or unpaid expenses or interest resulting from such transactions, and
  - (ii) To the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by such other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of such transaction.
Hurdle #3 – The related party rules – Section 707(b)/267 interplay

► Temp. Reg. §1.267(a)-2T, Q&A 2&3.
  ► §267(a) CAN act to disallow losses at the partnership level.
  ► Temp. Reg. implement related party rule changes ostensibly made by the 1984 Act.

  ► For transfers after 9/27/85, “the bill provides that the provisions of sections 707(b)(1)(A) and 707(b)(2)(A) will apply whether or not the person constructively holding a 50-percent partnership interest was himself a partner. . . This rule is intended to replace the rule in the Treasury regulations, which was suggested by the 1984 Committee Reports.”
Hurdle #3 – The related party rules – Section 707(b)

- Things to watch on a sale by an ostensible partner (or its affiliate) to a partnership:
  - Not more than 50% in partnership capital.
  - Not more than 50% in partnership profits.
- Cash flow waterfalls and preferences.
- Profits waterfalls and preferences.
- Liability sharing and guarantees.
In summary . . .
Things to think about

- Remember the farmer’s golden rule: Hogs get fat, pigs get slaughtered . . . Who has the bundle of sticks??
  Questions to ask –
- Is the sale price within the realistic range of FMV?
- Is there reasonable equity supporting the sale price?
- Are the buyer and seller true, arm’s-length third parties?
- Are there economic or business “tails” that survive closing?
  - Puts/calls/other types of options?
  - Does the buyer need the seller’s expertise?
- The catch-all: Would a prudent business person sell under these terms, absent a potential tax refund claim?
Finally . . .

- Questions and answers.
- Thank you!!