Office of Chief Counsel
Internal Revenue Service
Memorandum

Release Number: ***20124603F***

Release Date: 11/16/12
CC:LBI:HMT:DET:POSTF 151619-11

date: 9/28/12

to:

LB&I:HMT Group

from:

LB&I Associate Area Counsel (   )

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subject: Whether Taxpayer is entitled to a claimed abandonment loss in Year 4.
UIL: 165-13.00.

Taxpayer =
City, State =
Month 1 =
Month 2 =
Month 3 =
Month 4 =
Month 5 =
Month 6 =
Month 7 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Date 1 =
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Inc. 1	=
Inc. 2	=
Principal	=
N1	=
N2	=
N3	=
N4	=
N5	=
N6	=
N7	=
N8	=
N9	=
N10	=
N11	=
N12	=
N13	=
N14	=
Amount 1	=
Amount 2	=
Amount 3	=
Amount 4	=
Amount 5	=
Amount 6	=
Amount 7	=
Amount 8	=
Amount 9	=
Amount 10	=
Amount 11	=
Amount 12	=
Amount 13	=
Amount 14	=
Amount 15	=
Amount 16	=
Amount 17	=
Amount 18	=
Amount 19	=
Amount 20	=

Issue:

Whether Taxpayer is entitled to a claimed abandonment loss under I.R.C. § 165 in Year 4.

Conclusion:

Taxpayer is not entitled to a deduction for an abandonment loss of the Community Project in Year 4 because the facts and circumstances show that it did not abandon the project and continued to pursue its claim for recovery.

Facts:

In Month 1, Year 1, ("Taxpayer") approved a development project in City, State which was to include active adult homes in a golf course community ("Community Project"). The project originally included N1 active homes, but in early Year 2, due to the pressures of a market downturn, the Community Project was renegotiated and restructured. On Date 1, Taxpayer entered into two agreements with Inc. 1., Inc. 2, and Principal (collectively, "Seller"): (1) a purchase agreement (Year 2 Purchase Agreement) to buy N2 finished lots on N3 acres in City, State from Seller and (2) an Amenity Center Contract for the construction of a N4 sq. ft. center with amenities for the property. In addition, Taxpayer entered into a third agreement with the Seller: an oral agreement under which Taxpayer would construct the amenity center and the Seller would reimburse Taxpayer the costs. Principal personally guaranteed the obligations under each of the agreements. In total, the three agreements (collectively "Year 2 Agreements") called for Taxpayer to deposit approximately $Amount 1.[1] Under the terms of the Year 2 Purchase Agreement, Taxpayer was required to pay $Amount 2 per lot delivered by Seller. The total deposit of $Amount 3 was to be applied to the purchase of the developed lots as the Seller completed development of the lots. The deposit was applied toward the purchase of each lot at the rate of $Amount 4 per lot. Of the $Amount 3 deposit, $Amount 5 remained after delivery of N5 developed lots by Seller in Year 2 and Year 3. Whether the taxpayer is entitled to an abandonment loss for this remaining amount of the deposit is the subject of this memo.

Principal died unexpectedly in Month 2, Year 2. Construction of the Community Project (including the amenity center) ceased in mid-Year 3. According to Taxpayer, Principal's death led to a

Year 2 . In a letter dated Date 2 from Taxpayer's Attorney to the Seller, Taxpayer alleges that "

Year 2

." Following this letter, in Month 3, Year 3, Taxpayer sued Seller for failure to fulfill its contractual obligations. At the time Taxpayer filed suit, Taxpayer had acquired N5 developed lots from the Seller at a cost of $Amount 6 (N5 lots at $Amount 4per lot). The initial deposit of $Amount 3 was applied toward the purchase of the delivered lots. Therefore, the remaining unapplied balance on the initial deposit at the time of the suit

[1] The Year 2 Purchase Agreement for developed lots required Taxpayer to deliver a total deposit of $Amount 3 (an initial deposit of $Amount 7 and an additional deposit of $Amount 8) which was paid by the Taxpayer to Seller in Year 2.

was $Amount 5. In the suit, Taxpayer sought return of the $Amount 5 deposit ("Deposit") under the Year 2 Agreements.[2] Seller counter sued. A memorandum written by the Division President of Taxpayer's Central State Division from Month 4

Year 5 ("President's Overview") stated that, as estimated by

.[3]

In Month 6, Year 4, Taxpayer terminated its selling efforts related to the homes it constructed at the Community Project and closed its sales center on the premises. At this point, of the N5 developed lots that Taxpayer had acquired since Year 2, there remained N8 unsold developed lots, N13 model homes and N14 spec homes in various stages of completion. In an e-mail to the then current owners of the community, Taxpayer informed said owners it would

.[4] In a correspondence dated

. Consistent with this statement, Taxpayer continued to pursue its remedies against the Seller.

Through a series of negotiations and court filings in the litigation, the parties entered into a purchase contract on Date 5 ("Year 4 Agreement"). Prior to the execution of the Year 4 Agreement, Taxpayer's Management documented its position with respect to the Community Project in a Date 6 memorandum ("Date 6 Memo") to its Asset Management Committee ("Management Committee"). The stated purpose of the Date 6 Memo was to "

" The Date 6 Memo noted that, as of Month 7, Year 4, Taxpayer's investment in the Community Project included the following four components of costs:

Common Development Costs	$Amount 10
Deposit under former Lot Purchase Agreement	$Amount 11
Receivable related to Amenity Center	$Amount 12
Lot Cost Receivable	$Amount 13
	$Amount 14[5]

[2] A memorandum written by the Division President of Taxpayer's Central State Division from Month 4, Year 5 states that Taxpayer is seeking a return of the $Amount 1deposit. The $Amount 1 includes the balance of $Amount 9 of the deposit and $Amount 20 related to the amenity center contract at the time the Taxpayer filed suit in mid-Year 3.

[3] Second paragraph, section I of President's Overview dated Month 4, Year 5. While the Month 4, Year 5 President's Overview states that Taxpayer is seeking a return of the $Amount 1 deposit, the suit Taxpayer filed against Seller sought return of the $Amount 5.

[4] President's Overview (Month 4, Year 5).

[5] The Month 5 Year 4 Memo showed the numbers without the last three zeroes. They have been added

In the Date 6 Memo, Management represented to the Management Committee that "

."

The memo outlines the principal points of the settlement as follows:

(1) N9 N10 N5 ,[6] . "

."

(2) .

(3) $Amount 15.

(4) .[7]

Month 5 Year 4 $Amount 11 $Amount 12

Date 6 Year 2 Year 4 . Taxpayer wrote off the $Amount 5 related to the Deposit under Year 2 Agreements for both financial statement and tax purposes in the third quarter of Year 4.[8]

.

On Date 5, Taxpayer executed the Year 4 Agreement providing for the purchase of N7 acres, including entitlements[9] to N5 homes for $Amount 16. The Year 4

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here to clearly show the amounts at issue.

[6] All N5 sites consisted of developed lots that Taxpayer acquired under the Year 2 Purchase Agreements and were part of the property to be developed under the Year 2 Agreements.

[7] Taxpayer relinquishes its claim to the Deposit as a term of this agreement.

[8] Taxpayer also wrote off the Amenity Center receivable, which is the subject of another memo.

[9] Per the Year 4 Purchase Agreement Section 10.1 states that the "

N6

" Taxpayer explained entitlements are necessary in the land development/homebuilding industry because they give the landowner rights to build homes. Since the Taxpayer would develop the land under the Year 4 Purchase Agreement, it was necessary that these rights were part of the transfer of the N7 acres.

Agreement also gave Taxpayer title to the amenity site as well as the structure which Taxpayer later incorporated into the new amenity center. Upon the closing of the Year 4 Agreement, N11 homes were planned for the Community Project, N12 of which Taxpayer built and sold between Year 2 and the middle of Year 3. The closing date for the Year 4 Agreement was set at Date 7. This date was later extended to Date 8, via amendments to the Year 4 Agreement. The Date 8 date aligns with the date the parties executed the Settlement Agreement, discussed below.

The Year 4 Agreement is prefaced with statements referring to Taxpayer's desire to purchase the property[10] and references the parties' desire to "

." Section 11 of the Year 4 Agreement addresses the "Pending Litigation" between the parties and states
related to the Year 2 Agreements until the "
Year 4
." Further, the parties "
"
closing of the Year 4 Agreement. The Year 4 Agreement provided that if the closing occurred, then all pending claims and related litigation between the parties were to be dismissed.

Section 19 of Year 4 Agreement addresses "Defaults and Remedies." The parties agree that the property at issue is:

.

Section 19.3.2 at page 56. Under the Year 4 Agreement, the remedy to Taxpayer, in the event of Seller default, is specific performance.

[10] This property represents a smaller, " " project than the project which was the subject of the Year 2 Purchase Agreements.

The status of the Community Project was the subject of the previously referenced President's Overview in Date 6 from the Division President of Taxpayer's Central State Division.[11] In the Overview, the Division President summarized the background of this project, tracing the historical progression from the Year 1 approval of the project to the Year 2 renegotiation and Year 2 Agreements, to the death of Seller's principal in Year 3, the ensuing litigation, and its decision to cease sales and operations in the Community Project in Month 6, Year 4. The Overview then explained that Taxpayer is . Both options were discussed in the Overview, with a detailed analysis of both risks and opportunities under both scenarios.

Under the , the Overview stated that Taxpayer's calculations indicate a " $Amount 17" and suggests that other intangibles, such as impact on Taxpayer's brand name, as well as and reputations, need to be considered. Discussion under the provided . The included a financial overview of the Purchase Agreement executed in Year 4. The Overview provided that for $Amount 18 Taxpayer would acquire N7 acres along with entitlements for developing and building N6 dwelling units for no additional consideration and the amenity center and capacity reservations. The Overview noted that no deposit is due with the transaction as Taxpayer " $Amount 19 ." The Division President then provided that assuming the closing occurs on Date 8, per the terms of the Year 4 Agreement, all claims in the litigation between Taxpayer and Seller would be dismissed. The Division President concluded by recommending that Taxpayer adopt the , and " ."

On Date 8, the date of the closing of the Year 4 Agreement, the parties executed a settlement agreement ("the Settlement Agreement") which referenced the Year 2 Agreements and Year 4 Agreement, and dismissed all issues in the litigation between Taxpayer and Seller. Specifically, the Settlement Agreement provides as follows: " Year 4 ." The Settlement Agreement also states that the parties "

[11] The Overview was submitted by the Division President to the Taxpayer's President.

Year 2

“. . . and that, via the Settlement Agreement, “

.”

On Taxpayer’s Form 1120, U.S. Corporate Income Tax Return, for Year 4, the abandonment loss of $ Amount 5 relating to the Deposit was reflected on Line 26 (Other Deductions) on a separate line named "Preacquisition Expenses."

Discussion

1. Taxpayer Has Not Established Abandonment of the Community Project related to the Community Project for Purposes of section 165.

To be allowable as a deduction under section 165, a loss must be evidenced by a closed and completed transaction, fixed by an identifiable event. Treas. Reg. § 1.165-1(b) and 1(d)(1). The “identifiable event” must be observable to outsiders and constitute some step which irrevocably cuts ties to the asset. United Dairy Farmers, Inc. v. U.S., 267 F.3d 510, 522 (6th Cir. 2001). To establish the abandonment of an asset for purposes of section 165, a taxpayer must show both (1) an intention to abandon the asset, and (2) an affirmative act of abandonment. CRST, Inc. v. Commissioner, 92 T.C. 1249, 1257 (1989), aff'd, 909 F.2d 1146 (8th Cir. 1990); A.J. Industries, Inc. v. United States, 503 F.2d 660, 670 (9th Cir. 1974); Rev. Rul. 93-80, 1993-2 C.B. 239. An affirmative act of abandonment must be ascertained from all the facts and surrounding circumstances. Burke v. Commissioner, 32 T.C. 775, 780 (1959), aff’d, 283 F.2d 487 (9th Cir. 1960).

Taxpayer argues that it abandoned the Community Project. Taxpayer states, “

.”[12]

Taxpayer determined that “certain components” of the Community Project including the Deposit, had been rendered “without value.” Taxpayer argues the company’s determination that the Deposit had “no value” and its decision in Date 6 to write the amount off is an identifiable event leading to abandonment. However, in Corra Resources v. Commissioner, 945 F.2d 224, 226 (7th Cir. 1991), the Seventh Circuit observed that, “[i]ntra-corporate affairs . . . do not generate signs visible to outside observers and therefore do not mark the crossing of the

[12] Page 4, Taxpayer Memo to Exam, Date 3.

Rubicon." Id. at 226. Thus, the intra-company communications of Taxpayer, between its management and/or Division and even its communication to its accounting department to write off the project "do not generate signs visible to outside observers" and therefore do not constitute an "identifiable event" to establish an abandonment.

Taxpayer asserted that it informed Seller of its intention to "walk away" from the project.[13] Taxpayer may further argue that it acted to abandon the Community Project in Month 6 Year 4, when it terminated its selling efforts of the development, closed the sales center, and ceased construction of the amenity center. While these facts may be relevant to consider, an intent to abandon and an affirmative act of abandonment must be ascertained by examining all the facts and surrounding circumstances.

As discussed below, there are several acts and events that occurred in Year 4 that, together, show that Taxpayer did not irrevocably cut ties with the Community Project and did not intend to abandon the Community Project.

A. The Year 2 Agreements and the Year 4 Agreement are Part of the Process of Acquisition of the Community Project.

Section 165 requires that substance, not form, govern in determining a deductible loss. Treas. Reg. § 1.165-1(b). Mere changes in the terms of a transaction do not constitute abandonment. An otherwise abandoned expenditure, if part of an integrated plan that is implemented, is not an abandonment loss under section 165. Nicolazzi v. Commissioner, 79 T.C. 109, 132 (1982), aff'd, 722 F.2d 324 (6th Cir. 1983). Furthermore, if potential transactions are alternatives, only one of which can be completed, no abandonment loss is proper unless the taxpayer abandons the entire transaction. Haspel v. Commissioner, 62 T.C. 59, 72-73 (1974) (taxpayers were not entitled to an abandonment loss for the cost of original architectural plans which were rejected, since the original plans for the foundation and superstructure were an integral and inseparable part of a continuous project).

In FRGC Investment, LLC v. Commissioner, T.C. Memo. 2002-276, aff'd, 89 F. A'ppx. 656 (9th Cir. 2004), the Tax Court denied a 1997 tax year abandonment loss where the circumstances surrounding the taxpayer's project showed that renegotiation and obstacles over several years were merely steps in continuing and successful attempts to acquire the property. In 1995, the taxpayer entered into a real estate contract to purchase 240 acres for development from an entity owned by an individual. After objections to surveys and other title reports, the escrow for the contract was cancelled. In 1996, the taxpayer entered into a second real estate contract with the same entity to purchase 404 acres of the

[13] Taxpayer mentions in its Date 3, Memo to Exam that it communicated its decision to walk away from the project. Taxpayer, however, has not provided any facts to support it informed Seller.

same land for development. Approval for zoning the development became unlikely so in 1997, the taxpayer and the entity executed mutual cancellations of the contract to release the escrow. In 1998, the taxpayer and the individual owning the entity that was a party to the first two contracts decided to execute a third contract. The contract was fulfilled and the escrow closed that same year, resulting in taxpayer owning the land that it sought to develop. The taxpayer claimed a section 165 loss for expenses incurred in 1997, and argued that the 1997 contract had been abandoned due to the cancelled escrows. The tax court disagreed and found that the taxpayer's claims that the 1998 contract was different from the purportedly abandoned 1997 contract were rebutted by the fact that the taxpayer moved forward to purchase the same real estate for the same purpose, although there had been changes in the terms of the agreement. The court viewed the earlier 1995 and 1996 purchase agreements as steps in the taxpayer's continuing efforts to acquire the property. Additionally, the taxpayer entered into a new purchase agreement with the counter-party only two weeks after the cancellation of the 1996 purchase agreement. The court held the taxpayer's execution of a new purchase agreement in January 1998 to be inconsistent with the taxpayer's contention that the project was abandoned in 1997. The court further found that in substance, the first agreement was merely a step in the partnership's continuing and successful attempts to acquire the property.

In the present case, Taxpayer continued its effort to acquire the Community Project through Year 4, as evidenced by the Year 2 Agreements and Year 4 Agreement. These agreements, along with the pursuit of legal remedies and continued negotiations, were all steps in the process to acquire the Community Project. Taxpayer views the Year 4 Agreement as separate and distinct from the Year 2 Agreement, the related litigation and the Settlement Agreement. A review of Taxpayer's own records, however, demonstrates that it treated all these transactions and the litigation as intertwined with the ultimate goal of acquiring and developing the Community project:

1. The Date 6 Memo from Taxpayer's management to the Management Committee discusses the Taxpayer's investments with regard to the Year 2 Agreements and references the deposits under the agreements. The Date 6 Memo goes on to state that

   . Taxpayer states that settlement of the Year 2 Agreements and its related litigation will be "

   ." The principal terms of the anticipated settlement are embodied in the Year 4 Agreement.

2. The Year 4 Agreement is prefaced with statements which refer to Taxpayer's desire to purchase property subject to certain terms and conditions and goes on to state that the parties desire to "

." The language within the Year 4 Agreement supports the view that the Year 4 Agreement was designed to settle the legal disputes between the parties arising out of the Year 2 Agreements in the form of a renegotiated purchase agreement for the Community Project.

3. In the Month 4 Year 5 President's Overview, which described events of Year 4 and prior years, Taxpayer requested approval of the as laid out under the terms of the Year 4 Agreement. The Year 4 agreement is referenced in the Settlement Agreement. In the Overview, Taxpayer again discusses the project from its inception, beginning in Year 1, and describes the Year 2 and Year 4 Agreements. The Overview concludes that a -

   " ." Furthermore, the did not require a deposit as the Taxpayer previously paid Seller a $Amount 19 deposit on the original contract with Seller. In addition, the Overview specified that if the Seller defaulted on the Year 4 Agreement, the litigation between Taxpayer and Seller would resume since the Year 4 Agreement was considered by the parties as the form of the settlement. Accordingly, the Year 4 Agreement and the Settlement Agreement were dependent on one another. Taxpayer saw the series of transactions as part of the overall strategy related to the acquisition of the Community Project.

4. The Settlement Agreement incorporates by reference the series of transactions and agreements, including the Year 2 Agreements, the Year 4 Agreement, as well as the litigation, and notes that each item is a material fact underlying the Settlement Agreement. The Settlement Agreement further provides that it and the Year 4 Agreement supersede and cancel any and all prior agreements, negotiations, arrangements and understandings between Seller and Taxpayer.

In addition, the fact that Taxpayer continued to service the existing homes already sold at the Community Project is further evidence that Taxpayer did not intend to abandon the Community Project. This is consistent with the language in section 19 of the Year 4 Agreement that mentions Taxpayer's sales of homes to customers in the Community Project and that " " as part of the Taxpayer's development.

These facts collectively show that in substance, Taxpayer's business purpose was to acquire the Community Project in State. The Year 2 Agreements and the negotiations that led to the Year 4 Agreement were steps in Taxpayer's continued efforts to acquire the Community Project. These integrated steps to acquire the Community Project do not support a claim of abandonment.

B. The Ongoing Litigation

For a loss to be sustained under section 165, a loss must be evidenced by closed and completed transactions. United States v. S.S. White Dental Manufacturing Co., 274 U.S. 398, 401 (1927); Treas. Reg. § 1.165-1(b). Thus, if there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, the loss is not deductible until it can be ascertained with reasonable certainty whether such reimbursement will be received. Treas. Reg. § 1.165-1(d)(2)(i); Ramsey Scarlett & Co. v. Commissioner, 61 T.C. 795, 806-807 (1974), aff'd, 521 F.2d 786 (4th Cir. 1975); Estate of Scofield v. Commissioner, 266 F.2d 154, 159 (6th Cir. 1959), aff'g and rev'g. in part 25 T.C. 774 (1956). Whether a reasonable prospect of recovery exists is to be determined by all of the facts and circumstances. In determining whether a taxpayer had a reasonable prospect of recovery, the fact that the taxpayer filed a lawsuit to recover the loss gives rise to an inference that the taxpayer has such prospect. Dawn v. Commissioner, 675 F.2d 1077, 1078 (9th Cir. 1982). See also Estate of Scofield, 266 F.2d at 159.

Treas. Reg. § 1.165-1(d)(2)(i) requires that a taxpayer ascertain with "reasonable certainty" whether it will receive reimbursement for the loss before deducting a loss under section 165. The examples provided in Treas. Reg. § 1.165-1(d)(2)(i) involve some type of resolution of a claim for reimbursement, for example, a settlement, adjudication, or abandonment of a claim. In addition, before a taxpayer takes a loss, the regulation requires that the taxpayer produce objective evidence of abandonment of the claim, such as the execution of a release. Taxpayer has not shown that in Year 4 it did not have a reasonable prospect of recovery or that it abandoned its claims against Seller in the litigation. Taxpayer continued to pursue litigation against Seller through Year 4 to enforce its rights related to the Community Project, including engaging in settlement negotiations with the Seller to attempt to resolve the litigation. The taxpayer's continuance of the litigation in Year 4 is inconsistent with an intent to abandon the project in that year. The recovery process was not finalized until the Settlement Agreement was executed on Date 8, which resulted in the dismissal of the litigation. In addition, under the terms of the Year 4 Agreement, Taxpayer agreed to relinquish its claim to the deposit pending the closing of the Year 4 Agreement which occurred on Date 8. Thus, there was no closed and completed transaction in Year 4.

Conclusion:

To be allowable as a deduction under section 165, a loss must be evidenced by a closed and completed transaction, and fixed by an identifiable event. In this case, examining all the facts and circumstances, Taxpayer did not sustain an abandonment loss in Year 4. The facts and circumstances, including ongoing litigation, the settlement negotiations, and the executed purchase agreement in

October of Year 4 collectively show that Taxpayer did not sustain an abandonment loss in Year 4.

If you have any further questions or comments, please contact at .

By: ______________________________

Attorney, LBI ( )