Partnership Abandonment

Why It Still Works and What to Watch Out For

By Ryan C. Sheppard

Consider the following scenario: an individual has entered into a limited partnership that he knows is going bad, and he believes his investment will not be recovered. With careful planning, accelerating these losses into the current year to offset ordinary income could provide significant tax savings. The Internal Revenue Code (IRC) is littered with traps, however, so careful navigation is required to avoid unintended consequences, such as triggering capital loss treatment.

How to Abandon

Abandoning a limited partnership can lock investment losses into the current year, providing just the relief clients need. The courts have stated that a limited partnership interest may be abandoned under IRC section 165 if the following occur:

- The owner affirmatively intends to abandon the interest;
- There is an affirmative act of abandonment; and
- The intent and affirmative act are communicated to all interested parties [*Echols v. Comm'r.*, 935 F.2d 703 (5th Cir. 1991), http://bit.ly/29UPreQ].

Revenue Ruling 93-80 (1993-2 C.B. 239) further states that "to establish the abandonment of an asset, a taxpayer must show intent to abandon the asset, and must overtly act to abandon the asset." The defining case in this regard is *CRST, Inc. v. Comm'r* [92 T.C. 1249, 1257 (1989) http://bit.ly/2a4hNo4]. In this case, the court stated: "Where the taxpayer has not relinquished possession of an item there must be a concurrence of the act of abandonment and the intent to abandon, both of which must be shown from the surrounding circumstances, in order to determine if a loss has occurred in the year of the deduction. … Mere intention to abandon alone is not sufficient to accomplish abandonment."

One can surmise that intent to abandon can be reflected by the owner's expectation of no remuneration either now or in the future. To effect the abandonment, however, the taxpayer must also clearly show the willful, affirmative act of abandonment. The *Echols* case gives some guidance on communicating the intent and act of abandonment. The Fifth Circuit held that the taxpayers showed their intent to abandon when they called a meeting of the partners and informed them they would not contribute any additional funds to the partnership. The court stated that this was "a clear and unequivocal indication to (the partners) and the world that taxpayers were walking away from their ownership interest in the partnership." At the same meeting, the taxpayers tendered their title to their partnership interest to "anyone … who would 'step forward and assume' the non-recourse payment on the Partnership's obligation." The court held that this constituted a willful, affir-

mative act of abandonment, and that these actions in concert "were more than sufficient to constitute an abandonment."

Capital versus Ordinary Loss

A capital transaction exists when a taxpayer sells or exchanges for consideration a capital asset. Under IRC section 741, a partnership is considered a capital asset (other than in IRC section 751 matters related to inventory and unrealized receivables), and thus, the sale of a partnership interest would trigger capital gain or loss treatment. When a taxpayer *abandons* a partnership, however, does an ordinary loss automatically occur? The answer seems to be, "It depends." Both the asset and abandonment must first be further defined.

Under Revenue Ruling 93-80, ordinary loss can occur from the abandonment of partnership interest under IRC section 165(a). Abandoned partnership interests are treated as ordinary losses for tax purposes, *assuming that no exchange has occurred*. Avoiding an exchange is the key to ensuring more favorable ordinary loss treatment. An exchange can be triggered by receiving an actual (i.e., cash) or a deemed distribution. Furthermore, under IRC section 752(b), a liability shift can cause a deemed distribution. Revenue Ruling 93-80 makes it clear that "any decrease in a partner's share of partnership liabilities is deemed to be a distribution of money to the partner under section 752(b). … For purposes of determining whether or not section 752(b) applies to create a deemed distribution upon abandonment or worthlessness, liability shifts that take place in anticipation of such event are treated as occurring at the time of the abandonment or worthlessness under general tax principles." Therefore, any relief of liability from a partnership abandonment, either contemplated or occurring at the time of the event, would trigger a deemed distribution and cause capital loss treatment. Even a de minimis actual or deemed distribution will result in capital loss treatment—obviously not a favorable outcome.

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Revenue Ruling 93-80 further gives a hypothetical: "LP is a limited partnership in which D and E were general partners and F was one of the limited partners. During 1993, LP became insolvent, and F abandoned F's limited partnership interest. F took all steps necessary to effect a proper abandonment, including written notification to LP. LP's partnership agreement was amended to indicate that F was no longer a partner. At the time F abandoned the partnership interest, F had a remaining adjusted basis of 200x dollars in the partnership interest. *F did not bear the economic risk of loss for any of the partnership liabilities* and was not entitled to include a share of the partnership liabilities in the basis of F's partnership interest. F did not receive any money or property on leaving the partnership." In such a case, an exchange has not occurred, and F's abandoned partnership interest can be treated as an ordinary loss.

In contrast, cash distributions or relief of debt from the partnership will cause an exchange transaction, no matter the amount. In *Blum v. Comm'r* [133 F.2d 447 (2d Cir. 1943)], the owner was treated as having sold the property rather than abandoned it because he received a mere $250 when the transfer was made.

Review the Partnership Agreement and State Law

Advisors must carefully determine whether the taxpayer would be relieved of any liability whatsoever. Consultation with legal counsel is also strongly recommended, including a review of abandonment provisions related to the partnership agreement and concurrence with various state laws.

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Ryan C. Sheppard, CPA, CFF, *is a partner at Knight Rolleri Sheppard CPAs LLP, Fairfield, Conn.*